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Speech

Már Guðmundsson, Governor of the Central Bank of Iceland, comments in Session I in the conference *Fragmentation in the International Financial System: Can the Global Economy Become One Again?*, organised by the Central Bank of the Republic of Turkey and the Reinventing Bretton Woods Committee, Cappadocia, Turkey, 14 July 2012.

For the most part, I will discuss some flaws in the international monetary and financial system(s) (IMFS) and in the European Union (EU) framework for cross-border banking and financial stability as they relate to both net capital flows and vulnerabilities in gross capital positions. My perspective on these issues is that of a policy-maker from a very small, open, and what used to be financially integrated economy, but it is also informed by the work I was involved in during my tenure at the Bank for International Settlements.

The current international and monetary and financial system is in some sense a non-system, a hybrid of miscellaneous exchange rate regimes and diverse rules on cross-border capital flows and activities of financial institutions. This opens the door to country choices that, in the aggregate, cause and perpetuate global current account imbalances. This problem and its solution have been discussed extensively, and I will not dwell on that topic here. Instead, I want to pose this question: Supposing that all countries had free capital movements, freely floating exchange rates, and first-rate macroeconomic policies aimed at internal balance, would everything then be fine, at both the national and global level?

I think there are strong indications that it would not be.

There are a few reasons for this. First of them is the tendency of exchange rates to move away from equilibrium values for extended periods, with sharp corrections at the end of the process and with excess volatility throughout. The research on this phenomenon is still ongoing, but there are strong indications a number of factors suggest that the process is related at least partly to how asset markets function and how expectations are formed, and would not disappear even if macroeconomic policies were perfect.

There will be net capital flows associated with this process, as well as swings in current accounts and effects on domestic financial systems that can ultimately lead to serious financial instability. In a small, open, and increasingly financially integrated economy, the process runs as follows: Domestic interest rates at the longer end of the maturity spectrum tend to

become more closely correlated with the global rate, or the rate of the largest trading partner, and less correlated with the domestic policy rate. This means that monetary transmission tends to go increasingly through the exchange rate channel, which is only a problem, however, if the exchange rate behaves badly. Unfortunately, there is copious evidence to suggest that it is a problem. Uncovered interest rate parity (UIP) does not hold except over long horizons. On the contrary: Interest rate differentials give rise to widespread carry trading, which is by nature a bet against UIP. Exchange rates thus diverge from fundamentals for protracted periods, followed by sharp corrections. So the exchange rate often seems to be as much a source of shocks and instability as a tool for adjustment and stabilisation. Ultimately, these cycles take the boom-bust form and, in extreme cases, result in serious financial instability or crisis. So this is basically a macroeconomic problem that can turn into a financial stability problem.

Another reason is related to vulnerabilities deriving from the size and composition of countries' gross capital positions and, behind that, of banks, governments, corporations and households. These are currency mismatches and maturity mismatches in terms of foreign currency. While current account imbalances and wayward exchange rates can be termed the net capital flow problem, we can call this the gross capital problem. Of course, the second of these will turn into a net flow problem at the critical moment, thus affecting the exchange rate; for instance, when there is a run on foreign-denominated gross liabilities that were previously matched with more illiquid gross assets. But the difference is that, prior to the crisis, the net capital flow problem was there for everybody to see, in the form of global current account imbalances – or, in my country, huge capital inflows, a double-digit current account deficit, excessive credit growth, and an asset price bubble. But the gross capital problem was hidden and not much talked about. To take an example, the euro area as a whole had a more or less balanced current account position. A factor that garnered little attention before the crisis, however, was that European banks had built up huge USD-denominated balance sheets that were also balanced to a large extent – except, of course, in maturity. This became a major problem when there was a run on such dollar-denominated bank liabilities post-Lehman, and many big European banking names might not still be with us were it not for the USD swap lines granted to the ECB, the BoE, and the SNB. The gross capital problem is basically a financial stability problem that can turn into a macroeconomic problem.

So the financial crisis revealed a major fault line in cross-border banking, in the form of large foreign currency balance sheets featuring significant maturity mismatches, but with limited lender-of-last-resort (LOLR) facilities in terms of foreign currency. Maturity mismatches are the bread and butter of modern banking, of course, and we know how to deal with the risk in a domestic setting: with central bank LOLR operations and deposit insurance, complemented by regulation and supervision, partly to deal with the moral hazard issues created by this safety net.

Of course, central banks can lend out their foreign exchange reserves, but there is a well-known limit on that process. Some form of global liquidity provision is therefore called for. The swap lines granted during this crisis were precisely that, and most studies seem to support the conclusion that they made the crucial difference in relieving the strain in banks' foreign exchange funding. To a significant degree, this was the domestic LOLR process replicated at the international level.

