*Concerns about Competitive Monetary Easing**

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Good morning. The world seems to be struggling back to its feet after the great financial crisis, and financial markets are buoyant. This is partly because central bankers are collectively engaged in extreme monetary easing through unconventional policies.

I have two worries about this environment. First, unconventional policies tend to be feasible when domestic commercial banks are willing to accumulate significant central bank reserves without question. But those are typically situations where lending is unattractive – because of debt overhang, structural problems, or simply weak demand. Of course, a hope is that when commercial banks accumulate enough reserves, their behaviour will change. But this may be a long time coming, if at all.

In the meantime, the consequences of these sustained unconventional policies pile up in the financial markets, where risk taking increases, without necessarily increasing real investment or consumption. And they spill over into foreign markets as capital flows lead to greater leverage and stronger exchange rates in recipient countries, and a shift in demand away from them.

The second worry I have is that such policies prompt a reaction by foreign central banks in both competitor industrial countries and in emerging markets. These may espouse unconventional policies once again in order to avoid exchange rate appreciation or capital inflows. Even as each central bank does, what is most appropriate for its domestic circumstances, aggregate world demand may be weaker and more distorted than it should be, and financial risks higher.

The international rules of the game need to be revisited as the world has changed. Both advanced economies and emerging economies need to adapt, else I fear we are about to embark on the next leg of a wearisome cycle.

Unconventional Policy

By unconventional monetary policies (UMP), I mean both policies that hold interest rates at near zero for long, as well as balance sheet policies such as quantitative easing or exchange intervention, that involve altering central bank balance sheets in order to affect certain market prices.

Let me first say there is a role for unconventional policies – when markets are broken or grossly dysfunctional or when deflationary expectations are strongly entrenched, as in Japan.

The key question is what happens when these policies are prolonged long beyond repairing markets – and there the benefits are much less clear. Let me list 4 concerns:

1. Is UMP the right tool once the immediate crisis is over? Does it distort behavior and activity so as to stand in the way of recovery?
2. Do such policies buy time or does the belief that the central bank is taking responsibility prevent other, more appropriate, policies from being implemented? Put differently, when central bankers say, however reluctantly, that they are the only game in town, do they become the only game in town?
3. Will exit from unconventional policies be easy?
4. What are the spillovers from such policies to other countries?

For reasons of time, let me focus on the last two.

Exit

The macroeconomic argument for prolonged unconventional policy in industrial countries is that it

* Governor Dr. Raghuram G. Rajan's remarks in the Policy Panel Discussion, at the '2014 BOJ-IMES Conference on Monetary Policy in a Post-Financial Crisis Era', organised by the Institute of Monetary and Economic Studies, Bank of Japan in Tokyo on May 28, 2014.

has low costs, provided inflation stays quiescent. Hence it is worth pursuing, even if the benefits are uncertain. Central bankers such as Governor Stein have, however, raised concerns about financial sector risks that may build with prolonged use of unconventional policy.

One reason is that leverage may increase both in the financial sector and amongst borrowers as policy stays accommodative. One channel seems to be that a boost to asset liquidity leads lenders to believe that asset sales will backstop loan recovery, leading them to increase loan to value ratios.

When liquidity tightens, though, too many lenders rely on asset sales, causing asset prices and loan recovery to plummet. Because lenders do not account for the effects of their lending on the 'fire sale' price, and subsequently on lending by others, they may have an excessive incentive to build leverage.

Leverage need not be the sole reason why exit may be volatile after prolonged unconventional policy. As Feroli *et. al.* argue, investment managers may fear underperforming relative to others. This means they will hold a risky asset only if it promises a risk premium (over safe assets) that makes them confident they will not underperform holding it.

A lower path of expected returns on the safe asset makes it easier for the risky asset to meet the required risk premium, and indeed draws more investment managers to buy it – the more credible the forward guidance on 'low for long', the more the risk taking.

However, as investment managers crowd into the risky asset, the likelihood of possible fire sales increases if the interest rate environment turns. Everyone may dump the risky asset at that point in order to avoid being the last one holding it.

Ideally, market players would exit trades gradually, and asset prices would fall gently, as probabilities of the interest rate environment turning increase. But a rise in long rates may upset an incipient recovery. The central bank's attempt, however, to hold long rates down till the last possible moment by reassuring markets that policy rate hikes are a long way away, is not without danger. If economic data turn up strongly, its reassurance may not carry credibility, and market players will exit trades en masse.

Leverage and investor crowding may therefore exacerbate the consequences of exit. The consequences of exit, however, are not just felt domestically, they could be experienced internationally.

Spillovers

Perhaps most vulnerable to the increased risk-taking in this integrated world are countries across the border. When monetary policy in large countries is extremely and unconventionally accommodative, capital flows into recipient countries tend to increase local leverage; this is not just due to the direct effect of cross-border banking flows but also the indirect effect, as the appreciating exchange rate and rising asset prices, especially of real estate, make it seem that borrowers have more equity than they really have. Exchange rate flexibility in recipient countries, in these circumstances, sometimes exacerbates booms rather than slowing inflows.

