Lorenzo Bini Smaghi: What has the financial crisis taught us? The global dimension and international policy cooperation

Speech by Mr Lorenzo Bini Smaghi, Member of the Executive Board of the European Central Bank, at the 21st Century Forum 2010, Beijing, 7 September 2010.

*   *   *

Abstract

A striking feature of the crisis is the synchronised manner in which shocks have been transmitted across market segments and countries. And a key lesson of the crisis is that keeping an economy in order does not necessarily insulate it from external shocks. An excessive focus on the domestic economy may exacerbate global economic and financial imbalances, ultimately making future global crises more likely and more severe. The key challenge faced by global policy-makers is to make the system safer and avert future crises. A new paradigm for international cooperation is thus required from global policy-makers – one in which longer-term objectives, such as sustainable growth, are fully internalised. The speech also highlights the importance of peer-reviewed mechanisms and strong surveillance in this context.

Introduction[1]

It is a great pleasure to share with you some thoughts about the financial crisis, which will be the focus of my talk today. If I had to pick a striking feature of the crisis from which we can draw lessons for the future, I would choose the term "contagion". It's contagion that has made this crisis truly global. The synchronised manner in which shocks have been transmitted across market segments and countries is perhaps what distinguishes this crisis from previous ones. The growing interconnectedness of the world economy has enabled the crisis to spread above and beyond what would be warranted by fundamentals and to attain a truly global dimension.

To me, a key message for all of us from the crisis is that keeping an economy in order, keeping one's own house in order, so to speak, does not necessarily insulate it from external shocks. Moreover, an excessive focus on the domestic economy may actually exacerbate global economic and financial imbalances, ultimately making future global crises more likely and more severe. The key challenge faced by global policy-makers is to make the system safer and avert future crises. No country is immune to them.

Strengthening international cooperation in the global economic and financial sphere is crucial. Policy-makers have been paying lip-service to international cooperation for years. It is a policy prescription that is commonly stated but – let's admit it – rarely defined, and therein lies the problem. To some, the upper bound of international cooperation is determined by the advice to put your house in order. Understood in this way, international cooperation is an exercise in which the national authorities are solely responsible for identifying and solving problems, albeit in a process which is monitored by other parties. Advocates of such a form of cooperation – if we can call it that – tend to cite its advantages: they claim, for instance, that national authorities "know best" or that full sovereignty and the absence of finger-pointing increases the chances of achieving cooperative outcomes.

[1] I wish to thank Marcel Fratzscher, Marco Lo Duca and Francisco Ramón-Ballester for their contributions to this speech. I remain solely responsible for the opinions contained herein.

Moreover, the “put your house in order” approach to international cooperation neatly provides both the recipe for corrective action as well as the blueprint for the sustainability of the system: if each party managed to keep its own house in order – the theory goes – policy failures would not occur, negative spillovers would be contained, and crises would not happen.

In this talk today, I would like to explain why a system of international cooperation built on the “put your house in order” concept is insufficient to achieve global economic and financial stability.

I will outline the global roots of the crisis, and in particular how a lack of coordination of international policies was inspired precisely by the “put your house in order” approach to international cooperation. Insufficient cooperation was evident in a number of areas. There were, for instance, supervisory and regulatory inconsistencies involving systemic players as well as a lacklustre policy response to global imbalances. I will also review how the gaps in the system in turn helped the crisis to spread globally across segments and countries.

All of this suggests that maintaining the pre-crisis mode of cooperation – i.e. the one which did not anticipate and keep at bay the trouble we got into – cannot be a sustainable recipe for the recovery. I will argue that a new paradigm for international cooperation is required from global policy-makers − one in which longer-term objectives, such as sustainable growth, are fully internalised in a time-consistent manner. I will conclude by pointing to the importance of peer-reviewed mechanisms and strong surveillance in this context, and also draw on the European experience to this end.

