

Comments on M Obstfeld's: “Dilemmas and trilemmas: living with financial globalization”

By C Borio

Inaugural Asian Monetary Policy Forum, 24 May 2014, Singapore

- Thank organisers for the very kind invitation to this event,
 - In particular to discuss Maury's paper
 - It is a pleasure and privilege to have this opportunity
- As I discussant, I am in a difficult position
 - Very thoughtful, rich and balanced paper
 - I very much agree with its basic thrust
- In particular, I agree with the key statement
 - Financial globalization reduces the room for manoeuvre of monetary policy (MP), but does not eliminate it
 - MP can still have a significant effect on domestic financial conditions, provided it involves a significant degree of exchange rate flexibility
 - It is all a matter of tradeoffs and choices
 - This is a statement that, by the way, applies equally to the globalization of the real economy
 - To the growing importance of global relative to domestic factors in the inflation process (BIS research)
- I also agree with some of his sub-statements
 - The long-term rate (econometric analysis) as well as credit conditions and asset prices (descriptive analysis) are more sensitive to global influences than the short-term rate
 - Impact of global risk appetite on risk premia and quantities (“global liquidity”)
 - Our own work at the BIS supports this
 - Financial globalization also undermines the room for manoeuvre for financial regulation
 - Although I would not say that this is a bigger problem than for MP (his conclusion)
- There are aspects that, if Maury had the time and room, could benefit from further analysis
 - What are the features of an economy that influence the room for manoeuvre?
 - Size; degree of dollarization; inclusion/not in global indices; fixed vs flexible interest rates; depth of domestic markets, creditworthiness, etc
 - Are there non-linearities in the spillovers and hence in the tradeoffs?
 - Very long period of unusually aggressive MP in advanced economies and its link with the search for yield

- In my comments, I would like to broaden the focus and put Maury's analysis in context
- Question: What does this all this mean for
 - Key weakness in the international monetary and financial system (IMFS)?
 - Policy?

I. Weaknesses in the IMFS

- *Achilles' heel: IMFS amplifies weakness of domestic monetary and financial regimes:*
 - "Excess financial elasticity" (EFE): inability to prevent the build-up of financial imbalances (FIs)
 - Fis= unsustainable credit and asset price booms that overstretch balance sheets leading to serious financial crises and macroeconomic dislocations
 - Credit and property prices are key
 - Financial Cycles (FCs) are much longer than business cycles (as conceived and measured) – Graph 1
 - 16-20 years vs up to 8 years
- Origin of EFE lies in very nature of economic processes
 - Interaction between loosely anchored perceptions of value and risk, otoh, and liquidity (financing) constraints, otoh
 - mutually reinforcing processes through which financial booms sow the seed of their subsequent collapse
 - aka "procyclicality" of the financial system
- But it depends critically on policy regimes: it is amplified by...
 - Liberalised financial markets
 - Weaken financing constraints
 - MP frameworks focused on (near-term) inflation
 - Provide less resistance to build-up of FIs (expansionary bias)
 - ...and, paradoxically, by positive supply side developments
 - ↑ financial boom; ↓ inflation
- IMFS exacerbates this through some of the channels discussed in Maury's paper
 - Interaction of financial regimes: mobile financial capital across currencies and borders
 - Adds external (marginal) source of finance (Graph 2)
 - External credit tends to outpace domestic credit during booms
 - Transmits financial conditions
 - Term and risk premia
 - Makes exchange rates subject to overshooting
 - For same reasons as domestic asset prices
 - Interaction of monetary regimes: generalises expansionary bias of monetary frameworks in core economies and hence the risk of build-up of FIs

