Remarks by Acting Assistant Secretary Mark Sobel At IMF Conference on Restoring Financial Stability The International DimensionDecember 1, 2009

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Introduction

I thank the IMF Legal Department, Japanese Ministry of Finance and Financial Services Agency, and Bank of Japan for sponsoring this event. It is an honor to be here.

For starters, I am not a lawyer. But in many years at the Treasury Department, I have helped shape U.S. policy toward the IMF, the various "G" groupings such as the G-7 and G-20, and on international financial regulatory matters. I would like to offer some policy perspectives on international efforts to strengthen the global economic and financial system, which will hopefully serve as a good kickoff for this conference. I will focus on the global response to restore growth and the road ahead; the role of the IMF; and current efforts to strengthen financial regulation and supervision across the globe.

Restoring Global Growth

In the last year, we witnessed the deepest economic collapse in decades. But whereas during the Great Depression, the downturn persisted for a decade, only a year after the events of last autumn, financial markets have stabilized and a modest recovery is underway. We cannot be complacent – unemployment remains unacceptably high, financial stresses abound, and individuals and businesses must still restore the health of their balance sheets.

But the response to the crisis has been extraordinary. Seven decades ago, countries chose the path of bilateralism and isolationism, encapsulated in the protectionist beggar-thy-neighbor policies of the 1930s. In the current crisis, countries chose the path of multilateralism, avoided recourse to protectionism, and instead worked together to undertake enormous and cooperative macroeconomic stimulus and financial repair efforts.

In the United States, we did our part – through the strong efforts of the Federal Reserve; through the bold financial stabilization initiatives of the current and prior Administrations, including the transparent stress tests under the Supervisory Capital Assistance Program; and through fiscal stimulus pursuant to the American Recovery and Reinvestment Act.

Others did their part as well. For example, IMF data show that in the fourth quarter of 2008 and first quarter of 2009, when global GDP fell at a 6.7 percent annual rate, the G-20 undertook a massive discretionary fiscal stimulus to support demand, equal to 2 percent of 2009 GDP. Monetary policy became increasingly and highly accommodative, while countries recapitalized financial institutions, ensured no systemic institution failed, and provided liquidity support to unclog markets and guarantee inter-bank flows.

In a world of nation-states, it is up to the sovereign to act. But strong economic and financial interconnections among countries, the greater dispersion of global economic weight, and the common threat posed to all required a concerted global response. G-20 Finance Ministers and Central Bank Governors, and G-20 Leaders, developed this response. G-20 cooperation will remain essential for the future. Let me highlight two challenges where IMF support will be vital.

First, G-20 countries will need to design exit policies, once recovery is assured, in order to unwind the extraordinary government support provided during the crisis. The Fund has already begun important work to advance our thinking on this front. Last week, the Fund's Managing Director rightfully referred to a delicate balancing act, noting that a premature exit runs the risk of killing the recovery, while waiting too long to exit could lead to the next crisis. Policymakers in the U.S. and around the world are highly cognizant of these risks and will work together closely to get the balance right.

Second, the G-20 countries must cooperate to achieve a durable recovery, avoiding past excesses. As U.S. consumers save more and as our government embarks on a path of fiscal consolidation, economies with large and sustained surpluses must shift growth towards domestic demand and reduce reliance on exports. Otherwise, global growth will simply be lower. It would neither be healthy nor realistic for the global economy to rely on a single engine of import demand going forward.

One of the key outcomes from the Pittsburgh Summit was the commitment by G-20 members to a Framework for Strong, Sustainable, and Balanced Growth. In St. Andrews, Scotland, G-20 Finance Ministers and Central Bank Governors set out a detailed process and timeframe for achieving the Framework's goals, and launched a new consultative mutual assessment process to evaluate whether individual country policies will collectively deliver our agreed objectives.

The IMF has a critical role to play in this mutual assessment process by evaluating whether policies pursued by individual G-20 countries are consistent with a more sustainable and balanced trajectory for the global economy and, if needed, recommending how policies could be adjusted to improve the global outlook. We look forward to working with the IMF on the Framework. What the United States and other G-20 countries ask of the IMF, and frankly what is needed, is candid, transparent and independent assessments to support this process.

Ultimately, it is up to individual countries to deliver the policies needed to achieve strong, sustainable, and balanced growth. But the fact that all of the G-20 countries signed up to this detailed process, recognizing that policy formulation in their countries will need to take broader global interests into account to avoid the booms and busts of the past, demonstrates the strong collective resolve to tackle global challenges going forward with the same force that we brought to overcoming the crisis.

Role of the IFIs

Turning to the IFIs, this crisis highlighted that the IMF has lost none of its agility in reacting quickly as a first responder and in serving as the lynchpin of the international monetary system.

The IMF created the Flexible Credit Line (FCL), responding to the demand for a higher access, faster disbursing Fund instrument for "countries with very strong fundamentals, policies, and track records of policy implementation." It increased its capacity to provide precautionary support to help forestall crises. It revamped its low-income lending framework and sought to provide financing for the crisis in more user-friendly ways to countries. Today, non-concessional financing, including through the FCL, equals roughly $164 billion, compared with about $2 billion just before the crisis.

