World Growth, Global Imbalances and Regional Safe Asset Providers:
Comments on paper by Pierre-Olivier Gourinchas and Hélène Rey

David Vines
(with thanks to Dylan Smith)

Economics Department, Balliol College, St Antony's College and Oxford Martin School, Oxford University;

Centre for Economic Policy Research, London

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1 Introduction – Helene Rey's empirical wake up call

1.1 The Global Credit Cycle

The Conventional Wisdom

- "It is difficult to think of plausible economic mechanisms through which globalization should impair in any substantial way the ability of central banks to control domestic inflation through national monetary policy." *Michael Woodford, 2007*

Helene Rey's empirical attack

- "There is a global financial cycle in capital flows, asset prices and in credit growth... The global financial cycle is not aligned with countries' specific macroeconomic conditions. In a number of countries, this can lead to excess credit growth (or alternatively to monetary conditions which are too tight) ... Our VAR analysis suggests that one important determinant of the global financial cycle is monetary policy in the center country, which affects leverage of global banks, credit flows and credit growth in the international financial system. This channel invalidates the "trilemma", which postulates that in a world of free capital mobility, independent monetary policies are feasible if …. exchange rates are floating." *Helene Rey, 2015*

This wake up call was given prominence in the 2014 Mundell Fleming Lecture

1.2 The analytical implications of Helene’s attack

- Woodford’s ideas based on “uncovered interest parity” (UIP)
    - An unjustified application of the “ efficient markets hypothesis” to the global economy
- We no longer believe that the exchange rate will necessarily smoothly move so that expected changes exactly compensate for differences between home foreign interest rates.
    - As a result independent monetary policies may cease to be easily obtainable
- UIP must be replaced with a careful analysis, using modern portfolio theory, of the international allocation of investment portfolios in the face of differing risks and return across countries
    - Sometimes independent and effective monetary policy is possible – the recent case of Australia is a spectacular example – but sometimes it is not.
- A number of us are beginning to carry out the necessary work, including my Oxford student Dylan Smith

1.3 The policy implications of Helene’s attack

- Calls for capital controls to protect emerging market economies from tapering in the US, coming from Ramanujam Ragan, from the IMF and from Olivier Blanchard
- Calls for international cooperation in the setting of macroeconomic policies in advanced countries, to avoid ‘exchange rate warfare’ as countries seek to defend themselves from the effects of the global credit cycle.

1.4 The extensions of this idea in today’s paper

- I expected more of the same today.
- Instead we got something which seemed to be completely different.
- But – on reflection – it turns out to build on what has come before

2 The first and second parts of today's paper

- The Gourinchas and Rey paper can be thought of as building on these ideas about the global credit cycle
- The paper adds additional empirical support to a well understood opinion – which I share – that low long-term real interest rates are likely to continue
- We can identify forces behind this empirical finding, which I will discuss
  - Deleveraging by the financial system
  - Lack of confidence by consumers and investors
- Long term implications of these forces are shared across countries for reasons related to Rey's analysis of the global credit cycle
  - The international transmission of these forces causing low long-term interest rates can be thought about using Mundell Fleming ideas
  - But we should - and can - also think of this transmission as happening through the portfolio allocation process, using ideas coming from Rey's global credit cycle work

- Low interest rates will have significant implications for global macroeconomic policy making. These implications were discussed today by Mario Draghi
  - The shock of 2008 led to a reduction of interest rates *and* to fiscal expansion
  - But at the Toronto G20 summit it was decide that final policy should cease to be expansionary and should begin to be concerned with reducing public sector deficits and preventing further rise in public debt.
- We can think about this using the Tinbergen-Meade targets and instruments
  - something which Mario Draghi recommended
- Two objectives of macroeconomic policy became important
  - Preserving aggregate demand *and* managing public debt
- But only one instrument of policy was available
  - The interest rate had reached the zero bound
  - Two objectives and one instrument leads to a prisoners' dilemma
    - The outcome has been exchange rate warfare
      - QE as an instrument to depress the exchange rate, diverting demand from abroad
      - The effects of this largely cancel out across countries
- As Mario Draghi said today, in these circumstances, international coordination of monetary policy, fiscal policy and structural reforms becomes crucial
  - See papers by Caballero et al. (2015, 2016); and Blanchard's (2016) paper given in Singapore.
  - And see Vines (2016) "Concerted Unilateralism: when international macroeconomic cooperation is helpful and when it is not", in Bayoumi, Pickford and Sabacchi (2016) *Managing Complexity Economic Policy Cooperation after the Crisis,* Brookings

