11 April 2008

Speech by the Chancellor of the Exchequer, Rt Hon Alistair Darling MP at the Brookings Institution, Washington.

Let me start by thanking Strobe Talbott and the Brookings Institution for organising and hosting today's seminar.

This weekend, Finance Ministers from the world's major economies have the opportunity to make a difference.

Today I want to make the case for urgent action by the world's major economies to deal with what is the biggest economic shock since the Great Depression. And to make the case for reform of our international institutions to meet the challenges of the twenty first century.

My starting point is that most problems are capable of resolution if we have the political will to act.

That is why I came into politics: we can make a difference if we choose to do so.

And this year every country, every government has one aim: to maintain stability through the world economic slowdown and promote global prosperity.

But whether it is financial stability: dealing with high food and commodity prices; or indeed ensuring security of energy supplies - if we act together we can deal with these challenges.

At the end of the Second World War, nations realised that they had to act together to prevent problems arising in one country spilling over into others.

The need for international cooperation is even greater today. As we have seen, problems that arise in one country - the US sub prime market - spread across the world in weeks.

But the great institutions set up over sixty years ago - the IMF, the World Bank - were designed for another age. They need to be reformed and refocused to deal with today's challenges. Financial stability is the most pressing, but is just one example of where nations need to act together.

So reform of our institutions is essential. But so too is urgent action now on the big challenges - financial stability, how to deal with rising food and commodity prices that are already impacting developing and developed countries alike.

What I want to say concerns financial stability. And let me start with my view on where we stand today, and let me start at home in the UK.

Britain, with its central role in the world's financial system has, like every other developed country, been affected by the problems that started in the US housing market last summer, and which have spread around the world.

But with low inflation, record employment and numbers claiming unemployment benefit at their lowest level for a generation, and with the action taken last year to curb inflation, Britain is well placed to withstand the slowdown in the global economy.

We cannot be complacent and must remain vigilant, but the UK economy has proved resilient to a number of shocks over the past decade, demonstrating the pay-off to the Government's macroeconomic policy framework and the promotion of open and flexible product, labour and capital markets.

As a result of this resilience, in the past decade the UK is the only G7 economy to have avoided any negative quarter of growth.

But these are uncertain times. There are huge challenges ahead. All major economies will see slower growth this year.

The fundamentals in the UK are sound: high employment; historically low inflation; lower debt.

And these are providing the flexibility and resilience to respond to today's challenges.

The IMF forecast that the world economy will grow more slowly this year than the average of the last decade.

Oil prices have been above $100 a barrel in recent months and food and metal prices have increased sharply too. This is bringing new inflationary pressures.

And the Prime Minister has called for international action to tackle the particularly heavy and immediate impact of energy and food prices on developing countries - but they will affect every economy.

Here are two examples of where countries acting together can make a difference.

Since last summer, global financial markets have suffered a prolonged period of turbulence with liquidity being squeezed.

But there are good reasons to believe that we will get through these difficult times provided we take the right actions at home and together.

Governments and Central Banks around the world have already taken action in response to these developments. And they will continue to do so.

Central banks have made co-ordinated efforts to improve liquidity in money markets, signalling our collective determination to whatever action is necessary to ensure stability in our own countries and in the world economy.

And we must ensure that we continue to do whatever is necessary, to maintain confidence in the financial markets.

The evidence shows that economies which are both stable and flexible are more resilient in the face of shocks.

So we will continue to take no risks with stability. And we will continue to look to the long term, preparing our economy and country for the challenges we face over the next twenty to thirty years.

But the immediate challenge is to deal with the current uncertainty in the financial markets.

Britain will continue to play a full role in the European Union and in the international response to financial markets turbulence.

We must ensure more resilient financial markets and more effective supervision for the future.

And market-led actions must play a key role in reducing uncertainty, improving confidence and restoring normal market functions.

At the G7, we must make sure we take the action necessary to calm global markets and strengthen them against future shocks.

This weekend's meetings of the IMF and the G7 occur at a critical time in shaping the international response to recent events.

We need to understand what lies behind this current turmoil.

The global economic stability that has characterised recent years has coincided with a wave of innovation and restructuring in financial markets.

This has been driven, in part, by what is known as 'the search for yield' during a period where we have experienced historically low interest rates.

Financial innovation has brought considerable benefits.

It has allowed increased access to finance, with the easier and more efficient allocation of capital with, and between, economies.

It has also increased the scope for risk to be diversified. That is all to the good.

But recent events have also highlighted that the increased complexity and sophistication of markets carry risks that need to be better managed and understood.

