Financial Globalization: How Central Banks and Supervisors Should Coordinate, Cooperate and Communicate

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Outline of my talk today

1. Globalization and the increased need for global cooperation (and coordination)
2. Monetary policy
3. Banking operation
4. Supervision and regulation
5. Some additional thoughts and concluding remarks

PART 1: Globalization and Increased Need for Cooperation (and Coordination)

The usage of “cooperation” and “coordination” in my talk

The distinction is somewhat blurred. But, I use these words according to the following:

Coordination ⇒to act based on prior agreement on specific action to achieve mutually beneficial state

Cooperation ⇒to act without prior agreement on specific action to achieve mutually beneficial state

“Cooperation”

- “When you work with someone to achieve something that you both want, it is cooperation.” *(Longman Dictionary)*
- “Organizing the activities of two or more groups so that they work together efficiently and know what the others are doing” *(Advanced Learner’s English Dictionary)*

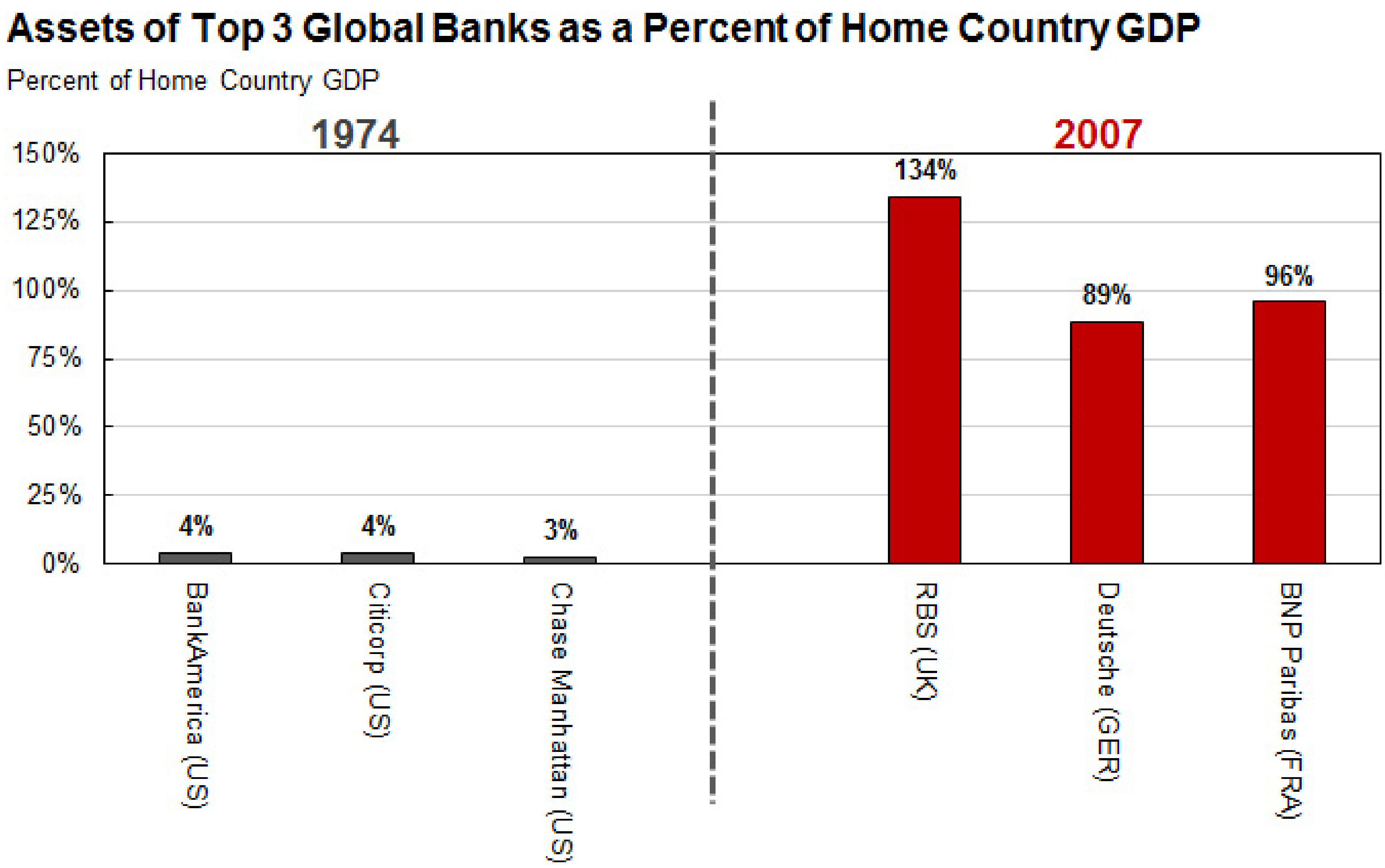
“Coordination”

- “The organization of people or things so that they work together well” *(Longman Dictionary)*

The progress of financial globalization

- Massive increase in financial transaction
- The size of big financial institution exceeding GDP of the country where its headquarters is located
- Complexities of financial transaction (derivative transaction etc.)
- Increased speed of financial transactions
- Non-existence of “world central bank” and “world regulator”

Asset size of top global banks as a percentage of home country GDP has increased tremendously



Source:Daniel Tarullo, “Regulating large foreign banking organizations” (2014)

Global cooperation among central banks and central banks' cooperation with other authorities

- Three activities of central bank as a guardian of money (depending on legal framework of central bank)
  - Monetary policy
  - Banking operation:
    - LLR: lender of last resort
    - Payment system policy
  - Financial supervision and regulation
- Globalization inevitably calls for global cooperation (and coordination) in above three areas of central banks' activity, though its form and intensity are different.

PART 2: Monetary Policy

Change in the debate on policy coordination and cooperation and evolution of my thinking

- The height of “international policy coordination”: Plaza accord (1987) and Louvre accord (1987)
- The rhetoric, realities and consequences
- “Put one’s house in order”.
  - “Open economy trilemma” (“impossible trinity”) as a supporting economics argument
- New developments and/or recognition:
  - Further progress of financial globalization
  - Zero lower bound of interest rate
  - Safe-haven characteristics
- Renewed interest in the debate on “putting one’s house in order” and “keeping global village in order”(Caudio Borio’s terminology (2015)).
- What is realistic solution in this new world?

Plaza Accord: Too much emphasis on current account imbalances

10. These positive economic developments notwithstanding, there are large imbalances in external positions which pose potential problems, and which reflect a wide range of factors. Among these are: the deterioration in its external position which the U.S. experienced from its period of very rapid relative growth; the particularly large impact on the U.S. current account of the economic difficulties and the adjustment efforts of some major developing countries; the difficulty of trade access in some markets; and the appreciation of the U.S. dollar. The interaction of these factors – relative growth rates, the debt problems of developing countries, and exchange rate developments – has contributed to large, potentially destabilizing external imbalances among major industrial countries. In particular, the United States has a large and growing current account deficit, and Japan, and to a lesser extent Germany, large and growing current account surpluses.

Plaza Accord: Commitment of policies by G5 countries

The Ministers of Finance and Central Bank Governors agreed that recent economic developments and policy changes, when combined with the specific policy intentions described in the attached statements, provide a sound basis for continued and a more balanced expansion with low inflation. They agreed on the importance of these improvements for redressing the large and growing external imbalances that have developed. In that connection, they noted that further market opening measures will be important to resisting protectionism.

