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New Policy Paradigms for a New World Order

By Dominique Strauss-Kahn

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Over the past quarter-century, the global economy enjoyed a remarkable stretch of stable growth and low inflation. The so-called "Great Moderation" lulled many policymakers into a false sense of security about their ability to manage the economy and deal with financial crises. But as the Great Moderation metastasized into the Great Recession, fatal flaws in conventional thinking came to light. One of the most notable was just how poorly we grasped the linkages between the financial system and the broader economy — as well as the linkages between countries.

Today, as policymakers seek new paradigms for managing the economy in 2011 and beyond, a better understanding of these linkages will be essential to promoting economic growth and reducing the risk of crises. Equally important is the realization that by working together, we can build a more successful and more stable global economy for the benefit of all countries.

Let me spell out what this means for three policy objectives: building a stronger and safer financial sector; achieving more balanced and more stable growth; and managing large and volatile capital flows.

A stronger and safer financial system is the bedrock of a successful economy. This requires strong regulation with a sensible rulebook for financial markets and institutions. And to ensure that everyone plays by the rules, financial institutions must be supervised intensively.

Now, even with the best rules and supervision, crises will still occur. This is why we need effective resolution mechanisms to deal with institutions that get into trouble. Finally, given powerful interactions within the financial sector and across the broader economy, we need an overarching framework to manage risks in the financial system as a whole.

Much has already been done to advance regulatory reform, notably the recent agreement to strengthen bank capital (Basel III). Yet we are far from having the supervision needed for proper implementation of the rules. Effective resolution mechanisms and systemic frameworks remain even more elusive.

Moving to the broader economy, we have learned that growth must be balanced to be healthy. At the national level, this requires tools to prevent excesses in one sector from bringing down the entire economy. At the global level, it requires a better distribution of growth across countries to prevent destabilizing imbalances.

What are the implications for macroeconomic policy?

Monetary policy needs to look beyond its core focus on low and stable inflation and pay much greater attention to financial stability. The debate now is how, exactly, to factor this imperative into monetary policy, and how to coordinate the work of monetary and regulatory authorities.

For fiscal policy, the crisis showed the value of maintaining low public debt and deficits during good times. Countries with healthier public finances have more space to cushion the economic impact of crises. But the Great Recession has caused public debt and deficits in many advanced economies to soar.

How quickly fiscal retrenchment should be launched — and the right balance between higher taxes and lower spending — will vary by country, reflecting factors like the strength of the economic recovery, the market's appetite for debt and initial spending and revenue ratios. But the common objective for fiscal policy must be to support durable medium-term growth and job creation.

The distribution of income is another important issue. In the years leading up to the crisis, inequality rose in many countries, with worrisome consequences for social cohesion. Rising inequality may also have increased vulnerability to crisis. With fewer people able to dip into savings during bad times, the impact on growth is even larger.

Turning to the international dimension, understanding better how policies adopted in one country spill over onto other economies is key. This approach lies at the heart of the Group of 20's efforts to achieve strong, stable and balanced global growth. The International Monetary Fund is also stepping up its work in this area, through "spillover reports" on China, the euro zone, Japan, Britain and the United States.

Gaining a better appreciation of the financial linkages between countries is also important. During the crisis, we saw how quickly capital fled from countries previously considered safe bets. Today, many of these countries are reeling from a veritable tsunami of returning money.

Policymakers in many emerging-market countries worry that surging capital inflows will drive up the value of the local currency, destabilize financial markets, and fuel economic overheating. Their reactions range from buying up the foreign money to prevent currency appreciation to adopting capital controls and, in extreme cases, to keeping the money out altogether. The situation has become quite tense, with talk of “currency wars” and a real risk of financial protectionism.

Clearly, we need to get a better handle on what is driving these capital inflows. We also need to identify the best policies for dealing with them, keeping in mind the impact of these policies on the global economy as a whole. And we should explore whether a system of global rules aimed at reducing the volatility of capital flows would be useful.

Global financial insurance is an important related issue. Just as a family backstops its savings with insurance, countries should be able to tap into a global financial safety net. Much has already been achieved since the crisis through more resources for the IMF and new financing instruments. But more is needed, and the IMF is exploring cooperation with regional financing mechanisms, as well as new ways to use its instruments in a systemic crisis.

Tying all of this together, one principal policy failure in the run-up to the crisis was a lack of imagination. We failed to appreciate just how intricate the global economic and financial web had become. Let our next failing not be the result of a lack of cooperation. We must reach across old dividing lines — both within economies and between them — and work together to build a stronger, more resilient global economy.

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