The Globalization of Financial Markets/Challenges to Monetary Policy

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1. The background: globalized financial markets

The "globalization of financial markets" is one of those wonderful catch-phrases typycal of the inventive spirit of the American language which conveys a lot without necessarily being very precise. For the purpose of this discussion I shall use it in its broadest possible sense, to cover all aspects of the financial revolution which started some fifteen to twenty years ago and which continues unabated, namely:

- deregulation of domestic markets;

- the abolition of cross-border capital controls;

- the accelerated progress in communications technology and information systems;

- the successive waves of financial innovation.

Interacting among themselves, these four developments (plus a number of others) have gradually, but also radically, transformed our financial landscape. Here are those changes which, I believe, are of major significance for the conduct of monetary policy:

1. Continuously expanding and deepening international financial integration, which can be measured by the growth of almost any indicator you care to look at: banks' exposure in foreign currency or to external debtors; gross or net capital flows; short or long-term

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financial or direct investment; cross-border volume of payments; and so on. As a result, financial impulses emanating from any one country (and not necessarily just from the very large ones) are quickly transmitted to others. This applies very clearly to long-term interest rates and equity prices.

2. The gradual erosion of the neat distinction between various types of financial assets and liabilities. In particular, "money" has ceased to be clearly distinguishable from other liabilities of financial intermediaries. At the same time, despecialization is blurring the demarcation lines between the various type of financial intermediation. Finally, securitization makes it increasingly difficult to distinguish intermediation in the narrow sense of the word from financial market activity in general. In addition, it increases the "opaqueness" of the markets, by hinding the linkages between market segments and geographical areas.

3. Globalization entails tough, generalized and geographically widespread competition between financial market participants throughout the world. Such competition has a great number of advantages. It increases market efficiency in the technical sense used by economists: it enhances the allocative efficiency of financial markets; it accelerates the process of innovation and thus provides risk-averse market participants with an opportunity to protect themselves against unexpected interest or exchange rate fluctuations. But it also leads to the erosion of profit margins of financial intermediaries as a group – a fact that will be welcomed by all non-financial market participants, though it will be understandably less appreciated by the intermediaries themselves. Even more important, when competition is regarded as a dynamic process, one inevitably thinks of Schumpeter's definition of competition as a process of "creative destruction". The question, then, is whether "destruction" in the financial industry is any more dangerous than in, let us say, the electronics industry. An even tentatively affirmative answer to this question would imply that globalization enhances systemic fragility.

It is against this background that I propose to consider four challenges to the conduct of monetary policy. The order in which I list these does not imply any judgement about their relative importance.

2. Money supply targeting

Using an appropriate M as an intermediate target has distinct advantages. A money supply target clearly defines the 'stance' of monetary policy, which helps the formation of expectations by market participants. When the targeted rate of growth of M remains unchanged, monetary policy can be said to be on an even course. While the central bank still has to take decisions on operational interest rate targets, in a broader sense market interest rates are the outcome of changes in nominal GDP, and therefore of the demand for money, against the background of a steady expansion of the targeted M. The central bank can argue (perhaps somewhat disingenuously) that interest rates just 'happen'. The implications of this are substantial. First, targeting relieves the central bank of some of the pressure which might be exerted on it by the government or Parliament. Second, the decision-making body of the central bank is more easily able to avoid the temptation of 'judgemental' adjustments to monetary policy. And third, a money supply target which is relatively well understood by the public gives a clear signal to market participants about the range of price adjustments and wage settlements that is compatible with a stability-oriented monetary policy. Outside this range, they would run the risk of pricing themselves out of the market.

The trouble with globalization is that it introduces elements of uncertainty either in the monetary authorities' decision-making process or in the transmission mechanism, i.e. the way in which a monetary policy decision affects prices and the real economy. In other words, it casts doubt on the two basic conditions which have to be fulfilled if targeting is to be operated rigidly and efficiently: on the controllability of the targeted M and on the existence of a sufficiently stable relationship between this M and prices.

