

General Discussion: Monetary Policy Options and Tools

Chair: Stanley Fischer

Mr. Barnes: My question is for David Li. First of all, thank you very much for your very interesting remarks. You emphasize unique features of China and a challenge for central bankers is the dominant role of commercial banks in financial intermediation, the minor role of the corporate bond market and an irrelevant stock market. I presume therefore that it would help the operation of monetary policy and improve financial stability if you had a larger, more liquid bond market and stock market. Do you see that occurring as a target of policy and over what time scale? Thank you.

Mr. Henry: I want to start by agreeing with much of what Governor Carstens had to say, especially about the need for emerging markets to strengthen internal policy. I would like to make an assertion about the external environment to see whether you have a similar view or whether you disagree. You spoke about the impact of unconventional monetary policy in developed countries on emerging markets in terms of the kinds of things that developed country policymakers could do to help emerging markets. I think it's important to acknowledge, especially in a world in which the IMF tells us that a 2-percentage-points decline in the emerging market growth is associated roughly with a 0.5-percentage point decline in U.S. growth, that it may in fact be optimal and not just a cooperative gesture for the

Fed's reaction function to incorporate feedback effects of the kind you alluded to from domestic policy such as prospective tapering in the United States to emerging markets. So I wonder what your reaction is to that assertion.

Ms. Moyo: Two questions directed to Professor Li. First, I noticed that you perhaps deliberately did not use the term shadow banking; clearly a lot of the issues in the markets right now in regard to China are around specifically the shadow banking issue of which the magnitude is not entirely clear to many of us interested in China. I wonder if you could speak a little to that specifically. I know that you did allude to it slightly in talking about the credit issues but in terms of credit channels and prospects for China's growth trajectory over the next several years, I think that's a big issue. Second, I was rather surprised that you mentioned the RMB internationalization given the issues around the slowdown but also recognizing that China has been engaging in more internationalization via swaps and other sort of loan agreements internationally. I just wonder if you could give us a little bit of a sense of what you see as a timeline for this given the financial deepening concerns that you raised yourself. Thank you.

Mr. Padoan: Thanks to all speakers for very fascinating presentations. I was struck by the fact that you actually said you have one point in common although you have not said it that way. Point in common is that all three regions face a common challenge, which is dealing with tapering in the U.S. This is the observation, but then my question is specific to Frank Smets. Can I press him a little bit to elaborate a bit more on what the ECB plans to do to deal with that tapering off? If I understood him correctly he said, "forward guidance has been introduced" and this is a very important event, which changes the policy tool kit in the ECB and also to deal with that, can you please elaborate a little bit more what that means in practice and as a subnote to that you of course mentioned OMT we all know the impact of that whatever it takes day that Mario Draghi put on the table and you also mentioned of course OMT as a successful instrument perhaps exactly because it was not used so far. But then to try to push the discussion a bit further, what about a generalized OMT, meaning that it would not be used only for countries that accept to

have conditionality but rather sort of European style QE with direct interventions across the board if, for instance, tapering becomes a big problem for your area.

Mr. Eichengreen: I want to echo first what Governor Carstens said about how it would have been good if emerging markets had tightened fiscal policy more during the good times because they could loosen it now that the bonanza is over. But I wanted to press him about what he cosmetically referred to as macroprudential policies, but what concretely means capital inflow taxes and controls. I think the evidence shows that these worked better during the good times, when there was a relatively diffuse interest in getting money into emerging markets, than more recently, when there has been a very concentrated interest in getting money out of specific countries. So, if you put those observations together—that there is a strong incentive for foreign investors to retrench, outflow controls can do little to prevent them from doing so, and fiscal policy is on hold—then all the burden of managing the adjustment is on the shoulders of central banks.

Mr. Levy: This is for Frank Smets. I'm looking at your upper left chart on Page 3 and we see the five-year term premiums for Europe really came down coincident with the ECB's rather massive bank lending program in the fourth quarter of 2011 and then the OMT in the fourth quarter of 2012. Regarding the massive ECB direct lending to banks—approximately a trillion euros—through the LTRO program are due to expire sometime the end of next year. How is the ECB going to deal with that; how is it going to think about exiting this crucial role it's playing amid the critical debate about banking reform that seems to be stretched out?

