# Coordinating the Next Move: Monetary Policy in the Post-crisis World

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## Bank of England's New Face

Even before succeeding Mervyn King at the helm of the Bank of England (BoE), Mark Carney was a familiar face to many in Britain. For the first time since the BoE was established in the late 17th century, the governor came from abroad— Carney was the governor of the Bank of Canada. That aside, central bankers and monetary policy have been under the spotlight since the global financial crisis. This is a big change from the past when central bankers rarely hit the headlines and were regarded "being boring" as a virtue. Above all, they abhorred mixing up with politicians. Not anymore.

The need to rekindle and support economic growth in the U.S., the U.K., Japan, and to avoid financial collapse in the eurozone, has pushed central bankers towards more active monetary policy and a more aggressive language. They have descended from their ivory towers and joined the fight against deflation and stagnation. Their weapons? A "big bazooka" of monetary policy. They have embraced non-conventional measures, such as various forms of quantitative easing (QE). The Fed switched to QE in late 2008 as nominal interest rates—the conventional measure—could not be further lowered (they cannot be negative). Since then, liquidity has been injected in faltering economies through the purchase of financial assets in the market in order to lower the cost of borrowing. Then came the sovereign debt crisis in the eurozone and in July 2012, Mario Draghi of the European Central Bank (ECB) promised "whatever it takes to save the euro". That was enough to calm the markets. A few months later, Haruhiko Kuroda, the newly-appointed governor of the Bank of Japan (BoJ), embraced "aggressive" monetary policy—the first "arrow" of Japan's new approach to economic policy—in order to fight deflation and move consumer prices up—the objective is two percent inflation by 2015. What will Governor Carney do?

Many expect a sudden change in the approach to and in the stance of monetary policy at the BoE, and an end to the purchase of assets that, starting in March 2009, have been undertaken to inject money directly into the economy and so to boost nominal demand. But Governor Carney is unlikely to be thinking about changing yet. The economy is recovering at a historically slow pace, and a broader set of financial conditions are not quite right for exiting ultra expansionary monetary policy. The issue is rather how to get more traction and maximum effectiveness out of the existing QE and other measures such as Funding for Lending.

The change in monetary policy, however, will eventually happen, and it is most likely to happen under Carney's stewardship. The key challenge is therefore to adapt monetary conditions to how the economy evolves and 'forward guide' the market by sending a reassuring message, in particular to those sectors of the equity and credit markets where improving growth, rather than excessive liquidity, is the primary driver of expected returns.

'Forward guidance' will be the leading approach in monetary policy in the forthcoming months. The Fed has indicated that it will end QE in 2014 and interest rates are expected to rise again in 2015. In theory there is plenty of time to prepare the ground for a smooth exit. But this may not be the case if other central banks, notably the BoE and the BoJ decide to go for the exit too. While the latter is unlikely to change its stance—although that is not impossible if the target of 2 percent inflation is achieved earlier than expected—the former might be pushed to move at the early signals of a steady recovery if the inflation outlook does not improve. Since the global financial crisis in 2008, inflation in the U.K. has been consistently above the 2 percent target, and the March 2013 Budget reiterated that the key objective of monetary policy is to meet the inflation target of 2 percent per year. This would be the best-case scenario for the U.K. But Governor Carney might not be so lucky and may end up dealing with a faltering recovery and growing inflationary pressures in a pre-election year when all eyes will be on the economy.

## Back to Global Imbalances: Spillovers and `Hot Money'

Since 2008, the unprecedented level of monetary stimulus that the Fed, the ECB, the BoJ, and the BoE have engineered as a response to the global financial crisis has unleashed approximately $9.5 trillion. This looked like a collective response in the sense that the central banks in the advanced economies faced similar conditions and followed similar expansionary paths as their economies were confronted with recession, credit crunch, budget deficits and ballooning public debt. In reality, however, these central banks have been acting together more by chance than by design, following quite different approaches and trying quite different ideas under the unifying mantra of "going beyond the zero bound" and "thinking the unthinkable", while making policy against the correct expectation that others would also be following similar policies. Most of all, they have been acting on domestic grounds, with little coordination in terms of assessing the spillover impact of the huge additional liquidity they put into the system.

Fast-growing developing countries and financial centers like London, New York and Hong Kong have been flooded with money in search of investment opportunities and easy profits. Financial markets have been thriving even if economic growth has been sluggish. In the U.K. in the last 12 months, the FTSE All Shares Index produced an impressive 25 percent return despite the underlying weakness of the U.K. economy. The London property market has grown by almost 20 percent since late 2010, compared to the much more modest rate of 2 percent for the property market in the whole country. Properties in desirable parts of London command seven-digit prices. While acquiring residences in one of the most dynamic cities in the world, wealthy foreigners also buy into Britain's legal system and rule of law. And, in the most difficult times of the eurozone crisis in 2011 and 2012, individuals and companies from member states of Europe's monetary union turned to London as a safe haven.

Bond markets have also benefited from investors' search for yield in 'safe haven' securities. Even eurozone peripheral bonds have looked attractive thanks to the implicit support provided by the ECB and the Outright Monetary Transactions (OMT) programme. Even in China, where controls restrict capital movements, is experiencing strong inflows. In the first quarter of 2013, China's foreign-exchange purchases were $195 billion—in 2012 as a whole they were approximately $100 billion. Over the same period, China's foreign-exchange reserves expanded by $128 billion, reaching $3.4 trillion.