1. The global roots of the crisis

In its most basic form, the crisis demonstrated the lack of cooperation at various levels:

Inconsistent rulebook

Before the crisis, the system displayed an interesting dichotomy, with finance being increasingly global while supervision and regulation largely remaining national in scope and only loosely coordinated internationally. The fact that rules and regulations differed for systemic players in areas such as bank capital and liquidity requirements or accounting standards was not thought to be a problem as long as the applicable “rulebook” was clear in each jurisdiction. This was consistent with the “put your house in order” premise for international cooperation. Few observers at the time paid attention to the apparent contradictions inherent in the system, but in hindsight the shortcomings resulting from this arrangement are all too evident. Diverging rules and regulations encouraged regulatory arbitrage by financial institutions. More broadly, the system was not equipped to cope with the international nature of the crisis. For example, the absence of a clear cross-border banking resolution framework in Europe conditioned the authorities’ initial response to the crisis in this field, which was initially hesitant and “national” in character. The absence of a common rulebook for global financial systems exacerbated other weaknesses in the “put your house in order” category, including poor risk management by institutions and a generalised underestimation of risk, leading to an overextended financial sector.

Global imbalances and negative externalities

Excessive global imbalances[2] had a major role in creating the fragilities that led to the crisis. Policies inspired by the “put your house in order” philosophy were the main determinants of

---

[2] Obstfeld and Rogoff, “Global Imbalances and the Financial Crisis: Products of Common Causes”, http://elsa.berkeley.edu/~obstfeld/santabarbara.pdf

global imbalances because they lacked medium-term orientation and global coordination. In other words, these policies were excessively short-term and did not fully account for the knock-on effects (or negative externalities) on each other.

The years prior to 2007 were characterised by low financial market volatility and risk premia across market segments and low yields across the maturity spectrum. In this environment, banks and other investors engaged in a "search for yield" spurring financial innovation. The pace of financial innovation exceeded the supervisors' and market participants' capacity to solve a number of valuation, risk management and incentive issues. The result was a highly opaque system of credit risk distribution.

The low-yield environment therefore played a key role in the accumulation of fragilities that led to the crisis. Its core macroeconomic precondition was a global glut in net savings as well as liquidity, coupled with a lack of safe financial assets at global level. The savings and liquidity glut was largely the outcome of policies that reinforced or insufficiently countered the effects of savings-investments and current account configurations.

Part of the responsibility for the creation of global imbalances lay with those countries that underestimated the risks of high consumer indebtedness and large current account deficits. However, export-led growth strategies pursued by several systemically important emerging market economies, including China, also contributed substantially to the build-up of fragilities at global level. These strategies, intentionally or not, led to persistent interventions in the foreign exchange market on a unilateral basis and the accumulation of large external reserves reinvested in the borrowing countries. In the short term, the strategies generated growth in these economies; however they had several negative effects, both at domestic and at global level. Domestically, they led to forms of financial underdevelopment that had negative consequences on capital allocation and income distribution. At global level, export-led growth strategies made it easy for the US to incur large and increasing current account deficits and to delay the necessary adjustments. They also gave rise to an accumulation of dollar-denominated assets which could not be reinvested in emerging market economies due to their financial underdevelopment in the form of a shortage of safe financial assets. Moreover, the build-up of these assets resulted in a de facto taxation of consumption and a subsidy for inefficient investment, which in turn prevented an efficient inter-temporal smoothing of consumption and a rebalancing of growth towards domestic demand.

All of these factors contributed to the compression of yields across the maturity spectrum. According to the average estimates of a pool of studies, central bank purchases of US Treasuries alone lowered US long-term interest rates by around 70 basis points, with some studies estimating an impact of up to 200 basis points.

