Global Economic Symposium
Istanbul 27-29 September 2010

Panel on "Rebalancing Trade and Capital Flows"

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1. The role of macroeconomic policies in the global crisis

Policy responses to the global crisis have helped stabilize confidence and limit the threats of financial instability, but at the cost of a huge accumulation of public debt. This could potentially lead to a higher cost of borrowing if markets were to become concerned about its sustainability, and of a protracted period of very low policy interest rates and abundant liquidity, which may end up fuelling new asset price bubbles, thus building up the conditions for the next crisis.

In order to reduce the risk that again in the future a combination of distortions may lead to large and destructive financial crises, it is essential to address both macroeconomic and financial policy failures. Important changes in financial market regulation and banking supervision are already being introduced. In the macroeconomic area, an effort is being conducted to strengthen the coordination of economic policies in the context of the G-20.

Beyond exiting from exceptional expansionary policies, the global economy will face the challenge of adapting to an extended period of higher private saving in the advanced economies, where the process of deleveraging is still at its early stages. A shift to a more sustainable global pattern of demand is needed, with important policy implications to facilitate this adjustment over the medium term. Policy frameworks should adjust to allow for stronger growth in private demand in economies with substantial external surpluses that have accumulated large reserve positions over the past several years. In other words, the composition of global demand will need to shift in order to deliver strong, sustained and balanced global growth, as in the G-20 intendments. Supply-side policies and structural reforms will be important to support potential growth-which may have been damaged by the crisis.

One may wonder what would have happened to the global economy had this policy framework been implemented in due time. Such a counterfactual scenario has been studied by Catte et al. (2010) who show that, if a substantial and globally coordinated demand rebalancing had been undertaken in the early 2000s, internal and external imbalances would not have accumulated to the extent that they did (Catte, P., P. Cova, P. Pagano, and I. Visco (2010), "The role of macroeconomic policies in the global crisis", Banca d'Italia Occasional papers, No. 69, July). In particular, the scenario considered contemplates tighter monetary and supervision policies in the United States and an increase in domestic demand in major surplus economies. The latter would have been the result of wealth effects obtained through productivity enhancements in the nontradable sector in advanced surplus economies and of policies aimed at directly rebalancing growth towards domestic demand – such as measures that reduce households' precautionary savings and reforms of corporate governance which decrease retained earnings, coupled with exchange rate appreciation – in emerging economies. Even though it is difficult to say whether in

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that scenario the financial crisis might have been avoided, its propagation would likely have been less destructive, as both the US financial system and the global economy would have been less vulnerable to it. Specifically, US housing prices would not have expanded at the same pace as they did and the pattern of current accounts would have been better balanced.

Overall, the results of such a counterfactual scenario highlight the complementarity of policy actions in deficit and in surplus countries with respect to the correction of both internal and global imbalances. Notwithstanding announcements about the importance of coordination and cooperation in the design and development of crisis strategies, in practice, countries have proceeded to adopt policies that appear to be national in character. Strengthening multilateral coordination to mitigate global distortions remains a priority. The issue of cooperation extends beyond the design and implementation of stabilization policies and appears particularly relevant in managing exchange rate flexibility.

2. Exchange rate flexibility and financial flows

For countries in surplus, the rebalancing toward domestic demand should normally be accompanied by an exchange rate appreciation to help re-direct production toward nontradables and part of the additional absorption toward imports. The consequent terms-of-trade gains would help stimulate domestic consumption. In principle, an effective exchange rate appreciation can be achieved in different ways depending on the exchange rate regime. Greater exchange rate flexibility could, for example, take the form of exchange rate fluctuation within a moving (e.g. gradually appreciating) target band, defined with reference to either the dollar or a currency basket. It is possible to imagine a wide range of variants of this regime depending on the width of the band, the speed of appreciation, the composition of the basket and whether the margins of the band are "hard" or "soft", as well as depending on the degree of pre-commitment to each of these parameters.

In the case of China, for example, while the appropriate size of the renmimbi's appreciation will depend on considerations of macroeconomic balance in the context of the ongoing demand rebalancing, the degree of exchange rate flexibility could be used as part of the authorities' strategy for addressing the need to manage the effects of capital inflows while preserving domestic macroeconomic and financial stability. For countries facing large capital inflows, greater exchange rate flexibility may represent the most effective line of defence, reducing the need to accumulate official reserves. The main challenge posed by capital inflows for fixed-exchange-rate countries is to prevent them from feeding excessive growth in domestic credit, asset market booms and inflationary pressures, given the difficulty of fully sterilizing the domestic effects of reserve accumulation in a context of limited development of the internal financial market.

