Unwinding Financial Sector Interventions
Preconditions and Practical Considerations

EDITORS
Udaibir S. Das and Michael G. Papaioannou

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Preface

Although at present the global economic recovery is under way, there are significant uncertainties concerning financial stability. This makes the process of exiting from the monetary, financial, and fiscal support provided in the past few years particularly delicate. Thus, it is all the more important to understand the keys to the exit process which, as we have currently seen, is proceeding at different speeds in different parts of the world.

As the current financial crisis unfolded, governments and central banks rose to the challenge by taking unprecedented steps to avoid the collapse of the global financial system and avert a devastating impact on the global economy. Liquidity support, capital infusions, and public guarantees were provided to banks and other financial institutions; policy interest rates were lowered substantially; and fiscal stimulus packages were introduced. On top of this, international institutions like the IMF enhanced their lending facilities to help emerging markets and developing economies better cope with the threats posed by the crisis. These measures were broadly successful as they were able to avert a 1930s-style Depression.

Depending on the strength of their economic recovery, a number of countries have already started exiting from their monetary and financial support measures while others have maintained much of their support in place. As regards fiscal policy, the situation is also quite different across countries: while some had to move quickly to reduce deficits under market pressure, others will only start to remove their fiscal stimulus in the future.

The ultimate goal of an “exit” process is to converge to a situation of price stability, sustainable public finances, financial stability and the restoration of market discipline in a safer financial sector. This will provide the necessary conditions for strong, sustained and balanced economic growth. In practice, this means several things: removing the degree of monetary accommodation introduced through low interest rates and the credit and quantitative easing policies of central banks; pursuing a policy of fiscal consolidation to bring public debt back to reasonable levels; and withdrawing the measures now in place to support the financial sector, while introducing the necessary reforms to make it safer.

In this policy response, two things are particularly challenging: reducing public deficits and debt levels sufficiently, and achieving a consistent exit process across countries. The weakened state of public finances in the big advanced economies—the United States, Japan, much of Europe—will continue to require vigorous policy action. Population aging meant that the fiscal situation in these countries was already extremely challenging before the crisis, and higher fiscal deficits in response to the crisis have added to the problem. Countries must thus develop and communicate a clear plan for
reining in public deficits and public debt, to be implemented over time in a manner which is consistent with their specific economic and financial situations.

A consistent international approach to exit is also essential to contain the risk of destabilizing spillover effects. Especially among those economies whose financial markets are closely linked, withdrawing financial guarantees or tightening regulation in an uncoordinated way could trigger sharp movements in international financial flows that could disrupt the recovery and undermine credibility.

To examine issues related to exit strategies from crisis interventions, the IMF convened in Washington a high-level conference on “Unwinding Public Interventions in the Financial Sector,” on December 3, 2009. This conference was another IMF initiative to help countries prepare the groundwork for a sound exit, following the IMF’s high-level principles for policies during the exit process that were proposed to the G-20 in early November 2009. The main messages and deliberations of the conference fed into a paper on “Unwinding Crisis-Related Intervention Measures: Implementation of Strategies,” that was discussed by the Executive Board of the IMF in early February 2010.

Many people contributed to the successful undertaking of this conference and to the production of this volume: first and foremost, the panelists of the four sections of the conference, who not only made insightful presentations but also generously provided written statements with their comments; as well as John Lipsky, first deputy managing director of the IMF, who provided the opening and closing remarks; Carlo Cottarelli, director of the Fiscal Affairs Department of the IMF; Olivier Blanchard, economic counselor and director of the Research Department; Reza Moghadam, director of the Strategy, Policy, and Review Department, who chaired, along with me, the four sessions of the conference. In addition staff both within and outside the Monetary and Capital Markets Department (MCM) helped with the background material and organization of the conference. Udaibir S. Das, assistant director, Sovereign Asset and Liability Management Division of MCM, and Michael G. Papaioannou, deputy division chief of the same division, edited the manuscript. Sean M. Culhane and his team from the External Relations Department helped with editing and production of this publication. I am grateful to all participants and colleagues.

José Viñals
Financial Counsellor and Director
Monetary and Capital Markets Department
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## Abbreviations

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<tr>
<td>ABS</td>
<td>Asset-backed securities</td>
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<td>AIG</td>
<td>American International Group, Inc.</td>
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<td>APS</td>
<td>Asset Protection Scheme, UK</td>
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<td>BCBS</td>
<td>Basel Committee on Banking Supervision</td>
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<td>BIS</td>
<td>Bank for International Settlements</td>
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<td>CB</td>
<td>Central Bank</td>
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<td>CDS</td>
<td>Credit default swap</td>
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<td>ECB</td>
<td>European Central Bank</td>
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<td>ECOFIN</td>
<td>Economic and Financial Council of the European Union</td>
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<td>EME</td>
<td>Emerging market economy</td>
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<td>FDIC</td>
<td>Federal Deposit Insurance Corporation</td>
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<td>FOMC</td>
<td>Federal Open Market Committee</td>
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<td>FRNs</td>
<td>Floating rate notes</td>
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<td>FSB</td>
<td>Financial Stability Board</td>
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<td>G-20</td>
<td>Group of Twenty Finance Ministers and Central Bank Governors</td>
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<td>G-7</td>
<td>Group of Seven Industrialized Countries</td>
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<td>IMFC</td>
<td>International Monetary Fund Committee</td>
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<td>IMF</td>
<td>International Monetary Fund</td>
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<td>IOR</td>
<td>Interest on reserves</td>
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<td>IPAB</td>
<td>Instituto para la Protección al Ahorro Bancario, Mexico</td>
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<td>IPO of EdF</td>
<td>Initial public offering of Electricité de France</td>
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<td>IRR</td>
<td>Internal rate of return</td>
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<td>LIBOR-OIS</td>
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<td>M&amp;A</td>
<td>Mergers and acquisitions</td>
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<td>MCM</td>
<td>Monetary and Capital Markets Department</td>
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<td>NPLs</td>
<td>Nonperforming loans</td>
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<td>OECD</td>
<td>Organisation for Economic Co-operation and Development</td>
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<td>QE</td>
<td>Quantitative easing</td>
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<td>RMBS</td>
<td>Residential mortgage backed securities, UK</td>
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<td>SFEF</td>
<td>Société de Financement de l’Économie Française</td>
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<td>SIVS</td>
<td>Structured investment vehicles</td>
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<td>SMEs</td>
<td>Small and medium-sized enterprises</td>
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<td>SPVs</td>
<td>Special purpose vehicles</td>
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<td>TAF</td>
<td>Term Auction Facility, Federal Reserve</td>
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<td>TARP</td>
<td>Troubled Asset Relief Program U.S.</td>
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Overview

The IMF’s Monetary and Capital Markets Department moderated a conference of senior policymakers, academics, and senior representatives of the private sector on unwinding public interventions initiated during the crisis. Participants agreed that an exit strategy is vital. Its main goal would be to secure safe, stable, and sustainable economic and financial conditions, including a new financial environment. They emphasized that the strategy will need to be cohesive, consistent, comprehensive, and well explained to anchor public expectations.

Relevant economic and financing indicators should be used to guide the exit process. It was stressed that there were risks linked both to unwinding too quickly and too slowly. Political pressures could make exit from fiscal measures challenging, while problems with assessing output gaps could complicate decisions to reverse monetary measures. Participants’ views varied on both the timing and sequencing of the exit strategy. They welcomed the role of the IMF in addressing issues related to the exit process, noting in particular its continued work on establishing sound principles to guide the process.

Main Messages

Discussions distinguished areas in which a broad consensus appears to be emerging from those in which views remain disparate; and they addressed possible challenges that policymakers are about to face.

Consensus on the importance and goal of the exit strategy

Participants were in broad agreement that an exit strategy from monetary, fiscal, and financial sector interventions is essential. The pivotal goal of the exit process would be to arrive at a condition of price stability, fiscal sustainability, and financial stability, including a new financial landscape that would be much safer than currently exists. Those conditions will provide the necessary underpinnings for stable, strong, and sustainable growth. The strategy will need to be clear, cohesive, consistent, and comprehensive in addressing the debt and asset management issues generated by the intervention measures. That said, tailoring the strategy will likely be more an art than a science because of the uncertainties and the need to have firm assurances that it will not undermine recovery. Such strategies will need to be flexibly implemented and reflect changes in the economic, financial, and political environment.
Different perspectives on the timing and sequencing of the exit process

Presenters were of different minds regarding the timing and sequencing of the exit process. Some argued that it was better to exit soon because of possible fiscal policy lags or potential new asset bubbles, while others maintained that it was too early to exit given the highly uncertain global economic prospects. Further, some participants felt that credible programs for returning to fiscal sustainability in key countries should be announced first to ensure a more orderly exit from extraordinary monetary accommodation. Others argued this may not be feasible because the political process of unwinding fiscal interventions would likely be long and complicated, and, hence, monetary policy should be unwound first. IMF staff members expressed the view that the risk from exiting too early is higher than from exiting too late and that fiscal policy should start adjusting first.

Some principles for an exit strategy

Conference participants agreed that exit strategies need to be consistent at three levels: across monetary, fiscal, and financial policies in each country; across different financial sector interventions; and internationally, to avoid spillover effects, including from advanced to emerging markets economies. They also stressed that the measures to be unwound first are those that impose known distortions. Further, discussions emphasized that economic and financial indicators should provide a basis for guiding the exit strategy. These indicators should include quantity as well as price signals, in particular regarding developments in aggregate and sectoral credit.

Main challenges ahead

Views regarding the major challenges were fairly uniform. The most difficult task will be the fiscal exit. Credible fiscal rules and institutions are needed to reverse debt trends; debt ratios should be reduced; and contingent liabilities should be better accounted for in the fiscal accounts to clarify the fiscal risks.

Timing and sequencing the unwinding of monetary ease will be challenging, mainly because of uncertainties related to the correct estimation of potential output and size of output gaps in a postcrisis environment.

It will be relatively easy to unwind financial interventions that have sunset clauses or have penal rates, as they become unattractive when market conditions normalize. The challenge regarding financial interventions is rather how to offload risky assets from central bank balance sheets, which threaten central bank autonomy, and how to unwind debt guarantees and blanket deposit insurance.
Introductory Remarks by John Lipsky

As the crisis abates, governments are being confronted with new challenges. One of the most important will be to balance the withdrawal of fiscal and monetary support for the financial sector with the reestablishment of sustainable growth, price stability, and sound public finances while creating a more stable and resilient financial system.

Recognizing the importance of the impending challenges, the IMF Board’s International Monetary and Financial Committee and its Executive Board asked the IMF staff to provide concrete views on exiting from the crisis-related financial intervention measures. The request was one of the motivations for holding this conference. It has been organized to provide a forum for discussion of some of the key issues regarding the unwinding, including management of the public finance aspects. The topics covered include strategies governments could follow to normalize their involvement in the financial sector, key principles for timing and sequencing these strategies, and areas for domestic and cross-border coordination.

I will note here some of the implications of the crisis for sovereign balance sheets and outline some broad considerations for unwinding the unprecedented public interventions. The interventions greatly increased the size of sovereign balance sheets through the acquisition of financial system assets and through the buildup of debt, including the accumulation of contingent claims.

As a result, the balance sheets of the central banks in 6 advanced countries and that of the ECB increased by an average of more than 8 percentage points of GDP between June 2007 and June 2009. At the same time, the government balance sheets of 16 advanced countries increased on average by about 5.5 percentage points of GDP. As we all know, this ballooning of balance sheets poses significant management challenges, as the downsizing of these balance sheets will require substantial and sustained policy efforts.

In particular, the unwinding of monetary and fiscal policies will need to place government debt on a sustainable path while accommodating growing private credit demand and supporting the economic recovery. Low interest rates have so far muted the impact of the dramatic growth in government debt, but a significant increase in interest rates would bring the underlying vulnerabilities more clearly into focus. Unconventional monetary policy measures eventually will be unwound, and private sector credit demand will pick up. At that time, the growth of government debt and the corresponding financing needs will raise the possibility of crowding out.

Moreover, adverse implications for sovereign balance sheet risks—arising from the accumulation of weak sovereign assets, greater contingent liabilities,
and still-increasing government debt—will need to be managed. So will strategies for asset disposal and the withdrawal of public guarantees. Government refinancing risk has been manifested in increasing sovereign debt issuance and a drift toward shorter debt maturities, developments that signal a worrisome trend in debt management strategies and in sovereign liability management more generally.

These broad concerns suggest a few considerations regarding the unwinding of public interventions.

Of course, the evolution of financial market conditions—including trends in sovereign credit spreads—will influence both the prospects for a systematic unwinding of public sector support and the balance of risks to financial stability during the unwinding.

