Gertrude Tumpel-Gugerell: Policy discipline and spillovers in an interconnected global economy

Speech by Ms Gertrude Tumpel-Gugerell, Member of the Executive Board of the European Central Bank, at the SNB-IMF High-Level Conference on The International Monetary System, Zurich, 10 May 2011.

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Ladies and Gentlemen,

First of all, it is a great pleasure to be here today at this conference.

In May 1351 – so from today almost exactly 660 years ago – Zurich became the fifth member of the Swiss Confederacy, which at the time was a loose confederation of de facto independent states to better coordinate policies and lawmaking among these states within the confederacy.

This example links nicely to the current need of better policy coordination and collaboration in today's world of growing global integration and interconnectedness through trade and financial links than ever.

The topic of today's session "policy discipline and spillovers in an interconnected global economy" is therefore extremely timely both from a global and European perspective.

In my intervention, let me, therefore, briefly touch upon four questions:

1. Under what circumstances can a lack of policy discipline lead to macroeconomic imbalances with destabilizing effects for the economy?
2. How can such imbalances spill over to other countries and the global economy?
3. What are recipes to prevent imbalances and their spillovers?
4. What can we learn from all this for the current situation in Europe?

So let me turn to the first question:

1. Under what circumstances can a lack of policy discipline lead to macroeconomic imbalances with destabilizing effects for the economy?

Prior to the crisis, the deficiencies of macroeconomic policies and the lack of sufficient international cooperation led to the build-up of unsustainable external imbalances among key deficit and surplus economies. Such global imbalances paved the way and contributed to the financial crisis to unfold. This has not only revealed insufficient policy discipline and cooperation, but also the lack of an effective mechanism to influence macroeconomic and structural policies in key countries where those appeared unsustainable from the standpoint of global economic and financial stability.

The global economy has become increasingly interconnected and its degree of integration will most likely continue to increase in the future. [Foreign trade is projected to exceed the pre-crisis levels next year, reaching a new historical high of about 64% of the world's GDP. Financial openness, defined as the amount of foreign assets and liabilities, is estimated to be more than 300% of the world's GDP in 2009]. This interconnectedness brings externalities and policy challenges. And the recent global financial crisis has been a reminder that this can have dramatic consequences on the stability of the international financial system and that national policies do not suffice in preventing such imbalances from occurring.

The growing integration of the world economy has contributed to create another dimension of loose policies: the failure to recognise the impact of domestic policies on other countries or the global economy, where the policies' externalities can be detrimental to global growth and the stability of the global economic system. This lack of policy discipline is often an outcome of an excessive focus on short-term objectives as opposed to long-run sustainability.

The exit from monetary policy easing and fiscal accommodation after a recession is a case in point. A delayed exit from accommodative monetary policy after a recessionary period may contribute to excessive risk taking and large international capital flows. As you know the ECB Governing Council decided to raise by 25bp its official rates in April. Similarly, exiting too late from stimulative fiscal policy may run the risk of triggering an adverse adjustment in global asset prices and global exchange rate configurations. In this respect, the commitment taken by the G20 countries to reduce their deficit by half by 2013 is of utmost importance.

2. How can such imbalances or policy failures can spill over to other countries and the global economy?

There are a number of historical examples, in which loose policies and the neglect of negative spillovers – led to imbalances and disorderly adjustments in international markets. In the late 1970s, the US was criticised by some observers for conducting an overly loose monetary policy, which allegedly led to a decline of the US dollar to historical lows. External imbalances widened (to about 2 per cent of GDP in aggregate terms at that time only!), and many countries, especially Japan and Germany, accused the US to seek gaining competitive advantages. It was the Fed's decisive policy action under Paul Volcker, raising the Fed's policy rate to a peak of around 20 per cent in 1981, which ended this "Great Inflation" experience.

Another – more recent – example for a lack of policy discipline comes from the euro area. Fiscal indiscipline in some – but not all! – euro area Member States had widespread financial markets implications. It is clear that there is a need to strengthen fiscal discipline significantly.

The ECB has called repeatedly for a "quantum leap" in this respect that would go beyond current proposals made by EU Heads of States and Governments, though the package proposed by the European Parliament is already an improvement in some respect. This "quantum leap" would include quasi-automatic applications of sanctions on the basis of clearly pre-defined criteria and without scope of discretion or waivers. I will come back to that later.

These examples show that many policy makers – even today – believe that the "put your own house in order" approach is a sufficient recipe for international cooperation. International cooperation is solely an exercise in which the national authorities have the main responsibility for identifying and solving problems, albeit in a process which is monitored by other parties. Advocates of such a form of cooperation tend say that national authorities "know best", or that full sovereignty and the absence of finger-pointing increase the chances of achieving cooperative outcomes. Moreover, 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.

