

William C Dudley: What does interconnectedness imply for macroeconomic and financial cooperation?

Remarks by Mr William C Dudley, President and Chief Executive Officer of the Federal Reserve Bank of New York, at the Swiss National Bank-International Monetary Fund Conference, Zurich, 8 May 2012.

* * *

It is a pleasure to have the opportunity to speak here today. As I see it, the complex interconnections that exist between the real and financial sectors of the economy, both within and between countries, have important implications for both macroeconomic and regulatory policy. In particular, cross-border coordination in both realms is warranted. Often, macroeconomic and regulatory policies are too narrow in their focus. At times, policies are designed with the goal of being “best” at the national level. Yet the resulting mix of national policies is distinctly inferior to what a well-coordinated global regime could have produced.

Today I will discuss two important challenges that go along with living in an interconnected world. The first is how to define what aspects of macroeconomic policy or regulation require greater international coordination and harmonization. Some issues can be handled effectively at a national level, but the crisis has demonstrated clearly that many can not. The second challenge is how to make international coordination workable so that progress can be made in a timely manner while still preserving sufficient autonomy for countries to fashion policies to suit their particular idiosyncratic structures. As always, my remarks today reflect my own views and not necessarily those of the Federal Open Market Committee or the Federal Reserve System.

We live in a globalized economy in which the flows of products, capital, and ideas across borders have led to significant economic gains for literally hundreds of millions of people around the world. Thus, there is a strong public interest in ensuring that this global economic integration is supported by a coherent set of coordinated national macroeconomic policies and a harmonized international regulatory regime. This applies to the policy actions we undertake to reduce economic imbalances as well as to the regulations we develop to address the vulnerabilities in our financial system that were exposed by the crisis. The better we are able to develop cooperative global solutions to these types of issues, the more successful we will be in creating a sounder and more sustainable global economy and financial system.

It is clear that there were important imbalances in both economic and financial activity in the years preceding the financial crisis. For example, in the U.S., too much of economic activity was based on an unsustainable housing boom. The turmoil in financial markets that was unleashed when the boom collapsed subsequently forced the U.S. and other countries to undergo significant adjustments. These adjustments were often sudden. They transmitted large shocks across the global economy. These shocks, in turn, necessitated other adjustments in trade, investment, and in financial markets elsewhere.

More generally, we know that the global economy operates under an important constraint – the sum of trade balances around the world, properly measured, must add up to zero. When one country follows policies that are designed to increase exports, there must be an offsetting adjustment elsewhere – either higher imports or fewer exports by another country. Similarly, there is the same adding up constraint in terms of the financial flows that accompany trade and investment on the capital account – current account balances around the world – again properly measured – must add up to zero.

What this means in practical terms is that the outcomes for economic activity and capital flows for any individual country depend not only on the public policy and private decisions made within that country, but also on policies and mix of activities pursued in other countries.

For example, for Germany to have a large trade surplus with the rest of Europe, other European countries must run trade deficits. And if Germany runs such surpluses it must accumulate large financial claims on the other countries. Or, if the U.S. has an unsustainably high level of consumption, the adjustment to a lower, more sustainable level must be offset by greater investment and exports if the U.S. economy is to be able to operate close to full employment.

The fact that it takes (at least) two to tango to make these types of adjustments is just another way of saying that our economies are interconnected. In order for the U.S. to reduce its dependence on consumption and to increase its exports, there need to be offsetting adjustments in other countries, such as China. Thus, the key issue to consider in crafting internationally coordinated macroeconomic policy is not whether these adjustments will ultimately take place. They will take place because they have to take place. Instead, the issue for policymakers is whether the policies we put in place will allow adjustments to occur in a way that is consistent with a stable global economy, high levels of employment, and low inflation.

At times, the situation is akin to the Prisoner's Dilemma – a non-cooperative approach will lead to inferior results for both players compared to a cooperative approach in which each side foregoes the chance for highest potential payoff in exchange for the payoff that maximizes returns jointly. But effective cooperation that leads to higher joint returns is difficult in this game because of the complexity of the inter-linkages and the political and institutional constraints that constrain the scope for action at the national level.

In macroeconomic terms, the prospects for achieving a more cooperative solution can be enhanced by policy transparency so that the policy goals and reaction function of each authority can be well understood by others. This again applies both within and across countries. For example, the Federal Reserve is making efforts to provide greater clarity about its inflation objective in the context of the dual mandate. In doing so, the Fed is also continuing to underscore that actions such as our purchase of U.S. government securities are driven exclusively by our monetary policy goals, and that these policy actions will not continue beyond the moment they become inconsistent with our dual mandate objectives. In general, policymakers should strive to ensure that we have both fiscal and monetary policy frameworks that are transparent and viewed as credible and durable.

Interconnectedness means that events – be it the tragedy of a Japanese earthquake and tsunami, a revolution in Libya, or a financial crisis sparked by a housing boom and bust in the United States – can be transmitted to domestic economies located far away from the initial source of shock, often at market-speed measured in milliseconds. This interconnectedness underscores our common interest in cooperating not just to facilitate needed economic adjustments, but also to address fragilities in our interconnected global financial system.

I think coordination on regulatory matters differs from on macroeconomic issues in two important respects. First, the benefits to cooperation and coordination on certain aspects of regulation seem easier to identify up front. Second, while policy coordination on regulatory issues is also very challenging, it may not be quite as difficult as in the macroeconomic realm. The stakeholders are not typically as numerous or diffuse, the problems are generally easier to identify, the gains from a cooperative solution are more obvious, and the cooperative solutions themselves may be easier to implement.

