"A Role for International Policy Coordination?"

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Challenges and Prospects"

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A. Introduction

The subject of this conference is International Policy Cooperation while the subject of this panel is International Policy Coordination. Since these are two very different things, I will focus on the former. I take cooperation to be a more informal means of maximizing joint welfare, and to involve a much broader range of instruments than just traditional macroeconomic policies. In my comments I will range over the prospects for international cooperation with respect to monetary and fiscal policies, but also a much wider range of both instruments and policy regimes.

Since cooperation can be directed to various objectives, I will distinguish in my remarks between crisis management (and resolution) and crisis prevention. To get well ahead of myself, I will conclude that in both spheres cooperation has been inadequate to date, and the prospects are dim for any improvement. Lurking behind this political reality is a grim fact. Policymakers have a number of false beliefs about which policies will suffice to extricate ourselves from the current crisis and to prevent future ones.

B. International Cooperation and Crisis Management

Before turning to solutions, it always pays to identify clearly the **nature of the problem**. My contention would be that we have had many years, perhaps even decades, of unnaturally easy monetary policies and credit conditions in the Advanced Market Economies (AME's)[1]. A series of "booms" and "busts", characterized by each bust leading to an easing of monetary policies which fuelled the next boom, culminated in the crisis which began in 2007. This ongoing crisis was characterized by such a high level of private sector debt (primarily

[1] White W R (2013) "The Short and Long Term Effects of Ultra Easy Monetary Policy" Proceedings of a Conference on "A Changing Role for Central Banks?" Austrian National Bank, Vienna, June

households) and financial sector leverage (primarily banks) that a normal post War cyclical recovery could not be expected. This was not a normal downturn.

The near term situation has not been eased by the perception of some policymakers that regulatory tightening and fiscal tightening were necessary in order to restore their room for maneuver going forward. In effect, crisis prevention took precedence over crisis management. This left monetary easing as "the only game in town" in the AME's. On the one hand, monetary easing was the proper response to the illiquidity of markets which manifested itself so suddenly after the failure of Lehman Brothers. On the other hand, monetary easing has a number of downsides as well. Not least, if there is an underlying problem of insolvency (which there is) rather than just illiquidity, then easy money keeps alive "zombie" companies and banks and impedes the normal "Schumpeterian" adjustment process. In this way, it has had negative supply effects to go along with whatever positive effects it might have had on aggregate demand.

Moreover, there can be little doubt that monetary conditions since the crisis have had important effects on financial markets. As I speak, equity markets in many countries are at record highs, credit spreads and measures of risk (the Vix) near record lows, CDO's and CLO's are again rising rapidly and credit standards have been falling fast. In all those AME's where the banking system has remained "healthy", and where mortgage demand has been stimulated by low interest rates, both household debt and house prices are at record levels. To me, the financial markets of the AME's today look very similar to those in 2007.

It would be a great error to suggest that all the problems originated in the AME's. Many Emerging Market Economies (EME's) have for many years pursued policies of semi fixed exchange rates against the currencies of the AME's, above all the US dollar. In pursuit of this objective they have eased domestic monetary policy and intervened massively in foreign exchange markets. In so doing, they have imported many of the economic distortions (not least higher asset prices) of the AME's but have also generated significantly higher domestic inflation as well.

Moreover, after having to deal with the problems associated with capital inflows and currency appreciation, they now look forward fearfully to the prospect that all this might reverse. The developments in the spring of 2013, associated with just musings about the prospects of the Fed "tapering" its bond purchases, indicate that these fears are not unfounded.

In short, the global crisis is by no means over. The BIS has recently estimated that the level of debt in the G 20 countries (household plus corporate plus government) is now 30 percent higher than before the crisis. There is much deleveraging still to do. Moreover, fears of a Fed "taper" are not the only source of concern. China is apparently engaged upon a massive shift in its growth strategy, which may or may not go smoothly. The results of "Abenomics" in Japan, not least the Bank of Japan's unprecedented polices, remain to be seen. And, while financial markets are calmer, the problems in the euro zone have by no means gone away. Finally, with prospects for monetary tightening significantly more likely in the US, the UK and China, than in Europe and Japan, exchange rate volatility could be of a high order. Given the degree of international interdependence, in both the real and financial sectors, problems anywhere seem almost certain to have important implications everywhere. To sum up, the global economy still remains highly exposed.