At the same time, clarifying fiscal accounts could help to manage fiscal policy during the unwinding process. For example, quasi-fiscal activities, which were a prominent feature of the response to the crisis, would be more transparent if they were transferred to the budget. Likewise, guarantees and other contingent liabilities require appropriate management.

Unwinding public sector interventions in the form of capital injections, as well as the purchase of assets and the assumption of liabilities, also will give rise to sequencing issues. A key consideration in disengaging from these types of interventions should be their impact on asset prices. In some cases, this task may be carried out more successfully if assigned to a specialized asset management company. In other cases, a decentralized approach may work best to take advantage of market incentives.

Ideally, the most distortion-inducing and redundant measures will be discontinued first. Careful evaluation of the implications of the intervention measures for financial sector competition, along with the role of the financial regulatory structure at the time of the unwinding, therefore will provide important guides to policy action.

Another important general consideration is the need to maintain the coherence of unwinding strategies across countries, as coordination issues could influence capital flows and financial intermediation and could give rise to regulatory arbitrage.

Although it is not the subject of the sessions today, you probably are aware that the IMF has been asked by the G-20 leaders to provide an options study regarding possible financial sector taxation to compensate for the costs of risk mitigation for potential financial sector crises.

Rather, the four sessions today will focus on (1) the prospects for unwinding public interventions in the financial sector, (2) the public finance aspects of
unwinding, (3) indicators for guiding liquidity support and financial sector guarantees, and (4) restoring private control of crisis-related assets. I hope that the presentations and exchange of views at this conference will prove challenging and helpful.
The Financial Crisis—Where Are We Now, and What Are the Prospects for Unwinding Public Interventions in the Financial Sector?

Hervé Hannoun
Bank for International Settlements

The leverage-led growth model—a combination of excessive leverage in the financial system, overindebtedness of households, low interest rates, and global imbalances—was at the heart of the crisis.

But the paradox is that the policies that have been adopted to remedy the crisis consist, all in all, of even more of the same: borrowing, debt, leverage.

Let me illustrate this with a few facts regarding the main balance sheet adjustments under way:

- There has been some reduction of household debt but it still remains at a very high level (Figure 1).

Figure 1. Household debt, major advanced economies¹
As a percentage of disposable income

Source: National data.

¹ The European Union, Japan, the United Kingdom, and the United States; weighted average using 2005 GDP and PPP weights.
Leverage of banks also remains high by historical standards despite a reduction in the first half of 2009 (Figure 2).

The decline in commercial bank intermediation has been more than offset by the sharp rise in central bank balance sheets (Figure 3). While interbank claims of BIS reporting banks have shrunk by $3 trillion since early 2008, central bank balance sheets have surged from $3.5 trillion to around $7 trillion. This has cushioned the decline in the growth of private bank credit, which turned negative in the last quarter. The near-zero interest rate policy conducted by G-10 central banks has also supported the maintenance of private debt but poses the risk of spurring risk-taking.

And last but not least, there has been a colossal surge in public debt in advanced economies, by 20 percentage points of GDP in two years, to almost 100 percent of GDP in 2009.

Overall, taking decelerating private debt and accelerating public debt together, major economies are still leveraging up (Figure 4). Private debt seems to be still rising in relation to GDP well after government interventions. The ongoing surge in public debt in relation to GDP leaves aggregate leverage (total debt) on a rising trend in many advanced countries.
Figure 3.

Global interbank claims¹

Central bank assets¹,²

Bank credit to the private sector²,³

Sources: Datastream; national data; BIS.

¹ In trillions of current U.S. dollars; BIS reporting banks. ² Total for Canada, the European Union, Japan, Sweden, Switzerland, the United Kingdom, and the United States. ³ Annual percentage change in bank credit to the private sector; weighted average of growth rates using 2005 GDP and PPP weights.
Figure 4. Private and public debt
As a percentage of GDP

Sources: IMF; Organisation for Economic Co-operation and Development (OECD); national data.

Note: The vertical line marks September 15, 2008, the date of the Lehman Brothers bankruptcy.

1 Total debt excluding equity issued by nonfinancial businesses, households and nonprofit organizations; definitions may differ across countries; for the Netherlands, bank credit to the private sector.
2 Data for 2009 are based on latest quarterly information available; for France and Germany, bank credit used to update private sector debt.
3 General government total debt; for the Netherlands, data for 2009 are OECD projections.
In a nutshell, we are implementing the leverage-led growth model while
promising to break with this model in the future by designing sound
medium-term frameworks for fiscal consolidation and bank capital
regulation. Promising to “be virtuous, but not now” is a perilous balancing
act for policymakers.

Timing and speed of unwinding

The current debate on “exiting too soon” versus “exiting too late” echoes
the debate a year ago on the calibration of the stimulus deemed necessary to
counter the recession (the risk of “not doing enough” versus the risk of
“doing too much” and of overcalibrated stimulus). The difficulty at this point
is that, while the recession is abating and the recovery is gaining pace, there is
a question mark over the exact measurement of the large-scale stimulus that
is in the pipeline and therefore a question mark over the calibration of the
stimulus. It may well be that the combination of central banks’ balance sheet
expansion and government debt issuance will more than compensate for
private credit retrenchment (Figure 4), resulting in overcalibrated stimulus.
Another key uncertainty for policymakers arises from the well-known
fragility of the measurement of output gaps. As was the case in the 1970s, we
may be seriously overestimating economic slack. Mismeasurement of output
gaps and growth potential by a wide margin may lead to an understatement
of the underlying deterioration in fiscal positions (Figure 5).

Figure 5. Output gap in major advanced countries¹

![Graph showing output gap in major advanced countries](image)

Source: OECD, *Economic Outlook* (various issues).

¹ Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, the United Kingdom, and the United States;
weighted averages using 2000 and 2005 GDP and PPP weights.
The dominant view is that “it is too soon to be implementing the exit strategy but not too soon to be planning for it” or, to be more specific, that “it is too soon to implement any fiscal, prudential, or monetary tightening.” I think that our views should be less categorical.

**On fiscal policy**

The dominant view (“it is too soon to tighten”) is highly questionable. Postponing the fiscal adjustment to a time when the recovery has consolidated may not be possible.

Inaction and postponement could prove to be a risky policy. Simply communicating on the design of future medium-term frameworks for consolidation may calm the rating agencies for a while, but it does not address the mounting concerns in the bond markets about fiscal solvency in the medium to long term.

**On interest rate policy**

The dominant view (“it is too soon to tighten”) may be right. But central banks need to keep open the option of starting to reverse the near-zero interest rate policy at any point in time so as to avoid any perception of unconditional commitment to keeping interest rates very low indefinitely. Otherwise market participants will take the current easy financial conditions for granted and start speculating again. Central banks therefore need to make clear that they are adding weight to the “risk-taking channel” of monetary policy and that they will not accept a return to financial excesses.

**On central banks’ unconventional balance sheet policies**

The dominant view emphasizes the risks associated with the premature withdrawal of unconventional balance sheet policies. Here we need to distinguish between central banks’ short-term liquidity-providing measures and their large-scale outright purchases of long-term securities.

The short-term liquidity-providing facilities can be self-unwinding (a number of them having a fixed expiration date in 2010) and do not pose major exit problems. The pace of that unwinding should be linked to confirmation of the normalization of the LIBOR-OIS spread and a smooth return to private credit intermediation.

Exiting from the outright asset purchases will be more challenging. Given the potential impact on asset prices, central banks may be tempted to adopt a “buy and hold” stance. However, the key issue here relates to the potential role of central banks in directly influencing long-term bond yields and credit spreads: market participants should be under no illusion that we are entering into a new permanent accommodative monetary policy regime in which
In normal times, central banks will need to go back to their usual approach of controlling only the short end of the yield curve and of refraining from interventions with potentially distorting effects on relative asset prices. Exiting from unconventional monetary policy is necessary to make clear that the unconventional will not become the new normal. The sooner the exit, the better.

**On prudential policy**

On prudential policy, the consensus view again is that “it is too soon to tighten capital requirements”: stronger capital requirements for banks are to be phased in as financial conditions improve and the economic recovery is assured, with the aim of implementation by end-2012. This medium-term phasing-in adopted by the Basel Committee and the G-20 addresses the concern over whether banks would be able to continue their financial intermediation function of providing stable flows of lending. In the meantime, there has been a market-driven increase in banks’ Tier 1 capital ratios of around 2 percentage points between end-2006 and end-June 2009 (Figure 7). But we should not draw too much comfort from this improvement since we know that credit losses in banking lag the business cycle.
There is at least one area where the postponement of a tightening of capital requirements is simply not defensible: the trading book. The additional capital charge there needs to be implemented by the end of 2010 given the extremely low current level of capital requirements on the trading book, even relative to banks’ economic capital estimates.

To conclude on the timing and speed of unwinding: as a minimum, we should recognize that a premature exit and a late exit can be equally damaging.\(^1\)

Beyond that, experience suggests that the biggest risk is exiting too late and too slowly or, in the case of fiscal policy, not exiting at all. The political economy pressures are overwhelmingly in that direction. There are three serious risks associated with the policy of “doing nothing now”:

- On the fiscal side, the “do nothing” stance could fuel the concern over fiscal solvency, with the potential to trigger bond market disruption. In some G-7 countries, sovereign CDS spreads are as high as bank CDS spreads (Figure 8). It would be more prudent to start the fiscal consolidation effort in 2010 already.

- On the interest rate policy side, in addition to the medium-term inflation risks posed by excessive stimulus, the biggest risk in the short term is related to asset price misalignments. The combination

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Figure 8. Credit default swap premiums

United States
- Sovereign
- Banks
Jan 09: $5 bn
end-Oct 09: $11 bn

Japan
- Gross notional sovereign
- CDS volumes outstanding
Jan 09: $7 bn
end-Oct 09: $14 bn

United Kingdom
Jan 09: $14 bn
end-Oct 09: $24 bn

Germany
Jan 09: $38 bn
end-Oct 09: $57 bn

France
Jan 09: $23 bn
end-Oct 09: $44 bn

Italy
Jan 09: $158 bn
end-Oct 09: $214 bn

Greece
Jan 09: $37 bn
end-Oct 09: $56 bn

Spain
Jan 09: $66 bn
end-Oct 09: $87 bn

Sweden
Jan 09: $7 bn
end-Oct 09: $14 bn

Sources: Datastream; Depository Trust & Clearing Corporation; Markit; BIS calculations.

1 Five-year on-the-run CDS spreads. 2 Simple average over sample of major banks.
of near zero policy rates in G10 countries and excessive risk-taking could create a series of asset price bubbles. Indeed, many observers are concerned by the ongoing resumption of carry trades on currency markets induced by the large interest rate differentials between advanced and emerging market economies (Figure 9). This calls for monetary policy to take better account of asset prices and credit booms, as the BIS has long been advocating.²

- On the prudential policy side, the biggest risk to long-term financial stability and sustainable economic growth would arise if the regulatory reform of banks’ capital and leverage were sidetracked.

Some representatives of the banking industry have raised objections to the planned strengthening of capital requirements and the introduction of a leverage ratio as a supplement to the risk-based capital requirement framework to contain the build-up of leverage in the system.

I know that the regulatory authorities will remain firm on these two fronts. Some banks don’t seem to “get it,” and are still promising returns on equity of 20 percent or above to their shareholders. Excessive leverage and risk-taking can no longer be the way to deliver on such promises. They must be

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grounded in sound, sustainable business models that are robust over a full cycle.

To summarize, we need to embed exit strategies in an overall financial stability framework ensuring consistency across all the elements: unwinding of exceptional fiscal and monetary policies and strengthening of macro- and microprudential approaches to financial supervision.

**International coordination of unwinding**

Let me finally move to the discussion of the elements of unwinding in which international coordination is essential.

The exit from monetary and fiscal stimulus will have to take into account domestic economic conditions and will therefore be essentially a national decision. That said, G-20 governments have been signaling coordinated fiscal stimulus for the past 18 months. This suggests that coordinated signals should symmetrically be expected in the direction of fiscal consolidation. On the monetary policy side, where decisions are also national, the interest rate cuts announced jointly by central banks on October 8, 2008 were an unprecedented collective action with a powerful signaling effect.

The intensity of the cooperation among central banks was also reflected in the reciprocal bilateral swap lines established to address cross-border foreign currency liquidity shortages. These arrangements will expire early next year, and a smooth coordinated unwinding can be expected.

More generally, the central banking community will continue to make use of existing cooperation forums—especially the committees hosted by the BIS (e.g., the Committee for the Global Financial System and the Markets Committee)—to share information and perspectives on the unwinding of unconventional interventions.

Regarding exit from government financial sector support, international coordination is crucial because of the global nature of large and complex financial institutions and the knock-on effects on other countries.

