



EUROPEAN CENTRAL BANK

EUROSYSTEM

The reform of the IMS: Getting the policy mix right

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Disclaimer: The views expressed here are solely the views of the presenter
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Has the policy pendulum swung too far?

- **Nature of and response to financial crisis as guide to what reforms of IMS are needed**
- **1997-98 Asian crisis – “all evil is local”**
 - **Domestic sources of vulnerability**
 - **Orthodox domestic solutions: i. monetary & fiscal tightening; ii. financial policy contraction; iii. No capital controls, FX depreciation**
- **2008-09 financial crisis – “all evil is global”**
 - **Claim: sources are global**
 - **Domestic policy responses: i. monetary & fiscal easing; ii. financial policy accommodation; iii. Capital controls & FX management**
- **Systemic crises always contain global/common and idiosyncratic dimensions – has policy pendulum swung too far?**

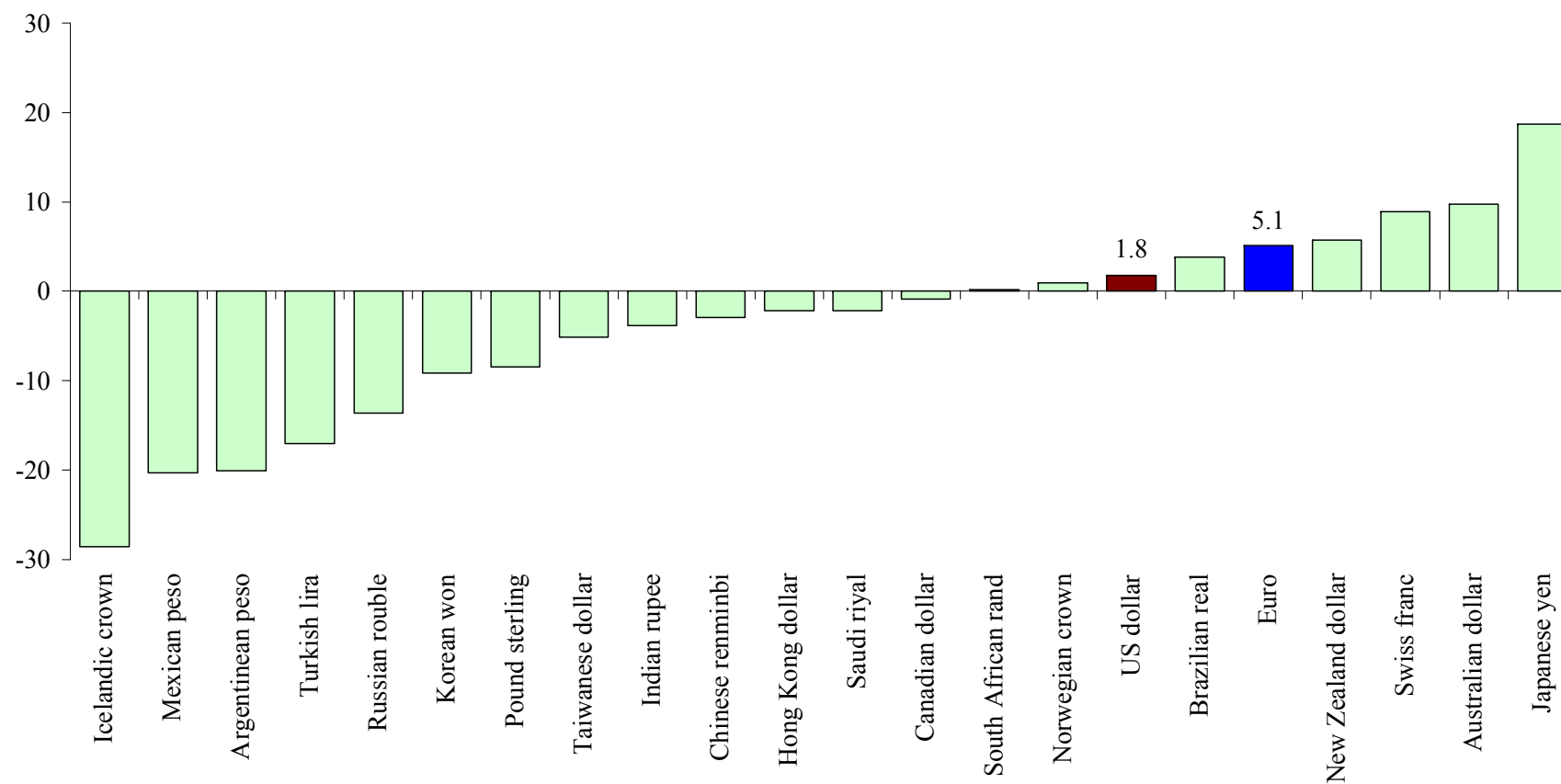
Implications of crisis for policy and IMS

- **If nature of crisis is mainly global, focus on**
 - **Change nature of IMS itself, e.g. exchange rate system (SDR, multi-currency system etc.), global regulatory system, global institutions/IFIs**
 - **Provide liquidity and insurance mechanism (FCL/PCL, GSM, possibly even global LOLR) with few strings attached**
- **If vulnerability to crisis is mainly domestic, focus on**
 - **Reduce sources of vulnerability – macro policies, financial regulation and development, institutions, etc.**
 - **Surveillance with traction and other policies to enforce good policies and reduce moral hazard ex ante**
 - **Conditionality of lending to foster reforms**

