Mario Draghi: Challenges of surveillance and coordination

Introductory comments by Mr Mario Draghi, Governor of the Bank of Italy and Chairman of the Financial Stability Board, at the VIth International Symposium of the Banque de France on "Which regulation for global imbalances?", Paris, 4 March 2011.

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The recent crisis has greatly raised our awareness of two processes that have been shaping the world economy: first, the growing interconnections between economies, that make the global system vulnerable even to local shocks; second, the move towards a multi-polar setting in which no single dominant politico-economic power exists and new subjects, such as the fast-growing emerging economies, are coming to the fore.

Both processes are a reflection of fundamentally benign developments, such as free trade, free capital movements and the spreading of technological innovation which have brought enormous benefits to the world economy. However, as the crisis has forcefully shown, the potential for inherent instability is greater; and the damage that may result from this instability is too large to ignore.

In the past decades, after the end of the Bretton Woods regime, weak forms of policy cooperation prevailed. In terms of the international monetary arrangements in place, it was a "non-system". For a long time, stronger forms of international policy coordination were deemed unnecessary: many theoretical and empirical analyses in the 1980s converged to show that any gains from such macroeconomic coordination were likely to be of modest size.

However, we may now need to revisit that fairly sceptical conclusion. In the new global environment, policies (and policy errors) in individual economies can have substantial spillover effects. Moreover, the costs of uncoordinated policies may increase in a non-linear fashion if those policies lead to large systemic breakdowns.

In my view there is one main, simple lesson we should take from the crisis: if we want to preserve the gains brought by open, competitive markets on a global scale, we need stricter and more effective international cooperation.

The common response to the crisis was a quantum leap forward in international economic relations. With a coordinated, prompt and synchronous set of policy measures we managed to avoid the worst consequences for the global financial system and the world economy. As the situation improves, it would be naïve to think that we can now go back to the previous loose coordination.

There continue to persist underlying "fault lines" (to use the words of Raghuram Rajan) that pose significant risks at the global level: an uneven recovery, diverging economic policies, protracted low levels of interest rates, increased sovereign debts, large imbalances in international payments, and pressures on exchange rates.

Correspondingly, we should continue to improve international cooperation. There are three main priority areas:

– first we need to complete the reform of the international financial system;
– second, we have to develop a better system of macroprudential surveillance, refining the authorities' ability to identify systemic risk and, especially, to act upon early warnings;
– third, crucially, we need to establish a coherent set of norms, rules of conduct and formal institutions shaping coordination of national economic policies.

We have come a long way towards strengthening the financial system since the crisis began. My own experience in the Financial Stability Board is that it is certainly possible – at times even surprisingly easy – to come to a shared diagnosis and devise a common response even to extremely complex problems, when there is a willingness to do so.

The new Basel III regulatory framework is now in place, with new capital and liquidity requirements and limits to financial leverage. Its gradual phasing-in will prevent it from hampering the economic recovery. The over-the-counter derivatives markets will have a sounder and more transparent basis. We have identified many of the perverse incentives that encouraged excessive risk taking – in banks' executive compensation systems, in the role of credit rating agencies and in accounting rules – and we have begun to rectify them. The activity of the FSB is now concentrating – in accordance with the mandate given by the G20 – on two crucial priorities: tackling the moral hazard problem posed by systemically important institutions (SIFIs) and extending the rules to the "shadow banking system".

The reform of the financial system is however not complete. There is a danger that, as the world economic recovery advances, the sense of urgency – a major propeller so far – might now weaken. It would be unforgivable not to keep the momentum in international cooperation and miss the occasion to decisively strengthen the international financial system. There are two obvious compelling reasons for this. First, neither our public finances nor our citizens would be ready to withstand a new crisis. Second, in a global system where external imbalances remain large and capital flows may be subject to sudden reversals, it is essential to rely on a financial system that is at the same time efficient and more robust, immune to the perverse incentives that led to the accumulation of excessive risks that generated the crisis.

Consistent implementation of the agreed reforms at the national level is the arena where the effectiveness of international cooperation will be tested. In the absence of a global enforcer the only practical way forward is to strengthen both the peer review process and the reach of international institutions, *in primis* the IMF, which retains the responsibility for surveillance over the global financial system.