While a crawling peg does not provide greater monetary autonomy than a fixed exchange rate (it may even require maintaining lower interest rates than those in the anchor currency), exchange rate flexibility – even within the limits of a fluctuation band – introduces a perception of two-way exchange risk, which should help discourage one-sided speculative bets on a renminbi appreciation. This buffering effect will be greater if the fluctuation band is sufficiently wide. Such a regime would allow greater leeway for an autonomous monetary policy: a rise in domestic interest rates would normally be associated with a more appreciated exchange rate within the fluctuation band, and thus with greater scope for future depreciation; it would not, therefore, trigger capital inflows if the band is credible.

A possible second line of defence in the face of excessive capital inflows, particularly when these are a structural phenomenon, could be greater liberalization of capital outflows. This should be part

of a broader process of fostering domestic financial development, both in order to ensure an efficient allocation of the country's huge pool of savings and to support China's increasingly globalized and sophisticated companies. Related to this broad project is also the objective of enhancing the role of the renminbi as an international currency. In this context, the introduction of some degree of exchange rate flexibility (possibly increasing over time) can be seen also as a way of gradually allowing domestic investors and firms to familiarize with the management of exchange risk. Here the interaction with financial market development is important: as domestic firms and banks become exposed to currency risk, they need to be given access to markets where they can hedge against it. On the other hand, liquid derivative markets are unlikely to develop unless a demand for hedging exists. At the same time, the development of deep and open markets in a broad range of renminbi financial instruments – an essential condition for China's currency to take on a major international role – requires a switch of the monetary policy strategy from quantitative targets to the use of the interest rate and open market operations. This requires financial deregulation and the development of a liquid secondary market for government bills and bonds, so that the latter may act as a reference to price riskier private assets.

3. Reserves and the international monetary system

Over the past decade international reserve holdings have become increasingly concentrated in the hands of emerging market countries, and have grown well above traditional "precautionary" norms (e.g., in terms of months of imports or as a ratio to short-term external debt). As well, global reserves have remained concentrated in a few currencies, particularly the US dollar, whose share in global reserve assets far exceeds the share of the US in the global economy. These developments are a symptom of unsolved problems in the underlying international monetary system (IMS).

Large-scale reserve accumulation has significant costs at both the national level (in terms of foregone consumption and investment, or quasi-fiscal deficits incurred when reserve accumulation is financed or sterilized with debt offering higher yields) and the global level. Beyond the traditional motives for holding reserves (such as smoothing out the impact on consumption of shocks or ensuring inter-generational equity for oil producers), recent large-scale reserve accumulation has been driven by two main factors: (a) growing and volatile capital flows – and the related need to insure against international liquidity shocks for countries with an only limited financial intermediation capacity; and (b) the absence of automatic adjustment mechanisms in global imbalances – policies aimed at maintaining an undervalued exchange rate can persistently put off adjustment for surplus countries. As long as reserve issuing countries are willing to incur debt to purchase their imports, an export-led strategy leading to persistent current account surpluses and reserve accumulation remains a feasible policy option. However, as economies relying on undervalued exchange rates and demand from reserve issuers grow larger, a purely domestic adjustment for the reserve issuers becomes increasingly difficult.

Both "precautionary" and "non-precautionary" reserves have a bearing with IMS stability, but require a different treatment. To reduce the world demand for precautionary reserves, the definition of benchmarks to gauge the adequacy of precautionary reserves, such as IMF guidance on "desirable" ranges of precautionary reserve levels based on country circumstances, could be helpful. To address the other underlying driver of reserve accumulation (capital flow volatility), countries could agree, also with the help of the IMF, on a new multilateral framework for managing capital flows. This framework should (i) cover all types of capital flows; (ii) specify the benefits of capital account liberalization under specific circumstances, as well as the need of appropriate measures to contain excessive movements if and when necessary; (iii) discourage systemic countries from adopting comprehensive capital controls that may generate greater capital flow volatility elsewhere, or are used in place of policy measures aimed at decreasing global

current account imbalances; and (iv) encourage countries to take concerted actions to limit volatility of capital flows. This would require substantial enhancement of financial data gathering at the national level, as well as more timely monitoring of capital flows at a supra-national level.

