BALSILLIE SCHOOL OF INTERNATIONAL AFFAIRS

Discord and Disruption

2019 Global Trends Report

An Anthology of Briefing Notes by Graduate Fellows at the Balsillie School of International Affairs

The Foreign Policy Research and Foresight Division at Global Affairs Canada is proud to support and be associated with the Graduate Fellowship Program/Young Thinkers on Global Trends Initiative. The challenges facing Canada today are unprecedented and truly global. Tackling those challenges require fresh ideas and engagement with new generations of thinkers, researchers, and activists to help create opportunities for a sustainable future. We would like to thank the students and professors of the Balsillie School of International Affairs for their time, effort and commitment throughout the year to make this initiative successful. The results of their work, which has been encapsulated in this anthology, will help inform the work of Global Affairs Canada as it relates to foreign policy, trade and international development.

Global Affairs Canada   Affaires mondiales Canada

BALSILLIE SCHOOL OF INTERNATIONAL AFFAIRS

67 Erb Street West
Waterloo, ON N2L 6C2 Canada
Telephone: 226 772 3001

Financial Stability and Global Macroeconomic Cooperation: Canada's Role Amid the Removal of Monetary Policy Accommodation by Leading Central Banks

Melsen Babe

Issue

The withdrawal of current or expected monetary policy accommodation by large, systemically important economies has the potential to create adverse global spillovers in the form of financial risks. The trade-off between asserting sovereignty over matters of domestic policy making and the benefits accrued from international cooperation lie at the forefront of the risks Canada faces, as well as the opportunities that are presented against this backdrop.

Background

The response to the 2007-2008 Global Financial Crisis has relied disproportionately on monetary policy accommodation in the large, systemically important economies — the United States, the euro zone, Japan and the United Kingdom — with China, where significant fiscal stimulus has been implemented, being the only exception. The setting of interest rates at the zero lower bound and even in negative territory in the euro area — and, more recently, Japan — as well as quantitative easing, have been employed by monetary authorities of the major central banks in an effort to spur growth. Renewed confidence in the strength of the global economy, coupled with a recent uptick in inflation expectations are prompting central bankers to wind down monetary policy accommodation.

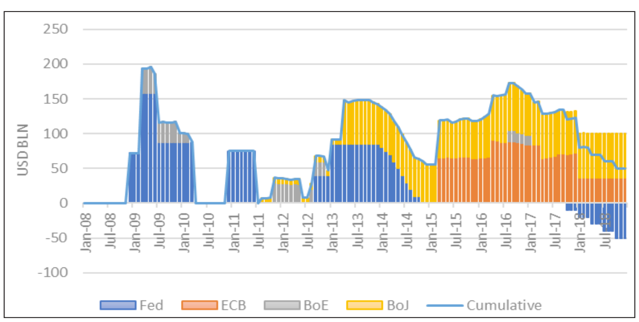
The Concerted, Global Withdrawal of Monetary Policy Accommodation

The US Federal Reserve has embarked on an interest rate hiking cycle and is currently in the process of reducing its USD$4.5 trillion balance sheet by incrementally ceasing the reinvestment of principal on the maturing bonds that it holds. The European Central Bank's (ECB) Governing Council has markedly curtailed purchases under the extended Asset Purchase Programme. Moreover, the council has hinted that a review of the language pertaining to its policy stance and forward guidance may be warranted, which constitutes a notable deviation from the long-held position of maintaining interest rates "at their present levels for an extended period of time, and well past the horizon of the net asset purchases" (ECB 2018).

Similarly, the Bank of Japan (BoJ) and the Bank of England (BoE) are also planning to participate in this global movement of monetary stimulus withdrawal. The BoJ, which has focused on yield curve control with an explicit zero percent target for 10-year Japanese government bonds since the second half of 2016 (BoJ 2017), has trimmed the amount of its purchases of longer-dated JGBs (Reuters 2018), which could potentially signal a willingness to raise the entire yield curve. Adding credence to this theory, is Governor Kuroda's (2017) mentioning of the restriction imposed by the "reversal rate" on maintaining persistently low interest rates (Brunnermeier and Koby 2018). For its part, the BoE raised its bank rate in November 2017 for the first time in a decade, while its asset purchases remain fully tapered (BoE 2017).