Significant progress has also been made in setting up top-down, system-wide oversight arrangements at the national, regional and international levels. These arrangements are designed to deliver more encompassing surveillance, with broadened macro-prudential perspectives and better mechanisms for triggering actions on identified risks. Examples include the European Systemic Risk Board in Europe, the Financial Services Oversight Council in the US, and the IMF-FSB Early Warning Exercise to assess macro-financial risks and systemic vulnerabilities at the global level.

A lot remains to be done in this, in many respects, unchartered territory. We now need to improve analytical tools, design instruments of intervention, elaborate organizational arrangements by which the different authorities can effectively share information and, especially, coordinate actions to prevent and to manage critical situations. A painful lesson of the recent crisis – and the many preceding it – is that the authorities did too little to act upon "early warnings" that, though weak and imprecise, were often clear enough to have warranted more forceful preventive action.

Challenges even more severe lay ahead on the macroeconomic policy front. Here the risk is very tangible that, with the emergency now over, a purely domestic orientation again prevails in economic policy decisions – a tendency of which some signs are unfortunately already evident. The consequence would be larger imbalances, increasingly erratic capital flows, and greater exchange rate volatility – all factors that ultimately can hamper the recovery. It is imperative to resist such tendencies and abide to the pledge – repeatedly stated by the G20 – to work together to ensure a lasting recovery and set the world economy on a path of strong and sustainable growth.

A "new Bretton Woods" is perhaps a rhetorical exaggeration but we do need a common realization that the present, weak cooperation arrangements for managing the world economy are inadequate. Greater interdependence requires stronger policy cooperation and some form of disciplining mechanism to ensure that national policies are mutually consistent. Stronger cooperation in turn necessarily presupposes an agreed set of benchmarks and rules in all the relevant fields. Individual economies should not only continue to “keep their own house in order” – which is probably at this point a still necessary, but insufficient condition. They must also be induced to take more fully into account the global effects of their own policies, whose mutual consistency needs to be ensured.

To achieve this objective we need a decisive improvement in the governance of the international monetary system, addressing those problems that have hindered its proper functioning. The central issue is, in my view, the need for a more effective process of multilateral surveillance over national economic policies.

Some steps forward are being taken. The “legitimacy deficit” of international bodies has been at least in part addressed with the agreement on the IMF quota reform at the Seoul summit of November 2010; the very same leadership role taken by the G20 in international economic affairs is a recognition of the need to increase legitimacy and representation. The IMF has been given more resources and more incisive monitoring power, for example by making FSAPs compulsory for all systemically relevant members over a 5-year cycle, and is enhancing its traditional machinery for surveillance (bilateral and multilateral).

In parallel the G20 is proceeding with its own peer review process (the Framework for Strong, Sustainable, and Balanced Growth) to identify objectives for the global economy and the policies needed to achieve them. The evaluation of the mutual consistency of such policies is the goal of the “Mutual assessment process” (MAP). The MAP requires an assessment of the nature and the root causes of impediments to the adjustment of persistently large imbalances and indicative guidelines, composed of a range of indicators, to facilitate a timely identification of imbalances that require preventive and corrective action. This is an essential and, at the same time, a very demanding task.

As agreed by the G20, there must be a shift to a more balanced global pattern of demand. Some progress in this direction is being made, but important challenges remain. Emerging market countries of systemic relevance ought to prioritize structural reforms and greater exchange rate flexibility to strengthen domestic demand; further fiscal consolidation is necessary in advanced countries, based on growth-friendly measures; finally, all G20 members should implement product and labour market reforms to boost their potential output.

It is also to be welcomed that both the IMF and the G20 under the French presidency have started ambitious and comprehensive discussions on possible avenues for the reform of the international monetary system.

Let me conclude by saying that in all the above fields Europe can and should bring to the international debate a wealth of experience. In Europe, we have come – in some cases rather belatedly – to the realization of the close interdependence among our economies and of the consequent need for effective rules and governance. The single currency is acting as a powerful device to reinforce surveillance, coordination and the peer review process in an institutional setting where economic policy decisions remain to a very large extent in the national domain. This makes Europe a natural laboratory for experimenting solutions that can be of use at the global level as well.