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G20 Seminar
Monetary and Macro-Prudential Policies in a Context of High Liquidity:

Luiz Awazu Pereira da Silva
Deputy-Governor
Central Bank of Brazil

It is my pleasure to begin and welcome all of you to this G20 Seminar, organized with the support of the French Presidency.

Thanks to G20 Presidency (France), to our sponsors (Reinventing Bretton-Woods, the Inter-American Development Bank -IADB, and the World Bank --WBG) and to international and global financial institutions. We have also here a number of distinguished academics, former central bankers, economists from the IMF, the OECD, the BIS and global financial institutions.

Thanks for the participation of all of you.

The motivation for this conference is a set of old and new challenges for all of us, academics, policy-makers and market economists. The relationship between "Monetary and Macro-Prudential Policies" represents both an analytical and policy challenge for advanced and emerging economies alike.

How could both policies contribute to price stability and financial stability? How can they complement each other, making financial sector growth more sustainable, making it safer for the taxpayer and making financial institutions more resilient? That is –and we can say literally— the trillion dollar, or euro or yen or yuan or Real question.

Now for once, the LAC region demonstrated a high degree of resilience during the global financial crisis and the turbulence in the European financial markets. Why?

- Macro stability pays off: it's the reforms put in place by many LAC countries over the last decade that preserved us; the adoption of sound macroeconomic frameworks; and also keeping price stability with higher risk premia required relatively higher real interest rates and conservative public debt management, with a strong fiscal stance;
- Tighter, more traditional, more regulated macro-prudential frameworks and tougher financial sector supervision: e.g., (a) banks operating with capital ratios well above Basel requirements; (b) reliance on stable domestic funding and appropriate foreign currency liquidity risk management; (c) low direct exposures to agency problems in mortgage credit origination; (d) strict limits to bank exposures to complex derivatives

and structured finance; and (e) higher reserve requirements and "old-fashion" direct instruments for allocating savings instead of more "trendy" modern intermediation with "shadow-banks" and more sophisticated products such as securitization, and the alphabet soup of derivatives, (f) limited reliance on problematic forms of securitization, etc.

This LAC outcome seems to confirm the view that tighter monetary policy and "traditional" regulatory-prudential frameworks bring more macro & financial stability. It would be a counterfactual illustrating Svensson's view that it was not monetary policy that led to the emergences of bubbles and then to financial instability. For Svensson, the financial crisis was not caused by monetary policy; for him, it was regulation that failed.[1] And LAC would be a successful counterfactual case in point. But, of course, many others – we´ll hear here – argue otherwise.

And then, came the response to the global crisis, an unprecedented powerful, bold, timely reaction to fight decisively the real, severe risk of deflation and depression. Quite successful. Indeed advanced economies avoided 1929. Stretching a bit the story, this outcome seems to vindicate – "the Greenspan-Bernanke approach[2]" – it´s the lean against Vs. clean after debate - that attempts to detect and prick asset bubbles at an early stage would be impossible, unpractical and harmful. If necessary, mopping up after the burst of a bubble through interest rate cuts to help economic recovery would be safer.**[3]**

So we could say that we have two counterfactuals. One in "crisis-prevention", LAC with its more traditional combination of tighter money and tougher macroprudential that reined excessive leverage and asset growth. One in "depression-avoidance" or "crisis-resolution", Advanced Economies with zero-interest and QEs.

Now both counterfactuals have collateral effects. Sticking to LAC's "old-fashion", romantic view about financial system growth would be like closing your mind to the benefits of modern financial intermediation. And sticking to ZIF and QE for too long requires animal spirits to react sooner than later to liquidity in balance sheets. And the credit channel, the financial accelerator in the US seems still not to be fully working yet. Moreover, as we know too well down here in the tropics, in particular for EMEs, unusually high levels of global liquidity are presenting our policymakers with augmented-"impossible-trinity" challenges. Excessively large inflows working through our credit and asset markets, are compounding domestic inflationary pressures; they exacerbate risks to financial stability.

So we need a way for safer financial sector growth and we also need a way for our post-crisis challenges; the global economy needs a rebalancing, in terms of both sustainable growth and lower inflation between AEs and EMEs. And everyone is just busy at that, the G20, the FSB, the BIS, the IFIs and academia at large.

