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MANAGING GLOBAL LIQUIDITY

In the Chapter IV of its report, devoted to Global liquidity, the Palais Royal Initiative (PRI) stressed "*the search for the appropriate approach to the management of liquidity conducive to balanced monetary and financial conditions at the global level is particularly challenging.*"

Since the publication of this report, some progress has been made in the understanding and the measurement of global liquidity. Yet an effective framework for its effective and regular monitoring has proved elusive and significant progress have still to be made in this domain (§1)

If it is evident, from the start, that private liquidity conditions are shaped by the monetary and fiscal policies of the major advances economies and transmitted abroad through capital flows, the actual transmission is determined by many factors. Among them can be listed the conditions prevailing on international financial markets, the development of new financial techniques by the private sector, the associated regulatory and prudential responses of the authorities, capital account regulations, as well as exchange rate arrangements and interventions policies.

At the same time, as regards official liquidity, no significant progress have been made in the organisation of the safety nets system (swap networks and IMF facilities), essential in times of financial stress and some economies have accumulated large amounts of official reserves.

Thus it appears that the proper management of global liquidity should involve not only central banks and the IMF but also governments and other official bodies in charge of macro financial stability (§2). In fact, if each of these institutions can exert an influence on global liquidity either on its official component or on the supply or the demand side of the private one, none of them has the capacity to manage it entirely (§3). Thus a cooperative effort is necessary and the organisation to be put in place should involve all of them, be it to different degrees (4).

1° A statistical framework still to be improved

Global liquidity is a complex notion and there is no agreement about how best to measure it. Actually, the approach adopted by the IMF differs from the one considered by the BIS.

The IMF's measure focuses on the funding for banks, based on their liabilities, while the BIS measures international credit through the assets of financial institutions and the issuance of bonds. This duality of approaches- and results- is indeed disturbing even though the two statistics complete each other and, taken together allow a significant diagnosis of the global monetary and financial situation. However it should be noted that none of them gives a clear indication of the impact shadow banking operations might have on liquidity conditions an risks.

If it were possible to draw a comparison with a national statistical framework, one could find similarities between monetary aggregates and IMF's statistics, both extracted from bank's liabilities, while BIS' indicators in their "private" component (see below) use a similar source as the one of national credit aggregates, that's is financial institution's assets.

Information which can be drawn from each of them are indeed complementary: IMF's statistics divide banks liquidities (liabilities) between "core" that is what banks can rely upon in normal times, such as retail deposits, and "non core" that is borrowing in the wholesale markets or directly from the central bank against collaterals. This indicator helps to understand the origin of global liquidity and to clarify the transmission channel from a major central bank monetary policy to capital flows, which generate what the BIS, calls "private global liquidity". In 2012, the IMF established also price indicators of liquidity, which opened the possibility to detect potential tensions especially in global wholesale markets (Chen and alii). It is a pity that the production of the latter indicator was not persued and that the former became unpublished a few years ago. The BIS' measure is broader than the IMF's one in the sense that it includes an "official" component (IMF quotas and drawing capacities, regional safety nets, swap agreements, official reserves) and a "private" one which includes both banks loans and bond issuance. It gives precious indications on pending risks in international finance and allows an easy comparison between the outstanding stock of international credit and the capacity of official international support to maintain an adequate level of liquidity in situation of stress.

For now, the private component assessed by the BIS amounts to $ 11 500 bn. On the other hand, official liquidity includes IMF quotas ($634 bn), drawing capacities on liquid assistance procedures such as IMF borrowing resources ($662 bn), regional safety nets (Chiang Mai initiative $240bn; European Stability mechanism –ESM € 500bn) and central banks discretionary swap assistance on an ad hoc basis (in 2008, the US Fed swapped $583 bn against currency deposits by other central banks in search of liquidity in dollars). Official reserve assets should also be considered (the main EMEs own 5000 bn-including gold- 2/3 belonging to China). As the 2008 experience shows that the supply of private liquidity cannot be relied upon in period of stress, the comparison of the two component indicates that the capacity of official international support to accommodate a liquidity shortage looks limited to roughly 1/5 of the outstanding stock of international credits and loans, taking in account that regional arrangements have been designed to deal with balance of payment crises of one or a few specific countries. This evaluation also does not take in account the stock of national official reserve assets, which can hardly be considered as set aside for international cooperation.

The quantitative dominance of private over official global liquidity in normal times can make global liquidity very fragile in time of stress. Unless strong decisions are taken to develop official safety nets, for instance by granting the IMF a capacity akin to the one of an International Lender of Last Resort (See § 3d), the stability of the system will continue to be fragile and based mainly on prevention, as it is the case to day.

