View metadata, citation and similar papers at core.ac.uk

brought to you by CORE

provided by Research Papers in Economics

Complementarity and coordination of macroeconomic and financial policies to tackle internal and external imbalances

Mario DRAGHI
Governor
Banca d'Italia

Policy responses to the global crisis have helped stabilise the economies and contained the threat of financial instability. But growing sovereign indebtedness, a weakened financial system and uneven economic growth prospects at the global level pose risks of new imbalances and vulnerabilities. To limit those risks it is essential to address both macroeconomic and financial market failures. Important changes in financial market regulation and banking supervision are already being introduced. In the macroeconomic area, an effort is being made to strengthen the coordination of economic policies in the context of the G20. New institutions, such as macroprudential authorities, are being set up in many countries to monitor and contrast the emergence of systemic risk. There are, however, several areas where policy frameworks need to be further strengthened. At the international level we need surplus and deficit countries to rebalance global demand and ensure a return to sustained global growth, without conflicting policy actions leading to potential instability. Effective macroprudential policies require a clear definition of responsibilities, and need to be consistent with the conduct of monetary policies. In Europe, more effective economic governance is needed to proceed on the route towards greater economic integration and to fortify the euro, including tighter rules on fiscal policies, a broader surveillance over macroeconomic imbalances and an effective mechanism for crisis management.

1| The recovery from the Great Recession: risks and priorities ahead

Until now the economic recovery has been strong in emerging countries; weaker than would be required to reduce unemployment in the United States; uneven and generally sluggish in the euro area.

Policy responses have differed according to countries' cyclical position and policy priorities. In advanced economies, monetary policies remain accommodative in order to put the recovery on a firmer root. However, the expectation of low interest rates for a prolonged period could encourage excessive risk-taking in financial markets, creating asset price distortions and vulnerabilities. In the years preceding the crisis, persistently low global interest rates and optimistic expectations of continued macroeconomic stability (the "great moderation") led market participants to underestimate risks in many asset classes. This helped to create a financial environment conducive to the explosion in private debt and the widening of external imbalances. A compression of risk and liquidity premia brought on by the "search for yield" provided strong incentives for financial institutions to increase leverage.[1] These phenomena may well reappear as economies and financial systems recover from the crisis, unless their underlying causes are addressed. Hence the need for central banks to put in place a timely and determined monetary policy correction, once macroeconomic conditions permit it, and for supervisory and regulatory policy to contain the accumulation of risks by financial institutions.

Budgetary policies in Europe are now clearly directed at reducing public sector deficits and containing debt growth; this is not yet the case elsewhere. It is essential that governments deliver the fiscal adjustments they have committed to implement, particularly in those euro area countries where concerns over the sustainability of public debt are more acute. In perspective, a sound fiscal position is also necessary to meet the pressures arising from population ageing. In countries where age-related expenditures are expected to grow significantly, reforms of pension, health and long-term care systems are urgent. Growth-enhancing structural policies can reduce the burden of fiscal adjustment and make it credible.

The situation of international financial markets has clearly improved since the most acute phase of the crisis, but strains still remain. In Europe, in particular, the interplay between sovereign risk and the fragility in parts of the banking sector are still creating significant tensions.

International imbalances, which had temporarily narrowed as an effect of the recession, are beginning to widen again. Capital flows into some emerging markets, driven by interest-rate differentials, are putting pressure on exchange rates. Some countries are using foreign exchange intervention to resist appreciation, in order to support their exports. External imbalances are not necessarily bad *per se*. In open economies, it is desirable for saving to be invested where it is used the most productively, and imbalances can therefore emerge naturally from differences in saving behaviour, in rates of return on capital, or in the degree of risk or liquidity of different assets. However, persistent imbalances can be symptoms of underlying distortions if the incentives to save and invest and the pricing of risk and liquidity are themselves distorted.

An uneven recovery, diverging economic policies, protracted low levels of interest rates, risks related to the increase of sovereign debts, large imbalances in payment systems and pressures on exchange rates are all factors that pose a significant threat to the global economy.

