

## Special Feature A

# Asian Monetary Policy Forum 2020<sup>1</sup>

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## 1 Introduction

The 7<sup>th</sup> Asian Monetary Policy Forum was conducted virtually on 12 June 2020. As in past years, it was convened under the auspices of the Asian Bureau of Finance and Economic Research (ABFER) and co-organised by the University of Chicago Booth School of Business, the National University of Singapore (NUS) Business School and the Monetary Authority of Singapore (MAS). This year's presentations revolved around three key themes: (i) the economic impact of COVID-19 and macroeconomic policy response; (ii) international economic cooperation and coordination; and (iii) a safe-asset perspective to integrated macro policymaking.<sup>2</sup>

## 2 Welcome Remarks

The Forum was opened by Edward S. Robinson, MAS Deputy Managing Director and Chief Economist, with a characterisation of the extraordinarily sharp economic decline effected by the unique transmission of the COVID-19 shock compared to that of usual business cycle recessions. On the supply side, there has been a reduction in labour supply due to lockdowns and social distancing measures. On the demand side, the sharp fall in global consumption and investment demand, as well as disruptions to global trade, amplified the negative supply shock. The mutually reinforcing interactions of supply and demand shocks produced a sharper decline in economic activity than in conventional business cycle recessions and resulted in a "sudden stop". This reflected the unique nature of the negative supply and demand shocks during the pandemic—which some have termed "Keynesian supply shocks" (Guerrieri *et al.*, 2020).

## 3 Opening Address: Gita Gopinath

### Characterising the COVID-19 Shock

Gita Gopinath, the IMF's Economic Counsellor and Director of the Research Department, delivered the Forum's Opening Address, noting at the outset that COVID-19 represented the first truly global crisis since the Great Depression.

Simultaneous recessions for AEs and EMs represent a highly unusual feature of the current crisis, even compared to past shocks that have had global reach. For example, during the GFC, several large EMs, notably China and India, managed to largely avoid the severe crisis experienced by most AEs. Thus, Gopinath argued that the current crisis is significantly broader and deeper than the GFC. As countries attempt to reopen their economies,

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<sup>1</sup> This article provides an overview of the AMPF 2020 discussions, based on the full documentation of proceedings by Chia Wai Mun, Associate Professor of Economics at the School of Social Sciences, Nanyang Technological University (NTU). It has benefitted from comments and inputs by Professor Bernard Yeung, President of ABFER and Stephen Riady Distinguished Professor at the NUS Business School. The views in this article should not be attributed to MAS, NTU or NUS.

<sup>2</sup> All videos of the presentations and accompanying materials are available on the ABFER-AMPF webpage, which can be accessed at <http://www.abfer.org/events/abfer-events/asian-monetary-policy-forum/187:e-ampf2020>.

heterogeneity in countries' success at containing the pandemic is already leading to a desynchronised phasing out of containment measures across countries, which will continue to dampen the global economic recovery.

Aside from the direct impact of the public health crisis on domestic economies, COVID-19 has also manifested as a multi-faceted external shock, disrupting commodities markets and portfolio flows across countries. In particular, the health crisis has led to a collapse in demand for transportation and hence a sharp decline in oil and commodity prices, which led to a further deterioration in economic conditions for commodity and oil exporters. Further, many EMs, including some Asian economies, experienced large reversals in portfolio flows at the beginning of the crisis. While flows have somewhat normalised, the risk of sharp withdrawals in external financing remains a prominent one as the crisis unfolds.

Unlike the GFC, there has been a disconnect between financial markets and the real economy in both AEs and EMs. Despite the crisis, there have been substantial increases in stock prices across the globe, beyond what could be explained by the outstanding performance of technology and pharmaceutical firms in stock indices. While borrowing spreads in EMs widened during the early phase of the COVID-19 crisis, they have been generally lower than during the GFC. Gopinath highlighted three Asian countries, namely Vietnam, Malaysia and India, where sovereign spreads were larger during the GFC than those seen so far during the COVID-19 crisis. She noted that given the projected scale of the hit to the global economy, one might expect these spreads to be significantly larger in the current crisis. Similarly, exchange rate depreciations among EMs and developing economies have been far more modest relative to the scale of the pandemic shock.