2° Managing global liquidity: a shared responsibility

There is no doubt that macroeconomic policies in the major reserve issuing countries are at the origin of private liquidity creation and credit extension. Given the international role of the dollar, it is especially the case for the US macroeconomic policy: Global liquidity will tend to rise when US budget deficits increase, boosting the supply of long term assets, or when the Federal Reserve lowers dollar rates. One consequence, stressed by the PRI, is that *"seemingly appropriate liquidity conditions in individual economies may add up to excesses or shortfalls internationally".* This remark lies in the centre of the "Triffin's dilemma". Preventing such a situation or mitigating its consequences would imply a collective and international monitoring of global liquidity so that national policies (monetary, fiscal or regulatory) can take in account this important international factor.

A big difficulty is that governments and parliaments have assigned to central banks mandates that are fully oriented to domestic objectives. This inevitably limits the room for any central bank acting alone to take account of international concerns. Apart from changing the laws governing major central banks, which is hard to imagine even at a medium term horizon, the best way to circumvent the problem would be to enhance significantly international cooperation up to a point that taking in account the international environment would appear in conformity with national interests. This kind of cooperation would imply not just willingness within the central bank community but more a large degree of will at the political level. Indeed, it is difficult to imagine a big cooperative effort taking place within the central bank community while the spirit of multilateralism is clearly declining at the governmental level.

Independent of the impact of major economies' monetary policies on global liquidity, however, the monitoring of changes in private global liquidity is not exclusively in the hands of central banks. It is clear that the regulation of international financial institutions has a strong influence on liquidity conditions. International banks in particular have been requested to substantially increase their own holdings of liquid assets. This means that banks are induced to reduce the liquidity they provide to non-bank entities and to capital markets in general. Hence regulators must also play their part in the management of global liquidity. Similarly, the control of international capital flows and exchange rates policies, which play a key role in the transmission mechanism from domestic monetary policies to international financial markets, are more in the realm of Treasuries than of central banks.

Again, when considering safety nets, essential in time of financial stress, swap networks are made available by central banks, but IMF facilities play also a key role and decisions regarding them are relevant to Treasuries.

3° Managing global liquidity: the stakeholders and their means

From the rapid review included in the previous paragraph, one can conclude that managing global liquidity requests the involvement of a number of official institutions: Central banks, Treasuries, regulatory bodies in addition to the IMF have a role to play as none of them has the means to manage global liquidity on its own, while each of them hold a certain degree of influence.

a) Central banks shape largely the environment in which private global liquidity is created and priced. Either directly or through capital markets, monetary policy influences the liability side of financial institutions' balance sheets.

In general terms, this applies to domestic banks operating in their national currency but when this currency has an international status, as it is the case for the dollar and less significantly for the Euro, monetary policy will also influence institutions engaged in international operations. In this case, monetary decisions will impact both domestic and international credit markets. Expansionary monetary policy will facilitate financial institutions' funding on capital market and credit growth; conversely a restrictive policy will limit the capability to extend bank liabilities and reduce credit supply without any possibility to differentiate between domestic and international conditions, under the influence of capital flows.

Through their interest rate policy, central banks can also modify the cost of credits and the price to pay for "non core liquidity". Traditionally, monetary policy has worked mainly through short-term interest rates. But recently long-term rates have become the focus of policy and long rates worldwide have been depressed by massive central bank purchases of long-term securities. This has greatly stimulated the issuance of long-term bonds, a key and perhaps risky trend linked to the rise in private global liquidity, in recent years.

Central banks are also important stakeholders in official global liquidity as they usually manage the official reserves of the country. They are also participants in regional safety nets based on swap agreements such as the one set up by the Chiang Mai Initiative. Swap operations could also be decided on an ad hoc basis in case of need.

Recent history has shown how difficult it can be for the authorities to gauge global liquidity conditions. At first, as the global financial crisis was deepening the massive scale of the private flight to liquid assets was probably underestimated and some actions by the official sector such as increases in forex reserves or the timing of a revision of the "sound practices for managing liquidity in banking organisations"" might have aggravated illiquidity in markets in 2008.

Eventually, the failure of Lehman Broth. led to a radical expansion in official liquidity assistance. In 2008, the Fed swapped $ 583 bn against currencies deposited by other central banks in search of liquidity in dollar to help their financial institutions weakened by the crisis. During the global financial crisis, central banks in many countries provided also large amounts of liquidity assistance in their own currency in order to deal with major episodes of financial distress, with systemic implications. As financial institutions operate in different currencies, liquidity shortfalls can affect several jurisdictions simultaneously, so there is a need not yet fully satisfied for a strengthened cooperation among central banks in the domains of information sharing, collateral policy, eligibility of recipients etc., independently from the traditional allocation of responsibilities between home and host authorities (See Nakaso Group report –BIS-CGFS- "Designing Frameworks for Central Bank Liquidity Assistance-April 2017).

b) Regulatory authorities influence strongly the functioning of financial institutions, especially their capacity to supply credits and thus to act as an interface between major national capital markets and the global market.