………

Plaza Accord: Explicit reference to monetary policy

"The Government will implement policies with the following explicit intentions."

France: To secure the attainment of monetary aggregates growth targets, consistent with decelerating inflation.

West Germany: Deutsche Bundesbank will continue to ensure a stable environment conducive to the expansion of domestic demand on a durable basis.

Japan: Flexible management of monetary policy with due attention to the yen rate.

The UK: To operate monetary policy to achieve further progress towards price stability and to provide a financial environment for growing output and employment; and to buttress monetary policy with a prudent fiscal policy.

The US: Conduct monetary policy to provide a financial environment conducive to sustainable growth and continued progress toward price stability.

Louvre accord: Monetary policy aiming at reducing the external surplus

7. The Ministers and Governors agreed to intensify their economic policy coordination efforts in order to promote more balanced global growth and to reduce existing imbalances. Surplus countries committed themselves to follow policies designed to strengthen domestic demand and to reduce their external surpluses while maintaining price stability. Deficit countries committed themselves to follow policies designed to encourage steady, low-inflation growth while reducing their domestic imbalances and external deficits. To this end, each country has agreed to the following undertakings.

West Germany : Monetary policy will be directed at improving the conditions for sustained economic growth while maintaining price stability.

Japan: The Government of Japan will follow monetary and fiscal policies which will help to expand domestic demand and thereby contribute to reducing the external surplus…. The Bank of Japan announced that it will reduce its discount rate by one half percent on February 23.

The US: Monetary policy will be consistent with economic expansion at a sustainable non-inflationary pace.

Feldstein's sober assessment of international policy coordination

Although international coordination of macroeconomic policy-making sounds like a way to improve international relations more generally, there is a serious risk that it will have the opposite effect. An emphasis on international interdependence instead of sound domestic policies makes foreign governments the natural scapegoats for any poor economic performance. Pressing a foreign government to alter its domestic economic policies is itself a source of friction and the making of unkeepable promises can only lead to resentment. It would in general be far better if the major industrial countries concentrated on the pursuit of sound domestic economic policies and reserved the pursuit of international cooperation for those subjects like international trade and national security in which cooperation is truly essential. (Feldstein (1988) p. 12)

Plaza and Louvre accord in retrospect

- Heydays of international monetary policy coordination
- Domestic optimum that a central bank in each country conventionally attempt to achieve might be a second best in light of spillovers and spillbacks. In theory, there exists a first best domestic optimum which is attained if all countries internalize spillovers and spillbacks. In this sense, there might be a case for international policy coordination. But, the problem is that we do not know what is right policy because of a lack of our knowledge.
- Anyway, realities was “international policy coordination” was the mechanism of imposing interest of key reserve currency country on other countries. Prolonged monetary easing was one of causes for massive bubble in Japan in late 1980s
- That was a bitter memory for Japan.

A case for “putting one’s house in order”: Economics argument

- “Open economy trilemma” : A country cannot achieve the following three objective simultaneously.
  - Autonomous monetary policy
  - Free capital movement
  - Fixing of exchange rate
- Most of advanced economies gives up the objective of fixing of exchange rate. Under this regime, the country is supposed to be able to conduct autonomous monetary policy, that is, to insulate its own economy from foreign influences.
- The implicit assumption here is that pursuing domestic (local) optimum reasonably lead to global optimum.

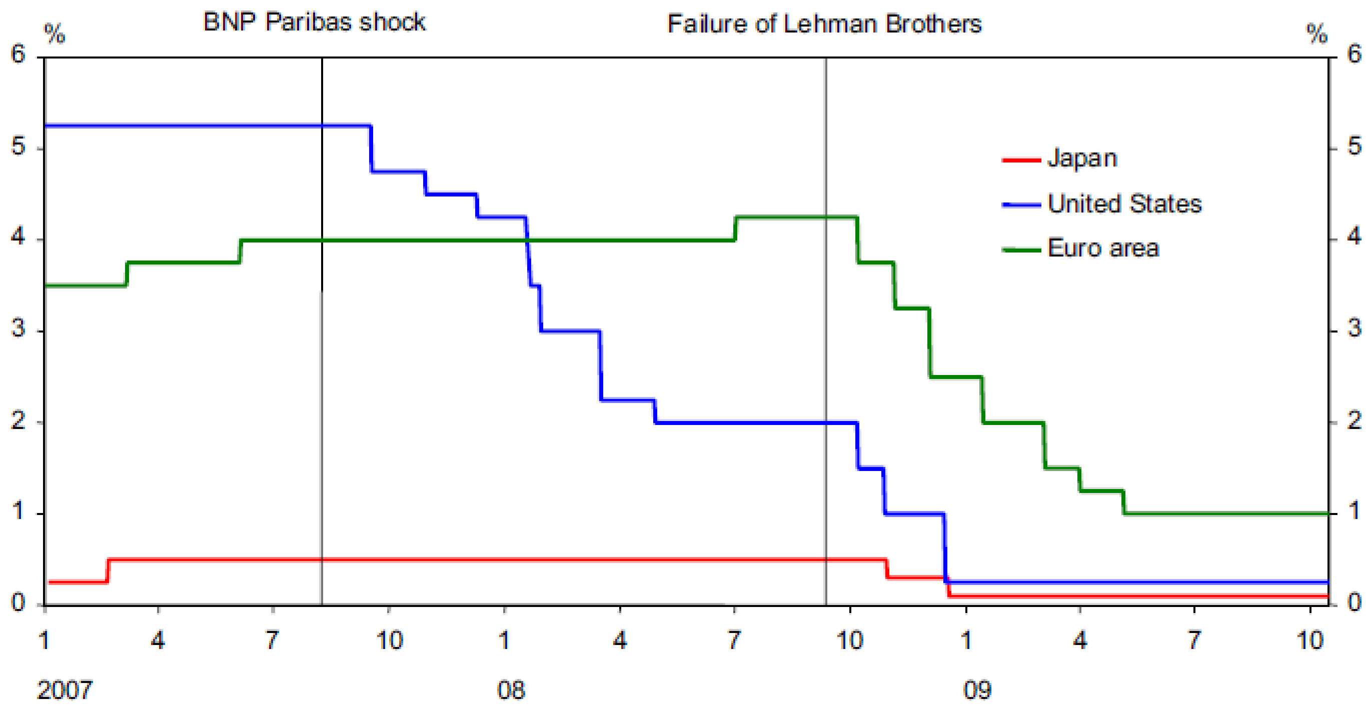
Does the implicit assumption hold?