### Policy Responses So Far

The relative resilience of financial markets reflects the scale and timeliness of monetary policy responses, via the cutting of policy rates and the infusion of liquidity. In this regard, Gopinath noted that central bank swap lines have been important for maintaining liquidity in global financial markets. Aside from monetary policy, some countries have also expanded fiscal spending on a much larger scale than during previous crises. However, many EMs, in particular some low-income Asian economies, face more constrained fiscal space. Another challenge has been the need for governments to disburse transfers to larger segments of the population that are usually out of reach of safety-net programmes. This is particularly challenging for low-income Asian economies with a large proportion of their populations in informal employment.

### Outlook for Recovery and Policy Considerations

Gopinath highlighted some factors that may prove advantageous for Asian economies. First, they benefit from low global oil prices as net importers. Second, the region has had much better success in containing the spread of the virus. Third, Asian EMs generally have lower external and fiscal vulnerabilities in comparison to their peers.

Conversely, Asian countries are exposed to contractions in international trade, given their relatively high degree of openness. Beyond the crisis, ongoing geopolitical risks stemming from US-China tensions and the rise in protectionism may have spillover effects on Asian economies through their impact on global supply chains. In addition, the potential for high volatility in capital flows remains, even though it has so far been mitigated by central bank actions to ease monetary conditions via currency swap lines and emergency liquidity facilities.

As long as a medical solution to COVID-19 remains elusive, economic policymakers will have to continue finding ways to support incomes and revenues of workers and firms, in order to preserve job matches. However, as some activities become unviable, it may become necessary to shift the policy emphasis from preserving job matches to reallocating workers to growing sectors that can absorb them. Policymakers may also have to contend with difficult choices about allocating support to firms that have strategic importance. To complement economic policy support, public health policies that minimise health uncertainty, such as widespread testing, contact tracing (effective if the number of cases is low), and mask wearing (the least economically disruptive intervention) should continue. Effective communication to the public about the phased reopening will also be important for reducing uncertainty.

Maintaining financial stability and ensuring sufficient liquidity in international debt markets will also be crucial, as critical spending needs of developing economies have to be met. The IMF has so far implemented several policies to ensure that financing needs are met. These include making available emergency financing for countries that face difficulties undertaking health spending, providing debt service relief so that they can use their resources for local health spending needs, and putting in place a new short-term liquidity line.

Gopinath concluded by emphasising the importance of global cooperation, in view of real risks from rising protectionism and geopolitical tension. The benefits from globalisation will continue to be significant, even while efforts to mitigate some of its distortionary consequences continue.

## 4 Keynote Speech: Adam Posen

In his speech, Adam S. Posen, President of the Peterson Institute for International Economics (PIIE), considered the challenges of global cooperation and provided an evaluation of realistic international coordination and cooperation possibilities against the backdrop of the current global health and economic crisis.

Posen reflected that the experience of global policy coordination during the current pandemic has seen a mixture of successes and failures. On both monetary and fiscal policy fronts, there has been rapid convergence within the economic community on optimal policy responses to the pandemic. Posen attributed the ability to achieve such convergence to the lessons learned from the GFC.

Posen then shared his views on failings in international coordination that have characterised the current crisis. In particular, he highlighted the importance of political divisions, both domestic and international, in preventing international coordination that would have helped to reduce the severity of the public health crisis. At the root of these political divisions is geopolitical distrust.

Posen presented potential solutions to the problem of geopolitical distrust, drawing on his joint work with Maurice Obstfeld from the University of California, Berkeley, that emphasises a key principle for international policy coordination: agreement should be sought over establishing commonality in the actions and approach of governments, rather than trade-offs individual countries are required to make (Obstfeld and Posen, 2020). A salient example of the former is in the G20's agreement on currency issues in 2012, under which the world's major economies agreed to avoid competitive currency devaluations, which has by and large been adhered to. By requiring each country to adhere to the same broad standard

of behaviour that binds all other parties, the 2012 G20 agreement on currency devaluation avoided disputes over what constituted desirable target outcomes for individual countries.

