

1. The current state of the financial system and capital markets
  - a. The global financial crisis of 2007–09 and the “Great Recession” have propelled three key facets of economic policy into uncharted territory simultaneously:
    - i. Monetary policy—policy interest rates at zero and enormous increases in central bank balance sheets; unprecedented central bank quantitative easing and credit easing; very large decreases in money multipliers (“reserve hoarding” by banks); central bank purchases of private sector assets that have significant credit risk.
    - ii. Fiscal policy—massive fiscal stimulus measures to mitigate the recession has caused actual and projected fiscal deficits to jump *far outside* the range where fiscal sustainability can be restored without an extraordinary fiscal effort.
    - iii. Financial regulation—moral hazard has been spread throughout the global financial system, not as a result of premeditated and internationally harmonized regulatory actions but because of the contagion in the provision of state guarantees to prevent deposit flight from one national banking system to another.
  - b. The new architecture of financial regulation is still an unfinished project. Recent proposals have not been closely coordinated internationally, creating large areas of uncertainties that make it difficult for financial institutions to design appropriate medium-term business strategies.
2. Intended and unintended consequences
  - a. As expected, policy interest rates at zero and the huge stock of central bank liquidity have led to a rather steep yield curve.
  - b. However, unintended consequences of the policy stance are already evident:
    - i. Zero policy interest rates in key economies, sticky exchange rates against the U.S. dollar, and the rapid growth of central bank liquidity have led to a highly correlated rise in the prices of global equities, junk bonds and—in regions less touched by the crisis—real estate.
    - ii. As risk appetite has returned, risk spreads, volatility, and other market-based measures of risk have declined.
3. Sequencing of the exit from the current extraordinary stance of economic policies

- a. The first important point to keep in mind is that the ability of financial institutions and markets to adjust to the authorities' exit from their extraordinary initiatives depends fundamentally on the creation of an appropriate environment of macroeconomic conditions, one that stabilizes expectations of sustainable noninflationary growth..
- b. The second thing to remember is that fiscal sustainability is the essential element of sound economic governance over the longer term.
- c. Therefore, in the long term, a sustainable fiscal stance—one that does not require continuous increases in debt or in the tax burden as a proportion to GDP—is the bedrock of sound macroeconomic management. And the expectation that governments will implement sound macroeconomic policies is the ultimate anchor that stabilizes expectations and thus financial markets.

#### *Step one*

Create confidence that the fiscal position in the United States, the United Kingdom, and other countries that are currently running unsustainable fiscal deficits will be brought back to a sustainable level in the not-too-distant future.

#### *Step two*

- First, maintain policy interest rates as low as possible for as long as possible without causing inflation expectations to become unanchored.
- Second, make a major shift to exit from current policies of quantitative easing, credit easing, and purchasing of private sector financial assets to liquefy key (segmented) markets.

Normalization of monetary policy is not feasible without the first step. Unless there is a credible fiscal plan, raising policy interest rates will cause market-determined longer-term rates to rise, increasing the debt-to-GDP ratio. This would be a very negative signal for financial markets.

But even if a forceful adjustment plan to achieve fiscal sustainability can be announced soon and is seen by the markets as credible, the challenges for monetary policy will still be enormous.

#### *Step three*

Establish a credible macroprudential regulatory agency or “financial system risk regulator” in the United States and other key jurisdictions:

- The agency must be responsible and accountable for identifying changes in the level of systemwide financial risk.

- The agency must have the authority to create countercyclical buffer mechanisms, which mitigate systemwide risk by building higher capital buffers and stronger liquidity cushions in the upswing of the credit cycle and allowing them to run down in periods of financial stress.

#### *Step four*

Establish an internationally harmonized intervention and resolution regime for large, systemically important, cross-border financial institutions. The regime must shift the burden of bearing financial losses to unsecured creditors and shareholders to motivate them to monitor financial risks actively. The blanket guarantees on bank liabilities that were introduced during the panic in the fourth quarter of 2008 can then be eliminated.

#### *Step five*

Transform the current ad hoc system of swap facilities among key central banks into a permanent, collateralized, multicurrency Lombard facility.

The institution could be based on a permanent system of swap facilities among the central banks responsible for the key currencies. It would have consistent rules on collateral and haircuts to allow, for example, the ECB to lend dollars overnight to banks in the euro area or the Federal Reserve to lend euros to U.S. banks in need of overnight foreign currency liquidity.

#### *Step six*

In other countries, take appropriately coordinated policy actions to support the sequenced exit by the countries at the heart of the recent financial crisis:

- Needed fiscal policy actions in those countries where deficits and debt are rising should have the same priority as those described above for the United States and the United Kingdom.
- But the monetary and exchange rate policies should be different. Central banks in China and other emerging market economies should implement policies that allow their real exchange rates to rise. For most of these countries exchange rate appreciation would be a more efficient means of achieving this objective than allowing their inflation rates to accelerate.

China should also use this opportunity to undertake a sequenced liberalization of capital transactions and to strengthen the capital adequacy of its banks, both of which would tend to mitigate the upward pressure on its exchange rates.

#### *Step seven*

Phase in internationally harmonized reform of the global architecture of financial regulation in a way that avoids a credit crunch but limits the scope for regulatory arbitrage across jurisdictions.