Weak surveillance mechanisms

Surveillance mechanisms with "put your house in order" at their heart proved to be weak in the run-up to the crisis. The IMF recognised that a surveillance framework centred around "put your house in order" was insufficient to meet the demands of the world economy in 2007, when it updated its Decision on Bilateral Surveillance over Members' Policies and placed the concept of external stability (the country-level counterpart to international stability) at its heart. The Decision also reaffirmed that Fund surveillance should focus on promoting countries' external stability and examining whether a country's exchange rate, fiscal, monetary and financial sector policies are consistent with this objective. Unfortunately, the IMF's 2007 Surveillance Decision was never implemented as originally devised, largely because of some countries' resistance to having their exchange rates labelled as "fundamentally misaligned". The revised surveillance guidelines have shied away from this label in an effort to reduce stigma and thereby increase the traction of Fund surveillance with policy-makers. I will come back to this and other Fund efforts to modernise surveillance at the end of my talk.

Weaknesses in surveillance before the crisis were not only apparent in multilateral institutions but also in regional peer-reviewed mechanisms, such as the ones underpinning the economic governance of the euro area. The problems associated with the implementation of the EU's Stability and Growth Pact (SGP) and the statistical deficiencies which undermined confidence in Greece have been the salient examples in this regard. I will also come back at a later stage to the policy efforts undertaken by European authorities to deal with these shortcomings.

Not all the pre-crisis surveillance failings can be attributed to the inadequate identification of risks. Even when the policy prescription was correct, implementation was lagging. In 2006, the IMF organised a series of discussions with systemic players in order to devise a concerted solution to the problem of global imbalances. This initiative was an important step forward in itself, as it was a clear recognition that the system was not self-sustaining and that policy externalities on peers could be significant. However, the policy response by the parties involved in the IMF's multilateral consultation process on global imbalances was lacklustre.

2. The global transmission of the crisis

The level of interconnectedness in the world economy means that policies inspired by the "put your house in order" philosophy cannot insulate an individual economy from external shocks. In this context, the role for international policies is twofold. First, international cooperation can restore market confidence – the lack of which is an important source of contagion. Second, adopting a new regime of international cooperation to avert a new crisis would also benefit domestic financial and economic stability.

Channels of contagion

The crisis was severe; it developed very rapidly and had a global impact. After the collapse of Lehman, the shock caused substantive real costs almost everywhere. China, too, was affected: exports fell considerably and took 13 months to reach their pre-crisis (October 2008) level again. That is why I consider global contagion one of the most striking features of the crisis.

By using the word contagion, I want to emphasise that the crisis spread across countries in a way that went beyond what the traditional linkages, such as trade, or vulnerabilities implied by domestic fundamentals, would suggest.

The way the crisis spread indicates the existence of an interconnectedness which enables the fast transmission of both positive and negative shocks across economies through multiple channels. I would emphasise the role of "confidence contagion", in transmitting the crisis across the globe. After the collapse of Lehman, the steady worsening of the economic and financial environment in the shape of negative events that exceeded the most pessimistic expectations resulted in a situation of unprecedented "Knightian uncertainty". This shows how the failure of a systemic market player, such as a major financial institution or a sovereign, can make it an extremely complex task to map and quantify risks and to identify credible scenarios. The way the crisis unfolded shows that such a situation can lead to multiple market failures.

First, when uncertainty and risk aversion increase, international liquidity can dry up and investors can unwind in a disorderly way their positions with adverse consequences at global level.

After the failure of Lehman, uncertainty about the solvency of counterparties led to a run on US money market funds. As a consequence, a global shortage of US dollars emerged, affecting banks in emerging market economies as well.

Dysfunctional money markets and uncertainty about their own cash needs led banks to aggressively seek liquidity by unwinding their positions in several market segments.

Furthermore, in an attempt to strengthen their capital bases in the view of adverse market conditions and potential losses, banks became more risk-averse and sold off risky assets, amplifying the initial shock. The resulting disorderly unwinding of the positions of international leveraged investors resulted in a sell-off of emerging market asset classes and a sharp depreciation in the currencies of these economies. Gross capital inflows went into reverse and financing conditions were tightened, reducing liquidity across market segments and raising bond yields in both international and local currencies.