Recipient countries should adjust, of course, but credit and flows mask the magnitude and timing of needed adjustment. For instance, higher collections from property taxes on new houses and income taxes on a more prosperous financial sector may suggest a country's fiscal house is in order, even while low risk premia on sovereign debt add to the sense of calm. At the same time, an appreciating nominal exchange rate may also keep down inflation.

So, when source countries move to exit unconventional policies, some recipient countries are leveraged, imbalanced, and vulnerable to capital outflows. Recipient countries are not being irrational when they protest both the initiation of unconventional policy as well as an exit whose pace is driven solely by conditions in the source country. Having become more vulnerable because of leverage and crowding, recipient countries may call for an exit whose pace and timing is responsive, at least in part, to conditions they face.

The Case for International Monetary Policy Coordination

Hence, my call for more coordination in monetary policy. I do not mean that central bankers sit around a table and make policy collectively, nor do I mean that they call each other regularly and coordinate actions. We certainly communicate with one another enough at the BIS.

In its strong form, I propose that large country central banks, both in advanced countries and emerging markets, internalise more of the spillovers from their policies in their mandate, and are forced by new conventions on the 'rules of the game', monitored by an impartial agency, to avoid unconventional policies with large adverse spillovers and questionable domestic benefits.

Given the difficulties of operationalising the strong form, I suggest that, at the very least, central banks reinterpret their domestic mandate to take into account other country reactions over time (and not just the immediate feedback effects), and thus become more sensitive to spillovers. This weak 'coordination' could be supplemented with a re-examination of global safety nets.

Let me be more specific. The key rationale for coordination and international monitoring is adverse policy spill overs. Yet international agencies, with only a few notable exceptions, have overwhelmingly endorsed the recent unconventional policies. Essentially, they argue, it is OK to distort asset prices if there are other domestic constraints to reviving growth, such as the zero-lower bound. But net spillovers, rather than fancy acronyms, should determine internationally acceptable policy.

Otherwise, countries could legitimately practice what they might call quantitative external easing or QEE, whereby they intervene to keep their exchange rate down and build huge reserves. The reason we frowned on QEE in the past is because we believed the adverse spillover effects for the rest of the world were significant.

But, if domestic demand is difficult to alter because of a variety of constraints, one could argue QE works primarily through demand shifting, not unlike QEE. Therefore, if we are unwilling to evaluate all policies based on their spillover effects, there is no legitimate way multilateral institutions can declare that QEE contravenes the rules of the game.

The second danger is that a mismanaged exit will prompt fresh distortionary behaviour. Indeed, the lesson some emerging markets will take away from the recent episode of turmoil is: (i) don't expand domestic demand and run large deficits; (ii) maintain a competitive exchange rate; and (iii) build large reserves, because when trouble comes, you are on your own. In a world with deficient aggregate demand, is this the message the international community wants to send?

Two obvious remedies suggest themselves: Less extreme monetary policies on all sides with some thought given to adverse spillover effects when setting policy, and better global safety nets to mitigate the need for countries to self-insure through reserve buffers.

Operationalising Coordination: Some Suggestions

In an ideal world, UMPs such as QE or QEE should be vetted by an independent multilateral agency for their spillover effects. For instance, following a complaint by an impacted country, the independent assessor could analyse the effects of such policies and come to a judgement on whether they follow the rules of the game. Policies where the benefits are largely domestic, while the costs fall largely abroad, would be especially carefully scrutinised. And if the assessor deems the policy reduces global welfare, pressure should be applied to stop such policies.

The problems with such an idealistic process are easy to see. Where is such an impartial assessor to be found? And if a truly independent assessment came to the conclusion that certain policies were in violation, how would such a judgement be enforced?

A More Modest Proposal

Perhaps then, it would be better to settle for a more modest proposal. Central banks should not just worry about the immediate flows of capital to other countries from its policies, but the longer run reaction such as competitive easing or sustained exchange intervention that this would bring about. This would allow central banks to pay more attention to spillovers even while staying within their domestic mandate.

At the same time, we should reduce the incentive for countries to engage in a repeat of substantial reserve accumulation by building stronger international safety nets. An interesting proposal from the IMF is a liquidity line from the IMF, where countries are pre-qualified by the IMF and told (perhaps privately) how much of a line they would qualify for under current policy – with access limits revised every year after the Article IV discussions and any curtailment becoming effective 6 months later. Such a pushed line could overcome the problem that no country wants to approach the Fund because of the associated stigma.

Conclusion

The current non-system in international monetary policy is, in my view, a source of substantial risk, both to sustainable growth as well as to the financial sector. It is not an industrial country problem, nor an emerging market problem, it is a problem of collective action. The sooner we recognise that, the more sustainable world growth we will have.