In order to effectively tackle these risks and put the recovery on safer grounds, action by policy makers is necessary in many areas. The rest of the article concentrates on three of them. First, the framework for international coordination needs to be significantly improved: we now need to strengthen cooperative arrangements that could support growth and make the global economic and financial system less prone to excesses and crises; this includes the completion of the financial regulatory reform. Second, we need to implement well-designed macroprudential policies that, together with monetary policies that guarantee price stability, contain the emergence of financial imbalances. Third, there is an urgent need for a reform of the framework for economic governance in Europe.

1 *See, among others, Adrian and Shin (2008) and Brunnermeier (2009).*

2| International coordination: the G20 framework

At the 2009 Pittsburgh Summit the G20 pledged to work together to ensure a lasting recovery and set the world economy on a path of strong and sustainable growth over the medium term. To meet this goal, the Framework for Strong, Sustainable, and Balanced Growth has been launched. The backbone of this framework is a multilateral process through which G20 countries identify objectives for the global economy and the policies needed to achieve them. The evaluation of the mutual consistency of such policies is the objective of the "mutual assessment process" (MAP) of their progress towards meeting these shared objectives.

In particular, the MAP requires an assessment of the nature and the root causes of impediments to the adjustment of persistently large imbalances. Indicative guidelines composed of a range of indicators would serve as a mechanism to facilitate the timely identification of large imbalances that require preventive and corrective action.

As agreed by the G20, there must be a shift to a more balanced global pattern of demand. In economies with substantial external surpluses and large reserve positions, policies should aim at fostering private demand. In most advanced economies supply-side policies and structural reforms ought to enhance potential growth. These conclusions follow from a hard-won recognition of the inevitability and welfare-improving nature of collective action.

Progress is being made, but important policy challenges remain in order to meet the objectives of strong, sustainable and balanced growth. In particular, only limited steps have been taken towards external rebalancing. Priority areas include: structural reforms and greater exchange-rate flexibility to strengthen domestic demand in emerging economies; further fiscal consolidation in advanced economies based on "growth-friendly" measures; and product and labour market reforms across all G20 members to boost productive capacity.

Tackling the problem of external imbalances is crucial. One may wonder what would have happened to the global economy had this rebalancing been implemented in due time. Such a counterfactual scenario has been studied at the Bank of Italy,[2] focusing on the period 2002-2007. Overall, the results of the exercise, obtained simulating a global macro-econometric model, highlight the complementarities of policy actions in deficit and surplus countries for the correction of both internal and global imbalances. In the simulation period in the United States there would have been a slowdown in activity, as opposed to the sharp fall observed in the last recession. Importantly, housing price increases would have been much smaller and closer to historical experience, while the improvement in the current account balance would have been substantial. At a global level, the dispersion of current account balances would have remained almost unchanged, where in fact it actually doubled.[3]

Whereas there is no guarantee that the Great Recession would have been avoided, the global environment would have been much more balanced. As a result, the propagation of the crisis would probably have been less destructive, because both the US financial system and the global economy would have been less vulnerable.

In a global system where external imbalances remain large and capital flows may be subject to sudden reversal, 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 risk that eventually generated the crisis.

Under the aegis of the G20 and through the activity of the Financial Stability Board (FSB) and its members, the reform of the rules governing the global financial system is taking important steps forward. Our aim is to recreate a financial system with less leverage, where transparency allows us to identify and manage risks, system-wide prudential and regulatory oversight is strengthened and ailing intermediaries can fail without disruptions to the rest of the system and the real economy.

2 *See Catte* et al. *(2010).*
3 *The dispersion is calculated as the sum of the absolute values of the current account balances in the United States, Japan, Germany and China scaled by world GDP.*

The new Basel rules are a milestone of the reform. They introduce a homogeneous definition of banks' capital across countries; they significantly increase both the quality and quantity of banks' capital, thus raising their ability to absorb losses; they constrain bank leverage, on- and off-the-balance sheet; they introduce new liquidity standards, thus reducing liquidity mismatches within the system. The new rules are being introduced gradually, in order to preserve the capability of the banking system to finance the economy.

