



IMF RESEARCH CONFERENCE

Experts Warn Financial System Risks Still High

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- Need for much better understanding of macro-financial linkages
- IMF researching how the financial sector affects the broader economy
- Global imbalances raise concerns about future stability

Governments need to rethink how the financial sector intersects with the broader economy if future crises are to be avoided, economists agreed at a panel discussion at the International Monetary Fund's recently held Economic Forum.

Opening the November 5-6 research conference, IMF Managing Director Dominique Strauss-Kahn remarked on the positive effects of the timely and effective policy interventions at the global level that have helped stave off an even worse outcome to the recent global crisis.

Strauss-Kahn noted that macro-financial linkages are at the heart of the two-way interactions between the real economy and the financial system. "One of the most important lessons we painfully learned is that we need to have a much better understanding of macro-financial linkages," he said. "At the IMF, we will utilize the results of recent research on macro-financial linkages in order to help our membership devise policies that promote global financial stability and economic growth."

The Economic Forum, chaired by IMF Chief Economist Olivier Blanchard, wrapped up the 10th Jacques Polak Annual Research Conference in Washington, D.C. Since it was first launched, the research conference has become one of the major international forums for researchers and policymakers to exchange their views about issues related to the global economy.

Graceful exit

Around the world, discussions are under way on how to best move toward unwinding public sector support. Of all the measures of public support implemented thus far—fiscal and monetary policy, interventions to specific institutions, and government support programs—perhaps the one



Panelists at the 2009 Economic Forum. Implementing the correct policies will be critical in the months ahead (Photo: IMF)

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most delicate to unwind will be monetary policy.

Panelists at the 2009 Economic Forum

Olivier Blanchard, (panel chair) Economic Counsellor and Director of Research, IMF

Franklin Allen, Nippon Life Professor of Finance and Economics at The Wharton School of the University of Pennsylvania

Randall Kroszner, Norman R. Bobins Professor of Economics at the University of Chicago Booth School of Business

Laurence Meyer, Vice Chairman and Director of Macroeconomic Advisors

Eswar Prasad, Tolani Senior Professor of Trade Policy at Cornell University and Senior Fellow at the Brookings Institution

Former Federal Reserve governor, Laurence Meyer, explained that exit for the United States will mean raising the federal funds rate; withdrawing the reserves that were put in by the various programs; and shrinking the balance sheet by selling previously purchased assets—such as, mortgage-backed securities—or letting short-term assets “run off” as the various facilities or programs are scaled back or shut down.

Meyer predicts the federal funds rate will not be increased until the middle of 2011, saying the Federal Reserve would, however, tighten earlier if another asset bubble developed. Despite having just emerged from a collapse in the housing market, Meyer believes, “we are already on bubble alert.” He points to market concerns of an emerging bubble in the corporate bond and other markets, noting credit spreads have disappeared, equity prices are increasing, and housing market prices are slowly rising.

Market concern over long-term inflation expectations might also lead to a tightening, as might a collapse in the dollar. “If there was freefall in the dollar, even if the short-term economic conditions weren’t very good, the Fed would have no choice but to raise rates,” he said.

Policy overhaul

When it comes to redesigning monetary policy, there is disagreement as to how this might best be accomplished. Wharton finance and economics professor Franklin Allen believes more checks and balances could be built into the Federal Reserve System. “We need to have a third mandate—a financial stability mandate,” he said.

But more importantly, he says, outsiders should be checking the Federal Reserve. Allen favors a financial stability board, which would be independent from the Fed, with members sitting on the Federal Open Market Committee, not with a majority, but perhaps a substantial minority, so that given a dissent in the Board, they would be able to provide a counter effect.

Allen sees quantitative easing as an extremely risky policy, and as something that has been undertaken with very little discussion in policy or academic circles: “The notion is that you print money and buy up long-term bonds, but what happens if inflation ticks up?” Selling the bonds and reversing the liquidity could be problematic and, he argues, central banks need a mechanism to check what is going on and prevent such risky moves.

On the other hand, both Meyer and former Federal Reserve governor, Randall Kroszner, believed this might compromise the widely cherished independence of central banks. “If you ask a central bank whether it should intervene directly in an asset bubble, they would say, ‘yes’, but we have additional tools to do that,” said Meyer “we don’t want to compromise monetary policy being supervised in regulatory policies.” Panel chair Blanchard summed up the essence of the discussion, asking, “How can you balance this central bank independence and avoid misbehavior? If you think of monetary policy as a set of tools, then it seems wrong to have two decision makers. The need for coordination and information means there can only be one institution using these tools optimally.”

Too broad a mandate could also risk overloading central banks, particularly in emerging

markets, a view held by Brookings Senior Fellow and Cornell professor, Eswar Prasad. Where a central bank has a well-defined mandate, he believes it could be possible to incorporate many of these issues within that mandate. "Although the world has changed in many ways," he said, "we should not be throwing out everything that we thought we knew."

What to watch for

Picking up and building on one of the potential risks referred to earlier by Meyer, Allen noted that while a run on the U.S. dollar might be less likely, there are other advanced economies where the risks are greater, particularly those that followed policies of quantitative easing and purchased large amounts of financial assets. "If there is a run on the currency, it is going to be very difficult for [the central bank] to sell these assets back into the market without substantially raising rates."

Global imbalances are again beginning to raise concerns. Pressures remain in many economies around the world, says Prasad, where many economies, such as China, Japan and Germany, ride the coat-tails of the United States. In China, Prasad noted that just in the first six months of 2009 China's state banks had pumped \$1 trillion of lending into mostly state-owned enterprises. But the huge stimulus could result in a problem of overproduction that would again lead to imbalances with the need to export surplus output. Both Prasad and Allen worry that the crisis may have also incentivized emerging markets to continue with a policy of amassing huge stocks of reserves.

Allen points to countries such as Korea and some others across Asia that may have come through the crisis in good shape and avoided the large decrease in GDP and increases in unemployment experienced by other export-oriented countries. He suggests these countries will conclude, rightly, that they need more reserves. Prasad says a number of countries thought to have had vast reserves saw them depleted very quickly during the height of the crisis. Here, they both agree that changes to the international architecture—through better Asian representation at the IMF—would be helpful, but these changes need to move more quickly than they are at present.

Emerging markets are moving out of the crisis with a new perspective, argues Prasad, where they now recognize better the importance of strengthening financial systems, but doing so in very limited contexts. Prasad sees a new path developing as emerging markets move forward with their financial development and broadening financial access, one that emphasizes the importance of regulation.

"Perhaps ultimately what we should hope for is a convergence of the emerging markets moving toward more sophisticated, but better regulated, financial systems and perhaps the United States move toward a less sophisticated, in some ways, but more stable financial system." But with no agreement yet among experts on what are the optimal regulatory structures for less developed financial markets, he sees a need for a great deal of work to be done in the area.

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