Second, uncertainty can also have other important real negative effects. Some studies highlight the role of uncertainty in business cycle fluctuations. For example, it has been shown that the collapse of stock prices in October 1929 generated temporary uncertainty about future income, which led consumers to forgo purchases of durable goods[3]. Additionally, theoretical and empirical studies show that major uncertainty shocks have a large real impact on the US economy, bringing about a substantial drop and rebound in output and employment. This occurs because higher uncertainty causes firms to suspend their investment and hiring. In turn, this affects consumer confidence and spending. Productivity growth also falls because this pause in activity freezes reallocation across units[4].

We saw how this mechanism can work after the collapse of Lehman in September 2008. The high level of uncertainty froze investment and consumer spending in advanced economies. In this context, trade was hit very hard, due to a composition effect, as it mainly comprises durable goods[5]. The mounting expectations of a global slowdown caused a rapid decline of commodity prices which impacted heavily on commodity exporters.

European experience: the Greek crisis, contagion and the role of European cooperation

The shock to market confidence generated by the Greek downgrade has parallels with the Lehman collapse in September 2008. Also in that case, contagion caused tensions across markets and countries. This reinforces the idea that policies inspired by the "put your house in order" philosophy are not enough to insulate a domestic economy from external shocks.

The Greek credit rating downgrade last April took place in a weak environment, with international investors extremely sensitive to negative events. Confidence contagion spread the shock across the region. Financial tensions quickly propagated across market segments in Europe. Contagion from sovereign risk moved to the banking system as the market focused on the exposures of European banks to troubled euro area governments. The loss of confidence in the banking system led to new strains in money markets. Furthermore, the shock spread across the globe through a network of leveraged international investors who moved to safe havens as soon as the business climate deteriorated.

On the eve of the first weekend in May financial markets were on the verge of a global contagion risk, with systemic implications. Correlation and volatility indicators increased to levels above those reached right after Lehman Brothers' failure.

In this context, the recent experience in Europe may illustrate how successful international cooperation can calm markets and halt contagion. To restore market confidence, the EU Member States agreed to establish a comprehensive package of measures, consisting mainly of three elements. First, it was agreed to speed up structural reforms and accelerate fiscal consolidation, especially in countries experiencing the strongest market pressures.

---

[3] Romer (1990), "The Great Crash and the Onset of the Great Depression", Quarterly Journal of Economics, Vol. 105, No. 3 (Aug., 1990), pp. 597–624.

[4] Bloom (2009), "The Impact of Uncertainty Shocks", Econometrica, Vol. 77, No. 3 (May, 2009), 623–685.

[5] Brincongne, Fontagné, Gaulier, Taglioni and Vicard, "Firms and the Global Crisis: French Exports in the Turmoil", Document de Travail n. 265, December 2009.

Second, the ECOFIN Council adopted a regulation setting up the European Financial Stabilisation Mechanism (EFSM), which allows the European Commission to raise up to €60 billion for lending to troubled EU Member States. Third, euro area countries established the European Financial Stability Facility (EFSF) to provide loans of up to a total of €440 billion to euro area countries in difficulty, subject to strong policy conditionality in the context of joint euro area-IMF programmes. On 15 June, the EFSF agreement entered into force and on 4 August the Facility was activated. The IMF is also expected to contribute by providing financing amounting to at least half as much the euro area contribution to each programme.

Both the EFSM and EFSF financial assistance will be subject to strong policy conditionality and take place in the context of joint EU-IMF programmes. These policy actions and the recent bank stress tests have succeeded in reducing market tensions and restoring confidence. I believe these policies were successful mainly because of the unprecedented and exemplary coordination at European level.

