

General Discussion: Global Liquidity: Public and Private

Chair: Janet L. Yellen

Mr. Meltzer: Claudio Borio sort of got to this problem at the end. This subject, broadly thought of, is a fundamental problem of monetary economics that both policymakers and economists usually want to avoid discussing. How much should domestic policy restrain its action in order to increase the stability of the global system? That's a fundamental problem, has always been a fundamental problem, of monetary theory. And we've had different responses. Under the gold standard, the international standard received considerable attention. Under current policy in central countries, no international role has had much importance, except in crisis. And the swap chart shows the response in a crisis to prevent the spillovers that would be damaging to everyone. And there's no anticipation now of what will be done in a crisis, so there can be no planning for how the international monetary system and the domestic system can interact. That's a fundamental problem. Years ago, at one of these meetings, I proposed that the three or four major currencies be bounded by a zero-to-2-percent inflation objective, which would satisfy a domestic price level problem. At the same time, it would prevent a large amount of spillovers. That system would work, only if there were incentives and penalties for violating it. There may be better ideas, but we will not find a

durable structure without limiting domestic policy actions and that's an urgent task, I believe, as we move into the 21st century.

Mr. Kim: In your presentation, you said currency swaps by central banks were a success and had contributed greatly to stabilizing the financial market. And you elaborated in detail about the issues related to arranging, establishing the global financial safety net. I would like to hear your view about the progress made by the international forum on this issue. I think one of the problems that we all have in dealing with such an issue is that in many regards establishing the global financial safety net is an issue related to emerging economies, but as we all know when the G-20 meetings started several years ago one of the more important policy issues was achieving global rebalancing. But we know that we have ended up with imbalances in foreign reserves these days. The amounts of foreign reserves held by emerging economies have increased, rather than decreased. And I think one of the reasons is because we didn't succeed in dealing with the incentives for accumulating foreign reserves by emerging economies. And I think to that extent, establishing a global financial safety net benefits not only emerging economies, but also advanced economies. I'd like to hear your view on this.

Mr. Signorini: My comment is that I would be slightly less pessimistic than you are on the effect of international cooperation between central banks in times of crisis. Or perhaps, correspondingly, a bit less optimistic about the potential for ex-ante agreements that would amount to a set of rule-based international liquidity arrangements. As you put it, there is a trade-off between two different situations. In a domestic context there is a lender of last resort, which means there is an inherent tendency in private agents, absent liquidity rules, to build up less than optimal reserves of liquidity, because of moral hazard and increased risk of a crisis. In the international liquidity context, where there is no lender of last resort, there is a tendency to build up excessive reserves of liquidity that are wasteful and potentially distorting. In the case of national financial systems, the answer to the risk of moral hazard is liquidity regulation, which is the path that we are taking. If we go too far we may incur the risk of sequestering too much of safe assets into required reserves. On the

other side, you say the solution to the problem of the wasteful and distorting excess of official reserves would be some kind of international ex-ante arrangement. This however raises the issue of moral hazard and one has the impression that it's not very easy to write rules ex ante in a way that may avoid or minimize the problem of moral hazard. It reminds me of a notion that is now less fashionable than it once was, "constructive ambiguity," or the notion that the lender of last resort would be expected to intervene to avoid a systemic crisis but without pre-committing to any specific action and especially without pre-committing to bailing out any specific agents that might run into trouble. I think that the international kind of cooperation and swaps agreement that we have seen during the crisis has some elements that resemble the idea of constructive ambiguity: a very second-best solution by definition, but in a situation where a first-best solution is a bit difficult to devise in theory and very difficult in practical, institutional, terms to apply.