The regulation of capital ratios has a significant effect on the balance between risky assets on one side and the minimum capital required, on the other, limiting the ability of financial institutions to expand their offer of credits, especially to risky borrowers. Similarly, the leverage ratio limits the size of the balance sheet and thus , the credit supply, in proportion to equity. In addition, the more financial institutions are leveraged, the more private global liquidity risks to be unstable; regulation in this domain is thus an element of global financial market stability.

Regulators can also influence directly credit supply through their liquidity regulation. Increasing the minimum requested of long term liquid assets as it was made compulsory in 2018 reduces in proportion the lending capacity of financial institutions and the size of private global liquidity. In addition, host countries can force international banks to hold liquid assets in their own jurisdictions, making the local operations of these banks safer to the risk of maintaining additional liquidity in economies where it is already abundant.

c) Treasuries, acting on behalf of governments, can influence private global liquidity by their decisions regarding economic policy, exchange rates, capital flows regulations, and international agreements on financial matters.

In general terms, changes in the macroeconomic stance influence balance of payments disequilibria and thus the final supply or demand for external funding. Changes in the supply of government bonds, usually the pre-eminent safe and liquid asset, have a direct effect on the liquidity of bond markets.

In borrowing countries, and especially in EMEs, decisions in the domain of exchange rate policy or in the management of currency mismatches modify the demand for international credits.. The same is true for capital controls aiming at protecting the economy against disruptive capital inflows or outflows.

On the lending side, financial structures largely depend on legislative decisions. No doubt, for instance, that international funding provided by and channelled trough the so called “Shadow banking” would be strongly influenced if legislative decisions were taken in major countries to limit or at least control this segment of the financial industry.

Considering official global liquidity, agreements in the domain of safety nets, especially those available through the IMF are, by definition , relevant to Treasuries. This has been especially the case on August 2009 when a general allocation of SDRs was decided, in the amount equivalent to $250 bn, (plus a one-time allocation of SDRs 21,5 bn ($34bn) resulting from the 4th Amendment to IMF Articles) to cushion the effects of the financial crisis on global liquidity.

d) The IMF, according to its Articles, has nearly all the elements to be the world's macro prudential authority. However, in practice, its capacity to act and in particular to take part in the management of global liquidity is hampered by its key shareholders and by the decline of multilateralism. For instance, the IMF does not have a sufficiently broad mandate in the surveillance of capital flows and in the area of capital controls to influence national policies in this domain. Also, IMF surveillance over the policy of its member policies, which could have an influence on the supply of global liquidity is restricted by its inability to interfere in the macroeconomic decisions by the most advanced countries. On the other hand, the impact of the surveillance on the economies where the demand for liquidity comes from remains limited.

The SDR, which, according to IMF's articles, was designed to become "the main principal reserve asset" in the international monetary system, remains marginal in size. It has nevertheless demonstrated its usefulness during the crisis with a rapidly decided exceptional allocation. This experience shows how useful it would be to develop a permanent financing mechanism akin to a global Lender of Last Resort for helping member countries in need. SDR would be the natural instrument for this purpose as it can be issued in unlimited quantities, being an IMF liability against itself. Such an approach would have the additional advantage of preventing, at least in part, the trend towards further precautionary reserve accumulation.

The IMF could play a key role in the management of global liquidity, just by using its current Articles to the best possible advantage, it is a pity that this international institution remains so largely underused.

4° What international arrangements for managing global liquidity?

Although the question of global liquidity is a frequent topic of discussion in financial market commentaries, because traders know that changes in market liquidity can have major implications, it surfaces only from time to time in the general economic debate, is rarely referred to in academic circles and is not systematically reviewed within the main official international policy forums.

Due to the significance of the issue, it is important that it appears on the agenda of top officials international meetings, as a key element of the international economic situation, subject to a strict and regular surveillance. Finding an adequate channel for this step forward looks essential.

The PRI devoted a full chapter of its report to global liquidity at a time (2011) where it was neither clearly defined nor adequately measured. It suggested (suggestion N° 9) that the IMF and the BIS work together towards a shared analytical approach for a better measurement and surveillance. We know the progress made since then on these two points but we know also that significant efforts are still needed before a more coherent and comprehensive set of statistics is made available, especially to decision-makers and analysts. Our working party should recommend that the IMF starts again publishing its series of core and non core banks liabilities and update in view of publication its price indicators of liquidity. In the spirit of the PRI suggestion, the IMF and the BIS should then work together to complete information and analysis on the influence that shadow banking can exert on liquidity conditions at the global level, harmonise their indicators around a common theoretical framework and thus jointly produce a more coherent and comprehensive set of indicators; these are indispensable elements of a much needed "global risk map" called for by the EPG (Octobre2018).

