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Mr. Tharman Shanmugaratnam
Chairman, International Monetary and Financial Committee

Mr. Marek Belka
Chairman, Development Committee

Dear Chairmen:

On the occasion of the upcoming IMF/World Bank Spring Meetings, we would like to share with you our concerns about the risk of fragmentation in a global economy.

Regulatory fragmentation and lack of policy coordination threaten to add considerable headwinds to a global economic recovery that is still struggling to gain traction. The decisive actions at the G20 Summits in London and Pittsburg laid out a vision of globally coordinated financial regulatory reform and policy actions. But that vision is increasingly eclipsed by nationally driven regulatory and economic policy measures. These threaten to fragment the global financial system, creating policy uncertainty as well as an uneven playing field. Such moves could also increase the costs to all users of financial services.

This looming fragmentation goes against the grain of an increasingly integrated global economy, which has thrived on cross-border flows of trade and finance. The development of a globalized economy and financial system has underpinned an unprecedented period of prosperity since the end of the Second World War, and has lifted hundreds of millions of people out of poverty in recent decades. The disruption of cross-border financial flows that results from an increasingly fragmented world will have significant economic costs, without necessarily strengthening the overall financial system. Cross-border financial flows have already declined by 60% since their peak in 2007.

Regulatory fragmentation can be seen through the increasingly national approaches in key reform areas, such as provisions for resolution of failing firms, and capital and liquidity requirements. Differentiation in the implementation of globally agreed standards and domestic bias in supervisory practices, have also contributed to a sense of financial "Balkanization". Incoherence and complexity are compounded by the extraterritorial overreach of some national measures.

While progress is still being made toward globally harmonized resolution for large financial institutions, based on the Financial Stability Board's (FSB) Key Attributes of Effective Resolution for Financial Institutions, some major countries appear to assume that cross-border coordination will fail during a crisis, and thus have focused on securing supervisory information and resources for resolution within their jurisdictions. This has led to efforts to "ring fence" capital and liquidity within national boundaries—as reflected, for example, in the US Federal Reserve Board's proposal for enhanced supervision of Foreign Banking Operations (FBOs), among other national initiatives. These measures would raise costs and diminish global financial institutions' ability to manage capital and liquidity, reducing efficiency in global markets. By restricting the redeployment of capital and liquidity resources among affiliates of global groups, they could increase the fragility of the global financial system, instead of making it more resilient.

Even the agreed Basel III capital standards are being implemented in non-uniform ways, as countries are "adapting" the specifics of capital requirements, gold-plating international norms with local add-ons, and accelerating timetables for implementation —resulting in an inconsistent global regulatory environment, despite G20 goals. Moreover, and especially during financial crises—such as the Euro Area sovereign debt crisis—there has been anecdotal evidence of home bias in supervisory guidance, not only regarding the allocation of capital and liquidity, but also lending and investment decisions.

Some national measures constitute clear extraterritorial interference in the rest of the global financial system. Examples of this include significant portions of pending proposals for derivatives' regulation in the US and EU (despite wide recognition of the cross-border nature of derivatives markets), the US Foreign Account Tax Compliance Act, and the Financial Transactions Tax agreed among 11 European countries. National measures involving significant extraterritorial reaches into other markets will increase the complexity and uncertainty of the global regulatory framework and financial risk, undermining mutual trust among policy makers, without which a globally cooperative approach will be impossible.

The retreat from global arrangements that have greatly benefited the increasingly integrated global economy is also evident on the trade front. Launched 12 years ago, the Doha Round of multilateral trade negotiations seems to have been abandoned by the major trading blocs. Instead, regional and bilateral trade agreements have proliferated—354 such trade agreements have been notified to the World Trade Organization (WTO) at last count. While these are to be welcomed as interim measures to promote trade liberalization, such regional trade agreements nevertheless increase the complexity and reduce the transparency of the international trading system. They are second best to a global trade regime, in that they potentially divert trade from the most efficient producers, to the cost of all participants in the global economy.

In the field of economic policy, while efforts continue to be made in the mutual assessment process (MAP) under the auspices of the IMF, there has been little policy coordination in recent years. Fiscal consolidation and monetary accommodation, particularly in mature economies, have been almost exclusively done on the basis of national economic and political considerations—without global coordination, with the exception of ex post "damage control" communiqués. In the area of fiscal policy, this lack of coordination has led to adjustment efforts being put on deficit countries without compensating moves by fiscally stronger countries, leading to overall weaker economic activity. This has been particularly the case during the Euro Area sovereign debt crisis. Moreover, uncoordinated announcement and implementation of asset purchase programs by various major central banks, while justified by domestic economic circumstances, have also contributed to unnecessary market volatility.

The G20, the premier forum for global economic and financial policy coordination, should now rise to the challenge, as it did in 2008 and 2009, to breathe new life into the global cooperative spirit for financial regulatory reform and policy coordination. It should reaffirm support for the FSB and encourage members to move away from national approaches and re-focus their efforts to promote globally coordinated reform. The G20 also should provide a fresh and determined push to revive the Doha Round of Multilateral Trade Negotiations, which could energize currently sluggish global economic growth.

Similarly, the International Monetary and Financial Committee should re-engage members—especially major countries—in economic policy coordination, moving forward from the complex mutual assessment process to a more direct commitment by major economies to coordinate their policies for their benefits as well as those of the global economy.

Sincerely,