- Directly:
 - currency areas extend beyond national jurisdictions (eg, US Dollar)
 - More direct influence on financial conditions elsewhere
 - MP has a powerful impact on risk premia and financing terms (“risk taking channel”)
 - Indirectly: through resistance to exchange rate appreciation
 - Central banks keep policy rates lower than otherwise...
 - Impact on domestic interest rates
 - ...intervene in FX markets and invest proceeds in reserve currency assets
 - Impact on foreign bond yields
- Evidence
 - Amplitude and length of FCs have greatly increased since financial and monetary regimes have become more conducive to them since early 1980s
 - And have gained further strength following the real globalization of the global economy
 - FIs have continued to present day, with some differences pre- and post-crisis
 - Pre-crisis: build-up mainly in some large advanced countries
 - Reflected also in aggregate cross border bank credit growth
 - (Asia was still recovering from its crisis in the late 1990s)
 - Post-crisis: build-up in some countries less affected by the crisis (Graph 3)
 - Including in Asia, but not only (Lat Am, Advanced Economies)
 - Again supported by external credit, but this time mainly through capital markets
 - Strong growth of UD dollar credit outside the US
 - Unusually easy MP conditions for world as a whole pre- and post-crisis – the Great Deviation (Graph 4)
 - and strong FX reserve accumulation
 - evidence that US MP stance has an effect on policy rates elsewhere over and above domestic macroeconomic conditions (including BIS research)
 - Maury’s results in my view underestimate the impact

II. Policy implications

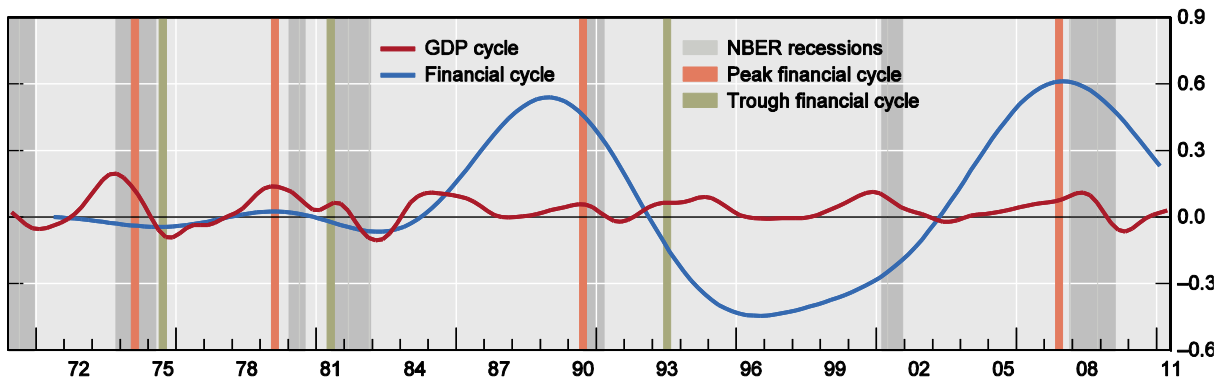
- Going back to Maury’s all important tradeoffs
 - How can we improve them?
 - More and better instruments
 - Better calibration
- 1. *Adjust national policy frameworks*
 - Put own’s own house in order

- How? By addressing systematically the financial cycle
 - Prudential policy (PP)
 - Tackle procyclicality of the financial system through macroprudential measures
 - MP
 - lean against build-up of FIs even if near-term inflation is under control (“lean option”)
 - will require greater acceptance of exchange rate flexibility
 - Fiscal policy (FP)
 - extra prudence, fully recognising hugely flattering effect of financial booms on fiscal accounts
 - adjust tax code (at least remove subsidies to debt)
- 2. *Adjust international arrangements*
 - Take additional steps to put the global house in order
- How?
 - Focus less on current account (C/A) imbalances and more on FIs
 - Some of the most disruptive FIs have built up in countries with C/A surpluses
 - US 1920s; JP 1980s; China now?
 - Asking countries to expand demand can make matters worse
 - Eg, JP 1980s
 - Design arrangements in which international financial and monetary spillovers are better taken into account, which means
 - incorporating financial factors systematically into macroeconomic thinking/models
 - adopting a more top-down analysis of the global economy
 - Analogous to shift from micro to macroprudential perspective in regulation
 - going beyond models in which the national accounts boundary (balance of payments) coincides with the territory in which
 - a currency is used (no international currencies)
 - decision units operate (no transnational banks or firms)
 - residence (BoP) vs nationality principle
 - misleading “triple coincidence” (Borio, James & Shin)
- Progress has been limited
 - More progress domestically
 - Mainly in PP; less in MP and little in FP
 - Hardly any internationally
 - Mainly in PP
- Risks