This is particularly the case for deposit insurance. Disengaging from extraordinary depositor protection measures requires strong international coordination, a good example of which is the initiative taken jointly by Hong Kong SAR, Malaysia, and Singapore to coordinate the exit from the full deposit guarantee.

Another area requiring strong international coordination is the removal of guarantees on wholesale bank liabilities, which may not be a smooth and easy process. The introduction of these measures in the urgency of the crisis was
poorly coordinated internationally as regards the fee structure, pricing, and subsidy element of the guarantees.

Among financial institutions, there are differing degrees of dependence on public support. Weaker banks continue to rely on government facilities, while stronger institutions are again able to fund themselves in the senior unsecured bond market. Although it is justifiable for markets to discriminate among financial institutions and to rank (tier) financial institutions according to their dependence on public support, those processes carry a risk: they might in turn lead to pressures toward a new wave of consolidation and even more concentration in the financial sector, thus aggravating the “too big to fail” problem. This means that prudential supervisors have to do everything they can to deal with weak institutions by continuing the process of disposing of bad assets, raising capital, and downsizing where necessary.

In addition, international coordination among market regulators could be useful in directing special attention in this period to the integrity of the information related to financial institutions, ensuring that the tiering assessments floated in the markets are based on solid facts and disclosures and not on rumors or stigma. International coordination in the domain of market integrity and fair competition within the financial sector is also essential to counter any temptation toward “financial protectionism” or promotion of national champions. Finally, internationally agreed prudential standards and their coordinated implementation are essential to ensuring a level playing field, as is the role of the Financial Stability Board in promoting coordination among the standard-setting bodies involved in global regulatory reform.
Malcolm D. Knight  
Deutsche Bank

The global financial crisis of 2007–09 and the “Great Recession” have propelled three key facets of economic and financial policy—monetary, fiscal, and regulatory—into uncharted territory simultaneously:

1. **Monetary policy**—zero policy interest rates 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.

2. **Fiscal policy**—massive fiscal stimulus measures that have caused actual and projected fiscal deficits to jump far outside the range in which fiscal sustainability can be restored without an extraordinary fiscal effort.

3. **Financial regulation**—“moral hazard” increased 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.

The new architecture of financial regulation is still an unfinished project. Recent proposals have not been closely coordinated internationally, creating large areas of uncertainty that make it difficult for financial institutions to design appropriate medium-term business strategies.

**Intended and unintended consequences**

As expected, policy interest rates at zero and the huge stock of central bank liquidity have led to a rather steep yield curve. However, unintended consequences of the policy stance are already evident:

- 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.

- As risk appetite has returned, risk spreads, volatility, and other market-based measures of risk have declined.
Sequencing of the exit from the current extraordinary stance of economic policies

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.

The second point to remember is that fiscal sustainability is the essential element of sound economic governance over the longer term.

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 of 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.

Given those points, here is the sequencing of exit steps as I see it:

**Step one**

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

To anticipate, the second step—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.

As a backdrop to step two, the authorities will need to maintain policy interest rates as low as possible for as long as possible without causing inflation expectations to become unanchored.

**Step two**

Make a major shift to exit from current monetary policies of quantitative easing, credit easing, and purchasing of private sector financial assets to liquefy key (segmented) markets.
Step three

Establish a credible macroprudential regulatory agency or “financial system risk regulator” in the United States and other key jurisdictions. The agency must have two key features:

- the responsibility and accountability for identifying changes in the level of systemwide financial risk; and
- the authority to require financial institutions 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 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 European Central Bank (ECB) to lend dollars overnight to banks in the European Union 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 this sequenced exit by the countries at the heart of the recent financial crisis with the following similarity and difference:

- Fiscal policy actions to address rising deficits and debt should have the same priority as those described above for the United States and the United Kingdom.
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, currency appreciation would be a more efficient means of achieving the objective than allowing 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 rate.

**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.
Antonio de Lecea  
European Commission

Public support has been essential in supporting the economies stricken by the crisis. Addressing a successful exit strategy will be extremely challenging, as the economies are now interconnected, and the risk of policy spillover is significant. The European Union (EU) has taken the lead in defining and communicating a framework for unwinding public interventions in the financial sector. It combines a credible withdrawal of the support measures and good international coordination.

The need for a credible exit strategy

The design of a credible exit strategy and its clear signaling to the market is crucial before actual withdrawal of the support measures. This strategy is essential to anchor expectations and build the public confidence necessary for effective financial, fiscal, and monetary policy interventions. Even if the banking sector has been stabilized, it is not yet able to stand alone without government support. Therefore, to avoid distortion or inappropriate risk behavior, markets should receive a clear signal that public support will not be maintained beyond what is absolutely necessary. Exit strategies need to address several, possibly conflicting, objectives such as sustaining the recovery, rebuilding a stable and viable financial sector able to sustain lending without state support, and strengthening potential growth while tackling macroeconomic imbalances.

The EU exit strategy

The EU is leading the way in designing and developing public awareness of a credible fiscal and financial exit strategy and has a well-established policy coordination framework based on both rules and peer pressure. EU countries will coordinate their various exit strategies through the existing regional budgetary framework, that is, the Stability and Growth Pact. Moreover, the EU Economic and Finance Ministers agreed on the main principles which should underlie the exit strategies: (1) reinforcing incentives to return to a competitive market, (2) ex ante exchange of information on the intention to phase out, (3) transparency toward the public and the financial sector, (4) set the timing on the basis of an assessment of the stability of the financial system (various macroeconomic and financing conditions), and (5) applying the initial phasing out to the general guarantee schemes.

The EU’s coordination framework, though by no means perfect, has shed light on both the issues and the processes relevant for coordination. Even though the initial positions of the various countries were often different, and
even though the recovery path and pace may vary across countries and regions, the case for coordination of exit strategies is robust and has been underlined by G-20 leaders.

Specificities of this crisis

Compared to the effort required in past crises, the design and implementation of strategies for unwinding public interventions in the present case has been and will remain particularly challenging, for three main reasons. First, the crisis has been truly global—the degree of interconnectedness and the risks of spillovers across countries are substantially higher than in previous crises as a result of increasing integration. Second, in several countries, today’s rise in deficits and debt comes on top of comparatively high starting points for the ratio of government debt to GDP; in many cases, the withdrawal of the fiscal stimulus and cyclical recovery will not be sufficient to prevent government debt ratios rising to even higher levels. Third, the problem of sustainability generated by the sizeable fiscal deficits is compounded in many countries by the pension and health care effects of aging, which soon will start to hit hard.

As a consequence of these three issues, it is difficult to estimate whether the eventual impact of the crisis will be similar to those of previous crises. There is, for instance, a very high degree of uncertainty about the impact of this crisis on potential growth, about the valuation of assets and liabilities, and hence about the expected losses in the expanded public sector balance sheet.

Timing and coordination are essential

Given the interconnectedness, both in terms of geographic and policy areas, the timing of the phasing-out strategy will be crucial. It should be contingent on the situation in the economy, the financial markets, the health of the individual financial institutions, and possible national specificities. The identification of appropriate timing should also take into account the exit from other support measures, such as the fiscal stimulus and the conventional and unconventional support provided by the central banks.

In particular, several elements must be monitored: (1) macroeconomic conditions and stability (as reflected by indicators such as growth, insolvencies, unemployment, monetary conditions, external developments); (2) banks’ behavior as it relates to a return to “normal market conditions,” that is, adequately easy access to private financing; (3) the strength of the banks’ balance sheets and their capacity to deal with impaired assets; and (4) the actual performance by the financial sector of its role in allocating capital in the economy and ensuring a proper functioning of the credit channels.
I would like to thank the organizers of this conference for having invited me to take part in this very timely event. The views expressed here are mine and should not be construed as fully reflecting the positions of the institution I represent.

I will try to address the specific questions put forward by the organizers.

What are the key interdependencies among various types of intervention measures that might make unwinding a complex matter?

Unwinding of policy measures taken in the midst of the financial and economic crisis will be complex because of both their exceptional scope and scale, most notably in advanced economies.

As regards scope, the full gamut of policy areas has been mobilized to support impaired financial sectors and sharply contracting economies. Financial sector measures included mainly bank liabilities guarantees, recapitalization, and asset relief schemes. On the fiscal front, policy steps intended to support aggregate demand, while mitigating financial systemic risks, have resulted in a significant transfer of risks from private to sovereign balance sheets. On the monetary side, central banks’ liquidity management policies used to supplement dysfunctional interbank markets or specific segments of capital markets, have also been reflected in a sizeable “leveraging” of central bank balance sheets. One key interdependency linking these remedial actions stems from the fact that the more these exceptional fiscal and monetary measures are applied on the demand side, the more they undermine incentives to restructure financial institutions on the supply side.

As regards scale, these policies have been stretched to the limits. Specifically, the operation of rule-based fiscal and monetary policy frameworks has been temporarily, but significantly, altered through the use of unconventional measures. This exceptional degree of discretion will have to be phased out gradually as financial and economic conditions stabilize. Such phasing out should be used by relevant authorities to signal that policy modes are gradually shifting as conditions are “normalizing.” Decisions taken by the ECB Governing Council on 3 December 2009 to initiate a gradual phasing out of its enhanced credit support measures illustrate how adjustments in policy modes may be used to “validate” improving financial conditions. In addition, timely exit is needed both to anchor market expectations and to restore policy room that may be required to face further unexpected shocks. The effectiveness of exceptional measures ultimately depends on the credibility of steady-state rule-based policy frameworks. This implies that relevant authorities must map out early enough a reversion to “normal”
modus operandi. As regards the risk of additional shocks in the period of rehabilitation, the experiences of countries having faced serious financial dislocation confirm that it is crucial to keep enough policy space, at any point in time, to be able to sustain lasting recoveries.

Which intervention measures have the greatest potential for cross-sectoral and cross-border spillovers?

With respect to the financial sector, the potential for spillovers and distortions exists in two areas in particular.

As regards the first area, various financial sector support measures are likely to impact capital flows or distort competition. For example, blanket guarantees, such as deposit insurance schemes or guarantees of banks’ other liabilities, are likely to affect capital flows, depending on the degree of asset substitution or cross-border financial integration. More targeted measures, such as recapitalization or asset relief schemes, are more likely to distort competition. With a view to mitigating these risks, coordination has taken place, to varying degrees, at the level of the European Union (EU) as well as at the G-7 and G-20 levels. Until now, these initiatives have proved effective in preventing any material rise in financial protectionism.

With respect to the second area, regulatory and supervisory reforms under way in major advanced economies need to be mutually consistent given the cross-border dimension of the ongoing financial crisis. However, such an outcome may prove difficult to achieve for at least three reasons. First, while further regulatory and supervisory convergence is being fostered by the relevant multilateral forums (e.g., the Financial Stability Board, the Basel Committee on Banking Supervision), residual divergences might well persist for some time in certain areas (e.g., capital requirements, accounting standards).

Second, beyond divergences in rule setting, another potential source of regulatory and supervisory arbitrage arises from the lasting tension between supranational rules or standards, on the one hand, and national enforcement and accountability frameworks on the other hand. Third, the supervisory overhaul encompassing micro- and macroprudential arrangements both in the United States and the EU is bound to improve relevant authorities’ ability to identify and address incipient systemic risks. However, it remains to be seen whether these enhanced policy frameworks will contribute to greater global financial stability given prevailing differences in policy constraints and preferences between the two economic areas.

Which crisis policies, when unwound in an uncoordinated manner, bear the greatest downside risk of distorting capital flows and financial intermediation, or of regulatory arbitrage?
Distortions are likely to arise not only as a result of uncoordinated exits but also if exceptional measures are not removed in a timely manner. The EU may be used as a test case given its high degree of financial integration.

Steps have already been taken to restructure banks that had benefited from public support. The first objective of such reorganization is to prevent competitive distortions within the EU single financial market. A second objective consists in reducing the fiscal cost of policy intervention. While the EU rules governing state aid measures ensure consistency within the single market, it is not clear whether an adequate degree of convergence is currently secured among the EU and other large economic areas (e.g., bank resolution activities in the United States).

Further steps that have just been initiated relate to the gradual removal of exceptional financial support. As recommended by the EU Council, blanket guarantees on bank borrowing should be the first type of exceptional support to be gradually phased out, as access to funding markets continues to improve. The first objective of such sequencing is to restore normal market functioning for most financial institutions, while addressing persisting problems in individual financial institutions with appropriate prudential resolution tools (i.e., recapitalization, asset relief schemes). The second objective of this approach is to avoid overburdening fiscal and monetary policies as conditions gradually normalize and macroeconomic instruments lose their usefulness and effectiveness. In addition, by reverting to rule-based macroeconomic policies when appropriate, the EU would facilitate timely exits by other G-20 members.

