Fragmentation Risks

The benefits of globalization must be preserved by enhancing the international structures that ensure financial stability

Christine Lagarde

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AFTER the strife of the past five years and the depth and breadth of the crisis—brought about in part through deep global interconnections of economies and financial markets—it could be easy to lose sight of the benefits of integration. We must not.

There is much to be gained from a more integrated and interconnected global economy. Trade and financial integration over the past few decades have underpinned strong growth and job creation in many places. This globalization has helped poorer economies narrow somewhat the income gap with richer ones. It has also helped to bring societies closer together and make them more open.

But new and unfamiliar risks can also arise. These risks must be kept at bay if we are to reap the rewards of integration.

A risk cascade

As the crisis has shown repeatedly, risks can cascade through the system very quickly, sometimes in unexpected ways. Small shocks—defaults on mortgages in the United States, uncertainty about Greek government bonds, bank stress in Spain—can become global issues. In today's interconnected world, crises do not recognize borders.

With fragilities and limited policy buffers in the advanced economies that are the "core" of the global financial system, it is no surprise that systemic volatility is high. Risk sentiment switches rapidly between "on" and "off." Things are unlikely to change soon—working through the fragilities and rebuilding buffers may take several years. How can we help preserve and enhance the gains from integration, rather than see them reversed by those who prefer to retreat inward?

In a nutshell, the problem is that the architecture for stability of the international financial system has not caught up with the rapid pace of integration. Finance is global, but the architecture for ensuring systemic stability has remained predominantly national. That means that the capacity of policymakers to cope with shocks can be easily overwhelmed, and policymakers may find themselves rapidly running out of policy "bullets."

A spotlight on cooperation

No part of our interconnected world is immune. The crisis is global, and the way out must also be global. By working together, we can make the whole of our policy actions more than the sum of their parts.

For example, the coordinated fiscal stimulus in the immediate wake of the crisis helped avert a far greater economic calamity. Recently, the global community pledged more than \$450 billion to increase IMF resources and help close potential global financing gaps. But five years into the crisis, we can also see how costly the absence of effective cooperation can be.

IMF research indicates that a coordinated strengthening of policies across the Group of 20 (G20) advanced and emerging economies could raise global GDP by 7 percent and boost jobs by 36 million over the medium term. This is especially important because about 30 million jobs were lost during the crisis. The value of this collective policy action—reflected in the G20's Mutual Assessment Process—is something the IMF has advocated for some time.

Reform of the financial sector must also be a global endeavor. There has been progress—higher capital ratios and discussion on liquidity ratios, for instance. But a better financial architecture is still under construction. The priorities include:

- **Better regulation,** which is needed to implement what has been agreed and make more progress on what has not, including in cross-border bank resolution. It is also needed to look into all the hidden corners of the financial sector, such as shadow banks, tax havens, and derivatives. The latter could be moved to a few clearing houses to help transparency and lower overall risk.

- **Proper legal authority, adequate resources, and operational independence** for supervisors, similar to the prestige and autonomy central bankers enjoy. Better regulation can work only if it is enforced, which means that supervisors have to have the capacity and willingness to enforce rules.
- **Recognition that financial institutions themselves have responsibilities.** There need to be the right incentives, a framework for private sector accountability, top-quality internal governance systems, and improved risk management practices, including tax systems that discourage excess risk-taking.

Of course, policy cooperation is not the sole domain of the G20 or international institutions. We have seen recent examples of countries taking account of connections within and across regions. In the euro area, positive steps include reinforcing the common firewalls—the European Financial Stability Facility and its permanent successor, the European Stability Mechanism—and a commitment to unified banking supervision and deeper fiscal integration. It is critical to press ahead with implementation. In Asia, there has been renewed commitment to collaborate, including the recent decision to double the size of the Chiang Mai Initiative Multilateralization (CMIM), in which 10 Asian countries agree to swap currencies. The CMIM's role has been broadened from fighting a crisis to preventing one.

Notwithstanding these efforts, I fear not only that global cooperation has slowed but that there are signs of reversals: a growing mindset for nations to protect their domestic depositors and creditors at the potential expense of others, more support for local financial systems, and doubts about the gains from internationalization. At the same time, we need more progress on issues such as cross-border resolution of troubled banks or filling data gaps.

In an era of high systemic risk, protracted low growth and high unemployment, and growing social strains, episodic triumphs of systemic perspective and global collaboration are not enough. We need sustained strong policy cooperation to cope with the risks.

Enter the IMF

The IMF has a key role to play. It must pay more attention to understanding interconnectedness and incorporating this understanding into risk and policy analysis. It must draw implications for cross-border cooperation and strengthening the design of the international financial and monetary system. Its policy analysis must focus on the stability of the system as a whole, not just of individual countries.

Given our unique global perspective, we can lay out the interconnections between countries and indicate how developments and policies in one country affect others—our "spillover" analysis—to help inform policymakers' decisions. This analysis can help better connect global surveillance with country-level specificities. Our recent spillover reports covering the Systemic-5—China, Japan, the euro area, the United Kingdom, and the United States—are at the frontier of this new type of integrated analysis.

We recently approved a new Surveillance Decision to help ensure that the Fund's assessment of member countries' economies and its views of the global economy are consistent and that its oversight covers spillovers on global stability from member countries.

We are also delving more deeply into the health of financial sectors and their impact on the real economy—the "macro-financial" linkages. We will certainly not reinvent the wheel nor try to be standard-setters here. But we will develop our surveillance mission in the financial sector, in good understanding and coordination with organizations that set and coordinate international financial standards, such as the Financial Stability Board or the Basel Committee.

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There are some big gaps in our policy repertoire. For example, there is no easy way to spot the global buildup of financial risks and imbalances that can unwind rapidly. The national income accounts allow us to see at a glance imbalances and risks in the real sector. But there is no equivalent on the financial side, either globally or in most countries.

We are making progress in mapping global financial risks, digging deeper to connect the dots through bank stress tests and innovations such as the Early Warning Exercise of the IMF and Financial Stability Board. But given the complexity of the interconnections, stronger cooperation and more progress is needed to close these gaps, including through the data gaps initiative.

We have also been trying to better understand the roles of countries and the nature and implications of their interconnections (see the 2012 IMF Board paper, "Enhancing Surveillance: Interconnectedness and Clusters," available at *www.imf.org*). For example, while the Systemic-5 are connected with much of the broader system, many other economies form tightly knit trade or financial "clusters", such as in the euro area or the Asian supply chain. Some economies connect different clusters. These may be called gatekeepers, and include economies such as Austria, which financially links central and eastern Europe, and Sweden, which connects the Baltics. These economies can be merely conduits that pass shocks from one economy to another, but they can also dampen or amplify shocks. As such, ensuring their stability can be a global public good, helping to attenuate the propagation of shocks through the system.

The biggest challenge, arguably, is political. Policymakers usually have rigid domestic mandates. It can be difficult to persuade domestic stakeholders to consider, let alone undertake, difficult choices when the benefits accrue internationally. ■