Fabrizio Saccomanni: Managing international financial stability

Edited text of remarks by Mr Fabrizio Saccomanni, Director General of the Bank of Italy, at a meeting at the Peterson Institute for International Economics, Washington DC, 11 December 2008.

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I am delighted to be here at the Peterson Institute to present my views on international financial instability before such a distinguished audience of eminent scholars and officials, among which I am fortunate to count many old friends. This is my first visit to the Institute since I was invited to join its Advisory Committee and I would like to express my gratitude to Fred Bergsten for the invitation. I am honoured to participate in this important body of the Institute and I look forward to contributing to its activity in the promotion of policy–oriented research in the field of international economics.

Instability in the age of globalization

International financial instability is a subject that has fascinated and intrigued me since when I was a young economist at the IMF and witnessed with considerable anxiety the collapse of the Bretton Woods system on August 15, 1971. The ensuing decade of instability was mostly attributable to the shock of the downward floating of the dollar and the resulting two oil-shocks of 1974 and 1979. After some unsuccessful attempts to rebuild Bretton Woods, the negotiations for the reform of the international monetary system ended in 1976 with the legalization of freely floating exchange rates and that seemed sufficient to fix the problem. A tired US Treasury Secretary, William Simon, commented: “All is well that ends”.

At the beginning of the 1980s, following the process of liberalization, deregulation and privatisation set in motion by Margaret Thatcher and Ronald Reagan, it was widely expected that full international capital mobility would interact with floating exchange rates to ensure adjustment of balance of payments disequilibria and a stable financial environment. Instead, these new conditions paved the way for the emergence of a global financial system in which financial innovation and the ICT revolution combined to produce an extraordinary expansion of financial sectors and markets compared with the real sector in both industrialized and emerging countries. The seeds of instability were thus planted on fertile soil. Indeed since the 1980s financial disturbances have occurred with increased frequency and intensity and have entailed major international repercussions.

I will not review here the long list of debt crises, currency misalignments, illiquidity in credit markets, asset price bubbles, that have characterized the age of globalization, a subject to which I have devoted considerable attention in the last few years.[1] I would rather quote from a paper written by Michael Bordo, Barry Eichengreen and others in 2001 on “the crisis problem”:

> *since 1973 crisis frequency has been double that of the Bretton Woods and classical gold standard periods and matched only by the crisis-ridden 1920s and 1930s. History thus confirms that there is something different and disturbing about our age*.[2]

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[1] See Saccomanni F. (2008), *Managing International Financial Instability. National Tamers versus Global Tigers*, Cheltenham, UK and Northampton, Ma: Edward Elgar.

[2] See Bordo M., B. Eichengreen, D. Klingebiel and M.S. Martinez-Peria (2001), “Is the Crisis Problem Growing more Severe”, *Economic Policy*, April, pp. 53-82.

So, given that the situation has not improved since 2001, what is different and disturbing about the age of globalization? Here are some features that I regard as crucial.

What is different

- The world economy operates under a "market-led international monetary system" in which market forces determine exchange rates and the international allocation of capital. This is the key point of a paper Tommaso Padoa-Schioppa and I wrote for a conference organized by Fred Bergsten and Peter Kenen at this Institute to celebrate the 50th Anniversary of the Bretton Woods System in 1994.[3] In the paper we underlined the risk that the increased globalization of financial markets could lead to "disturbances that may have an impact on the stability of the financial system".
- Global financial intermediaries operate in a highly competitive environment, but with essentially uniform credit allocation strategies, risk management models and reaction functions to macroeconomic developments and credit events.
- Financial innovation (mainly through securitization and derivatives) has greatly enhanced the ability of global players to manage market and credit risks.

What is disturbing

- There is no stability-oriented anchor for the macroeconomic policies pursued by systemically relevant countries.
- Monetary policies targeted exclusively to consumer price inflation are not likely to prevent unsustainable trends in credit flows and in asset prices (equity, real estate, bonds, foreign exchange).
- The procyclicality of the financial system has been enhanced by factors leading to excessive credit creation followed by sharp credit contraction. These factors are related to both market dynamics (underpricing of risk, overestimation of market liquidity, uniformity of financial strategies and of risk management models, information asymmetries, herd behaviour) and to financial regulation (capital requirement, fair value accounting).
- Perverse incentives and loopholes in the regulatory system have made it possible for financial innovation to transfer credit risks to unregulated entities.
- Widespread conflict of interest, between originators of financial products, credit rating agencies and law firms, has facilitated the dissemination of highly complex, risky and opaque instruments among investors with inadequate risk management culture.