1. The existence of zero lower bound of interest rate and safe-haven characteristics
2. The use of “core CPI” in the conduct of monetary policy and resulting neglect of inflation due to commodity price change

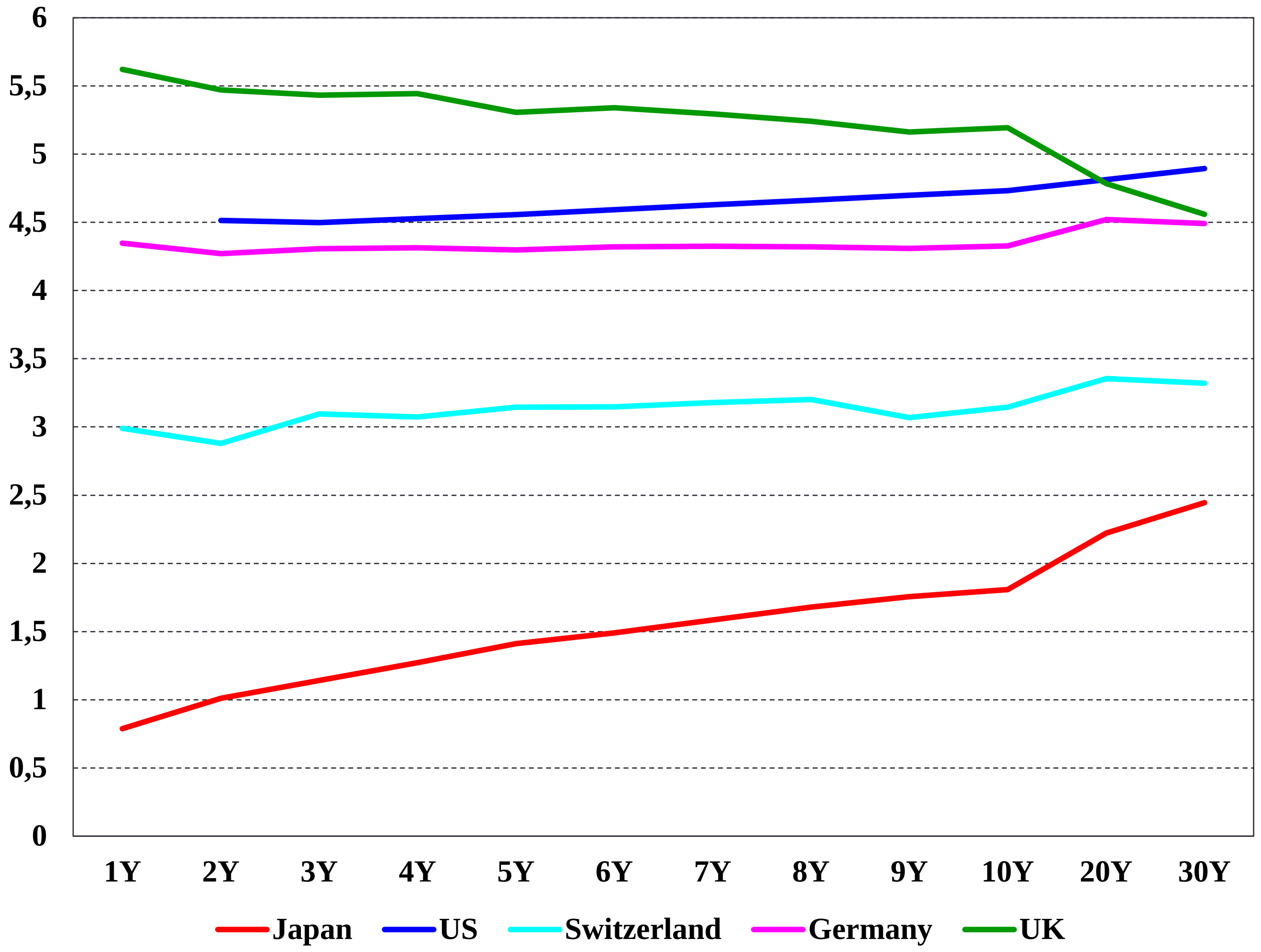
1: Issues deriving from zero lower bound of interest rate and safe-haven characteristics

- For a country that is faced with zero-lower bound of interest rate ahead of other countries and the lowest long-term interest rate, interest differential is determined passively by global economic conditions and for that matter, foreign monetary policies.
- The difficulty is compounded, if the currency of the country is a safe-haven currency.
- Japan and Switzerland were exactly faced with such difficulties after global financial crisis.
- This is a sort of classic “N-1” problem.

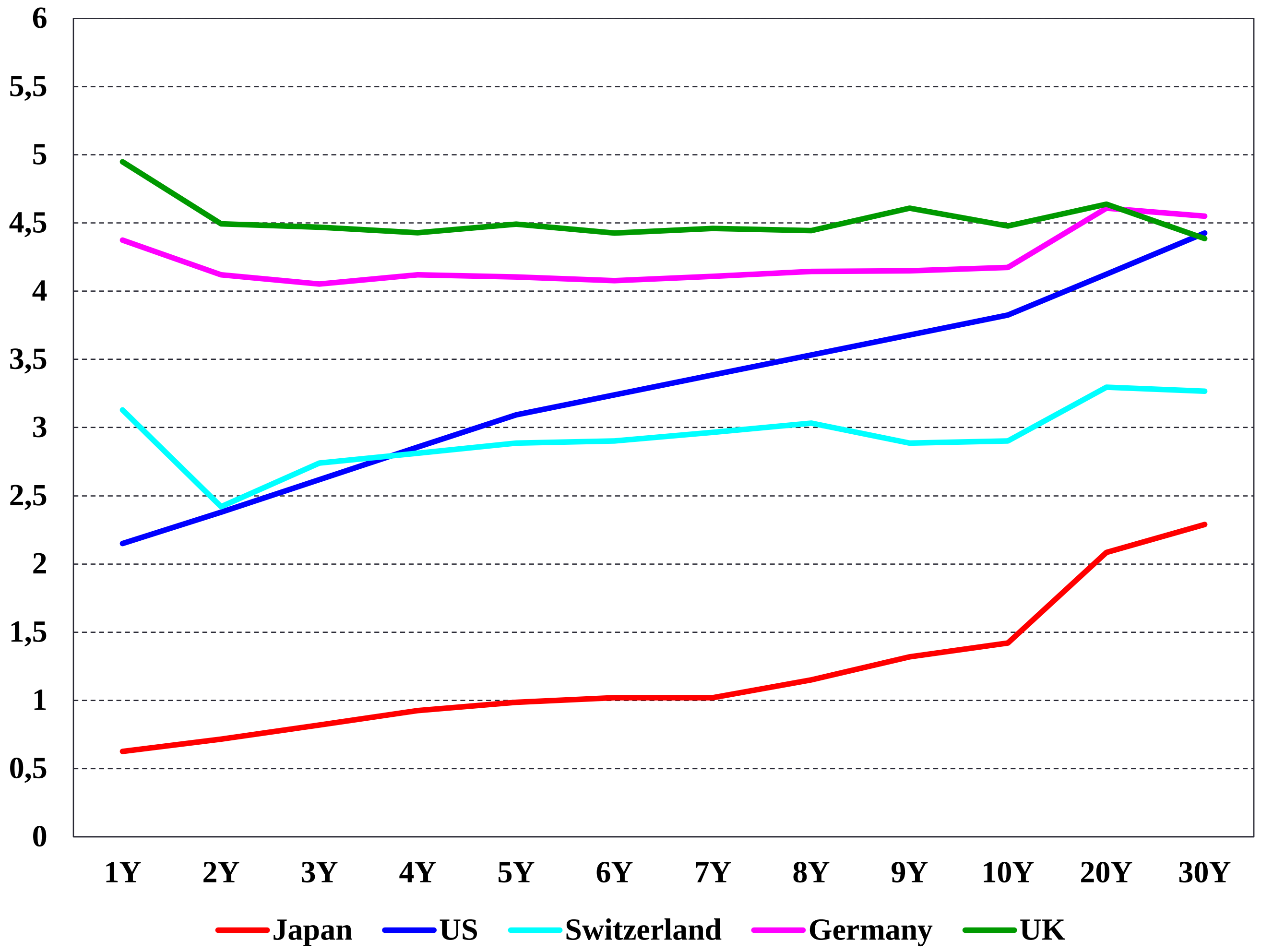
Japan did not have room for decline in policy rate after global financial crisis.