Reforming the IMS and finding the right policy mix

- **Heterogeneity of effect of 2008-09 crisis on countries and regions**
- **Strong effect of 2008-09 crisis on EMEs indicates that sources of vulnerability were both global and domestic**
- **Need for better global policy cooperation (e.g. G20 SSB Framework, financial regulation/Basel III)**
- **Requires also domestic policy reform in AEs and EMEs**
- **A few examples: capital flight, FX depreciation and the massive accumulation of FX reserves of EMEs**

NEER changes in crisis affected mainly EMEs (%)

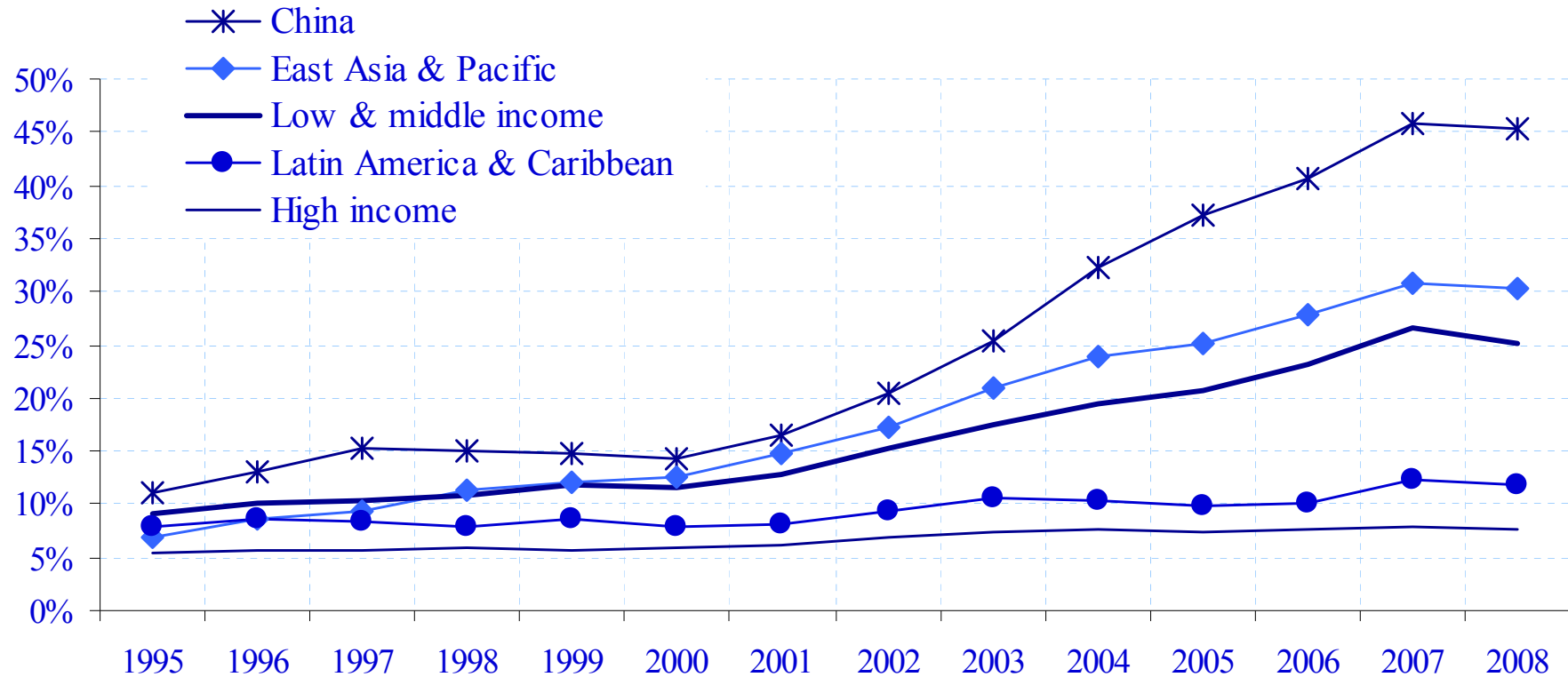


Notes: Changes in NEERs from 12 September 2008 to 12 September 2009.

Sources: national sources, BIS and ECB staff calculations.

Why so much reserve accumulation in Asia?