The response to financial instability

The response of the international community to the episodes of instability that have affected the world's monetary and financial system since the 1980s has been on the whole conducted on a case-by-case basis, with an emphasis on "domestic" factors and circumstances, rather than on "systemic" determinants. This has reflected the prevailing conventional wisdom

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[3] See Padoa-Schioppa T. and F. Saccomanni (1994), "Managing a market-led global financial system" in P.B. Kenen (ed.), *Managing the World Economy. Fifty Years After Bretton Woods*, Washington, DC: Institute for International Economics, pp. 235-68.

according to which crises are inevitable as they are mostly the result of immutable human factors like greed and gullibility. Crises are also seen as part of a physiological process whereby “unfit” market participants are eliminated and the “fittest” survive and become stronger. In this context, market excesses are tolerated in the conviction that they will self-correct in a relatively short time. From a policy point of view, the conventional wisdom recommended the so-called “house-in order-approach”. This assumes that all imbalances have a domestic origin and that, if all countries adopt appropriate policies at home, there would be no systemic problems to cope with and therefore no need for an internationally coordinated response. Obviously, domestic factors do play a role in triggering crisis situations, but they are often amplified and propagated by the operation of global financial markets. Thus a balanced response to crises should ideally address both types of factors.

In reality, the policy response has been generally biased towards adjusting the domestic causes of imbalances, such as in the case of IMF financial support packages to emerging countries during the 1990s. Actions targeted to tackle systemic problems have been sporadic or partial in scope. Occasional interventions to correct exchange rate misalignments of major currencies have been conducted by G7 countries, but have been mostly of an “oral” kind in recent years, despite some evidence of success in arresting unsustainable or unwarranted trends, such as the appreciation of the dollar in the mid-1980s, the appreciation of the yen in 1995 or the depreciation of the euro in 2000.

Also the much-hyped “reform of the international financial architecture” (IFA), launched by the G7 countries after the Asian-Russian crisis of the 1990s, turned out to be focused essentially on the need to strengthen financial systems in emerging market countries, mostly through the adoption of a series of standards and codes of good conduct. The plan drew criticism from a high level Task Force, set up by the Council on Foreign Relations and led by Morris Goldstein,[4] for not addressing more fundamental issues, like the moral hazard implied by IMF sponsored bail-outs or the overlapping of roles of the IMF and the World Bank in crisis management and resolution. A minority of that Task Force, including Fred Bergsten and Paul Volcker, criticized the plan for ignoring the question of reforming the world’s exchange rate regime, an omission that they equated to “watching Hamlet without the Prince of Denmark”.

In the end the IFA reform obliged the IMF to invest a large amount of resources in a Financial Sector Assessment Program (FSAP) which produced reports, highly valuable but not widely read, on almost all its member countries, but with the significant omission of the United States and China. Another main objective of the reform, that of closing loopholes in the financial regulatory regime, again forced the IMF to concentrate mostly on the activity of off-shore financial centres based in exotic islands, rather than on hedge funds and other unregulated financial market participants of greater systemic relevance.

At a conference on “Reforming the IMF for the 21st Century”,[5] organized in 2006 by this Institute, the mandate of the Fund, its governance and resources, were thoroughly reviewed by an impressive range of academics and officials, including the Managing Director of the Fund. In that context it was recalled that financial sector supervision had led to “a mission creep” in the IMF, diverting resources from its key institutional task of conducting surveillance on macroeconomic and exchange rate policies of member countries. This concern way bluntly underlined by a senior US Treasury official, claiming that the IMF had been “asleep at the wheel of its most fundamental responsibility – exchange rate surveillance”.[6] However,

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4 See Goldstein M. (ed.) (1999), *Safeguarding Prosperity in a Global Financial System. The Future International Financial Architecture* (Goldstein Report), Washington DC: Institute for International Economics.

5 See Truman E. (ed.) (2006), *Reforming the IMF for the 21st Century*, special report, April, Washington, DC: Institute for International Economics.