Let me mention a few practical examples, going beyond the obvious problems arising even in a 'closed' economy as a result of the blurring of the demarcation line between 'money' and other financial assets. On the level of definition and measurement there is the – intellectually not very exciting but practically quite tricky – question of whether or not to include in the targeted M such items as non-residents' holdings of assets denominated in domestic currency or residents' holdings of foreign currency assets. Then there is the associ-

ated question of how to deal with assets held in offshore centres. More fundamentally, the combination of changes in interest rate differentials with shifting exchange rate expectations may induce portfolio movements which can significantly destabilize the behaviour of the targeted M.

Does this mean that globalization will end up by steering central banks (I am, of course, thinking of those which cannot afford to use the exchange rate as an intermediate target) more and more away from money supply targeting and towards direct inflation targeting?

I do not believe that the neat textbook distinction between these two strategies has much practical relevance. At present, even those central banks which have a very explicit inflation target closely monitor one or several Ms. How could they do otherwise? And those which target an M do this in a medium-term perspective, while taking other considerations into account at the same time.

Let me try out on you an idea which I aired publicly a few years ago. M, or a couple of Ms, would be announced as a target. This would be interpreted as an obligation for the decision-making body of the central bank to explain publicly why, if it wishes to disregard a deviation in the growth of the M from the targeted path, it does *not* intend to take corrective action. Whether the announced M would in this case still deserve to be called a target – or whether it should be called an indicator – is a matter of semantics. The substance of the matter is the commitment to explain the reasons why the decision is taken to disregard the signal given by a divergence from the target. Such an obligation would mean that the central bank is not free to undertake *ad hoc* decision-making: the obligation to go public *is* a constraint. It would also imply that, while we may have trouble in finding the proper money supply figure, the role of money (indeed of money supply) in the inflationary process would continue to be firmly acknowledged. Finally, it would go a long way towards complying with the requirement of democratic accountability.

3. What is price stability?

I see two very different challenges arising under this heading.

The first relates to the rate of inflation which could be considered as equating to price stability and therefore regarded as an appropriate (implicit or explicit) target for monetary policy. There seems to be a broad consensus that price stability should be defined as a situation in which market participants disregard inflation as a factor in their decisions. But what is this threshold in practice? A range of between 1 and 3%? 2% or less? 0%? This is an important debate of great strategic and operational significance for central banks, and one which has a lot to do with measurement problems linked to changes in the quality of goods and services, as well as with the tricky problem of measuring the real output of services (from which you can derive implicit price indices). But I do not think that it can be connected with financial globalization.

The second challenge seems to have a more explicit link with globalization. It concerns the role of asset prices in assessing inflation or in the process of inflation itself. There have been numerous examples in recent years of asset price increases being significantly faster than increases in the prices of goods and services. There were even instances – the most obvious was that of Japan – where booming asset markets went hand-in-hand with unquestionably stable prices of goods and services. Some of the asset price 'bubbles' may have had nothing, or little, to do with globalization. Many of the real estate booms were home-made. At the same time, the cross-border interconnection between equity and long-term debt markets has introduced an international dimension.

When the consumer price index is practically stable, a stock market boom in any one country raises the question of whether the stance of monetary policy is not too lax. The answer is not intuitively obvious. Even in a 'closed' economy, the origins of such a boom are not easily identifiable. Nor is it simple to guess its impact on future developments in the prices of goods and services. If such a boom is propelled by a financial impulse coming from abroad – either through the process of expectations or as a result of genuine capital inflows – it will be even more difficult, if not actually impossible, for the central bank concerned to devise the appropriate monetary policy response.

4. The challenge of real exchange rate misalignments

I define a real exchange rate misalignment as a significant and lasting movement in the real exchange rate (probably best measured by changes in the effective real exchange rate) which cannot be justified by any adjustment to a 'real' shock. I know that, deep in their hearts, many academic economists question whether such misalignments really occur. They do not deny that even without 'real' shocks there can be departures from PPP – for instance, when market participants come to expect a change in the stance of monetary policy – but such departures will be corrected over time. In other words, PPP is likely to hold in the long run.