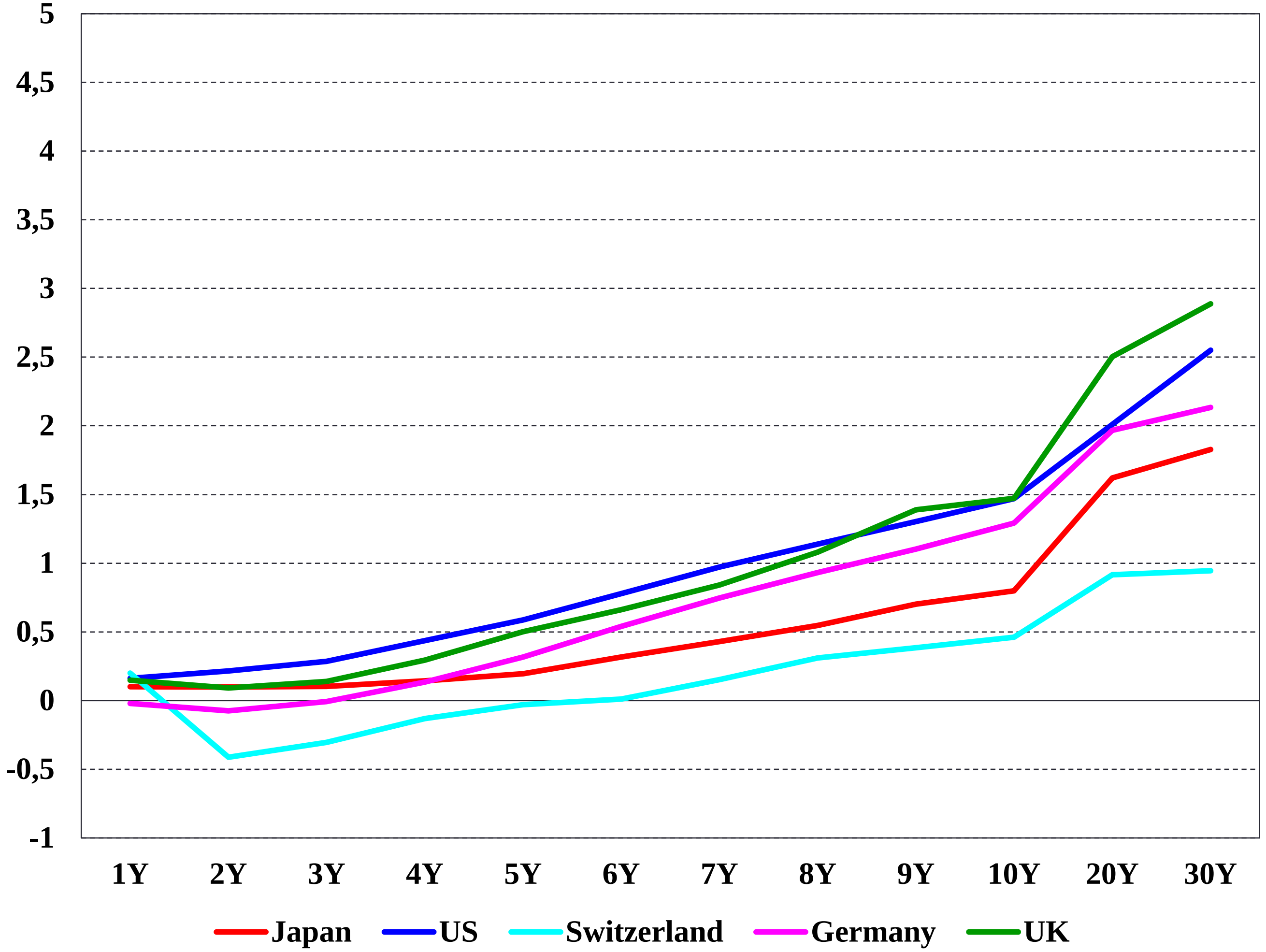
Yield curve in Japan, US, Germany UK and Switzerland as of July 2007



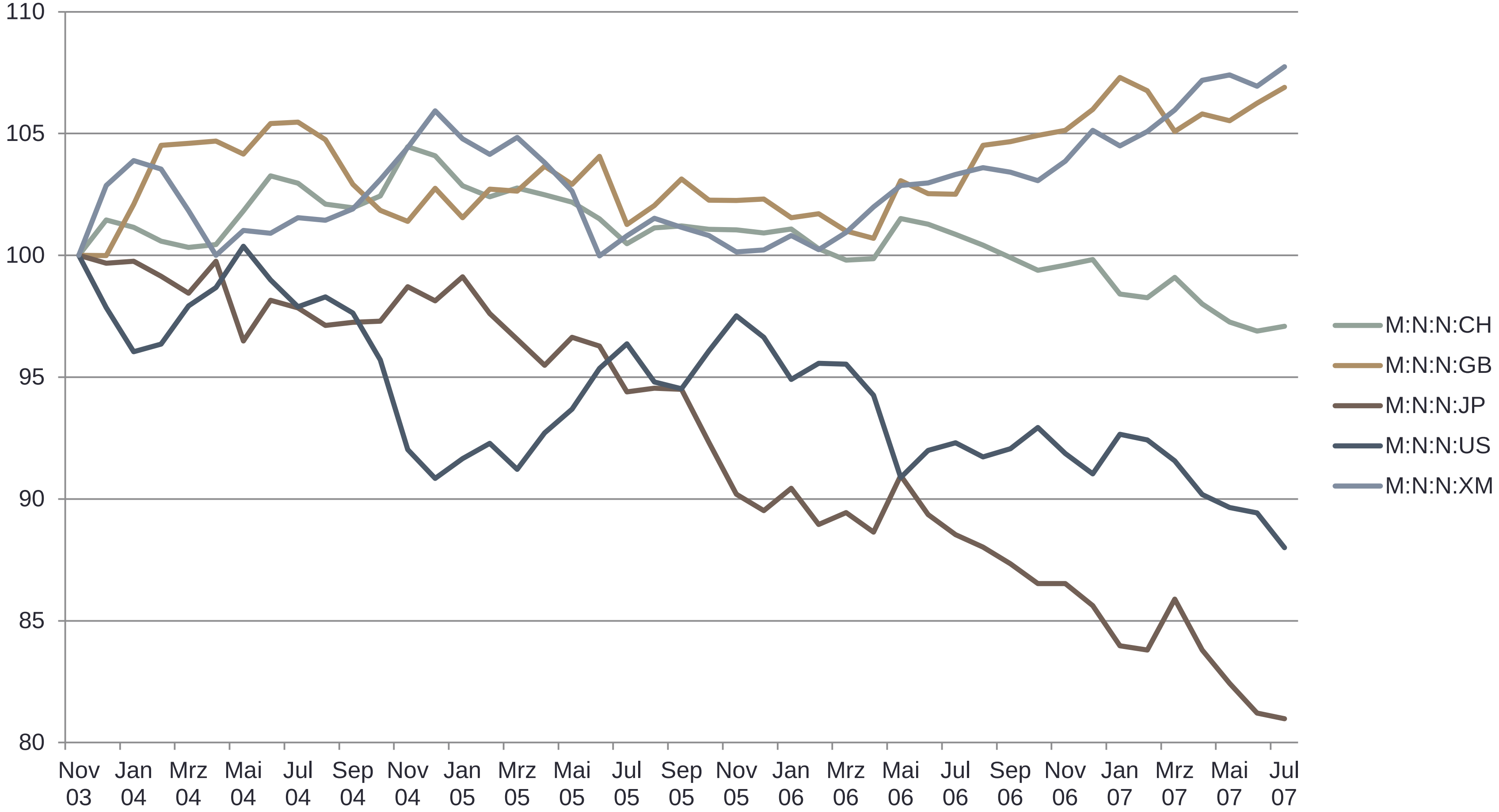
Yield curve in Japan, US, Germany UK and Switzerland as of August 2008