What solutions might be suggested that would involve international cooperation? I would recommend, in principle, at least five possibilities. However, each comes with some specific caveats and each is also subject to some general factors likely to impede international cooperation. These impeding factors will, moreover, likely be amplified depending on the state of the economy. I take it as a given that national, parochial and near sighted interests will gain influence if the crisis worsens.

Recognizing that the global economy suffers from a shortage of demand, my first proposal is that countries in a better position to expand domestic demand should do so. Countries with relatively low levels of debt, particularly external debt, should use whatever instruments seem appropriate. In China household consumption could be encouraged in various ways[2], which would help demand elsewhere as well as encourage the "rebalancing" sought by the Chinese authorities themselves. A similar point could be made with respect to Germany, the only country in the OECD where the ratio of household debt to GNP has actually been falling in recent years. Such stimulus would be particularly helpful given the need for "rebalancing" within the euro zone. As well, China and Germany, as well as many other countries, still have relatively favorable fiscal positions that could be extended further.

Counterarguments to this proposal are not hard to find. Compared to five years ago, even creditor countries have less room for maneuver. In many countries inflation is on the rise. In a still larger set of countries, other imbalances (not least rapidly rising house prices) threaten problems going forward. For example, given recent rates of growth of credit in China, is this really the appropriate time to end financial repression? As for the relative good health of the fiscal situation in many countries, the counterargument made is that their absolute position remains dire and improving it must be their first priority.

My second proposal would be to encourage both public and private investment. Public infrastructure in many AME's, including Germany, has deteriorated significantly. Moreover, in most countries, corporations are highly profitable and have highly liquid balance sheets. However, international considerations weigh on such possibilities. Countries worry that if they "go it alone" on investment spending, the resulting increase in sovereign debt will hurt their credit rating. As for private investment, it will continue to be held back by fears of protectionism and uncertainty about future tax burdens.

A third proposal with an international dimension would be to let the exchange rates of creditor countries strengthen. This would help address inflation fears in such countries as well as deflation fears elsewhere, particularly in the United States. Unfortunately, with the US seemingly ahead of others in its cyclical

[2] For example, higher wages, a stronger exchange rate and a less repressed financial system would all encourage more consumer spending. See Pettis M "The Great Rebalancing" Princeton University Press, Princeton, New Jersey

recovery, the dollar seems more likely to strengthen than to weaken. Indeed, should the US economy weaken more than expected, a return to "Risk-Off " behaviour might lead to the same outcome. In any event, countries asked to appreciate will likely continue to resist this outcome since it leads to large capital losses on their reserve holdings and also interferes with export led growth strategies. From a shorter term perspective, virtually every country (both debtors and creditors) is looking for export growth to be the key to economic recovery. Evidently, this does not add up globally.

A fourth proposal would be to use structural reforms to encourage the production of more non tradable in countries with surpluses and more tradable in countries with deficits. This would be particularly helpful in the euro zone, where the nominal exchange rate is fixed. Such proposals will, of course, be resisted by vested interests everywhere. In China the political resistance is likely to be particularly fierce since so many members of the CCP have amassed vast fortunes through pursuit of a growth strategy emphasizing subsidized investment in tradables. Countries in Northern and Central Europe likewise see no need to change a growth strategy that, until now, has been highly successful.

A final proposal is that unserviceable debts everywhere should be more quickly and definitively written off. The recognition that "half a loaf is better than no loaf" has motivated debt restructuring for millennia[3]. This would remove the headwinds to spending, suffered by debtors, and would also encourage structural reforms since the creditors would no longer seize all the benefits of faster growth. Households in many English speaking countries would benefit from this, as well as households and even a number of sovereign debtors in peripheral Europe.

At the domestic level, there are numerous impediments to getting the benefits from such debt restructuring[4.] Not least, when debtors cannot pay, creditors do

[3] See Graeber D (2011) "Debt, the first five thousand years" Melville House, New York

[4] For an analysis of the particular legal impediments to explicitly reducing household debt in the US, see Ellis L (2008) "The housing meltdown: why did it happen in the United States?"BIS Working Paper 259, Basel. However, in most of the US, households can still walk away from their "non-recourse mortgages", an outcome that is likely to be even more costly to lenders than an agreed reduction in debt service obligations. Repossessed houses tend

not get paid. This raises immediately the question of the solvency of domestic lenders. Unfortunately, in many countries domestic legislation to deal with the insolvency of financial institutions is totally inadequate. This creates a strong bias in the direction of forbearance ("extend and pretend") and maintaining the illusion that unserviceable debt will somehow become serviceable.