Conclusions

Conditions for exiting exceptional policy support are gradually falling into place. As systemwide support measures (e.g., liquidity management measures, blanket guarantee schemes) lose their usefulness and effectiveness for a large majority of financial institutions, their orderly phasing-out will be warranted. Timely withdrawal is essential to underpin medium-term credibility of rule-based macroeconomic policy frameworks. At the same time, support measures targeted at individual institutions should remain in place for the time being, as they are required to preserve financial stability.
During the past two years, governments and central banks have undertaken unprecedented measures to face the risks stemming from the global financial crisis. Most measures were interpreted as extraordinary actions to avoid an economic and financial collapse. At the same time, it was accepted that some costs and risks would need to be controlled. These include tax burdens and possible unintended consequences such as distortions of market participants’ behavior because of reinforced moral hazard. Due to these costs and perils, exit strategies have become a crucial issue.

This conference is exceptionally timely as it addresses the issue of unwinding public interventions in the financial system. In my comments, I will focus on some questions related to the adoption of adequate exit strategies from the perspective of an emerging market economy (EME), with reference to the Mexican experience in the recent and previous crises.

Before moving to the core of the subject, an initial warning seems in order. Exit strategies should not be used as a means to return to a “business as usual” scenario. Just as important as disengagement by the public sector from extraordinary interventions is the government’s engagement in order to prevent future crises. Essential tasks to achieve this goal include sound macroeconomic policies and a revised regulatory and supervisory framework for financial institutions.

EMEs and the global crisis

The recent global financial crisis did not initially have a major impact on EMEs. At a certain stage, a commonly held view was that these economies were decoupling from developed countries. Financial systems in EMEs were solvent and profitable, with high domestic net interest margins having dissuaded local banks from investing in more risky assets. At that stage, the impact of the crisis in EMEs worked through the real side of the economy: a decrease in international trade, a fall in commodity prices, and lower remittances.

However, the worsening of the global turmoil after the Lehman Brothers bankruptcy had major effects. Investment inflows suddenly shrank, and the massive asset sell-off that followed had an adverse impact on exchange rates, domestic interest rates, and local stock markets. Subsidiaries of foreign banks in EMEs constituted an important source of liquidity for their parent firms, which in some cases restricted credit in host countries. Some evidence suggests that since the end of 2008, credit growth in EMEs with a large foreign bank presence has been smaller than in other EMEs.
The financial instability and contraction of output and employment led to the adoption of emergency measures in several EMEs. However, a return to full health in these regions still depends on the recovery of the developed world. The actions adopted in advanced countries to support their financial systems, together with their fiscal and monetary stimuli, have set the stage for the upturn. Proper exit strategies are crucial in order to maintain the improvement of economic prospects.

Preconditions and the unwinding strategy

Governments in many countries have taken numerous measures to support financial systems, including deposit insurance, guarantees of nondeposit liabilities, asset purchases or asset guarantees, special lending facilities and extraordinary central bank liquidity facilities, and capital injections and emergency loans. Exit from these interventions should aim at restoring sustainable financial stability and economic growth.

To achieve a durable and safe disengagement by the public sector, certain preconditions seem desirable. In particular, it is necessary to verify that intermediaries no longer need support, as reflected in their decreased demand for assistance, available access to market sources of funding, and reconstructed balance sheets. This implies the strengthening of capital, reserve, and provisioning ratios under “fair value” conditions. Also, macroeconomic stability should be guaranteed in terms of sound monetary and fiscal policies, so that no undue future financial instability is built into current stimulus measures. On the other hand, economic recovery should clearly be underway, allowing banks to return to normal lending.

Given these preconditions, several elements may contribute to a successful exit strategy. The first one is to price the measures in such a way that a market-based exit is a natural outcome. The incentives of market participants should lead them to draw less on support measures as markets normalize, for example in the cases of debt guarantees, central bank lending facilities, or haircuts to the assets exchanged in a balance-sheet cleanup plan.

A second element is that the timing and sequencing of exit plans should depend on the progress of the preconditions mentioned above, which implies that the timing of withdrawal is partly endogenous and cannot be completely fixed in advance. Although some measures might have been established for a specific time period, others need to be flexible to accommodate unforeseen developments.

A third element is to reconcile the steps of the exit plan with the implementation of any new regulatory and supervisory measures. The
combination of higher requirements and lower support should not destabilize banks.

A fourth element is to explore possible cross-border effects so that adequate internationally coordinated measures can be taken. For example, developing countries have been shown to be highly sensitive to relatively smaller changes in the global economic environment. Exit strategies from firm-specific actions may affect countries where those firms play a significant role.

A fifth element is an adequate communication of plans to the public to avoid unnecessary surprises and gain social support. The advance notice of exit strategies, their objectives and timelines, will facilitate adjustment in the regions that expect some indirect impacts or spill-over effects. Transparency and time consistency greatly increase a plan’s credibility.

These elements uncover interdependencies among measures that may make the unwinding process particularly complex. For example, highly accommodative monetary policy in place for too long may stimulate carry-trade transactions that would cause asset price bubbles in EMEs; removal of public sector support without enhanced regulatory rules may facilitate excessive risk-taking; and lack of international coordination may lead banks and their creditors to arbitrage facilities in different countries.

Mexico’s experience in times of crisis

Let me now turn to Mexico’s experience with public sector interventions during the past two crises, which may be useful to policymakers in other countries. The 1995 crisis brought about a sharp depreciation of the peso, a drastic rise in inflation and interest rates, and a deep recession. As a result, the capacity of borrowers to honor their debts was severely impaired, which caused a deterioration of banks’ balance sheets. The authorities responded with a series of measures to stabilize the financial system.

In the wake of the crisis, a dollar-credit window was established at the central bank to help banks service their obligations and reduce the volatility in a highly illiquid foreign exchange market. This facility charged a high dollar interest rate to ensure that the resources were used only for temporary liquidity shortages. The outstanding amount of dollar loans from the central bank peaked in April 1995, and by September of that year all banks had repaid them in full. Thus, the high rates charged on the facility gave financial institutions an incentive to exit, allowing for the facility’s quick termination.

At the same time, to avoid panic, the government announced a blanket guarantee on banks’ liabilities. With the establishment of the new deposit insurance agency (IPAB) in 1999, the coverage was gradually reduced, and by
2005 it had reached its current coverage level (in U.S. dollars) of about $130,000 per depositor and institution.

Also, a program was implemented for banks to sell their nonperforming loans (NPLs) in exchange for the injection of new capital. The deposit insurance agency bought two pesos of NPLs for each peso of new capital injected by shareholders. The NPLs acquired by the agency would still be managed by the selling bank. The scheme included a loss-sharing agreement under which, after 10 years, 30 percent of the losses would be assumed by the banks and 70 percent by the deposit insurance agency.

Unfortunately, measures to fully capitalize the banking system and build conditions for a return to lending activities took several years. One reason was that NPLs were acquired with promissory notes that were nontradable, and, hence, banks could not sell them to finance lending. More importantly, capitalization was limited by legal restrictions on foreign ownership of banks, which were not completely abolished until 1999. Finally, it took three more years to approve reforms to improve the protection of creditors’ rights.

In contrast, during the recent crisis, the emergency measures were milder and, in general, regarded as temporary, with the imposition of explicit deadlines and limits on the amounts of resources committed. An important difference from the previous crisis was the relative strength of the current banking system.

Specifically, in the foreign exchange market, the Bank of Mexico conducted extraordinary interventions as well as daily auctions of dollars with and without a minimum price. The amount offered in the daily auctions was gradually reduced to zero in the case of those with no minimum price. Additionally, the Bank of Mexico and the Federal Reserve agreed on a currency swap line for up to $30 billion, with a deadline extended to February 2010. Finally, the IMF granted a one year contingent credit line to Mexico for about $47 billion. Both facilities are good examples of internationally coordinated measures.

On another front, the sharp steepening of the yield curve had negative effects on institutional investors’ portfolios. To address those effects, the Bank of Mexico conducted interest rate swap auctions. Also, the government and the IPAB reduced the placement of medium- and long-term securities and increased the placement of short-term issues. At the same time, the central bank introduced an auction mechanism to acquire IPAB bonds and implemented the buyback of long-term debt. These measures have begun to see a gradual unwinding. In addition, regulations were amended so that, for a period of six months, investment funds were allowed to carry out purchases and sales of government debt securities with any financial firm belonging to their financial group.
Finally, government-owned development banks launched temporary guarantee programs to facilitate the refinancing of commercial paper issued by businesses and by nonbank, non-mortgage-related financial firms for up to 50 percent, a program that closed to new users in July 2009. These guarantees were adequately collateralized, and their pricing reflected the firms’ debt ratings. Another guarantee program was implemented for nonbank mortgage financial institutions for up to 65 percent, which will conclude in 2010.

In short, in comparison with the previous crisis episode, emergency measures in the recent crisis were considerably less extensive mainly because Mexico had a more resilient financial system, which, in turn, reflected a stronger and more efficient regulatory and supervisory framework as well as improvements in banks’ risk management and macroeconomic fundamentals.

Concluding remarks

In conclusion, careful consideration of the timing of exit from the various public sector interventions is needed. The magnitude of the global crisis, the interdependency of implemented measures, and the needed reforms of the financial system will likely make the exit a long process. Given that support measures may have undesirable moral hazard effects, it is imperative to implement new rules of the game that induce responsible risk taking in the future. This effort should devote special attention to minimizing the size of the “too big to fail” problem, a subject that deserves a whole conference in and of itself. Clear leadership and social consensus around exit strategies and pending reforms will be essential.
Managing Fiscal Risks—Public Finance Aspects of Unwinding

Mitsubishi Furusawa
Ministry of Finance, Japan

I will start with a few comments on fiscal policy exit strategies in general and then turn to more specific comments on unwinding public interventions in the financial sector.

One of the serious challenges in an exit strategy is determining the appropriate time to begin its implementation. In Japan, the government had supported the economy with a series of fiscal stimulus measures from 1992 to 1996. It unwound those measures in 1997 through the combination of a legally binding fiscal consolidation path, tax increases, and medical benefit reforms. The international community broadly supported these moves toward exit. For instance, in June 1997, the communiqué of the Denver Summit called for appropriate structural reforms in the fiscal area as a priority for Japan, and in July 1997, Japan’s Article IV Consultation endorsed these fiscal correction measures. While it is difficult to draw a firm conclusion as to whether the 1997 measures are an example of the premature implementation of an exit strategy, I will raise three points based on this experience.

First, when assessing economic conditions, we have to be vigilant not only about macroeconomic indicators, such as growth and employment, but also about the progress made in balance sheet adjustments in the corporate or household sectors since these adjustments are a drag on economic activity.

Second, we must take into consideration the aggregate impact of various fiscal policy measures on the macroeconomy, which could affect expenditures, revenue, and social benefit reforms.

Third, we have to be mindful of the potential impact of external shocks on both the domestic economy and financial markets. We might have underestimated the degree to which the Asian financial crisis in the second half of 1997 may have undermined financial market confidence.

With regard to the challenges that are specific to fiscal policy exit strategies, I can raise a few more issues. As the IMF pointed out in its proposed principles for exit strategies, achieving fiscal sustainability will be a complex process and will take a long time. For instance, in December 1996, the Japanese government decided on the basic elements of a fiscal consolidation
path, but it was not until November 1997—almost one year later—that Japan’s Parliament approved a related law. The process for the increase in Japan’s consumption tax rate was even longer, as the increases were originally called for in 1994 but did not become effective until April 1997.

These issues highlight two additional challenges. First, we have to face the reality that each major fiscal policy measure needs to go through a different domestic political process, and it is difficult to manage the timing of implementation. Second, we must be aware of a significant time lag between the decision and its implementation as well as between its implementation and effects.

On the topic of unwinding public interventions in the financial sector, I will address three points.

The first point is the importance of applying a step-by-step approach, with a clear timeline, while paying due attention to the economic environment. Japan started offering a 100 percent deposit guarantee in June 1996, in the midst of the financial sector turmoil. The government had initially set a sunset-clause to take effect for this measure at the end of March 2001. Nonetheless, due to the sluggish economic environment, it postponed its expiration and took a gradual approach. Japan lifted this 100 percent guarantee for time deposits in April 2002 but maintained the 100 percent guarantee for savings accounts until March 2005.