Further, financial risks emanating from elevated leverage in virtually every sector — state, banking, corporate, and consumer debt (Study Group of China Finance Forum 2017) — are compelling Chinese officials to place particular emphasis on deleveraging. Although the People's Bank of China has yet to reduce the assets it holds on its balance sheet (Yardeni Research Inc. 2018), Chinese monetary authorities are tightening their monetary stance by hiking interest rates, although only marginally so as to prevent a liquidity crisis, in addition to increasing reserve requirements (Bloomberg 2017). Apart from deleveraging in order to fend off financial fragility risks, China's recent removal of accommodation is also driven by the tightening of monetary conditions by the Fed. Indeed, a tighter stance by the Fed possesses adverse spillover effects on emerging market economies that do not follow suit due to an arbitrage in rates and ensuing capital outflows, as demonstrated by the taper tantrums of 2013 and 2014 (Rajan 2014; Miyajima et al. 2014).

Figure 1: Liquidity Injections by Leading Central Banks



Note: The injections are anticipated to decrease dramatically over the next few months.

Source: Author, using data retrieved from the Fed, ECB, BoE and BoJ websites in 2018.

Implications for Canada

While a lower-for-longer conventional and unconventional approach may possess adverse consequences — such as distorting the pricing mechanism of financial markets and leaving central banks with little room to manouever during the next downturn — the tightening cycle major central banks have embarked upon poses risks for Canada and the global financial community if commensurate measures are not taken to mitigate its effects. Adverse spillovers stemming from primarily the Fed's — and other leading central banks secondarily — tightening cycles affect small open economies such as Canada. To begin with, US short- and long-term interest rates not only impact corresponding rates in other emerging market and small open economies, but also policy rates, under both fixed and floating exchange rate regimes (Hofmann and Takáts 2015).

Furthermore, the cross-border spillover of liquidity conditions can amplify domestic imbalances to the point of instability. As a result, "the IMFS [International Monetary and Financial System] as we know it today not only does not constrain the build-up of financial imbalances, it also does not make it easy for national authorities to see these imbalances coming" (Caruana 2015). This phenomenon hinders the conduct of monetary policy in Canada. Most central banks target domestic inflation and let their currencies float or follow policies consistent with managed or fixed exchange rates in line with domestic policy goals, thereby interpreting their mandate exclusively in domestic terms.

Global liquidity conditions can spill over via four channels: through the conduct of monetary policy as easy monetary conditions spill over to the rest of the world in an attempt to resist currency appreciation and maintain competitiveness; through the international use of currencies, especially given the broad use of the USD and the Euro; through the integration of financial markets, which allows global common factors to move bond and equity prices, as well as uncertainty and risk aversion (as reflected in indicators such as the Volatility Index - VIX) to affect asset markets and credit flows everywhere; and the availability of cross-border capital flows, regardless of currency, which provide a source of funding that can amplify domestic credit booms and busts. Consequently, monetary and financial regimes reinforce each other through these channels by creating an easing bias in times of monetary accommodation and by amplifying financial tightening when accommodation is withdrawn by major central banks, respectively (Caruana 2015).

Risk 1: Spillovers due to the withdrawal of accommodation by leading central banks may amplify the tightening of financial conditions in Canada.

When the major central banks lowered their policy rates to the zero lower bound, the Bank of Canada (BoC) acted in a similar fashion, guided by concerns over economic weakness and by the impetus to resist CAD appreciation, which would lead to a loss of competitiveness. When the BoC raised its policy rate in 2011 (while major central banks were easing) in response to a temporary uptick in inflation, the CAD appreciated markedly. In other words, the unconventional monetary policies utilized by the major central banks have heavily influenced liquidity and financial conditions in Canada. Characteristically, when major central banks engaged in domestic bond-buying sovereign debt programs, demand for similar alternatives boosted purchases of Canadian sovereign debt, thereby driving down Canadian long-term bond yields.

Likewise, tighter monetary conditions as a by-product of the withdrawal of monetary accommodation will also be imported in Canada via global financial markets. Specifically, the integration of financial markets possesses the potential to make matters worse, given the current historically low pricing of volatility, as reflected by the VIX. A sharp reversal of volatility to the upside could quickly trigger margin calls and further restrain liquidity in an environment already characterized by a withdrawal of accommodation, as was witnessed briefly in February 2018.