Mr. Carstens: With respect to the first question of Peter Henry, if I understood your question you meant that pretty much that advance economy central banks, namely in this case the Fed, should take the spillover effects of their actions in the rest of the world economy. I think deep down my sense is that yes of course that would be great if those effects are internalized. Now, we have to be realistic on this and my own sense is that what would have the most impact right now is to have a much better, clearer implementation of the tapering effort. At the end of the day, we cannot depend forever on unconventional

monetary policies and I think there is also this factor that if you keep sort of pampering the markets, the inflow of capital could be such that most stability risks could be accumulated in emerging market economies. I think that all the world would be much better off if there could be an easy transition to more normal monetary policies and, of course, this is predicted under the basis that as the tapering effort takes place it would be because of a stronger economy. I think right now the main challenge is communication and how can we sort of move out of a one-sided market in the bond market. The only way is if markets could anchor much better their expectations and we can prevent the overshooting that I think we're looking at it right now. With respect to Barry Eichengreen, I predict for me fiscal policy has been of the essence. In Mexico we took two fiscal reforms in 2007 and one in 2009 and I fully agree with you that many emerging markets sort of lost the opportunity to do it. Now, the macroprudential policies that I refer to I think mostly they were designed and implemented to try to limit inflow of capital and basically the idea behind it is that many emerging markets knew that sooner or later the reversal would take place. So, the idea was how can you sort of mitigate or minimize a negative impact of those many fast capital inflows and of course they are not designed to face the reversal. To face the reversal you have to go in other directions.

Mr. Fischer: Do we know what they are?

Mr. Carstens: At least each country has their own weaknesses; each country has to address their issues. I think it's important to first of all as I said to keep sovereign risk under control to keep inflation risk under control and in some cases even to use credibility enhancer mechanisms, for example the flexible credit line of the fund, and more than anything those would imply some policy commitment that the country should make. I think those are the most important aspects. Also, in some exceptional cases some intervention in some specific financial instrument markets something the foreign exchange market. I think that through this period international reserves were accumulated and you know they are accumulated at some point to be used.

Mr. Li: Yes, these are very important questions. The first one, whether a larger stock market or bond market would help China's financial stability and especially the monetary policy? For sure, almost by definition. Why? Because huge money stock trapped in the commercial bank is what we call a tiger, a tiger in the cage, a cage being the commercial banks. The tiger may come out anytime to go after goods market or asset markets. They are people known very well in China and the issue is the stock market is extremely difficult to be well established. Why? You have to have good institutions, good rule of law and, frankly speaking I'm not 100 percent optimistic in this regard. It's a long-term project. Bond market is relatively easy because it's a fixed commitment. You have to pay that service, otherwise you'll go under. However even with the bond market, what is missing is good and working bankruptcy procedures. So far many, many investors in China work under the wrong assumption that bond issuers would never go under. So, in the coming years it would be very important to see a few genuine bankruptcies in which some investors get real losses and in the process institutional reforms being pushed out. That leaves me to the issue of shadow banking. Actually, I tried to talk about this but I was tight in tongue that is my risk No. 1, my challenge No. 1—shadow banking. That is we know that the Chinese banking sector is having a lower quality of assets in comparison with five years ago. Inside China, many people are attacking the previous government saying that why do you have to go through the four trillion stimulus package you guys accumulated a huge amount of credit and therefore risks. Some people even blame the policymakers in China helped more the American economy, the global economy than domestically by this tremendously expensive monetary policy after the financial crisis. I don't agree with this, I disagree because nobody knew at that time, five years ago, what would happen. Many people in China argued the sky is falling down because of the financial crisis. Anyway, currently we are stuck in this situation of tremendous amount of nonperforming debt. Nobody knows the exact number, I for one think a 30-40 percent of the total, total debt, total outstanding credit being in the shadow banking is a good estimate. Out of this, a 10 percent, easily 10 percent nonperforming debt rate is a good assumption. So I think, as I mentioned moments ago in my

