What have we learned from the crises?

The debate on macroeconomic and financial polices

AFS-JICA Seminar Series
Academy of Financial Studies, Colombo
August 28, 2013

Akira Ariyoshi
Asian Public Policy Program

一橋大学 HITOTSUBASHI UNIVERSITY

Pre-crises: Life was simple

- Fiscal policy should eschew discretionary policy; use automatic stabilizers and focus on long-term fiscal sustainability.
  - Discretionary policy doesn't work or can't be timed properly. (Multiplier less than 1, even zero or negative in small open LDCs.)
- Monetary policy by independent CB should target inflation using short-term interest rates.
  - Low and stable inflation will ensure stable long-term economic growth
- Financial systems and capital flows should be liberalized.
- Exchange rates should be flexible.
- Transparency, Disclosure, Governance and Institutions are important
  - Markets will check bad behavior.
  - Supervision of individual institutions will ensure financial stability.
  - Crisis occur in countries with weak governance and institutions.

Crises: Common Causes

	Global Financial Crisis	Euro-zone Crisis
Credit extension beyond repayment capacity	Sub-prime mortgages, real estate bubble.	Greece Government (and other euro periphery).
(Public and private) failure to recognize mounting vulnerability	Not seen as bubble. AAA rating for securitized products. Sub-prime market is small.	Weak enforcement of SGP. No sovereign risk premium. Greece is a small country.
Not act decisively to prevent crisis	Refuse to save Lehman Bros.	EU constitution 'prevents' Greek bail out.
Magnifying factors - **Opacity, interconnectedness and spillovers lead to contagion** - **Macro-financial linkages**	- Complex layers of products and linkages through derivatives markets. Uncertainty in bank solvency and public backstop - Freezing financial markets. Financial/economic negative feedback loop. Global trade spillovers.	- Linkages through cross-border debt holding and loans. Uncertainty in fiscal data. Dithering euro area response; threat of private sector bail-in. - Freezing government debt market. Negative debt sustainability feedback. Bank/sovereign linkage.

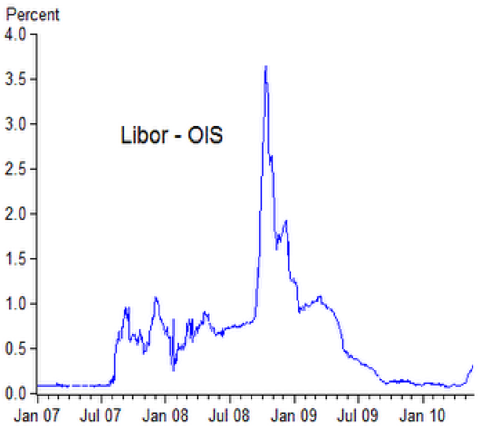
Crises: Different responses

	GFC (including Europe)	Eurozone crisis
Financial sector policies	Massive government intervention (liquidity support, guarantee, recapitalization)	Fiscal constraints limit support in crisis countries. Forbearance and private recapitalization.
Monetary policies	Unconventional policies in the face of zero bound on interest rates. Replace broken private intervention. Increase CB balance sheet. Act on expectations.	Policies to support sovereign debt markets and to provide liquidity to crisis countries.
Fiscal policies	Large coordinated discretionary stimulus (G20).	Fiscal consolidation to restore fiscal sustainability.
International monetary policies	Massive cross-border official liquidity support (FED and IMF).	Constraints on 'bail-out'. Private sector 'bail-in'.

Differences in outcomes

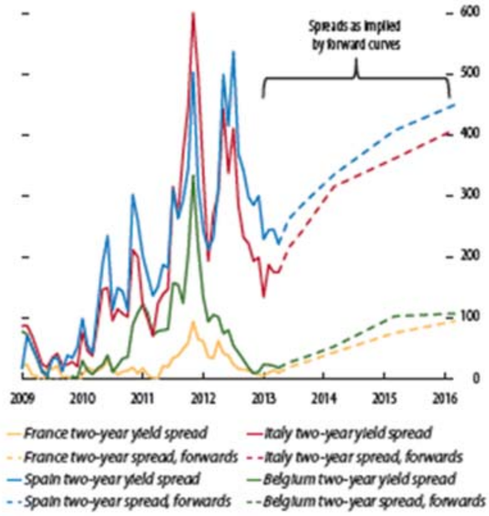
Acute phase of GFC ends relatively quickly, while Euro-zone crisis drags on.

