Benoît Cœuré: Global liquidity and risk – a re-interpretation of the recent crises

Speech by Mr Benoît Cœuré, Member of the Executive Board of the European Central Bank, at the BIS-ECB Workshop on global liquidity and its international repercussions, Frankfurt am Main, 6 February 2012.

* * *

I wish to thank Roland Straub for his contributions to the speech. I remain solely responsible for the opinions contained herein.

1. Introduction

I am delighted to deliver the dinner speech today at this BIS and ECB workshop on global liquidity. Our two institutions have worked closely and extensively on the topic of global liquidity in recent years, notably in the context of Basel-based organisations, such as the Committee on the Global Financial System, so it made sense for us to organise a workshop on this subject. On a more personal note, as a former co-chair of the G20 Sub-Working Group on Global Liquidity Management, I am particularly pleased to see that work is progressing on this important issue.

The global economic and financial crisis in 2007–08 forcefully demonstrated that fluctuations in global liquidity conditions can lead to distortions in asset prices and cross-border capital flows. These distortions contribute to the emergence of bubbles and to financial crises when the bubbles burst. This is not a new story, but a recurrent theme in modern economic history. In this regard the recent financial crisis has not really been exceptional.

Liquidity, no matter how defined, is widely understood to follow cyclical patterns. These patterns feature one important element which is not yet sufficiently appreciated and which I would like to stress today, namely the *self-reinforcing interaction between risk appetite and liquidity.* This particular interaction ultimately determines the relationship between the official and the overall level of global liquidity. In this connection, I should perhaps add that Claudio Borio and his colleagues at the BIS were among the first to note this self-reinforcing interaction and introduce the concept of the risk-taking channel.[1]

This evening there are several things I'd like to consider: I'll outline some of the key concepts in global liquidity and also cover liquidity cycles. I'll talk about the interaction between liquidity and risk appetite in the Asian crisis, and between liquidity and the recent financial crisis. I'll discuss the relationship between global liquidity and the availability of safe assets, and the impact of the post-Lehman global liquidity cycle on emerging economies. Finally, I'll explore some of the policy implications.

2. Key concepts in global liquidity

The Landau Report of the CGFS has pointed out that global liquidity has two separate, but interdependent, components. The first component can be labelled as "official liquidity", and can be defined as "the funding that is unconditionally available to settle claims through monetary authorities"[2]. Official liquidity can be generated through various instruments. Central banks can create it in their *domestic currency* through regular monetary operations or

---

1 See Borio and Zhu, 2008, "Capital regulation, risk-taking and monetary policy: a missing link in the transmission mechanism?", BIS WP No. 268.

2 CGFS Paper No 45: "Global liquidity – concept, measurement and policy implications", Basel, 2011.

through emergency liquidity assistance. In addition, authorities can provide official liquidity in *foreign currency* by selling foreign exchange reserves and through swap lines between central banks.

The other component is private (or private sector) liquidity. Private liquidity is created to a large degree through cross-border operations of banks and other financial institutions, and increasingly within the shadow banking system.

In normal times, private liquidity dominates official liquidity. But private liquidity is highly pro-cyclical and highly endogenous to the conditions that prevail in the global financial system. The inherent endogeneity of private liquidity means that it can easily evaporate in times of financial stress. The pro-cyclicality is documented via the strong interaction of private liquidity and the global risk appetite of financial institutions. Indeed, the global risk appetite is one of the main determinants of the multiplier that links levels of overall liquidity to levels of official liquidity.

Consequently, while only central banks can create official liquidity (the IMF can only mobilise it and reallocate it across countries), for global liquidity cycles to emerge there is no need for new injections of official liquidity. What is needed is that private or official investors reallocate existing liquidity to other market segments. And when viewed in this light, the true driver of liquidity is the underlying set of factors that allows this portfolio reallocation to take place. Let me explain.

3. Relationship between liquidity and recent crises

A glance at the history of global capital flows over the last 20 years suggests that the liquidity cycles that posed a threat to global financial stability originated in *both* advanced and emerging economies. Until 1997, Asia drew in almost half of the total capital inflow into developing countries. The economies of South-East Asia, in particular, maintained high interest rates that attracted foreign investors looking for high rates of return. The region received large inflows of money and saw dramatic increases in asset prices. At the same time, the region experienced high growth. This achievement was widely acclaimed as being part of the "Asian economic miracle".

