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Crisis Management and Policy Coordination: Do We Need a New Global Framework?

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Thank you. It is a great pleasure to be here, to address this timely conference, and to discuss the all-important issue of policy coordination in crisis management. I have been talking a lot lately about the need for cooperation in macroeconomic and financial policymaking, and that again is my theme today.

Decisions taken by countries based solely on their own national interest may end up hurting everybody. And—as happened often in the past—when this crisis broke, countries were not initially inclined to coordinate policies. Initial policies tended to be reactive, responding to the needs of particular institutions as they arose. These problems were particularly acute in the financial sector. Here, the authorities did not always respond effectively, in a coordinated manner, to the threats posed by systemic risks associated with large cross-border financial conglomerates.

Let me give you a few examples. As the crisis broke, countries acted in an uncoordinated manner to expand lender of last resort facilities, increase protection of creditors and depositors, and recapitalize banks with public funds. While countries reacted to the moves of others pretty quickly, the lack of coordination had some destabilizing effects, at least in the short term. In some cases, cross-border shifts in deposits took place. There have also been tendencies toward more explicit financial protection, where countries favor domestic lending and capital repatriation by cross-border banks.

I can point to distinct coordination failures with the Lehman bankruptcy and the collapse of the Icelandic banking system. When Lehman fell, countries moved immediately to ring-fence assets in their own jurisdictions. The case of Iceland was similar. Although Icelandic banks had a large number of nonresident depositors, the authorities failed to coordinate with the countries in question. Some of these countries ending up seizing Icelandic bank assets to protect their own depositors. Not the best outcome.

Mistakes were made, but policymakers learned from these mistakes, and are still learning. As the financial crisis evolved, and became more global, policy responses gradually became more coordinated. We saw the benefits of cooperation with the global fiscal stimulus, and with coordinated liquidity provision by central banks. We are now seeing signs of a more common approach to the cleansing of bank balance sheets. We also saw some recent agreements—brokered here in Vienna—with banks agreeing to keep supporting subsidiaries in eastern Europe. I think this all augurs well for the future.

In my remarks today, I want to stress the importance of a coordinated approach to crisis management in macroeconomic and financial sector policymaking. I think countries have made great progress in taking a common approach to monetary and fiscal policy, as they search for solutions to this global crisis, but less so in financial sector regulation and supervision. Let me address each issue in turn.

Experience with monetary policy coordination

Let me begin with monetary policy. Policymakers immediately deployed the monetary arsenal as the first line of defense against the crisis. What was different about this crisis was how far they were willing to go, both in terms of actions and coordination between countries. This coordination was mainly informal—central banks followed the same path and innovated in similar ways—but was sometimes more explicit. Contrast this with the Great Depression, which was longer and deeper than it could have been because the monetary policy response was neither consistent nor coordinated.

As the crisis progressed, we saw successive waves of monetary policy action, as central banks went progressively further to prevent a economic freefall. In the beginning, central banks focused their attention on easing liquidity, to lubricate financial markets and get the machinery working again. They loosened the terms and

availability of existing central bank facilities, expanded the range of counterparty institutions, and widened eligible collateral.

But as the crisis deepened, and uncertainty continued to smother activity, central banks went further than ever before. In the ground zero of the crisis, the Fed has been particularly fast and aggressive, cutting rates by a cumulative 500 basis points. Other major central banks have also slashed rates to historic lows, even if not to the same extent as the Fed. But they all traveled the same path together, and that is what is important.

But even that was not enough to do the job, and the ammunition began to run out as policy rates approached the zero bound. Central banks then began to move into new territory, deploying unconventional measures to resuscitate markets. Options on the plate included purchasing longer-term securities and providing credit directly to borrowers and investors. The tactics differed among central banks but the ultimate goals were similar. Remember, for most countries, this is uncharted waters—but the fact all were willing to jump in at the same time provided a needed boost to confidence.

I should note there were a couple of key occasions where the coordination became more explicit. First, there was an unprecedented coordinated cut in policy rates by six major central banks in October 2008—by 50 basis points. Second, on the liquidity provision front, the Fed authorized temporary foreign exchange swap lines with 14 different monetary authorities. Today, the central banks in the United Kingdom, the euro area, Switzerland, and Japan all have access to unlimited swap lines across different maturities. This unique arrangement was designed to alleviate the global shortage of dollar funding, and represented a true global solution to a global problem.

Experience with fiscal policy coordination

This crisis taught us that monetary policy was not enough, and that countries also needed to dip into their fiscal policy arsenal. As you know, the IMF has been out in front calling—as early as January 2008—for a discretionary fiscal loosening for countries that can afford it. We made this recommendation because our forecasts suggested an exceptionally large and long-lasting decline in demand. We saw it as especially important to avoid the risks of deflation, which would wreak havoc on the economy by raising the debt burden and further impairing the financial sector.

Indeed, fiscal stimulus should be especially effective in current conditions. During these times, the prevailing uncertainty holds back lending, which reduces the effectiveness of monetary policy. It also makes it less likely that any fiscal expansion will be crowded out by higher interest rates. With constraints on credit, spending follows current income, which again boosts the effectiveness of any stimulus, especially if directed toward the credit constrained.

But there is one key caveat—the fiscal stimulus needs to be coordinated. Fiscal stimulus is less effective in more open economies, as some of the spending feeds through to imports, benefiting output and employment in other countries. This is why collective action is so important, why countries must act in unison. If more countries act, the burden on each individual country is lessened.