6 See Adams, T.D. (2006), “The IMF: back to basics” in E.M. Truman (ed.), Reforming the IMF for the 21st Century, special report 19, April, Washington, DC: Institute for International Economics, pp. 133-8.

this unexpected “wake-up call” turned out to be less motivated by global stability considerations, than by more prosaic concerns about the widening bilateral trade gap of the United States with China, entirely attributed to the undervaluation of the renminbi. Ted Truman, who had chaired the conference, concluded that: “The IMF is in eclipse as the pre-eminent institution of international financial cooperation. Consequently, the world is worse off.”

To have permitted this “eclipse” is probably the most crucial flaw in the response of the international community to the challenges of globalization. It led to the perception by the markets, and the public opinion in general, that widening global payments imbalances, exchange rate misalignments, fast growing monetary and credit aggregates, exceptionally low risk *premia*, were not seen as posing a threat to global financial stability. This perception was reinforced by the recent decision taken by the IMF shareholders to “downsize” the institution because its lending activity to members had shrunk to almost nil in the high tide of international liquidity, as if it had nothing else to do.

The international community thus went on to confront the worst economic and financial crisis since the 1930’s with unjustified complacency, ill-prepared, and with its key institution weakened by internal policy disagreements.

The response to the current crisis

In reviewing the response to the current crisis, I will not address the unprecedented array of immediate crisis management measures undertaken by central banks and national Governments in the major countries to underpin banking and financial systems and to support economic activity. I will rather concentrate on the longer-term work being undertaken in the IMF context, in the G20 and in the Financial Stability Forum (FSF) to reform the international monetary and financial system in order to make it less crisis-prone than the present one and more resilient to shocks. On this more systemic issue, a lively debate has developed involving politicians, academic economists and financial analysts. A recurrent theme in the debate is the call for a “new Bretton Woods” and the recent meeting of the Heads of State and Government of the G20 here in Washington last November was seen by many observers as the starting point of a process that could lead to a fundamental reform of the world’s monetary and financial system.[7]

If by a “new Bretton Woods” one means a system built upon the foundations of the “old” one, it may be appropriate to recall how this was shaped. In essence, the Bretton Woods system was based on three main pillars: (i) a stability-oriented anchor for macroeconomic policies, operating through the par-value regime for member currencies in terms of gold and the US dollar; (ii) an obligation to maintain freedom from restrictions for trade and other current international transactions; (iii) the possibility of introducing restrictions on capital movements for restoring equilibrium in the balance of payments. Obviously, in any reform project, these pillars would have to be adapted to the new reality of financial globalization. Leaving aside for a moment the “anchor” question of the first pillar, it must be noted that in the G20 Summit Declaration of November 15, 2008 one can find encouraging language on the issues covered by the two other pillars.

As regards free trade, paragraph 13 of the G20 Declaration has strong words on the “importance of rejecting protectionism” and a firm commitment both to “refrain from raising new barriers to investment or to trade in goods and services” and to strive for “a successful conclusion of the WTO’s Doha Development Agenda with an ambitious and balanced

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[7] See, for example, Eichengreen B. and R. Baldwin (eds) (2008), “What G20 Leaders Must Do to Stabilise our Economy and Fix the Financial System”, London: Centre for Economic Policy Research, a VoxEU.org publication circulated on the web on the eve of the G20 meeting.

outcome". This is a rather non ritual language and it sounds pleasantly out of tune with the widespread feeling that protectionism is on the rise again as a result of the crisis.

As regards financial regulation, paragraph 9 of the G20 Declaration broadly outlines an approach that rules out any form of old-time restrictions that would impede or distort the operation of financial markets. This is good, and it should allay the fears of a return to the past. However there is a strong commitment "to ensure that all financial markets, products and participants are regulated or subject to oversight as appropriate to their circumstances". The G20 further outlined the need to strengthen transparency and accountability, to promote integrity in financial markets and to reinforce international cooperation in the regulatory field, broadly endorsing the program and the division of labour agreed upon in this field by the Managing Director of the IMF and the Chairman of the FSF. The FSF, in the words of Chairman Draghi, is working in particular to ensure that financial systems would have more capital, less leverage and would be subject to more effective regulation. This would imply, inter alia, reducing the procyclicality of the regulatory framework and its reliance on "self-regulation" by market participants, which paves the way to "regulatory capture". This is a welcome change from the attitude that allowed in the past a growing proportion of markets, products and participants to go unregulated on the grounds that "they have no systemic impact". This is the attitude that brought to us the "shadow banking system" made up of unregulated SIVs and conduits, distributing opaque structured products containing subprimes and other risky assets with the active marketing of unregulated rating agencies.

