Neighbours matter

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Let me start by thanking Frank Smets for inviting me to participate and the Bank of Japan for extending their hospitality. It is a privilege and an honour to speak this afternoon at the Second Annual Fall Conference of the International Journal of Central Banking. And it is a pleasure to visit Tokyo.

We have learned many policy lessons from the crisis. One of them is simple and straightforward: your neighbours matter. This is especially true for the big ones.

The intuition is very similar to what we carefully consider when buying a house. Neighbours matter. They determine to a large degree the value of your own house. For instance, even if you keep your house and yard pristine, the fact that your neighbours don't will affect your ability to enjoy your house.

This analogy, I believe, translates to monetary and financial policy. Even if you maintain domestic price and financial stability, you can still be susceptible to disturbances, possibly severe ones, originating from abroad.

In my remarks, I will discuss why neighbours matter, and then turn to the implications of this for policy. First, I describe some straightforward examples that underline what everyone now knows: financial shocks affect innocent bystanders just as real shocks do. I believe that these examples show that good domestic policies are not enough. They are necessary, but they are definitely not sufficient. For good economic policy, we also need new information and new tools – to prevent, and perhaps to manage, future crises. In particular, we need international cooperation, coordination and consistency.

Crisis propagation mechanisms

One obvious solution to the problem of cross-border shocks is to become self-sufficient. But autarky is a pretty extreme response to the neighbour problem. You do not respond to the unkemptness of your neighbour's yard by moving to an island or to an isolated house in the middle of a forest.

Similarly, severing international financial linkages is not the best way to stop a crisis propagating. I think that you would all agree that economic globalisation has clear benefits. If we are to reap those benefits, we have to maintain the momentum towards global financial integration. Hence, we should not erect new national barriers, as they would also prevent us

[1] I would like to thank Előd Takáts for his assistance. The views expressed here are those of the author and do not necessarily reflect those of the BIS.

from taking advantage of the positive effects of globalisation. Instead, we need to make sure that national authorities are confident that they will not be punished for their openness.

Achieving this goal means first understanding the nature of the shocks and of the transmission mechanisms that can create problems for even the most conscientious authorities. In the following remarks, I describe two examples of such cross-border financial shock propagation. First, what happened in cross-border bank lending to emerging markets. Second, the experiences of FX swap markets.

During normal times, cross-border bank lending serves to channel funds from advanced to emerging economies. Presumably, international and global banks are shifting resources from regions with low growth, low marginal product of capital, and low rates of return to those with high growth, high marginal product of capital, and high rates of return. This transfer takes place swiftly and with minimal friction. This would seem like an unambiguously good thing.

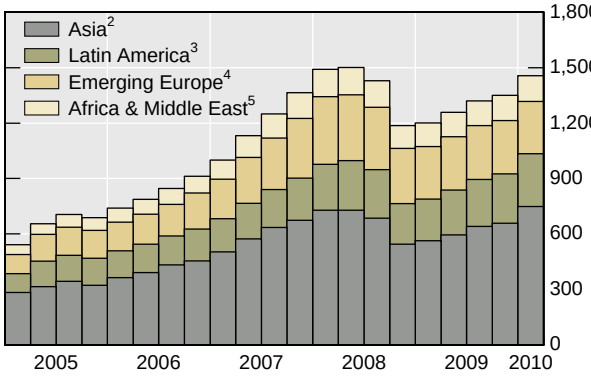
However, the system, great in normal times, can turn against us in a crisis (Graph 1). Cross-border bank lending to all emerging market regions developed rapidly until late 2008. However, during the financial crisis we witnessed a dramatic turnaround (Graph 1, left-hand panel).

Furthermore, this recent decline was primarily a consequence of reduced loan supply (Graph 1, right-hand panel). My BIS colleagues separated the changes in cross-border bank lending to emerging market economies into components due to supply and demand. The analysis suggests that, during the crisis, supply factors were dominant. It seems that international banks limited, or perhaps were forced to limit, cross-border bank lending when it was possibly most needed in emerging markets. In sum, the strong decline in late 2008 was not a home-grown problem.

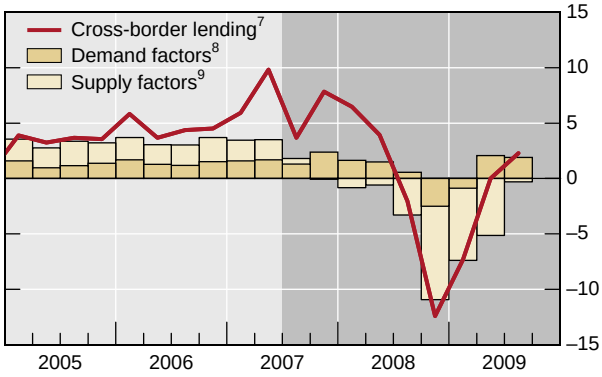
Graph 1

Cross-border lending

Consolidated cross-border foreign claims of reporting banks on emerging markets[1]