3. The way forward: exiting from the crisis through cooperation

The main lesson from the crisis is that global problems demand global solutions. We cannot get out of the crisis simply by maintaining the "put your house in order" approach to international cooperation; it should be dealt with in a coordinated fashion. In this context, I would like to emphasise the following:

Need for a consistent rulebook

It is clear that the global financial system cannot continue to effectively function under nationally based regulatory environments. This is why the work being conducted under the auspices of the G20 process on global principles for rules and regulations of various financial activities is important. For example, progress is being made by the Basel Committee on Banking Supervision (BCBS) towards a new regime for bank capital and liquidity standards, with the broad aim being to raise both the quantity and quality of capital, to be implemented by end-2012. The Financial Stability Board (FSB) has devised a number of standards for sound compensation practices, and is cooperating with other relevant bodies to establish a single global accounting standard. Discussions under the G20 aegis are also ongoing in a number of other areas, including the expansion of the perimeter of regulation and supervision (e.g. hedge funds, credit rating agencies, over-the-counter derivatives), and the treatment of systemically important financial institutions, including ways for the financial sector to contribute to the costs associated with government interventions. It is essential that these global initiatives are brought to a successful conclusion so as to ensure a comprehensive and level playing field for all parties.

In parallel, work is also under way to strengthen the existing framework for cooperation on financial regulation and supervision in Europe. Micro-prudential supervision is set to be reinforced with the creation of a European System of Financial Supervisors, including three new European Supervisory Agencies in banking, insurance, and securities. At the macro-prudential level, the European Systemic Risk Board (ESRB) is soon to be established to conduct oversight of the EU financial system in order to prevent or mitigate systemic risks.

Importance of strong surveillance

In a global economy marked by increasing interconnectedness, the potential for negative cross-border spillovers is high, implying that the need to appropriately factor in negative externalities arising from policy choices is greater. This is why strong surveillance is essential in the system. The IMF has recently made several proposals in order to modernise surveillance, including producing spillover reports and adopting a multilateral surveillance decision. Fund staff have put forward these instruments in order to fill the existing "policy

gap" in the Fund's bilateral surveillance. The gap means that member countries are not required to change their domestic policies as long as these are consistent with domestic stability, despite of their negative externalities for others. But policies cannot be judged only on the basis of countries' best short-term interests, for if they undermine stability in other countries, they might ultimately have negative repercussions at home. These initiatives are welcome insofar as they go in the same direction and entail a more accountable system with an appropriate factoring-in of negative externalities.

The Fund's efforts to modernise its surveillance practices is welcome. Adopting a "multilateral perspective" towards bilateral surveillance which systematically analyses inward and outward spillovers is one of the "surveillance priorities"[6] identified by the Fund for the 2008–2011 period. Other surveillance areas targeted for improvement include the analysis of exchange rates and external stability risks, risk assessment, and financial sector surveillance and real-financial linkages.

As far as Europe is concerned, the ECB has recently put forward a number of proposals[7] [7] to reinforce the economic governance of the euro area. These include: i) strengthening surveillance over budgetary policies and more effective prevention/correction of excessive deficits and debts, inter alia through the quasi-automaticity of excessive deficit procedures and sanctions; ii) an improved framework for competitiveness surveillance and the correction of economic imbalances; and iii) the design of an appropriate euro area framework for crisis management. These proposals will be taken up by the taskforce chaired by European Council President Van Rompuy which is looking at economic governance in the European Union. The taskforce is expected to report to ministers by October 2010.

The recent experience in the euro area also shows that surveillance cannot be "outsourced" or delegated to markets. Markets can be very erratic and move in a discontinuous fashion. The trends in euro area bond markets before, during, and after the crisis suggest that markets tend to undervalue risk in "good times" and overvalue it in "bad times". This is why market surveillance can usefully complement, but not replace, enhanced surveillance by policy-makers themselves.

Peer-reviewed frameworks as a way to achieve longer-term objectives

In the aftermath of the crisis, peer-reviewed frameworks could help to steer policy-makers' choices away from objectives which may appear beneficial in the short term but are ultimately unsustainable in the long term. In this context, the Mutual Assessment Process (MAP) for sustainable growth launched by the G20 is promising, as some weaknesses are better seen "from the outside".