Risk 2: The BoC's independence is at risk from the influence of leading central banks' monetary policies.

The global spillovers emanating form monetary policies enacted by major central banks threaten the ability of small open economy central banks, like the BoC, to pursue independent monetary policy setting. Robert Mundell's "impossible trinity" dictates the open macroeconomic policy choice. Trilemma policy arrangements affect the sensitivity of peripheral countries to policy changes in the centre economies, consisting of the United States, Japan, the euro area, and China (Aizenman, Chinn and Ito 2016). Moreover, the type of exchange rate regime a country implements affects the extent of sensitivity to changes in policies or financial conditions in the centre economies. The latter observation is especially important in the Canadian context given Canada's floating exchange rate regime, because the extent of pass-through from foreign interest rates to domestic interest rates is higher under floating exchange rate regimes than pegging regimes (Cerra and Saxena 2008).

Additionally, the performance of the BoC has implications for Canada's stature in the global arena. While the central bank conducts policy autonomously and independently *of* government, it is not independent *from* government. As such, the BoC's actions will continue to impact Canada's influence in international macroeconomic policy making. Further, the central bank governor plays an important supporting role in international fora such as the G20 and the International Monetary Fund (IMF).

Risk 3: The negative effects of tighter financial conditions on the Canadian housing market and the Canadian economy at large.

Extremely low interest rates, derived from global financial markets, have led to a credit boom and the buildup of excessive leverage in Canada. In turn, this credit boom has been reflected in heavy borrowing by Canadian consumers and, subsequently, in the housing market. Although the ability of Canadian consumers to continue to accumulate debt softened the blow of the 2007-2008 slump on the Canadian economy, domestic policy makers and international bodies are now explicitly expressing concern over Canadian household debt and the melt-up in the Canadian housing market (Bank for International Settlements [BIS] 2017; Schembri 2016). Notably, Governor Poloz (2017) has highlighted the financial stability risks associated with elevated housing prices and record household debt levels as a pressing matter of immediate concern to the BoC, while the BIS and the IMF have singled out housing as one sector where risks are highest, especially for Canada.

A rise in interest rates is already translating into higher mortgage payments, which is problematic because of stretched household debt levels. In addition to the negative consequences such a trend would entail for the affordability of debt service payments, an abrupt tightening of monetary conditions would also adversely impact the Canadian economy. Real estate related economic activity, the largest single contributing category, accounted for approximately 13 percent of the total Canadian GDP as of October 2017 (Statistics Canada 2018). Underlying the real estate sector's high level of contribution is the recent slump in commodity prices, particularly crude oil prices.

Risk 4: Interest rate increases possess negative implications for investment.

Interest rate hikes create a negative environment for investment due to two main reasons. First, and most explicitly, tighter financial conditions raise borrowing costs for businesses. Coupled with the appreciating effects on the Canadian dollar, higher interest rates discourage investment and consumption, thereby lowering spending, output, and employment. In turn, these conditions translate to lower wage growth and investment. The scenario sketched above is precisely one that unfolded in Canada during the 1990s, as a direct result of the contractionary policies of the late 1980s. In an effort to control the inflationary pressures during the late 1980s, the BoC tightened monetary conditions in the latter half of the decade and introduced inflation targets in 1991. However, the economy reacted more swiftly than had been predicted, and the 1990-1991 downturn was deeper than anticipated, as inflation came down faster than planned (Fortin 2001).

Further, the removal of monetary policy accommodation represents a reversal of the greatest monetary experiment to date. As such, uncertainty exists over the degree of success of this reversal while avoiding negative unintended consequences for the global economy and financial stability. Although Fed officials have communicated on numerous occasions that they expect the removal of policy accommodation to be quite uneventful, concerns over its materialization endure. Uncertainty undermines investment, as businesses become risk averse and choose a more conservative allocation of their capital. A failure to successfully uphold NAFTA would further exacerbate the latter problem, as cross-border investment across North America would be hampered.

Prospects for Cooperation: Why should Partners Care?

