Reforming the international monetary and financial system and preserving monetary and financial stability in financially integrated small and open economies

Már Guðmundsson, Governor of the Central Bank of Iceland, panel comments in the 50th Anniversary Conference of the Central Bank of Malta, Valletta, 4 May 2018.

Let me begin by congratulating all at the Central Bank of Malta on the Bank's 50th anniversary and thank Governor Vella for the invitation to speak at this conference. I spoke in a Central Bank of Malta conference here in Valetta around the middle of the 1990s. At that time Iceland had more or less fully liberalised its capital account and had a pegged exchange rate. Malta also had a pegged exchange rate but still had some capital controls. The world has changed since then and our understanding of it even more. We in Iceland went towards a flexible exchange rate and inflation targeting, while you entered monetary union. Overall, we have both done well, but our road in Iceland has been bumpier.

The heading of this panel is *Challenges facing central banks after the financial crisis*. That is a big menu. For my introductory remarks I choose two related issues that have been high on my mind for years, both as a policy maker in a small, open and financially integrated economy and during my tenure at the BIS. These are potential reforms to the international monetary and financial system (IMFS) and how small, open and financially integrated economies (SOFIEs) can preserve monetary and financial stability in a world of global financial integration and large and volatile capital flows. Both of these are unfinished business and the road ahead is foggy.

The post-war global economic order was initially based on the principles of free trade in goods, current account convertibility, and monetary stability through fixed but adjustable exchange rates vis-à-vis the US dollar. Open capital accounts were the exception, however. At the time, trade integration was seen to be more important for economic progress than financial integration.

It worked well for a long while, and some call the period from 1950 to 1970 the golden years. Yet there were inherent flaws in this set-up that contributed to its demise in the early 1970s, not least the well-known Triffin dilemma regarding the conflict between the domestic economic objectives of the country providing the main reserve currency and the required international supply of that currency. In this case it was the US dollar. Then capital accounts were opened up, with strong momentum in the 1980s and early 1990s. Capital controls were increasingly undermined by technology and financial innovation, and strong arguments were being made to the effect that open capital accounts would bring significant benefits. After all, ongoing real economic integration at a global level demanded at least some degree of global financial integration. In turn, freer capital movements, the ongoing cross-border financial integration, and the growth of private capital flows that followed undermined pegged exchange rates and thus contributed to the spread of flexible exchange rate regimes and inflation targeting in many parts of the world, but in the European Union this development provided part of the rationale for a monetary union.

The current international monetary system and the official part of the global financial safety net largely reflect the contours of the global economy as they were before global financial integration and private capital flows reached the level we have seen in this century.

Back then, the global macroeconomic problem was related to global current account imbalances and asymmetric adjustment. Keeping your own house in order was in most cases both necessary and sufficient for maintaining economic stability in individual countries. IMF facilities to lend to sovereigns of debtor countries facing balance of payments difficulties were the most important part of the global financial safety net (GFSN).

The world we currently live in is different. Financial imbalances in both net and gross balance sheets can be more important than current account imbalances and certainly were so in the build-up to the great financial crisis (GFC). This is a world of cross-border spillovers and spillbacks. It is a world where, for small and open economies (SOEs), keeping your own house in order is certainly necessary but no longer sufficient, at least not if we restrict ourselves to traditional demand management and prudential instruments. Financially integrated small and open economies can still be overwhelmed by large and volatile capital flows driven by push factors. It is a world that needs additions to the GFSN, some of which we partly have – such as FX liquidity provisions to internationally active banks through central bank-swaps – but some of which we do not have.

The international community is certainly aware of these issues. The IMF has done good analytical work in this area and proposed reforms. Work has been done under the auspices of the G20 looking at potential reforms to the international monetary sytem (IMS), and currently the Eminent Persons Group is working on a report to the G20 to be delivered at this year's autumn meetings of the IMF. But progress in this area is slow and with current set-ups we are not going to get far without having the main reserve currency country on board.

This raises the question that I will turn to next: in the absence of global (or regional) reforms, what will individual SOEs have to do in order to reap the benefits of cross-border financial integration in safe manner? In order to answer this question, we need to understand how cross-border financial integration affects the ability of SOEs to preserve both monetary and financial stability.[1]

First, a simple theory. If we have a world made up of one very large country and several very small countries, with full cross-border financial integration (in the

[1] For a more expanded version of what follows, see my published work, in particular Gudmundsson (2008) and Gudmundsson (2016).

economic sense of these terms rather than the legal one), and assume that relative risk premia are constant, then long-term interest rates in the small countries will be pegged to long-term rates in the large one. This, of course, is an “unrealistic” theoretical simplification. But it gives us a reference point to start to think about these issues, and it indicates the direction we might be heading in as global financial integration progresses.

In this type of world, the small countries could still have independent monetary policy of a sort, provided that they have a flexible exchange rate regime. They could pick their own inflation targets and set their own short-term rates that would affect economic activity in the short run and inflation in the long run. In this case, monetary policy works mostly through the exchange rate channel. If exchange rates are “well behaved” and the financial sector is sufficiently regulated and supervised, then a floating exchange rate and “keeping your own house in order” is sufficient for independent monetary policy and financial stability.