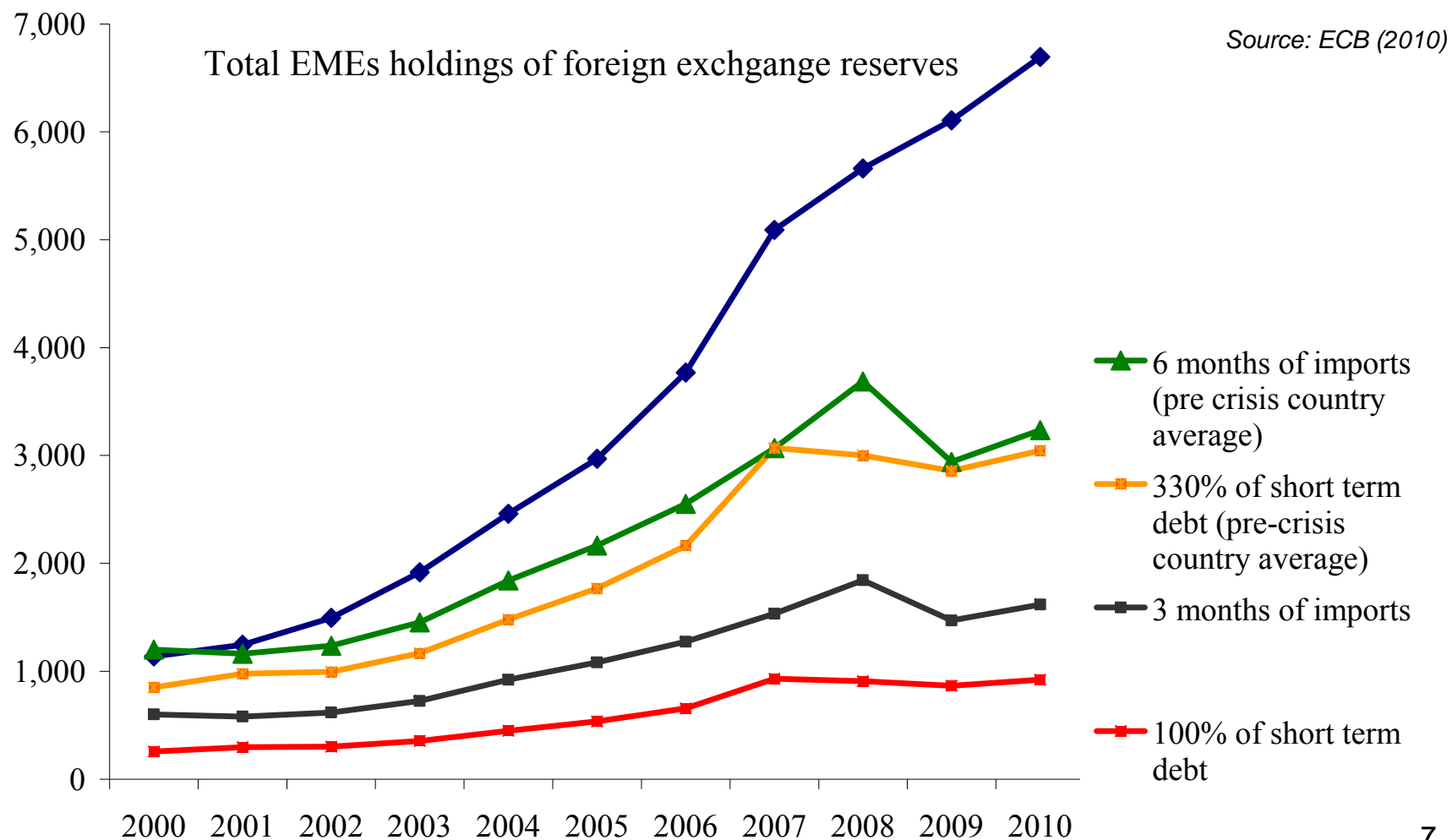
International reserves as a share of GDP (%), 1995-2008



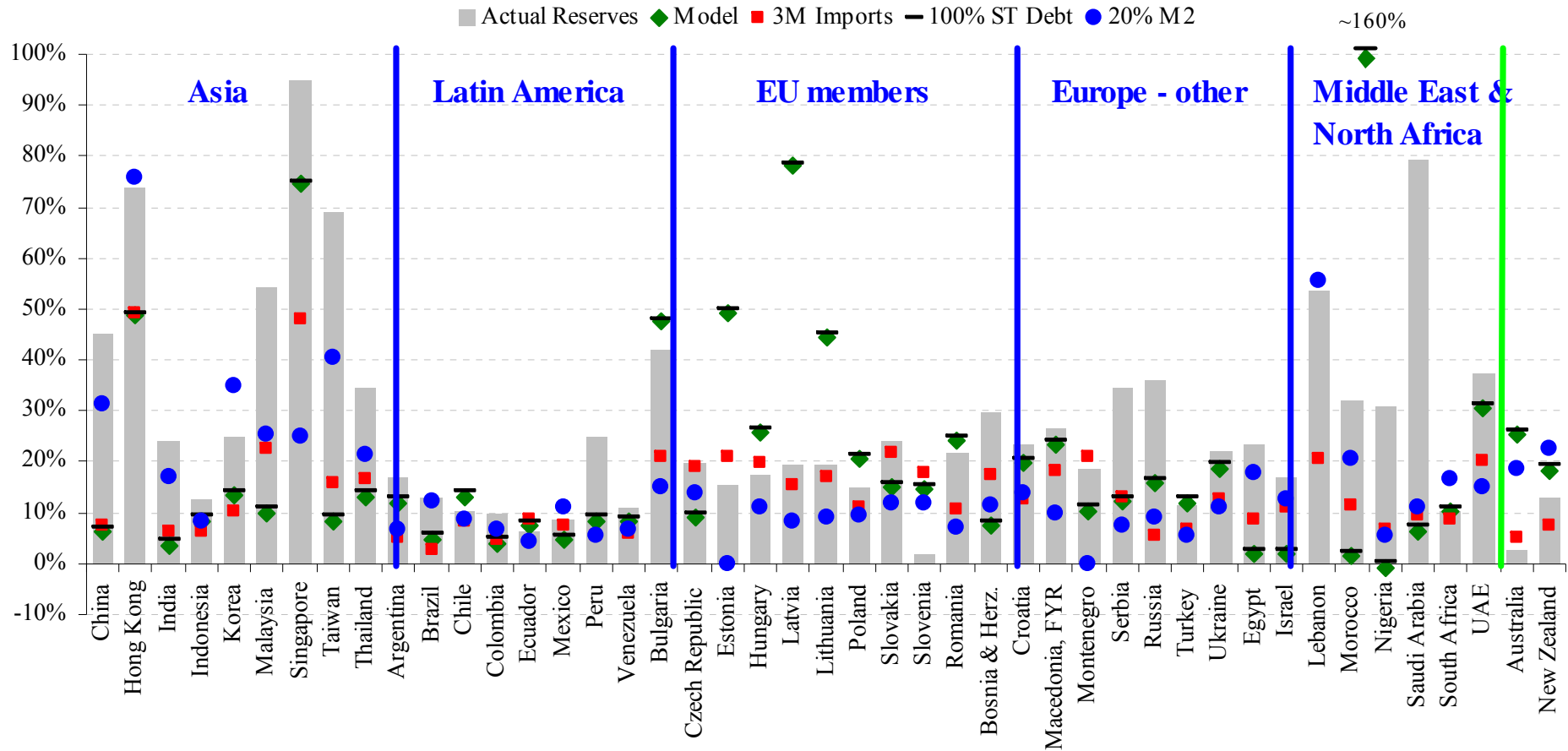
Source: ECB, Mileva (2010)

