

Risk-Taking, Global Financial Integration and Multi-Polarization¹

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Today's IMS: Incomplete and Under Pressure

Pressures on the International Monetary System (IMS) are likely to intensify as the global economy enters a period of ongoing transition². The shockwave sent through global financial markets in the spring of 2013, triggered by the anticipation of the slowing of asset purchases by the Federal Reserve, has shed light on vulnerabilities inherent in an evolving IMS. The rise of emerging market economies has coincided with their financial systems becoming more integrated with the global financial system. This has brought with it both greater opportunities and potential for higher volatility³. Overlaying these events is a legacy of large debt burdens in advanced economies along with high leverage in their financial systems. These imbalances have begun to unwind, in part due to global financial regulatory reform efforts⁴, but the deleveraging process has been slow⁵ and will likely remain a key drag on global growth. These risks are elevated as they could potentially unfold in an IMS that is incomplete.

Addressing these challenges require commitments and actions. The objective going forward is to take the necessary steps to address the key gaps in the IMS, such as following through on international reform commitments, increasing our collective understanding of complex macrofinancial linkages and risk-taking channels as well as strengthening international cooperation.

¹ Thank you to Tim Scholz and Glenn Purves for their contributions.

² IMF. 2013. World Economic Outlook. Transitions and Tensions. October.

³ See Chapter 2 of the IMF April 2014 Global Financial Stability Review (April 2014).

⁴ For an update see the FSB Chair's Letter to G20 Ministers and Governors on financial reforms (February 2014).

⁵ Bank of International Settlements. 2014. Global Liquidity: Select Indicators. March.

Gaps in the IMS

There are, in my view, five key gaps in the IMS, four of which are well documented, and addressing them is largely an issue of implementation. The first is insufficient progress on exchange rate flexibility. A more efficient mechanism to enable the adjustment of relative prices is a necessary release valve that reduces pressures on the system as a whole. The next is strengthening the resiliency of the domestic and global financial system to absorb crossborder capital flows and put them to productive uses. Third, there is a necessity for robust macroeconomic policy frameworks that keep inflation low and stable, preserve sound public finances and facilitate the efficient allocation of resources across the economy. There is also a strong international component including an effective global financial safety net (GFSN) that enables countries to have their liquidity needs met as they undertake necessary economic adjustments. The IMF plays an instrumental role in this regard but alternative liquidity avenues such as Regional Financing Arrangements (RFA) are increasing in prominence, and their integration into the GFSN remains a work in progress⁶.

Increasing Importance of the Risk-Taking Channel

The fifth and last element is critical yet more complex, and one that I believe requires further consideration in policy circles. It is developing a better understanding of global financial linkages and risk-taking channels, and using this information to feed into policy decisions. There has been important research on this topic in the last few years such as the role of global factors in driving asset prices⁷ (charts 1 and 2), investor herding⁸ (table 1), cross-border lending⁹ and carry trades¹⁰, as well as investors searching for yield¹¹ and taking on greater credit risk¹² in a low interest rate environment. These channels imply an important link between macroeconomic policy setting and financial stability, and contribute to what are sometimes referred to as “spillovers” or the cross-border impact of policies implemented for domestic purposes. These have featured prominently in G20 discussions over the past few

⁶ For key topics see RFA discussions in Washington (April 2013) and the G20 Seoul Conference (December 2013).

⁷ Rey, H. 2013. Dilemma not Trilemma. VOX. August.

⁸ Rajan, R. 2005. Has Financial Development Made the World Riskier? NBER Working Paper 11728. November.

⁹ Bruno, V. and H. S. Shin. 2014. Cross-border Banking and Global Liquidity. January.

¹⁰ Burnside C., M. Eichenbaum and S. Rebelo. 2011. Carry trade and momentum in currency markets. April.

¹¹ For example, Rajan (2005), Stein (2013), Shin (2013).

¹² Jiménez et al. 2011. Hazardous Times for Monetary Policy. June.

years¹³. That policy makers are beginning to pay greater attention to the risk-taking channel and its cross-border manifestation is a good thing. They are increasingly important to the functioning of the IMS but, as much of the research above suggests, there is a risk that they are insufficiently integrated into our formal macroeconomic models and policy decisions.

