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AN INTERNATIONAL FINANCIAL ARCHITECTURE FOR STABILITY AND DEVELOPMENT

Global Monetary Policy Coordination Meetings

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Abstract

Monetary policies are confronted by short and long term challenges. In the short term, "normalization" of money creation and interest rates, following years of unorthodox policies, puts financial stability at risk in major monetary centres and in EMEs. Longer term challenges extend over the theoretical framework of monetary policies and their institutional settings: a lack of clarity and trust in monetary action weakens its effectiveness and endangers financial stability. This paper argues that global coordination is crucial to face these challenges. It proposes to convene appropriate official meetings to coordinate short term normalization and to start facing long term challenges.

Challenge

Today's monetary policies are confronted by short and long-term challenges.

The main short-term challenge can be labelled "normalization". For years the creation of liquidity has been overabundant and the level of interest rates extremely low. Monetary expansion has been driven by policy decisions of the developed world[1]. With the global recovery and the end of the fears of deflation, the times have come to get back to normal money creation and interest rate settings[2].

Normalization is a challenge for technical reasons, as the shrinkage of central banks' balance sheets, the reabsorption of excess liquidity, the increase in short term rates and the end of the direct manipulation of medium-long term interest rates, can be complicated to implement with the right timing and in the right order. Moreover, it is far from clear whether or not central banks will try to reproduce the old normal or converge to a new normal where monetary expansion will expire but their balance sheets will remain very large and the role of the interbank market will be kept narrower by their direct motherly relations with the banking systems[3]. However, given the very uncertain features of normalisation, the main reason to consider it as a challenge has to do with the reaction of markets. Their expectations interact with normalisation announcement[4] in ways that may diffuse panic and precipitate liquidity crises and disruptive volatility in asset and currency prices. Financial stability is at risk, particularly in an over-leveraged global economy where increases in debt have often been generated to help private and public debtors to cover up their difficulties in staying profitable or solvent.

The challenge of normalisation looks difficult and risky also because each central bank tends to proceed along lines that reflect the specificities of its own country or currency region. That monetary policies do not need to be coordinated is part of current orthodoxy. However, international spill-overs of national policies are such that without coordination the path towards normalization looks harder and bumpier. The first move of a normalizing country could trigger expectations that complicate the decision process of the other normalizers with unforeseeable consequences for the credibility of the policy announcements of all of them. Moreover, as normalization gets enacted in the most developed monetary regions, emerging economies must undergo a difficult adjustment of their debtor positions denominated in the leading currencies. They will also have to adapt macroeconomic strategies to a rising cost of capital. They could be seriously hurt by the unwinding of the "search for yield" that has been in place since the beginning of the crisis. Their financial fragility could then emerge as a source of global trouble.

As far as the longer term is concerned, monetary policy challenges are even greater. They extend over the theoretical framework on which monetary strategies are based and over the institutional setting surrounding central banks. They picture a situation where a lack of clarity, trust and international consensus in monetary instruments can weaken their effectiveness and aggravate sources of financial stability.

- The relationship between monetary policy and inflation, the main pillar of today's monetary strategies, has been weak since the end of the past century: until the Great Recession, liquidity and credit grew much faster than prices while during the last years vigorous monetary expansions went together with subdued inflation often threatening deflation. Moreover, price levels dynamics increasingly respond to global forces, thus eluding the influence of uncoordinated national or regional monetary policies.

- Unconventional policies and their initial unwinding have also shown some weakening of the credibility of monetary announcements which have perhaps been overdone by an intense reliance on "forward guidance".

- Quantitative easing is raising doubts about central bank independence from governments and markets and about the boundary between monetary and fiscal policies as many observers note that massive central banks' purchases of long term securities and sovereigns may have significant distributive consequences and modify the incentives to fiscal adjustments.