Reserve accumulation beyond self-insurance?

EMEs foreign exchange reserves and reserve adequacy benchmarks (USD bn)



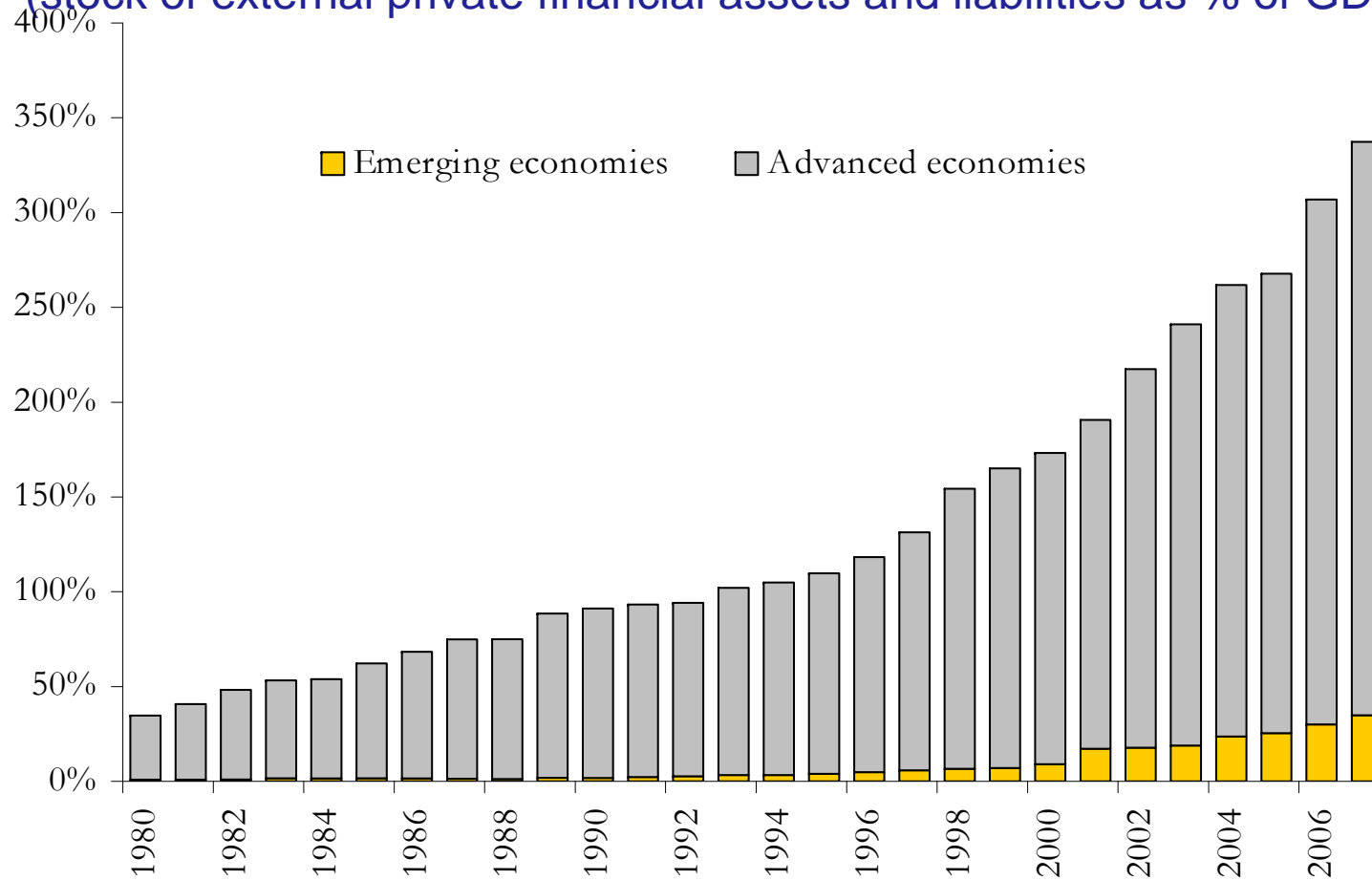
Are EMEs over-insured? Or overly vulnerable, and why?