But the self-reinforcing interaction between risk appetite and liquidity came to the surface here. The surge in capital flows weakened incentives to improve transparency and corporate governance; it also fuelled leverage, pushing up asset prices further, to unsustainable levels. Those prices eventually underwent a correction, causing individuals and companies to default on their obligations.

The shortage of liquidity created by the crisis changed risk sentiment, thereby increasing the global demand for safe assets. With the US dollar still reigning supreme, the United States became a hub for the recycling of the liquidity that was available globally[3]. All of a sudden, capital was flowing uphill, from emerging to advanced economies, a puzzle famously known as the "Lucas paradox".

Clearly, however, the surge in capital flows to the US was mainly driven by the desire of the official sector in emerging-market and oil-exporting economies to increase their war chests of reserves and insure against global shocks, and not by utility-maximising decisions of their private sector. Nevertheless, those inflows contributed to the decline in long-term interest rates and increased risk appetite in many of the advanced economies. The self-reinforcing interaction between risk appetite and liquidity came back with a vengeance. Of course, one should not neglect the domestic inefficiencies in advanced economies that allowed the

[3] Ricardo J. Caballero, Emmanuel Farhi, and Pierre-Olivier Gourinchas: "An Equilibrium Model of "Global Imbalances" and Low Interest Rates", American Economic Review 2008, 98:1, pgs 358–393.

financial crisis to occur in the first place. That said, the global dimension of the underlying forces is striking.

The eventual implications of this interaction for the advanced economies were not so different from those for Asia a decade earlier. Again, one saw distorted incentives within the lender-borrower relationship, a highly leveraged economic climate, and upswings in asset prices to unsustainable levels. This resulted in the "Great Recession" and the corresponding fall in global economic activity.

The ensuing sovereign debt crisis in the euro area can be seen – at least to some extent – through the lens of global liquidity and its cycles. In an environment of abundant liquidity and high risk appetite, sovereign yields in the euro area converged at very low levels. Government bond spreads did not reflect differences in macroeconomic fundamentals. This distorted incentives, both in the public and the private sectors. Sovereigns over-borrowed and put off necessary reforms. In some Member States it was the private sector that took on excessive debt, fuelling unsustainable real estate bubbles which, when they burst, pulled the banking system down and then affected public finances. In other words, abundant liquidity undermined market discipline, which could otherwise have become an important pillar of macroeconomic and fiscal discipline in the euro area.

4. Shortage of safe assets and global liquidity

There is also a striking link between the global liquidity cycle and the shortage of safe assets in the global economy. Let me elaborate.

Financial crises, but also economic downturns in general, trigger a rise in global risk aversion. This in turn induces a flight to safety by global investors, resulting in an excess global demand for safe assets. As an illustration, think of the current nominal yield on some short-term sovereign debt, which is close to zero and has even turned negative in some constituencies. The consequent shortage of safe assets globally, however, is a significant impediment to the functioning of the global financial system. How can we, as policy-makers, address this recurrent problem?

First, emerging market economies should develop an efficient financial system and sound legal, regulatory and macroeconomic policy frameworks in order to create safe, globally accepted financial assets.

Second, the euro area needs to regain its role as a global supplier of safe assets. Some investors have doubted whether the sovereign debt issued by some euro area countries can be considered as risk-free. However, by restoring fiscal discipline, euro area sovereign debt will be viewed once again as risk-free. We have made significant progress in the last couple of years, with the establishment of the EFSF, the launching of the ESM, the approval of the six-pack legislation and of the fiscal compact.

Third, the unused resources of the international monetary system need to be mobilised. According to estimates, US government bonds of around USD 2.1 trillion and overall reserves of USD 6.5 trillion[4] are held by emerging market economies. However, standard methods to quantify the optimal level of reserves suggest that the current level of reserves would not be justified purely for precautionary motives. It would be advisable, therefore, to utilise some of these excess reserves to stabilise the international monetary system, while Europe is enhancing its firewall. One obvious way to do this would be via the IMF. The IMF could borrow global excess reserves and use them to support programme countries that are

[4] Data on US government bonds is from TICS: http://www.treasury.gov/resource-center/data-chart-center/tic/Documents/mfh.txt. Data on reserves in emerging economies is from Haver Analytics and national resources.

suffering from liquidity shortages, under strict conditionality. Restoring confidence in these economies would in turn stabilise regional debt markets and contribute to the global supply of safe assets.