The second point concerns government guarantees. Their use can be effective when the government needs a large financial commitment to anchor financial market confidence, although upfront cash provisions are not necessarily required. For instance, in dealing with the financial sector problems of the late 1990s, the Japanese government set guarantees (which I will give here in dollar terms) of more than $550 billion for borrowing by the Deposit Insurance Corporation, which operates deposit insurance systems and addresses banking sector problems. At its peak in 2001, the Deposit Insurance Corporation used about $260 billion of this guarantee. Thereafter, as the economic environment improved, banks started to unwind government interventions, and use of the guarantee decreased to less than $100 billion in 2007. Capital injections from the Deposit Insurance Corporation to viable banks reached about $140 billion; to date, 75 percent of the injected capital has been returned, and the government has not yet incurred any losses.

That brings up the issue of unwinding government guarantees. Some types of guarantees, such as those for the Deposit Insurance Corporation, could continue to exist as a permanent scheme, enabling the government to deal with problems of banking sector solvency. In fact, this scheme allowed our government to promptly address the problems of several banks in the
aftermath of the current financial crisis. On the other hand, it is desirable to continuously review another type of guarantee scheme aimed at addressing credit bottlenecks and promoting bank lending to specific sectors: In 1998, Japan introduced a special guarantee scheme to facilitate bank lending to small and medium-sized enterprises (SMEs). To cover the potential losses of bank lending to SMEs under this scheme, the Japanese government set a guarantee of around $340 billion. By March 2001, loans had been extended up to the guarantee amount, and the scheme was terminated as originally planned.

The third point is the importance of appropriate arrangements for institutional guarantee schemes. Due to the unprecedented problems in the banking sector, the above-mentioned special guarantee scheme for SMEs presents some extraordinary features, such as very few conditions for its application and a 100 percent guarantee. In addition, most of the lending under this scheme was made without any collateral. This institutional setting was one reason why the losses from the scheme turned out to be much larger than originally estimated by the government, with fiscal costs of more than $30 billion. This cost highlights the importance of making sure that the guarantee scheme will both prevent moral hazard and ensure an appropriate distribution of potential risks.
I will lay out my view of the problem as it relates to the United States, the approach to a solution, and the risks posed by a failure to make real reforms.

The problem

1. The underlying fiscal problems of the United States have significantly worsened as a direct result of the manner in which the financial crisis of 2008–09 was handled.

2. The U.S. economic system has developed relatively efficient ways of handling the insolvency of nonfinancial firms and small or medium-sized financial institutions. A large number of these institutions have failed so far this year without causing major disruption to the economy.

3. The United States does not yet have a similarly effective way to deal with the insolvency of large financial institutions. The dire implications of this gap in our system have become much clearer since fall 2008 and there is no immediate prospect that the underlying problems will be addressed by the regulatory reform proposals currently on the table. In fact, the banking system’s underlying problems are likely to become much worse.

4. The executives who run large banks are aware that the insolvency of any single big bank, in isolation, could potentially be handled by the government through the same type of receivership process led by the Federal Deposit Insurance Corporation for regular banks. However, these executives also know that the failure (i.e., default on obligations) of more than one such bank could cause massive economic and social disruption across the United States and the global economy. The prospect of such disruption, they reason, would induce the government to provide various forms of bailout. They also invest considerable time and energy into impressing this point on government officials in a wide range of interactions.

5. Even more problematic is the underlying incentive to take excessive risk in the financial sector. Given the limitation on the downside provided by generous government guarantees of various kinds, the head of financial stability at the Bank of England has bluntly characterized our repeated boom-bailout-bust cycle as a “doom loop.” The implication is repeated bailouts and recovery programs led by fiscal stimulus.

6. The implementation of the Troubled Asset Relief Program (TARP) exacerbated the perception (and the reality) that some financial
institutions are “too big to fail.” Being too big to fail lowers their funding costs, enabling them to borrow more and to take more risk. The consequences include a contingent fiscal liability—both for specific bank rescue measures and, on a larger scale, the fiscal stimulus needed to offset a potential future credit crisis.

7. U.S. national debt will increase substantially as a result of direct bank bailouts and, more important, the discretionary fiscal stimulus needed to keep the economy from declining—as well as the standard deficit due to cyclical slowdown (a feature of the automatic fiscal stabilizers). Privately held government debt as a percentage of GDP will increase from around 40 percent to the 70–80 percent range.

8. Any country that provided unlimited government support for its financial system—while not implementing orderly bankruptcy-type procedures for insolvent large institutions and refusing to take on serious governance reform and downsizing for major troubled banks—would be castigated by the United States and come under pressure from the IMF. Yet this is the approach that the U.S. has implemented.

9. At the heart of every crisis is a political problem—powerful people, and the firms they control, have gotten out of hand. Unless that problem is dealt with as part of the stabilization program, all the government has done is provide an unconditional bailout. That may be consistent with a short-term recovery, but it creates major problems for the sustainability of the recovery and for the medium-term. Again, this is the problem in the United States looking forward.

10. The Obama administration argues that its regulatory reforms will rein in the financial sector in this regard. Very few outside observers—other than at the largest banks—find this convincing.

**Toward a solution**

1. As legislation on restructuring the banking industry moves forward, attention on Capitol Hill is increasingly drawn to the issue of bank size. Should our biggest banks be made smaller?

2. There is a strong precedent for capping the size of an individual bank: the United States already has a long-standing rule that no bank can have more than 10 percent of total national retail deposits. This limitation is not for antitrust reasons, as 10 percent is too low to have pricing power. Rather, its origins lie in early worries about what is now called “macroprudential regulation” or, more bluntly, “don’t put too many eggs in one basket.”
3. This cap was set at an arbitrary level—as part of the deal that relaxed most of the rules on interstate banking—and it worked well (until Bank of America received a waiver).

4. Probably the best way forward is to set a hard cap on bank liabilities as a percentage of GDP; this is the appropriate scale for thinking about potential bank failures and the cost they can impose on the economy. Of course, there are technical details to work out—including how the new risk-adjustment rules will be enacted and the precise way that derivatives positions will be calculated in measuring size. But such a hard cap would establish the benchmark around which all the specifics can be worked out.

5. What is the right cap on the size of a bank’s liabilities: 1 percent, 2 percent, 5 percent of GDP? No one can say for sure, but it needs to be a number so small that we all agree that any politician who cares about our future would have no misgivings about the failure of a bank at that size limit and would be confident that if it did fail, our entire financial system would not be at risk.

6. A hard cap at 4 percent of GDP seems about right for a bank with the most conservative possible portfolio. This would mean that no bank in our country would have more than about $500 billion of liabilities, even with a relatively low risk portfolio. On a risk-adjusted basis, most investment banks would face a cap of around 2 percent of GDP.

7. A large American corporation would still be able to do all its transactions using several banks. They would even be better off—competition would ensure that the margins would be low and that the banks give the corporations a good deal. This would help end the situation in which banks take an ever-increasing share of profits from our successful nonfinancial corporations (as seen in the rising share of bank value-added in GDP in recent decades).

8. Indeed, the whole world would soon realize that our banks are more competitive and offer better pricing than others.

9. If, as might occur, the Europeans subsidized their big banks with cheap finance and implicit subsidies, the United States should let our nonfinancial corporations benefit and understand that our banks may become ever smaller. We can let Europeans subsidize banking because we all get better deals through their taxpayer subsidies, and then our corporations will have more profits to bring back to America.

10. Today our politicians and regulators lack credibility. They have bailed out too many banks and need to show they have truly regained the upper hand—by installing such a hard size cap without exception.
11. The litmus test is simple. Does Goldman Sachs continue to grow and, because it has demonstrated it is too big tofail, continue to be regarded as almost as good a risk as the U.S. government? (Goldman’s credit default swap spread is currently only about 70 basis points above that of the United States.) Or will the government impose a cap on the size of such institutions and require Goldman Sachs to find sensible ways to break itself into pieces—becoming small enough so that it will not be bailed out again next time?

**In the absence of real reform**

1. In the absence of real reform, progress toward reducing the risks inherent in the U.S. financial system is unlikely. As long as there are financial institutions that are too big to fail, we face a potential fiscal cost. We should recognize that cost in our government budget and balance sheet accounting.

2. The overriding principle behind IMF fiscal assessments is the need to capture true total fiscal costs. Best practice for the United States needs to reflect this approach.

3. All subsidies and taxation—including the entire cost of supporting the continued existence of large banks—should be reflected transparently in the budget and subjected to the prioritization of the budgetary process.

4. Our current accounting for guarantees and government assumption of other contingent liabilities creates the impression that government actions to support the banking system are costless. This is a dangerous illusion—as seen in the recent increase in the U.S. federal government deficit and debt.

5. If we don’t recognize these costs explicitly, we run the risk of taking on an ever greater contingent liability. If the financial system reaches the point at which its failure cannot be offset by fiscal (and monetary) stimulus, then a Second Great Depression threatens.
Exceptional support for aggregate demand and for the financial sector has been inescapable for Germany in response to the crisis: from the end of 2008 to the beginning of 2009, the German government implemented discretionary fiscal policy measures up to almost €100 billion, with the effect mostly in 2009 and 2010. The German rescue scheme for the financial sector amounts to €480 billion. Since recovery remains fragile, it is not yet time to withdraw support. Further fiscal stimulus therefore will be provided by the Growth Acceleration Law effective as of January 2010.

These measures contributed to a stabilization of the real economy: quarterly growth rates of GDP have been positive since the second quarter of 2009. A severe weakening of the budgetary position, however, is the other side of the coin. Without any consolidation measures in the near future, this leads to a large deterioration of long-term sustainability gaps. The situation, which is similar in many other countries in the European Union (EU), also creates a great challenge for the European Stability and Growth Pact. From 2011 on, therefore, fiscal consolidation must and will be the top policy priority of German fiscal policy. While withdrawing financial policy support should not put financial stability at risk, a timely exit is important to minimize fiscal risks and to avoid costs that distort competition.

The need for fiscal rules in this situation and a firm commitment to them seem to be a necessary requirement for a credible exit. Germany is committed to fiscal exit strategies at two levels. On the European level, principles developed by the Economic and Financial Affairs Council (ECOFIN) of the Council of the European Union were endorsed by the European Council with a starting date for fiscal exit in 2011 at the latest. For Germany, the deadline for the correction of the excessive deficit is in 2013, with a minimum annual improvement in the structural balance of at least 0.5 percent of GDP.

The new constitutional budget rule constitutes the framework for the fiscal exit strategy on the national level with an overall limitation of structural deficits (federation: 0.35 percent of GDP; states: zero percent of GDP) while allowing automatic stabilizers to work. This rule will come into effect in 2011 with transitional periods—where structural deficits have to be reduced to the aforementioned levels—for the federal level until 2016 and for the states until 2020. The institutional framework is also strengthened by the fact that borrowing via additional funds to cover special financing needs—which was possible according to the old budget rule—will be justified only as an exception to the new rule from 2011 on.
Exit from support to the financial sector in Germany will be realized by a bottom-up approach that allows for a gradual phasing out. A combination of procedural rules and incentives is ensuring a timely exit that responds flexibly to individual needs. By law, the German rescue scheme expires at the end of 2010. It is approved by the EU Commission on a six-month basis under state aid rules; an obligation for renotification ensures that an exit will not be inappropriately delayed.

Exit from individual stabilization measures (guarantees, recapitalization, and impaired asset relief) will be taken once viability of the individual bank is ensured. Guarantees (currently €127 billion) are limited to a maximum of five years and will phase out automatically at maturity. Banks that receive a recapitalization under the German rescue scheme (recapitalizations so far: €22 billion) have to present a restructuring plan under state aid rules. State aid rules provide for an automatic exit. They strike a balance between competitive functioning of the financial market and the need to stabilize the financial system. The possibility of creating bad banks allows the liquidation of impaired assets (to date, €6 billion), while the remaining core bank has to prove its viability and follow a restructuring plan.

The support measures to the financial sector have also increased requirements for fiscal policy analysis and management. Most of the financial market support measures have not yet had an impact on public deficits, but they increased the level of gross debt markedly. Supplementary tables published by Eurostat in the context of the Maastricht notification provisions create a certain degree of additional fiscal transparency with respect to all interventions at the EU level, though comparability across EU member states might not be perfect.

The government has to be careful in designing the exit path—not too early and not too late, differentiating between supporting the financial markets and the economy as a whole. Putting aside gross economic error or obvious political misjudgment, the risks from “too late” are, in my opinion, much more serious than those from “too early,” hampering market expectations and the structural reform agenda with a huge impact on sustainability and potential growth in the long run.
Nigel Ray  
Australian Treasury

This note focuses on the practical issues around the conduct of fiscal policy, particularly the Australian experience.

Although Australia is a small, open, advanced economy, it has a relatively greater share of its exports in primary commodities than would be the case for most other small, advanced economies.\(^3\) Despite a national saving rate that is around the average for OECD economies, a high investment rate means that Australia is traditionally a large net importer of capital.\(^4\)

Taken together, these two facts mean that Australia’s economy is highly sensitive to developments in the world economy and in world financial markets. As a result, the global financial crisis and the associated global downturn provided one of the more severe possible tests of Australia’s economic resilience.