The problem is, however, that exchange rates are sometimes far from being smooth reflections of underlying fundamentals. The evidence suggests that foreign exchange markets exhibit excess volatility and that exchange rates diverge from fundamentals for protracted periods. In some sense, the existence of carry trade can be construed as evidence of this, as it involves betting that interest rate differentials are not fully compensated by exchange rate movements; i.e., that uncovered interest rate parity does not hold, except at long horizons, and then often through sharp and disorderly corrections.

This, in turn, gives rise to two concerns: first, regarding detrimental effects on the traded goods sector , and second, on financial stability where volatile capital flows, currency mismatches, and rollover risk of foreign currency debt are among the key players. Adverse effects on financial stability can be particularly severe when a blocked interest rate channel and an erratic exchange rate channel interact badly with other economic and financial risks that can face small, open, and financially integrated economies – such as the global financial cycle, domestic financial vulnerabilities, and policy conflicts.

We saw trends before the GFC that were consistent with this story. Data on long-term interest rates and spreads in small advanced economies and in many emerging markets economies showed strong and growing correlations with long-term rates and spreads among core rate setters (mainly the US and the eurozone), although still some way from the theoretical limiting case. The GFC reversed this process somewhat, as risk premia skyrocketed, cross-border banking partly retreated to home base, and restrictions on capital movements were in some cases reintroduced. It has come back to a significant degree.

Before the crisis, some argued that these patterns could be due to common shocks, convergence of monetary policy frameworks, and increased credibility of those frameworks. However, case studies, comparisons of the pre- and postcrisis periods, and other observations make it more and more plausible that global financial integration is the main driver.

The bottom line is that it is becoming more difficult to conduct independent monetary policy in small, open, and financially integrated economies, and although a flexible exchange rate is a necessary condition for doing so, it might not be sufficient, especially when we factor in the financial stability aspects. This, I think, is why we find on occasion that we are closer to facing a dilemma than a trilemma. I think it is still a trilemma, but with trade-offs of variable severity.[2]

What can individual countries do about this?

First, those that have the option can enter a monetary union. That has its own pros and cons, as you all know very well. But for a SOE were the MU constitutes the biggest trading partner, issues of excess exchange rate volatility and domestic currency mismatches become much less pronounced.

Second, they can give up on independent monetary policy while maintaining their own currency by either pegging the exchange rate or pegging interest rates to those of global rate setters. The problem with the first is that, as history shows, it can be difficult to maintain with free capital movements. The problem with both is that other policies, such as fiscal policy, will then have to take care of domestic economic stabilisation. But will they?

Third, they can use FX intervention to reduce the effect of volatile capital flows on the exchange rate.

Fourth, they can increase resilience and the ability to live with exchange rate fluctuations (reduce the fear of floating) by strengthening financial regulation and supervision or employing macroprudential tools.

Fifth, if everything else fails, they can introduce tools aimed directly at the financial integration part in order to regain greater monetary independence and shift the effect of monetary policy more to the interest rate channel and towards the non-traded goods sector. These so-called capital flow management measures are probably most needed when countries are faced with large capital inflows at the same time as domestic conditions warrant significantly higher interest rates than among core rate setters.

In Iceland, we have used many of these tools in recent years. We have used FX intervention to reduce short-term exchange rate fluctuations and, in recent years, to lean against strong appreciation pressures. We have introduced a liquidity coverage ratio and a net stable funding ratio in foreign currencies. In 2016 we were faced with strong capital inflows that flattened the yield curve as the policy rate was being increased and more was signalled. We then introduced a special

[2] Rey (2013) and Obstfeld (2015) analyse this issue and provide somewhat different views on whether it is a dilemma or a trilemma.

non-renumerated reserve requirement of 40% with a holding period of a year on capital inflows into the bond market and high-yielding deposits. It worked, and monetary transmission through the interest rate channel was restored. As a result, we also avoided the build-up of significant carry trade positions with the associated risk to financial stability. We see such instruments as temporary and only to be used as a third line of defence. Furthermore, it remains an open question whether they will be seen to be more in the nature of macroprudential tools or as infringements on our treaty obligations to maintain free capital movements. We are hoping that everybody has learned the lessons of the crisis where large and volatile capital flows played a key role.[3]

In concluding, let me come back to the IMFS and ask what I have said about the plight of SOFIEs means in terms of desirable reforms. First, we need to continue to adapt IMF surveillance and facilities and other parts of the GFSN to modern realities. Second, we need to further reduce financial regulatory flaws and gaps at the regional and global level regarding capital flows and cross-border banking. Third, we need to try to find ways to make central bank swaps a more transparent and reliable part of the GFSN. Finally, international organisations and treaties need to accommodate but monitor SOFIEs' use of macroprudential and capital flow management tools. With time, we might develop a new consensus on the rules of the game.

[3] For more information on the special reserve requirement on certain capital inflows in Iceland, see Central Bank of Iceland (2017).

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