Conference on International Cooperation in Times of Global Crisis: Views from G20 countries

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How many international lenders of last resort?

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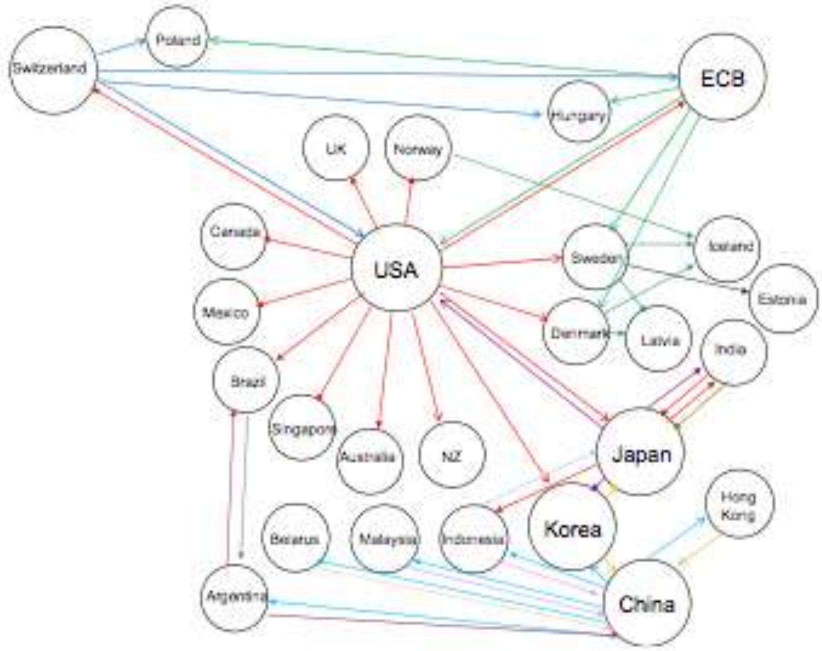
In the 10 minutes that the organizers have allocated to me I can cover only one topic that fits into the general issue of "How many international lenders of last resort?" which this panel is addressing. The topic I want to cover is whether it is useful to institutionalize, possibly within the framework of the IMF, the network of swaps that were created and amply used during the crisis. Many observers have indeed put forward the idea that the swap network, *"one of the most notable example of central bank cooperation in history"* according to Obstfeld, Shamnaugh and Taylor (Caruana made a similar point: *" The extension of such swaps in unlimited amounts represents a turn in central bank cooperation that the founders of the BIS would have found unimaginable.*") , should get an institutional character. This idea is often connected to the perceived need to have an international lender of last resort, forcefully put forward by Stanley Fischer and subsequently taken up by a number of economists. The answer to the question I am addressing, which I want to articulate in my intervention, is a straightforward, and I understand possibly controversial: no, the swap network should not be institutionalized, either at the Fund or in some other international body.

To start my reasoning, let me first recall some basic facts about the swap network:

1. While the FED had the most extensive network of swaps, other central banks, including the ECB, the Swiss National Bank, the Bank of England and the Bank of Japan had a number of swaps in which they lent their own currencies, as in the chart taken from Allen and Moessner (slide 2);
2. For some central banks (ECB, Bank of England, Swiss National Bank, Bank of Japan) to which the FED lent dollars, there was no limit to the amount which could be drawn;
3. The amounts effectively drawn under the swaps were very large, well exceeding 500 billion dollars in the fourth quarter of 2008 (Slide 3).

Another characteristic of the swaps, albeit one deriving from an assessment rather than being a simple quantitative aspect, is that the swaps were mostly an extension of "non standard" monetary policy measures taken domestically. The clearest example in this respect is that the swaps granted by the FED were a complement of the Term Auction Facility (TAF), as explained in Baba and Packer. More generally, a central bank could allow another central bank to provide central bank liquidity in its currency, with large and potentially unlimited effects on its balance sheet, only in very special circumstances, which is equivalent to say that this can be done only as part of "non standard measures" i.e. measures taken in very rare cases as a complement of "standard" monetary policy tools.



In very basic terms what happened during the crisis is that a number of central banks in advanced economies (in particular the FED, the ECB, the Bank of England and the Swiss National Banks) did something that is normally anathema: giving up the control of their balance sheet. For those with a monetarist inclination, the heresy can be brought in better relief by saying that central banks no longer controlled the growth of the monetary base.

The reasons for this choice are obvious and, while not an integral part of my story, they are worthwhile recalling:

1. Central banks had to complement the impaired intermediation of the market by bringing part of it on their books, to avoid even more extended damages to the real economy (as we argued in our book (Slide 4),
2. Financial and economic conditions were such that there were no inflationary risks from such loss of control of the balance sheet. In particular the chain of causation moving from base money to wider money aggregates, through the money multiplier, and then to inflation, through the money demand function, was totally broken during the crisis.

Based on what I have said so far, I you can start seeing why my answer to the question whether the network of swaps established and used during the crisis should be institutionalized is no. The swaps were absolutely extraordinary measures, taken in very special circumstances as integral components of overall monetary policy and thus can not be institutionalized which would mean, in my understanding, that they would be made permanent and, directly or indirectly, not decided in full independence by the relevant central banks. To make the point more forcefully, it would, in my view, be totally unacceptable to have a set-up in which on a permanent basis central banks would have lost, completely or in part, the control of their balance sheet. This would be tantamount to giving up the best technology available to manage a fiat currency: an independent central bank primarily devoted to price stability.

This is an important and possibly controversial but relatively narrow conclusion. It does not at all imply that the swaps were a mistake; indeed I believe they were a significant component of the overall action of central banks that avoided a repeat of the Great Depression of 1929-1933. Neither does this conclusion exclude that central banks will continue, as they have done for at least since the second half of the nineteenth century (Borio and Toniolo, Simmons), to lend money to each other. Finally, it does not contradict the point forcefully made by Stan Fischer about the need of an international lender of last resort, to be based at the

IMF. My conclusion just says that the decision to grant swap lines to other central banks, and more generally to lend them money, must remain a decision taken independently by central banks in full consistency with their monetary policy, in turn dedicated to price stability. In other words central banks must be fully responsible for controlling their balance sheet also when, in exceptional circumstances, …they decide not to control it any more.

Indeed, if anything, this principle must now be forcefully reiterated because the recourse to non standard measures by central banks during the crisis may raise requests of similar interventions also in less extreme circumstances. Economic agents, public opinion, governments have seen central banks doing things nobody thought they could do. It is, in smaller scale, analogous to what happened with the abandonment of the gold standard: nobody (or nearly nobody) thought this was possible and when this happened it was a sort of epiphany raising the illusion that through monetary policy one could achieve nearly any macroeconomic goal. It took several decades and the invention of independent central banks devoted to price stability to overcome that illusion, with all its consequential damages.

In a way I am restating the obvious: monetary policy is a powerful tool to steer the economy and, in particular, to counter its intrinsic vulnerability to instability phenomena, which sometimes develop into fully fledged crises; it is not, however, an omnipotent tool and its over-use can have very serious negative consequences. I would indeed go one step further: the more parsimonious is a central bank in normal times the more can it be bold during crises without engendering inflationary risks. In today´s jargon, it is the credibility capital accumulated during normal times that allows a central bank to resort to "non standard measures" during a crisis.