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Financial Globalization: Shifting Balances

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Dear Participants,

Let me welcome you all to this Conference on behalf of Banco de España and of the other two co-organizers of the Conference: The Latin America and Caribbean Department of the World Bank and the CREI [the Centre for Research in International Economics of the Pompeu Fabra University].

You need a very good reason to stay indoors in Madrid during the summer, but I think this Conference makes it more than worthwhile. It is a privilege to host such a large gathering of selected speakers, discussants and participants to deliberate on the present and future of financial globalization.

In the aftermath of the financial crisis, the world has substantially changed in ways which are still difficult to fully grasp, since we have not yet reached the new steady state. But one area where changes will be most fundamental for the future of the global economy is that of financial links between countries, institutions and markets.

As the title of the conference suggests, we may be facing a period of 'shifting balances' in the process of financial integration and in the nature of international movements of capital. A central dimension of this shift is geographical, that is, how the volume, direction and composition of financial flows between emerging and developed economies may be changing. You will have the opportunity to discuss this during the next day and a half, with a particular focus on Latin America, which will be the subject of the final panel of the conference.

The relevance of financial globalization is underscored by its role in the period leading up to the crisis. The strong economic and financial development over the past decade was built upon the impressive expansion of financial transactions at the international level. Let me illustrate the intensity of this process with some numbers. The sum of external assets held by countries more than doubled between 2000 and 2007, from 85 % to 174% of their GDP, after following a moderate upward trend in the preceding decades. This rapid expansion in stocks of external assets was fuelled by the increase in international capital flows, which jumped from 13% to 26% of world GDP, in gross terms, during the same period. This rapid growth was underpinned by a growing array of financial investors and instruments that developed under the impulse of financial innovation and resulted in the widely increased availability of credit and funding worldwide.

This higher availability of finance and credit contributed to the better allocation of resources at the global level. It supported the expansion of productive capacities in emerging economies, some of which –China, Eastern Europe- were just joining the global market. More generally, what we call globalization - namely the massive transformation of the world economy through increased economic and commercial linkages and international production chains, that set the stage for a

decade of intense global economic expansion - cannot be understood without the parallel process of global financial integration.

However, this hectic process of growth also had its downside in terms of the accumulation of significant and different imbalances, both at the domestic and international levels. Moreover, as the degree of interconnection between agents, markets and countries deepened, the degree of exposure of each of them to global and external shocks increased, making them more vulnerable to adverse external events.

The generation of imbalances during the global expansion has been well described before. The integration of emerging economies into world production networks provided for a long decade of non-inflationary growth and, consequently, easy monetary policies. Loose financing conditions and the ample availability of credit in an interconnected environment fostered excessive indebtedness in the private sectors of a large group of countries. Many advanced economies, like the United States, the United Kingdom and Spain, but also some emerging economies, such as the new members of the European Union, increased their net financing needs, which were mostly covered by a group of emerging economies - along with some advanced economies - whose current account surpluses reflected growth patterns heavily biased towards external demand.

The link between global imbalances and the financial crisis has been hotly debated. Arguably, global imbalances were not the trigger of the crisis; a more general failure of the regulatory and supervisory - but possibly also monetary - policy framework, was instrumental in this connection. But global imbalances played some role, contributing to shaping the loose financial conditions conducive to the crisis, and enabling growth patterns which were unsustainable in the long run.

As mentioned, Spain accumulated increasing financing needs during the upswing. Indeed, it was one of the countries which most benefited from the process of financial globalization, which in our case was compounded by the process of integration into the European Monetary Union. In this setting, a large reduction in financing costs and much greater access to external financing, along with the deeper consequences of integration into an area of established macroeconomic stability, triggered a phase of strong economic development. As in the more general case, this strong growth did not come without the generation of major imbalances - some shared with other countries, some of our own - to which we are painfully adjusting at present.

But Spain did not only join the process of financial globalization as a borrower of funds; it also played a key role as a supplier of funds to the global market, mainly in the form of FDI to Latin America. I think this latter role was to the benefit of both sides. It improved the economic and financial infrastructure of the region, in particular by strengthening their financial systems, from

which they have benefited in the crisis. And it contributed to the internationalization of the Spanish economy, which is a clear source of strength in the current circumstances.