Monetary and macroprudential policies are quite possibly important components of this Graal. And the departure point is trivial: all countries, all policy makers in one degree or another are always combining the management of aggregate demand using fiscal and monetary policy with the management of credit and financial cycles, using prudential and regulatory tools: micro-prudential instruments (to ensure the liquidity/solvency of individual firms) and macro-prudential tools (to address externalities and systemic risk).

Policy-makers challenge is the art of sequencing the known results of these policies to achieve both price stability & financial stability. The "art" is to get the adequate level of expansion in financial and credit markets, i.e. the "right" multiplier, since we know very well that there is an inherent procyclicality in credit / financial markets (too little growth you get anemic financial and capital markets; too much growth and you get bubbles, excessive leverage, etc.). Monetary plicy is used to affect output and hence inflation. Macro-prudential policy lowers risk, reduces excessive credit growth and hence, eventually, affect directly demand and inflation.

There is a vast number of proposals and bright ideas some made by participants present here and in international fora such as the G20, the FSB and the BIS: lowering incentives for excessive risk-taking through the cost of capital channel; changing traders' remuneration rules; increasing liquidity and capital in a counter-cyclical way; augmenting Taylor-rules to account for the role of financial variables in the cycle; creating capital surcharges for Globally Systemically Important Financial Institutions; and, last but not the least, complementing monetary policy with macro-prudential tools, etc. There are also warnings that risk is not properly priced in a global financial system that is so interconnected through financial assets that are difficult to evaluate and are not registered in a comprehensive manner (e.g., lots, lots of counterparty uncertainty). Say, this new complicated financial world would have more "Black Swans" than white ones, all with big fat tails. But then, if so, it would probably mean that the distribution of risk does not follow –at least always—the nice, well-behaved, easy to compute Gaussian curve. And finally, there are for us in EMEs, significant imperfections and frictions in our credit and financial markets. We have levels of collateral, the size of bank credit vis-à-vis equity finance and asymmetries of information that would probably mystify even Jo Stiglitz.

That is why this seminar revolves around these questions:

Session 1 – How should monetary policy and prudential regulation be used in order to ensure macroeconomic and financial stability?

Session 2 – How should financial stability be defined and measured?

Session 3 – Should we define new rules for central banks to react to financial instability?

Session 4 – Experiences with the New Policy Challenges for Macro and Financial Stability in Emerging Markets

But this is not a policy-making seminar. It is a venue to exchange experiences: it is important to hear the views of all countries in the G20 and elsewhere, look at the variety of situations around the world and listen to different voices, academics, policy-makers and market economists.

We hope that the seminar will show to all participants the progress so far in this important topic. I have seen from the program a number of very interesting contributions that illustrate the analytical rigor with which these questions have been treated. It simply confirms to me that policy options, naturally adapted to country circumstances, have been based on solid analytical ground and that decisions are taken after a careful examination of their foundations and their micro, macroeconomic and welfare implications. Policy-maker pragmatism is not a trial-and-error process. It is an informed choice, using the best available scientific knowledge and the best information set to serve the general public, deliver low inflation and financial stability.

I wish you a very productive seminar. Thank you, merci e obrigado.

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[1] Due to distorted incentives for excessive leverage and lack of due diligence, lax regulation and supervision, rapid growth of securitization, myopic and asymmetric remuneration contracts, idiosyncratic features of the US housing policy (the GSEs), information problems, hidden risk in complex securities, and underestimation of correlated systemic risks. These causes had little to do with monetary policy (Svensson (2010))

[2] See, for example, Alan Greenspan (2002) and Ben Bernanke (2002). More recently, Chairman Bernanke seems to have evolved slightly from this position; see the closing section of Bernanke (2010).

[3] "The past 10 years have been the decade of inflation targeting. (…) Narrowly defined, inflation targeting commits central banks to annual inflation goals, invariably measured by the consumer price index (CPI), and to being judged on their ability to hit those targets. Flexible inflation targeting allows central banks to aim at both output and inflation, as enshrined in the famous Taylor Rule. The orthodoxy says that central banks should essentially pay no attention to asset prices, the exchange rate, or export prices, except to the extent that they are harbingers of inflation" Frankel (2009).