On the regulatory side, I'll start with a few broad observations. First, it is essential that regulations be harmonized internationally to a much greater degree than in the past. This will ensure there is a common minimum level of standards, which in turn will help discourage regulatory arbitrage and a "race to the bottom".

Second, it is critical that the harmonized regulations produce something that is coherent and effective on an international level, and that the different regimes in specific jurisdictions add up to a workable whole.

Third, regulatory harmonization and cooperation, by necessity requires trust and a willingness to share relevant information across jurisdictions. A corollary to this is that national regulators need to be willing to constrain their unilateral actions somewhat in order to facilitate engagement and cooperative solutions on a global basis.

In this respect, I think there are two areas where considerable progress has been made since the crisis – the capital regulation of globally active banking organizations and the establishment of global standards for financial market infrastructures. The first initiative is designed to ensure that globally active firms have sufficient capital to keep their risk of failure very low. The second initiative is designed to strengthen the financial market infrastructure so that if a large globally systemic firm were to fail, this event would not threaten to bring down the entire financial system.

But even in these areas there still is much to do. With respect to Basel III, it is important that the regime be implemented on a consistent basis around the world. In particular, the definitions of capital must not be watered down and risk-weighted asset calculations must be done in a consistent manner around the world. An identical portfolio of assets should generate a comparable amount of risk-weighted assets regardless of the country in which the bank's home office is domiciled.

With respect to standards for financial market infrastructures, the Principles for Financial Market Infrastructures, which were published last month, are an important step forward. These principles establish the minimum standard for important FMIs around the world.

But the establishment of these standards is just the first step. National authorities now need to ensure that their domestic regulatory regimes embody these principles, and these national regimes have to be credibly assessed for ongoing conformance to the new standards.

Global standards for financial market infrastructures are necessary if we are to build a safe global system of central counterparty clearinghouse (CCPs) infrastructures through which to clear standardized over-the-counter derivatives trades around the world. For national regulators to be comfortable with such an arrangement there has to be an appropriate level of information exchange and cooperative oversight, and the Principles explicitly mandate this. Although cross-border information exchange and cooperative oversight are certainly not new – the coordination of currency settlement around the world through CLS is one important example – the model has to be further developed and adopted more broadly across a wider range of important global financial market infrastructures.

How we proceed from here will be critical to our success in building a global financial system that is both stable and efficient. By facilitating the greatest netting down of risk, global CCPs through which all standardized OTC derivatives trades would be cleared, hold out the potential for the greatest amount of risk reduction and, thus, improvement in financial stability. But, for that outcome to occur, there needs to be a global oversight framework that ensures that the CCPs are held to global standards – not just in theory, but also in practice.

There are other areas where we face significant challenges in effective global information exchange and regulatory cooperation. We have much more to do to develop resolution regimes for globally systemic financial institutions, including establishing the rules of the game for the exchange of supervisory data for such firms, in clearly identifying ex ante the responsibilities of home and host countries in terms of potential liquidity support, and in overseeing the orderly wind-downs of such firms when they encounter difficulties.

The exchange of supervisory information is important both for understanding the consolidated condition of a bank that operates in a host country, and for gaining insights into broader financial stability issues. For example, giving supervisors in host countries improved access to consolidated balance sheet information for foreign firms operating in their jurisdiction would allow for a more accurate assessment of a firm's liquidity position and funding plans.

Another area where there needs to be greater international cooperation is in defining the roles of home and host countries especially during times of stress. What is the responsibility, for example, of the host country to provide lender-of-last-resort liquidity to foreign firms operating in their jurisdiction? At what stage, if any, does that responsibility shift to home country? Should these responsibilities change depending on the degree of information exchange or the degree or duration of stress?

On the resolution front, we know that the benefits of a harmonized global regime would be substantial. By providing greater transparency to investors and depositors about the rules of the game in the event of distress, such a regime would likely reduce the likelihood of runs and financial panics while also allowing financial intermediation to occur on a global basis.

However, it is proving challenging for some jurisdictions to provide clarity around how an orderly resolution would be implemented in practice. At the same time, this lack of clarity within jurisdictions is contributing to and exacerbated by the lack of a harmonized approach across different legal and regulatory regimes. Many questions must be answered: How would different creditor and counterparty claims be treated? Who would provide the bridge financing to facilitate the orderly liquidation? Would the home country regime ensure equal treatment of all banks' claims around the world, regardless of jurisdiction or legal entity? Would there be clarity about this, *ex ante*?

If an effective global resolution regime with clearly defined *ex ante* characteristics were to turn out to be a bridge too far, national authorities may have to fall back on a subsidiarization model, in which global firms would have to establish subsidiaries on a country-by-country basis each with their own capital and liquidity buffers. Such a regime would require greater capital and liquidity as the banks would lose the significant risk diversification benefits gained from operating in many different countries. Such a regime would also presumably make it more difficult for these firms to provide financial services seamlessly to multinational corporations, global asset managers, and others that operate on an international basis. Even in this scenario, however, it would be important to ensure that national resolution regimes could interact with each other in a coherent manner.

To sum up, my view is that we live in a globalized world both with respect to the macro-economy and the financial system. But too often we set macroeconomic policy and regulatory policy at a national level, and miss important opportunities to coordinate and make the global economic and financial system stronger overall. We need to understand where greater global perspective is required and we need to apply that perspective consistently across jurisdictions in a timely manner. If we don't do this, we won't achieve all the benefits that are possible from global specialization and we will continue to run significant risks with respect to financial stability.

Thank you for your kind attention.