We have a solution, then, at least at the conceptual level. But it is not clear that it is a reliable, practicable solution. At present, the swap lines are not a permanent and reliable feature of the international monetary system; for instance, they have been challenged vehemently in political discussion in the US. Furthermore, there are important unresolved governance issues, such as who should decide which countries get a swap line and which do not. It is thus an important item on the reform agenda to clarify the extent to which standing foreign currency LOLR facilities for solvent cross-border banks can be set up without going through national governments. This is one of the key issues currently under review in the case of the Spanish banking crisis.

Let me now say a few words about Iceland's financial crisis, as it puts the issues raised so far into sharp focus, but then lead us into the crisis in EU banking.

Iceland was already on its way into a recession when its three cross-border banks failed in the first week of October 2008. This was partly unrelated to the banking collapse and followed the turn of the domestic economic cycle, after an unsustainable boom and serious overheating during 2005-2007 and a currency crisis in the first half of 2008. . The proximate cause of the demise of the banks was the post-Lehman run on foreign exchange liabilities, which amounted to 7.5 times Iceland's GDP, while their total balance sheets were 10 times GDP. The banking collapse and the associated wealth loss and further depreciation of the currency deepened the recession.

Two separate but interrelated sub-stories of the large Icelandic saga were converging in a tragic grand finale that autumn. These were:

1. Iceland's boom-bust cycle and problems with macroeconomic management in small, open, and financially integrated economies. (Net capital flow problem and fundamentally nothing new).
2. The rise and fall of three cross-border banks operating on the basis of EU legislation (the European "passport"). (Gross capital problem and unique in Icelandic history – and, at the time, in EU history).

The banking system expanded very rapidly in just five years, from a combined balance sheet of less than 2 times GDP (at the end of 2003) to almost 10 times GDP (in mid-2008). Most of this expansion was cross-border, and a lot of it had very little to do with Iceland, as both financing and investment took place abroad.

A number of domestic mistakes were made throughout the process, and I do not have time to go into them here, but the expansion of the banks was greatly facilitated by Iceland's membership in the European Economic Area (EEA), as the EEA Agreement provides a legal and regulatory framework based on European Union Directives, including free movement of capital and provision of financial services. The underlying principles are those of home licencing for operations anywhere in the EEA and of a level playing field for competition, where size and location supposedly do not matter. This European "Passport" enabled the Icelandic banks to operate throughout the EEA, including through branches in other EEA countries.

We now know that there are deep flaws in this framework and that these flaws are important elements in the current euro area crisis. A key issue here is the contradiction between, the European passport rights on the one hand and, on the other hand, national supervision, national deposit insurance and national crisis management and resolution regimes. This is what recent proposals of a banking union are supposed to deal with. However, for EEA countries outside the euro area, this framework also has embedded in it a potentially huge foreign currency liquidity risk in the banking system that is not covered by a lender of last resort.

Let me conclude by briefly outlining what I think the analysis so far means in terms of reform of national monetary and financial stability frameworks, on the one hand, and EU and global frameworks (IMFS), on the other hand.

At the national level, monetary and exchange rate frameworks might respond to recent experience by moving away from free floating towards some form of managed float. I call it "inflation targeting plus," where an inflation target is linked with active foreign exchange intervention policy aiming at reducing excess volatility and leaning against capital inflows but without targeting an exchange rate level, and the joint striving for price and financial stability is supported by macroprudential policy and fiscal policy. In addition, countries will consider tools aimed directly at the net capital inflow problem, including taxes or reserve requirements. The gross capital problem will be dealt with by putting prudential limits on the size and composition of home-headquartered banks' foreign currency balance sheets and foreign-denominated lending to domestic households and unhedged companies. In the absence of global and EU reforms, individual countries will therefore self-insure in various ways and impose prudential restrictions that might further fragment the international financial system.

At the EU or euro area level, it is logical to consider some kind of a banking union, but in my mind, this would involve a two-tier system, wherein domestically oriented banks that are not systemically important for the area as a whole will remain within the domestic system of supervision, deposit insurance, and LOLR.

What should happen at the global level is somewhat less clear to me. Some temporary retrenchment is probably not undesirable at this point, as cross-border banking – and perhaps financial globalisation more generally – far outpaced developments in public frameworks. The issue of global liquidity provision to banks needs further exploration. And finally, if countries are increasingly taking unilateral action to protect themselves, someone – probably the IMF – must monitor the process. Going forward, some rules of the game might have to be considered so that we are not faced with unintended consequences for the global system.