Given the extent to which debts are now traded internationally, and the particular exposure of banks that are "too big to fail", writing down debt (or restructuring it in some equivalent way) is fraught with a related but even greater danger. In particular, there is no binding international agreement that would allow the orderly winding down of an affected bank classified as a G-SIFI by the Financial Stability Board[5.] Moreover, if there were to be such an agreement, it would also have to include clauses concerning burden sharing across governments. Even in Europe, where the political urgency for Banking Union might seem the greatest, little progress has been made. It is symptomatic that the unification process in Europe has begun with banking supervision, rather than banking resolution and deposit insurance as might have been expected given an ongoing crisis. This sequencing was chosen precisely because it allows the issue of burden sharing to be put off into an indefinite future.

The inability of global governments, six years after the failure of Lehman Brothers, to deal with the "too big to fail" problem reflects other considerations as well. First, has been intensive lobbying by the financial firms concerned in support of the status quo. Second, none of the major countries involved seems to want to give political leadership to the issue. It is hard to avoid the conclusion that major sovereigns prefer a system without rules so that they can seize the assets within their jurisdictions in the event of a major failure. Closely related, there is a trend emerging towards the imposition of bank holding structures within national jurisdictions. Such structures are a substitute for international agreements but

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rapidly to lose their value. In contrast, in most of Europe, creditors can demand payment from debtors for many years after the declaration of personal bankruptcy.

[5] A G-SIFI is a Global, Systemically Important Financial Institution.

also represent a sharp reversal of the process of financial globalization. Whether in the end this will prove a good thing or a bad thing remains to be seen.

If there are impediments to international cooperation with respect to each of the policy proposals just discussed, there are more general impediments as well. First, for long standing historical reasons, both the US and China have a “go it alone” mentality, especially when it comes to exchange rates. Second, many creditors have a sense of “moral authority” implying that they have no responsibility for adjusting to deal with emergent problems. In effect, debtors must do all the adjusting and so cooperation is otiose. We see this starkly in the euro zone today. Third, it is hard for countries to cooperate when they have different views about the nature of the underlying problem. For historical reasons, Central Europeans are mostly focused on the dangers of government deficits and inflation, while North Americans are more worried about unemployment and deflation. Fourth, different countries have different political systems and different political constraints. In the US, the President proposes, but Congress disposes, while the euro zone requires unanimity for all important decisions. Neither of these structures encourages broader, global cooperation.

Two other impediments to international cooperation, one very old and the other rather new, must also be taken into account. The old one is the unwillingness of countries to give up sovereign power. While this willingness has increased with time, the change has not been commensurate with the increased need for international cooperation generated by globalization of all types. The new impediment has been the pursuit of ultra easy monetary policy in many important countries. Viewed as a “free lunch” by politicians, it has served to disguise the need to purse the policies suggested above and the degree of international cooperation required to realize them. Unfortunately, as also noted above, monetary policy alone is incapable of providing the “strong, sustainable and balanced growth” desired by the G20. Arguably, the pursuit of this false belief has left the global economy in a worse state today than it was in 2007.

C. International Cooperation and Crisis Prevention

False beliefs have also bedeviled the search for policy measures to prevent future crises. Better international financial regulation, greater success in pursuing price stability, use of macro prudential instruments and capital controls, and ad hoc measures to strengthen the International Financial Architecture have all been suggested as necessary (sometimes even sufficient) conditions to prevent further crises. While perhaps welcome in themselves, pursuit of these objectives has also diverted attention from the single most important requirement for future stability. We urgently need reform of the International Monetary System[6]. In the following paragraphs, I discuss all these issues in turn.