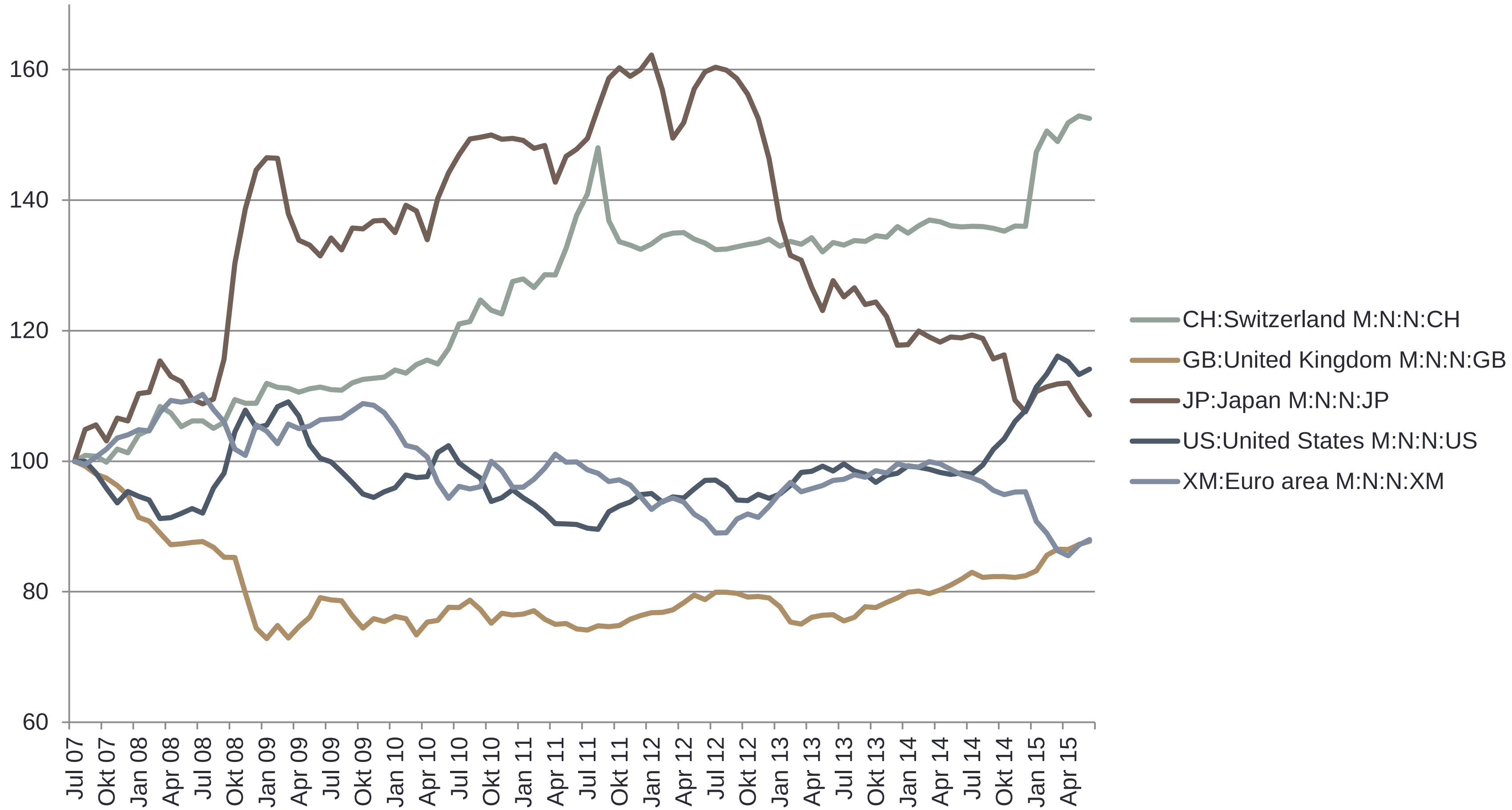
Yield curve in Japan, US, Germany, UK and Switzerland as of July 2012



Yen depreciation: November 2003 to July 2007



Yen appreciation (July 2007 to July 2012) and yen depreciation (since July 2012)



"Beggar-thy-neighbor policy" or "enrich beggar-thy-neighbor policy" (Bernanke's terminology)

