

Commentary on “Financial stability and globalization: getting it right”

Malcolm D. Knight

Bank for International Settlements

THE FIRST YEARS OF THE TWENTY-FIRST CENTURY resemble closely those of the twentieth. We are living through the second wave of economic globalisation, and we have been enjoying an era of remarkable growth in productivity and income levels in many countries. But despite the promise of eternal prosperity that seemed to be offered by the previous era of globalisation, it did eventually end, first interrupted by World War I and later in the throes of the global Great Depression that followed the “roaring twenties”.

That long ago experience should continue to keep us alert and humble. Alert, so that we do not take this current period of prosperity for granted, but instead work actively to safeguard it. Humble, so that we do not fall into the trap of thinking that we have finally found the answers to the fundamental economic questions with which the world confronts us. Globalisation is a market-driven process boosted by technological advances and the “animal instincts” of entrepreneurs. But, unlike technological change, globalisation is not unidirectional or inevitable; ultimately it hinges also on political decisions. And those decisions in turn are shaped, to a considerable degree, by the extent to which we can use them to harness the forces of globalisation so as to increase their benefits and reduce their costs.

In fact, the present wave of globalisation exhibits all the dynamism, but also some of the excesses, that were found in the process of capitalist transformation at the turn of the twentieth century and in the 1920s. Seen in this light, Frederick Mishkin’s paper is a very useful compendium of all the things an emerging market country needs to do to embrace globalisation – to catch this wave, if you like, without being drowned by it.

In my remarks, taking my cue from Mishkin’s paper, I would first like to stress some of the dilemmas that countries face when seeking to embrace globalisation. Then I will provide some reflections on the challenges ahead for central banks, focusing on the relationship between monetary stability and financial stability.

And – I have to say in the spirit of humility – I will be raising more questions than providing answers.

1 Globalisation and institutional reform: lessons learned

Let me first highlight, without much elaboration, three crucial points on which I agree entirely with Mishkin.

- 1 Embracing globalisation is a highly desirable goal. The enormous benefits it brings in terms of resource allocation and long-term growth potential are well known. I also agree with Mishkin that a key under appreciated benefit is the fact that globalisation is a vital catalyst for implementing domestic structural reforms that are desirable in their own right. In a nutshell, being able to sustain the challenges of globalisation is an unmistakable “signal” of institutional maturity.
- 2 Being able to enjoy the benefits of open financial borders does require the presence of broad-ranging institutional underpinnings: putting them in place is a major challenge that cannot be achieved overnight. Mishkin’s paper lists them in detail. They range from property rights and legal systems, through adequate prudential regulation and supervision, to sound macroeconomic policies, monetary and fiscal.
- 3 Institutions that work well in particular countries at a particular stage in their development need not always be well suited to other countries or other times. This reflects, in part, different legal, cultural and historical traditions, and, in part, sequencing issues. The proper sequencing of the move to globalisation is idiosyncratic; it is country specific. Mishkin again provides several examples. I would highlight, for instance, that the Basel Committee on Banking Supervision has for some time emphasised, in its Core Principles for Effective Banking Supervision, the legal and institutional preconditions that need to be in place in order for regulation and supervision, and hence instruments such as commercial bank capital adequacy standards, to be effective.

From these three points, however, several dilemmas follow, which I think could have been highlighted more in Rick Mishkin’s paper. They result in challenging trade-offs.

- 1 There is a “Catch 22” regarding the link between institutional reform and globalisation – and I am thinking particularly of financial globalisation

here, but not necessarily only of emerging market economies, as the experience in some industrialised countries has shown in the past. Waiting for all the preconditions to be in place obviously slows the pace of their adoption, given that openness is a catalyst for change. But not waiting until all preconditions are in place is quite likely to lead to costly episodes of financial stress.

The implication is that, particularly for emerging market economies, the process of embracing globalisation is bound to be either very long or quite painful. Since the early 1990s, we have been fortunate – so far – that the financial crises that have occurred have been used by a large number of countries to strengthen their institutional and policy frameworks rather than to retreat into isolationism. Just think of the macroeconomic and structural reforms that emerging market economies in East Asia undertook following the Asian financial crisis, as reflected in the widespread improvements in their credit ratings since the crisis broke out in 1997. Indeed, history seems to show that it took a crisis at the core of the global economy – in the United States and in the other industrial countries – rather than just at the periphery, to throttle and then reverse the previous globalisation wave of the early twentieth century.

This consideration puts a premium on efforts by the international community to enhance the process of structural change to embrace globalisation. Ultimately, progress can only be based on enlightened self interest and a sense of ownership of the reforms.

- 2 There is a clear tension between the call for uniformity demanded by the global capital marketplace and country-specific circumstances: this is a hard call to make. Think, for instance, of the nuances between principles-based accounting and rules-based accounting, or of the delicate balancing act in developing generally applicable best practices for corporate governance. Or recall the obvious difficulties major banks face in many countries in adopting the more advanced variants of Basel II.

To my mind, all this puts a premium on soundness over uniformity *per se*, and on patience over haste. I therefore fully endorse the view taken by the Basel Committee and the international financial institutions, for instance, that countries should adopt Basel II only when ready, even though this naturally complicates cross-border issues.