- The evolution of financial regulations after the global and euro area financial crises has complicated the transmission mechanism of monetary policy, defied the separateness of monetary and financial stability targets and questioned the respective roles of monetary and macro-prudential policies and authorities. Current pressures to weaken regulation need careful scrutiny as they could result in unintended destabilizing effects. The explicit definition and introduction of macro-prudential policies has been one of the great advances in the last decade: however, their role looks still insufficient and controversial, their design inadequate; moreover, the maneuvering of their instruments isn't well orchestrated with monetary policies and lacks international coordination.

Proposal

Both short and long-term challenges that confront monetary policies require a more intense global cooperation. The latter can help to manage normalization and start solving the conceptual, strategic and institutional problems that, in the longer run, hinder the trust in the effectiveness of monetary policy tools.

First and foremost, cooperation can be helpful to overcome problems that render the "normalization" of monetary policy a difficult operation that can put at risk financial stability. The difficulty and risks of normalization tends to postpone its completion, unnecessarily prolonging the extra-expansionary stance of monetary policies and the use of unorthodox monetary tools. The global game suffers from a "first mover problem" which only cooperation can remedy.

Normalisation can be shaped and timed differently in the various countries and monetary regions, according to the different features of the past unorthodox expansion, to the specific aspects of the regional financial systems and of the macroeconomic situations. But its technicalities can benefit from coordination and, possibly, from mutual help. Gradual asset sales by the Fed, for instance, aimed at shrinking its balance sheet, can be easier if the other major central banks are well informed about the US strategy and perhaps even ready to provide help.

Different central banks' bylaws shouldn't be an insurmountable obstacle to agree on a coordinated feature of normalization. To square with national mandates, the "coordinated strategies" will turn out to be a "minimum common denominator" of national views on what should be done in a coordinated fashion. Any specific aspect will have to be decided at a national level. However, the common denominator will be crucial and help the markets to be more stable.

The most important potential benefit of monetary policy coordination is its impact on markets' expectations and reactions. Markets must know that the complex process is governed in a cooperative manner. This prevents them from panicking and discourages destabilizing speculation based on expected strategic hostilities between the major central banks and on their alleged differences in timing and scope. The whole process can then take place with smaller divergences and volatilities of interest and exchange rates, smoother capital flows and less impact on stock prices. The timely provision of well-considered information is one of the main remedies to market imperfections.

Markets must therefore be informed in an official manner on the main agreements reached by the coordination process. In fact we can even presume that some coordination (together with the exchange of crucial information) has always been taking place among the major central banks, who have also special occasions to do so, like their regular meetings in Basle. The proposal here is to officially admit the existence of such coordination efforts, make them more regular and structured and, most importantly, communicate at least part of the conclusions to the markets. Note that, in theory, such a process, by involving reciprocal official commitments among monetary authorities of different countries, would also act as a "commitment technology", a device to increase the credibility of each of them by the general public, market operators and governments as well.

Only a sufficiently transparent coordination can convince the markets that each normalizer has a compatible plan to move, with tools and speed appropriate for that country but not harmful for other countries' plans. Already several years ago, in his seminal contribution on the matter[5], John B. Taylor showed how the benefits of international coordination increase when monetary policies do not follow a set of established rules. As rules cannot easily govern the complex tâtonnement which is now required for going back to normal liquidity, normal central banks' balance sheets, normal interest rates, both policy effectiveness and financial stability would greatly benefit from coordinated monetary announcements.

Coordination positively affects the behavior of major financial markets connecting the advanced countries that coordinate their policies. However, its stabilizing impact involves the emerging economies as well, their exchange rates and cross border capital flows. Interest rate spillovers into EMEs become expected and gradual, easier to manage by central banks with interventions and timely currency swaps to which EMEs access can be expanded and stabilized. Quite obviously, the benefits of coordination on emerging economies are higher the deeper is the involvement of EMEs

monetary authorities in the coordinating arrangements. While the main strategies cannot but be adopted by the major central banks, the voice of EMEs authorities should play a role and their information set should be such as to allow them to maximize their benefits in terms of stability.