The standard argument in favour of macroeconomic cooperation is that cooperation is beneficial because of economic interdependence. Depending on relative size and the degree of openness, a development in any one country may be transmitted rapidly to other countries. Significant international economic interdependence can therefore lead to spillover effects, which, for countries lacking effective policy levers to counteract them, leaves cooperation as the only alternative (Frankel 2016). Current account transactions of goods and services and capital account transactions of assets can serve as channels for the transmission of economic fluctuations across countries (Choudri and Kochin 1980; Cantor and Mark 1987; Cole and Obstfeld 1991). The prevailing rationale for macroeconomic cooperation then is that it is best seen as a facilitating mechanism for internalizing, or mitigating, these spillover effects. This rationale gains particular saliency in an environment where open capital accounts occupy a central role and are combined with the existence of asymmetries in the exchange-rate regime in systemically important economies (Lane and Milesi-Ferretti 2014). This is precisely the role that multilateral institutions such as the G7 and the G20 are supposed to facilitate, and the central role for which they were created within the rules-based international order.

Integrating the links between financial stability and monetary policy has been the source of widespread discussion within international economic and financial fora, especially after the Global Financial Crisis. For instance, former General Manager of the BIS, Jaime Caruana (2015), has highlighted the need to find a framework that can satisfactorily integrate the links between financial stability and monetary policy. The development and adoption of such a framework underlies an overarching consideration, namely the trade-off between sovereignty and international coordination. In this vein, the recommendations below fall within both the international and domestic domains and position Canada uniquely among its global partners.

Recommendations

Canada should make a renewed push — at minimum — for macroeconomic cooperation at the G20 Buenos Aires Summit to take place in late 2018.

It is in this environment that Canada can step up and guide efforts pertaining to macroeconomic cooperation. While some may argue that Canada, as a middle power, faces limitations in driving forward change within the scope of multilateral institutions such as the G7 and G20, considerable room exists for Canada to continue to make a significant contribution on this front. Canada possesses substantial political capital and stature embedded in multilateral financial institutions due to the roles played by then-Finance Minister Paul Martin (along with then-US Treasury Secretary, Larry Summers) in creating the G20 and broadening its scope, as well as due to Mark Carney's role as chairman of the Financial Stability Board.

Moreover, Canada's proven record in emerging from the financial crisis relatively unscathed compared to a large number of G20 partners places Canada in a unique position to achieve this objective. As a result, Canadian policy makers are seen as credible on matters pertaining to macroeconomic policy and financial stability, and Canada punches above its weight internationally in this respect.

Still, there are those who argue that short of an economic or financial crisis, such discussions are relegated to a marginal capacity within the G7 and G20. On the contrary, placing this issue at front and centre is consistent with a turn to crisis prevention after the crisis, which is also reflected in the push for macroprudential regulation, and doing so would not break from convention. For instance, French President Macron has suggested that cryptocurrency regulation should be widely discussed at the upcoming G20 summit and his push was successful, as the regulation of cryptocurrencies has entered the agenda of this year's G20 summit. While cryptocurrencies have formed a buzz in the financial community due to their novelty, by comparison, the issue under discussion is more salient and possesses more far-reaching implications for the international monetary system.

Addressing this vital global issue falls well within the purview of priorities set by Global Affairs Canada in the latest two Departmental Plans, namely strengthening the rules-based international order, and reinforcing Canada's relations with the US and other key partners to advance Canadian interests (GAC 2017; 2018). In line with this recommendation, Canada should advocate that G20 partners:

- pledge to refrain from competitive currency devaluations; and
- implement fiscal strategies that are conducive to growth while enhancing resilience and ensuring debt as a share of GDP is on a sustainable path.

The BoC should resist keeping pace with major central banks in its tightening cycle in favour of an even more gradual approach.

The data-dependent BoC should not react too keenly to recent favourable economic data by raising interest rates prematurely. Instead, it should signal a preference to let inflation run above its two percent target, within its three percent upper bound, especially since inflation has been undershooting. Sustaining a slightly more accommodative policy amid a global tightening cycle would cushion the Canadian economy from the spillover effects of major central banks.

Two main risks could arise from this choice. First, an easier stance would weaken the CAD vis-à-vis the USD. However, some weakening of the currency may be warranted, as according to the 2017 IMF Article IV consultation, the CAD is overvalued by about two to 10 percent relative to medium-term fundamentals and desirable policies.