The second step is to address the risks created by systemically important financial institutions (SIFIs): institutions that, because of their dimension, complexity and presence in vital parts of the global financial system, if in distress, might endanger the entire system and would therefore be bailed out at all costs. Last November the G20 approved the proposals of the FSB on SIFIs, which are based on four pillars:

i) implementing in every country a resolution framework which would enable authorities to resolve SIFIs without disruptions to the financial system and without taxpayer support; in order to achieve this, we need to modify national legislations with the requisite legal and statutory powers and tools to transfer businesses or create bridge banks to maintain essential financial services and impose losses on creditors. We also need to define agreements at the international level between host and home authorities that clearly identify roles and responsibilities in resolving an institution;

ii) requiring SIFIs, and initially in particular global SIFIs, to have a higher loss absorbency capability than non-systemic intermediaries, beyond the minimum requirements of Basel III. This could be met by introducing an equity capital surcharge, or a required level of contingent convertible capital, or else a requirement to issue a certain amount of "bail-in-able" securities (i.e. debt instruments that could suffer losses or be converted into shares in situations of distress for the firm). These latter capital instruments would also help in disciplining creditors and shareholders, hence correcting the moral hazard problems posed by the systemic institutions that are "too-big-to-fail".

iii) adopting a more effective and intense supervision of SIFIs, commensurate to their size and complexity. In many countries this will require an effort to strengthen the supervisory authorities' mandates, independence, resources and powers.

iv) improving critical infrastructures, including the standardisation of over-the-counter (OTC) derivative products as well as their exchange and clearance in regulated platforms with central counterparties; such measures will help to reduce contagion among institutions upon default and will ensure that key infrastructures do not themselves pose a systemic threat.

The FSB is also working on another problem that emerged from the last crisis: the role and functioning of Credit Rating Agencies. The aim is to avoid an excessive and mechanical reliance of institutions and markets on official ratings, in particular by reducing their scope in regulation, and to limit in this way the most obvious drawbacks of the current system, in terms of procyclicality and potentially destabilising pressure on the markets.

Finally we need to prevent regulatory arbitrage from leading to an accumulation of risks in the "shadow banking" sector, that –though hardly hit by the crisis and consequent stricter controls– continues to play a major role in liquidity transformation and credit intermediation. Designing regulatory safeguards to address the risks associated with a resurgence of the shadow banking activity will be a key priority of the FSB's agenda in the coming years.

We will never be able to avoid all crises. But the changes under way will help to significantly reduce their likelihood and scale.

3| Macroprudential policies and their interaction with monetary policy

The development of well-designed macroprudential policies is another fundamental front that is taking shape in the international landscape. New institutions are being created around the globe with the responsibility of monitoring and limiting financial imbalances and systemic risk. These include the IMF-FSB framework for assessing financial vulnerabilities at the global level, the constitution of the Financial Stability Oversight Council (FSOC) in the United States and of the European Systemic

Risk Council (ESRB) in the European Union, as well as similar initiatives in other countries. There are a number of challenges that need to be addressed by policy makers in this area.

A first important question concerns macroprudential policy objectives. The final objective for macroprudential policy must be financial stability. However, this objective is hard to measure and proxy. Financial crises are infrequent events, can take many different forms and may have many different causes. All this makes macroprudential policy more difficult to make operational than, for instance, monetary policy, for which we have a clear mandate (price stability, inflation targets), with relatively precise proxies (measures of inflation) and instruments (short-term interest rates).

Against this background, when shaping the mandate for the macroprudential authority, a trade-off emerges between clarity and specificity, on one side, and robustness, on the other. At one extreme we have a "broad" definition of objectives, such as reducing the likelihood and the severity of financial crises, as well as ensuring the resilience of the financial system. This formulation of the mandate has been chosen for the main macroprudential bodies created in the aftermath of the crisis, including the ESRB and the FSOC. At the other extreme, the objectives could be "specific" and contemplate, for instance, "moderating the credit cycle".

A "broad" mandate is all-encompassing and obliges the macroprudential policy authority to look at every potential source of crisis. At the same time, this very feature might make it harder for the authority to motivate its actions clearly. Risk warnings or policy recommendations based on a certain set of analyses could easily be challenged by the addressee on the basis of an alternative set of analyses. Furthermore, it is not obvious how one may assess compliance with this mandate. Financial crises have occurred on average every 20 years: it is difficult to hold the macroprudential policy authority accountable during periods in which no financial crises occur, and so measuring its performance can be challenging.