Demand and supply factors in cross-border bank lending to emerging markets[6]



[1] In billions of US dollars. [2] China, Chinese Taipei, Hong Kong SAR, India, Indonesia, Korea, Malaysia, the Philippines, Singapore and Thailand. [3] Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela. [4] The Czech Republic, Hungary, Poland and Russia. [5] Saudi Arabia, South Africa and Turkey. [6] Demand and supply model reported in Table 1 of the June 2010 *BIS Quarterly Review*; for each quarter, the graph shows the average estimated forecasts across countries in the sample; average quarter-on-quarter changes, in per cent. [7] Quarter-on-quarter growth rate (logarithmic) in BIS reporting banks' cross-border gross claims vis-à-vis each country; actual data, in per cent. [8] Quarter-on-quarter growth rate (logarithmic) in seasonally adjusted nominal GDP in US dollar terms times its panel coefficient estimate plus a share of constant and country fixed effects. [9] Volatility of the S&P Financials Index times the panel coefficient plus a share of constant and country fixed effects. The constant and fixed effects are divided between demand and supply factors in the ratio of the appropriate standalone estimate constants and fixed effects.

Sources: Datastream;BIS estimates.

My second example is the FX basis swap market. FX basis swap spreads can be thought of as a measure that combines currency shortages and money market stresses. Arbitrage

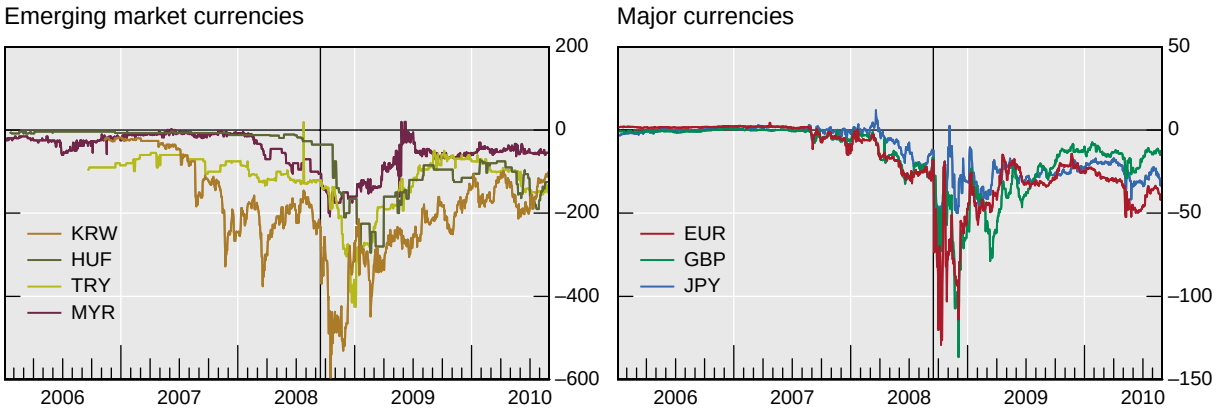
theory tells you that, absent currency shortages or money market stresses, the spread should be zero. And, in spite of obvious frictions, it usually is close to zero. That is, normally there are no currency shortages, and neither emerging nor advanced economy money markets experience any significant stresses.

However, during the financial crisis, emerging market spreads skyrocketed (Graph 2, left-hand panel). The graph shows stress in four markets: Korean won, Hungarian forint, Turkish lira and Malaysian ringgit. The scale is in basis points. The negative spread tells you how much you will have to pay for US dollars in a transaction. Interestingly, Graph 2 tells us that the stress did not come entirely unexpectedly – there were signs well before Lehman (see the vertical line). In the case of the Korean won, the spread was more than 200 basis points before the Lehman failure, rising to 600 basis points at the peak of the crisis.

Graph 2

Cross-currency basis swap spreads against the US dollar, one-year maturity[1]

In basis points



[1] The vertical line marks 15 September 2008, the date on which Lehman Brothers filed for Chapter 11 bankruptcy protection.

Source: Bloomberg.

Furthermore, the stress was not only an emerging market phenomenon. The crisis also massively affected the major advanced economies and their currencies: the euro, sterling and the yen (Graph 2, right-hand panel). This indicates that it was not only emerging market money market risk that was moving spreads. Rather, both advanced and emerging economies were subject to money market stress. Also, there was a shortage of US dollars. In fact, people with dollars were able to, and did, make quite a bit of money.

Good domestic policies are not enough

These examples show that financial shocks travel very quickly across international borders. Importantly, good domestic policies are not enough to stop these shocks. If foreign banks decide to stop lending to everyone, you can be the best, most creditworthy borrower in the world and it won't help.

My view is that most emerging economies learned the hard lessons from crises in the past decade. They learned about the dangers of currency mismatches and of weakly capitalised banking systems. And they avoided these mistakes this time around. They reformed their financial systems and increased their foreign exchange reserves – in many cases substantially.