Obviously, the systemic impact of these G20 commitments will depend on the actual outcome of the negotiations underway in the relevant trade and regulatory bodies.

Turning, finally, to the anchor question I must say at the outset that this is the area where little progress has been made so far in official *fora*. The G20 Declaration mentions the need to reform international financial institutions, but mostly to reflect more adequately "changing economic weights in the world economy in order to increase their legitimacy and effectiveness". How can we be sure that these steps will ensure that a global crisis such as the present one will not happen again? Pro-cyclicality is an inherent feature of all financial systems and it is likely that a mere rebalancing of power would not achieve significant results in the absence of effective supra-national mechanisms to promote stability-oriented macroeconomic policies at the national level, especially by systemically important countries. Unfortunately, the G20 Declaration has placed insufficient emphasis on measures against the perpetuation of policies that led to unsustainable imbalances at the global level in the recent past.

These are difficult problems, but the time has now come, perhaps, to have a fresh look at what are the possible technical solutions. I do not think that the "old Bretton Woods" can offer a viable arrangement for the 21st Century: fixed exchange rates are gone. And yet one must admit that freely floating exchange rates have not really helped the adjustment of global imbalances. Perhaps this is because currencies have now become financial assets that are traded for profit motives with little or no relation to the economic situation or the balance of payments of the issuing country: the exchange rate has thus become more part of the problem than of the solution.

From this point of view it would appear more logical to look again at anchors based on a system of target zones for key currencies or to a substitution account that would replace national reserve currencies with the SDR, which I presume is still alive somewhere. But although logical, a revival of these proposals seems hardly promising for reasons that are perhaps more ideological than practical but that are still strongly held.

Realistically, the only anchor that one can think of today is an *institutional anchor*, i.e. an anchor based on institutions endowed with effective multilateral surveillance powers. This, again, is easier said than done. Willem Buiter, with his typical bluntness recently wrote: ”Don’t waste time on multilateral surveillance. The IMF will never have any influence on large member states with strong government budgetary positions and strong external positions”.[8] This is a valid point and indeed so far IMF surveillance has not been very effective despite various attempts to strengthen it. Yet, in my view, a further effort by the international community in this direction is needed.

As I argue in my book, the IMF, drawing also from the expertise of the FSF and other relevant international institutions and standard-setting bodies, must be entrusted with the task of identifying unsustainable trends in payment imbalances, credit flows, asset prices, exchange rates, and of formulating specific policy advice to the relevant member countries to promote monetary and financial stability. This is an area where additional research is required and where the IMF could supplement the analytical work conducted by the Bank for International Settlements and in the central banks’ community. Monetary policies and regulatory measures should be designed to complement each other in the context of a “macro prudential approach”, whereby the objectives of fighting inflation and preserving stability in financial systems could be jointly pursued.

If the policy indications formulated in the context of IMF multilateral surveillance are not followed, the IMF should make its own assessment known to the public opinion. It is possible that this may create a certain volatility in financial markets, but it will also strengthen the market perception of a two-way risk, thus contributing to brake unidirectional unsustainable market trends that inevitably lead to credit booms (and busts), bubbles, and misalignments.

In the end, I think that the gravity of the present crisis requires a strong determination to correct the flaws and the inadequacies of the present market-led international monetary and financial system. In embarking in this difficult effort, the international community should follow the good suggestions that Barry Eichengreen and Richard Baldwin outline in the Introduction to the book I have already quoted: “strengthen existing institutions; start thinking outside the box; do no harm”.[9]

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[8] See Buiter W. (2008), “Some Suggestions for the G20 on November 15th” in Eichengreen B. and R. Baldwin (eds), op. cit., pp. 17-20.

[9] See Eichengreen B. and R. Baldwin (eds), op. cit. pp.1-2.