3 months Libor-OIS spread

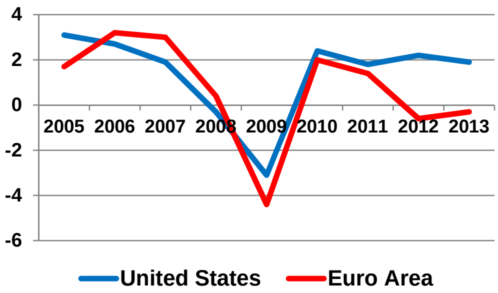


Libor-OIS spread is a measure of the credit risk premium charged in interbank lending.

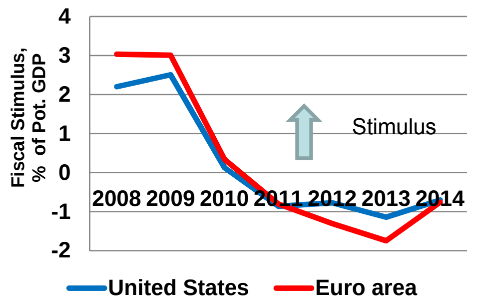
Figure 1.13. European Sovereign Bond Spreads, Current and Implied by Forward Curve
(In basis points over German benchmark)



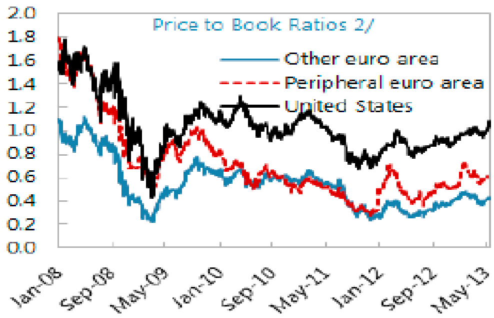
Growth in Euro-area stalls



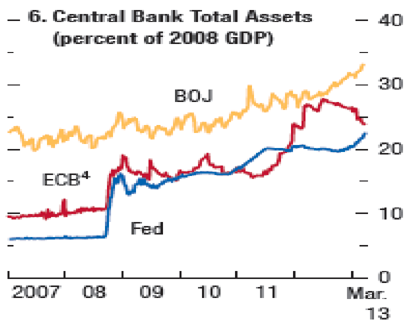
Fiscal contraction in Europe despite negative growth



Bank balance sheet repair not seen in Europe



Monetary policy provides support



Sources: IMF (various publications) and author's calculations

Lessons

- Cost of financial crisis is huge and impact is prolonged.
- Advanced economies are not immune to crisis.

  – What to do to avoid a financial crisis:
    - Strengthen financial sector regulation and supervision.
    - Focus more on financial stability as an explicit macroeconomic policy goal, because microprudential policies are not enough.
    - Have a better mechanism to limit spillovers and contagion.
    - Sovereign debt sustainability is a cornerstone of financial stability.

    → How do you design such a system? How do you get from A to B?

  – What to do when a crisis hits:
    - Provide liquidity, support demand and restore confidence (if you have the capacity).

    → How do you deal with constraints and trade offs when the capacity is not available? How much consideration needed to guard against moral hazard?

Lessons and Debate: Monetary Policy

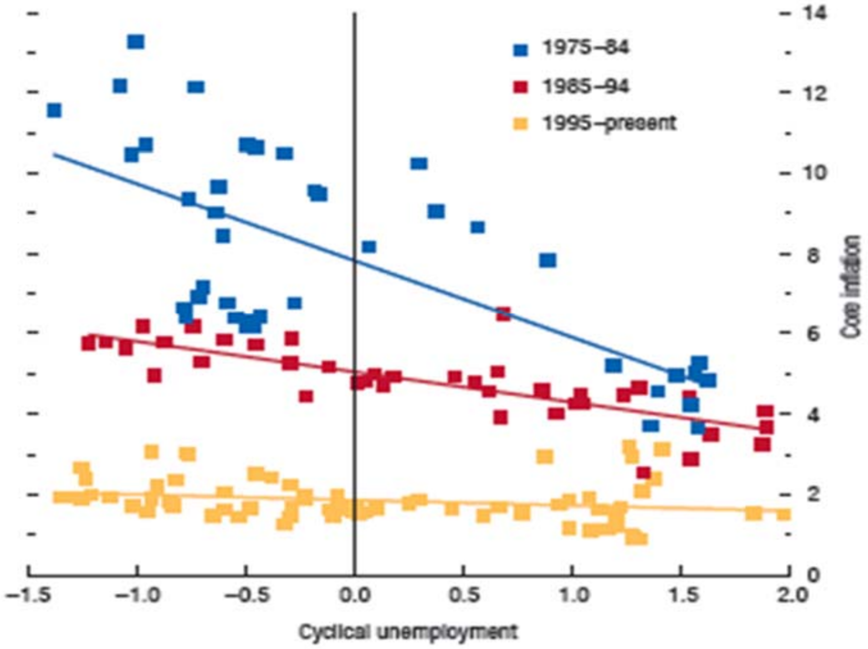
- Is inflation targeting still valid?
  – Stable prices do not guarantee financial stability (though low inflation still an important policy goal).
  – Less agreement on how to incorporate financial stability concerns in monetary policy. → Focus on macroprudential tools.