- 3 Judging the state of readiness of a country to liberalise and open up its markets has proved extremely difficult. How many times have countries thought they were ready to liberalise and open up, only to be proved wrong? Crises have often appeared inevitable only *ex post*. If memory serves me right, Mexico had been upgraded by the rating agencies just before its 1994 financial crisis broke out. And in Asia by the mid-1990s

fiscal probity, high investment levels and low inflation had been thought to insulate the region from difficulties. We should not, therefore, be lulled into a false sense of security; rather we should redouble efforts to strengthen institutional underpinnings.

2 Central banks: some certainties and one open question

I have not yet said anything about central banks. However, they clearly have a key role to play in strengthening the institutional set up. They are guardians of payment and settlement systems, repositories of financial know-how, responsible for monetary policy and, where relevant, in charge of financial supervision. Here, let me just highlight two certainties and one open question.

First certainty

Financial stability is a very complex task: central banks are an important, but by no means the only, player. Moreover, in a number of countries certain key financial stability responsibilities have been transferred to other agencies, notably in the prudential area. This makes it all the more important for central banks to retain influence, based on their know-how and competence, and to intensify their cooperation with other authorities nationally and internationally. This would help strengthen to further the macro-prudential, as opposed to micro-prudential, orientation of current efforts to secure financial stability. The establishment of international fora like the Financial Stability Forum, in which central banks play a prominent role alongside prudential regulators and ministries of finance, has been a step in the right direction. At the BIS we have been working hard to support such analytical and operational cooperation. The fact that the Basel Committee now reports to a joint group of central bank Governors and Heads of Supervision is one concrete such example.

Second certainty

Even more important, over the longer term and from a macroeconomic perspective, securing sustainable price stability is the best contribution that central banks can make to financial stability and to successfully embracing a globalised world. Countries have learned the hard way the enormous economic and social costs of inflation during the historically anomalous 'Great Inflation' era of the 1970s and early 1980s. Conversely, looking further back, the Great Depression was marked by a very painful, if historically equally anomalous, precipitous price *deflation*.

The open question

However, is whether we have indeed fully learned the lessons from the past. To be intentionally provocative, a stylised lesson that I draw from the past is that focusing exclusively on *short-term* inflation control, over a one-to-two year horizon, and paying only limited or no attention to monetary and credit aggregates, is not sufficient to ensure monetary and financial stability over the *longer term*. The political economy of a number of inflation targeting regimes, in which short horizons help to strengthen accountability, has favoured such a shift. Rick’s paper discusses this issue in the context of financial liberalisation in individual emerging market economies, but not the risks in the dynamics of globalisation as a whole.

Why do I say this?

First, history indicates that short-term inflation control is not sufficient to prevent the emergence of macroeconomic instability. Inflation, for instance, did not rise to any significant degree during the run-up to the Great Depression in the 1920s or of Japan’s ‘lost decade’ of the 1990s. Nor was it a problem in the run-up to the Asian crisis of 1997–98. And, indeed, looking back to the late nineteenth century Gold Standard period, financial crises were typically not preceded by rising inflation.

Second, some of the most serious mistakes in the history of monetary policy implementation were the result of not paying sufficient attention to money and credit expansion. The episodes I have just highlighted were indeed preceded by unusually strong cumulative expansions in “liquidity”, broadly defined, typically alongside equally unusual increases in asset prices, not least those of real estate. The same is true for the Great Inflation. And on the downside, failure to focus sufficiently on the contraction in such aggregates certainly contributed to the depth of the Great Depression in 1931–33.

Third, recent formal empirical evidence, including research carried out at the BIS,¹ has confirmed this observation. In particular, it has found that unusually strong cumulative expansions in credit aggregates alongside similar increases of asset prices herald serious financial stress, economic weakness, and disinflation beyond the one-to-two year horizons common in monetary policymaking.

My final observation is that all of this acquires greater significance at the current juncture. The world economy has been experiencing, and may now be emerging from, an unusually long period of historically low inflation-adjusted policy interest rates, unusually strong expansion in global liquidity, exceptionally buoyant asset prices, and strong global growth. And this has occurred at a time

¹ See “Asset prices, financial and monetary stability: exploring the nexus”, BIS Working Paper 114 by Claudio Borio and Philip Lowe and “Securing sustainable price stability: should credit come back from the wilderness?”, BIS Working Paper 157 by Claudio Borio and Philip Lowe.

when globalisation should, if anything, have raised the world's natural interest rate, by boosting global growth potential while helping to keep a lid on inflation. But just because inflation has remained remarkably quiescent so far, should we assume that all is fine?

I say this in that spirit of humility which should underpin all policies. We must always remain alert and avoid complacency. The major policy mistakes in history that I highlighted earlier were made precisely when policymakers felt they had finally come to master the secrets of the economy. Preserving macroeconomic and with it, financial stability, is essential. We should not forget that it was financial stress at the core of the global economy, and its international ramifications, that proved fatal to the first wave of globalisation. I certainly do not have the answers. But these questions are worth asking.