presentation, there will be a most likely a sweet and sour treatment. That is, don't push it. Much of the debt is trapped in the local governments and much of the local debt is dependent upon property price or land price essentially. If the economy contracts too quickly land price will come down, it would worsen the financial standing of local governments. Most likely what will happen is a gradual process to force local governments to work out with their banks, with their commercial banks and in the process the central government—the minister of finance will have to pay money. I don't think commercial banks will suffer great losses because these commercial banks are globally listed corporations nowadays everywhere in the world so having them taking some loss is having global impact. Instead, the minister of finance will issue bond, the treasury bonds in China is only about 18 percent of GDP, I argue around in China too low, they should increase, to low public debt can be a be a problem in China, so issue public debt, issue central government debt. Use that money to push that money to work out of commercial banks.

Finally RMB internationalization. That was a hot, hot topic right after the financial crisis. Many people here, where I stand are witness to this. However, now the issue cools down because people realize that risks, as I mentioned in my presentation the risk is for both for China and the U.S., for everybody in the process. So people I think are settling down, they are taking it gradually. The sequencing, first do the commodity trade, trade settlement try to use local currency RMB. Second, try to encourage elderly capital outflow relieving the central bank of some of the currency reserve. Let people go out and therefore making room for more capital to come into the economy. And also, very interesting in the coming one or two years I am extremely interested in observing what may happen to many of the emerging economies facing the tapering off of the U.S. policy when some of them are having lower and lower currency reserves. Maybe some of the currency swap agreements they reached with the Chinese central bank may kick in. I don't know what will happen. There were agreements there, they are shelved somewhere in a warehouse and people never mention that. People don't believe this currency swap agreements will ever be used, but maybe down the road they will be

used. I don't know what will happen but I'm extremely interested in observing that.

Mr. Fischer: Frank Smets, you are going to give us an explanation of the European monetary policy in the next two years or so, so thanks very much.

Mr. Smets: I don't think so. Let me start with the last question, which I think is the easiest. I think the beauty of operational framework is that actually the exit is almost endogenous you look at the size of our balance sheet and particularly the monetary policy operations on Page 6, you actually see that since the introduction of the LTRO there has been an unwinding of the size of our balance sheet and that is basically endogenous because banks are returning some of the funds they have received from us. So, in that sense we don't really have to make conscious decisions at least partly on exit on this part. The other thing to mention since the governing council in its May meeting decided to extend the fixed term full allotment to July 2014 and obviously if it would turn out that it would be useful to have longer term; it could decide to do that again. I don't see that as a big issue. The question on the generalized asset purchase program, first of all, the OMT was designed for a very specific goal, very specific objective so I think we cannot compare the two. The generalized asset purchase program, particularly of government bonds, would need to have very different objectives. Basically what I try to argue against maybe illicitly of what I said if you want to effect the government bond term structure, it's probably more effective to do it through forward guidance and I think this comes back to some of the discussions we also had this morning and lastly of course the transmission process in the euro area is very different than the transmission process in the U.S. It is still the case, although banks are very important, but markets are much more important in the U.S. than in the euro area so from that prospective effecting the directly government bond market through asset purchases I think is a less efficient instrument for the euro area relative to the U.S. On your first question, I think I'm going to pass that one.

Mr. Frenkel: Frank Smets demonstrates that prior to the crisis the rates on the 10-year bonds of the various governments within the eurozone have been very similar. This compression of spreads disappeared with the eruption of the crisis. It is obvious that during the first few years following the introduction of the euro, markets have mispriced sovereign risk and hence countries like Greece, Portugal, Ireland and Spain could borrow at rates that were very similar to those paid by the German government, even though, in retrospect obviously, they were very different in their risk characteristics. The relevant question is: What was responsible for the market failure that resulted in a massive mispricing of sovereign risk? An alternative hypothesis, however, could argue that the compression of spreads does not represent only mispricing of risk, but rather, the expectations that no sovereign will be allowed to default since other members of the eurozone will make all efforts to “bail out” troubled countries in order to secure the existence and integrity of the eurozone system. Indeed, as the record shows, to some extent some of these expectations proved right and the “true” risk of troubled countries was socialized by stronger members of the eurozone. Thus, the compressed spreads may have reflected a combination of two factors: mispricing of risk and the expectations of bail outs.

