Masaaki Shirakawa: International financial stability as a public good

Keynote address by Mr Masaaki Shirakawa, Governor of the Bank of Japan, at a high-level seminar, co-hosted by the Bank of Japan and the International Monetary Fund, Tokyo, 14 October 2012.

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Introduction

Once again, it is a great pleasure for me to welcome you to Tokyo on the occasion of the annual IMF-World Bank Meetings.

About two years ago, at the Per Jacobsson Lecture in Basel, my old and respected friend, the late Tommaso Padoa-Schioppa, offered his insights on how to strengthen the governance of the rapidly integrating global economy.[1] Since then, the subject has been in a corner of my mind. Today, I am happy to co-host with the International Monetary Fund a high-level seminar devoted to that topic.

Many of you here today probably heard Tommaso forcefully present his case, but for those members of the audience who were not on hand at that time, I would first like to offer you a brief summary. Tommaso observed that one of the causes of the Great Financial Crisis was the failure of national governments to properly rein in market forces, which were fast becoming global in nature. He saw that the increase in cross-border financial activities required a corresponding increase in the provision of basic facilities or services – supporting or facilitating those activities – including prudent regulation and supervision from a cross-border perspective. Nevertheless, the supply of such facilities or services was deficient or lacking because national governments inherently could not provide for them. The solution, he argued, was to enhance supranational governance of the global economy.

I. The Great Financial Crisis and the supply of global public goods

As Tommaso and many others have pointed out, the Great Financial Crisis has exposed the naïve simplicity of the view that, if the economic policies of individual economies are geared towards domestic economic stability, and private actors are allowed to operate freely in such an environment, the global economy would be all right. The painful realization is that the self-correcting power of the market goes only so far. Markets must sometimes be nudged, pushed, or even forcefully shoved off their existing trajectory so as to prevent them from running into disasters. In order to function properly, markets also depend on things that are not provided spontaneously by themselves, such as the rule of law, respect for private property, and the safety and freedom of passage. "Public goods" is the name ascribed to these facilities or services in economics textbooks, and global public goods are those needed for the global economy to function properly.

So, what are the global public goods that support the functioning of the global financial system?

One obvious but only partial answer is the appropriate regulation and supervision of cross-border financial activities. The Great Financial Crisis has demonstrated that there were many shortcomings in this area, and the international community has taken steps to correct them. Good regulation and supervision are important, but by themselves are not sufficient. The soundness of individual financial institutions is one building block of financial stability. In this sense, the international public good supporting global financial

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[1] Padoa-Schioppa, Tommaso, "Markets and Government Before, During, and After the 2007–20XX Crisis," The Per Jacobsson Lecture in Basel, Switzerland, June 27, 2010.

markets is not provided solely by regulators and supervisors. Various agents, including but not limited to central banks, ministries, and regulatory boards, work together to realize a stable international financial environment through conducting prudent monetary policy, performing effective regulation of financial actors, and promoting robust market infrastructures.

By looking at international financial stability as a public good, we can apply a well-established microeconomic analytical framework to it. A public good is a good that is both non-rivalrous and non-excludable: that is, one's use of a public good does not reduce the availability to others and one cannot effectively prevent the use by others. Consequently, two important features of public goods are that they will not be provided if left solely to the market, and that they tend to be consumed excessively when they are provided at all. The latter insight allows us to interpret the Great Financial Crisis as being the consequence of overconsumption of a public good – namely, international financial stability. Financial institutions took stability for granted and shouldered excessive risks. This exaggerated the impact when the risks were manifested; markets could not regain stability by themselves and had to wait for interventions by the public sector, including the coordinated provision of liquidity by central banks.

II. Providing global governance in a globalized world

In a world where globalization is deepening, and where national financial systems are becoming more interconnected, financial stability must increasingly be achieved at the global level. To make this happen, good governance at the global level is essential. Fortunately, nobody is against strengthening global governance as a concept. Everyone instinctively realizes that something must be done to ensure the proper functioning of the financial system, which has expanded beyond national borders and has become global. Unfortunately, progress, though accelerated by the Great Financial Crisis, has still not been fast enough.

Why is this the case?

Professor Dani Rodrik of Harvard University has offered us an informative perspective.[2] He claims that hyperglobalization, the nation state, and democratic politics cannot be maintained simultaneously. For example, in recent years, the advances in information and communication technologies have enabled financial institutions to expand their activities across borders. As we have seen recently in Iceland and Ireland, such institutions could get into trouble because of activities outside their home markets. When the government of the home market attempts to bail out these institutions without destabilizing the global financial markets, the cost could be so huge that it would exceed the ability of the home-country taxpayer to pay, thereby compromising democracy. If we wish to avoid this outcome, we would either have to opt for a democratically elected global government that could provide a global safety net, thus compromising the nation state, or opt to restrict the global activities of financial institutions to the extent manageable by democratically elected national governments, thus compromising globalization.

