Arnout H. E. M. WELLINK
President
De Nederlandsche Bank

Financial globalisation and financial innovation

I have been asked to introduce the round table with a group of very distinguished panellists who will discuss the topic of "Financial globalisation, growth and asset prices". I was pleased to see that the panellists, through their different fields of expertise, will be able to illuminate us with a broad range of ideas on this topic.

Before giving them the floor, let me raise a few issues. Financial globalisation, like most good things in life, has its doses of risks and challenges. The recent wave of financial globalisation, which began in the mid 1980s, has been seen as a catalyst for financial innovation. We have witnessed borders opening for banks and other market players. As a result, global financial markets have become deeper and more diversified and financial products have become more complex. In response to these changes, supervisors and the industry have had to keep pace by adapting the regulatory structures. The Basel II framework in that sense is inherently flexible with its risk-based approach. Even so, as lessons from the turmoil become clearer, it may be necessary to fine-tune certain elements of Basel II.

To make our work as central bankers even more interesting, financial globalisation has changed the environment for monetary policy with the growth of cross-border financial flows and the transfer of risk across different jurisdictions. In response, central bankers have also taken a number of steps to adapt their strategies to support financial markets and price stability. Just to mention a recent example, the collective actions among central banks to facilitate liquidity provision in short-term money markets were an important initiative in this sense.

But to what extent does increasing financial globalisation affect the efficiency and stability of asset prices and economic performance in general?

Financial globalisation, growth and asset prices

In the past years, as financial globalisation and deeper financial markets became more prominent there was an improvement in the stability of the macroeconomic environment. Global inflation was contained, accompanied by a decline in the volatility of economic growth, exchange rates and interest rates leading to the so-called Great Moderation.[1] These factors contributed to improving market sentiment. Liquidity seemed plentiful and this perception had a strong influence on the behaviour of investors and their risk tolerance, which grew with the search for yield. Alternative asset classes began getting large injections of liquidity. Real estate, high risk credit products, private equity and art, for instance, saw their prices rise considerably, which increased the potential for financial bubbles. Capital flows to and from emerging markets have also been surging. In the past five years, emerging markets have seen capital inflows almost six fold, raising challenges for many economies.

This environment contributed to a new trend in financial innovation, mainly through securitisation and a change in banking strategy to the so called "originate-to-distribute model". This model allowed banks to originate loans, pool credit risks and sell them on to investors. The securitisation of mortgage loans became an important platform for the originate-to-distribute model. Initially, a problem that started in the US housing market, spread rapidly across borders and across other financial markets, particularly to where credit risk had been transferred but not exclusively. There continues to be a generalised uncertainty related to valuation losses of securitised products (USD 250-600 billion), the use of credit ratings, possible spillover effects to other financial institutions (including monoliners) and the overall impact of the turmoil on global economic growth. The recent developments in the US and in foreign financial markets are stimulating considerable review and analysis.

1 *B. Bernanke in a speech given in 2004 indicated that among the explanations for the Great Moderation (the decline in economic volatility in the past years) were structural changes led by deeper financial markets, a more stable monetary policy and good luck.*

Regulators, supervisors, central banks, accounting boards, rating agencies and academics are trying to distil lessons from the crisis. To help address and coordinate this endeavour, the Financial Stability Forum for instance, has set up a working group on Market and Institutional Resilience. This group has analysed the causes of the market turbulence and proposes policy directions to strengthen financial resilience. The results of the report will be available in April 2008.

The quality of financial globalisation matters

If markets remain fragmented, not all the fruits of financial globalisation can be reaped. Consequently, we probably need to work more in a concerted fashion to enhance the quality of globalisation. Let me address some lessons from the recent turmoil.

• First, I would stress that complacency in *risk management* is often fertile soil for financial distress. Complacency spread through global markets has contributed to over-optimistic assumptions for market liquidity conditions and led to a great reliance in rating agencies.

• Second, in the past, *liquidity risk management* had not been at the centre stage. Most improvements in liquidity risk management were tailored for each country. Today, there is consensus among supervisors and the banking industry that liquidity risk management needs to be upgraded to capture the implications of a more globalised financial system and the rapid growth in financial innovation.

• Third, the *originate-to-distribute model* encountered several shortcomings. The sub-optimal incentives in the chain of origination, acquisition and distribution led to a poor assessment of risks, based on the expectation that credit risk could be quickly transferred through securitisation. Another important weakness was the inadequate information on products and the quality of underlying assets. Moreover, the model's dependency on market liquidity made it extremely vulnerable.

• Fourth, recent events that have led to changes in the implementation of *monetary policy* through open market operations. G10 central banks took coordinated measures to bring money market rates back down to target levels.

• Finally, from our specific experience at the Dutch Central Bank, I must add that the combination of *central bank and supervisor* led to a successful internal communication structure and to timely interaction with the financial industry during recent events.

Follow-up issues

To conclude, the pace of financial developments has accelerated with financial globalisation. Consequently, we must remain exceptionally alert and flexible to encounter adverse dynamics that may threaten financial or economic stability. In my opinion, developments that should be followed closely are the strengthening of risk management and the implementation of Basel II. There are other interesting issues to follow-up such as the role of sovereign wealth funds in a context of globalised financial markets. I trust that the panellists will focus on this and other interesting issues in the coming hours.