Destabilizing spill-overs of reserve countries' monetary policies into EMEs, to be sure, such as those that in 2013-4 caused a postponement of normalization in the US, have long be recognized as a possible, though debatable justification for international coordination and/or mitigating arrangements like currency swap facilities[6]. Note, however, that today's challenge of normalization calls for coordination among advanced countries also to avoid instability risks in the same reserve countries.

The term "normalization" describes the gradual exit from the extraordinary **stance** of monetary policies that was adopted to deal with the major crises of the last 8-10 years. However, the normalization must be extended to the **instruments** used by monetary authorities, that have been now for long rather non-standard: while some innovations can become permanent parts of a reinstated orthodoxy (like some elements of forward guidance), the plan is to substantially normalize the central banks' set of tools. The basic strategy to move towards the normalization of instruments should, at least in part, be included in the coordination process and in the communication of its conclusions. The latter would serve as a coordinated **road map** for coming monetary policy decisions. The various central banks would be able to act differently, but in a way jointly agreed and communicated, fully in accord with the recent stronger reliance on **forward guidance**. The organisation of the coordination procedure can thus become **a multilateral cooperative research effort to devise the future developments of monetary policy techniques in an increasingly interconnected monetary world** where idiosyncratic decisions of individual countries, if taken without the understanding and agreement of the other main monetary actors, are bound to become increasingly destabilizing or ineffective.

This effort can result in a **permanent multilateral forum** for monetary coordination. The perspective of such a forum can **bridge the short run need to cope with normalization and the requirement to face the above mentioned longer term challenges to monetary policies**. The latter call for a combined theoretical and practical planned action to update theories and institutions, possibly including also some aspects of central banks' bylaws that are now biasing monetary strategies towards an emphasis on national interest that doesn't square with the increasingly intense global financial links. It is also essential to cope with the increasingly evident links between pure monetary policy themes and issues in financial regulation. Coordinated international efforts should be devoted to stimulate an adequate scholarly research attention to the long term issues. Over time the result could very well be bringing into question the limits of the orthodoxy to be reinstated in the short term.

The short term management of normalization can serve as an opportunity to start a wider and permanent endeavor to use **global cooperation for renovating the conceptual and institutional framework of monetary policy strategies and techniques**. This action plan should be publicly announced and provide for the appropriate communication of its works and conclusions. It should start as soon as possible, at least among the major monetary centers of the world, even if its results must wait the "long term" to become evident. Long term challenges, as argued above, put at risk the credibility and effectiveness of monetary policies spreading doubts and skepticisms the can severely weaken financial stability and growth. The urgency of normalization efforts should also be an excuse and a justification to try an ambitious path towards the clarification and solution of more structural issues. Along the latter path the **contribution of scientific and technical research** is obviously essential and should be exploited with appropriate arrangements involving the main international research networks that connect academic thinking with policy making.

A multilateral initiative is needed to convene and host the meetings where official coordination takes place, both on the short term front of normalization and along the longer term action plan facing the more general and fundamental challenges. The initiative could be formally considered by the G20 under the umbrella of the Mutual Assessment Process (MAP) established in the 2009 Pittsburgh Summit[7]. We propose the **Bank for International Settlements** as the appropriate venue, also providing the secretariat of the **"Global Monetary Policy Coordination Meetings"** (GMPCM). The BIS seems a more neutral and less politicized place than the IMF. Moreover, Basle, as the host of the BCBS, is also better suited to emphasize and facilitate the connections between monetary and regulatory issues and to organize in a more flexible way, with variable geometry, the meetings where major central banks are joined by EMEs monetary authorities.