Mechanism of monetary easing in the face of zero-lower bound of interest rate

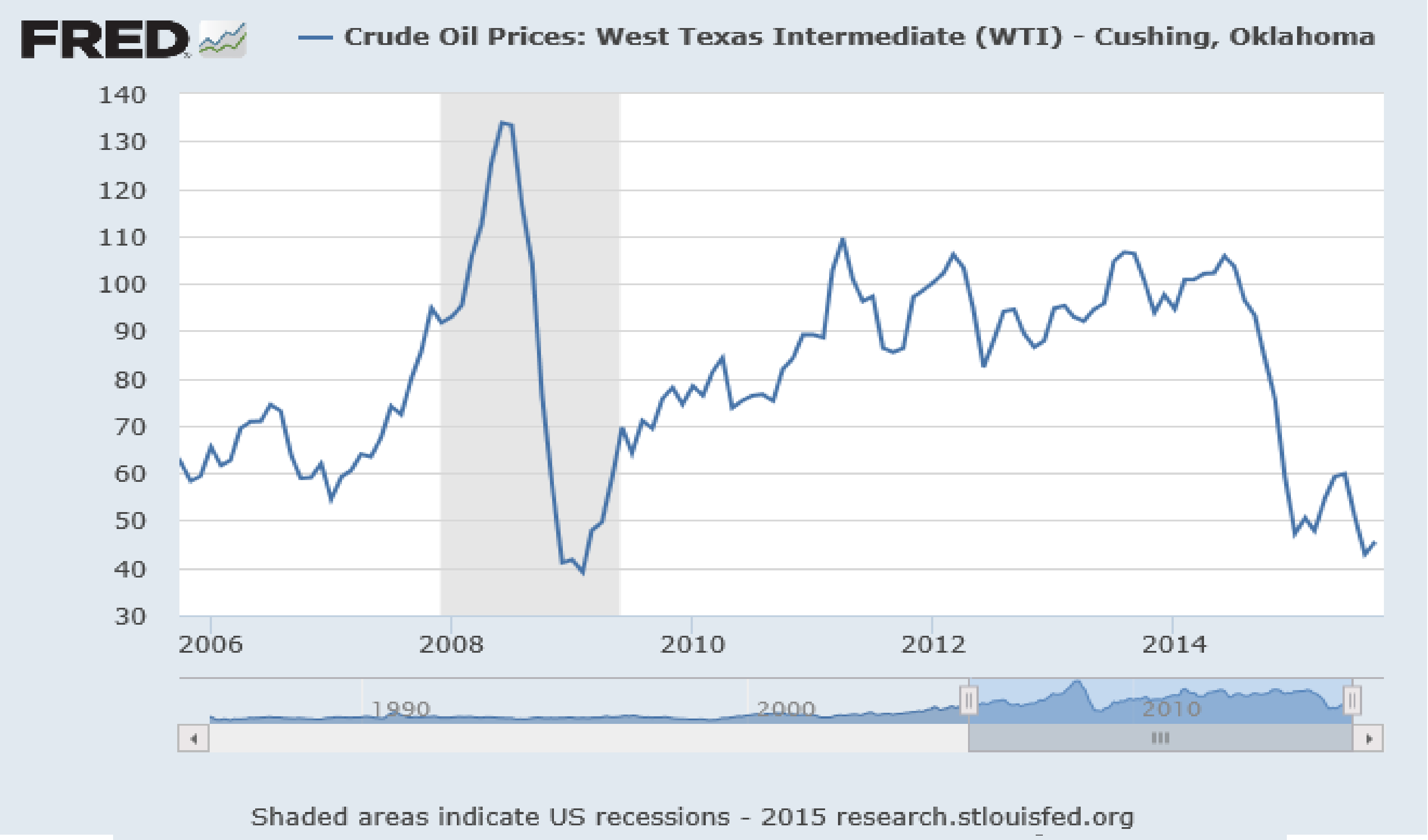
1. Bringing future demand to the present ⇒Cannot count on this mechanism indefinitely
2. Bringing demand from somewhere else to home country by depreciating the exchange rate ⇒Works only when a single country is hit by a shock.

- What would happen when many countries deploy QE aggressively for extended time? The end result is global easing bias with no discernible effect on global growth.
- "attempts by individual central banks to boost growth and inflation via currency depreciation has been self-defeating"(Stephen King (2015))
- The issue here is the lack of mechanism of internalizing the externality.⇒potential need for cooperation or coordination

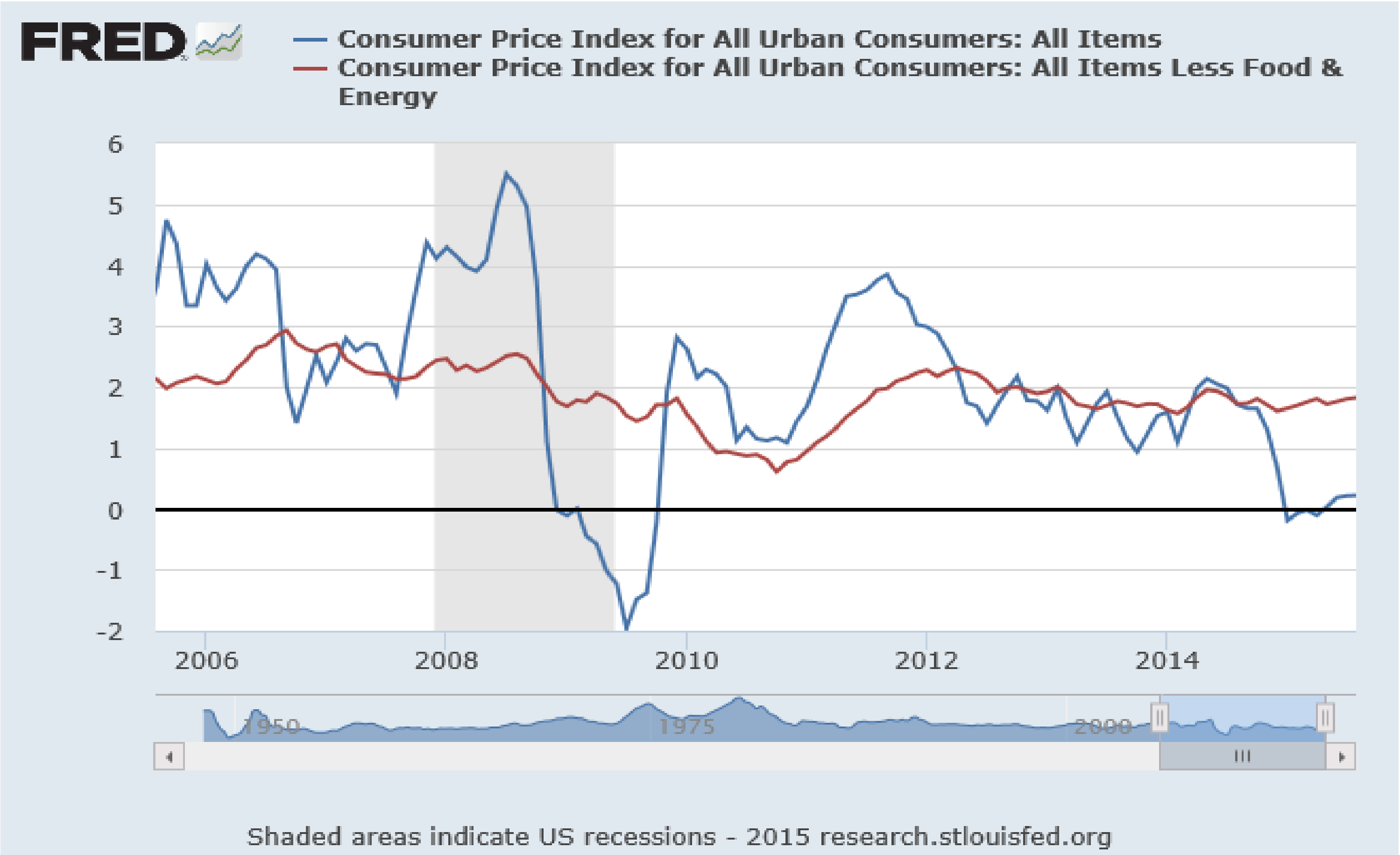
2: Commodity price and the use of "core CPI" in the conduct of monetary policy

- Commodity prices are affected by underlying demand/supply balances as well as global monetary conditions.
- Nonetheless, if central banks in advanced economies conduct monetary policy on the basis of "core CPI" excluding food and energy, it could mean disregarding inflationary impact of their own making. The end result is global easing bias.
- The issue here is the lack of mechanism of internalizing the externality. ⇒potential need for cooperation or coordination

Crude oil prices: West Texas Intermediate (WTI)

