Speech

It is now two years since the outbreak of the global economic crisis. As recovery takes hold, major steps are being taken to make global financial and economic governance more effective. I appreciate having the opportunity to share with you my views on this important matter.

Policy dialogue and coordination, in forums like ASEM and the G20, have played a key role in enhancing financial and economic governance. But there is no room for complacency. Further steps are necessary to reform the financial and economic architecture in order to prevent future crises, or at least cushion their impact.

I would argue that the liberalisation of capital accounts and the growing importance of international capital flows represent the single most important change to the world economy over the last 20 years. This globalisation of the financial system has brought us enormous gains in prosperity. At the same time the global financial crisis and the earlier Asian crisis have taught us the painful lesson that we are still not properly equipped to deal with the risks of capital flows. Designing the economic and financial system to manage capital flows is therefore crucial if we are to improve economic and financial stability and development.

To this end, I propose a comprehensive five-pillar approach to enhance financial and economic governance, with the ultimate goal of making capital flows work. The five pillars are macroeconomic policy, financial sector regulation, IMF surveillance, management of excessive capital inflows or volatility, and global safety nets. Let me address each in turn.

Macroeconomic policy is the first pillar, as it has a significant impact on capital flows. The policy debate on global imbalances has so far focused on exports and imports. However, imbalances are sometimes driven by capital flows rather than by goods and services. What’s more, capital flows have a considerable impact on the real economy and on jobs. We should adapt our macroeconomic policies accordingly and take capital flows into account.

The second pillar in making capital flows work is appropriate regulation for the financial sector. The financial sector can be exposed to significant risks and also contribute to the risks associated with capital flows. Both excessive inflows and outflows of capital can have harmful effects on countries. These risks are addressed by the new Basel standards on banking supervision. They provide buffers to absorb losses from mismatches and downturns. Yet global adoption of the Basel regulatory standards should not be the end. Future innovations in the financial sector, especially in advanced countries, should be closely monitored.

Thirdly, while the IMF has provided substantial assistance to countries in liberalising capital inflows and outflows, it should pay more attention to surveillance on this matter. As the third pillar, I propose incorporating this in the IMF’s existing surveillance framework. This will help each country to formulate appropriate policies.

At certain times, the three pillars mentioned so far may not be enough to ensure efficient allocation of capital. We then need a line of defence against the risks posed by capital flows. So in exceptional circumstances, as a fourth pillar, measures could be considered to curb excessive capital inflows and the volatility of inflows. These measures should be market-based, clearly communicated, and temporary.

Finally, as a fifth pillar we need to install global and regional safety nets. Safety nets are sometimes necessary to dampen the effects of the ‘mood swings’ of markets, whether rational or not. This would guarantee countries predictable and stigma-free access to international financial liquidity, even in times of crisis. I believe that better integration and coordination of existing safety nets at country, regional and global level will strengthen these initiatives. The recently established European Financial Stability Fund is a good example of such coordination.

Let me conclude with the following message. The Netherlands is well known for its innovative solutions in water management. This has enabled us to weather storms and control the flow of water, so that we can benefit from our geographical location. In the global financial landscape we now face flows of a different kind – capital flows, which offer unique opportunities, while entailing serious risks. I believe that the five pillars I have mentioned will make it possible to channel capital flows effectively, and form a solid basis for a reformed global financial architecture. This will enable us reap the benefits, while riding the tides – by making capital flows work.

Thank you.