I strongly believe that the "putting-your-house-in-order" concept is not sufficient in today's globalised economy. Raghuram Rajan wrote in his book "fault lines": "in an integrated economy and in an integrated world, what is best for the individual actor or institution is not always best for the system." Therefore, just as micro-prudential regulation has failed to identify key systemic risks in international financial markets, a narrow focus on national policies alone is unlikely to deliver the global public good of a stable global monetary system and sustainable growth. Failing to properly recognise the impact of domestic policies on others, and the second round feedbacks on the domestic economy can be detrimental to growth and stability.

An excessive focus on the domestic economy may exacerbate global economic and financial imbalances, ultimately making future global crises more likely and more severe. This is all the more true for systemically relevant countries, which have a special obligation for international cooperation.

3. What are recipes to prevent imbalances and their spillovers?

Sound macroeconomic policies at the national level can – of course – help to address external shocks and spillovers. But – as mentioned – there are clear limits of national policies with regard to fully prevent spillovers from systemic shocks or economic imbalances in an increasingly integrated world economy.

Moreover, a global economy requires global policies.

The G20 Framework for Strong, Sustainable and Balanced Growth, which is the first systematic multilateral assessment of global imbalances, is therefore welcome. It is a constructive approach to ensure that macroeconomic and structural policies of key countries take into consideration their external spillovers, and in particular the risks they entail for the global financial system. The recently agreed set of indicative guidelines for global imbalances is an important milestone in that respect. By using structural approaches, the G20 Framework will help us in benchmarking acceptable levels of global imbalances, and provide guidance on how to deal with unsustainable imbalances in an orderly manner. It is now of foremost importance to implement the Framework effectively, and to fully live up to the expectations that the G20 process raised internationally.

Multilateral surveillance on domestic policies of systemic countries to ensure their orientation towards medium term stability and sustainability should be strengthened on other fronts as well. The ECB has always been supportive of the IMF's Multilateral Surveillance Decision in this respect, and the recently conducted first round of IMF spillover reports can be seen as a step towards a broader and more comprehensive framework. Moreover, today's multilateral surveillance framework is probably insufficient with respect to disciplining mechanisms, and what is needed is a mechanism that ensures that IMF members look beyond their short-term policy goals and internalize their impact on the global system. What is needed more than ever, is a mechanism to ensure that the concept of external stability becomes a cornerstone of multilateral surveillance. This means that it needs to be taken into account whether a country's exchange rate, monetary, fiscal and financial sector policies are destabilising for other countries or regions. This would be a considerable strengthening of international cooperation to achieve our common goal of economic and financial stability.

4. What can we learn from all this for the current situation in Europe?

Also Europe had to learn the hard way that loose policies and large imbalances also in the private sector, rather than only the public sector, may have severe implications for public sector budgets and risk systemic crises. Especially in the banking sector, our regulatory framework and surveillance turned out to be insufficient. While finance was getting increasingly regional or global, regulation remained mainly in the national realm, and discipline was delegated too much to the markets itself.

But in less than two years, the institutional structure of the EU and the euro area has changed significantly to take some of these lessons into account. These changes were driven by the insight that both mutual solidarity and policy discipline are needed to restore confidence, and to prevent further divergences. With this in mind, the EU Heads of State have created a new financial supervisory architecture, increased macroprudential supervision, and introduced new measures for macroeconomic surveillance. All the more, it was recognized that even with the highest degree of regulation and surveillance, crises may occur, and a speedy, transparent and predictable emergency response mechanism is needed to secure financial stability. The creation of the EFSF and the ESM are important milestones towards this end.

Can similar results be achieved at the global economic governance level? What are the “common goals” that we are sharing at the international level? Our previous quid-pro-quo multilateralism has left us with high risks for economic and financial stability, and ultimately growth and prosperity. It is therefore in a country’s own interest to better internalize externalities of domestic policy making for the greater public good of global economic and financial stability. International policy coordination like this may provide us with Pareto-superior solutions, and the recent commitments made at the IMF and the G20 level – which are means towards this end – are good starting points to deliver such progress if implemented effectively.

Let me say in conclusion:

The economy is global. So policies cannot remain local. Having experienced the worst financial and economic crisis since WWII, we know that policies and policy coordination at a global level are needed. The most important areas on the global policy agenda are the reform of financial regulation and policies to address macroeconomic imbalances. On both fronts we have already made a lot of progress. But continued efforts are needed. Equal regulatory treatment of financial institutions, regulating the shadow banking sector and structural reforms to improve competitiveness will be needed for a sustainable and stable economic and financial system for the future.

I thank you for your attention.