The G-20 also endorsed President Obama's proposal at the London Summit to enlarge and expand the IMF's New Arrangements to Borrow (NAB) by up to $500 billion. This announcement helped staunch a serious capital drain and contagion risk facing emerging markets. Last week, the NAB creditors put the finishing touches on the expanded and enlarged NAB. Not only was more than $500 billion raised, the agreement ensures that the IMF has a multilateral facility, modernized to reflect global capital flows, to act as a shock absorber against tail risks to the system.

There is much discussion now on further evolving the Fund's toolkit to better meet members' needs. In particular, recent discussion has centered on the desirability and feasibility of the Fund providing "insurance" to countries through contingent financing, swaps or other instruments.

We look forward to working with the Fund with an open mind to study this question and to hearing the views of the membership. There may well be worthy and useful ideas for the Fund to come from a study. Central to this argument is that Fund provision of insurance would discourage countries from accumulating excess reserves. Behind this argument lie complex assumptions that will require a full, transparent exploration.

First, the international community needs a much better understanding of the rationale for reserve accumulation. Countries do accumulate reserves as a buffer against shocks. But as stated in a recent "IMF Staff Position Paper," reserve holdings can also be a "byproduct of efforts to limit nominal exchange rate appreciation."

Second, the jury is still out on the question of reserve adequacy. If we are to propose new facilities to discourage "excess" reserve accumulation, then we must understand what qualifies as excessive. Historically, the IMF targeted country reserves equal to 3 months' imports. But in light of the Asian crisis and increasing integration of emerging markets into global capital markets, analysts focused on the Greenspan/Guidotti rule, that reserves should equal 100 percent of external debt maturing over the coming year.

In the wake of the current crisis, some have suggested an even greater level of reserves is needed as a shock absorber, owing to ever-greater capital mobility, which can quickly reverse in a crisis. However, at a certain point, the cost of incremental reserves can become prohibitive for the country and for the world. The Fund should undertake a comprehensive review of reserve adequacy in light of the crisis before rendering judgments on insurance.

Third, questions about "insurance" and reserve needs also relate to exchange rate regimes. On the one hand, flexible exchange rates have not dampened reserve demands as much as early proponents believed. But large emerging market countries increasingly integrated into the global system should adopt more market-oriented and flexible regimes consistent with underlying fundamentals. Such flexibility is critical for better controlling monetary policy in line with domestic circumstances, rather than those of an anchor country currency such as the United States, and to enable the exchange rate to act as a proper pricing signal to economic agents with respect to allocating resources between the external and domestic sectors.

Historically, the international monetary system placed asymmetric pressure on deficit countries to adjust, rather than surplus countries. But as discussed above, the current crisis has highlighted the need to overcome deflationary bias and promote strong, sustainable, and balanced growth.

In short, insurance cannot substitute for a rebalancing of global demand and tough and vigorous IMF surveillance, in particular over members' exchange rate policies.

As part of these debates, the Fund will need to canvass its members assiduously – would IMF insurance facilities truly address the underlying motivation behind excess reserve accumulation; are there members who would actually use such a facility at this time and if so, what features would they find attractive; what would such facilities imply for resource demands and do creditor countries agree; what would such facilities mean operationally for the IMF, for example, with respect to pricing and ex ante and ex post conditionality?

In advancing these debates on the Fund's mission and mandate, we cannot lose sight of the pressing need to modernize the IMF's governance structure to reflect the changing dynamics of the world economy. This means giving greater representation to dynamic emerging market and developing countries. Progress was made on this front in 2006 and 2008, and at Pittsburgh when G-20 Leaders committed to a shift in quota share of at least five percent to dynamic emerging market and developing countries as part of the quota review ending in January 2011. The year ahead will be critical in terms of implementing the specific steps to achieve the promised shift.

Financial Regulatory Consequences of the Crisis

The origins of the largest financial crisis in generations are complex and will be written about for many years to come. But while historians will have the benefit of time to reflect, policymakers faced an urgent need for action. Useful assessments by the IMF in its Global Financial Stability Report (GFSR) and by the BIS in its annual reports informed our efforts in real-time. These assessments underscored the many macroeconomic and microeconomic dimensions to the financial crisis.

- First, global macroeconomic drivers, including the uneven distribution of global demand and associated large persistent current account imbalances, set the stage.
- Second, the interaction between imbalances and their financing resulted in large capital flows that depressed interest rates, setting off a reach for yield, which in turn spawned the development of complex and opaque instruments, carry trades, increased leverage, and other manifestations of effervescence.
- Third, these dynamics combined with a third driver, regulatory and supervisory failures.

In hindsight, neither market participants nor regulators adequately appreciated the risks inherent and embedded in complex financial products, let alone the aggregation of these risks across the system. Supervisors and regulators, who are always behind the markets, were further hindered by their firm-by-firm approach that deprived them of a more encompassing macro perspective of the forces at play.