By contrast, a "specific" mandate (e.g. moderating the credit cycle) would be relatively simple to define and monitor. Risk warnings or policy recommendations based on this type of mandate would be harder to challenge, and could trigger more expedite and effective action. A "specific" mandate would also simplify accountability. However, the flip side of the coin is that the macroprudential authority could not be held accountable for not acting upon signals and events falling outside its mandate: it would be difficult to blame it if a crisis developed while credit growth was subdued, e.g. because credit growth took place outside the official definition of credit.

Altogether, there are good reasons why the "broad" type of mandate was chosen by the ESRB and by the FSOC. At the same time, regulators and the macroprudential authorities themselves should be wary of the risks posed by this formulation in the coming years, which shall be crucial for the establishment and the success of the new policies.

Similar difficulties emerge in the definition of the appropriate tools for macroprudential policies. As systemic financial risk can emerge from many sources, there may be on occasion the need to act with very different instruments. This implies that in general macroprudential authorities will have to act "through" other authorities, for example those responsible for micro-prudential, fiscal or other economic policies. At the same time, the evidence shows that financial crises are very often associated with large fluctuations in credit and asset prices. Most analyses, including the Bank of Italy's, indicate that in order to moderate the growth of credit and asset prices and reduce the likelihood of financial crises, instruments such as countercyclical variations in banks' capital requirements or in loan-to-value ratios may be useful.

This means that instruments of macroprudential policies will affect variables that are also affected by monetary policy, such as credit supply or loan rates. The potential interaction between the two sets of policies needs to be well understood and taken into account.

As recently emphasised also by Governor Noyer,[4] the objectives of macroprudential and monetary policies must remain clearly distinct. In particular, the crisis has reinforced the case for monetary policy to remain firmly focused on maintaining price stability: inflation expectations have remained well anchored throughout the crisis, giving monetary authorities the flexibility to react strongly to the downturn, also with unconventional measures.

4 *See Noyer (2010).*

While price stability remains the primary objective, it is also a clear lesson from the crisis that monetary policy should also be better prepared to counter developments in money and credit that can fuel the build-up of financial disequilibria, even in the absence of immediate inflationary dangers.[5] In this endeavour monetary policy can receive substantial support from macroprudential policies: by reducing the pro-cyclicality of credit creation, they can help to dampen the economic cycle.

On the other side, coordination failures might arise between the macroprudential authority and the central bank. In this regard, the key question concerns the relationship between the policy interest rate and the "new" macroprudential instruments. It is necessary to fully understand the macroeconomic effects of macroprudential policies. This is the case, in particular, if one accepts the view that macroprudential tools, such as capital buffers, should be steered discretionarily.

The theoretical and empirical analysis of the interaction between monetary and macroprudential policies is at a very early stage; we must push forward a research agenda on these topics. Current research at the Bank of Italy indicates that macroprudential policies based on countercyclical capital buffers or a loan-to-value ratio to smooth fluctuations in lending may help to dampen output fluctuations. However, lack of cooperation between monetary and macroprudential authorities may create the risk of a coordination failure and suboptimal macroeconomic results (such as significant instability of macroprudential and monetary policy instruments).[6] These results are due to the fact that macroprudential policy and monetary policy affect closely related macroeconomic variables but have different objectives, so that at times they can push in different directions.

In this respect, the new European institutional arrangement seems appropriately designed. In the European Union, consistency between macroprudential and monetary policy will be ensured by the composition of the ESRB, where central banks play a prominent role. Moreover, the potential conflicts among the two policies will be limited by the fact that the tools and actions of macroprudential policy will normally be more selective, on a sector basis and geographically defined than is the case for monetary policy.

4| A new European economic governance

Recent financial market turbulence, especially that associated with the sovereign debt crisis in some euro area countries, has made it painfully clear that the economic integration and interdependence created by the common currency requires stronger coordination of economic policies and an enhanced governance.