3 The third part of today’s paper

- The paper presents a new argument about the exorbitant privilege, and duty, which faces the regional providers of safe assets
- Such providers undertake not maturity transformation but risk transformation
  - Depositors accept low yielding safe assets (eg Chinese holdings of US Treasuries)
  - They themselves get holdings of high yield risky assets (eg US hldings of emerging market assets)
- They are offered higher return (privilege) and higher risk (duty)
- The authors call this a “Triffin problem”, but it is a Triffin problem of a new kind
  - The (familiar) Triffin problem is often described as a “currency problem”, but it is not
  - This was macroeconomic policy problem of a James Meade / Swan diagram kind
    - In the later part of the 1960s it became impossible for countries to achieve both internal and external balance
      - Unwillingness of Germany and Japan to appreciate, and inability of US to devalue
    - Those running current account surpluses in Europe – a *flow* problem - had to accept an unwanted currency – the dollar – in return; a symptom of the underlying problem.
  - But the new Triffin problem is a 21st century Triffin Problem – really is a capital account problem; it is a *stock* problem
- This Triffin problem applies to Japan
  - This is why the yen has risen so strongly after the Brexit shock

- But this Triffin problem also applies to Germany
  - Depositors accept low yielding safe assets in German Banks (and this issue is magnified through Target 2 balances)
  - German banks holders hold risky assets elsewhere.
- And it has implications for Southern Europe
  - EMU has served to spread this privilege, and duty, to the rest of the Eurozone, with damaging consequences for GIIPS countries
  - The 'privilege' of a capital-account forces pushing towards an appreciated exchange rate for the Euro is not a privilege for the GIIPS countries
  - The 'duty' of German assets being risky has imposed a burden on the GIIPS countries
    - Their inability to devalue means that they have not been able to defend themselves, ex post, from the consequences of German banks investing their (relatively safe) deposits in (relatively risky) Southern European assets.
- This analysis leads to an additional argument for debt forgiveness in some of the GIIPS countries
    - I have repeatedly argued – along with many others - that a correction of macroeconomic policy is needed in Europe, with less austerity the North, more inflation in the North, and forgiveness of sovereign debt in the South
    - These existing arguments for debt forgiveness in the South are *flow* arguments
    - The paper by Gourinchas and Rey provides an additional *stock* argument for such forgiveness

4 Implications for thinking about Brexit vote

- I see the Brexit vote as having creating a global volatility shock
  - We can and should analyse the implications of this using an analysis of international portfolio allocation, building on Helene Rey's work, of the kind described above
- This shock has created a challenge for global macroeconomic policy of the kind identified in the second part of the Gourinchas and Rey paper
  - Mario Draghi today called for a coordination of monetary, fiscal and structural policies. But of what kind?
  - This shock strengthens the reasons – discussed above – for tempering fiscal austerity, and moving towards fiscal stimulus, to strengthen the global recovery
  - This would weaken the pressures – discussed above - pushing towards exchange rate warfare
  - The "two-in-five policy" promoted by the Australia in 2014, when Australia was president of the G20, pushed in this direction.
  - The commitment to this policy was allowed to slip by Turkey when that country was president of the G20. It should be re-emphasised by China
- This also shock has difficult implications for Germany and the Eurozone; we can analyse this, using framework provided in the third part of the Gourinchas and Rey paper
  - That analysis suggests that this shock will have difficult implications for the GIIPS countries
  - We have seen markets fall very significantly in Italy in the last few days, as this analysis suggests it would

- Finally, I would argue the difficulties which we now face have partly arisen from policies of fiscal austerity
  - Policies of austerity in the UK made it much more difficult for David Cameron to win the Brexit referendum vote
  - The policies of austerity in Germany have blunted the ability of the GIIPS countries to escape from the effects of the global financial crisis and have exposed GIIPS countries to extreme macroeconomic difficulty.
    - Germany's insistence that such policies of austerity be applied in the rest of the Eurozone has magnified this difficulty.
    - The analysis in the last part of the Gourinchas and Rey paper suggests that this difficulty may be even greater than had previously been realised.