This approach is in contrast to one where parties to an agreement are each required to make significant private trade-offs in pursuit of a target outcome, such as in the example of the Plaza Accord of 1985 between the US and its major trading partners. Countries that had large trade surpluses with the US, such as Japan and Germany, were required to appreciate their currencies against the US dollar, which led to subsequent unresolved disagreements over whether each country did enough to ensure desirable outcomes.

On the contrary, Posen argued that the recent international agreement to establish US dollar swap lines between the Federal Reserve and other central banks is an example of the desired approach, where agreement is reached on common behaviour for central banks to supply US dollar liquidity to other central banks in the event of market stress.

In assessing the finer practicalities of the current G20 agenda, Posen (in collaboration with his colleagues at PIIE) identified four crucial components around which international cooperation should be prioritised going forward. The first component is to increase peer pressure between governments to encourage compliance with best policy practice. The second is to take decisive action to prevent financial crises. The third is to prevent mutual economic aggression between economies who are already suffering from effects of the pandemic. The last and most crucial component of the G20's agenda should be to help the world's poor survive the current pandemic.

Returning to the subject of international policy coordination in the current crisis, Posen observed that the relative success of monetary policymakers so far in the response to COVID-19 can partly be attributed to a common analytical understanding among central banks about the symptoms and causes of financial crises. There is a shared recognition that financial crises can be prevented by timely interventions to provide market liquidity, via a combination of quantitative easing, credit swap lines and direct credit provision. This is in sharp contrast to the coordination failures among public health authorities around mutual reporting of disease data, coordinated tracking of border movements and sharing of scientific information during the pandemic. Posen attributed these failures of collective action to self-interested national governments who might have avoided data disclosures to avoid panic or faced political incentives to deny the severity of the disease.

Posen concluded on a positive note, reflecting on the successes of the G20 in fostering international coordination in monetary policy and, to some extent, fiscal policy in recent years. These successes give a measure of confidence that international coordination can be constructive during the current crisis. The nature of the COVID-19 crisis as a common threat with similar impacts across countries implies that effective frameworks for international coordination should rely on establishing common behaviour, rather than targeting outcomes.

## 5 Commissioned Paper

The background of this year's commissioned paper is the IMF's proposal for an integrated policy framework (IPF) for the joint use of monetary policy, macroprudential policies, foreign exchange interventions and capital controls to address the challenges of macroeconomic policymaking in a world of volatile capital flows and monetary policy spillovers (e.g., Basu *et al.*, 2020). Building on New Keynesian models, the IMF's IPF analysis typically motivates policy interventions based on frictions caused by price stickiness. The

AMPF 2020 Commissioned Paper, jointly contributed by Markus K. Brunnermeier from Princeton University, Sebastian Merkel from Princeton University and Yuliy Sannikov from Stanford University, proposes an integrated policy framework motivated by financial frictions that are particularly relevant for EMs. In his presentation, Brunnermeier emphasised that financial frictions, such as collateral requirements, create a demand for safe assets such as domestic money and government debt. The demand for the services provided by safe assets allows governments that issue them to borrow at lower rates, but EMs' ability to issue safe assets cannot be taken for granted as they have to compete with international safe assets denominated in foreign currency such as the US dollar.

### Characterising a Safe Asset

The two distinguishing features of a safe asset can be captured by the “good-friend” analogy and the safe-asset tautology. The good-friend analogy means that a safe asset is like a good friend that is available when one needs it, especially in times of market stress. The safe-asset tautology means that an asset is safe because others perceive it as such. These features imply that safe asset values remain relatively stable after negative shocks, and that the asset has high market liquidity.

Safe assets provide services to their holders as they may loosen collateral constraints, facilitate trade when there is no double-coincidence of wants, and allow for insurance through re-trading. Because of these additional service flows, safe assets are worth more than their fundamental value, which is defined as the discounted value of their underlying stream of cash flows. In asset pricing theory, safe assets are said to have a bubble component.

