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THE INTERNATIONAL AGENDA: IMMEDIATE PRIORITIES AND LONGER-TERM CHALLENGES

Remarks at the Asian Development Bank Institute Annual Conference, Tokyo, 5 December 2008

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- Honoured to address ADBi annual conference. I congratulate ADBi Dean Kawai on the choice of topic*: Asia's contribution to global economic development and stability*. Stability is indeed a global public good and nowadays it is in very short supply, to say the least. To paraphrase JFK, it is no time to ask what it can do for you but what you can do for it.

- I cannot remember any time when the sense of commonality was as high as it is now amongst countries participating in the world economy. Truly remarkable that policymakers coming from very different backgrounds and subject to very different political constraints have been able to agree at the G20 meeting on a set of principles to respond to the crisis.

- However several question marks remain and this is what I am going to focus my remarks on.

- I will address three aspects:
    - The short-term response,
    - The longer-term issues,
    - The institutional dimension.

1. The short-term response

- The speed at which policy thinking has evolved in recent months is striking. Many of the measures taken over the last year were simply unthinkable before 10 August 2007 – or even before 15 September 2008. There have been mistakes – some of them minor, like the ECB decision to raise interest rates in July, some of them major, as the US Treasury decision to let Lehman fail – but there has been a remarkable ability to innovate and learn from mistakes. Major difference with the Great Depression.

- Why?
    - Improvement in the ability of policymakers to learn from research insights, because of closer relationship between research and policy;
    - Also because policymakers have studied past experiences and have drawn lessons from them. Especially the Japanese banking crisis of the 1990s, the errors made in dealing with it, and the eventual success have served as a lesson.

- Nevertheless it remains to be seen whether the response will be <u>sufficient</u> and <u>appropriate</u>.

- By sufficient I mean proportionate to the problem. The shock we are all suffering from is of unprecedented magnitude and it is important not only to cushion its effects, but also to address the risk of a vicious circle between financial market developments and economic developments. This risk is still very much present and this is why governments need to act forcefully.

- North America, Europe and East Asia each represent about one quarter of world GDP at PPP exchange rates. Each needs to contribute to supporting global demand.

- More or less everywhere, monetary policy has moved or is moving aggressively towards easing – where there is still room – and unconventional measures are being contemplated. But there are limits to the effectiveness of monetary policy when money markets are clogged and when lenders are reluctant to take the risk of lending.

- On the budgetary front, what we learn from the US is that a major fiscal support initiative is being contemplated. In Europe a coordinated response is desirable (Pisani-Ferry, Sapir and von Weizsäcker, 2008) but it is likely to be somewhat weaker. The European Council has endorsed the principle of a fiscal boost amounting to 1.5% of GDP but some countries, most notably Germany, are reluctant. It remains to be seen whether, on the aggregate, Europe will be coming up with something significant[1]. In East Asia, China has announced a major budgetary programme and Japan or Korea have also moved towards providing support.

- On the whole, what we are likely to see is, however, a rather uneven reliance on fiscal support. This can be regarded as a natural development as long as the magnitude of the stimulus is roughly commensurate with the magnitude of the shock. After all not all countries are affected to the same degree. The US, especially, has been hit much harder than the other major countries, and whereas Europe suffered directly from the financial crisis, for Asia the trade channel is more important.

- However, there would be reasons for worry if responses were to differ too much or in a way that does not correspond to economic realities. Supporting global demand is a common goal and it is important to avoid free-riding behaviour. If such behaviour were perceived to be the case, governments would most probably shift to supply-side measures, giving preference to subsidising their producers rather than to supporting global demand.

- This brings me to the appropriateness issue. The lessons from history are very clear: in the type of situation we are confronted with, it is of utmost importance to avoid having recourse to trade-distorting or trade-reducing measures. This is why we can commend the very clear commitment to this end included in the G20 communiqué – and regret that some countries have started departing from it.

[1] Saha and von Weizsäcker (2008) provide an evaluation of the size of the European stimulus programmes.

- The devil is in the detail and the temptation is to support your producers through trade defence, subsidies, or non-cooperative exchange-rate policies. Already we are seeing signs of such temptation on all three continents, and temptation can only grow as the recession unfolds. So a good start has been made, but a good start is not enough. The current crisis will test every country's commitment to international cooperation.

2. **The longer-term agenda: policy issues**

- Dean Acheson, who represented the US State Department at the Bretton Woods conference, notes in his memoirs that the gestation period of these agreements had been 'about twice as long as that of an elephant'. Indeed it was in 1941 that Keynes and Harry Dexter White had embarked upon the design of the monetary and financial architecture which 44 countries signed up to in July 1944.

- This tells us something about the level of ambition of the discussions initiated at the G20 summit in November. If the goal really is to rebuild the foundations of international financial stability, one has to start from a clear idea of what the problems are and what the likely solutions will be.

- At the risk of overstatement I would argue that the agenda for <u>regulatory reform</u> is, intellectually at least, rather straightforward. Indeed many of the developments that have led to the current crisis can be attributed to pervasive regulatory failure. Economic theory – event economics 101 – tells you that, in a world of imperfect information, the way contracts are designed is essential for determining attitudes towards risk. The standard contracts for credit origination, rating and executive pay, to take only three examples, were bound to create perverse incentives towards inadequate risk evaluation and/or excessive risk-taking.