- Near term:
 - Countries that have experienced build-up of FIs could experience serious strains and macroeconomic damage
 - With feedbacks to the rest of the world (much bigger now)
- Longer term
 - Entrenching instability in the global economy
 - Asymmetric response to financial cycles
 - bias over time; loss of policy ammunition
 - a new form of “time inconsistency”
 - Putting at risk the open global economic order
 - Retreat into financial and trade protectionism

Graph 1

The financial and business cycles in the United States



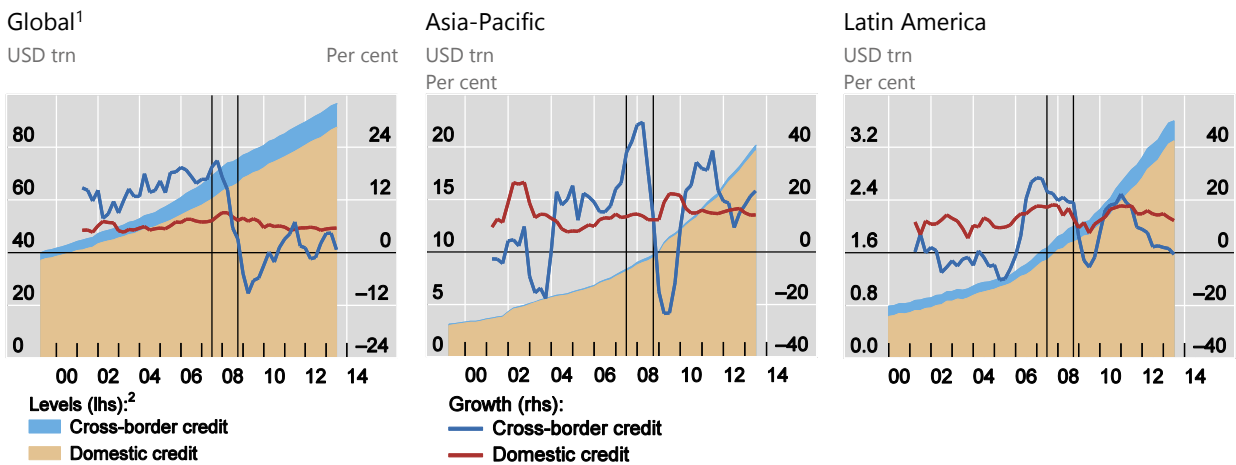
Orange and green bars indicate peaks and troughs of the financial cycle measured by the combined behaviour of the component series (credit, the credit to GDP ratio and house prices) using the turning-point method. The blue line traces the financial cycle measured as the average of the medium-term cycle in the component series using frequency-based filters. The red line traces the GDP cycle identified by the traditional shorter-term frequency filter used to measure the business cycle.

Source: Drehmann et al (2012).

Global bank credit aggregates, by borrower region

At constant end-Q1 2013 exchange rates

Graph 2



The vertical lines indicate the 2007 beginning of the global financial crisis and the 2008 collapse of Lehman Brothers.