During this crisis, the problems came from outside. As Guillermo Ortiz, former Governor of the Bank of Mexico, said: “This time, it was not us!” Advanced economies didn’t think they could possibly be the source of this sort of problem. After all, they had learned how to run monetary policy. They used interest rate instruments to hit inflation targets, which they thought would isolate financial shocks within the financial system and ensure real stability. However, when the policies of the advanced economies failed, the problems travelled at the speed of light to the emerging economies. And domestic price and financial stability in emerging markets didn’t stop these shocks.

This raises the question: what else do we need if domestic price and financial stability are not enough?

Need for new information and new instruments

In short, we need new information and we need new instruments. And, you will not be surprised to hear me say, effective international cooperation.

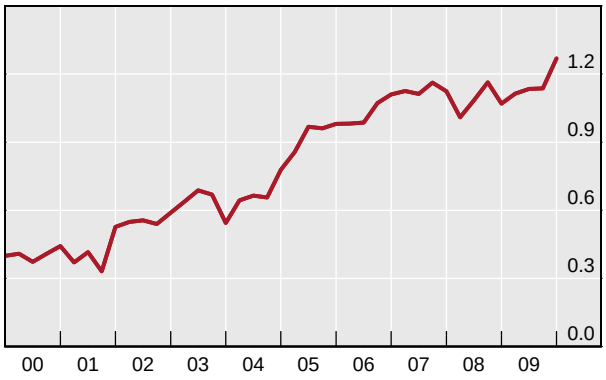
Starting with information, we need to know what risks are present and how they are likely to be transmitted. In general, the problem is not what we know and monitor, but what we do not know. There are data gaps. We at the BIS have identified several data gaps and are working hard to fill them.

Some of these data gaps we have plugged using existing BIS data (Graph 3). Let me now focus on US dollar positions, although we have done the exercise for all major currencies. The red line shows the amount of US dollar funding needed by banks with long US dollar positions, ie banks with more US dollar assets than liabilities. This funding can come either from US dollar borrowing or FX swaps. Hence, the graph also measures exposure to FX swap markets. You can see that this exposure has tripled in eight years. Moreover, it is still rising!

Graph 3

USD-long banks’ US dollar positions[1]

in trillions of US dollars



[1] Includes Canadian, Dutch, German, Japanese, Swiss and UK banks.

Sources: BIS consolidated statistics (immediate borrower and ultimate risk basis); BIS locational statistics by nationality.

However, we cannot fill all identified data gaps with existing data and some clever economics. We need more raw data to be able to monitor developing risks. In my view, first and foremost, we need balance sheet information.

Besides new information, we also need new instruments. First, we need new instruments to prevent future crises. This means better regulation. I believe that the new Basel banking

capital regulations, along with the application of macroprudential tools, will provide basic elements of crisis prevention.

Moreover, we need new instruments to deal with the fallout from future crises. We will probably never be able to avoid crises entirely. Hence, we need tools to cushion the blow when the next crisis comes. Among other things, that means mechanisms for crisis resolution. Strengthening the financial infrastructure would also increase the resilience of the financial system during crises. In this regard, the creation of central counterparties for derivatives clearing and settlement would not only increase resilience but also provide additional information.

In general, when thinking about new instruments, we need to keep the system flexible. We need to remember that regulation is an arms race between financial institutions and regulators. We need to make sure that the regulators have the right arsenal, while financial institutions redeploying their resources. Furthermore, I personally think that the regulatory perimeter requires much more attention going forward. We've done a great job on banks, but shadow banking is not going away.

Last but definitely not least, we need international cooperation, coordination and consistency in our efforts. Remember: neighbours matter. We need to ensure that there is no "race to the bottom" and that there are no regulatory loopholes. Again, this is very similar to our housing example. We need zoning and covenants that require everyone in a neighbourhood to meet certain standards.

Conclusion: neighbours matter

I conclude where I started. Your neighbours matter. What happens abroad might affect you – and not necessarily in a good way. Financial crises can happen often and with devastating consequences. And they travel fast from one country to another.

We need new information and new instruments ideally to prevent new crises or at least to stop their propagation. Flexibility in the future remains crucial. No single static instrument will suffice, as new risks and vulnerabilities will inevitably emerge. Furthermore, all these new lessons do not mean that we should forget old lessons. Current account imbalances, credit growth or currency mismatches will continue to matter.

Looking at monetary policy, everyone now agrees that that domestic price stability is not enough. This lesson, drawn by Bill White, has become part of the mainstream thinking. However, I would go even further and say that even domestic financial stability is not sufficient.

Your neighbours matter – more precisely, your neighbours' financial stability matters. If we are to continue to reap the benefits of globalisation, we need to ensure that shocks from your neighbours' financial systems will not propagate to your financial system – as they did in this crisis. In short, we need international cooperation, coordination and consistency.

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