Luncheon Address: The Global Calculus of Unconventional Monetary Policies

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Good afternoon. Let me thank Esther George for inviting me to this year's symposium. I am delighted to be here, as always. The Federal Reserve System, and this event in particular, are well known for being at the cutting edge of monetary policy research and analysis. The reflections of this morning certainly live up to that reputation.

The challenge for today's generation of policymakers is to rethink and reimagine how to get our economies back to work. One of the most striking aspects of that has been the willingness of central banks in advanced economies to "dive into the deep end" of the policymaking pool.

In many respects, central banks have been the heroes of the global financial crisis. Compared with conventional monetary policy, the unconventional monetary policies of the past few years have been bolder in ambition and larger in scale. These exceptional actions helped the world pull back from the precipice of another Great Depression.

The crisis also gave us cause to rethink the extent to which the world is interconnected. A bankruptcy in the United States in 2008 brought the world economy to its knees. Then eurozone troubles shook the global economy again. Another worry today is the risk of a slowdown in emerging markets pulling back growth everywhere.

Unconventional monetary policies bring an added twist. This is very much on our minds, of course, as we have watched developments this week. It reminds us that policy actions in one corner of the world can reach all corners—and it is the job of the IMF to shine a light on developments in all corners of the world.

More broadly, unconventional monetary policies involve navigating a new world. In one sense, it is like stepping into a dark room. To borrow some words from John F. Kennedy: "We are not here to curse the darkness, but to light the candle that can guide us through that darkness to a safe and sane future." It is our collective job to light a candle in that dark room.

So this is my main message today: We need to work better together to understand more fully the impact of these unconventional policies—local *and* global—and how that affects the path of exit. And, above all, we must use the time wisely and not waste the space provided by unconventional policies. Global policymakers—*all* policymakers, *within* countries and *across* countries—have a responsibility to take the full range of actions needed to restore stability and growth, and to reduce imbalances.

In that spirit, I would like to share some of the IMF's thinking in three main areas: One, how has unconventional monetary policy, in the U.S. and elsewhere, affected the world economy so far? Two, how will it affect the world going forward, especially as one prepares for exit? And, three, is there a mix of global policies that can better deliver lasting growth?

I. The Merits of UMP So Far

The natural place to start is: looking back, were unconventional monetary policies (UMP) needed and did they help? I know this is an open question for some. The Fund's clear assessment, however, is that the impact so far has been positive.

Why do I say that? Early in the crisis, UMP helped prevent a collapse of the financial system and a collapse of activity. This was the case with quantitative easing (QE) in the United States and large-scale assets purchases in the U.K. Later, the ECB's long-term refinancing operations and outright monetary transactions significantly reduced the tail risk of a euro area breakup.

Faced with financial turmoil, UMP helped support economic activity *and* financial stability—both domestic *and* global. This is certainly true in the initial phase of UMP, when these objectives worked in unison.

The Fund has been giving a good deal more attention to the wider implications of these policies in our revamped surveillance framework. We are tracing out the interconnections within countries—say, between the financial sector and the real economy—and between countries.

It is difficult to pin down the exact ramifications of these policies with any degree of precision. There are simply too many moving parts and certainly many different opinions across countries. As I said—we stand on "terra nova." That said, we have to try; we do try; and we will try harder.

We examined the spillovers of UMP in a report that we released earlier this month. Estimates suggest that QE by the Fed is likely to have reduced long-term U.S. bond yields by more than 100 basis points prior to the market correction earlier this year, boosting world output by more than 1 percent. I know that estimates vary. Still, we can say with some confidence that UMP shored up activity in the face of a possible global depression.

Measures of market risk tell a similar story, reducing market uncertainty during periods of elevated financial stress. The probability of extremely large price changes, for example, declined across a range of markets immediately following UMP actions by the Fed. Obviously the major gains were in the early phases, when the conditions were most severe. But even since, UMP has been a success. On balance *all* countries benefited: first from removing the gravest risks of financial turmoil, then from the boost to growth.

This may not always be the case going forward.

II. The Current Global Calculus of UMP

That brings me to my next main point: where do we stand with UMP today?

Let me say it up front: I do not suggest a rush to exit. UMP is still needed in all places it is being used, albeit longer for some than for others. In Europe, for example, there is a good deal more mileage to be gained from UMP. In Japan too, exit is very likely some way off. The day will come when this period of exceptionally loose monetary policy, both conventional and unconventional, must end—in line with economic recovery and its impact on inflation. We need to plan for that day, especially since we do not know exactly when it comes. One thing we can say for certain: the path to exit will and should depend on the pace of recovery, the latter mitigating the potential downsides of the former.