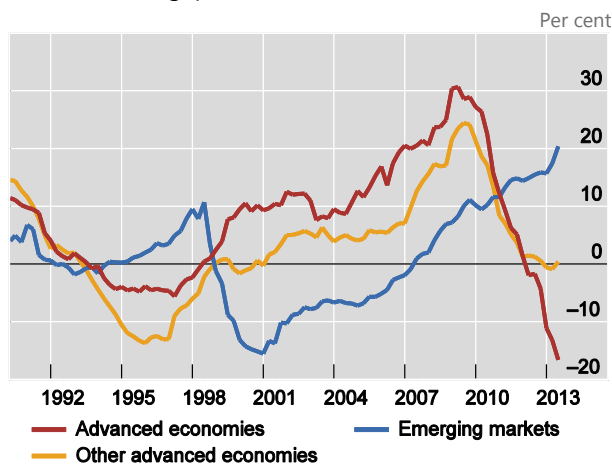
¹ Aggregate for a sample of 56 reporting countries. ² Total bank credit to non-bank borrowers (including governments), adjusted using various components of the BIS banking statistics to produce a breakdown by currency for both cross-border credit and domestic credit.

Sources: IMF, *International Financial Statistics*; BIS international banking statistics; BIS calculations.

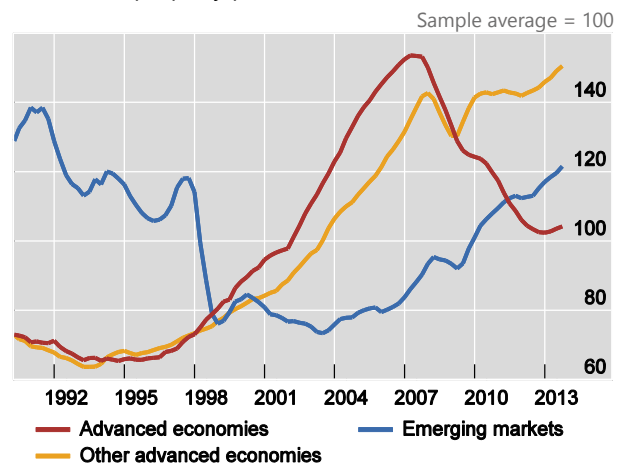
Credit gaps and property prices

Graph 3

Credit-to-GDP gaps¹



Residential property prices²



Note: advanced economies = Ireland, Spain, the United States, and the United Kingdom; emerging markets = Brazil, China, Hong Kong SAR, Korea, Indonesia, Singapore, Thailand and Turkey; other advanced economies = Australia, Canada, New Zealand, Norway and Sweden.

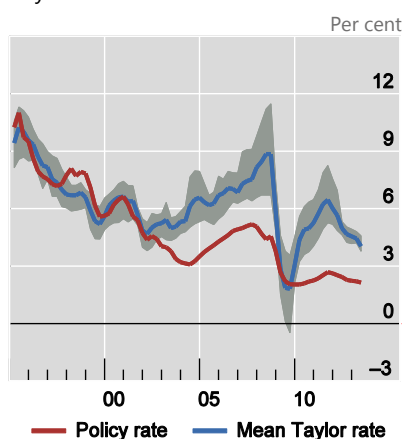
¹ The credit-to-GDP gap is the deviation from the credit-to-GDP ratio from a one-sided long-term trend. The smoothing parameter lambda is 400,000. Simple averages across countries. ² Seasonally adjusted, quarterly averages, CPI deflated residential property price indices; simple averages across countries; definitions may differ across countries. Emerging market aggregate excluding Turkey.

Sources: national data; BIS calculations.