Additionally, adopting a lower-for-longer approach could restrict the BoC's room to act during the next economic shock. This concern can be overcome by the precedent that has already been set by major central banks in the form of unconventional monetary policies, namely implementing negative rates and engaging in asset purchases. The BoC's own research shows that it, too, could lower its policy rate below zero if necessary.

The implementation of this recommendation may aid in combating some of the adverse effects identified in my analysis of implications for Canada stemming from the withdrawal of current or expected monetary policy accommodation, especially that of reduced investment. Maintaining a looser stance would also signal that Canadian monetary authorities have learned from the challenges their peers face or have faced in the past: some Fed officials are deliberating whether the central bank is tightening too soon; the ECB did not ease soon enough at the outset of the crisis; and the BoJ never eased aggressively enough.

While the first two recommendations may seem contradictory with one another, that is not the case. To start with, Canada is not a systemically important economy in terms of the country's monetary policy possessing spillover effects for other countries. Furthermore, Canada's floating exchange rate means that policy makers are not manipulating the CAD; indeed, market forces are responsible for its fluctuations. Lastly, historically, Canadian monetary policy has been cautious.

The Canadian federal government should stand ready to provide fiscal stimulus at the outset of the next downturn.

Central banks cannot effectively fight recessions by being the "only game in town" (El-Erian 2016). Given that extended leverage has prevented a contraction akin to that experienced by other advanced economies during the financial crisis, Canada might enter a recession with little room for monetary stimulus to be applied, especially if the second recommendation is followed. The federal government should step in by adopting policies appropriate to stimulate aggregate demand, since it certainly has room to run, as indicated repeatedly by the IMF's Managing Director, Christine Lagarde (2016).

About the Author

Melsen Babe is a student in the University of Waterloo's Ph.D. in Global Governance program, based at the BSIA, and a CIGI Graduate Fellow.

Acknowledgements

I extend my gratitude to my mentor Pierre Siklos for his support, guidance, expert feedback and patience throughout this process. Special thanks to the BSIA, CIGI and the Global Affairs Canada for providing me with this valuable opportunity.

Works Cited

Aizermann, Joshua, M.D. Chinn, and H. Ito. 2016. "Monetary policy spillovers and the trilemma in the new normal: periphery country sensitivity to core country conditions." *Journal of International Money and Finance* 68 (2016): 298-330.

BIS. 2017. "International banking and financial market developments." *BIS Quarterly Review* 2017 (September).

Bloomberg. 2017. "China Follows Fed in Tightening, Though Makes Smaller Moves." www.bloomberg.com/news/articles/2017-12-14/china-s-central-bank-raises-borrowing-costs-following-fed-hike.

BoE. 2017. "Monetary Policy Summary and minutes of the Monetary Policy Committee meeting ending on 1 November 2017." www.bankofengland.co.uk/-/media/boe/files/monetary-policy-summary-and-minutes/2017/november-2017.pdf?la=en&hash=7A84C9D21E7D59FCAB62C2BDAD4323A16C7E4479.

BoJ. 2017. "Minutes of the Monetary Policy Meeting on October 30 and 31, 2017." www.boj.or.jp/en/mopo/mpmsche_minu/minu_2017/g171031.pdf.

Brunnermeier, Markus K.,and Yann Koby. 2018, forthcoming. "The Reversal Interest Rate." https://scholar.princeton.edu/sites/default/files/markus/files/20p_reversalrate.pdf.

Cantor, Richard and Nelson C. Mark. 1987 "International Debt and World Business Fluctuations. *Journal of International Money and Finance* 6 (2): 153–65.

Caruana, Jaime. 2015. "The international monetary and financial system: eliminating the blind spot." Panel remarks at the IMF conference "Rethinking macro policy III: progress or confusion?" Washington DC, 16 April 2015. www.bis.org/speeches/sp150430.pdf.

Choudri, Ehsan and Levis A. Kochin. 1980. "The Exchange Rate and the International Transmission of Business Cycle Disturbances: Some Evidence from the Great Depression." *Journal of Money, Credit and Banking* 12 (4): 565–74.

Cole, Harold L. and Maurice Obstfeld. 1991. "Commodity Trade and International Risk Sharing." *Journal of Monetary Economics* 28 (1991): 3–24.

ECB. 2018. "Account of the monetary policy meeting of the Governing Council of the European Central Bank, held in Frankfurt am Main on Wednesday and Thursday, 13-14 December 2017." www.ecb.europa.eu/press/accounts/2018/html/ecb.mg180111.en.html.