Mr. Eichengreen: I want to speak to the safe asset question, if I may. I agree with Jean-Pierre Landau that what's going on in emerging markets at the moment will probably further increase the demand for safe assets and foreign reserves. The question is where they will find the supply. It seems to me the paper identified six ways of dealing with this problem, two of which are undesirable, and four of which are infeasible. The two that are undesirable are "make safe assets less safe" and "make them more expensive"—these were the routes, in a sense, that we went down before 2007. The ones that strike me as infeasible are, first, have the U.S. Treasury provide them indefinitely. Second, make them privately, the problem here being that private safe assets can become unsafe very quickly. Third, make them by tranching. That is to say, make only a portion of existing reserve assets safe without expanding the supply. And, fourth, make them through the creation of SDRs or through some kind of global safety net, where the problem here is that the supply will still depend on the capacity of the U.S. Treasury to back them. So that leaves us, it seems to me, with only the alternative of making them in more places—in other words, of making them in Frankfurt and Beijing by encouraging reserve diversification toward the euro and the renminbi.

Mr. Portes: I was going to wait for safe assets until after the first round, but let me just pick up on this point that Barry Eichengreen addressed. Where is the evidence for the shortage of safe assets? You don't see it in Jean-Pierre's table. You don't see it in the Committee for Global Financial Stability report that Bill Dudley chaired, which came out very recently. You don't see it in Goldman Sachs' estimates of the prospective supply-demand for safe assets. So in quantities, it's not obvious at all. As for prices, the claim is that interest rates now are historically low, but actually real interest rates were lower in the 1960s and 1970s on average than they have been in the past decade. So, if we want to go to the bottom of this, where's the beef? There's lots of good macroeconomic theory about the shortage of safe assets and its implications, but is there actually a shortage and is there a likely shortage?

Mr. Landau: I want to thank Claudio Borio because I think actually he gave a much better summary of my paper than I did and much clearer. Obviously, there are two differences. One I think, which is not absolutely fundamental because I agree actually with everything that he said about the long-term perspective and the long credit cycle and how it should be dealt with. I was rather talking of a different cycle, which is more like short term. After all, we had like three or four reversals of capital flows to emerging economies in the last three years. So, this is the kind of cycle I was dealing with and for me, what I call the buffer approach in foreign exchange results are maybe at the moment the only other instruments to deal with that. And of course, I was expecting, I think not everybody would agree that the foreign exchange reserve accumulation is on the precautionary. I think it is, but I recognize that a wide range of people, maybe including in this room, have other ideas about the motives of foreign exchange accumulation.

I think Governor Kim and a colleague from the Bank of Italy asked a very, very important question. My sense is that we need official liquidity for different reasons, or for additional reasons than 10 years ago. Ten years ago or 20 years ago, we needed official liquidity because we needed them to finance balance of payments for countries which had problems. So the problem was the mix of adjustment and

financing and we had IMF, and IMF conditionality. And we still have that because we have some problems of that kind in many countries, including in Europe. So that problem of official liquidity is there with us. But we have another one, which is providing official liquidity for the stability of the financial system as a whole, independently of the situation of balance of payment. And that's a different thing because it cannot be conditional and it cannot be ex-ante limited. At least I wonder whether it can be ex-ante limited. And so this is the big problem with the international safety net. My guess is that I think that what we had during the discussion of G-20, and I was partly part of it, made a very, very strong case that constructive ambiguity was not the right approach to this issue. So I think more or less this issue can be dealt with. The problem I still struggle with is how to conciliate the idea that it should be unlimited because if it's not unlimited, then the incentive to build up reserves will still go on and the fiscal implication, which Claudio Borio and I described. That's the problem I'm still struggling with and I must confess, I haven't found the solution. Because it doesn't mean that we cannot make some additional progress, it doesn't mean that an international agreement and a global safety net are out of reach. It may be I think the technical aspects about the moral hazard can be solved. They can be solved. Whether that will be sufficiently powerful to create a strong incentive to foreign nation reserve accumulation, I still don't know. So that would be my answer to Governor Kim.