Of the three potential outcomes, Professor Rodrik prefers the third one, calling not for hyperglobalization but "smart globalization." Many reasonable people would probably agree. In view of the slow and limited progress in strengthening global governance, and without any meaningful prospect of acceleration, such a choice seems sensible.

The problem, however, is that it may be difficult to restrain globalization effectively. The flip side of overconsumption of public goods is insufficient internalization of the costs for

[2] Rodrik, Dani, The Globalization Paradox: Democracy and the Future of the World Economy, W. W. Norton & Company, February 2011.

providing such goods. This could imply that profit opportunities arising from globalized financial activities may be sufficiently large such that there is a strong incentive to circumvent any restrictions. At the same time, the advances in transportation, and in information and communications technologies, make it ever easier for private actors to dodge inconvenient rules and regulations. From our experience, we know very well that the ingenuity of the private sector in this regard should never be underestimated. We all remember the Bretton Woods System, which was an attempt at smart globalization, and the collapse of this system offers us a cautionary tale. Furthermore, in a world where public and private actors taking part in economic activity are becoming ever more diverse, it would be quite a challenge to agree on what is desirable globalization and what is not. If, in despair, unilateral action, such as trade bans, mandatory domestic incorporation, or forced repatriation, is taken, everybody would become worse off.

Is there a way out of this predicament?

If the objective of global governance is to secure global financial stability, and if global financial stability is a public good, global governance can be analyzed as a microeconomic problem regarding public goods. There are well-known options to solving the problems posed by public goods. The most straightforward is to have the public sector provide the public goods. Alternatively, rules could be established regarding the consumption of public goods. Another option is to tax the consumption of public goods or subsidize the production thereof. There are still other options, such as changing the public character of the goods by increasing their exclusivity. Not all may be applicable to international financial stability, and some may be more easily implemented than others.

In view of the discussions during various international fora in which I have participated, I have a feeling that we are making it more difficult for ourselves by opting for the seemingly most obvious option – tasking the public sector with providing international financial stability. As Tommaso observed, there is a limit to what individual nation states can provide as global public goods. A coherent set of public goods provided by a single global public entity would be desirable, but there is no workable way of introducing such an arrangement consistent with our democratic principles. International organizations are often criticized for deficits in democratic accountability. On the other hand, a democratically elected world government with the power to tax is unthinkable in the near future. The current situation in the euro area is an example of this intractable problem.

We therefore should aim for a more practical approach, combining various options that are known for solving the public good problem. Some public goods, such as effective supervision of globally important financial institutions, could be provided at the national level. Supranational institutions could be asked to take on specific tasks, such as monitoring global financial developments and identifying macroprudential risks, without undermining democratic principles. Private actors could be made to follow certain rules, such as the Basel rules on capital adequacy, which are in fact rules regulating the consumption of global financial stability. It may even be possible to devise ways to influence the behavior of these actors through taxes and subsidies. For example, capital adequacy standards could also be seen in this light, considering that they would increase costs of engaging in riskier behavior. Some might even argue for financial transaction taxes as an option, though I do not believe that benefits would outweigh the costs, such as their impact on market liquidity. In any case, we must be willing to adopt a flexible and multi-tracked approach to global governance, which should be more adaptable to and consistent with the increasingly diverse global landscape.

III. Global governance and central banks

Turning to what central banks could do in the context of global governance, they are without doubt important actors given their role in monetary, prudential, and payment systems policies. Stable and sustainable growth in individual economies, which is the ultimate objective of central bank policies, is an important building block of a stable global financial environment. In times of emergency, as we have seen during the Great Financial Crisis, the coordinated provision of liquidity by central banks plays an important role in maintaining financial stability. Central banks are deeply involved in international rule making as well.

At the same time, a central bank is constrained by its mandate, which is granted by the nation state (or nation states in the case of the European Central Bank). While it is independent of the national government, its actions must be accountable, ultimately to the people of the nation. The central bank must be conscious of the legitimacy of its actions. Nevertheless, if this prevents it from thinking outside the box, when that is necessitated by a changing economic environment, a good outcome cannot be ensured. The gradual and sometimes spontaneous evolution of central banking since the middle of the 19th century underscores this point. One issue that immediately comes to my mind in this regard is the international spillover and feedback effects of monetary policy. Global financial stability would be elusive if these effects were not sufficiently internalized.

Concluding remarks

Every so often, we are tempted to say that big problems need big solutions. The reality, however, is that the best big solution turns out to be an aggregate of small steps. Global problems, therefore, require global solutions, but such solutions can be broken down into more manageable parts. I hope that all of you find today’s seminar to be such a small but important step forward.

Thank you for your attention.