Source: ECB, Mileva (2010)

Depth & sophistication of financial markets

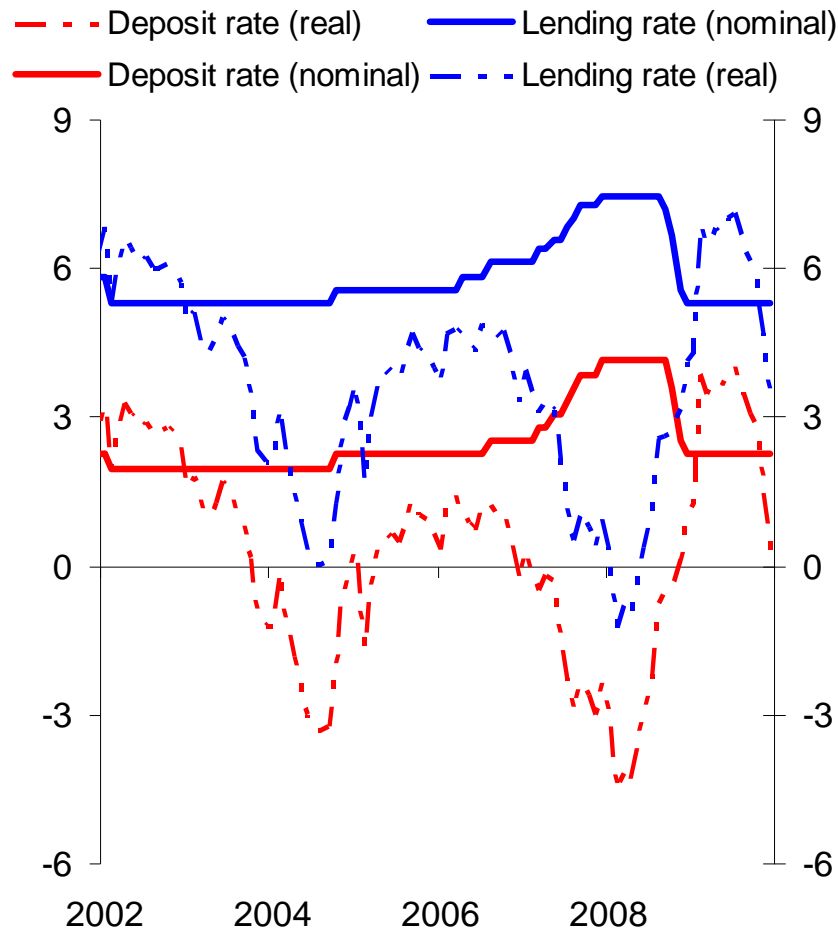
Financial openness and private sector asymmetries
(stock of external private financial assets and liabilities as % of GDP)



Source: IMF, ECB calculations.

FX reserves and financial repression

Real and nominal deposit and lending interest rates in China (%)



Source: CEIC.

2002-09 average:

- Real GDP growth: 9.9%
- Real deposit rate: 0.3% (1 year)
- Real lending rate: 3.6% (1 year)
- Nominal deposit rate: 2.5% (1 year)
- Nominal lending rate: 5.8% (1 year)

Implicit tax on households (compared with a situation in which real lending rates = real GDP growth):
4.1% of GDP in 2008-Q1 *

Who benefits? (in % of GDP)

- Corporate sector: 0,9%
- Banks: 1%
- Government: 2,2% (lower cost of sterilisation)

* using 2002-Q1 as benchmark.

In 2002-Q1 GDP growth rate \approx real lending rate.

Implications – domestic and global

Domestic

- Limits to monetary policy autonomy
- Undervalued exchange rate
- Negative returns on net assets abroad
- Financial market “repression”

Global



- Protracts global imbalances
- Artificially low yield environment
- Protracts exchange rate misalignments
- Lack of discipline on key actors of the international monetary system