Since the beginning of the crisis, enormous efforts have gone into improving **international financial regulation** in the pursuit of "financial stability". Spearheaded by Basel based groups, in particular the Financial Stability Board, many welcome steps have been taken[7]. Among these I would include the Basel lll requirements for banks, the new attention being paid to the dangers posed by the "shadow banking system" based on market funding, and the greater focus on systemic issues and the potential for "procyclicality" in the financial system. Also welcome have been efforts made to promote transparency, and to collect data relevant to the assessment of systemic risks in the financial system. Yet there are also grounds for belief that all this work will not prove adequate to ensure financial stability in the future, much less macro stability more broadly[8].

[6] For a much fuller explanation of the need to revisit this question, see Pringle R (2012) "The Money Trap" Palgrave Macmillan

[7] For a description of recent international developments and associated critiques, see White W R (2013) "The prudential regulation of financial Institutions: Why regulatory responses to the crisis might not prove sufficient" SPP Research Papers , School of Public Policy at the University of Calgary, Volume 6, Issue 32, October.

[8] Neither price stability nor financial stability can guarantee broader stability of macro aggregates like output or employment. The historical record seems quite clear on this. On the former see White W R (2006) "Is price stability enough?" BIS Working Paper 205, Basel, April. On the latter, see Reinhart C and Rogoff K S (2009) "This time is different: Eight centuries of financial folly" Princeton University Press, NJ. See especially p 145 where the authors state "Severe financial crises rarely occur in isolation. Rather than being the trigger of recession, they are more often an amplification mechanism".

First, radical measures thought necessary for crisis management purposes have made crisis prevention even more difficult. Moral hazard has certainly increased and even more imprudent behavior encouraged. As well, through the process of mergers and acquisitions, many banks that were previously considered "too big to fail" are now much bigger and more interconnected than they were before. Moreover, as noted above, solutions to the resolution problem are still wanting. Second, every new regulatory measure proposed to date has invited significant hostile criticism. While this might be expected from representatives of the financial industry itself, much of this criticism has come from the ranks of respected academics and even those within the official establishment[9]. In sum, the basic analytical foundations of this vast effort remain open to question. Third, implementation issues remain formidable. If national implementation differs it will, at best, invite regulatory arbitrage and a "race" either to the bottom or the top. Neither would seem optimal. At worst, the credibility of the whole international exercise could be lost.

Two other considerations also merit consideration, though here the issue is less one of risk than of radical uncertainty. All policy measures affecting complex systems are bound to have unintended consequences. A good example at the moment has to do with new regulations that could both increase the demand for good collateral and also reduce its supply. The effect on the liquidity of financial markets (already directly affected by new liquidity regulations) is essentially impossible to predict. Finally, the financial system is not only complex but also adaptive. Innovations designed to evade new regulations must be expected. Moreover, other innovations will arise spontaneously, providing not only new opportunities but new risks. Since many attribute the expansion of the shadow banking system over the last decade or so to efforts to game the previous regulatory system, this is hardly a set of concerns of only marginal importance.

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[9] For an example of the former, read Admati A and Hellwig M (2013) "The Banker's New Clothes" Princeton University Press, NJ. For examples of the latter see Haldane A (2013) "The Dog and the Frisbee" in "The Changing Policy Landscape". Symposium sponsored by the Federal Reserve Bank of Kansas City, Jackson Hole Wyoming. Also Blundell-Wignall A and Atkinson P (202012) "Deleveraging, Traditional Versus Capital markets and the Urgent Need to Separate GSIFI Banks" OECD Journal, Financial market Trends, Issue 1

Perhaps the biggest concern about relying primarily on better financial regulation to avoid future crises is that bad regulation and supervision was not the only factor contributing to the crisis. Recall that the world has experienced such crises from time immemorial, under a wide variety of regulatory and monetary systems. This has led many commentators to see the crisis as having **domestic macroeconomic roots**, not least an excessive expansion of credit encouraged by too easy monetary conditions. It is a thus a monetary and central banking issue, rather than (or in addition to) a regulatory one. To date, however, central bankers have suggested purely national solutions to what is still viewed as a problem arising in the domestic financial system. Moreover, even at this domestic level, views differ widely between central banks as to what needs to be done to prevent future crises.

