Crisis in a Global Economy. Re-planning the Journey
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HOW DO WE 'REPLAN THE JOURNEY'? PANEL ON FINANCIAL MATTERS

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Introduction

The financial system and the global economy look set to be on a path to recovery. This will be an uneven recovery, with Asia and Latin America growing substantially faster than Europe and North America, each of which must address large fiscal challenges in the years ahead.

Uneven growth will see the resumption of large cross-border capital flows. Flows into emerging market economies are projected to rise strongly, on account of their sounder fundamentals and growth. However, the flows from emerging to advanced economies will also be significant: advanced countries need them to finance accumulated debt.

In part as a result, the important global payments imbalances that preceded this crisis will remain. Indeed, the IMF forecasts that the modest unwinding seen during the recent crisis is unlikely to continue. The persistence of imbalances, and hence the ongoing accumulation of large net foreign liability positions, has the potential to put the global economy at risk.

This much is well recognized, and multilateral efforts are under way to reduce imbalances: for example, the G20 Framework for Growth announced at the Pittsburgh Summit. These efforts focus on a policy-induced rotation of demand: from domestic consumption to exports in current account deficit countries, and from exports to domestic sources of growth in surplus countries.

This is important. But efforts to achieve this rotation are not new, and we should not hold our breath for quick results.

An unwinding of payments imbalances necessarily involves changes in financial flows. And adjustments in the capital account can occur disturbingly quickly – forcing a rapid turnaround of demand that has very high economic, financial and social costs. This is the situation in Greece today. There are other countries around the world that, in the absence of precautionary adjustment, are prone to similar risk.

The costs of a forced adjustment are too high to accept. And yet a policy-induced switch of demand will take time to achieve. So what can be done in the meantime to reduce the probability and impact of a sudden swing in capital flows?

We must persist with the agreed agenda for strengthening the financial system. Financial sector reforms will help to contain the risks associated with large and at times volatile capital flows. Indeed, financial regulatory reforms are a precondition for strong and sustainable global recovery. Moreover, our experience is that the more opaque a financial system is the more fragile it is. We must address both the lack of transparency and the lack of robustness.

Financial reform agenda

The recent financial crisis, like so many earlier financial crises, was the result of excessive and misperceived levels of debt and perverse incentives to take on risk. Financial institutions failed to price risks appropriately, and their supervisors failed to understand the risks to which these institutions were exposed. Financial institutions created and invested in opaque products that they did not understand, and leveraged their balance sheets to acute levels. In the U.S., the SEC's relaxation in 2004 of pre-existing limits on leverage for investment banks increased the complexity of their risk management. The large volume of issuance of collateralized obligations by a few players increased both the market power of these players over the credit rating agencies and their dependence on this source of revenue. The market for complex products, including the rapidly growing CDS market, was concentrated in a relatively small number of major financial institutions.

We know what needs to be done to improve the pricing and the management of risks, and the development of policies designed to achieve this are well advanced, led by the Financial Stability Board. We now need to move quickly to implement these policies. In particular, they need to be implemented globally because risk is now priced and traded at a global level.

First, capital and liquidity frameworks need to be materially strengthened. Market participants and regulators overestimated the true degree of risk dispersion and diversification and, as a result, mispriced a whole range of risks. When mispriced risks are re-priced, they reveal that the capital and liquidity cushions that support the risk-taking are not nearly enough to absorb the damage. The Basel Committee on Banking Supervision will deliver a fully calibrated package of reforms by the end of 2010, which will be phased in carefully: the level and quality of bank capital will be increased; liquidity buffers will be enlarged.

Second, and closely related, the procyclicality of the financial system needs to be reduced. Financial institutions tend to underestimate risks during booms and overestimate them during busts. While the causes are complex, procyclicality can be reduced through changes in prudential and accounting rules, and the implementation of macroprudential policies. For example, banks can be required to build up capital buffers during good times that can be drawn down during periods of stress, to recognize early losses and make provisions against them. The FSB is moving initiatives forward to reduce procyclicality in all of these areas.

Third, moral hazard needs to be addressed. Moral hazard clearly contributed to the mispricing of risk prior to the crisis. Instead of exercising due diligence, investors relied on implicit guarantees when investing in structured investment vehicles, or housing-related securities, or bank securities. It is an even bigger problem now, after the exceptional government interventions in support of financial institutions, and the FSB attaches high priority to reforms to address too-big-to-fail institutions. Policies in this area include the establishment of effective resolution mechanisms and the reduction of the interconnectedness of institutions by moving OTC derivatives to central clearing.

While reforms of the financial sector will improve the pricing of risks, they will certainly not eliminate mispricing. There are many sources of possible pricing distortions, which might contribute to the build-up of imbalances. When these imbalances eventually unwind, the financial system should be a source of stability, not a source of shocks. Clearly that has not been the case in recent years. That is why strengthening the shock absorption capacity of the financial system is an absolute priority.

Some say that we need to postpone these reforms, to avoid derailing a fragile recovery. I respond that the recovery is too fragile to permit forbearance. Large payments imbalances remain with us, and gross capital flows are set to expand greatly in the years ahead. The possibility of a sudden reversal is high, as the situation in Greece demonstrates. If economic conditions deteriorate and we have not reformed the financial system, then we will face the risk of a renewed downward spiral. Options for further monetary and fiscal easing are limited – in some cases almost non-existent. The resilience of the financial system is thus critical to the sustainability of the recovery.