However, for obvious reasons, the IMF cannot be a stranger in this process. We therefore propose to start with two official meetings each year:

- **a "spring session"** of the GMPCM, hosted and organized by the BIS, with the help of the IMF , where **main aspects of the yearly monetary policy strategies** are coordinated behind closed doors and then suitably communicated;

- **an "autumn session"** taking place in occasion of the annual meeting of the IMF, as a separate event convened by the BIS secretariat of the GMPCM in conjunction with IMF representatives and in accord with the IMFC, where the **implementation of the spring strategic lines of action is checked**, supplementary themes are proposed and discussed and the first plans for next year's works are drafted. An adequately documented communiqué is then issued on the results of the autumn session.

Both sessions of the GMPCM initiative should have their **core meeting** where only central bankers are involved, thus preserving their crucial "independence". The initiative should not be interpreted as a weakening of their autonomy nor as an occasion to better hold them accountable to elected politicians. The core communique must also be authored exclusively by central bankers.

International coordination, as noted above, will try to find and communicate agreements on general strategic lines of action and will not eliminate the **accountability** of central bankers **to national political authorities** from which they derive their mandate. In fact the specific decisions will take place at the national level even if they will strive to be respectful of the "minimum common denominator" agreed upon during the GMPCM.

Wider meetings and workshops could take place "a later", particularly during the autumn session, with finance ministers, regulators, think tanks and academics, with variable geometry, to generate institutional cooperation on the issues that have been called above the "long-term challenges" of monetary policies, as well as to integrate and bridge the decisions and the needs of monetary authorities with the design of other policies. Appropriate communications should also be organized and scheduled in such a way as to spread substantive and rigorous information about the works of the side-meetings. The careful planning of the sessions is therefore a crucial task of the hosting/convening institutions.

References

[1] Past contributions by the T20 have analyzed policy issues arising from unconventional monetary expansions. See, for instance: https://www.brookings.edu/wp-content/uploads/2016/06/TT20-central-banks-monetary-policy-2.pdf.

[2] Already several years ago a T20-2014 paper by José Siaba Serrate, included in the recommendations for the Brisbane G20, was arguing along lines very much relate to the present policy brief. At that time tough the normalization problem could be safely presented as a less urgent process than today: "The path advanced economies must take in returning to normalcy will be a multi-stage, multi-year process....Unwinding unconventional monetary policies will not be an easy task. These are uncharted waters":
https://www.lowyinstitute.org/sites/defau
lt/files/serrate_the_threats_of_transition.pdf

[3] See, for instance, G. Claeys and M.Demertzis, "How should the ECB normalize its monetary policy", Bruegel, Policy Contribution n.31, November 2017, and their rich list of reference on the topic.

[4] QE announcements have had impressively large impacts on exchange rates and sovereign spreads, in proportion to the total changes that happened following factual QE interventions. For recent estimates of ECB's QE announcements effects (and related literature) see:
http://www.bancaditalia.it/pubblicazioni/qef/2018-0424/QEF_424_18.pdf?language_id=1

[5] https://www.bis.org/publ/work437.pdf

[6] See, for instance, https://www.imf.org/external/pubs/ft/wp/2014/wp1470.pdf

[7] https://www.imf.org/en/About/Factsheets/Sheets/2016/07/27/15/48/G20-Mutual-Assessment-Process-MAP . While very specifically devoted to monetary policy issues and also aiming at urgent and highly technical central banks' decisions, the GMPCM can be thought as belonging to an established G20-centred tradition of much wider efforts of macroeconomic global coordination.
The latter includes the Global Coordination Council (see
www.un.org/ga/econcrisissummit/docs/FinalReport_CoE.pdf and
https://www8.gsb.columbia.edu/faculty/jstiglitz/sites/jstiglitz/files/2012_G20_Glob_Econ_Coord.pdf) and, in monetary matters, the various efforts to reform the international monetary system, like the Palais-Royal Initiative (http://global-currencies.org/smi/gb/telechar/news/Rapport_Camdessus-integral.pdf).