After the financial turbulence that started in August 2007, activity in some of the most dynamic financial markets came to a halt. The dramatic deterioration of the financial situation in September 2008 prompted a further freeze of capital flows worldwide, against a background of extreme uncertainty. International capital inflows and outflows dwindled to just 3.5% of GDP in gross terms in 2008, 80% less than in the record year of 2006. Moreover, in the aftermath of the crisis we have seen a movement towards financial re-nationalization and segmentation of some financial markets in advanced economies in a broad attempt to reduce exposures to external shocks.

All in all, the crisis has meant a pause in the process of financial globalization and there are even risks of a reversal in the globalization process, at least in some respects.

The recent behavior of international capital flows shows that they have experienced a short-run downward adjustment related to the intensity of the crisis; but are they facing a correction towards a lower, more sustainable trend? Indeed, the accelerating process of financial globalization in the previous decade was unsustainable. Therefore, the pause in financial globalization may simply mark a dividing line in the process: capital flows will recover, but growth rates like those experienced before the crisis will not be repeated.

Incoming data and anecdotal evidence suggest that capital is flowing again, strongly in some cases. Flows to some emerging markets are resuming with such intensity that they could generate risks of overheating and to financial stability, as a result of their volatility. In any case, this strong recovery may respond to a transitory reversal of the previous intense outflows, so that the expected medium-term prospects are once again more moderate than in the past.

There are further factors supporting the idea of a moderate recovery in flows. In the first place, some of the markets for complex products, which were particularly active in international transactions, have collapsed. One important reason is that now markets may have developed a higher sensitivity to the risks derived from the financial excesses. Going forward, this sensitivity should lead to more cautious behavior from international investors and to more careful assessments of investment decisions. Such diligence by investors is a good recipe for stable and sustainable financial flows, although markets tend to have short memories and are prone to overshooting and excesses.

That is why the role of the economic and financial authorities is pivotal, and they are particularly conscious of the need to rebuild the financial system and international financial flows on a more

solid basis. Of course, the high degree of interconnection of financial markets means that building an adequate institutional and regulatory framework for the flow of capitals is central to success. A positive sign is that the coordination effort - triggered by the crisis - in rebuilding the financial system on a broad and common basis is unprecedented, and it is maintaining its momentum. The task before us is extremely complex but progress to date has been notable.

Still, there remains a risk of a reversal of financial globalization. Probably, the main factor behind this risk could be a regulatory overreaction to the crisis, imposing too narrow a frame on the financial system and international capital flows. In my view, although the previous situation of excesses was not sustainable, the risk of de-globalization is also very dangerous. We need only recall the consequences of the spiral of (trade) protectionism in the aftermath of the Great Depression.

As a matter of fact, there are no signs of policies that could lead to widespread financial isolationism. To be precise, in the immediate aftermath of the crisis some emergency measures might have suggested some segmentation of certain financial markets in advanced economies. But these fears have been rapidly dispelled, thanks in particular to the tight-knit engagement by world authorities, which has fostered a climate of dialogue and set the basis for coordination. All in all, in remarkable contrast with the 1930s, governments are not pushing for de-globalization and, insofar there has been any, it has been associated with market adjustment after the crisis.

However, the risks have not been fully dispelled. Now that even the most basic economic tenets have been called into question, the benefits of economic and financial globalization are one of the preferred targets. Therefore, we should take a proactive part in rebuilding financial globalization on a more robust basis and in keeping a positive perception of the process.

This is not an easy task, since we must strike the right balance between reinforcing the stability of the financial system and promoting financial developments and the benefits of improved resource allocation at the global level. I believe that a good compromise can be achieved if we maintain our coordination efforts and advance towards a common global financial framework. Improved regulation and surveillance - both at the global and domestic level - to mitigate excessive risk-taking will be crucial in this new framework.

Looking at the Conference agenda, I can see you will have ample opportunity to discuss the topics I have just addressed along with many others - such as the possible recomposition of capital flows or the re-emergence of global imbalances - from an analytical perspective. I trust you will have most fruitful discussions during these two days and that you enjoy your stay in Madrid.

Thank you very much