Monetary union (EMU) is not in question. There is a strong, common interest in preserving the euro, which ties together all participating countries –the sound ones and those at present in distress. Since its inception, the euro has emerged as a strong and credible currency in international markets; during the crisis it has provided an anchor of stability. It represents a crucial step towards greater European unity. The process is certainly incomplete and there are areas of fragility, some of which came under scrutiny because of the crisis. We need to address these hardships by moving forward rather than backward.

Policymakers in Europe must now concentrate their action on at least three areas:

First, they need to deliver the growth-friendly fiscal adjustments they have committed to implement.

Second, they need to focus on the structural reforms that Europe needs in order to boost potential growth; current problems in many countries stem as much from excessive debt as from the weak economic growth expected in the years ahead.

Third, they need to agree on a thorough reform of European economic governance. The crisis highlighted some major shortcomings. Fiscal rules and procedures have proved unable to deliver prudent

5 *It has been pointed out, especially in work at the Bank for International Settlements (see, for example, Borio and Lowe, 2004) that thanks to the success of macro-stabilisation policies and to structural changes in the responsiveness of aggregate supply (partly as a result of globalisation), inflation expectations are now much more firmly anchored, and episodes of excess creation of liquidity and credit tend to be reflected primarily in asset price bubbles rather than in consumer price inflation. Moreover, asset price cycles tend to be associated with large changes in indebtedness and add to financial vulnerabilities, thus posing significant risks for macroeconomic stability in the medium to longer run (Visco, 2009).*

6 *See Angelini, Neri and Panetta (2010). Similar results are obtained by Bean* et al. *(2010).*

policies: many member states entered the crisis with an already high public debt and insufficient margins of manoeuvre; in the case of Greece, the surveillance did not even guarantee the use of proper accounting and sound statistical standards. Moreover, macroeconomic imbalances were not given an adequate role in the design of EMU governance: tensions hit not only countries with problems of public finances, but also those with a high external deficit, unbalanced growth and/or a highly indebted private sector. Finally, an appropriate framework to safeguard the financial stability of the euro area in crisis situations was missing altogether.

Reform proposals have been set out in all the three areas by the European Commission and the Task Force chaired by President Van Rompuy.

Concerning fiscal surveillance, the Report of the Task Force states that "the debt criterion … should be made operational to be effectively applied". This proposal is clearly welcome. It is well known that, while the Maastricht Treaty requires countries with high public debt to reduce it "*at a satisfactory pace*", this provision has never been effectively implemented. The Report also envisages a wider range of sanctions, both financial and political, to be applied progressively, starting at an early stage in the budgetary surveillance process, in order to strengthen the incentives to comply with the rules in good times. However, the procedures remain too lengthy and largely determined by discretionary decisions of the European Council. This is the fundamental problem of multilateral surveillance as it is currently conceived. There is no independent enforcer of EU rules: the supervisors are the supervised themselves.

With regard to the surveillance of macroeconomic imbalances, the Task Force proposes an alert mechanism, based on the analysis of macroeconomic and competitiveness developments, and an enforcement mechanism that includes sanctions if a country in "excessive imbalance position" does not comply with the Council's recommendations. As the crisis showed, macroeconomic imbalances may lead to unsustainable development and dangerous spillovers to other countries.[7] However, designing and implementing effective control in this area presents several challenges. First, timely detection of macroeconomic imbalances may be problematic; second, identifying and reaching a consensus on the appropriate policies to tackle structural problems is not simple, to say the least. To avoid long and unproductive negotiations between the Council, the Commission and the country under examination, we need transparent procedures, a clear commitment on the part of member states and a clear focus on a limited number of indicators, the ones directly related to threats to financial stability. In this area, I expect that the ESRB will provide a significant contribution to the analysis and prevention of some of the major imbalances.