Specifically, the total real value of domestic safe assets such as money and government debt consists of the expected present value of primary fiscal surpluses plus the convenience yield, which represents the value of transaction, collateral and insurance services flows provided by the safe asset. When risk in the economy increases, so does the convenience yield and the bubble component of safe assets.

Brunnermeier and his co-authors provide a simple condition to characterise the conditions for emergence of a “bubbly” component in the value of the safe asset:

$$r + p < g \tag{1}$$

Inequality (1) states that the sum of the real risk-free discount rate,  $r$ , and the safe asset risk premium,  $p$ , have to be smaller than the growth rate of the economy,  $g$ , for the bubble value to be sustainable. That is because, to a first approximation, the growth rate of the economy provides an anchor for the growth rate of the value of services provided by the safe asset for its use as insurance, collateral and in transactions. When US interest rates are low and growth is high, EM governments have “room” to increase the supply of safe assets by the gap between the two sides of the inequality, without increasing indebtedness relative to GDP.

### The Three Phases of a Financial Cycle

Brunnermeier and his co-authors categorise the global financial cycle into three key phases. The initial phase is termed the *risk-off phase*, characterised by tight US monetary policy with high US interest rates. Households and firms in the EMs see the US dollar safe asset, namely US Treasuries, as an attractive investment. Thus, the domestic safe asset faces fierce competition from the US dollar safe asset and hence the value of EM government debt

is equal to the expected present value of fiscal primary surpluses. In this phase, there is no bubble.

Next comes the *temptation phase*, which starts when the US interest rate starts to decline. With a lower US interest rate, the domestic safe asset becomes more attractive relative to the US dollar safe asset. Households and firms borrow US dollars to loosen their collateral constraints or any restrictions as a result of macroprudential policy and use the domestic safe asset as a hedge for their risk. Cheap dollar funding leads to an investment boom which in turn boosts the growth rate of the economy. When the growth rate of the economy is larger than the value of services provided by the safe asset—the sum of real risk-free rate and safe asset risk premium—the safe asset acquires a bubble component. It is this “bubbly” value that tempts the EM’s government into increasing the supply of government-issued safe assets and hence “mine” the bubble. As long as the bubble term remains, the government can continue to issue new debt and hence generate a steady flow of revenue that does not have to be paid for by future taxes.

Finally, the *wobbly bubble phase* begins when the prospect of rising US interest rates makes it more difficult for the domestic safe asset to sustain the bubble. Specifically, Inequality (1) is increasingly binding. First, in order for the domestic safe asset to remain competitive with the US dollar safe asset, the real risk-free rate must be higher, making it harder to satisfy the bubble condition. Second, the possibility of the bubble bursting necessitates a positive risk premium, making the bubble condition harder to satisfy. When the bubble bursts, the value of safe assets falls back to its fundamental level and a reduction in asset prices and domestic investment results.

## Policy Implications

How should EMs insulate their economies from the US monetary policy cycle and avoid the bursting of safe-asset bubbles? Brunnermeier and his co-authors suggest an interpretation of integrated policy frameworks as a menu of policy interventions to prevent the bursting of the EM’s safe-asset bubble and avoid the third stage of the cycle.

They analyse the macroeconomic policy considerations through the lens of Inequality (1). As long as Inequality (1) holds, the bubble value of the domestic safe asset remains intact. From this perspective, fiscal measures including tax hikes that shore up the EM government’s long-run fiscal position can reduce the risk premium associated with the EM asset and support the fundamental value of the safe asset. However, instituting tax hikes directly undermines the government’s ability to effect countercyclical fiscal policy, which is problematic as risk-off conditions in global financial markets are likely to pose a contemporaneous drag on growth.