Innovation brings huge benefits provided institutions and regulators can understand what they are doing.

The problem is that too many institutions, too many boards who have primary responsibility for what their firms are doing, failed to understand the risks to which they became exposed.

There must therefore be greater transparency in the financial markets, providing greater certainty and confidence. That is why today, in the present context, the sooner institutions disclose their positions the better.

This is not just a matter for individual banks. It matters to us all. I see that in the past few days some banks have pleaded mea culpa. Indeed, but we are all feeling the consequences.

So we have seen all too starkly over the last few months that effective regulation and supervision is essential. Not requiring more regulation - though reform is needed - but effective regulation.

And the strengthening of international co-ordination too is necessary - financial institutions span the globe.

That is why cooperation between supervisors is so important - so that problems can be identified before they take hold and spread. And so that institutions that operate at a global level can deal with the regulatory systems more effectively as well as providing greater reassurance.

Our response needs to be measured and proportionate - we must not repeat what I might call the 'Enron mistake', where in an attempt to deal with an undoubted problem, there were unintended and undesirable consequences.

It is not a question of more regulation - often it is a question of regulators and management doing their job effectively.

And I welcome the Institute of International Finance's interim report, which sets out provisional views on action that the industry should take in learning the lessons from recent events.

There is a clear public interest here.

We have to recognise that interdependence is the defining characteristic of our globalised economy.

My constituents living in Edinburgh are directly affected by the failure on the part of Boards of Directors sitting thousands of miles away to understand the risks their firms had taken on.

So preventative action is crucial, but how do we respond to today's problem?

Across the world, Central Banks have taken action both individually and collectively to increase market liquidity.

In the UK our fiscal policy, as with monetary policy, will support stability.

Earlier this week the Bank of England cut interest rates to 5 per cent. It also added more liquidity into the system, totalling £15 billion.

Conditions are still difficult, for example the UK three-month LIBOR spread remains high compared to this time last year.

So I welcome the Governor of the Bank of England's commitment to provide liquidity assistance to the banking system to enable it to function normally.

And the financial industry will need to play a key role with us in identifying the measures that will maintain stability, not just now but for the longer term.

We need to reduce uncertainty. To improve confidence between financial institutions. And encourage the restoration of the normal functioning of markets.

This is precisely the type of collective challenge the G7, the Financial Stability Forum and the IMF were established to meet.

That is why at our meeting in October, the G7 asked the Financial Stability Forum to analyse the causes of market turbulence and develop a global policy response.

They have made a number of important recommendations - both in terms of immediate action which can help calm the markets - and medium term action to improve the resilience of the financial system.

Today, we must commit to implementing the Financial Stability Forum report fully and quickly.

First, transparency and disclosure.

A lack of transparency breeds uncertainty and mistrust, undermining the effective functioning of financial markets.

As a vital first step, we must encourage disclosure by financial institutions that is clear and consistent and contains detailed information about firms' risk exposure.

This needs to be supported by corresponding action by international accounting bodies and market participants in order to enhance transparency around the valuation of structured products and banks' off-balance sheet exposures.

Second, risk management.

Market turbulence has also highlighted the need for better risk management and stress testing practices within banks and other financial institutions.

As a priority, rapid implementation of the Basel II framework will improve the prudential regulation of banks and will support better risk management by banks.

This action needs to be supported by action in two further areas.

As we have witnessed, in times of stress, liquidity in financial markets can dry up very quickly.

In the UK, the Financial Services Authority is consulting on improvements to its regulatory framework for the management of liquidity risk; this should be supported by international action through the Basel Committee.

Credit ratings agencies also need to take action to strengthen the quality and integrity of the ratings process and enhance the information content of ratings, including through strengthening the IOSCO code of conduct to address conflicts of interest in the activities of ratings agencies.

I welcome the initial steps that have already been taken by some credit ratings agencies and by IOSCO.

But we should not hesitate to take action if the market-led response proves inadequate.

And to improve international co-ordination of supervision, the use of international colleges of supervisors should be expanded.

We also need to strengthen international co-ordination in crisis management.

We must ensure that the Financial Stability Forum recommendations are met with a clear commitment to act at both a national and international level.

But each of us has responsibility at a national level too.

And in Britain, we are taking action to modernise the UK regime to respond to the challenges of rapidly changing global financial markets.

We are determined that Britain and London in particular remain the preeminent financial centre in the world.

We are proposing reforms to banking system. With a view to the Government bringing forward legislation, alongside actions by the Bank of England and the FSA, to further enhance stability and confidence.