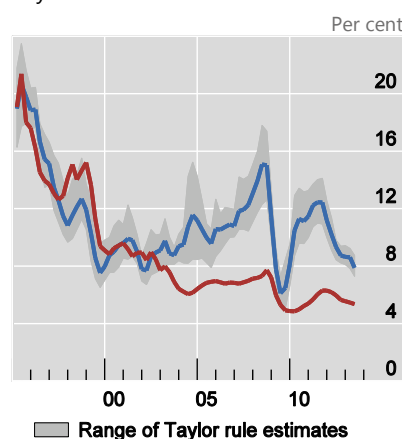
Taylor rules and FX reserves accumulation

Graph 4

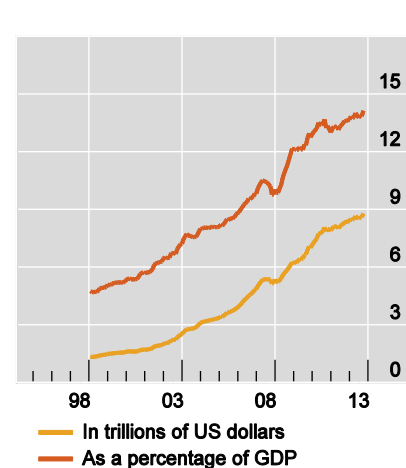
Taylor rule: Global¹



Taylor rule: EMEs¹



Global FX reserves



¹ for the details of the calculation, see

Sources: Hofmann and B Bogdanova (2012) and IMF.

References (BIS work only)

- Avdjiev, S, R McCauley and P McGuire (2012): "Rapid credit growth and international credit: Challenges for Asia", *BIS Working Papers*, no 377, April. <http://www.bis.org/publ/work377.pdf>
- Borio, C (2012a): "On time, stocks and flows: understanding the global challenges", *NIESR Review*. also available as *BIS Speeches*, www.bis.org/speeches/sp121109a.htm
- (2012b): "The financial cycle and macroeconomics: what have we learnt?", *BIS Working Papers*, no 395, December. <http://www.bis.org/publ/work395.htm> forthcoming in *Journal of Banking & Finance*.
- (2014): "The international monetary and financial system: its Achilles heel and what to do about it", BIS mimeo.
- Borio, C and P Disyatat (2010): "Global imbalances and the financial crisis: link or no link?", *BIS Working Papers*, no 346, May. <http://www.bis.org/publ/work346.htm> (earlier and shorter version published in *Asian Economic Policy Review*, vol. 5 (2), 2010, pp. 198-216.)
- Borio, C and A Filardo (2007): "Globalisation and inflation: new cross-country evidence on the global determinants of domestic inflation", *BIS Working Papers no 227*, March. <http://www.bis.org/publ/work227.htm>
- Borio, C, H James and HS Shin (2014): "The international monetary and financial system: A capital account historical perspective", Paper prepared for the Norges Bank conference, *Of the uses of central banks in history*, June 5-6, 2014.
- Borio, C, R McCauley and P McGuire (2011): "Global credit and domestic credit booms", *BIS Quarterly Review*, September, pp 43-57. http://www.bis.org/publ/qtrpdf/r_qt1109f.pdf
- Caruana, J (2012): "International monetary policy interactions: challenges and prospects", Speech at the CEMLA-SEACEN conference on "The role of central banks in macroeconomic and financial stability: the challenges in an uncertain and volatile world", Punta del Este, Uruguay, 16 November. <http://www.bis.org/speeches/sp121116.htm?ql=1>
- (2014): "Global liquidity: where it stands, and why it matters", IMFS Distinguished Lecture at the Goethe University, Frankfurt, Germany, 5 March <http://www.bis.org/speeches/sp140409.htm?ql=1>
- Drehmann, M, C Borio and K Tsatsaronis: (2012): "Characterising the financial cycle: don't lose sight of the medium term!", *BIS Working Papers*, no 355, November. <http://www.bis.org/publ/work380.htm>
- Hofmann, B and B Bogdanova (2012): "Taylor rules and monetary policy: a Global Great Deviation?", *BIS Quarterly Review*, September, pp 37-49. http://www.bis.org/publ/qtrpdf/r_qt1209f.pdf
- Takats, E (2014): "How does US monetary policy affect policy rates in emerging market economies?", *BIS Quarterly Review*, March, pp 6-7. http://www.bis.org/publ/qtrpdf/r_qt1403w.htm