In Canada, we have developed a robust framework for integrating risk-taking channels and their spillovers into our macroeconomic policy decisions. This framework is anchored in a flexible approach to inflation targeting whereby the Bank of Canada seeks to return inflation to its medium-term target, while mitigating volatility in other dimensions of the economy that matter for welfare, such as employment and financial stability¹⁴. Nevertheless, imbalances can arise in specific sectors and can be exacerbated by monetary policy settings. The first line of defense against a buildup of such imbalances is regulatory and supervisory policy, or what might be termed “microprudential” policy. In the case of more systemic risks, deploying a broader macroprudential buffer can further increase the resilience of the system and lean against excessive imbalances. Lastly, in some exceptional circumstances, the Bank of Canada might have to take financial stability into consideration even more directly¹⁵. It is important to note that Canadian monetary and financial authorities work in close cooperation with one another which fosters a common understanding of risks, timely sharing of information and ensures de facto coordination. This should be true not only within a country, but also across countries.

Conclusion: Need of a Complete IMS, Not a New One

To summarize, we have an IMS where international linkages are stronger than ever before. While this is generally a good thing, policies in one country can generate challenges such as excessive risk-taking elsewhere. A lack of exchange rate flexibility and other distortions create greater pressures on the system as a whole, while failure to account for international risk-taking channels can amplify policy spillovers and create tensions.

The solution, in my view, is not to start from scratch or re-think old and discredited ideas like the gold standard. Rather, policy makers need to finish the job they have started to ensure that the IMS supports broadbased economic growth by facilitating smooth external adjustments, the efficient allocation of capital and greater resiliency to shocks. This requires following through on key G20 commitments to allow greater exchange rate flexibility and complete core elements of the

¹³ In Los Cabos 2012, G20 Leaders committed to minimize the negative spillovers on other countries of policies implemented for domestic purposes.

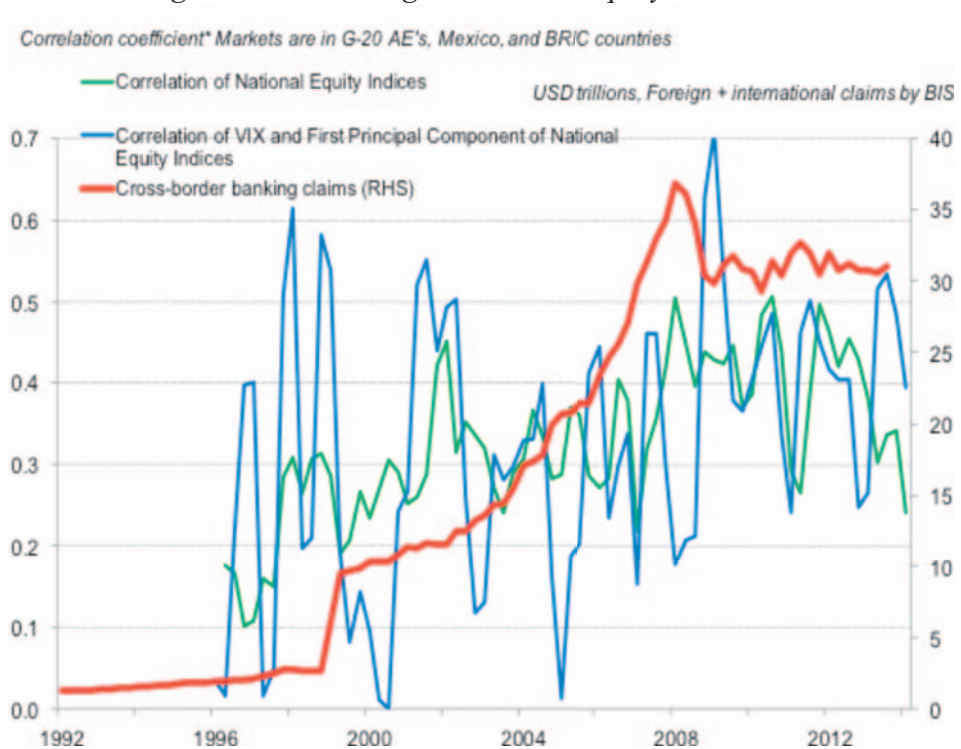
¹⁴ Bank of Canada. 2011. Inflation Targeting Renewal. November.