Finally, it is important that the euro area endows itself with a framework capable of addressing financial distress and avoiding contagion. The consequences of the absence of a well-defined crisis resolution mechanism clearly emerged last spring with the Greek crisis: the uncertainty increased the costs of finance for virtually all member countries, including those providing financial support. A crisis management framework has to be designed so as to ensure appropriate incentives for countries applying for financial support and for private credit markets, in order to limit moral hazard. At the end of November 2010, the Eurogroup agreed on the main features of a crisis management framework aimed at safeguarding the financial stability of the euro area as a whole. In particular, it has (i) stressed that assistance will be based on a stringent programme of economic and fiscal adjustment and on a rigorous debt sustainability analysis; (ii) clarified that the mechanism does not represent an unconditional bailing out and that there is always a possibility that private creditors may incur losses if the country concerned does not succeed in implementing the necessary adjustment.

These proposals move in the right direction. However, many important issues have yet to be settled. This is a classic case of "the devil being in the details". It is only with a clear manifestation of cooperation, solidarity and steadiness that the European community and the euro will be fortified.

7 *See, for example, Giavazzi and Spaventa (2010).*

Policy responses to the global crisis have helped stabilise confidence and limit the threat of financial instability. Countries acted together at the peak of the crisis. Yet, despite announcements about the importance of coordination, subsequently they resorted to policies that appear to have an essentially national focus. Strengthening multilateral coordination to mitigate global distortions remains a priority. In fact, the large accumulation of public debt and a protracted situation of abundant liquidity now carry the risk of creating new imbalances and vulnerabilities.

It is equally essential to proceed decisively with the reforms of financial regulation and supervision already drafted by the Financial Stability Board and the Basel Committee. These reforms will make financial systems both more resilient and less pro-cyclical and will correct the incentive distortions that played an important role in this crisis.

In general, this approach suggests striving for greater global governance. Global problems, after all, require global solutions, which calls for an important role for international organisations like the IMF and global forums such as the G20, alongside stricter international codes and standards.

In Europe, countries have responded to the crisis both individually, with fiscal policy measures designed to contain sovereign risk and prevent contagion, and collectively, with new institutions and rules. This process is not yet complete. Countries with the weakest public institutions were not in a position to overcome their economic policy difficulties on their own. With European rules that are quasi-automatic, fast-acting and sensitive to market signals, they can draw on the stronger countries for the determination they themselves lacked.

A monetary policy that ensures medium-term price stability and a stronger framework for controlling public deficits are fundamental. Restoring economic growth is equally essential for maintaining financial stability. This is the front on which the Union's cohesion will be tested: the ability to foster harmonious, sustained growth for all the member states, with common rules which, like those governing public finances, will provide help to those countries lagging behind in undertaking the needed structural reforms.

Bibligraphy

Adrian (T.) and Shin (H.) (2008)
"Liquidity and financial cycles", *BIS Working Papers*, No. 256.

Angelini (P.), Neri (S.) and Panetta (F.) (2010)
"Monetary and macroprudential policies", Banca d'Italia, mimeo.

Bean (C.) (2010)
"The Great Moderation, the Great Panic, and the Great Contraction", *Journal of the European Economic Association*, 8/ 2-3: 289–325.

Bean (C.), Paustian (M.), Penalver (A.) and Taylor (T.)(2010)
"Monetary policy after the fall", paper presented at the Federal Reserve Bank of Kansas City Annual Conference, Jackson Hole, Wyoming.

Borio (C) and Lowe (P.) (2004)
"Securing sustainable price stability: should credit come back from the wilderness?, BIS Working Paper No. 157, July.

Brunnermeier (M.) (2009)
"Deciphering the liquidity and credit crunch 2007-2008", *Journal of Economic Perspectives*, 23/1: 77-100.

Catte (P.), Cova (P.), Pagano (P.) and Visco (I.) (2010)
"The role of macroeconomic policies in the global crisis", Banca d'Italia Occasional Papers, 69, July.

Giavazzi (F.) and Spaventa (L.) (2010)
"Why the current account matters in a monetary union: lessons from the financial crisis in the euro area", *CEPR Discussion Paper Series*, 8008, September.

Noyer (C.) (2010)
"Monetary policy and macroprudential policy", speech delivered at the conference on "The future of monetary policy" organised by the Banque de France, Banca d'Italia and EIEF, Rome, October.

Visco (I.) (2009)
"The global crisis: the role of policies and the International Monetary System", in G20 Workshop on the Global Economy, Macroeconomic Causes of the Crisis: Key Lessons: 60-80.