COMMENTARY

Is There Macroprudential Policy without International Cooperation?

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In their paper, Steve Cecchetti and Paul Tucker claim that global financial stability requires common prudential standards, as well as cooperation and coordination of dynamic regulatory policy adjustments. Before going further with my remarks, it is appropriate to properly set expectations about the scope and coverage of the Cecchetti-Tucker (henceforth CT) paper, as its title might lead the reader to expect that a menu of macroprudential policy tools is being discussed. This is not the case: the paper does not provide a discussion of the appropriate cyclical policy tools to use by central banks. These are the instruments commonly labeled as macroprudential and which many countries are developing to deal with sectoral and asset class imbalances. The CT paper *is about structural financial stability* and the types of efforts under way in international forums to support such stability.

I broadly agree with the author's diagnosis of the context preceding this discussion. The financial landscape has changed significantly since the frameworks that came out of the Bretton Woods system. In the post–Bretton Woods era, frameworks have been developed for discussion of monetary policy. Substantial cooperation across different communities has occurred on setting these frameworks, including through many dialogues that took place around the tradeoffs between fixed versus flexible exchange rate systems.

The globalization of finance has boomed. Countries are highly interconnected through capital flows, financial institutions, and markets. As a result, the risk of financial contagion has increased. There is a clear quest for a common set of rules for global finance. In my opinion, there is a good justification of the view by Cecchetti and Tucker that a financial stability policy regime could focus on resilience. Regarding macroprudential instruments, the international policy community focus is on developing toolkits and broad frameworks

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of engagement. The paper argues for specific metrics, formal monitoring and international coordination, although as I mentioned, the focus is somewhat different than this more standard discussion of macroprudential instruments. For the remainder of these comments, I put aside the important semantic issues of defining macroprudential policies and the challenges surrounding implementation of such policies.

The main focus of the CT paper is a call for a quantification of specific stability goals, along with a proposed path to support and target those quantifiable goals. The paper also sounds a call for more cooperation around stress-test frameworks currently implemented within (some) jurisdictions, and an expansion of their purpose and scope.

According to Cecchetti and Tucker, a common prudential standard, or level of "required resilience" as it is called in the paper, would in this case necessarily have to be applied to all parts of the financial system in order to avoid fragmentation of the sector and hostility between institutions. They argue in favor of specific metrics, formal monitoring and international coordination. The authors also note that, as we live in a financially interconnected world, more sharing of information between economies is required to achieve stability. The current exchange of information is inadequate. As we saw in the financial crisis, contagion in one market can quickly spread around the world. International institutions and monetary policymakers should have the flexibility to respond to new financial scenarios to the best of their abilities.

As a brief overview, three questions are posed and answered: (1) Does global finance require a common prudential standard? Answer: Yes, construct a level of "required resilience" applied to all parts of the financial system to prevent balkanization and fragmentation; (2) Does global finance require international cooperation in overseeing the system's safety and soundness? Answer: Yes, increase shared analysis to identify and mitigate stability-threatening shortfalls against that standard of resilience; (3) Does global finance require notification, cooperation, and coordination of dynamic regulatory policy adjustments? Answer: Yes, adapt institutions to make this feasible.

While the authors provide a number of broad proposals, the real issue is what these proposals mean in practice. The paper needs to do more, as the details surrounding each proposal are lacking, and some of the proposals really require clarification. On the first question—whether global finance requires a common prudential standard—the idea is interesting and worthy of careful evaluation. While the authors provide a strong endorsement and call for quantifiable metrics, the proposal raises a number of practical and basic questions that need more fleshing out. The most basic question is, what does "required resilience" really mean? The concept of "required resilience" that is introduced is quite broad. Accordingly, multiple questions arise: How would one define risk tolerance, a crucial input into calculating the appropriate requirement, and, in turn, calculate the probability of a crisis? Would the requirement be time varying and dependent on known economic fundamentals and measured crisis risk, or would the requirement be fixed? The authors also suggest defining a level of crisis by considering its space of potential output losses. Would the potential loss from a crisis be the estimated global aggregate output loss or would it be based on some distribution of losses across countries? In this case, how do country losses (or gains) enter into the computations? Are weights based on a country's ability to absorb losses or on a country's role in systemic risk? Other issues to consider are tradeoffs of output gains from booms versus losses in busts. Does this matter? There is also the issue of predicting crises. Unfortunately, the historical record of experts foreseeing crises ex ante is quite poor, as many forecast approaches are backward-looking instead of forward-looking. This raises the additional practical question of whether the authors are proposing anything different from the bank and financial system metrics already used in monitoring financial stability risks.

Another smaller point, but still an interesting political economy one, is the authors' suggestion of having a democratic pedigree. This leaves open the question of whether a required resilience standard can be free of political influence and made with independent decisionmaking. The authors acknowledge the difficulty of creating a policy that is truly independent.

An additional question to consider is whether a level of "required resilience" should actually be applied to all parts of the financial system, as the authors argue, in order to prevent balkanization and fragmentation. Indeed, it might be useful to substantiate this, as it is not evident ex ante that a common metric would be appropriate to apply across countries and sectors. An optimal requirement might allow room for country variation based on its business cycle or financial cycle stage, by its level of economic and financial development (and, similarly, by the level of its financial linkages with the rest of world and the potential for spillovers), or by country risk tolerance. For example, the tolerance for housing price booms and busts may differ across countries. Another fundamental question to address is whether or not a common approach to resilience might lead to more correlated behaviors, thereby enhancing the probability of an adverse systemic event.

With regard to increased notification, cooperation, and coordination of dynamic regulatory policy adjustments, there are various forms of this under way by countries and institutions. Following the financial crisis, most countries implemented higher capital and liquidity requirements and began utilizing stress tests to assess emerging vulnerabilities. The authors propose that countries share the results of internal stress tests, conduct a sort of global stress test in which there is a common global scenario, and allow third-party evaluation of the results. This idea of sharing results and conducting coordinated global stress tests is worth fleshing out. Stress tests are an underutilized innovation.

Finally, the paper makes some arguments about where the lessons of monetary policy frameworks for macroprudential policy are limited. I disagree with this, as decades of lessons can usefully be extracted, including having a clear statement of goals, proven policy tools, evaluation criteria, and activation and deactivation conditions. All of these could support effective use, communication, and expectations setting; independence of tools from political influence; and having tools that are not for use as a form of industrial policy that is viewed as sanctioned by the international policy community.

Overall, the authors have taken on an important set of issues and have proposed a bold agenda. The current version of the paper is really useful in providing a strong and thoughtful discussion of key issues regarding the structural stability of the international financial landscape. This big-picture orientation and ambition is laudable. However, there are still many unanswered conceptual and practical questions that might need to be addressed for the proposals to receive broader attention.