Explaining fiscal actions

A clearly specified, credible fiscal strategy is important to marshal and maintain public support for fiscal policy actions.

The Australian government is required to produce a fiscal strategy statement at least annually. The statement must show how fiscal policy actions taken for the purposes of moderating fluctuations in economic activity are to be reversed, and it must show that they are consistent with long-term fiscal objectives.\(^5\)

The budget must also contain a statement of risks that includes contingent liabilities and publicly announced government commitments not yet included

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in the fiscal estimates. This requirement means that off–balance sheet liabilities, such as debt guarantees for other entities, must be disclosed at the same time as the balance sheet and other financial statements are updated and released.

Nontraditional fiscal measures should not be excluded from the reporting requirements. If they are excluded, then the public’s understanding of the stance of fiscal policy and of the risks that the government is facing is diminished. Contingent liabilities are not costless—financial markets will demand a premium to finance governments that have them, and ratings agencies and the IMF pay particular attention to them.

Medium-term fiscal targets

Economic theory does not give us precise guidance on appropriate fiscal targets, and each country will have different factors that need to be taken into account in formulating its fiscal objectives.

Australia’s high reliance on foreign saving and the weighting of its export income toward primary commodities mean that adverse developments in the world economy and financial markets have significant implications for the real economy. In these circumstances, relatively conservative fiscal objectives are appropriate because they allow the government to act to minimize temporary macroeconomic disruption if necessary. Countries not subject to the same level of external exposure as Australia may be able to adopt less conservative fiscal objectives.

Long-term economic considerations are also relevant. In Australia, factors such as growth in Asia and the aging of our population have fundamental implications for the future structure of the economy. Australia’s fiscal position needs to be robust to the future demands that will be placed on public services and infrastructure. Long-term budget projections can be very useful in identifying these types of pressures.

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7 Cottarelli and Viñals offer a range of goals for returning to fiscal normalcy after the crisis, from “stabilizing public debt ratios at whatever level has been reached as a result of the crisis,” to aiming at “placing the fiscal accounts on a sustainable path, one that is indeed stronger than before the crisis, and that ensures the resilience of the fiscal accounts to the demographic shock.” (C. Cottarelli and J. Viñals, 2009, “A Strategy for Renormalizing Fiscal and Monetary Policies in Advanced Economies,” IMF Staff Position Note 09/22 [Washington: International Monetary Fund], p. 8). www.imf.org/external/pubs/ft/spn/2009/spn0922.pdf.
The commitment to a fiscal target can be as important as the target itself. Just as different countries can sustain different inflation targets for monetary policy, different objectives can be sustained for fiscal policy. It is the clear statement of those objectives and the maintenance of policies consistent with those objectives that establish the credibility that can be so helpful for the conduct of macroeconomic policy.

Temporary fiscal interventions

It is important to distinguish the use of fiscal policy to boost aggregate demand temporarily from the longer-term objectives of fiscal policy.

Monetary policy is still the first choice for macroeconomic management, but it can be complemented by discretionary fiscal policy in limited circumstances, including where the downturn is likely to be deep, where it is synchronized across a number of countries, and where there is financial sector impairment that limits the potency of monetary policy.

It is important to specify which actions form part of a temporary stimulus, what their objectives are, and how and in what circumstances they will be withdrawn. It is also important to show how they are consistent with the government’s longer-term fiscal objectives. This allows the public and financial markets to judge the efficacy of the government’s measures and supports the credibility of the fiscal strategy.

Temporary fiscal stimulus needs to be clearly targeted at ameliorating temporary economic disruptions, and the budget’s automatic stabilizers must be allowed to operate. The beneficiaries of public guarantees require incentives to return to nonguaranteed financing as market conditions normalize. The timing of the withdrawal of fiscal stimulus also needs to be robust to changing economic circumstances.

Coordination of fiscal actions

In the current situation, advanced economies face the challenge of a simultaneous, large fiscal consolidation. An overly hasty effort to repair balance sheets could harm the global economic recovery.

This danger could argue for greater international coordination in the withdrawal of fiscal stimulus, although it is likely that, once a sustained economic recovery is under way, private sector activity will quickly use any resources freed up by the withdrawal of fiscal stimulus.

An area in which coordination might be a more important challenge is the involvement of different layers of government in the delivery and withdrawal
of stimulus. For example, this might be a particular challenge if subnational governments have wide spending powers combined with balanced budget rules.

Conclusion

To sum up, there are some useful guiding principles for fiscal policy:

- Communicating—to the public and the markets—the fiscal strategy and the fiscal position are of utmost importance, including specifying to the fullest extent possible the risks and contingent liabilities that are not shown on the government’s balance sheet.

- Long-term fiscal objectives need to be set with a country’s individual circumstances in mind and should provide adequate flexibility to respond to a plausible range of economic stresses.

- Monetary policy is at the front line of demand management, but discretionary fiscal policy can be useful in exceptional circumstances. When this option is exercised, the nature and role of the stimulus and its timetable for implementation and withdrawal should be clearly specified and consistent with the government’s long-term fiscal objectives.
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I have been asked to focus my remarks on two questions in particular. First, what macroeconomic and financial market indicators should guide the unwinding of liquidity support and funding guarantees? Second, are recent developments supportive of current plans for withdrawal? Before addressing these two questions, I would like to make three generic points about the withdrawal process.

First, the unwinding process will be easier—and indeed can be entirely automatic—if the policies have been well designed in the first place. Thus, the demand for central bank liquidity support should drop off as markets recover, if that support is provided at penal rates. Christine Cumming’s comments this morning about declining use of the Federal Reserve’s programs illustrate this point. Similarly, if funding guarantees are priced expensively, then the demand for them will drop off as risk appetite returns to unguaranteed funding markets. For instance, the insurance provided on newly issued bank debt under the United Kingdom’s Credit Guarantee Scheme is priced off credit default swap (CDS) spreads during the crisis period. Consequently demand for the guarantees has evaporated as risk appetite has returned to the market for banks’ debt.

It will, however, be more difficult to withdraw liquidity support that has been provided at nonpenal rates or against illiquid collateral that a central bank would not normally take in its operations, as the demand for support will remain even as markets return to normal. Similarly, it will be more difficult to judge when it is safe to remove nonpriced guarantees—the most obvious example being enhanced guarantees on retail deposits.

Second, support policies should be a bridge to a new, sustainable equilibrium. Some business models, such as those very reliant on short-term wholesale funding through securitization vehicles, and some asset structures, for instance for some sorts of mortgage-backed securities and complex structured finance assets, are unlikely to be sustainable without ongoing public support. Policy should not support these businesses or markets unless there is an identifiable market failure present. As the recovery proceeds, we will gradually get a better appreciation of which business models and which
asset structures can survive (possibly in altered form) and which should be allowed to perish. But there is a danger that political economy considerations may delay, or even prevent altogether, the withdrawal of support for these unviable businesses and assets.

Third, and allied to this, it is important that governments and central banks as far as possible stick to commitments they have already made regarding withdrawal of support. The looming withdrawal of support should encourage banks to take preemptive action to strengthen their balance sheets by retaining profits or raising new capital. For instance, funding costs are generally lower for well-capitalized banks, so the imminent withdrawal of funding support should encourage banks to improve their capital base. I recognize, though, that this may have some adverse side effects, as it could also encourage banks to cut back lending in order to improve capital ratios through that route.

So, turning to the first of my two original questions, what indicators should govern the pace of withdrawal? To begin with, in principle one can have a strong economy and a weak financial sector or vice versa, but in practice a stronger economy leads to lower default losses and, other things equal, a stronger banking system. So the usual clutch of macroeconomic indicators, such as growth, unemployment, and capacity utilization provide a suitable backdrop.

Second, the indicators of the state of funding markets and measures of credit risk are important. In particular, the terms on which banks can issue unguaranteed debt are critical. So banks’ CDS premiums potentially provide valuable information. It is worth noting, however, that these may give a misleadingly benign impression if they reflect a belief that the public sector will always ride to the rescue of a beleaguered institution. Moreover, it would be inappropriate to delay withdrawal until the CDS premiums for all banks have fallen back to low levels, as some lenders surely should be encouraged to merge with stronger brethren or else exit altogether. The state of the securitization market will also be critical, though the problem here is to know what structures deal adequately with the underlying information and incentive problems that were exposed by the crisis and will consequently be viable.

Third, indicators of the solvency of financial institutions, such as expected losses and capital and leverage ratios, should be valuable. In particular, these considerations should be brought together through the implementation of rigorous stress tests against a range of extreme but not implausible scenarios.

Finally, general indicators of risk appetite in financial markets, including a range of asset prices, should also be factored in.
So, regarding the second question, are recent developments generally supportive of current plans for withdrawal? I have to say that progress looks promising. The worst downside risks have largely dissipated as growth has returned to most of the G-20 economies along with a reduction in the likely losses in banks’ banking books and some writing up of the value of assets in the trading book. Risk premiums on financial assets have fallen back, CDS premiums have returned to levels seen prior to the collapse of Lehman Brothers, and LIBOR-OIS spreads are back to precrisis levels. And the issuance of unguaranteed bank debt has picked up. The main problem is the continued closure of the securitization market, which raises the question of how the funding gap will be filled when the copious quantities of public support are withdrawn.
The question I will discuss is whether financial institutions and markets are able to deal with the unwinding as planned and what the mechanisms and incentives should be to effect such an unwinding. In my mind the first part of the question is the most important, and in order to understand it better, we need to look closely at how banks are funding themselves and how that may evolve over time.

I have spent a large part of my career as a bond syndicate manager, and the first question we would ask on any transaction was, “Who is going to buy it?” If we are to replace state sponsored and provided funding for banks, we need to be confident that private sector demand and capacity exists.

We are getting some mixed messages as we look at markets. On the one hand, banks’ use of the various government schemes is clearly coming down significantly, market measures of risk appetite among investors suggests a degree of normalization, and private sector sources of funding are reopening.

On the other hand, that is only one part of the story, and numerous challenges remain as banks seek to be fully funded on a stand-alone basis. The investor base for bank securities has changed dramatically, the future calendar for refinancing is huge as the duration of liabilities has shortened over the last two years, and banks face a number of difficulties and competing pressures as they seek to grow their deposit bases and long-term wholesale funding. Clearly the extent of these difficulties varies dramatically across countries and regions; the injection of capital by the German state of Rhine-Westphalia into the WestLB bank was a timely reminder that not every country and not every bank is at the same point in the cycle.

Use of government-guaranteed issuance schemes has fallen dramatically and on a month by month basis is down 60 percent from its peak. Nonetheless, we still see issuance under these programs—for example, the Skipton and West Bromwich Building societies’ issue in the United Kingdom; and Bank of Queensland, among others, in Australia. In fact, in some areas, issuance has been increasing over the past three months. Any discussion on incentive mechanisms will need to understand whether such guaranteed issuance is driven purely by cost relative to the alternatives.

We see a similar pattern across most of the central bank liquidity facilities—for example, the term auction credit of the Federal Reserve’s Term Auction Facility or the holdings of its Commercial Paper Funding Facility. All show material declines. But the volume of funding which needs to be replaced before utilization returns to precrisis levels is clearly huge.
If we turn to our traditional barometers of risk appetite, again we see positive trends: whether we look at LIBOR rates, repos, or bank credit default swaps (CDS). All of these suggest spread compression and normalization. But the events of the past two weeks regarding the Dubai World development are a reminder of the fragility of investor confidence. And we can see this fragility reflected in the sovereign CDS levels if we look at Greece and the growing concerns regarding its deficit, concerns clearly exacerbated by the events in Dubai.

So, how are the alternatives to state supported funding developing? The maturity of euro commercial paper issuance shows a clear, healthy upward trend. From a low of around 20 days’ maturity in September 2008 as the events around Lehman Brothers were unfolding, we now see a level of around 60 days.

We see a similar pattern in covered bond issuance, a trend supported in particular by the European Central Bank’s purchase program, which commenced earlier this year. But—and this ties in with my point on the volume of funding required—volumes are still only at pre-2006 levels and, based on our forecasts, are likely to remain there next year. Further, senior unsecured issuance by banks has similarly recovered, but, again, volumes are still not fully at precrisis levels.

We have also seen the ratio of guaranteed to unguaranteed debt shift in the right direction, but we can also see that, for most of the period since the Lehman Brothers bankruptcy, guaranteed deals have consistently been larger.

Right now the growth of the covered bond markets and unguaranteed markets is critical because, for the time being, two key markets for term bank funding are effectively gone. The first is the senior bank floating rate note market, where we can see the postcrisis collapse in volumes; and the second is the European asset-backed securities (ABS) market. European ABS issuance levels in 2008 and 2009 do not reflect sales to third parties; they are retained transactions to be used as collateral with central banks.