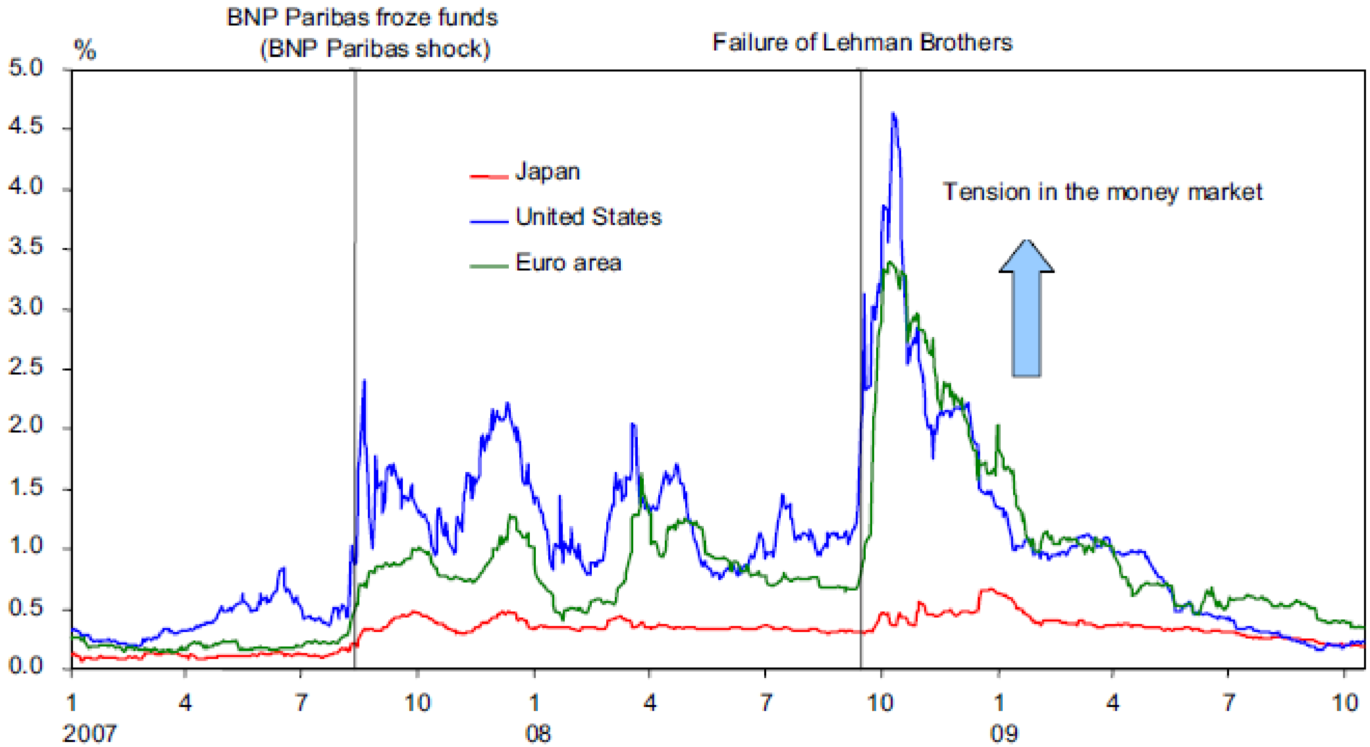


US consumer price inflation rate: headline and "core"



PART 3: Banking Operation

Strains in global money market



Coordinated response of central banks in the event of the collapse of Lehman Brothers

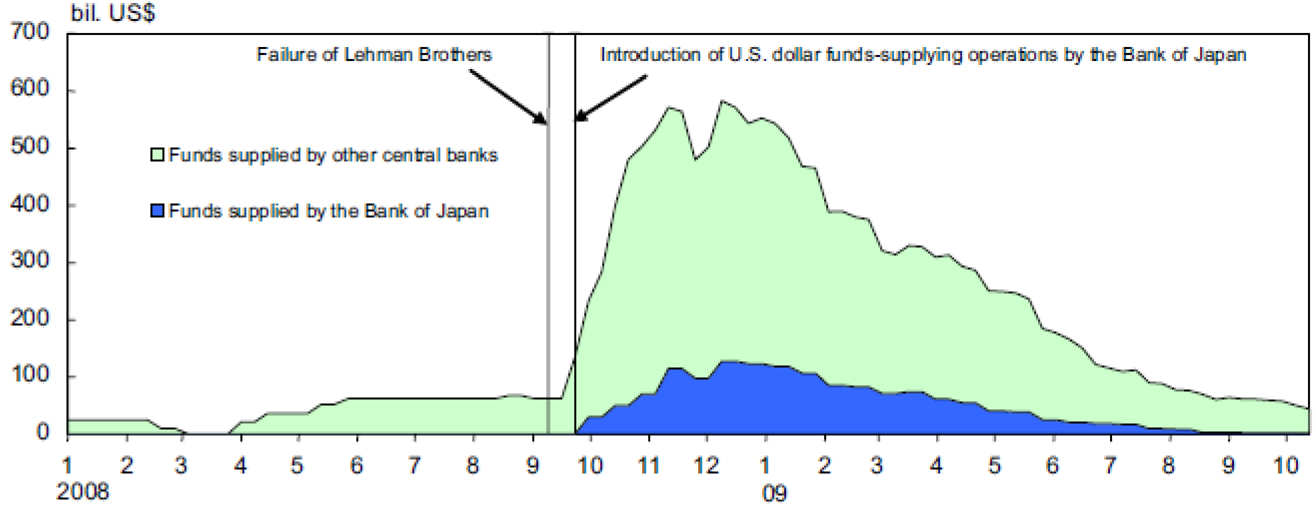
- Provision of dollar liquidity and swap arrangement between FRB and major central banks
  - This arrangement itself is new but it is essentially time-honored function of lender of last resort

Provision of ample dollar liquidity (US dollar funds-supplying operations)