¹⁵ Bank of Canada. 2011. Renewal of the Inflation Target. Chapter 4. November.

financial reform agenda. Countries that are vulnerable to swings in investor sentiment should take steps to deepen domestic financial markets and strengthen monetary policy frameworks. Lastly, policy makers should work together to develop a firmer grasp of evolving global financial linkages and risk-taking channels, and how they impact the real economy.

Annex

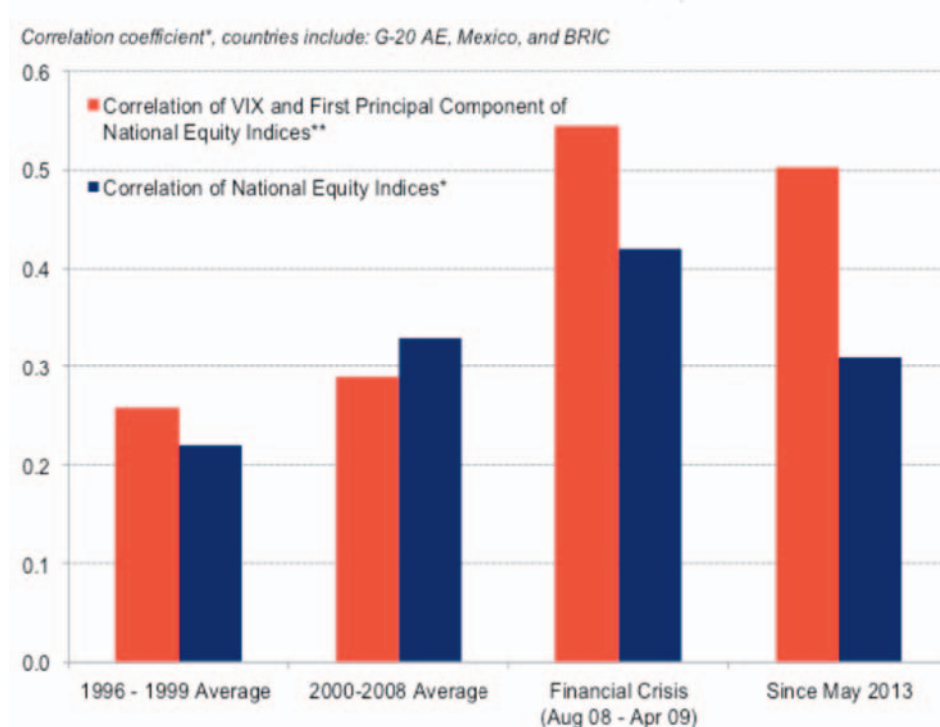
Chart 1: Integration and Linkages in Global Equity Markets



Source: BIS; Bloomberg Haver Analytics, Finance Canada Calculations.

Note: Average of 6-month rolling correlation of weekly movements p. p. Absolute value used for VIX correlation.

Chart 2: Co-Movements and Global Factors in Equity Markets



Source: BIS, Bloomberg Haver Analytics, Finance Canada Calculations.

Note: Average of 6-month rolling correlation of weekly movements p. p. Absolute value used for VIX correlation.

Table 1: Co-Movement in Emerging Market Economies' Currencies Post-Tapering

	May-2013 to Present						2001 to Apr-2013					
	Real	Rupee	Rupiah	Lira	Ruble	Rand	Real	Rupee	Rupiah	Lira	Ruble	Rand
Brazilian real	-	-	-	-	-	-	-	-	-	-	-	-
Indian rupee	0.80	-	-	-	-	-	0.10	-	-	-	-	-
Indonesian rupiah	0.75	0.71	-	-	-	-	-0.09	0.27	-	-	-	-
Turkish lira	0.82	0.65	0.88	-	-	-	0.04	0.70	-0.04	-	-	-
Russian ruble	0.82	0.56	0.59	0.82	-	-	0.32	0.75	0.19	0.59	-	-
South African rand	0.85	0.61	0.76	0.93	0.87	-	0.16	0.54	0.42	0.29	0.45	-

Source: Bloomberg and Finance Canada calculations.