Some central banks continue to believe that the achievement of near term domestic price stability will suffice to provide stability in the main macroeconomic aggregates. Thus, they would put most emphasis on the output gap (Pillar 1) as a guide to future inflation and to monetary policy. How this view can be maintained in light of the events of the last five years or so (described in Section B. above) is hard to fathom. In contrast, other central banks have not been so sure that Pillar 1 alone can be relied upon. For example, the Bank of Japan, until quite recently, pursued "two perspectives", encompassing Pillar 1 along with an implicit commitment never to allow credit to grow as it did prior to the beginning of their Great Recession. The European Central Bank also has a second "monetary" pillar, although its purpose is not yet crystal clear. Its original purpose (drawn from the Bundesbank) was to give signals of longer run inflationary problems arising from excessive monetary expansion. More recently the second Pillar seems increasingly to be used as a signal that excessive credit growth might lead to "busts" and even deflation in the future. These differences in interpretation about how best to conduct domestic monetary policy should be enough to shake confidence in the belief that "wise" central banks have the key to avoiding crises in the future[10].

Worse, these various approaches all focus on domestic considerations without reference to the international implications of domestic policy and vice versa. Given the growing literature on issues having to do with global liquidity and growing capital flows, to deny such externalities (especially for the Federal Reserve) seems odd at best[11]. Moreover, there is also evidence that international linkages, both real and financial, are getting stronger. Both the IMF and the OECD have documented how correlations in country growth rates rose sharply in 2009 and have since remained elevated compared to earlier periods. Correlations of all-in-returns across international financial assets have risen even more dramatically. Increasingly, one is led to the view that we are all in this together.

The traditional response of those focused solely on domestic monetary policy objectives, and wishing to stimulate demand, is that other countries can insulate themselves from the externalities by allowing their exchange rates to float freely upwards. The problem with this solution is that the theory of Uncovered Interest Parity only applies over long time periods. Thus, momentum trading can cause exchange rates to differ markedly and uncomfortably from fundamental considerations in response to changes in monetary policy elsewhere.

Further, as affected countries intervene to stabilize their exchange rates, and then reinvest accumulated reserves back in the currency of the country initially wishing to stimulate demand, credit conditions in that country become still more stimulative. In effect, the exchange rate channel is attenuated and replaced by a stronger domestic channel. As a side effect, price pressures are also less likely to emerge (via a lower exchange rate) to trigger a tightening of policy. The moot question, however, is whether the central bank's original policy setting took this

[10] Moreover, views on this matter and related matters have changed repeatedly in the post War period. Monetary policy is not a science. See White W R (2013) "Is Monetary Policy a Science? The Interaction of Theory and Practice over the Last 50 Years " in Balling M and Gnan E (eds) "50 Years of Money and Finance" SUERF, Vienna

[11] It must of course be recognized that, legally, the Fed has no choice but to follow its legislated mandate.

altered transmission channel adequately into account. If not, then the dangers associated with excessive credit creation are increased. Moreover, since there is no limit to how much countries can intervene to prevent exchange rate appreciation, this concern about international feedbacks might well be consequential.

There is also an emerging literature directed at attenuating the damage done to foreign countries when large countries (especially the United States) ease their monetary policy. What this comes down to is essentially an identification of the various stages of the **international transmission mechanism and the use of regulatory instruments** to block them[12]. Thus, it can be plausibly argued that the chain starts with lower policy rates in the US leading to increased leverage by globally active banks. The recommendation is to use leverage ratios, or some other measure, to stop this from happening. The next link is with capital flows abroad which can be stopped with capital controls. The next link is that capital inflows contribute to more domestic credit creation. This should be met primarily with macroprudential instruments, since higher policy rates would only attract more capital flows.

While this approach seems sensible at first glance, it must be recognized that the use of all the instruments referred to have their specific downsides. Capital controls leak over time and invite corruption. Macro prudential tools are still in their infancy and there are widely divergent views about their efficacy. Moreover, none of these recommendations address the problems that exchange rate intervention might pose for the country that is the source of the capital inflows. Finally, what is being suggested by this vein of literature has a strong flavor of "chacun pour soi" and "sauve qui peut", relying enormously on the technical

[12] See in particular Rey H (2013)" Dilemma not Trilemma: The Global Financial Crisis and Monetary Policy Independence" Symposium sponsored by the Federal Reserve Bank of Kansas City, Jackson Hole, Wyoming, August. Also see Committee on International Economic Policy and Reform (2011) "Rethinking Central Banking" The Brookings Institution, Washington, September, and Shin H S (2011) "Remarks at the IMF conference on Macro and Growth Policies in the Wake of the Crisis", Washington, 7-8 March,2011.

expertise that each individual recipient country can bring to bear. In short, it falls very far short of being a systemic response to a systemic problem.

