ECB Policy Roundtable on Global Liquidity in a Multipolar Currency World

Frankfurt, 1 September 2011

"International policy challenges stemming from global liquidity"

I would first like to thank the ECB for organizing this conference and for the invitation.

Global liquidity management is an important dimension of the reform of the international monetary system, which the French Presidency of the G-20 has put very high on its agenda.

As a short introduction to your discussions, I would like to address three questions: (i) where does global liquidity come from? ; (ii) can we better assess global liquidity and its consequences? ; (iii) which impact on policy decisions ?

1 - Where does global liquidity come from?

Let me follow a textbook approach here. Both demand-side ("pull") and supply-side ("push") factors can be identified:

- On the supply side, money creation by central banks, especially those issuing international currencies; money creation by the private sector (deposit-funded liquidity); and market-led money creation (collateralized liquidity, e.g. through the shadow banking system);
- On the demand side, growth in reserve-currency issuing economies; growth in emerging-market economies, as it offers opportunities for investment in international currency; and accumulation of foreign exchange reserves, in some instances due to undervalued to exchange rates.

A first analytical challenge is thus to identify demand and supply shocks to global liquidity, since the consequences are obviously different.

Now, can we identify situations of excess/insufficient global liquidity, and what are the main risks associated with excesses and shortages of global liquidity? Answering properly these questions requires measures of global liquidity.

2 - Can we better assess global liquidity and its consequences?

There is no such thing as an agreed assessment of global liquidity. Indeed, it is not an easy task: any measure of global liquidity should reflect both the liquidity created by central banks, commercial banks, but also markets, and foreign-exchange reserve accumulation. As requested by the G-20, this work is under way at the BIS and IMF. It faces many hurdles, beginning with daunting data gaps.

Indeed, no single measure can capture all the properties of global liquidity. Both quantity and price-based measures are needed. As Paul Samuelson once wrote, the Good Lord gave us two eyes and he had a purpose in that: we should watch both prices and quantities. Also, any relevant analysis should be dynamic, which requires sufficiently long time series.

The BIS has proposed using price indicators, including measures of risk appetite or credit standards; and quantity measures, including global credit aggregates (ideally, comprising both bank and non-bank credit). The former indicators provide information about the conditions under which liquidity is provided. The latter capture how such conditions translate into the build-up of risks, notably by offering a rough measure of leverage at the aggregate level.

The IMF has approached the issue of liquidity measurement by expanding traditional measures. They use monetary aggregates that include “core liabilities” in the financial system, and also less traditional sources of funds such as securities, repos, investments in money market funds and funding based on structured products. This approach is completed by the introduction of price-based measures. As noted by the Fund, the relative merit of each approach depends on the cyclical position. During upswings, the interaction between price and quantity of global liquidity can help identify the presence of a liquidity expansion and attendant risks. During downswings, price-based indicators are likely to convey more information as quantities are sticky downwards. Hopefully, this will help us detect periods of excesses and shortages of liquidity and better understand their consequences.

Now, what are the consequences of movements in global liquidity? Excesses may lead to GDP overheating, excessive credit growth, assets bubbles (financial assets, commodities) and/or misallocation of capital. As for shortages, they may lead to GDP and credit contraction, lack of financing leading to credit crunch, severe liquidity strains in some economies, irrespective of their fundamental strengths and soundness of policies.

In all cases, I believe that effects on the allocation of capital are as important, if not more, as effects in the aggregate. Here, I have in mind cross-sector allocation (too often, towards less socially-productive sectors in times of credit bubbles) as well as cross-country allocation (think of the current effects of capital flows into emerging market economies).

3 - Policy consequences

A first, intriguing question is the collective bias of policymakers in dealing with global liquidity. History shows that shortages of global liquidity are swiftly identified and addressed (think of the decisions taken in 2008 and 2009: activation of currency-swap lines, creation of IMF precautionary facilities and tripling of its resources at the London Summit). Meanwhile, excesses of global liquidity have built up for extended periods of time with little or no consensus in the international community, not to mention action. It would be interesting to understand why.

With that in mind, our work program could be the following:

- When global liquidity indicators are robust, they could feed into IMF multilateral surveillance (say, in the GFSR and WEO, and in the newly introduced "Spillover Reports" on the external effects of the policies of the larger economies).

- As a second step, they could be used to help detect shortages of global liquidity and trigger appropriate responses. That said, they should certainly not be pursued as targets since they will remain empirically fragile and subject to Goodhart's law.

- This leads us to the question of the instruments. There is no single answer but let me list a few of them:

    - Monetary and exchange-rate policy coordination between jurisdictions issuing reserve currencies. It is unclear how central banks can reconcile the increasing recognition of international spillovers and national price stability mandates.

    - Micro- and macro-prudential policies, and possibly financial market regulation, which can help moderate or encourage market-led money supply.

    - Altering the allocation of international liquidity when it is obviously misallocated.

Let me elaborate on the latter point. Currently, there are central-bank instruments (*i.e.* currency-swap lines) which are bilateral and discretionary, and IMF contingent facilities (*i.e.* the Precautionary Credit Line -PCL and Flexible Credit Line -FCL) which are multilateral instruments based on strict ex-ante eligibility. Central banks have their own reflections on their swap lines, notably within the Committee on the Global Financial System of the BIS in Basel. Meanwhile, there is an ongoing G-20 discussion on improving the PCL and/or FCL -the so-called “Global Financial Safety Nets” discussion. This might lead to shorten the duration of PCL and/or FCL and activate it in periods of systemic liquidity stress, with appropriate safeguards to avoid moral hazard. In short, Fund instruments would become more alike swap lines. Looking forward, one might therefore wish to reflect on the allocation of tasks between the IMF and central banks and on the optimal architecture of the liquidity-provision system.

Thank you for your attention.