And then of course, there is the question of safe assets. First, is there a shortage, and if there is, how should we differ? I think Richard Portes is right. We don't have hard evidence either on the quantities or the price. What we know for sure, that's why I included that slide from the Department of Treasury, is that the demand for high-quality collateral will increase massively in the next five to seven years. Massively, by an enormous amount of magnitude, because of the liquidity issue, because of the CCPs, because the increase margin requirements and on derivatives, and because the reuse of collateral, the rehypothecation is going to be forbidden. The velocity of collateral is going to be diminished and requirements are going to increase. And that's trillions and trillions of dollars of additional requirement. And here I'm less certain, but I have doubts, looking at what

happened in the past, on the ability of the private sector to manufacture such collateral, without at least some form of public intervention. So that goes to the heart of Barry Eichengreen's question of what is a safe asset. Has it got some kind of intrinsic characteristic? Or is it a product of policies and institutions? And I would say maybe a little bit of both. So I think, again, the way central banks are going in the future to define, manage and ... collateral is going to have a huge implication on all this involved. So, some solutions are unacceptable and some are impossible, but I see that deepening the cooperation of collateral is in my view, a very, very important issue of cooperation.

Mr. Borio: There is no shortage, as far as I can see, and the recent CGFS report has reached a similar conclusion. I don't think there is any shortage of safe assets as of now. But I do think that there is a serious risk of a progressive deterioration in the creditworthiness of both of the public sector and the private sector over time, unless we tackle these financial booms and busts differently from how we have so far. I also see a risk of a progressive loss of room for maneuver, not least for monetary policy. This is why at the BIS we have been arguing for a more symmetric approach to the boom and bust phases of financial cycles. In other words, I think there is a risk that what we're seeing is a deceptively stable disequilibrium that will come back to haunt us a few years down the road. If so, we'll have monetary policy with little room for maneuver and we'll have fiscal policy with little room for maneuver. This would put a lot of pressure on prudential policy, which will have to raise buffers at the wrong time in the financial cycle.

Mr. Kohn: A couple of points. One on the push versus pull. A lot of the emphasis here yesterday and today is on the influence of the United States and the other advanced economies on the emerging market economies, and the influence of easy monetary policy on other countries. But the recipient countries have considerable control over how this works out, and what the stability conditions are inside their own countries. I don't think we should lose track of what's happening on the other end of these flows. And a point that Claudio made was one of the ways that monetary policy from the United States was transmitted to the rest of the world, was by

resistance to exchange rate appreciation in many other countries, and that's why they imported the easier U.S. monetary policy early in the 2000s. And the second related point is I think the relationship between monetary policy and financial stability continues to be a very difficult one that Claudio Borio and I have discussed over the years. I think the concerns about financial stability need also to be taken together with concerns about where resource utilization is. So Claudio Borio said he thought monetary conditions were too easy globally right now. And he was worried about various financial stability issues, but I think you also have to worry about the fact that unemployment rates, almost everywhere in the advanced economies, are higher than their long term, where they ought to be at the long term. And that investment is low; productivity growth is low, in part because of that. It's not obvious to me that monetary policies are too easy now, gauged against this other metric of employing resources and the cost of having unemployed resources. This is a very difficult trade-off.

Mr. Carstens: I would like to make two comments. First, I'm surprised that in Jean-Pierre Landau's presentation, the IMF was not mentioned. The IMF is an institution that has been created to help us solve some of these issues, especially related to the international liquidity cycles. The IMF is not perfect; in particular I don't think the fund has the capacity to assist in an effective way in providing resources if there are widespread problems in advanced economies. But certainly, it can take care of many problems in emerging market economies and I think that, as Christine Lagarde reminded us yesterday, deadlines are getting closer and it would be good to have the governance changes and the quota increases at the IMF that have been committed, because I think that at some point, the fund represents an avenue to provide liquidity assistance for many countries. So I think that to refocus on the IMF would be very, very important. And I just cannot help to react to Don Kohn's last comment. Being in the receiving end of capital flows, certainly in Mexico we have allowed the exchange rate to adjust, but at some point, too much is too much. Real exchange rate appreciation has real effects and it affects our economies. And capital inflows have not responded primarily

to our local situation. So at some point, to put at least some gravel on the road toward appreciation is perfectly rational and desirable because such real exchange rate adjustment has real effects; also you have to prepare for the time when capital will flow out. At that stage, the accumulated international reserves could be very useful. So I'm mindful that the real appreciation of emerging economies' currencies are part of the adjustment process, but you also have to realize that excess liquidity has real effects on other economies.