- I am not saying that the solutions are self-evident. There are discussions, for example, between those who blame accounting standards and those who blame prudential ratios. There are trade-offs involved in the choice of response, especially between controlling risk and fostering innovation. There are institutional issues. There is the international dimension. But at least the diagnosis is reasonably well established and the type of response required is reasonably clear.

- However, we know that it would not be enough to address the regulatory failures one by one. Regulators do not think in systemic terms and they tend to miss correlations across risks. Indeed the most novel and challenging part of the agenda for reform is what is usually termed the <u>macro-financial dimension</u>. That is, the assessment of, and response to, threats to financial stability that arise from overall financial developments under certain macroeconomic conditions.

- On this issue there is much less clarity. It is telling that the G20 communiqué is, purposely or not, remarkably vague on the macroeconomic dimension. The key paragraph reads 'major underlying factors [..] were, among others, inconsistent and insufficiently coordinated macroeconomic policies, inadequate structural reforms, which led to unsustainable global macroeconomic outcomes'. This is obscure in the extreme.

- The analytical question for us economists is twofold:
  - Whether monetary policy in the US should have been more restrictive and whether this would have helped to avoid an excessive rise in asset prices, and;
  - Whether what we used to call global imbalances contributed to creating the problem and whether a less complacent attitude towards them would have helped.
- These are closely related but not identical questions. The second one is in fact broader because it involves other potential policy remedies, including fiscal and regulatory policies.
  - On monetary policy I have sympathy for the view expressed by the Federal Reserve that somewhat tighter monetary policy would have helped containing the housing and credit bubble but would not have changed the overall picture fundamentally. A central bank whose mandate is to maintain price stability (and even more one whose mandate is dual, like the Fed) can factor in the risk that asset price inflation will ultimately translate into price inflation and therefore err on the side of caution, but it cannot go much beyond. For sure, the low interest-rate environment contributed to the asset-price bubble, but for the Fed to prick the bubble, it would have had to raise interest rates much more aggressively than allowed by its mandate.
  - I think there is more in the view that global imbalances contributed to the problem. Remember Ben Bernanke's global savings glut or the academic version of the same story, the model of Caballero, Fahri and Gourinchas (2007). The rationalisation given to global imbalances was in both cases that the US had a comparative advantage in the supply of financial assets and that the rest of the world had high demand for those assets. So the simple story is that there was excess demand for US AAA assets and the US financial system responded by manufacturing more assets of lower quality.
- This simple story is not entirely satisfactory. It does not tell us why the balance between demand and supply involved quality rather than price adjustment, nor why European rather than Asian institutions accumulated toxic assets on their balance sheet. After all, Europe was not exporting much of its savings so it requires a more elaborate story to explain why Asia bought plain-vanilla government bonds while Europe bought the toxic waste.
- But the story is sufficient to warn against the neglect of the macro-financial dimension and to suggest responses that take it into account, both nationally and internationally.

- To start with the national dimension, if macroeconomic developments played a role in creating favourable conditions for excessive risk-taking, then as in previous financial crises, and if there are limits to what monetary policy can do to counter them, this has implications for regulatory design. Put simply, the less macroeconomic factors are taken into account, the tighter sector-specific and product-specific regulations have to be because they have to be suited to situations that are particularly auspicious for risk-taking.

- It is somehow like deciding on safety standards for a car and its components. Road quality standards, speed limits and signposts on the road are also there to ensure safety, and the less effective they are, the more your car needs to be equipped for rough conditions.

- This is why the macro-financial issue is high on the agenda. At national level, proposals have been made to equip policy institutions – either the central banks or an institution in charge of market stability – with new instruments to tame threats to financial stability (see for example Shafer, 2008). But there are other options to address the problem. There is in fact no water-tight distinction between micro and macro responses: automatic financial stabilisers stand somewhere between the macro-blind regulatory response and the discretionary macro response. For example, Kashyap, Rajan and Stein (2008) have proposed giving incentives to banks to subscribe to state-contingent capital insurance to make sure that they would automatically have access to additional capital in case of macrofinancial stress.

- Unsurprisingly, and in many ways appropriately, this brings us into the familiar 'rules vs. discretion' debate. How to strike the balance between automatic stabilisation and discretionary intervention is bound to be an important issue on the policy agenda.

- Turning to the international dimension, two issues deserve attention.

  - The first has to do with the international spill-over effects of regulatory policies. These are important, as uneven regulatory requirements are bound to trigger capital flows and/or the relocation of financial actors, and this has implications for the choice between rules-based and discretionary approaches: rules lend themselves more easily to coordination among independent national regulators.

  - The second issue is that recognising the importance of macro factors highlights the importance of effective multilateral surveillance of the risks to global financial stability and their links to macroeconomic developments. This surveillance does exist – in fact the Global Financial Stability Report of the IMF and the Annual Report of the Bank for International Settlements for 2006 or 2007 included strong warnings. But its effectiveness has been limited, to say the least. This brings me to my last point: international institutions, their role and their effectiveness.