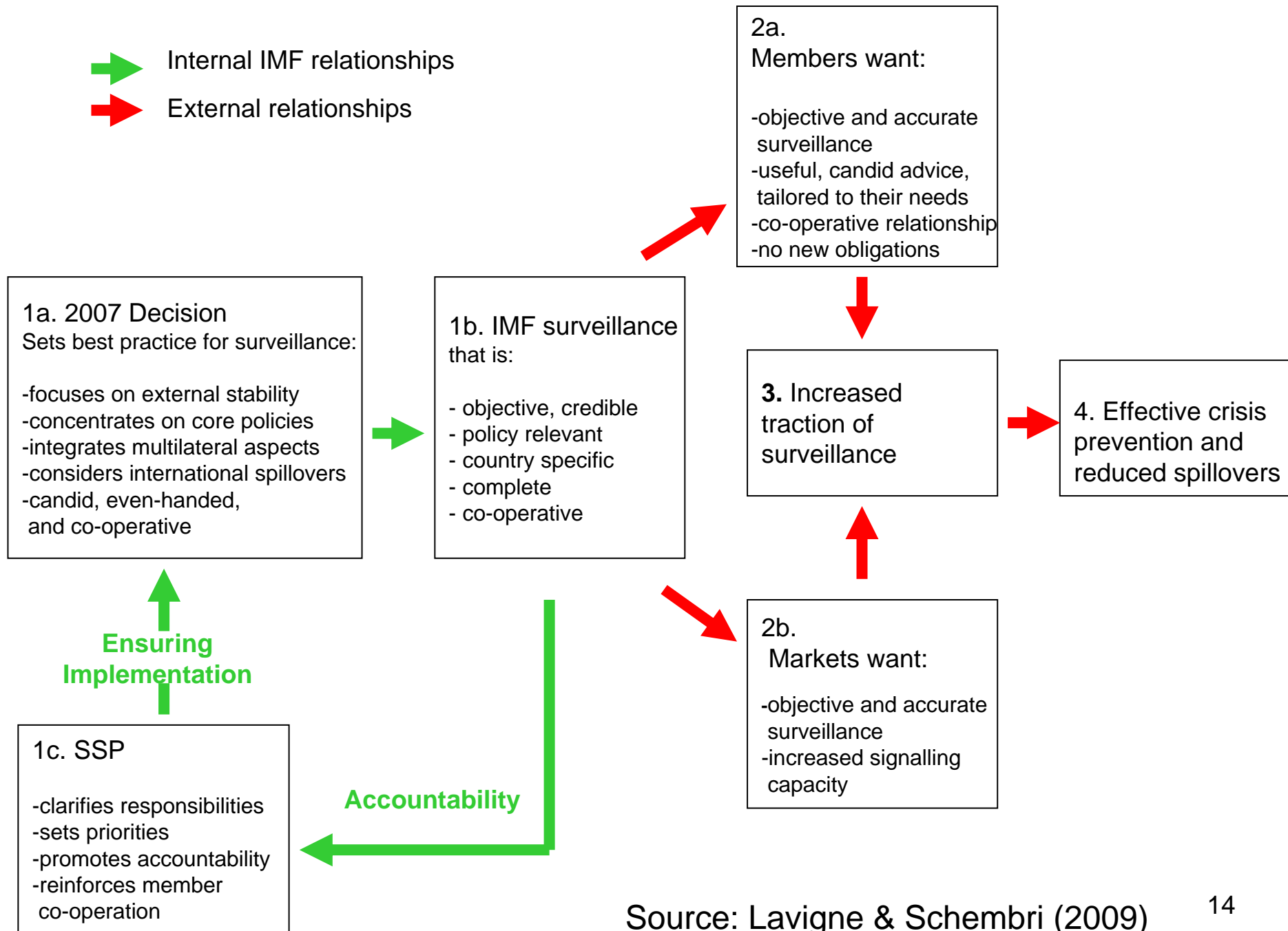
Domestic policy challenges are ample for all

- Advanced economies
 - Micro- and macroprudential policies
 - Fiscal & other demand and structural policies
- Emerging economies
 - High FX reserves as “self-insurance” not so much against global shocks, but against domestic policy failures
 - Financial development to obtain autonomy over macroeconomic policy – esp. monetary policy
 - Improve institutions and economic governance
 - Reduce domestic risks – better protection against future crises than FX reserves – esp. in light of current capital flow “bonanza”

2. One of the missing elements : surveillance reform

- Key for future crisis prevention – addressing both global and domestic dimensions!
- But lack of focus on reforming surveillance – IMF role
- Surveillance is performing poorly (IEO, 2006)
 - Low candor and “mission creep” (Adams 2005)
 - Low multilateral integration (IEO 2006)
 - Pol. interference, lack of evenhandedness (Cottarelli 2005)
- 2007 Surveillance Decision - benchmark for assessment
 - Objectives (external stability); scope (core policies, incl. exchange rates); principles
 - Integration of multilateral dimension in analysis
 - Statement of Surveillance Priorities

-  Internal IMF relationships
-  External relationships



Source: Lavigne & Schembri (2009)

Why has surveillance not been effective?

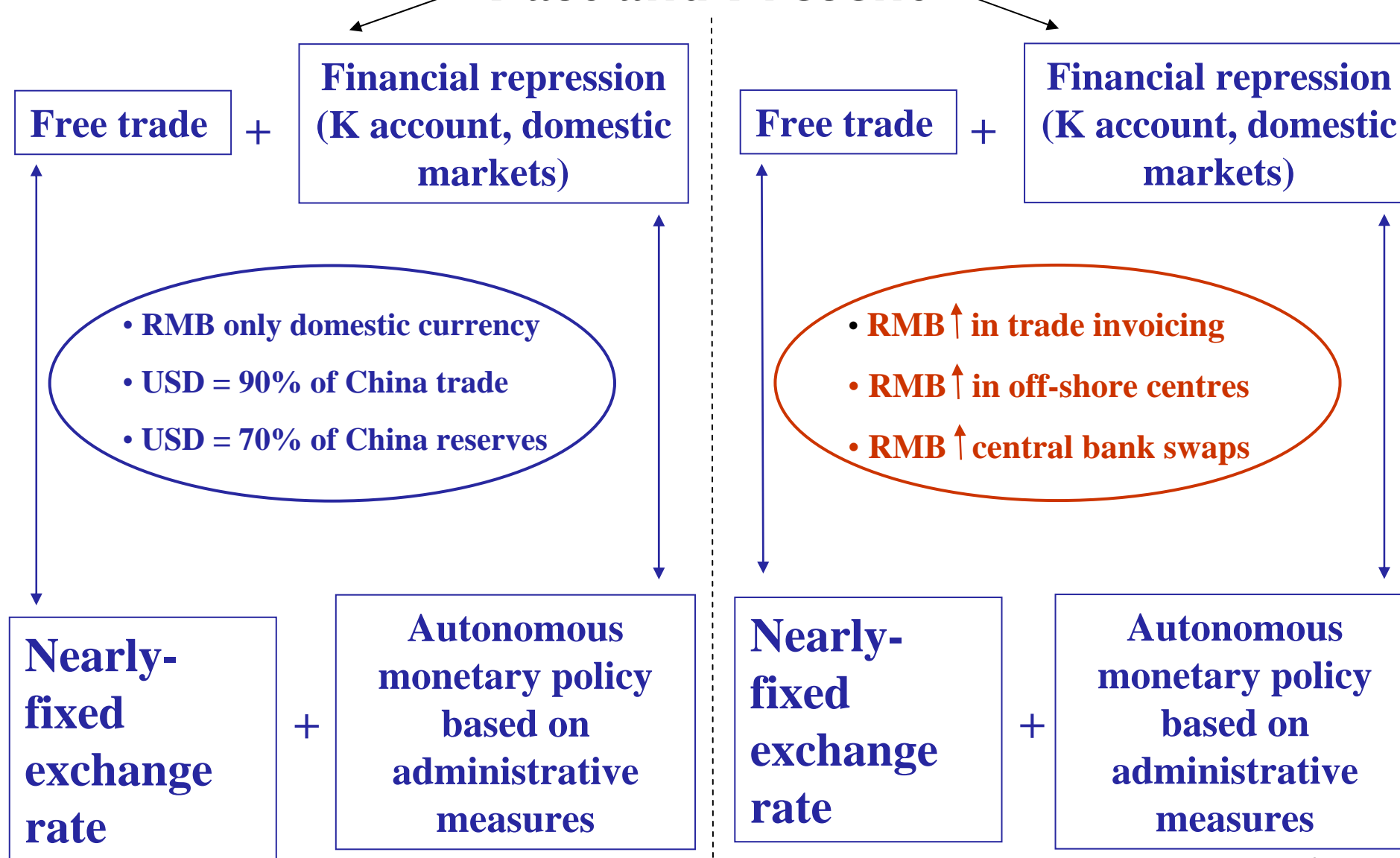
- Implications
 - Surveillance is not perceived as objective and unbiased
 - Surveillance is not as effective as it could be
- Towards finding solutions
 - Implement recommendations of IEO, Manuel reports
 - Clarify roles & responsibilities of Board, Management and IMFC
 - More strategic role for Board
 - Greater role for Ministers
 - Operational independence