Finally, it should be noted that there have been numerous ad hoc proposals for measures **to improve the International Financial Architecture.** First, the IMF has become more experienced in doing FSAP's, and is now regularly engaged in doing "Spillover" exercises. Second, the IMF has recently suggested that central banks in countries which are the origin of cross border capital flows have a responsibility to think about the implications for the recipient countries. Third, the supervisory community has similarly encouraged home supervisors to pay attention to the implications for host countries of the activities of their home country banks. This applies not only to cross border lending but to host country activities. Fourth, within the euro zone, agreement has been reached on strengthening fiscal rules and to extend the indicators for disciplinary action to current account imbalances, albeit on an asymmetric basis.[13] Similarly, in Europe, significant responsibilities for cross border supervision of banks has been given to the European Central Bank.

These piecemeal efforts are welcome, but they remain piecemeal. Moreover, in large part they remain "advice" as opposed to a binding rule to guide future behavior. The IMF for example, has no means of penalizing creditors who have no need of IMF assistance, nor any means of penalizing the US, the country with the world's largest external debt. To date, the joint status of the US as global hegemon, and the issuer of the world's principal reserve currency, have made it essentially impervious to outside influences or the concerns of others. Still more fundamentally, the problem remains the unwillingness of sovereign nations to give up enough power to make a globalized financial world work both efficiently and safely.

The central message of this section of the paper is that none of the measures taken to date seem sufficiently robust to be relied upon to prevent further

[13] Deficit countries will have to face disciplinary measures if the current account deficit exceeds 4 per cent of GDP. In contrast, surplus countries will be questioned only when the surplus is greater than 6 per cent of GDP. Germany has just crossed this threshold, and it will be interesting to see what will follow.

financial and economic crises. We should disabuse ourselves of this belief. To do so would, at the least, open the door to thinking about the prospective benefits from reforming the International Monetary System. It is instructive to note that our current global problems would never have been allowed to cumulate as they have, had either the gold standard or the Bretton Woods system still been in place. There might well have been different problems, but certainly not the ones we currently face. The "system" makes a difference.

A "system" is a set of arrangement that provides collective benefits to the participants and a set of rules to prevent behavior that could destroy the system and all its advantages. From this perspective we currently have a "non system". There are no rules to prevent the world's largest debtor from relying solely on policies to stimulate more demand and still more debt. There are also no rules to prevent the world's largest creditors from resisting currency appreciation in ways that cut off both the elasticity and absorption channels of trade adjustment. In addition, we have no guaranteed sources of adequate international liquidity when crises do occur. Nor do we have any international process of financial oversight to ensure that financial markets do not contribute to such crises.

Of course, it is always easier to say what you do not like than what you do like. I would go no further today than to suggest that we need to begin by examining more carefully the nature of the problems we seek to address through international monetary reform, and the dangers implicit in not doing so.

The traditional worry has been current account imbalances, the **net** international position of borrowers and lenders, which could easily culminate in currency crises. More recently, a further set of concerns have arisen over **gross** cross border flows and the prospects they raise for currency risk, credit risk, and liquidity risk. It is increasingly recognized that the materialization of such risks could potentially have systemic implications for both debtors and creditors. This recognition, combined with inadequate remedial measures at the international level, raises the danger that individual countries will try to protect themselves in idiosyncratic ways, often under the pressure of events. In the limit this could prove a major threat to globalization and all the benefits it brings.

A final concern about the current international monetary “non-system” is that the expansion of global monetary and credit aggregates continues to be dangerously **unanchored.** Each country is strictly pursuing its own short term interests without thinking about the increasingly important implications for others. This is of particular concern in the case of the US since its monetary policy choices have such an enormous influence on monetary and financial developments elsewhere. This absence of a longer term anchor could yet lead to high inflation and/or further credit induced “boom bust” cycles on a global scale.

Given the nature of all these dangers, and the shortcomings of remedial measures to date, policy makers would be well advised to address the issue of reforming the International Monetary System. They need to do this both more systematically and more urgently than has been the case thus far.