My second comment relates to the paper by David Li and refers to the volume and imbalance of trade between China on the one hand and the U.S. and Europe on the other hand. When focusing on the volume of trade between China and its trading partners, it is relevant to note that the volume of trade between China and the rest of Asia is almost double the volume of trade between China and the West (U.S. and Europe). In this regard, as China changes its engine of growth and switches from reliance on foreign demand to reliance on domestic demand, as well as reducing excessive inefficient investments, the international consequences may be profound. In particular, some countries in Latin America may be severely impacted.

Mr. Jordan: I have a question for David Li. You alluded before to the fact that the process of internationalization of the RMB has slowed down at the moment, but you also said that China’s focus is now on using the RMB as an international trade currency. Could

you elaborate on that? Why is it so important for China to use the RMB for trade, under these circumstances, and why is it important to have RMB hubs in Europe, and also in Asia?

Mr. Meltzer: I have two questions for David Li. Currently it's not a big problem to service the U.S. international debt, but when interest rates rise it will be a bigger problem and that is a problem that will only be finally solved as the U.S. moves from a consumption-oriented economy to an export-oriented economy. That's going to have a big effect on world markets because it's such a big country and its exports are so large and the discovery of shale is a big step in that direction provided it's not cut off by regulation. That's the first question, do the Chinese have concerns about that, do they have a way of thinking about it? Second is, China's aging population faces enormous growth in the future for pensions, healthcare in addition to pollution. It's hard to maintain an export economy in a consumption-based economy when you using so much of your resource to pay for pensions and retirements and healthcare. Is that entered into the calculations on how you look forward to China in the future?

Mr. Portes: Question for Frank Smets. On unconventional monetary policies, we are told there has been some discussion in the ECB council of trying to do something about easing financing conditions for small and medium-size enterprises. One proposal that has been going around is securitization of loans to those enterprises and enabling banks to use those securities as collateral with the ECB. Can you comment on why these discussions so far have yielded absolutely nothing coming out although they seem to have been going on for a while and whether you see any results in future?

Ms. Reinhart: Question for Agustín Carstens. I very much share a lot of the views you expressed about the causes and consequences of the capital inflow surge and more recent signs of reversal. Among the risks in the reversal we have gone from a period of a capital flow bonanza where the tendency was a currency to appreciate now to higher odds of currency depreciation also government financing cost, bonds financing both domestic and external will be higher. In that context can you on comment on what you see understanding is a

huge variation of emerging markets, inflation risks for emerging markets resurfacing.

Mr. Carstens: Yes, thank you. With respect to Jacob Frenkel's question on the potential impact on Latin America on lowering investment by China, here David Li can clarify. I mostly understood that the reduction in investment would take place locally. I honestly don't see much scope for a reduction of investment outside. I mean yes to the international reserves if the international reserves decreases but I think most of the real investment of China abroad has to do more with the strategic supply chains and to continue assuring access to very specific markets. My own sense is that as China moves to more domestically oriented growth, there is more consumption and so on a lower savings that certainly can have the potential to improve the trade balance between Latin America and China and that would certainly be welcome. At the same time, I also took note of David Li's claim that wages may be increasing very, very fast in China in the future and I think that is also a factor that would tend to benefit Latin America. On the comments of Carmen Reinhart, certainly my own sense is that pretty much most emerging market countries have a keen interest in keeping risk premium low. As a matter of fact if you make a composition of the increasing long-term interest rates in emerging markets you can see that the risk premium has not been increasing; there are other risks that have been adjusted as a reversal takes place. Certainly the lower rate of growth would help and especially to accommodate the impact on currency depreciation so my own sense is that emerging market economies have made important progress in controlling inflation. I hope especially if this is combined with the very conservative fiscal policy that inflation will not be an issue. So, my own sense is that this should not be a problem in the future.