3. Global currencies: How far to go for the RMB?

- Authorities are trying to square the circle: same macro framework, yet promotion of RMB internationalisation
- Odd sequencing: internationalisation and convertibility at the same time?
- Some RMB potential as invoicing currency
- Measures to boost the RMB role as store of value clash with lack of capital account convertibility
- PBC currency swaps USD 115 bn have never been used

Macro frame and international role of the RMB:

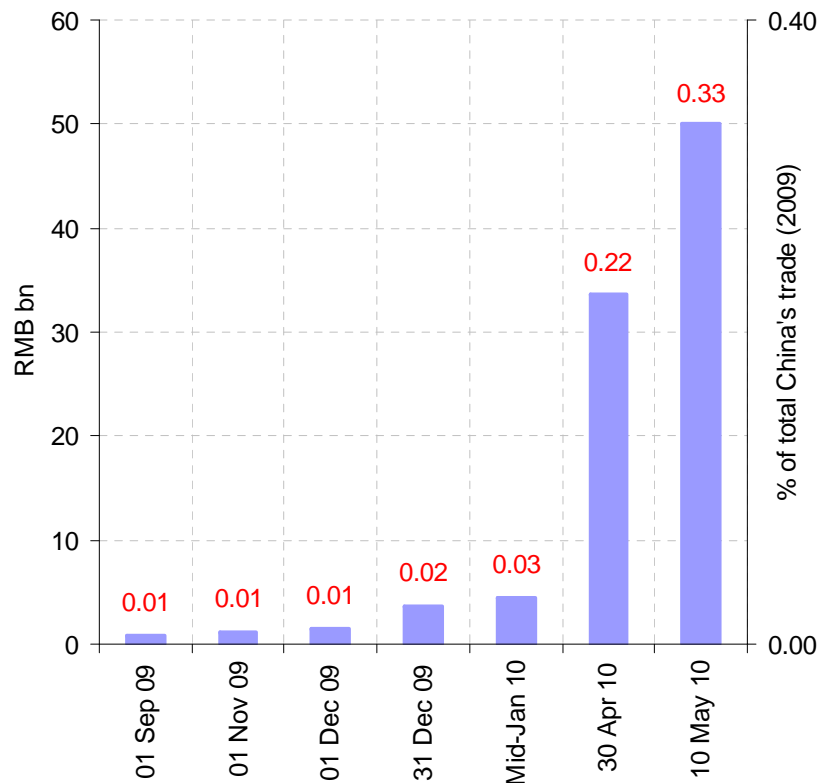
Past and Present



RMB share in China's trade invoicing: negligible but expanding

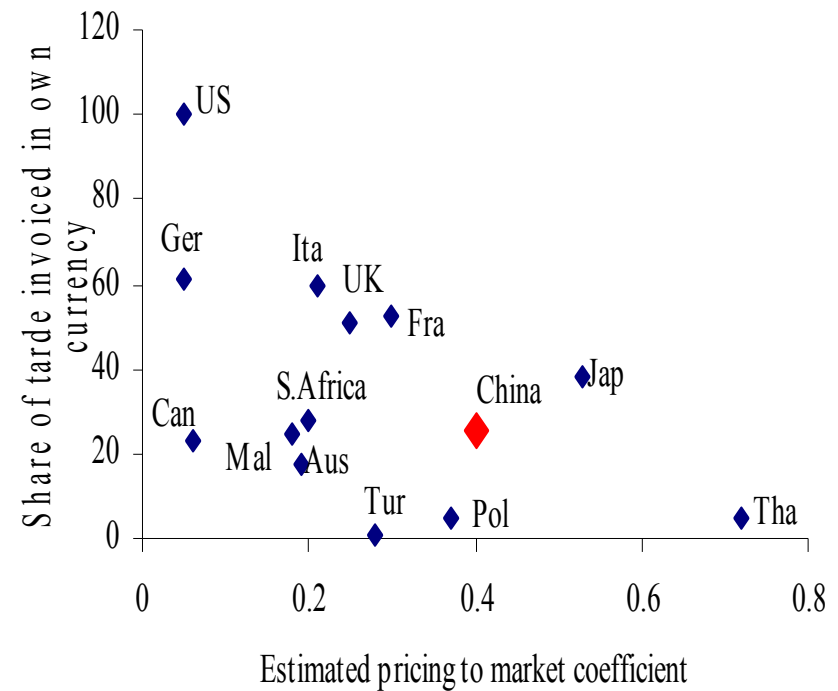
Volume and share of RMB in trade transactions