- Unconventional policies – do they work, or simply create larger imbalances?
  – Zero lower bound on interest requires (untested) unconventional policies.
  – Quasi-fiscal nature of policies damage CB credibility?
  – Transmission mechanism is not clear. (Is it essentially an exchange rate policy and/or forcing global monetary easing on other countries?)
  – Can you exit smoothly?

- Multiple goals in normal times?
  – Should monetary policy explicitly target output/unemployment?
  – Should monetary policy target asset prices?

A flatter Phillips curve

Average relationship between core inflation and cyclical unemployment in advanced economies in respective periods.



Lessons and Debate: Fiscal Policy

- Effectiveness of Fiscal Policy
  - Active fiscal policy is effective and useful in periods of deep and prolonged recession (multiplier around 2).
  - High debt levels reduce the feasibility of deploying fiscal policy, so maintaining fiscal space is important.
    - → But how much space, when do we use it, how do we maintain it, and (if we are not there) how do we get there?

- Austerity in Fiscal Crisis
  - Opposing views as to whether austerity in crisis is necessary or harmful. (Probably both. What is the trade-off?)
  - A compromise position is to argue for a combination of short-run stimulus and credible medium-term consolidation strategy.
    - → But can you implement this in practice?
  - How to implement austerity if there is no alternative. (Distributional effects, political acceptance.)

Debate: Financial Sector and Macroprudential Policies

- How much capital is enough?
  - How much is enough to reduce systemic risk to ‘acceptable’ levels.
  - Should we focus more on simple leverage?
- Does higher capital requirement and transition to higher capital force deleveraging and limits credit supply and thus damage growth?
  - Are forced higher charges incompatible with adequate supply of financial intermediation?
- Are restrictions on activity necessary, and to what extent?
  - Separation, ring-fencing regulated entities. Regulating shadow banking.
- How much scope for government backstop should be retained.
  - Moral hazard and dynamic inconsistency.
- Which macroprudential policies are effective/desirable?
  - Price based tools (capital and liquidity rules, etc.) or more targeted and quantitative rules (limits on LTV, credit to sectors, etc.)
  - Distributional consequence of measures.

Lessons and Debate: Capital Flows Management

- Realization that countries with ‘good’ policies can experience crisis.
  - Even countries without clear policy weaknesses and vulnerabilities may experience crisis
  - Capital inflows from push factors may increase vulnerabilities
- Are capital controls useful? – Yes, but…
  - Which measures are effective, and under what conditions?
  - Should capital flows management measures be used as a last resort measure, or be a regular feature of external policies?

Debate: Exchange Rate Policies

- Risks in monetary union is much larger than was supposed.
  - Can monetary union be maintained with tougher rules for individual countries without a banking union and fiscal union?
- Should central banks target exchange rates?
  - As an element of inflation target, or on its own merit?
  - Effectiveness of capital flows management measures determine feasibility.

Lessons and Debate: Crisis management

- The old trade-off: adjustment vs. voluntary financing. (IMF as an honest broker.)
- The new trade-off: adjustment vs. voluntary financing vs. collective debt reduction vs. debt repudiation.
  - How to construct an internationally applicable mechanism for orderly debt resolution.

Implications for emerging markets and developing countries

- Macroeconomic policy debate and theory for AE will become more relevant for EM and DC.
- Uncertainty as to what good policies are.
- But bad policies are still bad policies.

一橋大学 Hitotsubashi University

Thank you

APPP

Asian Public Policy Program