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Global liquidity and global imbalances

I am going to talk about global liquidity. I have two reasons for doing that. First, it is an issue at the center of the G 20 agenda for the French presidency. And, second, it happens to be at the core of one of the Main, and rather contentious, issue for international cooperation to day.

I' ll start with some preliminary remarks. Global liquidity admits several definitions and a potential infinity of measures. For this reason, I am somehow skeptical about measurement. and, ar least, would be prudent and cautious about resources devoted to it. This is not to diminish the achievements by the BIS. which doing a great job in enlightening us on this. Precisely, however, as the analysis develop, the complexity of the issue becomes more apparent.

What matters is the nature of liquidity. One moment it is there and then it is not. Liquidity is largely endogenous. Liquidity shocks cannot be forecasted which creates fundamental uncertainty. I Can' t think of any measure which would capture this endogeneity and the ensuing uncertainty.

To get a sense of the issues, it is useful to contrast two stylized versions of the past and the present, what could be called the old and the new world.

The old world predates the era of strong capital mobility. What mattered then was net capital flows. international liquidity mainly referred to instruments available to settle payments between monetary authorities. Is was publicly created by reserve currencies. There was a Triffin dilemma i.e an intrinsic contradiction between the demand for global liquidity and the implications on the financial soundness of the issuing country. And there were also asymmetries between reserve currencies and others. Reserve accumulation took place as an aside to exchange rates management. Many analysts still refer to this framework when they talk about global liquidity.

Moving to the new world, with increasing degree of financial opening and integration, what matter are gross flows; international liquidity is to a large extent, privately created, through cross border leverage and maturity transformation. There may be "asset shortage" i.e. undersupply of safe and liquid assets, or , more generally, of stores of value. One consequence of the crisis has been to cast doubts on the ability of some assets, up to now considered as riskless, to serve as reliable stores of value. So, there may be both increased demand worldwide for risk free assets and less certainty on the future supply of those assets. That Shortage can be aggravated by doubts about public debts sustainability. Benoit alluded to that this morning. Indeed, this is the new version of the Triffin dilemma which, I guess. will draw a lot of attention as concerns about debt sustainability in major countries develop.

Drawing both from the old and new world visions, we can look at global liquidity through two different lenses. In a narrow sense, it refers to instruments available to settle payments between central bank i.e. reserves and multilateral facilities. In a broader definition, it relates to the combined effect of monetary policies and capital flows, what could be called the global monetary and financial stance;

Reserve accumulation

The facts are well known. At the end of 2009, reserves had risen to 14% of global GDP and 8% of gross international exposures, doubling from their level in 2000 ; over half the worldwide reserve holdings are held by only five countries. Emerging market holdings amount to 32% of their GDP. If anything, the crisis seems to have led to an acceleration in the rhythm of reserve accumulation.

This evolution has Triggered projects to assess reserve adequacy mostly based on some form of cost benefit analysis. The Standard argument is that reserves are costly, they lead to resources misallocation and often are accumulated through exchange rate manipulation. There are Some truth in those assertions. But Again, very I am doubtful about any quantification , let alone, normalization in the level of reserves , for reasons similar to measuring liquidity.

The creation and destruction of international liquidity results from leveraging and deleveraging by private institutions., Interbank markets play a crucial role in this process. The more capital markets become integrated at the short end, the more international liquidity is provided by the private sector.

Because privately created, , international liquidity is subject , like domestic liquidity, to aggregate supply and demand shocks. Such Shocks occur when financial institutions leverage – or deleverage – their positions towards non residents. These are the shocks countries that seek insurance against by building excess reserves.

During the crisis, foreign exchange reserves were used as a tool for internal - as well as external -financial stability. National central banks, especially in Latin America, acted as dollar lenders of last resort to their domestic banks. This function will develop in the future and is bound to impact the demand for reserves.

In a sense, countries face the same dilemma as financial institutions when deciding on their appropriate liquidity position. On the one hand, liquidity has a cost, and should therefore be reduced to a minimum. On the other hand, liquidity provides an insurance against shocks and a guarantee of independence. For private financial institutions, there may be a tendency to underestimate liquidity needs in normal times, with the expectation that the lender of last resort will bail them out if and when a shortage occurs. For countries, the bias goes in the other direction. With no international lender of last resort, precaution motives will lead to over accumulation of liquidity.

The Size of reserves themselves has significant systemic implications.

In terms of allocation : A huge share of gross international exposures is in the hands of official entities. This takes us far away from the canonical model of free, atomistic and competitive global capital market. Reserve holders already are dominant players in key asset markets. What if total reserves grow to 15 - 20 % of gross cross border exposures.

In terms of stability. Movements of even small fractions of reserves could trigger enormous shifts in asset prices and exchange rates which would negatively affect reserves holders themselves. To quote Obstfeld : " to think that the international financial system will necessarily be more stable simply because all countries have more foreign exchange reserves is to subscribe to a fallacy of composition". The same author notes rightly that reserves are not "outside liquidity" in the sense that they can't protect their holders against a systemic symmetric shock which would affect all of them at the same time. That could explain the strong desire of countries with important levels of reserve and floating exchange rates nevertheless to gain access, when the crisis stroke, either to IMF facilities and/ or central banks swaps.

What is needed then is true "outside" liquidity. The question is not so much about the instrument than about the procedures. As for the instruments, the only real source of " outside liquidity " is Central Bank money, both on the domestic and international side ; other instruments, whether IMF facilities or SDR s are tools to intermediate between monetary authorities.