(cumulated since April 2009; volumes on left-hand side, and shares on right-hand side)



Source: Goldman Sachs.

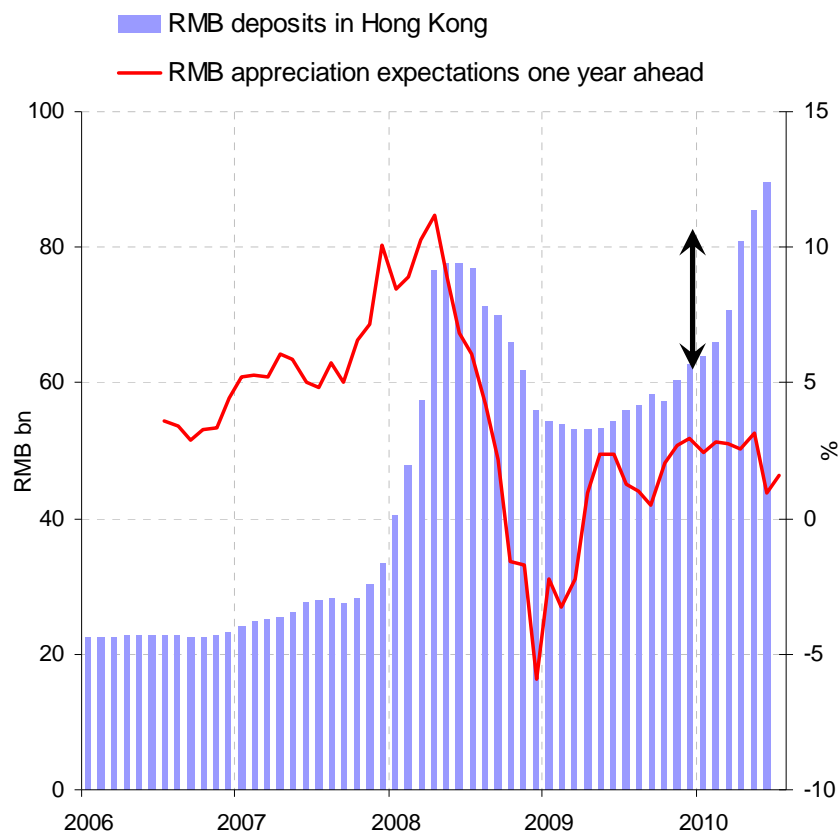
Estimated potential share of the RMB in China's exports based on pricing-to-market literature



Source: The estimated ERPT coefficients are from Bussiere and Peltonen (2008) and data on trade invoicing is from Kamps (2006). China's ERPT is from Cui et al. (2009) and the share of own currency trade invoicing is estimated from the country sample.

The RMB growth in the off-shore market is no longer just driven by FX expectations and Mainland decisions

RMB deposits in Hong Kong and RMB/USD non-deliverable forward rate



Source: CEIC

RMB-denominated bond issuances in Hong Kong (RMB bn)

Date	Issuer	Amount (RMB bn)
By Mainland Chinese banks		
Jul 2007	China Development Bank	5
Aug 2007	Export-Import Bank of China	2
Sep 2007	Bank of China	3
Jul 2008	Bank of Communications	3
Aug 2008	Export-Import Bank of China	3
Sep 2008	Chin Construction Bank	3
Sep 2008	Bank of China	3
Aug 2009	China Development Bank	2
Aug 2009	China Development Bank	1
By mainland subsidiaries of Hong Kong banks		
Jun 2007	HSBC (China)	1
Jul 2009	Bank of East Asia (China)	4
Sep 2009	HSBC (China)	2
By Chinese central government		
Oct 2009	Ministry of Finance	6
By non-financial corporate		
Jul 2010	Hopewell Highway Infrastructure Ltd	4
Aug 2010	McDonald's Corp.	0.2

Source: CITIC Bank Int'l (2010).

Finding the right policy mix

- **Policy pendulum may have swung too far – macro policy failures in AEs as well as EMEs were key**
- **There were no/few innocent bystanders**
 - Danger that wrong policy lessons are drawn from crisis
 - AEs: micro- and macroprudential policies, fiscal policy
 - EMEs: financial sector reform, institutions and governance crucial
- **Need for balancing of policy mix for reforms of IMS – insurance vs. good policy (surveillance)**
- **IMS based on USD has served us well**
 - High FX reserves as “self-insurance” not so much against global shocks or flawed IMS, but against domestic vulnerabilities & poor policies
 - Emergence of (other) global currencies should occur via market competition, not via policy intervention

APPENDIX

The RMB offshore market