This calculus will not be easy, however. Together, we need to keep an eye on both financial stability and growth. Together, we need to watch whether the benefits of UMP are subject to diminishing returns. Together, we need to analyze whether the financial side effects get worse over time.

Just as with entry, exit will take us into uncharted territory. Yet I remain optimistic. Central banks handled entry well, and we see no reason why they should not handle exit equally well.

So, the Fund and policymakers need to start thinking about what exit will eventually look like. That includes the implications for *global* economic and financial stability: the whole system, not just one part of it. This is an issue that the Fund has been watching and will continue to watch closely. It is, after all, the IMF's *raison d'être*.

For now, I would like to highlight a few aspects of how we are thinking about these channels and connections.

One, the Balance of Stability and Risk-Taking

The relationship between the two is not straightforward. Certainly, long periods of very loose monetary policy and ultralow rates, mixed with the hunt for higher yields could prove to be a recipe for unhealthy risk-taking. At the same time, the absence of UMP could easily have resulted in worse growth outcomes, with even greater risk of financial distress.

As always, we will know much more as time passes. In particular, we will know whether the global market correction earlier this year was a useful reminder that exuberance can go too far, or if it is the start of a new period of choppy conditions and regular scares. We all hope for the former, but prudence suggests planning for the latter possibility.

Some modes of UMP affect the long end of the yield curve, perhaps more so than conventional monetary policy. That would tend to affect a broader range of assets and asset classes than we typically see with conventional monetary policy, and thus creates a risk-taking incentive that could prove worrying.

Weighing these factors, our sense is that today's calculus of UMP benefits is still clearly positive for UMP countries.

Two, We Need to Look More Closely at the Spillovers

Admittedly it is difficult to disentangle the effects of UMP from other factors affecting economic outcomes. Still, tightening cycles in the past have created concerns or spillovers, and we should learn from history.

For now, advanced and emerging countries have generally done a good job managing the policy implications from UMP.

We have been working on a series of case studies: 13 of the largest non-UMP countries that collectively represent about 40 percent of global output.

Following the initiation of UMP, we have seen episodes of asset price increases and rising capital flows—by one measure, cumulative net flows to emerging markets rose by $1.1 trillion since 2008, squarely above its long-run structural trend by an estimated $470 billion. Corporate leverage and foreign exchange exposures also increased in several cases. Real estate prices were buoyant, for example, in Brazil, Canada, China, Korea and Thailand. Stock prices rebounded for a considerable time in China, Mexico and Russia. And credit expanded rapidly in Brazil, China, Korea and Turkey. In recent months, some of these developments have been partly reversed.

These positive trends, of course, are what we would expect, even with conventional policy. Again, it is the recipe of low interest rates and the hunt for return—investors search for other opportunities, capital flows into emerging markets, with the usual potential for appreciation and credit growth.

In general, countries have undertaken sound macroeconomic management, with actions to make their financial systems more secure—including macroprudential and capital flow management measures.

The upshot of all this is that the present calculus of UMP for non-UMP countries is, on balance, still positive. At least for now. We all know that the situation can turn quickly—as we have seen in recent days in some emerging market economies. These risks require constant monitoring and reassessment.

Three, Thinking More About the Taxonomy of Exit Will Help Better Assess the Balance of Risks and Spillovers

Let me ask a very basic question. What do we mean by "exit" from UMP? The answer to this is not always clear. We have seen many innovations. Yet the conventional and unconventional are often lumped together. Monetary policies today are multifaceted, involving "forward" guidance about future policies, purchases of private assets to support stability in specific markets, and less-focused "quantitative easing" purchases that aim to boost activity more generally.

In the long term it is clear that exit from UMP will involve phasing out, and ultimately reversing all of these policies. That does not mean that they will all occur at the same time.

Indeed, it seems likely that some of the more "conventional" aspects of UMP, such as guidance on the future path of policy rates or the rate of future asset purchases, will be adjusted well before any assets are sold. This means that exit from UMP is likely to be slower and longer than is often portrayed, and feared.

It is also safe to assume that exit will depend on progress on other policies and on the durability of the recovery. In fact, for exit to be understood and digested as smoothly as possible by the markets, it needs to be contingent on the strengthening of the economy.

III. A Better Mix of Global Policies

That brings me to my third and final main point: the broader policy path forward. Monetary policy, as good as it is assumed to be, cannot do everything, cannot provide all the answers, cannot solve every economic problem. I do not need to convince this audience of that point!

Fundamentally, UMP needs to be complemented by a broader spectrum of policies that can move the global economy forward.