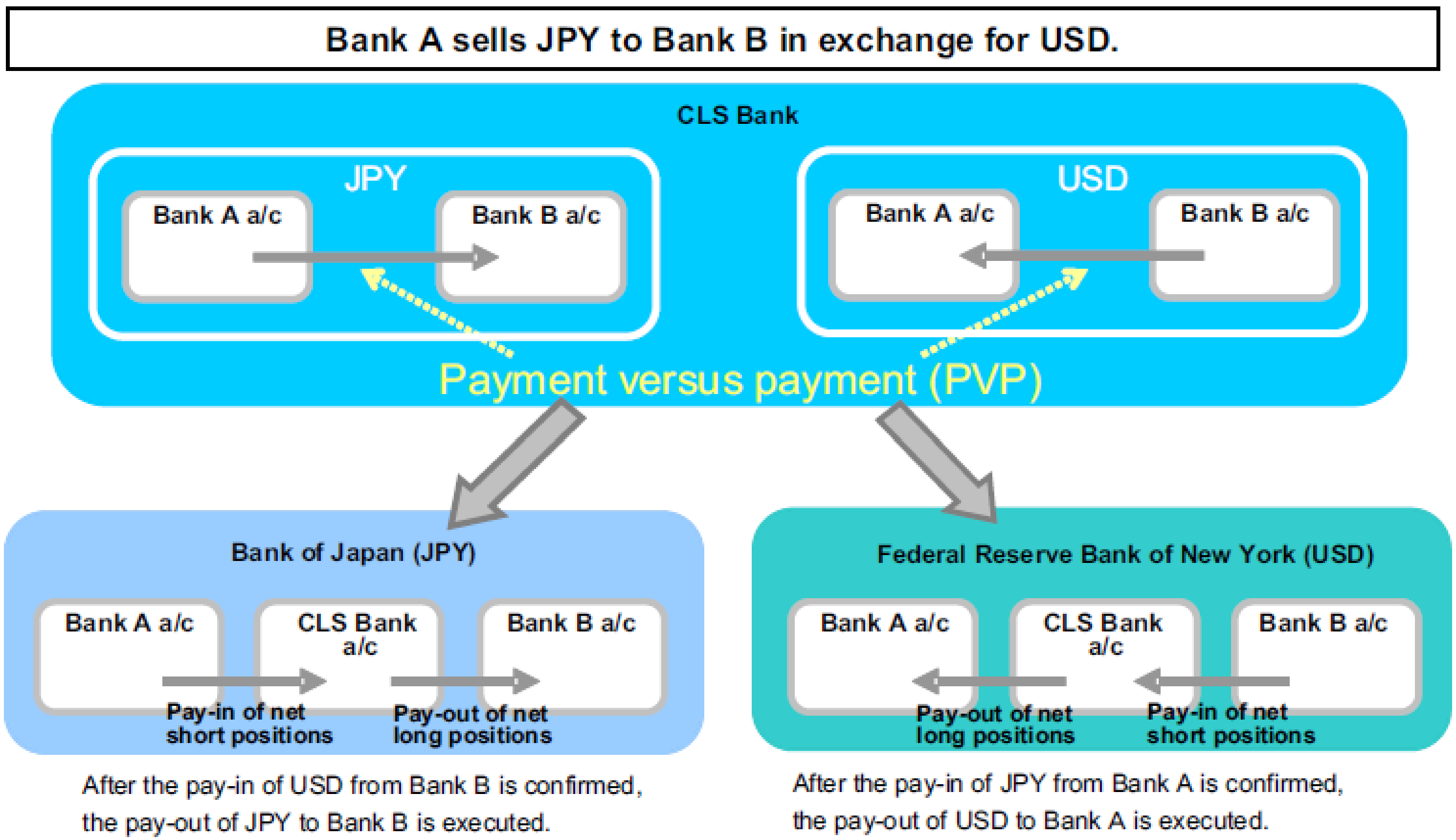
Outline of U.S. dollar funds-supplying operations against pooled collateral by the Bank of Japan

* USD funds supplied against pooled collateral pledged by financial institutions to the Bank of Japan

Amount outstanding of U.S. dollar funds-supplying operations by major central banks



Elimination of foreign exchange settlement risk due to time difference



Note: CLS means Continuous Linked Settlement.

Source: Bank of Japan.

Global cooperation among central banks in payment and settlement is underappreciated.

"The crisis that erupted in 2008 revealed the financial sector's many shortcomings. But the infrastructure that supports payment, clearing and settlement was not among them. On the contrary, the various financial market infrastructures – or FMIs – withstood the battering they received while the markets around them were in turmoil, and continued to function smoothly, with little or no damage.

(… …)

If in 2008, the market infrastructure had been in the same state as it was back in 1990, then the outcome could have been rather different. It has been said many times before, but it bears repeating: FMIs are fundamental to the ability of markets to work. A weak infrastructure can turn a small crisis into a huge one. The fact that the infrastructure *was* strong enough in 2008 is in large part thanks to the many efforts of this committee since its inception. The introduction of improvements such as real-time gross settlement (RTGS) for payments, delivery-versus-payment (DVP) for securities, and payment-versus-payment (PVP) for foreign exchange has made a real and substantial difference. "

(Jaime Caruana (2015))

Relative success of global cooperation of banking operation compared with monetary policy

Possible explanations

- Recognition that neglecting externalities causes really serious problem
- Delegation to experts due to technical nature of banking operation

- But, there remain big challenges.
  - Global safety-net?
  - Foreign exchange settlement of many emerging market currencies

PART 4: Supervision and Regulation

"New financial trilemma"

- We have to give up one of the following three.
  - Autonomous determination of financial regulation in each country
  - Integration of financial markets
  - Stability of global financial system
- Global financial crisis and preceding bubble show how serious neglecting externalities in finance is.
  - Strategic complementarity
  - Fire sale
  - Interconnectedness
- Against these background, the need for global cooperation (and coordination) has increased tremendously. Implicitly, many countries currently give autonomous determination of regulation, even though they "write" rules domestically.

How to formulate regulatory policy in globalized world?

- No magic solution
- “IMF process” vs. “BIS process” (Tucker(2014))
  - Legitimacy vs. effectiveness
- The reality is a combination of both
- Various bodies
  - BCBS (Basel Committee on Banking Supervision)
  - Group of Governors and Heads of supervisors
  - FSB (Financial Stability Board)
  - G20 (Group of Twenty)
  - IMF

The current state of global cooperation and coordination

- Compared to “ideal”, current situation is unsatisfactory.
- But, it is also true that we have seen the steady progress which was unthinkable, say, 10 years ago (Ingves (2013)). It is especially so after global financial crisis.
  - Peer reviews of members’ compliance with their agreements.
  - Framework of resolution of internationally active banks (for example, “Key attributes of effective resolution for financial institutions” (FSB))

PART 5: Some Additional Thoughts and Concluding Remarks

Intellectual spillover is rather significant

- Despite hype of globalization, we also have to be aware of the role played by domestic element.
  - Different history of inflation and unemployment
  - Different labor market practice
    - Flexible wage setting in Japan was a cause of both mild deflation and low unemployment rate.
  - Different stage of market development and infrastructure including supervisory and regulatory system
- Optimum policy might be different in each country reflecting these.
- Still, mainstream economics and its policy recommendations are built mainly on the US economy and society. Spillover is not confined to capital movement. In terms of policy, intellectual spillover rather significant.

Central banks have to make efforts at internalizing the externalities of their three activities as well

- When I talked about monetary policy, banking operation and supervisory/regulatory policy, I emphasized the externalities in each policy sphere at a global level as a reason for need for global cooperation (and coordination).
- Likewise, we also have to be aware of the externalities or interlinkage created by above-mentioned three areas of central banks' policy or operation .
- We have to strike the balance between monetary policy, banking operation and supervisory and regulatory policy in achieving global stability.

Concluding remarks

- Globalization calls for greater cooperation and possibly coordination among central banks and national regulators. Externalities is becoming large due to globalization.
- However, central bank and national regulator are naturally constrained by its own mandate of "domestic" stability. It is unrealistic for them to jump to the regime of acting on the basis of "global stability" instead of "domestic" stability.
- In terms of global cooperation and coordination, monetary policy is most difficult. Banking operation is less difficult. Supervision and regulatory policy is in between. We have to strike the balance between monetary policy, banking policy and supervisory and regulatory policy in achieving global stability.
- What we can hope is to clearly recognize what is domestic stability in a true sense after internalizing the externality.
- For this purpose, the efforts at producing "enlightened self interest" is crucial. Candid exchange of views among central banks at BIS is one such important example.

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