We have seen a significant shift in the investor demographic. The biggest buyers of longer-dated senior floating-rate notes (FRNs) were banks themselves, benefitting from the 20 percent risk weight under Basel I and using them for liquidity portfolios. An example from January 2007 is a €2 billion issue from a AA-rated European bank, in which one can see that nearly 70 percent of the order book was banks. Going forward, those bank liquidity portfolios will be invested in government bonds. Further, if we look at an order book for the AAA tranche of a UK transaction in prime residential mortgage-backed securities in late 2006, we can see that the dominant investor base was the structured investment vehicles or SIVS who are clearly no longer around. So the message is clear; banks need to cultivate
a new investor base for term funding—the so-called real money community of asset managers, insurers, and pension funds—to fill this gap.

We can also see this manifested in the difference between the investor pattern for guaranteed and unguaranteed issuance. Consider the case of the order books for two U.S. dollar issues by the same large bank in the United Kingdom. What you may notice is that the guaranteed deal is dominated by banks, but also that there is huge concentration in the order book, with the top 10 allocations accounting for more than 80 percent of the deals. The average order size is large at 67 million. In some respects what is happening here is that the banks that have benefitted from an inflow of deposits and liquidity in the crisis have recycled that to other banks through the mechanism of the guarantee schemes.

In contrast, the unguaranteed deal is primarily driven by fund managers and, to a lesser degree, hedge funds. But notice also how granular the demand is, with an average order size of 23 million and more than 160 orders in the book for a transaction that is 40 percent smaller.

This is a key point—the investor bases for guaranteed and unguaranteed issuance are different and we need to be confident that as we switch off the guarantee schemes that the broader investor base is deep enough and can provide the volume of funding required.

It is worthwhile at this point to consider the incentives and disincentives for banks to use the guarantee schemes. Consider France, where the government guaranteed issuance was via the SFEF agency, and Spain. We can see that in France banks were issuing unsecured funding even at points where guaranteed funding came at much tighter spreads; but perhaps more interestingly, in Spain some banks are still issuing guaranteed paper even though covered bonds are pricing at much tighter spreads. The reality is, of course, that the covered bond market is not yet open to all issuers, and therefore an increase in the guarantee cost in and of itself is unlikely to change things. So, although markets are reopening, not all financial institutions enjoy the same degree of access.

Finally, a couple of words on the refinancing burden and other challenges. The redemption profile of bank securities is sizeable, and unsurprisingly, the average maturity of liabilities has gone down. We estimate that for European financial institutions, we see 2010 redemptions approaching €700 billion. This represents only outstanding securities and does not reflect usage of central bank facilities. Average duration has fallen from around six years to nearer to four.

Banks have numerous incentives to restore stand-alone funding. One that I have not touched upon is the proposed new liquidity buffers that will
penalize short-dated funding—the negative carry of a large liquidity portfolio will be a significant cost to the business. But banks face other external challenges in trying to build wholesale and retail funding. Governments are competing issuers in wholesale markets and can also compete for retail deposits, as we recently saw in the United Kingdom with National Savings.

As highlighted earlier, insurance companies are an important target investor base. The new insurance regime in Europe, Solvency 2, will make it more costly for insurance companies to invest in longer-dated bank bonds. And finally, the fungibility of funding and liquidity between jurisdictions face potential constraints arising from the likely requirements regarding self-sufficiency of liquidity.
Dino Kos  
Portales Partners, LLC

What indicators are being used by the market to judge whether monetary authorities are approaching an exit from their ultra-accommodative policies?

I will focus on the United States because of the Federal Reserve’s influence and, more important, because it’s the situation I am most familiar with.

To set the stage, what are central banks—and the Federal Reserve in particular—exiting from? Four instruments are currently being utilized:

- zero short-term interest rates;
- assorted liquidity facilities;
- high levels of excess reserves; and
- asset purchases.

Thus, I would define a true exit as one in which the Federal Reserve reverts to targeting a nonzero interest rate and exits the remaining mechanisms. The liquidity facilities, designed to become unattractive as money markets normalize, have been contracting for months and are slated to wind down. However, asset purchases have more than offset the reserve contraction that the reduction of liquidity facilities would otherwise have implied.

Exiting the remaining aspects—zero interest rates, high levels of excess reserves, and asset purchases—will be a significant event for the Federal Reserve and for markets more generally. What signposts are investors and traders using to assess whether the exit is approaching?

Answer: The ones the Federal Reserve has told investors to focus on. In its November 2009 statement, the rate-setting Federal Open Market Committee listed the following elements:

- measures of resource utilization;
- inflation trends; and
- stable inflation expectations.

Resource utilization: Capacity utilization is at very low levels, while unemployment has reached 10 percent. In short, the output gap is very large and should not press against capacity constraints anytime soon.

Inflation trends: Headline inflation has been negative for much of the past year. Core measures are running at around 1.5 percent.
Inflation expectations: Breakeven rates from inflation-protected treasury securities (TIPS) suggest that longer-term inflation expectations have reverted to levels observed before the crisis. Despite worries about “quantitative easing” and “printing money,” the fixed-income market has not, to this point, priced in a high likelihood of inflation that will rise beyond the Federal Reserve’s implicit target.

Clearly, and not surprisingly, the Federal Reserve is placing a strong focus on inflation. However, readings of actual inflation are likely to lag. Therefore, other indicators will have to supplement this list of inflation signals. One candidate is the behavior of commercial banks. Despite high levels of excess reserves, bank lending has contracted over the past year. However, at some point, a reversal of this trend should emerge and could be an important signal by suggesting that both the demand for credit and banks’ willingness to lend are reviving. This may signal a healing of the credit intermediation process (one of the important reasons for undertaking the interventions) and indicate that the economy is improving, since stronger credit demand will signal a need to finance growing receivables, inventories, and capital expenditures. In short, it may suggest the need to begin removing accommodation before inflation signals begin to turn amber.

What about logistical and operational issues posed by the exit?

The Federal Reserve’s balance sheet grew by virtue of its asset purchases. Hence, the simplest means of exit would be to sell those assets. What is the probability of that happening? It borders on zero. Why? The Federal Reserve has acquired more than $1 trillion of mortgage-backed securities (MBS). The purchases have pushed down longer-term rates in general and have compressed the MBS spread in particular. During 2009, the government (mostly the Federal Reserve, but also the Treasury) has been the only buyer of MBS. Selling would likely push both the risk-free rate and MBS spreads much higher. The adverse impact on the housing recovery could be significant. The authorities will not wish to risk that outcome.

The more likely approach for exit will be to use the securities as collateral in reverse repos. However, there are only 18 primary dealers, and they have balance sheet constraints. A broader set of counterparties will be necessary. Money market funds are an obvious choice. But this also has complications. The money market segment grew from less than $2 trillion in 2005 to about $3.9 trillion earlier this year—before shrinking by $650 billion over the past eight months. In other words, the money market fund business is subject to wide fluctuations, which suggests that the Federal Reserve may want to limit its reverse repos to this segment.

An alternative for the Federal Reserve would be to increase the “interest on reserves” (IOR), the interest rate it pays on excess reserves. That would push
market rates higher. This method has the advantage of avoiding an abrupt drain, such as that in 1937, and gives the banks a longer period of adjustment to a world of lower reserve balances. However, there is a threshold question that has not been answered.

Assume the Federal Reserve raises the IOR to, say, 3 percent and leaves several hundred billion dollars of excess reserves in the system. Is that the same monetary policy as a 3 percent policy rate with minimal excess reserves? Are financial conditions the same even though in the first scenario the system stays awash with significant amounts of reserve balances?

Put differently, the IOR mechanism has surely affected the demand curve for reserves among commercial banks. What is the new equilibrium? How will the Federal Reserve know when to stop the draining process? How it navigates this process will have huge implications for markets, and more broadly, for the economy.
Given Japan’s experiences of exit from measures that dealt with the last Japanese financial crisis—including quantitative easing, blanket deposit guarantees, and capital injections—I would like to stress that there should not be any predetermined timetable or specific conditions for unwinding of public interventions. The timing, sequence, and modality of unwinding should be up to pragmatic judgments, including whether the financial sector can stand on its own without the measures in question, how probable it is that the financial sector will get into double-dip problems that would require resurrection of the measures, and whether the adverse impacts of the measures would outweigh their benefits. An exit strategy should differ from country to country, but it is my sense that the current stage of working out the problems of the European and U.S. financial sectors is where Japan stood in 1999 and 2001, respectively. For Japan, it took two to four more years to have a turnaround in its working out process.

For unconventional measures directed at acute symptoms, unwinding should not be postponed once the symptom disappears. In this spirit, the Bank of Japan has already decided on dates to terminate outright purchases of corporate instruments and other unconventional measures.

For unwinding directed at more basic policies, such as raising interest rates and repayment by banks of injected capital, the decision should take more time. On both fronts, resurrection of confidence in the financial sector should be a prerequisite for unwinding. One of the most important lessons from Japan’s financial crisis is that without a healthy financial sector, the normal transmission mechanism of monetary policy does not function. While the financial sector was in intensive care, monetary policy could do no more to underpin the economy than to support the financial sector’s recovery. Repayment of injected capital should require careful thinking, too. Merely dropping a hint regarding the expected timing of unwinding would accelerate deleveraging by banks, possibly resulting in another round of adverse feedback between the financial sector and the real economy. Basically, before the financial sector can emerge from the vicious cycle of deleveraging and the incessant revelation of credit losses, the completion of balance sheet adjustments in the corporate and household sectors should be in sight.

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8 The views expressed in this statement are Mr. Toyama’s and should not be construed as the views of the Bank of Japan or of any other person at the Bank of Japan.
Another condition for regaining confidence in the financial sector is the existence of safety nets for depositors and the basic functions of financial institutions. In the long list of safety-net measures, effective supervision is of utmost important. On the other hand, although toughened regulations may be significant in calming the public’s rage over the government and the financial sector, it may risk accelerating deleveraging.

The injection of taxpayer money into the financial sector is unpopular everywhere in the world. In Japan, severe criticism of the injection of public money to resolve the Housing Loan Companies in 1996 caused undue delay in policymakers’ decision to move ahead with expenditures of public money to resolve the banking sector. As a result, another couple of years had to be wasted until 1998, when failures of large financial institutions left the government no choices.

A healthy condition of the financial sector affects a large number of sectors in the economy. In particular, premature unwinding will deal a blow to small and medium-sized enterprises, which do not have access to the capital markets.

A rise in interest rates will adversely affect the sectors that have been helped by the ultralow interest rate policy. In Japan, a substantial portion of mortgage loan borrowers have selected floating interest rates rather than fixed rates in view of the prevailing low short-term interest rates. If rates rise, many of those borrowers may find it difficult to repay the mortgage, which will put further downward pressure on residential real estate prices.

A rise in interest rates will also cause a reversal of capital flows into emerging economies and the commodity markets. Investors will feel safe in continued risk taking until major central banks, in particular, the Federal Reserve, decide to make an exit. It is unfortunate that industrial countries and emerging countries blame each other for shocks that materialize when the direction of capital movements is reversed. The problems are twofold. First, a disparity in the correction of exchange rates emerges. The burdens of a U.S. dollar depreciation are put on currencies that are not pegged to the dollar or managed through intervention. Those currencies essentially assume the role of an anchor, with adverse impacts on the export sector and price stability when deflationary conditions exist.

Second, risk taking in emerging market equities and commodities may have pushed up their prices beyond a level reasonably justified by their fundamental values. How these irregularities or imbalances will play out when major central banks change monetary policy is uncertain. The recent incident of the Dubai World dramatically revealed that markets were already nervous over excessive risk taking. I am not optimistic that major industrial and emerging market countries can agree upon a coordinated action to
prevent further excessive risk taking or carry out orderly exits, as countries primarily calibrate their policies according to the conditions in their domestic economies. However, it is important for an institution such as the IMF to give warnings about movements in the markets that could give rise to another bubble and its subsequent bursting.

With respect to the external impacts of unwinding financial sector policies, I would stress only that recovery of confidence in financial institutions takes longer in foreign markets than at home.
Edwin M. Truman  
Peterson Institute for International Economics

There is a singular lack of consensus about what caused the economic and financial crisis of 2007–09. That there is a similar lack of consensus about how best to exit from the crisis should not, therefore, be surprising. Before I address the specific questions put to me by Olivier Blanchard, I would like to offer some general reactions to what I have heard at this conference.

