

General Discussion: The International Policy Response to Financial Crises

Chair: Alan Bollard

Mr. Crockett: I don't know if this is relevant, but I can't help but observe that Charles Dickens spent part of his childhood in a debtors' prison.

I get the impression from things that have been said here and elsewhere that the euro approach to monetary policy in the face of shocks is the steady-handed one that Jean-Claude referred to, which with some liberty could be defined as a focus on gradualism. Whereas in the United States, we heard this morning the approach of gradualism is dead. That's two questions. First of all, am I reading too much into this? If it has any element of truth, does it matter that the approaches on the two sides of the Atlantic in the face of shocks may be somewhat different?

And a second question, which I guess is addressed to the absent U.S. panelist, in the case of the United States, it seems kind of logical that there should be a commitment to low interest rates followed by a rapid tightening of policy when recovery is under way. That is behind Ric Mishkin's "gradualism is dead." But the problem, it seems to me, with that approach is you will be under considerable uncertainty: 1) When the recovery comes, is it real? and 2) When you approach the inflation problem, exactly when is inflation going to recur, for the

reasons Allan Meltzer said? Is it so justified to pursue this approach of we can be aggressive in tightening monetary policy in the face of the inevitable uncertainties about when and how that response will work?

Mr. Frenkel: I'd like to ask maybe the panelists to reflect on a naïve question, which is, Several of you have mentioned the need to take care of the procyclicality, the need to take care of current account imbalances, the need to articulate the return to the norm away from the license to kill the crisis gave us, the need to avoid loss of appetite for reform as the economic recovery comes, etc.

Now we are all in a political context. I have no idea, really, how you bring about those who need to make the decisions—and that's not central banks, it's really the politicians—to make sure that there is a meaning to the International Monetary Fund (IMF) surveillance because something will be implemented with their recommendation. Rather than argue who will change mark to market, which agency is doing what, and wait for more and more things, I have a feeling that we are all identifying the key challenges to be done, but we do not yet have an idea of how these can be implemented.

Ms. Malmgren: Interconnectedness has been a word that has come up throughout the discussions. It strikes me as interesting and ironic that we are comfortable with that concept for markets, but very little discussion about interconnectedness on the policy front. Some thought perhaps about how fiscal and monetary policy actions in other parts of the world may amplify or diminish our fiscal and monetary policy actions. To that end, it may not be so surprising if both the markets and the public find it difficult to distinguish between efforts to prevent inflation from falling with efforts to use inflation as a means of pulling us out of the ditch of deflation, and thereby begin to take out insurance. And it would be even more ironic to dismiss that effort to take out insurance against an unanticipated event, given that is exactly what we failed to do in the past. To that end, on the early warning systems, it strikes me that any time a market fails, policymakers need to look at it as a priority. For example, in June 2007 when the iTraxx trading screens literally went blank because the brokers were no longer willing to quote prices in credit, that wasn't even reported in the press. It took some time for

the Bank for International Settlements (BIS) to announce that they thought it was a market failure. Over the course of the last year, a number of government bond market auctions have failed. Perhaps that is something to consider going forward.

Mr. Makin: Two points that I would just like to read in here, especially after hearing the comments of the last panel. First of all, we need to remain a little bit humble about our ability to anticipate the future. As I recall it, no one brought up the zero lower bound at our meeting last year, and we were confronting that reality two months later. I would add to that the notion that inflation and deflation risks are symmetric, and we could still have deflation risks before us. Let's not forget what happened in Japan. Let's not forget what happened in the Great Depression.

Secondly, if you are going to talk about international policy responses to the financial crisis, I really do think China ought to be mentioned. It is the fastest-growing economy in the world. They implemented a fiscal stimulus approximately equal to 14 percent of GDP, yes, measured over a number of years. The growth rate in China went from 1.9 percent in the fourth quarter of last year and is now running at about 14 percent in the second quarter of this year.

They probably have something to tell us about policy responses to financial crises. I would strongly urge the conference organizers to think about getting some more Chinese participation in next year's meeting.

Mr. Dallara: First, on John Makin's comment about China, I would just add one further point, which might go in a somewhat different direction.

As we look out and try to take on this new challenge of detecting systemic risk in an early warning context, I very much appreciate the work being done at the BIS by Jaime Caruana and his colleagues on macro-prudential supervision.

One cannot help but look at the almost astoundingly rapid credit expansion of China over the last nine months and come away with some concerns, not just for China but globally. Coming to Jaime's thinking on how to approach large and complex financial

institutions, I think the research being done is going to be very crucial to help underpin macro-prudential supervision in both the United States and Europe, and hopefully globally.

Yet, I cannot help but be a bit concerned at the focus on size and complexity, because—if you look at mortgage brokers in California and Florida, if you look at northern Iraq, if you look at a real estate firm in Germany, Icelandic banks—viewing the world through a prism of large and complex financial institutions would probably have not led you to any of those potential sources of systemic risk. Indeed, complexity, as you pointed out I think yourself, Jaime, can at times be a source of resilience.

If you look at well-managed large and complex global financial institutions—and I would put that underscored well-managed because, as Stan emphasized yesterday, perhaps there has been insufficient accountability of management in global financial institutions over the last few years—you could argue that indeed some of them have been sources of stability and not instability, and therefore, we need to pause if we are concentrating too much of our effort at developing a macro-prudential technique and analytical approach through size and complexity alone.

Mr. Orphanides: It is a question for Jaime motivated by his discussion of supervisory structure and macro-prudential supervision. I think we all reached the consensus for the need of a stronger and more effective macro-prudential supervision. The consensus also seems to be that should be undertaken with a strong involvement of, if not completely under, central banks. But, for this to be effective, shouldn't we move beyond that in thinking about the future of supervisory architecture internationally and make a call perhaps that micro-supervision as well, at least perhaps if not all of just the systemically important financial institutions, should be consolidated under central banks to make this effective? Isn't this the opportunity in light of the crisis we've been through over the last two years to try to form a consensus on this matter and move forward before we have the next crisis?

Stan mentioned a couple of reasons yesterday why it may be useful to have supervision under central banks. One very important reason is the flow of information. One of the major lessons I take from the current crisis is that where we did not have supervision under central banks, we did not have internationally as good a flow of information as we could have.

He mentioned another reason, the coordination of monetary policy and macro-prudential policy, and I think we need to have that coordination for macro-prudential policy to be effective. Another reason in this forum is that we have proven in the last couple of years that among central banks we have an excellent record of international cooperation. If we have micro-supervision of systemically important institutions under central banks in light of the excellent cooperation among central banks, that would also enhance stability of the international financial order.