Let me step back from that for a moment:

There are certainly some who feel that the IMF has been reluctant to advise—or dare I say, has been "soft" on—those countries pursuing UMP. I disagree. We have consistently emphasized, for a number of years now, that the policy mix needs more medium-term fiscal, financial and structural reforms. But, even without these other desirable policies, it has been better to have than not to have UMP.

I do worry that all the hard work of central banks will be wasted if not enough is done on other fronts—to adopt the admittedly more difficult policies needed for balanced, durable and inclusive growth. I am talking here about all countries, not just UMP countries.

While we will not know the precise counterfactual, I would say this: UMP is providing the space for more reforms. We should use that space wisely. UMP should not be code for u*ltimately more procrastination*!

For UMP Countries, Getting the Mix Right Means Two Things

First, push ahead with deeper reforms to lay the foundation for durable and lasting growth. Do not waste the space provided by UMP.

We need this broader spectrum of policies to sustain growth over the longer term, to ensure fiscal sustainability, and to repair ailing banking systems. The exact combination of policies varies by country. The IMF has covered these issues at length on other occasions, most recently in our annual economic assessments for several major countries, so I will not rehash them.

More progress on the broader policy front can help make UMP more effective today, taming potential risks. It can also help open the door for a smooth exit.

Let me give you one example. Some countries—especially in the euro area—still need to work on financial repair, to unclog the financial plumbing and get credit flowing, reduce financial fragmentation, and help make monetary policy work better.

More broadly, making progress on regulatory reform can help make the system safer. Since UMP helped save the financial sector, it is only reasonable to ask for accelerated completion of financial sector reform in return.

The second responsibility is for central banks to manage the risks from exit. Everybody in this room understands the overriding importance of communication. Policymakers should be clear and open about the full range of considerations that will affect UMP decisions—both economic activity *and* financial stability.

It is also important to communicate risks on both sides of the equation—the risks to recovery from exiting too soon and the risks to financial stability from exiting too late. Yes, people have legitimate concerns that communication about financial conditions could undermine market stability. Yet saying too little could well be worse, leading to market surprises.

Even if managed well, exit from UMP may well present other, non-UMP countries with an arduous obstacle course.

So, How Should the Non-UMP Countries Prepare and React?

For the most part, they have already been ahead of the curve in dealing with potential risks. They should continue to follow their own lead. The precise policy actions will vary with country circumstances.

Non-UMP countries need to vigorously pursue the deeper policies that our reports have outlined for lasting medium-term growth.

Indeed, recent concerns about slowing growth potential in emerging markets only reinforce this point. The equally important issue, however, is what to do if faced with renewed financial instability. This presents serious risks to the non-UMP economies. The good news is that they have the tools to deal with it.

Exchange rate flexibility will help, but not at all cost. Some market intervention may help moderate exchange rate volatility or short-term liquidity pressures. So far, both advanced and emerging countries have used macro and micro-prudential measures to throw sand in the wheels of excess—dealing with frothy credit growth or potential financial sector vulnerabilities. In some circumstances, capital flow management measures have been useful.

Yet even with the best of efforts, the dam might leak. So, we need further lines of defense—lines of defense that reflect our interdependence, our common purpose, and our mutual responsibility for the global economy.

Here, swap lines—along the lines provided by major central banks early in the crisis—can help. For the Fund's part, we stand ready to provide policy advice and financial support, including on a precautionary basis through our various instruments.

Above all, we need to *all* work together, and work *better* together.

Conclusion

That is the right note on which to tie this all together.

There is scope for international policy coordination and cooperation to improve global outcomes. No country is an island. As I said at the outset, in today's interconnected world, the spillovers from domestic policies—UMP included—may well feed back to where they began. Looking at the wider effect is in your self-interest. It is in all of our interests.

I am not suggesting that this would be easy. Coordination is difficult to achieve in practice. Not everyone agrees about the size, or even the direction, of spillovers. Bridging or at least narrowing these differences is an important step toward deciding the future course of policy.

We can best meet these challenges by working openly together. Our discussion here today can help move us in the right direction.

As a forum for international policy cooperation, the Fund can help. It is also incumbent on us to use our surveillance to effectively support the policy decisions our member countries face. We can delve more deeply into the policy interconnections and spillovers among our member countries. We can offer clear analysis of what can be gained by working together. And we can encourage policymakers to understand how their actions fit into the global policy agenda.

Policies and policy coordination are not yet where they need to be. Failing to act at the global level, with each country playing its part, could put the global recovery at risk. With action, however, we can place the world economy on a path of strong, sustainable and balanced growth.

The world has done enough treading water. It is time now for policymakers to swim to the shore. Take this as some wisdom from a former synchronized swimmer!

Thank you.