So last year, in response to the problems encountered by the Northern Rock bank, we stepped in to preserve financial stability and to protect savers. But we need to overhaul and strengthen the effective supervision of the financial system.

First, to reduce the likelihood of banks failing we have proposed action to strengthen the regulatory and supervisory framework.

Second, to reduce the impact of failing banks and to do so in a way which minimises the potential impact on financial stability, we will introduce a "special resolution regime" for banks, which provides the Authorities with new options to deal with banks in difficulty.

Third, effective compensation arrangements in which consumers have full confidence in the compensation scheme in the event of a bank failing.

Finally, strengthening and improving co-ordination between authorities, not only within the UK, but also internationally, to address the issues raised by financial globalisation.

The recent financial turmoil has also highlighted the importance of links between the housing sector and financial markets.

There are a number of key differences between the UK and US housing markets which mean that the UK housing market is unlikely to experience problems in the way that the property market in the US has been affected.

First, in the US the falls in housing prices are being driven by a very large overhang of unsold houses. In the UK, by contrast, housing supply has not kept pace with demand.

Second, while the UK also has a sub-prime mortgage sector, it is much smaller than that in the US.

Third, regulation around mortgage lending is stricter in the UK than it is in the US.

Many of the regulatory changes now being suggested there in response to the problems in the market are already in place here in Britain.

In the UK we have responded with measured and proportionate policies.

We have taken action in specific sectors to ease the strains in the mortgage backed securities markets.

As I announced earlier this week, we will look at market-led initiatives to improve liquidity in the mortgage-backed securities market.

We will consider options for improving the mortgage-backed securities market aimed at broadening the investor base for mortgage-backed securities and improving the robustness of the market. There are similar initiatives taking place in markets in the US and Canada.

We are also considering what further action the industry could, and should, be taking to support borrowers and homeowners in difficulty.

The European Union is also looking at the key issues, to analyse the causes of market disruption and develop policy responses at a EU level.

And it is important that the EU and the US work together.

This is a common problem and we have to work together to resolve it.

As I said at the outset, there is a vital role here for our international institutions. They need to be responsive and effective in dealing with new global events. It is precisely for this reason that we need to accelerate the pace of change within them.

All countries face common challenges and can tackle them more effectively together. Challenges such as climate change and poverty. But also how to foster growth and prosperity.

And it is by working through international institutions that the global community comes together to meet these challenges. So it is vital that they are effective.

And let me remind you of an example of where we have it in our power to make a difference this year.

It is more important than ever to promote openness to trade and investment, including successfully concluding the Doha Development Round in 2008. Here is an example of where the world can act together and make a real difference. We just need the political will to do so - all of us, wherever we sit, rejecting protectionism, breaking down barriers to trade.

There are two key lessons that can be drawn from the current crisis.

First, that national economies are intimately linked and that events in one country can impact on others around the world.

Second that there is a need for us to take action in response to the risks that have been identified.

That is why the IMF needs to work with the Financial Stability Forum to develop an early warning system, focusing its surveillance more closely on financial sector issues and on the links between developments in the financial sector and the wider economy.

The IMF should also strengthen its analysis of spillovers between economies.

It is critical that the IMF and the Financial Stability Forum work closely together - they should analyse the risks to the global economy. And identify responses to mitigate those risks, reporting to Ministers twice a year.

But if global institutions are to give credible advice that is acted upon, we need them to be representative of the world we live in.

This weekend the IMFC will be discussing governance reform. I have already voted in support of the Resolution to make the IMF more representative of its members' roles in the global economy.

However, this is only a step in the direction of reforming international financial institutions.

There is a further debate to come about the governance of international institutions.

Today there are new challenges and international institutions need to adapt to today's problems.

The international meetings this weekend are important meetings which are taking place at a critical time.

The critical point is that all long-standing and established organisations need to be ready to change.

Because without change, without reform, and without the ability to demonstrate leadership and innovation, they will become marginalised and ineffective in supporting the co-operation needed to deal with global events and issues.

People around the World expect no less. Just as I believe that working together at home we can make a difference, we need to show that to work together at a global level we can tackle global problems that affect us all.

We are defined by our ability to prepare and deal with events.

I believe that my colleagues at the G7 and IMF are united in our aim to have a stable and resilient world economy.

And to deal with the problems that can be overcome if we are to ensure rising prosperity shared throughout the world.

I hope that the meetings this weekend will let us develop these ideas. Then let us agree them. And crucially then let us act - and act now.

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