5. Impact of post-Lehman global liquidity cycle on emerging economies

The outbreak of the global economic and financial crisis led to a speedy and coordinated response by major central banks. They supplied significant amounts of liquidity via different channels, including currency swaps and non-standard measures. In parallel, the IMF and multilateral development banks have been required to expand their balance sheets.

This global response has, however, also initiated a lively discussion among policy-makers about how to address liquidity shortages with instruments providing official liquidity. In particular, there has been increasing demand in policy circles for harmonisation, standardisation and some sort of pre-commitment to provide official liquidity through foreign-currency swap arrangements between central banks.

Let me just remind you, however, that foreign currency swap lines are, to some extent, the international extension of the lender-of-last-resort function of reserve currency- issuing central banks. As the lender-of-last-resort role in the domestic context is subject to the well-known principle of "constructive ambiguity", there is no reason to believe that a different approach would be warranted in an international context. That said, central banks should aim to improve the current infrastructure for conducting foreign exchange swap arrangements, ensuring that future policy responses face no technical obstacles.

The surge in official liquidity is, however, also associated with the launch of non-standard monetary operations in advanced economies. These policies seek to stabilise the domestic economy and have been criticised by emerging markets' central banks. Those of you who attended the G20 discussions in 2011 will remember the animated exchanges on this issue. If anything, this confirmed that, for any meaningful discussion of international monetary reform to take place, one needs to better understand the driving factors of global liquidity and its impact on domestic policies. The emerging market participants argue though that unconventional measures taken in developed economies have created excessive global liquidity and that this, in turn, was a key factor behind the massive increase of capital flows into their economies between 2009 and mid-2011. This surge was then widely blamed for the appreciation pressures exerted on their currencies, contributing to a build-up of financial imbalances and asset price bubbles, high credit growth and risks of overheating in those markets.

However, an important question is whether idiosyncratic "pull factors" have influenced the transmission process of official liquidity expansion. Indeed, recent studies argue that there is a significant degree of heterogeneity in the way different emerging economies were affected by US monetary policy[5]. Pull factors, such as country-specific fundamentals and institutional characteristics, are just as important as "push factors" coming from developed economies. For instance, countries with fundamentally undervalued exchange rates are of course prone to surges in capital inflows.

Conclusions

Reinterpreting recent crises through the lens of global liquidity cycles cannot hide the fact that the crises themselves have their origins in more fundamental "fault lines", to paraphrase

[5] Fratzscher, Lo Duca and Straub: "Quantitative Easing, Portfolio Choice and International Capital Flows", ECB mimeo.

Rajan.[6] Liquidity fluctuation and cycles simply exacerbate these underlying weaknesses. For instance, in the Asian crisis, regulation and supervision of the banking system was weak in many instances, as was corporate governance in general. Similarly, the recent financial crisis revealed gaps in regulation and supervision, especially in segments such as the shadow banking system, as well as the lack of a macro-prudential approach to financial supervision. Finally, the debt crisis in the euro area has its roots in insufficient fiscal discipline and, even more importantly, in divergent productivity trends among the Member States. Such divergence sows the seeds of balance-of-payment imbalances and ultimately leads to a sudden stop of capital inflows into peripheral countries. Obviously, adequate policy responses will have to focus primarily on these structural issues.

At the same time, it is essential to adopt measures that can break the self-reinforcing interaction between risk appetite and liquidity in order to avoid further financial crises. Here, I see three avenues that merit further reflection:

- Micro- and macro-prudential measures – these aim to prevent the build-up of financial fragilities and the emergence of credit and asset price bubbles. This includes of course the liquidity and capital adequacy-related measures which are at the heart of the Basel III accord. This may also include capital management techniques insofar as they are internationally consistent, and insofar as they are not a substitute for fundamental reforms;
- Further improvements in the financial regulatory framework – these would enable national supervisors and central banks to better monitor and, if necessary, rein in endogenous liquidity creation within the financial sector. This includes the oversight and regulation of the shadow banking system and the implementation of OTC derivatives market reform;
- Further reflection is also warranted on precautionary foreign-exchange reserve holdings and on international coordination in the face of global liquidity shocks. These deliberations should build on the seminal work done by the CGFS on liquidity arrangements between central banks, and on the progress achieved by the IMF with the creation of the Precautionary and Liquidity Line, in addition to the already existing FCL and PCL.

Progress along these three avenues would help to provide a consistent policy framework for addressing global liquidity.

I thank you for your attention.

[6] Rajan, Fault Lines, 2010, Princeton University Press.