Regarding the management of global liquidity, the PRI envisaged (suggestion N° 10) a joint responsibility between the IMF, the BIS and the FSB and recognised the impact that exchange rate regimes, financial regulation and supervisory policies might have, in addition to monetary stances, on liquidity level and conditions : "*The IMF, the BIS and the FSB should regularly monitor developments in global liquidity with a view toward formulating recommendations for all systemically relevant countries regarding the conduct of their policies (including monetary and exchange rate policies, as well as financial regulatory and supervisory policies) with a potential impact on global liquidity".* From the start, the PRI had acknowledged that global liquidity trends were not exclusively influenced by monetary policies and that its management should be the result of a cooperative approach among international institutions.

In a contribution *Reforming the IMS-A sequenced agenda* (2014), Michel Camdessus and Anoop Singh proposed a number of specific reforms aimed at tailoring the IMF's methods and instruments to today's problems and at strengthening its legitimacy and governance. They confirmed the importance of managing global liquidity as a global public good and proposed a specific mechanism to regulate it: a group of central bank governors-comprising those of the central banks whose currencies are included into the SDR- would be created in view of reporting periodically on global liquidity conditions to the IMF's International Monetary and Financial Committee (IMFC) whose role would be considerably enhanced to the point that it would become the ministerial organ of the G20, in charge inter alia of calibrating global liquidity.

This valuable suggestion is sensible, but only as a part of a profound strengthening of IMF's legitimacy and governance. Indeed the authors envisage first these structural and ambitious measures and "*preferably simultaneously or as a second step"* the ones related to global liquidity management. The second step cannot be envisaged independently from the first, especially as, in the present situation, the IMFC advises and reports to the IMF Board of Directors but has no formal decision-making powers. Proposing the creation of a central banks governors group would imply to enter first into the details of a fundamental reform of the IMS .

Which pragmatic proposal, could be readily taken into consideration by the decision-makers?

First, one should admit, even though with regrets, that in current circumstances, the appropriate forum for discussing global liquidity topics on a regular basis and possibly managing it when needed would not be the IMF, unless it is profoundly reformed, but the G 20 Finance Ministers and Central Bank Governors Group. During the Pittsburgh Summit, leaders designated the G 2O as "*the premier forum for our international economic cooperation"* with the objective to strengthen policy coordination, promote financial stability and modernize the international financial architecture.

Second, an effective institutional arrangement for managing global liquidity would depend together on a good statistical framework, central banks guidance and possibly action, input from Treasuries, expertise of financial regulators and IMF support. These requirements suggest the need for a cooperative approach across international institutions, as indeed envisaged by the PRI and again recently recommended

The report of the Eminent Persons group (EPG-Oct.2018) made a specific proposal that the IMF, FSB and BIS should integrate their surveillance efforts to produce a global risk map. Along similar lines, the recent report of the Independent Evaluation Office –IEO- of the IMF (IMF Financial Surveillance, January 2019) recommended that the Fund's work on multilateral financial surveillance should take greater advantage of working with international partners, noting in particular the need to intensify cooperation with the international regulatory agencies. The regular Early Warning Exercise, notably on financial and macro financial risks, produced by the IMF and the FSB is already highly influential .It appears that work has begun in the BIS, the FSB and the IMF on how to deepen and broaden this surveillance exercise. Our report could underline the importance to such an exercise of regularly and systematically monitoring global liquidity. This may be especially needed in the years ahead as monetary and financial conditions evolve to a "new normal", the contours of which remain uncertain.

How best to do this?

One could envisage that in advance to the G20 Ministers and Governors meetings, the FSB provide a report on the level, the nature and evolution of global liquidity, based on harmonised and enhanced statistics of the BIS and the IMF. The IEO report stressed that such a joint exercise should not “compromise the Fund’s capacity to raise out of the box issues”. The same should apply to the BIS so that the two institutions, in addition to their statistic support, could complete the FSB report by their own comments by reference for instance to the global economic situation, to financial stability prospects or to the regulatory environment. This joint report would then be submitted to the Ministers and Governors for consideration and possible decision, and made public.

Such an approach would imply first a joint statistical effort by the IMF and the BIS but, this being done, it would be easy to implement as it would request no institutional measure, just the inclusion of a new item in the agenda. This would deepen and extend the debate on this topic and would help making global liquidity better known by decision-makers and analysts. The EPG made a point of stressing that no one knew where the next crisis would start from. Hence it said that robust risk surveillance depended on the incorporation of non-official and contrarian views. It also underlined that the official international institutions should not converge on a diluted consensus. The above proposal could contribute to getting financial risks from global liquidity developments taken seriously without having to consider any institutional reform, just by using to their best current structures and arrangements. Of course this approach, pragmatic and adequate in the current situation does not preclude that more structural and ambitious measures be considered as a part of a significant reform of the IMS, so many times called for and never seriously considered.