3. **The longer-term agenda: institutions**

- Appropriate to start with <u>two major changes in the landscape</u>:
  - Emergence of G20 as a substitute to the G7
  - Emergence of the FSF as an effective regulatory body

- Each has its problems. G20 is a very welcome addition. The recognition of reality. But it has not yet passed the test of time.
  - Large and diverse. Unlikely to play the role of the G7, which has been more successful in addressing the problems of others than in addressing problems among its members. Coordination record of G7 is very weak, but has been successful in defining common positions on Russia or Argentina.
  - Likely : a slow learning process. G7 countries have to learn that they are not running the show any more, emerging countries have to learn how to cope with interdependence and the responsibilities this implies.

- FSF has been surprisingly successful so far (Angeloni, 2008). It has no status, no structure, no decision-making power and no staff, but it has been able to steer a coordinated regulatory response.
  - Question is why it has been successful. Most probably because of a combination of a clear political mandate from the G7, intellectual proximity among participants and, paradoxically, absence of formal powers. It is easier to engage in coordination when you know that it does not entail any formal transfer of power;
  - Question is how the FSF will perform in the future. An enlarged FSF operating in a quieter environment may face more difficulty reaching consensus and fostering implementation of commonly agreed guidelines.

- Anyway the landscape has changed and this raises questions: <u>what consequences for the institutional architecture? Especially, what role for the IMF?</u>
  - The Fund is not the central institution it once was, and it is not likely to regain its past centrality. It is one among several. Clear difference with Bretton Woods' time and even with ideas discussed at the time of the Asian crisis.
  - Certainly, it is in a better situation than a year ago. Then, there were
    - Questions about its relevance in a world of capital mobility. It is now back in business and questions today are rather about the adequacy of its resources in response to increasing demand for assistance.
    - Regional challenges – mostly but not exclusively in East Asia. Response provided in Europe with programmes for Hungary and soon Latvia suggests that Fund assistance can and probably will be combined with regional

support, but that in a situation of high risk aversion the Fund label has considerable, I would even say indispensable value.

- However, conditional financial assistance is the monopoly business of the Fund. What about its other businesses, especially surveillance?

- The surveillance record
  - Not a strong record. Good analysis – and Fund has strengthened intellectual credibility with Global Financial Stability Reports and World Economic Outlooks, that have been more accurate than most other assessments or forecasts – but few results.
  - Weak surveillance of US macro and financial developments. Nobody can remember what the Fund told the US authorities about their domestic policies. The Chinese insist that surveillance must start with 'the reserve currency-issuing countries' and they clearly have a point.
  - Exchange-rate surveillance as currently envisaged is a dead-end. At US insistence the Fund was recently made able to slate countries contributing to 'external instability', but it has been unable or unwilling to say anything clear to China. So the Fund has been too shy to resist US pressure and then too shy to criticise China.
  - Multilateral consultations were an innovative and well thought-out initiative but probably because of a lack of ownership among participant countries, they did not result in anything significant.
- Which way forward?
  - Problems of governance. Very hard for an institution to openly criticise its major shareholders. There is a need to reform further (including through reducing and consolidating Europe's representation, see Ahearne et al., 2006), but it will not be enough on its own.
  - One response could be to make country surveillance more independent. Already WEO and GFSR reports are issued under the responsibility of staff. Why not extending this to country reports? To vote on an analysis is not best practice. Fund analysis should be released under the responsibility of management.
  - On exchange rates there is an inconsistency in the procedures. A statement by the Fund that a country's policy contributes to external instability – let alone that it is manipulated – would almost certainly trigger a procedure at the WTO. So we are speaking of quasi-judicial powers and for them to be exercised the Fund would need

quasi-judicial procedures. The model here should be the WTO panels that decide on trade conflicts.

  - Absent such powers, the role of the Fund should rather be to provide expertise to the G20, that is, to help to base discussion on sound analysis but not to decide. This is what Mervyn King (2006) called the role of a cricket umpire instead of a referee (I have no idea what this means, which is why I find the image fascinating).

- We are thus talking of a complex and evolving landscape. Robert Zoellick (2008) was right to speak of a 'Facebook of multilateral economic diplomacy'. He is right. And we know that on Facebook the important thing is to make friends.

4. Conclusions

- Challenge to policymakers is not to waste time before addressing the urgent tasks ahead of them and not to lose the momentum for reform created by the crisis. The sense of urgency and commonality that characterised this autumn should not be lost.

- But at the same time there are difficult issues that deserve to be analysed and discussed. While some aspects are clear, research is still far from having fully understood the root causes and the mechanisms of the crisis – let alone being close to drawing policy lessons from it.

- Furthermore, the G20 has yet to develop the kind of common analytical framework which the G7 has been able to achieve, a framework that does not imply consensus but does facilitate making the best of differences of view.

- So there is a need to move fast while acknowledging that an unambiguous lesson born of experience is that there is nothing the best possible science can do to shorten the gestation period of a baby elephant.

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