It happened. Countries acted in a coordinated manner. Moving together, they delivered a global fiscal stimulus of 2 percent of GDP in 2009, exactly what we asked for a year ago. Although the coordination was not explicit, policymakers all did the same thing at the same time for the same reason. This was unprecedented, even if countries did not always receive due credit for this achievement. We are already seeing the payoff—IMF analysis suggests that the fiscal expansion boosted growth by between 1 and 3 percentage points this year, and up to a third of the gain comes explicitly from coordination.

Countries are still delivering stimulus for 2010. The jury is still out on whether this will be enough, or whether more may be needed.

Experience with coordination of financial sector regulation and supervision

Let me now address cross-border financial sector supervision and regulation. Unlike in the macroeconomic sphere, the experience with cooperation here is more mixed, and there is still some way to go. Many of the coordination failures I noted at the beginning can be traced to explicit weaknesses in this area. We clearly need more coordination on this level. Let me talk a little about this.

The crisis has exposed some clear fault lines—inconsistencies in regulatory systems across countries and clear conflicts of interests. Remember, supervisory authorities instinctively gaze inwards, focusing on the health of domestic financial institutions and protecting domestic customers. A number of conflicts come to mind. For example, when you care about domestic taxpayers, it is hard to agree on the

distribution of crisis resolution costs. And during bad times, every jurisdiction seeks to hoard as much capital and liquidity as possible, and to minimize risk.

So how do we improve coordination? I think a first step, an essential step, would be to focus more explicitly on global systemic risks. This mandate goes beyond financial supervisors, encompassing central banks and even governments. But we need to go further. We need an agreed framework of cooperation for dealing with cross-border firms that would address conflicts of interest—this would include harmonizing national legislation where necessary. I do not intend to discuss this in great detail, and will merely spell out some general principles. I think there are four essential areas: coordination of regulations, coordination of resolution tools, coordination in depositor and investor protection, and enhanced information sharing.

First, *the coordination of regulations*. One of the lessons of the crisis is that we must avoid regulatory arbitrage. Key aspects of prudential regulations must be applied consistently across countries and across financial activities. This is especially important today, as the road to a safer future involves strengthened financial regulation and supervision, not only of cross-border institutions but also of cross-border markets. This will only work if all countries sign on and take ownership of the initiative, and resist the temptation to offer loopholes.

Second, *coordination of resolution tools*. The framework needs to lay down common criteria for triggering early action when a firm gets into trouble. Strategies can differ across countries—the key is to get the best possible resolution strategy without resorting to lengthy court procedures.

Third, *coordination in depositor and investor protection*. The framework should bring some consistency to the amount of protection given to depositors and investors, and should feature explicit coordination principles.

Fourth, *enhanced information sharing*. Home and host country supervisors must be granted clear legal obligations and powers to share information among themselves, and also with local counterparts, and leave open the possibility of joint inspections.

How would such a framework be made operational? And who would oversee and enforce it? I think that institutions with expertise in the field—including the Financial Stability Board and the Basel Committee—will need to play a leading role. The IMF is certainly part of the process, even if we do not claim leadership. Our main role

involves monitoring the implementation of the agreed framework through our surveillance process. We would verify that the framework has been translated into day-to-day practices and check whether it is followed when a crisis occurs.

We also have a broader role. Go back to a key underlying rationale for better coordination in crisis management—giving policymakers the tools to address systemic risks. This overlaps with the mandate of the IMF. Going forward, we intend to focus our surveillance on systemic risks from all quarters, better integrating the macroeconomic and financial sector work, and better monitoring policy spillovers and cross-country linkages, including linkages between markets and between institutions. We are developing, in collaboration with the Financial Stability Board, a vulnerability exercise covering both advanced and emerging market countries. These new early warnings must be tough, and not shy away from “naming and shaming” where appropriate.

As an example of these issues, consider the case of eastern Europe. With heavy reliance on foreign currency-denominated debt, the reduction in capital flows puts pressure on balance sheets and economic activity in this region. In turn, this pressure gets transmitted back to western Europe, especially if the country’s banks have sizeable subsidiaries in the east. In this way, the adverse feedback loop is perpetuated.

Conclusion

Let me briefly sum up. I argued that the degree of macroeconomic policy cooperation displayed during this crisis was impressive. On the whole, countries did the right thing, and they did it together. World leaders embraced multilateralism, and are reaping the rewards. Vehicles like the G-20 were used to coordinate policies and deliver a unified message. This stands in stark contrast to the experience of the Great Depression, and is—in my view—one of the main reasons why we will almost certainly avoid a Great Depression scenario this time around—even if we are experiencing something we may call the Great Recession. I must also say that the IMF played a key role in signaling what should be done, and we were ahead of the curve in pinpointing the policy responses that have since entered conventional wisdom.

Of course, I also argued that the record is less favorable with cross-border financial regulation, and much remains to be done. I won’t downplay the challenges. It is one thing to give more resources to the IMF, or coordinate liquidity provision or fiscal

stimulus among countries, but it is quite another to change domestic legislation in line with international agreements.

I want to make one final point, a critical point. It would be wrong to pat ourselves on the back at this point and become complacent. This crisis is not yet over, and there will, in all likelihood, be further tests ahead. We should not forget that countries also need credible exit strategies from the policies put in place during the crisis. They need firm plans to wind down liquidity and return to predominantly private sector-led financial intermediation. With fiscal policy, there is a time to sow and a time to reap, and loose policies today must go hand-in-hand with tight policies tomorrow. Complacency on this front will only lay the groundwork for serious fiscal solvency problems down the road. These exit strategies will also entail coordination—perhaps even greater coordination because the choices become more politically difficult. The big challenges lie ahead. Let's not lose the momentum.

Thank you.