In addition, peer-reviewed frameworks can also help countries to pool strengths and resources so as to better tackle common vulnerabilities, as European cooperation to solve the Greek crisis clearly demonstrated.

A new paradigm for international cooperation

A successful exit from the crisis requires not only an enhanced role for policy cooperation but also a new paradigm. For example, even if regulation and supervision are consistently strengthened at global level, the persistence of international imbalances (if left unaddressed) will continue to render the system vulnerable to crises. Policy-makers thus need to recognise the fact that the interconnected nature of today's world economy requires a different way of

[6] See https://www.imf.org/external/np/pdr/surv/2008/index.htm

[7] See "Reinforcing Economic Governance in the Euro Area", http://www.ecb.int/pub/pdf/other/reinforcingeconomicgovernanceintheeuroareaen.pdf

addressing policies as well as a stronger role for cooperation. A system in which some policy-makers accept a degree of "intrusion" into their policies as a quid pro quo for intruding into the policies of others, with externalities being internalised in domestic policy-making for the greater public good of global economic and financial stability.

4. Conclusions

Let me conclude with some general observations on international policy cooperation. There is often a divide between theory and practice when discussing this issue. In theory, it is not difficult to demonstrate that international cooperation, by which countries internalise the external impact of their actions, and that of the others, before taking decisions, and subject themselves to international agreements, produces Pareto superior solutions. In practice, however, national policy-makers rarely subject their policies to international considerations and tend to take decisions purely with domestic interests in mind. Global problems require global and coordinated responses but, as the saying goes, "All politics is local" and thus decisions are often taken in a partial equilibrium context. How can we reconcile this dilemma?

One way is to learn from experience. The recent crisis is largely a result of policy decisions which were taken without giving due consideration to the broader international environment and which frequently had very short-term objectives. There was no shortage of warnings. The multilateral consultation process, which involved five large economies in the context of the IMF in 2006–08 – in which both China and the euro area participated – pointed to the risk produced by growing imbalances and tried to focus the attention of policy-makers on longer-term policies necessary for achieving sustainable and balanced growth. However, little attention was given to these recommendations because there was no sense of urgency. The respective economies were still growing and there were no signs of crisis. The same applies today: as the world is gradually recovering from the crisis, the focus seems to have turned again towards very short-term targets related to growth and employment, but with little consideration paid to sustainability. There is a risk that the mistakes of the past will be quickly forgotten or even ignored as soon as conditions improve.

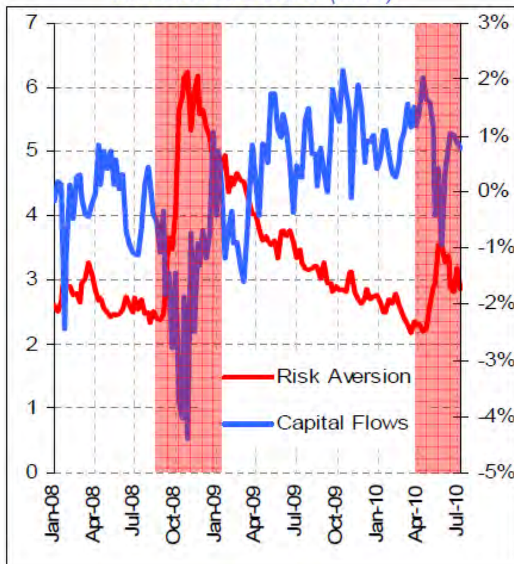
Those who do not learn from past errors are condemned to repeat them.