What's more interesting are the procedures. The dilemma here, is clear. Either, outside liquidity is conditional – and will never substitute for reserves or limit their accumulation. Or it is not, and there is a considerable moral hazard problem. I am not sure that attempts to fine tune conditionality and tailor it to various categories of borrowers through multiplication of facilities will really help and solve this dilemma.

One more promising avenue is to distinguish between systemic and idiosyncratic shocks. The latter should be covered by reserves. What about systemic shocks ? A considerable amount of work is currently devoted to devise contingent capital for financial institutions in times of crisis. The same intellectual framework can be extended to liquidity. What is needed is contingent liquidity i.e. liquidity available to nations in times of aggregate shocks to the international financial system.

Two basic principles should therefore be guiding future work on a multilateral safety net: (1) conditions for access should be specified ex ante; and (2) those conditions should be fully delinked from the situation of individual economies. Rather, they should depend on the state of the global economy and international financial markets. From the point of view of an individual country, access should be fully unconditional, once global conditions are met. Of course majlr issues of governance and decision process would have to be solved.

Let me come to the Aggregate monetary stance

the Concept of trilemma is very popular in international economics. So I will indulge in my little own trilemma which would go as follows.

First, countries are free to conduct monetary policies they deemed appropriate. Indeed, when Central Banks are independent, they are legally obliged to conduct their policies with purely domestic objectives in mind .This is true for all countries, whether small or large. The fact is that the world has enormously benefited from two decades of price stability resulting from monetary regimes based on Central bank independence and a focus on internal price stability.

Second, according to the IMF Articles, countries are free to choose their capital account and exchange rate regimes with the proviso that they do not engage in currency manipulation. The proviso has proved very difficult to define, let alone to implement. The IMF has met with some difficulties in trying to set up an efficient a symmetric process of multilateral surveillance. So, basically, there is total freedom in exchange rate regimes.

And, third, spillovers between national monetary policies have multiplied. International capital flows have made countries truly interconnected. In each country, domestic inflation is increasingly dependent on the combined effect of all monetary policies – the so called aggregate monetary stance. Actually, it is more than simple externalities. Inflation has become a global public "bad" , to which everybody contributes without fully paying the price. So, not surprisingly, it is becoming oversupplied.
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In current circumstances, those three basic realities have become much harder to reconcile. Spillover have become stronger and more variable. Commodity prices , under direct or indirect impact of monetary policy, play a growing role in the global and domestic inflation dynamics Low interest rates make capital flows more sensitive to small differences in non conventional monetary measures and risk premia.

In theory, there are at least three potential ways out of this tension :

the first can be summarized as the "put your house in order" paradigm: a combination of adequate domestic policies and floating exchange rates. It is strongly advocated in many advanced countries and less popular in emerging economies. It is doubtful that it would work, both from a policy and analytical perspective. Fear of floating arise from nominal domestic price rigidities and the feeling that global capital markets are far from efficient . This feeling has been somehow vindicated by the crisis. UIP does not hold and we see carry trades take place on a wide scale.

a second approach would be to have a Global Anchor for monetary policies, for instance by tying their exchange rates to a unit of value. But, as we all know, this leaves open the question of adjustment in relative prices could be very penalizing in a period of deep structural changes and divergences in economic cycle

And, finally, there is coordination, but then, we may loose the anchor provided by Central Bank independence.

So there are no easy solution. The difficulty can be captured through a simple thought experiment . To oversimplify the current discussion on global imbalances, the US asks for RMB appreciation and China demands an end to US large scale asset purchases. Now, suppose ghat one or the op awhat they want. US monetary tightening would undoubtedly reduce US growth and penalize China's exports. By the same token, an appreciation of the RMB would inflict on the US a negative term of trade shock, with uncertain future benefits in terms of activity since it is unlikely that production in US and China are very close substitutes. We could look at a cooperative scenario where both partners go midway. We get slower growth and higher inflation on aggregate. So, none of the participants would see its welfare increased if its proposals were adopted. Admittedly, this is something of a caricature, because not all effects are taken into account and LT effects may be different and more beneficial. But there is an element of truth.

To understand what is going wrong, we may need to take a broader perspective on the current international debate. The Striking fact is the multiplicity of objectives that we are trying to achieve at the same time :price stability, growth equal to potential, financial stability and reduction of current account imbalances. In theory, there may be a set of policies which, implemented together, would yield the good result. This could be called the " coordination plus anchor" solution. Its feasibility is nil, all the more so that it would certainly necessitate very intense coordination of fiscal policies i.e. mobilize additional instruments.

The Solution therefore is clear. There is a need to reduce the number of objectives and / or increase the number of instruments. Here, as time elapses, I will give some very personal remarks.

On the instrument side, there is a good case for having, at the global level, a more coordinated approach to financial stability. Capital markets are global, and so should be the macroprudential measures taken to achieve greater stability. This, in my view, is the main rationale behind the work on so called " capital flows management measures". They should not be seen, or devised, as macroeconomic tools, substituting to others in the adjustment process. Rather, they can be part of a set of macroprudential instrument which, if developed in a consistent fashion at the domestic and international level, could go a long way in reducing the frequency and amplitude of financial shocks.

As regards the objectives, the current focus is on reducing current account imbalances while, for individual countries, seeking to get as close as possible to potential. Not surprisingly, the side effects materialize in additional inflation in many parts of the world and incipient global financial instability. We may need, at some stage, to think deeper on the hierarchy of our common objectives, at least in the short run. The current approach seems predicated on the assumption that current account imbalances would trigger financial instability and therefore should be reduced as a matter of priority. Maybe the causality should be reversed. Let's try and get monetary and financial stability first, and this would create good conditions for the real economy to take care of itself.