Another set of policies aims to prop up the bubble component of EM safe assets, by ensuring that these assets maintain a stable value and high market liquidity. If implemented *ex-post* (after the risk-off transition), these policies may take the form of capital controls or exchange rate intervention. By preventing capital outflows, holders of the EM safe asset may be persuaded that there will not be a run on the safe asset, enabling it to maintain its value. It is also noted that such *ex-post* capital controls may raise the “bubbly” value of domestic asset from an *ex-ante* perspective. If agents know that the bubble will remain even after the increase in the US interest rate, they will be more willing to hold the domestic safe asset. Foreign exchange interventions, in the form of large purchases of the EM safe asset, can also help to maintain their value and market liquidity during the wobbly bubble phase.

*Ex-ante* macroprudential policy measures that restrict excessive leverage during booms can make the economy less vulnerable to the adverse amplification loop in the wobbly bubble phase, and hence help to preserve the safe-asset status of domestic public debt. Stricter macroprudential policy during booms allows central banks to accommodate capital outflows with a smaller stock of foreign reserves. Macroprudential policy that forces banks to hold more domestic government debt also implicitly imposes a restriction on capital outflows as it reduces the resources available to purchase foreign assets. Additionally, central banks can also accumulate reserves to credibly signal that they are committed to intervene in foreign exchange markets and impose losses on speculators attacking their currency.

The paper also explains why the Mundell-Fleming trilemma is realistically a dilemma. The conventional Mundell-Fleming trilemma states that countries may choose two out of three alternatives: fixed exchange rates, perfect capital mobility and monetary independence. The dilemma states that even if the exchange rate is fully flexible, competition between the domestic safe asset and US Treasuries curtails EMs' monetary independence. A reallocation towards US Treasuries leads to pressure on the domestic currency to depreciate and inflationary pressures. If the central bank chooses to tighten monetary policy to stabilise prices, bank capitalisation is impaired, potentially triggering a contractionary loop within the domestic economy. Conversely, if the central bank chooses to make monetary policy more accommodative, stress in the banking system is avoided, but lower domestic interest rates may cause the bursting of the bubble component of the domestic safe asset. Therefore, unable to pursue independent monetary policy, EMs face not a Mundell-Fleming trilemma, but a dilemma.

In summary, macroprudential policies and capital controls are substitutes while monetary policy is complementary to macroprudential policies and capital controls. Stricter *ex-ante* or *ex-post* macroprudential policies or both, possibly combined with capital controls, create more space for monetary policy.

How can we build a global financial architecture where EMs are less vulnerable to sudden stops? Brunnermeier and his co-authors suggest that the core problem is not a shortage of safe assets *per se*, but that safe assets are not consistently supplied to all countries. To solve this issue, they propose that EMs could issue two bonds, a senior bond and a junior bond with all the risk concentrated on the junior bond and no risk in the senior bond. As a result, the senior bond becomes a safe asset, making it easier and more sustainable to satisfy the bubble condition with no risk premium. Investors can reallocate assets towards the senior bond instead of US Treasuries, reducing the pressure on exchange rate and inflation.

In order to prevent the moral hazard problem of a country diluting its senior bonds by issuing super-senior bonds, the authors propose a system of international coordination. The idea is to create Global Safe Bonds (termed GloSBies), which pool liabilities from a group of countries tranching into senior and junior grades. The proposal calls for an international special purpose vehicle (SPV) that buys a fraction of EM sovereign bonds and requires commitment by participating EMs to service the portion of the debt sold as the senior tranche first. The senior tranche will then have safe-asset status, lowering overall funding costs for EMs. Under such a system, the authors argue that during risk-on periods, international investors will allocate a larger part of their portfolio to junior tranches, reversing the allocation during risk-off periods. Such a system would benefit from diversification of the pooled liabilities if the pool contains bonds from a sufficiently large group of EMs. Further, it can help to prevent large-scale capital flight from EMs, as they retain the ability to issue liabilities via senior tranches of GloSBies. The authors argue that eventually, EMs would not need the

Federal Reserve to intervene with swap lines or the IMF to provide short term liquidity, as the system is designed to be self-stabilising.

## Comments and Discussion

Following Brunnermeier's presentation of the Commissioned Paper, Bernard Yeung, President of ABFER and Stephen Riady Distinguished Professor at the NUS Business School, engaged him in a dialogue on the paper, based on comments by Viral Acharya from New York University and Frank Smets from the ECB and KU Leuven.