Mr. Li: First, on the issue of the supersized, huge size of Chinese commercial bank assets, absolutely it is a problem. It is a big risk for the economy financially and also macro economy wise. What is the potential solution to this? I think inevitably down the road in the coming one or two years there will be a process of asset securitization that is selling some of the assets of the commercial banks in the bond

markets with hopefully a better established bankruptcy procedure for the bond market. That is inevitable. The word asset securitization got a very bad reputation in China. Here in this country maybe you are very knowledgeable, people are very well educated. In China that is a very dirty word. It's been blamed for the financial crisis of '08, but inevitable, so I'm pushing hard on this issue domestically. The other issue is on the RMB's role, RMB internationalization why pushing the trait, well conceptually if a currency wants to become an international currency I would claim conceptually only two channels, one channel people doing trade, actually setting a bank, you are increasing the use of this capital. The other one is people making investments are using these currencies to buy and sell financial assets.

The trade one is relatively easy because it does not involve the future, you do barter trade, or Governor Carstens and I to trade RMB, done deal—no long-term implications. Whereas, if he buys, if his bank buys Chinese RMB assets, that involves long-term disputes and who knows down the road if RMB are credible or not, Chinese government credible or not. That requires a lot of work a lot of institutional work. I think the Chinese policymakers are now doing the easy things first and that is the general idea of reform.

On the issue of Allan Meltzer, the consumption-based economy. I really want to emphasize this is a something grossly undernoticed outside China even within China, that is the consumption household consumption as a share of GDP is coming up, the ratio is coming up. Household consumption is increasing faster than GDP in China. Why? Not because of government policy, but because of simple economics simple market force because China is running out of surplus labor related to the aging population. So wage-rate increase for blue collar workers, blue collar workers are getting higher and higher salary therefore more and more disposable income and therefore consume more. This is my research in the past one or two years. So, there is a change and this change will have global impact that is the next thing I will try to research on.

The third issue is on aging population, a big, big policy debate in China. Huge policy debate in China the policy debate is about when to abolish the one child per family regime. Which I joked yesterday

with Christine Lagarde this policy saved 300 million babies in the past 30 years, for good or for bad. I don't want to debate this religiously, but this is a fact. The world has, less 300 million babies are unborn, the biggest reduction of carbon dioxide movement in the past three decades. Current situation, everyone knows in China too harsh control on population, we should relax and I do believe within the coming one or two years there will be major changes in relaxing the family planning policy. Meanwhile, I would also emphasize China is still a poor economy—20 percent of per capital GDP of the U.S.—and also the majority of the population are not promised a big pension. This gives room for reform, this gives room for the delay in retirement age, and this gives room for tapering off of people's expectation of pensions. These reforms are also very, very important and either way I would argue in this regard China has an easier time in reforming than countries like Italy or other European countries, because it's been poor and not generously promised so aging is not a big concern in my mind.

Mr. Smets: On Richard Portes' question on the issue of promoting securitization in order to ease financing conditions for small and medium-sized enterprises definitely other people in the room know much more about these initiatives and where they stand. It's clearly something that the ECB has an interest in and would like to promote and the commission and the European investment bank have of course already taken a number of initiatives, but it has also been clear there are a number of obstacles including the regulatory treatment of ABSs of SME loans which makes it a longer term proposition. I think it is important from a financial system and infrastructure point of view, but as a short-term proposition to ease financing conditions for small and medium-sized enterprises I think that would be difficult.

On Jacob Frenkel's question on how to explain very high correlation of bond yields and very low spreads before the crisis. I think it is very difficult to say. Basically all three factors that I can think of play a role. First of all we know there was a generalized mispricing or underpricing of risk in that period which affected many financial markets including this I think this market. Secondly, of course the setup of EU was such that in those countries that entered also had to

subscribe to stability and growth so there were definitely views over there by becoming a member of the club you are also becoming a member of countries that have sort of sound fiscal policies and that obviously turned out to be not exactly right. Then third, they may also be a factor which is the “no bailout clause,” which is part of the treaty was not believed, but don’t ask me to put sort of shares on each of those three factors.