Well, I cannot claim to possess a convincing alternative theory which could provide a plausible explanation for the large and persistent real exchange rate misalignments which have occurred over the past twenty-five years, but I am sure that we *have* had major departures from PPP. Think of the cycles in the over or undervaluation of the US dollar; of similar developments in the yen; or, closer to us, of what happened with the pound sterling. It is possible that in the end corrective forces will prevail; but periods of over or undervaluation, even if they last 'only' three to four years, can do a lot of harm. The facts being what they are, I prefer to acknowledge that misalignments have occurred rather than trust theories which are not confirmed by observation. Similarly, while I cannot prove the validity of my conviction, I believe that some important features of the ongoing financial revolution play an important role in producing such misalignments: the massive development of trading activities, the growing dependence of banks on sources of income other than the interest spread; and last, but not least, 'short-termism' in financial management. The result is misalignments on a scale larger than those produced by pegged exchange rate systems.

Be that as it may, monetary policy concerns under this heading fall into two closely interconnected groupings.

First, consider the case of a country taken in isolation whose real exchange rate depreciates. How should monetary policy react to the resulting upward pressure on prices? Not at all – on the basic assumption that by maintaining an even stance, the inflationary impact will die out? But, in the absence of a reliable money supply target, how is it possible to demonstrate that the 'stance' has remained unchanged? Moreover, given the part played by current price developments in the formation of expectations, can the validity of this basic assumption be taken for granted? If not, monetary tightening would seem to be preferable, since, in any event, an exchange rate depreciation has a stimulating effect which should, arguably, be offset by higher interest rates. But what if real depreciation occurs when the current account displays a surplus, and domestic demand is demonstrably weak? The logical conclusion would seem to me that this is a situation that cannot be handled by monetary policy alone, or even more pessimistically, that there is no optimum way of handling it. Note that, with some variations, a similar reasoning but with opposite signs could be presented in the case of an unwarranted real appreciation of the currency.

Second, we should be aware that the harm caused by real exchange rate misalignments goes well beyond the direct problems they can create for the conduct of stability-oriented monetary policies. They are apt to have a highly distorting effect on cross-border transactions and prevent the optimum allocations of resources. They lead to misdirected investments. Moreover, past experience of investment decisions which have turned out to be mistaken because of major shifts in relative competitive positions is bound to have an inhibiting effect on future investment decisions. More generally, real exchange rate instability introduces an additional element of uncertainty into business decisions. No hedging techniques are available to insure yourself against lasting, highly unpredictable shifts in competitive positions. The inventiveness of financial engineering has no limits, but I suspect that hedging against these risks would be murderously costly. Very large corporations can diversify both their investments and their trade flows in ways which give them a measure of protection against currency misalignments. But such 'self-insurance' is not available to smaller firms – yet the involvement of such firms in cross-border transactions is fast increasing. Finally, for all these reasons real exchange rate misalignments are basically inimical to free trade: they are a source of mounting protectionist pressures.

But how can we fight misalignments? Exchange market intervention may be helpful, but it will be helpful only if it foreshadows a shift in those policy constellations which, in the eyes of market operators, justify the seemingly unwarranted real exchange rate move-

ments. But any such shift encounters horrendous obstacles. There is, to begin with, the sheer identification problem: what is wrong with the policy mix? Assuming a plausible and acceptable answer to this question, we come to the major obstacle of a co-ordinated international response. Which country will be willing to adjust which policy?

Fiscal policies are notoriously rigid, for obvious constitutional and political reasons. Fiscal policy shifts by major countries within the framework of international cooperation can be counted on the fingers of one hand. In fact, the German 'locomotive' episode of 1979 (the coinciding of which with the second oil shock left bitter memories in the Federal Republic) and the Japanese public investment programme of 1987 are the only examples I can think of.

In practical terms, the burden of adjustment would fall on monetary policy. And this could be a very heavy burden indeed. It need not be in all circumstances. Situations may arise when a shift in monetary policy by several countries, motivated by exchange rate considerations, is also justified by considerations relating to domestic balance. But in many instances a conflict could arise between the two policy targets. To bring exchange rate misalignments under control, interest rates may well have to be raised to levels that could be detrimental to growth or, alternatively, depressed to levels that cannot be sustained without creating excessive domestic liquidity.