Spillovers have also been affecting emerging market economies such as Brazil, Thailand, Malaysia, and Turkey through both capital movements and the exchange rate. Since 2010, these countries have been juggling the spillover impact of QE, in an attempt to maintain financial stability and manage capital inflows, without resorting to crude forms of capital controls. The specter of outright 'currency wars' that was evoked by Brazil's Finance Minister Mantega has not materialized yet, partly thanks to some effort to coordinate policies made by the G-20, however modest. But the impact on the exchange rate of Japan's monetary policy is taking quite a heavy toll. Since December 2012, the yen has lost about 25 percent of its value against the dollar and even more against the renminbi and the South Korean won. The latter has doubled its value against the yen over the last 12 months. And the ECB's cut in interest rates in May was more to adjust the exchange rate than to support economic growth. In addition, developing countries have expanded their foreign-exchange reserves by roughly $2.8 trillion since 2008. Inflexible nominal exchange-rate policies in countries like China may have intensified the effects of this process.

As interest rates remain close to zero, the search for yield has become frantic. What we see now is like a re-run of the pre-crisis years of the 'Great Moderation', when low inflation and low interest rates coupled with the "savings glut" in some parts of the world drove excessive debt and leverage, and more risk. But if world markets are back to the pre-crisis years, the world economy is not. In 2005-2006, the world economy grew at the annual rate of 5 percent while the U.S., the U.K. and the eurozone grew at 2.9, 2.7 and 2.5 percent respectively. Today, growth is sluggish as there is insufficient increased spending in surplus countries coupled with fiscal retrenchment in deficit countries, except the U.S. As a result this year the world economy is projected to grow at around 3 percent; the U.S. and the U.K. at 1.9 and 0.7 percent respectively, and the economy of the eurozone is expected to contract by 0.3 percent. Modest growth rates, and recession in the eurozone, make even more evident the disconnect between finance and the real economy.

## Is Coordination the New Game?

It is arguable whether monetary policy 'on steroids'—both in terms of the size of interventions and instruments—has achieved the desired impact. Surely the first round of QE in early 2009 helped reduce the sovereign yields in the U.S. and boost confidence and put the economy back on track by the end of that year. In 2010 growth bounced back, at a 5.3 percent pace for the world economy as a whole, 2.4 percent for the U.S., 1.8 percent for the U.K. and even 2 percent for the eurozone. But the impact of the further rounds of QE has been more muted and less in the direction of the real economy.

Fed Chairman Bernanke has recently warned about excessive risk-taking and "reckless speculation", and expressed concern that "easy monetary policy could inflate new bubbles in asset prices". The Bank of International Settlement's Annual Report warns about financial instability that prolonged support from central banks risks generating. In particular, it stresses that central banks cannot substitute fiscal authorities and governments in ensuring the sustainability of public finances and the implementation of reforms that are necessary to move economies back to the growth path. "After all", the Report concludes "cheap money makes it easier to borrow than to save, easier to spend than to tax, easier to remain the same than to change."

Where do we go from here? As monetary policy will eventually roll back, the question is how coordination can be achieved to ensure an orderly exit and to avoid that domestic policies in systemically important countries—in this specific case the U.S., the U.K., the eurozone and Japan—generate negative spillovers on, and systemic risks for the rest of the world. The Fed's announcement in late June that it will begin to phase out QE has rattled financial markets in Europe. In early July, the Fed almost reversed its message to calm the markets. It has been a powerful reminder of how much disruption changes in U.S. interest rates can create. A sharp adjustment in bond and equity prices in response to a change in market sentiment could significantly jeopardize financial stability.

Both the BoE and the ECB are concerned about the direction of monetary policy in the U.S. and the impact on borrowing costs, given the fragile recovery in their respective economies. In particular, due to recent problems in Greece and Portugal, short-term interest rates in the eurozone periphery have grown significantly more than in the core countries, increasing the fragmentation of credit markets and continuing to impair the transmission of monetary policy in the region. Since the Fed announcement, ECB President Draghi has embraced a more forward-guiding approach, and more crafted communication on future policy. In an unprecedented commitment, he said that the ECB would keep interest rates low "for an extended period of time."

As the world economy, through banking and finance, has become more interconnected and thus more complex, we need a policy framework to manage this complexity and to account for the spillovers or the negative externalities that a country's policies may generate on another country. This is the key lesson we learned from the global financial crisis. Risks to the world economy and global financial stability have therefore increased and have become systemic.

Growth continues to be elusive in many developed countries and the goal of "strong, balanced and sustainable growth" pledged by the G-20 in 2009 remains an empty promise. More action is necessary to channel the existing, risk-creating liquidity towards the real economy. Short-term speculative capital flows need to be curbed while long-term public and private investment, that create productive assets, need to be encouraged. We need to rethink monetary policy within a more coordinated and integrated framework where the impact of spillovers is assessed, action is sequenced and measures are consistent with fiscal policy and the agenda for growth. Most of all, we need active cooperation to rebalance the world economy, and to achieve changes in relative absorption between deficit and surplus countries, and changes in relative prices between deficit and surplus countries.