Ms. Lagarde: Complementing his point actually, I would like to also express surprise that there was not more recognition of the regional financial arrangements that we are seeing in many corners of the globe, whether it's in Asia, in Europe of course, and probably among the BRIC countries, possibly extended to a couple of other countries. And I think the combination between those regional financial arrangements, the role played by the IMF and the liquidity supply provided officially as indicated in Jean-Pierre Landau's paper is something that should be considered and is worth more thinking. Final comment I also want to make in response to the first comment made during the discussion is the fact that the IMF under the integrated surveillance decision, is now in a position to actually do the surveillance that it does and provide the advice that it should provide. Taking into account, not only the domestic consequences of decisions made by policymakers, including central banks, but also the spillovers of those decisions in the way in which they sort of feed back into the domestic policies that are decided at home on a regular basis.

Mr. Landau: On the IMF, I mentioned in the paper. I think it's, in a kind of ideal world, you would have conditional liquidity provision by the IMF and unconditional liquidity provision by other means. Actually, we have that kind of gray area of the precautionary arrangements of the IMF, which are half-conditional. It's very interesting to see how countries look at them. I think this is very important and if I'm not mistaken, during the crisis, Mexico took both a flexible credit line and the swap arrangements. And if I'm not mistaken, the flexible credit line was basically taken as a kind of stamp of credibility. So the conditionality aspect of the IMF is very important and the swap was used because it was unconditional. So that's where the gray area we

are, and I think we are not yet at the end of the reflection about the precautionary arrangements. And whether they are there to give us a seal of credibility or whether they can provide the amounts which are necessary, I think, but that's a very personal view.

On the regional arrangements, I also mentioned them in the paper. Just two things. They are very adapted when you have an asymmetric shock inside the regions, so one country in the region has a liquidity shortage as compared to the other countries, then pooling liquidity inside the region does make sense. If you have a global liquidity shock, regional arrangements bring virility? As compared to global arrangements? That said, for this part of the world, which are undergoing very deep financial integration; Asia of course. Having low regional liquidity arrangement would go a very long way in underpinning regional financial integration. So, I think they are very useful for solving, for progressing in regional financial integration and solving regional asymmetric shock. When you have a global liquidity shock, you have to have a global solution. That would be my answer.

Mr. Borio: Well, I think I have to respond to Don Kohn, and I'm sure that this is a conversation that will continue afterward, but just three points on what you said Don. The first one is that, of course I was referring to global monetary policy stance, so thinking of the world as a closed economy, not about the policy stance in individual economies. And that policy stance, regardless of what measure you use, looks very, very accommodating. Even if you use, for example, John's Taylor rule. And remembering that you're not including the fact that the impact of LSAPs is not taken into account, the impact of forward guidance is not taken into account. And furthermore, the impact, if you believe that you need to respond to financial imbalances, the impact of financial imbalances is not taken into account. Then you end up with a situation in which that measure looks very, very accommodating.

The second issue has to do with the measurement of economic slack. As you know, if you use somewhat different measures of economic slack during the boom pre-crisis, they show that actual output was going ahead of potential, particularly through financial information, was running ahead of potential during that period, which, by

the way, is what now typical production function approaches show nowadays, but only with the benefit of hindsight.

And the third point is that, to my mind, not all gaps or slacks are born equal. There may be types of slacks that are rather less amenable to monetary policy having a big effect. For example, if you think that you start from a situation in which the whole economy is already too overindebted, trying to use monetary policy to try and provide boost to that economy, may be a relatively blunt instrument, which is why I was talking about a different mix of policies in order to address financial balance which would use both fiscal policy and prudential policy in a way to try and address directly the asset quality.