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Prospects and Challenges for Financial and Macroeconomic Policy Coordination

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The challenges of operating in the context of the existing international monetary and financial system are clear. The world is frequently characterized by conditions of disequilibrium, financial imbalances, and at times dysfunctional markets. This chapter touches on the progress, challenges, and prospects for financial and macroeconomic policy coordination in a world that is more interconnected and interdependent than ever, with special emphasis on the perspective of the emerging market economies (EMEs).

There are several compelling reasons to advance a greater role for international cooperation and coordination: growing international interconnectivity, significant cross-border policy spillovers, and finally the immense potential benefits that can arise when countries come together for the common good. Progress has, however, been modest.

The challenges confronting international collaborative efforts arise from differences in circumstances and policy goals, and from the need to accord priority to national considerations. Additionally, the international interconnectivity and interlinkages are not well understood. The absence of clearly defined rules and explicit arrangements for such coordination further impedes international cooperation.

Finally, strong leadership is required to build an international consensus in a world environment that is highly diverse, with divergent aspirations and ideas as to how the goals of stability and sustainable economic performance might be achieved. There is therefore a need to have clarity on the objectives that are to be achieved and on the form such cooperation should take.

International Financial System Reforms

The greatest progress in international cooperation has been in the area of financial stability. The recent financial crisis in the advanced economies was marked by its international dimension, for which the policy response has been international. The crisis set in motion an international process for the fundamental reform of the financial system in terms of new international arrangements, a significant strengthening of prudential standards, a widening of the regulatory perimeter to include institutions previously not under regulatory capture, and oversight of systemically important institutions. Also significant has been the cross-border dimensions of the reforms, associated with the implementation of global recovery and resolution plans, and the stronger emphasis on macroprudential assessments to complement microprudential supervision.

Progress has also been achieved in the coordination of the overall design of the reform measures among the international standard-setting bodies. In particular, the efforts of the Financial Stability Board, the Basel Committee on Banking Supervision, and International Organization of Securities Commissions are now converging and becoming mutually reinforcing, including with respect to the framework for global and domestic systemically important banks and recovery and resolution planning.

The reforms have also created momentum for national regulatory authorities to strengthen cross-border supervisory arrangements, which have progressed significantly, including among EMEs. From the perspective of EMEs, the supervisory colleges and crisis management groups that have been established for the international financial institutions need to ensure that mechanisms for including host jurisdictions adequately take into account the importance of the banking institution in the host country, not just its importance to the home jurisdiction or to the financial group.

It is also expected that the global reform measures will reduce the incentives for national authorities to ring-fence domestic financial systems to manage the risk inherent in internationally more integrated financial systems. However, despite the focus on consistent implementation of global standards, authorities continue to be concerned about having adequate defenses against imported contagion. Such defenses have included policies regarding subsidiarization, the imposition of constraints on global funding and shared service business models, and the implementation of national resolution strategies independent of global arrangements. Such moves represent a retreat over time from globalization and result in more fragmented markets.

This situation occurs when the global standards are perceived to be incomplete and when the implementation issues are not sufficiently addressed, or when the costs and benefits are not viewed as being balanced, or when a global standard is incompatible with national priorities. As global resolution regimes develop, they will contribute to bridging the tensions between national authorities' requirement to be accountable for domestic financial stability and the need to preserve the efficiency of global business models. The level of trust and quality of cooperation between authorities across borders will, however, be highly important to avoid a retreat from the continued globalization of financial systems.

The financial stability frameworks have also become increasingly complex over a compressed period of time, with the risk that the financial institutions and supervisory authorities may not be fully prepared, particularly in terms of data, systems, and qualified resources, to effectively implement and support such frameworks. This situation has also diverted resources and management attention from the institutions to the complex implementation issues related to compliance, with less attention paid as well to the performance of their intermediation function.

A further issue has to do with proportionality. The regulation and supervision need to be commensurate with risk, so as to avoid unintended consequences, including disintermediation and financial exclusion, which may occur as a result of inappropriately stringent application of the global standards. How proportionality is to be achieved needs to be more clearly defined and supported, with practical guidance on the implementation of global standards. This approach can help preserve consistent and comparable regulatory outcomes without compromising risk sensitivity.

Finally, cumulative-impact assessments have been difficult to conduct, especially those trying to capture the interaction between new and existing standards. It is a challenge to assess the combined impact of constantly moving parts on stability, growth, and development.

Macroeconomic Policy Cooperation and Coordination

With regard to the evolving new frontiers for macroeconomic policies and the prospects for international cooperation and coordination, the issue before us is whether policymakers should have a more global perspective that takes into consideration the global implications of their policies and whether there should in fact be greater global collective action. Those skeptical of such cooperation maintain that national polices need to be based on national and domestic considerations. International cooperation and collaboration can, however, manifest in several forms that fall short of actual policy coordination. At one end of the spectrum is the exchange of information and assessments of the risks and vulnerabilities. Another form of cooperation is the adoption of an agreed-on framework of rules and standards. At the other end of the spectrum are coordinated joint policy decisions aimed at generating positive overall outcomes for macroeconomic stability and growth.

In practice, the increased intensity of such cooperation has been evident during the more recent financial crisis. The global response to such crises as late as the 1990s largely involved the multilateral agencies that dealt directly with the crisis-affected economies without facilitating much policy coordination across countries. The global financial crisis of 2007–2009, however, prompted coordinated interest rate cuts, the Fed's provision of US dollar liquidity facilities to several key central banks, and concerted fiscal expansion by several countries. While these actions did contain the depth of the crisis, they were not enough to strengthen the prospects for economic recovery. The failure to improve the prospects for economic recovery reflected not so much failure of international cooperation as the absence of a more comprehensive approach in the domestic policy action to address the consequences of the crisis.

An extensive literature has already highlighted the concern that monetary policy has been overly relied on to bring about results. Coordination of a less than optimal policy mix may then not only not yield the desired outcomes, it may also have its own unintended consequences. A second concern has to do with the underlying domestic and international environment potentially working against monetary policy. The transmission of monetary policy is affected during periods of high leverage, when balance sheets are impaired, and during periods of unstable and highly volatile financial markets. Monetary policy also cannot stimulate consumption and investment when there is no confidence over the future prospects of the economy. Thus, a macroeconomic response may avert a collapse of financial markets and the economy, but on its own it cannot deal with the challenge of raising the upside potential of the economy.

The impact of these policies has been felt beyond the borders of countries implementing them. The greatest impact has been felt by EMEs, which have been the recipient of large and volatile capital flows. No substantial progress has been made, however, in policy cooperation between the advanced economies and the EMEs. Nevertheless, the situation has led to greater efforts at cooperation and collaboration among EMEs. In Asia, this collaboration has been undertaken through a number of forums, especially the Executives' Meeting of East Asia and Pacific Central Banks (EMEAP) and ASEAN+3, in the areas of information sharing and surveillance, establishing an integrated regional crisis management framework and financial safety net arrangements (i.e., the Chiang Mai initiative of multilateralization, or CMIM, and currency swap arrangements, including in renminbi) not only to deal with the risk and vulnerabilities confronting the region but also to unlock the collective growth potential of the region.