Countries' perceived need of precautionary reserves is not entirely independent of the amount of IMF resources they can count on in case of trouble. Substantial progress has been made in recent times, with the creation of a new precautionary facility for countries with sound fundamentals and policy frameworks and the tripling of Fund resources. Further improvements are being debated to encourage the use of IMF precautionary tools and broaden the perimeter of their potential beneficiaries. Yet, as IMF lending remains attached to some form of "conditionality", countries may still prefer accumulating reserves, which are available immediately and unconditionally. A more ambitious option would be to do without IMF conditionality, and allow the Fund to lend to solvent countries against collateral (in the form of high-quality assets possessed by the borrower), on a temporary basis and at penalty rates. This would require an amendment to the Fund's Statutes, since lending against collateral is not currently allowed by the Articles of Agreement.

The search for incentives to reduce "non-precautionary" reserves explained by one-sided foreign exchange intervention remains problematic, as IMS stability is likely to be of second order importance to countries' own near-term interests. At a bare minimum, a "shared understanding" would be required among surplus and reserve issuing countries on the stability requirements of the system and on how their behaviour can undermine its stability. This understanding could be achieved either informally—at the G-20 level, through the "framework for strong, sustained and balanced growth"—or in a more institutionalized context for international cooperation such as the IMF. A concerted, non-coercive approach would be surely preferable to one based on "penalties" (including a threshold on "excess" reserves or automatic taxes on persistent current account imbalances for reserve issuers). This approach should contemplate: (i) for reserve accumulating countries, a move towards flexible exchange rates and a significant reduction of foreign exchange intervention, or the abandonment of their pegs to national currencies; (ii) for reserve issuers, the adoption of a macroeconomic (fiscal) policy framework to sustain credibility of their currencies and the IMS as a whole. More ambitiously, steps could be taken to strengthen the global reserve system by (iii) enhancing the role of the SDR. This said, both in the G-20 and IMF settings the question remains as to how to make countries accountable ex post for the implementation of these understandings.

A more diversified allocation of reserves among existing (or newly created) assets could, in principle, reduce global and individual exposure to risks stemming from economic shocks and policies of a single country, and provide more stable stores of value by increasing reserve issuers' incentives to pursue sound policies. Reserve diversification is a market-driven process that is unlikely to evolve rapidly without active promotion of the official sector. In addition, in the absence of greater policy coordination between reserve issuers to manage their exchange rates within acceptable ranges, a multi-polar system (with several reserve currencies operating as broad substitutes) may entail greater exchange rate volatility, especially in the transition phase. Thus, the diversification process should be managed in a smooth and transparent way, to avoid large swings unwarranted by economic conditions. The Fund could (i) promote greater transparency and an only gradual adjustment in the currency composition of reserves, (ii) engage with potential major reserve issuers to help remove the obstacles to a broader use of their currencies, and (iii) assist emerging market countries to pool and securitize part of their sovereign debt into a new composite asset, to be held as reserve asset by the members of the pooling arrangement.

Finally, and certainly more open to discussion, the SDR may offer a number of potential advantages as a new element (if not a currency) of a multi-polar system. Being a basket of major

currencies, it diversifies the currency and interest rate risks of its constituent currencies, and this would be especially important to cope with greater exchange rate volatility in a system with no dominant currency. Another advantage would be to align global "monetary conditions" (i.e., the reference rates off of which risky assets are priced) more with global conditions than with conditions in any single economy – all the more so if the basket were broadened. Finally, if countries with a current account surplus pegged to the SDR basket rather than to a national currency, the currencies of deficit countries could depreciate vis-à-vis others in the basket.

However, for the SDR to become a viable reserve currency, its supply should be increased significantly, and deeper and more liquid markets for this asset would be needed (currently there only exists an "official" market for SDRs). Over the years, SDR allocations have been regularly resisted by major IMF members. The development of a private SDR market would facilitate the process of diversifying reserve composition. Moreover, if the private SDR market were sufficiently liquid, it would become possible to carry out foreign exchange intervention directly in SDR. This might encourage countries to set their exchange rate vis-à-vis the SDR rather than the dollar. It would take time to ensure that a liquid, broad and diversified private market for the SDR develops, although the Ecu experience suggests that it could also prove highly successful. An important limitation that needs to be taken into account, however, is the absence of a lender of last resort in SDR. Market agents would always need to ultimately rely on the central banks issuing the four constituent currencies of the SDR basket.