Cerra, Valerie, and S. Saxena. 2008. "Growth dynamics: The myth of economic recovery." *The American Economic Review* 98 (1): 439-457.

El-Erian, Mohamed. 2016. *The Only Game in Town.* New York: Random House.

Fortin, Pierre. 2001. "Interest Rates, Unemployment and Inflation in the 1990s: The Canadian Experience." In Keith G. Banting, Andrew Sharpe, and France St-Hilaire (eds.), *The Review of Economic Performance and Social Progress, 2001*. Montreal: Institute for Research on Public Policy.

Frankel, Jeffrey A. 2016. "The Plaza Accord 30 Years Later." In C. Fred Bergsten and Russell Green (eds.), *International Monetary Cooperation: Lessons Learned from the Plaza Accord After Thirty Years*. Washington, D.C.: Peterson Institute for International Economics: Chapter 6.

GAC. 2017. "Department Plan 2017-2018." http://international.gc.ca/gac-amc/publications/plans/dp-pm/dp-pm_1718.aspx?lang=eng#a2.

———. 2018. "Department Plan 2018-2019." http://international.gc.ca/gac-amc/publications/plans/dp-pm/dp-pm_1819.aspx?lang=eng.

Hofmann, Boris and Előd Takáts. 2015. "International Monetary Spillovers." *BIS Quarterly Review* 2015 (September): 105–18.

Kuroda, Haruhiko. 2017. "Quantitative and Qualitative Monetary Easing and Economic Theory." Speech at the University of Zurich, Switzerland, November 13, 2017. www.boj.or.jp/en/announcements/press/koen_2017/data/ko171114a1.pdf.

Lagarde, Christine. 2016. "Boosting Growth and Adjusting to Change." Remarks by Christine Lagarde, Managing Director of the IMF, Northwestern University, September 28, 2016. www.imf.org/en/News/Articles/2016/09/27/AM16-SP09282016-Boosting-Growth-Adjusting-to-Change.

Lane, Phillip R. and Gian Maria Milesi-Ferretti. 2014. "Global Imbalances and External Adjustment after the Crisis." IMF Working Paper 14/51. www.imf.org/external/pubs/ft/wp/2014/wp14151.pdf.

Miyajima, Ken, M. S. Mohanty and James Yetman. 2014. "Spillovers of US unconventional monetary policy to Asia: the role of long-term interest rates." BIS Working Paper No 478. www.bis.org/publ/work478.pdf.

Poloz, Stephen S. 2017. "Three things keeping me awake at night." Remarks by Mr. Stephen S. Poloz, Governor of the Bank of Canada, to the Canadian Club Toronto, Toronto, Ontario, 14 December 2017. www.bis.org/review/r180102b.pdf.

Rajan, Raghuram. 2014. "Competitive Monetary Easing: Is it yesterday once more?" Remarks by Raghuram Rajan at the Brookings Institution, April 10, 2014. www.brookings.edu/wp-content/uploads/2016/07/rajan_remarks_at_brookings.pdf.

Reuters. 2018. "Japan's central bank trims bond purchases, prompting taper talk." www.reuters.com/article/us-forex-yen/japans-central-bank-trims-bond-purchases-prompting-taper-talk-idUSKBN1EY0FF.

Schembri, Lawrence. 2016. "Connecting the Dots: Elevated Household Debt and the Risk to Financial Stability." Remarks by Lawrence Schembri Deputy Governor of the Bank of Canada, Guelph Chamber of Commerce, Guelph, Ontario, 24 February 2016. www.bankofcanada.ca/wp-content/uploads/2016/02/remarks-240216.pdf.

Statistics Canada. 2018. "Gross domestic product at basic prices, by industry (monthly)." www.statcan.gc.ca/tables-tableaux/sum-som/l01/cst01/gdps04a-eng.htm.

Study Group of China Finance Forum. 2017. "Level and Structure of Leverage versus Financial Stability: Theory and Evidence." PBOC Working Paper No.2017/1. www.pbc.gov.cn/english/3278277/3278290/index.html.

Yardeni Research Inc. "Global Economic Briefing: Central Bank Balance Sheet." www.yardeni.com/pub/peacockfedecbassets.pdf.