This is no reason for not trying to promote policy co-operation between major nations, but it is a good reason for not being unduly optimistic about the outcome. I do hope, however, that EMU will be helpful in this respect. The European countries are particularly exposed to the risks of real exchange rate misalignments. In a Europe where inflation is under control and where inflation differentials have become almost negligible, even small changes in nominal exchange rates translate themselves into changes in real rates. And in a very closely integrated and highly competitive single market, even such small misalignments could have disturbing and perhaps disruptive consequences for the functioning of the single market. EMU will eliminate such risks and substantially diminish the exposure of individual countries to the gyrations of third countries' currencies.

5. Systemic fragility

Preserving the integrity of the financial system has been a traditional task of central banks. While in many countries the micro-prudential function has been given to institutions which are distinct from central banks, there is little doubt that even in these countries central banks continue to be held responsible, or at least jointly responsible, for securing the stability of the financial and payment systems as a whole.

I mentioned in my introductory remarks that globalization may have increased the fragility of our financial system. Let me put to you, for the sake of stimulating discussion, my own very tentative view on this matter. I do not think that the likelihood of a worldwide financial crisis has demonstrably increased. Many of the features of our evolving new system have two facets: while they may be a source of instability, they often contain built-in shock absorbers. Financial innovation, which may have led to asset price instability, has at the same time put at the disposal of market participants powerful devices which enable those that are wise to protect themselves precisely against asset price instability. Globalization itself has increased the depth and liquidity of markets. Securitization, while it has contributed to the 'opaqueness' of the markets, has led to a wider distribution of risks throughout the system. And so on. The point, however, is that in our globalized financial system we may well have to deal with the propagation of 'local' or 'sectoral' crises.

How can central banks discharge their macro-prudential duties in this environment? And what could this imply for the conduct of monetary policy?

The arguably most important policy duty is crisis prevention, i.e. trying to avoid the emergence of 'local' or 'sectoral' crises. This implies, first and foremost, the conduct of a monetary policy that is directed, in a medium-term perspective, towards the attainment of price stability. The lack of a credible commitment to that objective could seriously aggravate the risk of market overreaction and therefore that of systemic instability. The safest way to avoid asset market 'bubbles' is to stick to a cautious monetary policy. This will not eliminate all misalignments, nor wipe out short-term volatility, but it would at least mean that monetary policy ceased to be a contributory factor in such disturbances.

One difficulty that arises in this connection is to ensure that the central banks' commitment to maintaining price stability is fully credible to market participants. The downgrading of money supply targets would not be very helpful in this respect, since this would eliminate an unambiguous indicator of the resolve of central banks to pursue a stability-oriented monetary policy. Should such a downgrading become unavoidable, central banks would have to rely increasingly on other ways and means of conveying their message to the markets. At a minimum this would have to entail better and more detailed information on the economic analysis forming the basis for monetary policy decisions and on the decision-making process itself.

Other preventive measures are also required. I would suggest two which are essential, but have no direct link with monetary policy. First, central banks should do everything in their power to make our globalized financial system more transparent, with a view to providing information not only for themselves, but also for market participants. Second, central banks should contribute to enhancing the safety of both domestic and international payment, settlement and clearing systems, since these are the main transmission channels which could amplify any manifestation of crisis and turn a local or sectoral crisis into a genuinely global one.

When it comes to crisis management, central banks have a widely recognized and uncontroversial duty. Whenever there is a risk of any specific manifestation of crisis triggering a generalized retrenchment by market participants, central banks should pump liquidity into the *system*. Any such action would have implications for monetary policy. With hindsight, some of us might think today that the liquidity creation in the autumn of 1987 was excessive and contributed to the pick-up of inflation a couple of years later. I do not draw from this observation the conclusion that the concerted action of the central banks at that time was wrong. The risk of asset prices going into a tailspin was quite high. But this episode shows how difficult it can be to reverse in time and with sufficient vigour a massive creation of liquidity. The difficulty is not a technical one: it relates to analysis and to the decision-making process.