Acharya argued that when government expenditures are myopic in motivation and wasteful in terms of long-run economic outcomes, expanding the provision of safe assets may lead to crowding out of private sector growth, as most domestic savings would remain parked in the safe asset, potentially increasing endogenous risk in the economy arising from the safe asset's bubble component. With regard to the paper's policy recommendations, Acharya highlighted some difficult trade-offs: while capital controls may be desirable in good times to limit the exposure to external shocks, they may choke the growth of the already crowded-out private sector and aggravate the endogenous risk to the safe asset bubble.

Smets questioned the empirical relevance of the dilemma characterised by Rey (2013), mentioning the findings by Dedola *et al.* (2017) that US monetary policy tightening is deflationary in EMs. He also raised concerns about moral hazard issues arising from cleaning (*ex-post* policies) instead of leaning (*ex-ante* policies). If agents realise that the central bank or other government authorities will intervene by satisfying the demand for safe assets and thereby short-circuit the financial bust and negative feedback loops, the size of the domestic safe asset bubble may grow further, increasing the amplitude of the financial cycle.

Brunnermeier concurred with the importance of governance quality to support the safe-asset bubble and curb endogenous risk. Ideally, the advantages of the ability to issue domestic safe assets may provide incentives for EMs to develop strong governance in capital markets. To maintain the safe asset, *ex-ante* policies are more desirable. EMs could accumulate reserves as a protection against speculative attacks, maintain fiscal space to support credibility and seek more resilient forms of external finance, such as foreign direct investment. As a last resort, capital flow measures could be used when the bubble is wobbly, but authorities should have a clear strategy about how to remove them because losing access to international capital markets would cause damage to long-term growth. He acknowledged that there is a risk, however, that restrictions on capital flows may allow authorities in countries with poor governance to use the safe asset bubble to finance wasteful spending.

Brunnermeier highlighted the importance of building an international financial architecture that is self-stabilising. He proposed that the senior tranche of a pool of EM bonds could become a resilient safe asset for EMs with good governance. No EM would be able to do it alone because they would face the temptation of diluting their senior bonds by issuing super-senior ones. The pooled structure, with membership set by a neutral party with strong governance, would mitigate that moral hazard.

In his conversation with Brunnermeier, Yeung explored in greater detail the paper's implications for the implementation of an IPF for EMs. Specifically, the conversation revolved around: (1) possible policy responses from the already low-growth high-debt EMs to deal with huge capital outflows that they are experiencing in the midst of the COVID-19 pandemic; (2) the challenges faced in developing domestic safe assets by EMs that have weak governance; (3) what EM governments can do to create a more stable financial system; (4) the



considerations between *ex-post* and *ex-ante* policies; and (5) how a self-stabilising global financial architecture can become a reality.

## 6 Sum-up

The Forum concluded with closing remarks delivered by Steven J. Davis, William H. Abbott Distinguished Service Professor of International Business and Economics at the University of Chicago Booth School of Business. He noted the rapid and severe deterioration of the economic environment caused by COVID-19, and cited the example of the US economy, where the unemployment rate had risen from the lowest level in 60 years to its highest in over 80 years within a very short span of time. Nevertheless, in Asia, countries seem to have coped better with the public health crisis and currency depreciations among EMs have been modest relative to the scale of the pandemic shock. This reflected in part the role of central bank swap arrangements, which was a notable example of constructive global economic policy cooperation, in contrast to the failures in international coordination in the public health arena, reflecting fundamental distrust between the key strategic players in the global economy. Davis noted that previous periods of cooperation to secure and support the liberal international system had led to tremendous human development in most of the world. The significant contribution of this year's commissioned paper was in the formalisation of an integrated policy framework for the joint use of monetary policy, macroprudential policies, foreign exchange interventions and capital controls, together with the proposed issuance of a global safe asset as a means to achieve a self-stabilising global financial architecture beneficial to EMs.

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