FEDERAL RESERVE BANK of NEW YORK

Comments on "Global Liquidity Cycle and its Macroeconomic Implications," by Yao Yudong

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Global Liquidity Management Framework

- Decisions made in U.S., euro area, and Japan have spillovers to Emerging Market economies
  - Future tightening could put downward pressure on EM growth
  - Is there a new way to guide policies to moderate these spillovers?

- The paper suggests coordination though targeting global base money
  - Calculate <u>global base money</u> using SDR weights
  - Desired base money growth tied to velocity and global output
  - Shortfalls in monetary base growth in some parts of the globe to be made up in other parts
  - Alternative to exchange rate being focus of monetary policy coordination

Coordination is always a challenge

- Central banks' mandates focus on domestic objectives
  - Domestic economic and institutional reform strategies are key to enhancing resilience when facing external shocks and volatility
  - Global policy community could enhance credibility and effectiveness of reform by providing expressions of support even without coordinated market intervention

- Could the proposed framework improve on the current focus on exchange rates in policy discussions?
  - Are quantities (cross-border flows) easier to coordinate on than prices (exchange rates)?
  - What is the source of tangible spillovers—the exchange rate channel or the cross-border flow channel?

1. Monetary Base as measure of domestic policy

- Monetary base is not always linked to policy rate
  - Connection varies based on policy implementation framework
  - This is especially true as more central banks employ payment of interest on reserves to influence market rates, and the use of large-scale asset purchases
- Policy is more accurately measured by the policy rate, or the spread between the policy rate and the natural rate of interest
- Money is difficult to measure and velocity is an unstable guide

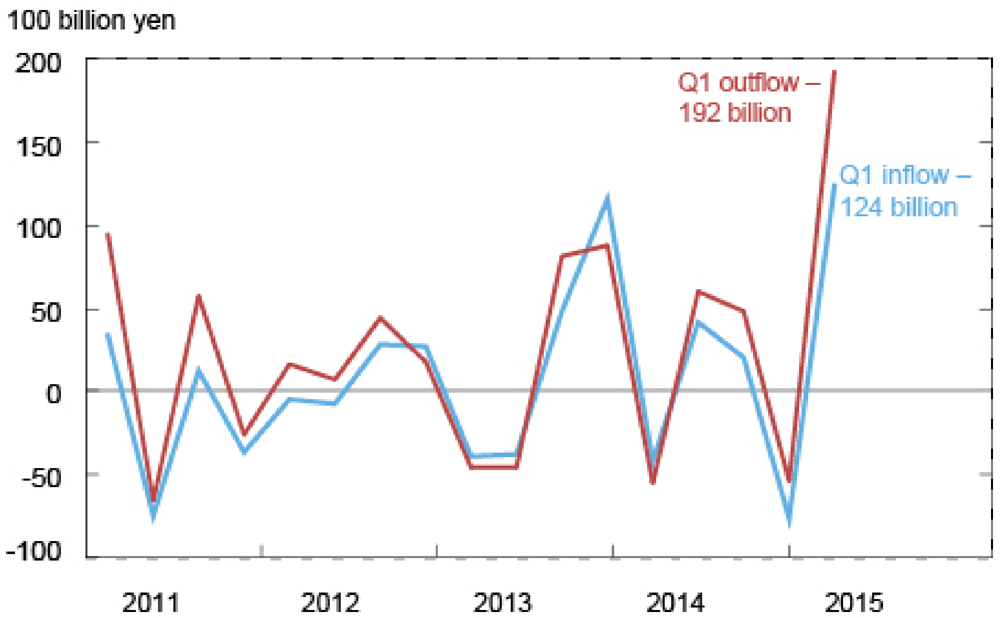
2. Framework assumes role for cross-border flows

- Is it the case that a shortage of base money in one country pulls base money in from the rest of the world?
  - Current account balances measure of a country’s lending/borrowing
  - Largely independent of changes in monetary policy

2. Net cross-border flows don't respond as expected

- The missing "wall of money" out of Japan: Did money flow out of Japan in search of yield when Bank of Japan started its asset purchase program?
  - No. Japan's current account surplus was stable, so net financial outflows were also stable. It was the exchange rate, not financial flows that reflected the change in the Bank of Japan's policy

Japan Financial Account



Sources: Haver Analytics; Japan Ministry of Finance.
Notes: Outflow includes government purchases. Data are not seasonally adjusted.

3. Exchange rates and capital flows

Exchange rates can and do move, even without significant cross-border flows.

Exchange rates have proven and significant effects on exports and imports, and GDP growth.

4. Do gross flows matter?

- Helene Rey (2013) and others point to gross, rather than net flows as an independent factor affecting measures of financial volatility, such as VIX.
- This suggests that gross flows could be an independent factor that could have cross-country spillovers.
  - Additional research on this issue is warranted and needed.

Shortage of International Liquidity vs. Saving Glut

- The author is concerned about policy moves in the U.S., euro area, and Japan leading to insufficient global liquidity, dampening EM growth

- Today, global interest rates are unusually low from a historical perspective. These rates seem to be needed so that global investment spending equals global saving
  - Suggests sufficient liquidity (high levels of savings) over the medium term regardless of monetary policy decisions