The Limits of Surveillance and Financial Market Failure

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The Limits of Surveillance and Financial Market Failure

Lessons from the Euro-Area Crisis

Edited by

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*Dedicated to the memory of
Rutsu Shigehara*

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Preface and Acknowledgements

The euro-area crisis, which erupted only a few years after the outbreak of the global financial and economic crisis originating from the US housing market debacle, revealed weaknesses in regional as well as global frameworks for financial and economic crisis prevention. In fact, neither regional surveillance within the European framework nor global surveillance by international institutions such as the International Monetary Fund and the Organisation for Economic Co-operation and Development (OECD) was effective in preventing such large-scale crises in developed countries. Can more effective surveillance be put in place to prevent their recurrence?

In addition to limits to effective surveillance, the repeated financial crises in developed OECD countries have shed light on deficiencies in the current prudential and monetary policy frameworks which were designed to secure financial market stability and minimize economy-wide disturbances arising from financial market imbalances while maintaining general price stability. How should prudential regulations be strengthened? How should the “herd instinct” of financial institutions leading to financial market instability and the problems of moral hazard and regulatory and supervisory “capture” by large financial institutions be dealt with?

What are the implications of these problems for better management of the euro area? How can member countries meet the challenges of adapting their macroeconomic, financial and structural policy frameworks required to run a single-currency area properly? How can they overcome political economy issues involved in running such an area?

This book deals with this range of difficult policy issues of our time. After the stage setting for discussion of these in Part I, Part II offers two contrasting views of the direction of and scope for future surveillance. One view is that surveillance should be comprehensive and cover all macroeconomic and financial aspects. An alternative view is that even strengthened surveillance would not have prevented the crisis in the euro area. Therefore we need to accept that the effectiveness of surveillance is limited by governments which impose

restraints on surveillance by international institutions in their “shareholding” capacity, as well as by self-restraint by the institutions. Elected governments are often reluctant to face up to the implications of warnings and alerts by international institutions if these could be politically unattractive.

Part III goes beyond surveillance and builds on the view that microprudential control needs to be strengthened to prevent financial market failure, both globally and in the European context. Since supervisors are subject to many of the same forces that limit the effectiveness of surveillance, contributors to this part focus on the need to strengthen regulatory frameworks and to make market processes work better. Key issues include capital adequacy, the desirability of separating many investment banking activities (notably those involving large derivative portfolios) from commercial banking, liquidity, governance to limit moral hazard and ways to ensure greater comparability and transparency of information disseminated to the markets.

Part IV discusses the combined use of macroprudential and monetary policies to secure financial market stability and minimize economy-wide disturbances. It addresses the issue of achieving an operational integration of monetary and regulatory policies in Europe where institutions are decentralized, noting that even within an individual country the monetary policy authorities and the banking and security regulators often have different policy orientations. A specific issue discussed in this context relates to banks’ attempts to offset changes in macroprudential policy by changing the riskiness of their portfolios in other ways. Given the need to ease the task of better coordination of supervisory policies, a scheme is proposed to put less pressure on the regulations and to apply more pressure on measures to influence the incentives facing bank managers with respect to risk-taking.

In the light of discussions of these issues, not only in the context of the euro area but also with a broader global perspective, Part V turns to the specific issue of how the euro area should be managed to contain, and prevent, the future re-emergence of excessive intraregional imbalances leading to crises. In this part, the root cause of the euro-area crisis is revealed as the balance of payments disequilibria associated with the build-up of unsustainable debts, both public and private, in several member countries where excessive

credit expansion was caused by the lack of monetary policy independence in the single currency area. It examines various efforts to reduce balance of payments imbalances and the respective roles of debtor and creditor countries in the area, and it points to the importance of flexible nominal wages and prices, and movements of labour in order to return to a sustainable equilibrium.

Part VI provides both an executive summary and a fuller report about oral discussions concerning these topical issues that took place among paper authors, preassigned discussants and other participants in the international conference entitled “The Limits of Surveillance and Financial Market Failure: Lessons from the Euro-Area Crisis”, which was held in Paris on 23 September 2013. The event gathered first-class economists with rich experience in domestic and international economic and financial policy-making, as well as policy advisory work, in Europe, the USA and Japan, and aimed at in-depth discussion of these fundamental issues of our time with a view to finding ways for better management of the euro area and the global economy more generally. The programme of the conference and the list of contributors to it are given in the annexes.

The conference was initiated as a non-bipartisan, non-political voluntary activity by me as president of the International Economic Policy Studies Association. Special thanks are due to Robert Raymond, advisor to the association and treasurer of La Maison de l’Europe de Paris, whose assistance enabled me to hold the conference at a magnificent hall in the premises of La Maison de l’Europe de Paris in the heart of the French capital.

For the publication of this book, I received invaluable assistance from Paul Atkinson, executive director of the association. I am also indebted to Aimee Dibbens, Commissioning Editor, Palgrave Macmillan, and Kate Boothby, Copy Editor, for their extensive help.

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Tokyo, 31 May 2014

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