The alternative is to strengthen surveillance procedures and rule-based mechanisms which oblige policy-makers to pay more attention to external conditions and to medium-term objectives. This is the avenue we are following in the European Union. Stronger procedures to avoid nominal divergences within the euro area are currently being devised and a more rules-based implementation of the Stability and Growth Pact is in the process of being agreed by the Member States, in particular within the euro area. Stronger cooperation should not replace sound domestic policies, but these are easier to implement and to explain to the public if they are framed in a broader context.

No crisis should be wasted – it is often said. We have to recognise the problems of the past, learn from them, and also be ready to implement changes in the way policies are carried out. This is important both at European and at global level, where much remains to be done to strengthen the procedures and institutions that form the basis for cooperation.

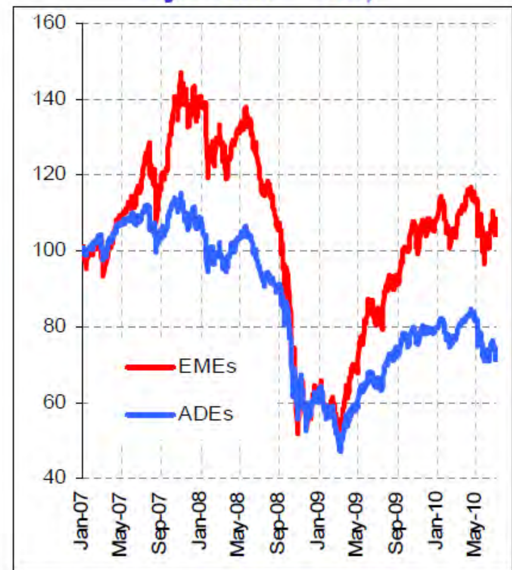
I thank you for your attention.

Capital Net Flows to EMEs (RHS) and Risk Aversion (LHS)



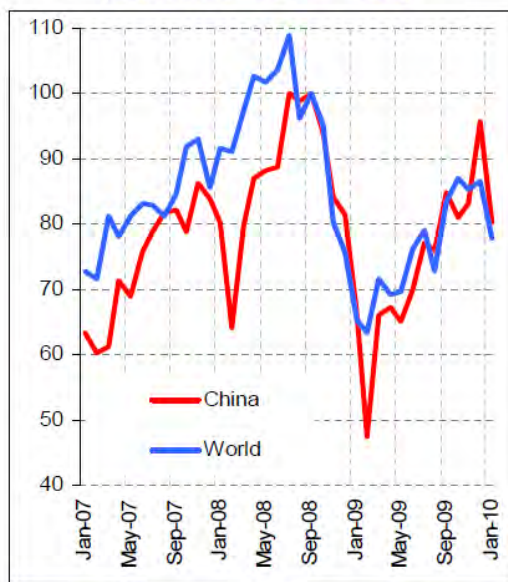
Source: EPFR and Bloomberg

Equity indexes (Jan 2007 = 100)



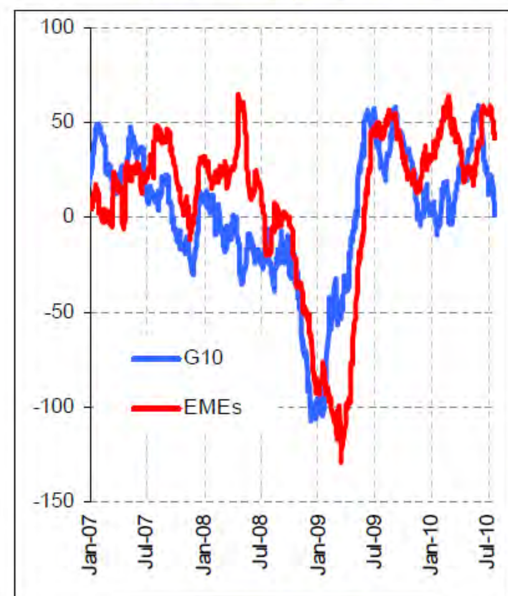
Source: Datastream

Exports (September 2008 = 100)



Source: IMF International Financial Statistics

Economic Surprise Index



Source: Citigroup