As the crisis broke out in the fall of 2007, the United States put forward an international strategy to tackle the roots of the crisis, which was quickly embraced by the G-7.

Our strategy was premised on several realities:

- First, regulation is a national activity and the responsibility for sound regulation begins at home.
- Second, today's financial system is global and financial stress can spread easily and quickly across national boundaries.
- Third, the benefits of dynamic and efficient global financial markets should be preserved while at the same time these markets must be soundly regulated.
- Fourth, the crisis revealed micro- and macro-prudential flaws that needed tackling.

So, how did we address these realities? Of course, we do not live in a day and age in which a "global" regulator can be the answer. National regulation is here to stay, but it also should be more consistent and convergent across the globe. Thus, national regulators, working through standard-setting bodies, such as the Basel Committee, IOSCO, and IAIS strengthened their collaboration. Also, the Financial Stability Forum, now Financial Stability Board (FSB), was seen as a critical element of the response and it was expanded to include the entire G-20. The United States has encouraged the FSB to loosely coordinate the activities of the standard setting bodies, while respecting their independence, to ensure that needed reforms to the global financial system are undertaken in a timely manner.

But the FSB's focus is primarily micro-prudential in nature. The IMF, in contrast, as the world's central macroeconomic institution, is responsible for bringing a more macro-prudential focus to bear in international discussions and we underscored the Fund should be a leader in defining and undertaking this task. Indeed, the growing need for a macro focus to supervision is increasingly evident, as seen in the EU discussion of a European Systemic Risk Board and in the U.S. discussion of a Financial Services Oversight Council.

Needless to say, in playing their critical roles, both the IMF and FSB should operate in line with their respective mandates and closely collaborate, particularly in addressing the inevitable overlaps that arise.

The strategy to strengthen the international financial system is working, in my view, and the United States is pursuing a vigorous agenda of regulatory reform at home in line with the international strategy. We are working with the G-20 to subject non-bank financial institutions, credit rating agencies, and hedge funds to greater oversight. At the Pittsburgh Summit, the G-20 countries agreed to focus further on building high-quality capital, reducing leverage, mitigating pro-cyclicality in financial regulations, strengthening adherence to sound compensation practices, improving the functioning of over-the-counter derivatives markets, and strengthening national resolution systems and the mechanisms to address cross-border resolutions of systemically important financial institutions. The challenge each G-20 nation faces now is how to implement this agenda domestically.

The IMF has played a vital role in advancing the G-20's agenda. The IMF, with its focus on surveillance, and the FSB are conducting and refining their early warning exercises on the build-up of macroeconomic and financial risks. Further, the IMF, in close coordination with the FSB and others, has been drawing lessons from the current crisis. It has furnished reports to the G-20 on issues such as the financial crisis and information gaps and conceptual and analytical approaches to the assessment of systemic importance, while work is underway related to strengthening national and cross border resolution frameworks and measures to recoup the cost of financial repair.

I have already mentioned the key role the GFSR played in the lead up to the crisis. Since markets work best when they have full access to information, transparency is critical. Earlier, I mentioned the transparency of the "bottom up" U.S. stress tests and their contribution to helping U.S. firms raise private capital and shore up confidence. The IMF has also greatly helped facilitate transparency through its "top down" GFSR exercises by assessing the capital needs, earnings, and write-downs of banks in several of the world's most advanced regions. These assessments are carefully reviewed by governments and market participants and have rightly earned great praise. We encourage countries to work with the IMF to develop more granular, transparent assessments.

The Fund's Financial Sector Assessment Program (FSAP) continues to make a key contribution to raising standards and bridging the gap between national and global spheres. In addition to its assessments of financial sector stability, the FSAP encompasses an evaluation of compliance with the financial sector standards and codes developed by international standard setters. All G-20 countries have committed to undertake an FSAP and the United States is currently undergoing one. IMF financial sector assessments have also facilitated raising standards in offshore financial centers and combating money laundering and the financing of terrorism. Looking forward, FSAPs and related Reports on the Observance of Standards and Codes (ROSCs) will be the key input to the FSB peer review process, launched by G-20 Leaders, to strengthen adherence to international prudential regulatory and supervisory standards.

As the world's central macroeconomic institution, we expect the IMF to continue strengthening its efforts to bring a strong macroeconomic focus to supervision and regulation.

Conclusion

In conclusion, we have come a long way since the onset of market turbulence two years ago, and particularly last autumn. But much more remains to be done. I cannot emphasize enough the importance of preserving the strong international cooperation that has been a driving force behind our swift and effective response to this global crisis. The job of building an effective international economic system for the 21st century is far from finished. From rebalancing the global economy to preventing financial instability and addressing global threats, the nations represented at today's conference along with the IFIs, must continue their close cooperation if we are to secure our economic goals and objectives. We remain especially committed to working multilaterally through the G-20 and IMF to advance our shared agenda.

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