First, the overall objective should be strong, sustained, and balanced worldwide growth. Financial sector repair is part of that process, but it is only one part. Nor is it the most important element for every country. The circumstances of individual countries differed in advance of the crisis. Their actions as the crisis unfolded differed as well. It is attractive to think about phased, coordinated exit plans, but I do not think that will be the most likely outcome, nor should it be the guiding principle. It is desirable for national plans to be phased, for partner countries to be as informed about those plans as is practicable, for antisocial behavior to be minimized, and for plans to be coordinated in that sense. However, reality will fall short of even that modest ideal.

Second, on the treatment of nonconventional assets purchased by central banks, my view is that this is not an issue of high importance, at least for the United States. The Federal Reserve appropriately took extraordinary actions during the crisis. As a result, the Federal Reserve has suffered criticism from many who should know better. Those critics are not going to be silenced by a quick restoration of the Federal Reserve’s balance sheet to the status quo ante.

The balance sheet of every central bank is ultimately a part of the balance sheet of its government as a whole, even if some central banks would like to pretend otherwise. The fact is that the United States more effectively shares a consolidated balance sheet between its central bank and treasury than do most other countries. Federal Reserve profits and losses flow through to the Treasury on a weekly basis. (In the case of international assets, this treatment extends to paper gains and losses, as holdings are marked to market.) It follows that it is of limited significance whether the Federal Reserve or the U.S. Treasury holds the unconventional domestic assets acquired in the crisis. If the Federal Reserve takes losses on its holdings, or on sales of its holdings, there will be an immediate loss of revenue to the Treasury from the Federal Reserve just as if the Treasury had held the assets. Perhaps the Treasury would be more likely to hold certain assets to their maturity, and perhaps the resulting losses to the taxpayers would be lower, but this is not obvious, as the assets would have to be financed in the meantime.
Third, in thinking about unwinding monetary stimulus, a focus on so-called excess reserves is not the right place to start. Today the U.S. banking system holds willingly—indeed demands—more reserves than is normal. This fact is inconsistent with the view that there is a huge monetary overhang that will soon lead to a renewed credit boom. It is true that if the Federal Reserve raises its policy rate (the federal funds rate) significantly relative to the rate it pays on what are technically excess reserves, then the central bank may face overly rapid growth of the money supply. But that is not the most important issue right now.

Let me now answer the questions Olivier Blanchard posed to me before this conference:

*Will the process of withdrawing public support in the financial sector be influenced by the ongoing regulatory and supervisory reform in major countries?* There will be unpredictable and unintended consequences of phased repair, reform, and recovery of the financial sector. But the aim of the financial sector reform is not to go back to business as usual. There will be some hiccups as we approach a new normality. The system should be able to absorb a few bumps in the road.

*Which country circumstances should most importantly affect the unwinding approach?* The truth is that each country is going to unwind its extraordinary support activities for the economic and financial system in its own way. I am concerned about the fixation I hear at this conference on putting fiscal recovery first. While that may be desirable in principle, it may not happen. What if the fiscal authority does not get its act together? Does that mean the monetary authority should just sit on its hands? I think not. But even if the fiscal authority initiates unwinding in a timely manner, it might take 18 months. Does that mean monetary policy should also be unchanged for the same period? Not necessarily. In the more likely event that fiscal policy in one or more countries is less than ideal, that also does not mean the monetary authorities should stand by until the fiscal authorities finally act. The risk is that political pressure on the monetary authorities will increase under these circumstances. It should be resisted.

Finally, if we think about monetary policy not in terms of its impact on the individual country but in terms of its impact on the global financial environment, we should be especially cautious. National monetary policy authorities mistakenly kept interest rates too low for too long in the past decade in the European Union, Japan, Switzerland, the United States, and many emerging market economies. This was a major contributing factor to the crisis via mechanisms such as the carry trade. History does not repeat itself precisely, but we should learn its lessons.
**What should countries most affected by financial crises be most watchful for?** There is an understandable concern that countries should avoid a premature exit from their support activities before financial repair is well underway. At this point, however, what I worry more about, at least in terms of monetary and financial policies, is a transition that is much too late rather than much too early. Countries should expect aftershocks from the crisis, much like the events we saw in Dubai in November. The seeds were sown years ago. There will be many more such aftershocks. That likelihood should not limit timely exiting.

**Which countries are most at risk from suffering distorted capital flows?** The countries that are most exposed will be most at risk from distorted capital flows; in other words, it will be those countries that have the greatest imbalances, broadly defined to include much more than current account and external debt positions. A country has a problem if it entered the crisis period with a high inflation rate and comes out of the crisis period with a high inflation rate—it therefore now has a relatively high nominal interest rate. If its exchange rate is pegged, its problem will be exacerbated because it is at additional risk of large capital inflows. Is that the fault of the central countries and their easy monetary policies or is it the fault of the imbalances in the peripheral countries? Bygones should be bygones and not become excuses for not addressing imbalances.

**What are the costs and externalities if countries unwind in an uncoordinated manner?** The answer to this question depends on what is meant by a coordinated manner. In my view, we are going to have differentiation in the timing and content of postcrisis policy adjustments. That is inevitable because the original interventions themselves differed along with countries’ ex ante circumstances. So we are going to have some inherent differentiation as countries exit. This will produce some adverse external consequences—negative externalities. The best we can hope for is shared objectives, open information flows, a minimum of free riding and deliberately antisocial policy actions (such as competitive nonappreciation of currencies), and international support for those countries caught up in the backwash of events. As we emerge from this crisis, it would be dangerous and inappropriate to try to run a convoy system in which the weak hold back the strong to the detriment of obtaining the goal of strong, sustained, and balanced worldwide growth.
Financial Crisis-Related Assets—Practical Considerations for Restoring Private Control

Aerdt Houben
De Nederlandsche Bank

How to design the unwinding of public interventions depends on the objectives governing the exit, the conditions in the financial sector, and the desired sequencing. Practical criteria for capital repayments can facilitate an orderly exit. Recent experiences contain several lessons on how to foster the restoration of private control in the financial sector.

Objectives for government interventions and exit

There are three leading objectives governing support measures and exit strategy:

1. The overriding objective is to preserve financial stability. Safeguarding the provision of credit to the economy and the robustness of the financial infrastructure should dominate other goals.

2. Distortions of market functioning should be minimized. Ensuring market discipline requires, inter alia, preserving a level playing field and providing adequate incentives for a timely exit.

3. Support measures and exit strategies should seek to minimize costs to the taxpayer.

Admittedly, in terms of exit timing, there may be a trade-off between the second and third objective.

The current setting for unwinding of public interventions

The exit from public support is currently being designed while the banking sector is still fragile. Funding profiles are short and refinancing needs over the next two years are massive, but wholesale and securitization markets have not opened up sufficiently. At the same time, central banks are expected to gradually withdraw their nonstandard liquidity support. And on the regulatory side, the Basel Committee on Banking Supervision is expected to recommend raising the liquidity requirements for banks over the next couple of years. In all, banks face severe financing challenges over the near term.
Sequencing

The design of the exit strategy should jointly consider the various support measures, as they are to some extent substitutes and should not be seen in isolation. In any event, an exit from liquidity support should be given priority to allow a return to normal monetary policy operations and to avoid residual risks accumulating on central banks’ balance sheets. Beyond this, in order to provide a back-stop, guarantee schemes could be kept open for as long as major funding vulnerabilities remain. At the same time, higher pricing of these guarantees could limit market distortions. Ideally, the schemes would temporarily continue to exist without being drawn upon. In any event, an exit from these guarantee schemes should be market driven, pre-announced, and gradual.

With regard to the unwinding of support for solvency, a flexible, tailor-made approach should be pursued according to the nature of the specific support instrument used, i.e., capital injection, asset guarantee, nationalization, or bad-bank structure. Capital injections and asset guarantees may generally be easier to exit in the short term. In contrast, unwinding a nationalization or bad-bank structure is likely to take longer, as that often requires developing and implementing a new bank business strategy. In this respect, there are several examples of supported banks in the European Union that are undergoing far-reaching structural changes in their business model, in some cases pressed by the EU competition authority.

Criteria for capital repayment

The repayment of capital injections should be assessed from both a micro- and macroprudential perspective. In the Netherlands, four explicit criteria and one implicit criterion are applied:

1. An institution’s capital level must be at least equal to the supervisory target level before as well as after repayment of public funds. Stress-testing is an important instrument to establish this target level.

2. Private capital that is used to repay public support should be of at least the same quality (core Tier 1) as the capital that is replaced.

3. An institution considering repayment of public funds should have demonstrated access to both equity and funding markets. This serves to limit liquidity risks after repayment. Admittedly, a clear-cut assessment of this criterion is currently hampered by the heavy reliance on central bank facilities and public funding guarantee schemes.
4. Finally, banks should not repay public support by freeing up capital through excessive deleveraging. Seen from a macroprudential angle, repayment should not exacerbate balance sheet constraints, forcing banks to cut back credit supply and thereby hampering economic recovery.

An additional, implicit criterion is that repayment of state support should not accommodate a bank that wishes to exit for the wrong reason (e.g., to circumvent restrictions on its compensation policies).

Lessons learned

Recent experience points to several lessons in the design and unwinding of public support schemes. A first lesson is that the schemes should provide incentives for a timely and automatic exit, for instance through exit premiums that start low and increase over time. In practice, such premiums have had a material impact on banks’ enthusiasm to exit. Second, schemes should be flexible in order to allow for a tailor-made exit across support instruments, institutions, sectors, and countries. Indeed, speed of recovery and readiness to exit have been uneven across these dimensions. Third, exit programs need to be based on a thorough assessment of a bank’s business model and forward-looking strategy.
Nigel Jenkinson  
Financial Stability Board  

My comments focus entirely on financial system support measures while recognizing that there are clear links between exceptional policies to support the financial system and extraordinary measures to bolster the macroeconomy. I will cover four areas: (1) the principles guiding exit, (2) transitional issues, (3) cross-border coordination, and (4) some long-term implications and objectives.¹

Principles guiding exit

There are a number of unexceptionable high-level objectives and desirable features that can be set out as guides to decisions on exit. In practice, however, tensions may exist between them (or even within them), and the challenge is judging how to balance the respective objectives and the associated risks. For example, all would agree that decisions on exit should be taken to support financial stability. But a balance still has to be struck between decisions to keep policies in place as a temporary backstop and the risk that such a backstop, if not very well designed, could lead to continued support for unsustainable business models, potentially sowing the seeds for future problems.

Less difficult is the principle that decisions should support market-based exit, for example by setting pricing incentives that lower the usage of support measures as markets normalize; and the principle that exit decisions should limit market distortions, spillovers, and arbitrage across borders. But there are potential tensions between the goal that exit strategies should be transparent and preannounced to give market participants time to prepare and the goal that they should be flexible to give the authorities the capability to respond to changes in market conditions. Again, in practice, a balance needs to be struck: to gain flexibility, announcements in some cases could be state-contingent—providing market participants with the information that will condition the policy decision—while still recognizing that decisions with preannounced timetables could sometimes yield benefits, given that they are likely to be easier to understand and thus to implement.

Timing and transitional issues

Decisions on the timing of withdrawal of support also require the weighing of uncertain costs and benefits. For example, timely repayment of public capital is desirable both to reduce financial market distortions and to lower fiscal risks. But prudential supervisors need to be confident that a bank repaying such support has a sustainable capital position, taking into account the higher standards that will be required in the future, and that the capital planning of the banking system collectively does not compromise aggregate credit provision. Moreover, the incentives of the individual banks may not be fully aligned with those of the authorities. For example, a bank may be particularly keen to exit the support arrangements to demonstrate renewed strength. But it may also be more prepared to take the risk that such an exit may be premature, relying on a too-big-to-fail backstop from the public authorities if it gets into trouble again. The moral hazard this engenders and indeed the crystallization of renewed failure are clearly outcomes the authorities wish to avoid.

As the financial system gradually heals, stronger banks will regain normal market access, while weaker banks may not. In its note for the November 2009 G-20 meeting, the Financial Stability Board judged that the case for systemwide support measures is diminishing given the improvements in recent months. In dealing with weaker banks, authorities face challenges in judging which are potentially viable as a whole or in part and ensuring that nonviable operations are resolved and wound down. There is a good case for separating the impaired assets from the healthy part of the bank to provide incentives both to manage the healthy business effectively and to seek maximum value from working out the impaired assets over time. There are, of course, risks that managing such assets down too quickly could lead to fire-sale externalities on the rest of the system; that needs to be reflected in the mandate of the management of the workout.

Cross-border coordination

Recognizing the differences in the strength of national financial systems, the optimum timing of withdrawal from support is likely to vary across countries. Nonetheless, there are gains from coordination, given that support measures and uneven exit decisions distort the allocation of capital across borders. There are clear gains to be realized from information exchange and stronger forms of coordination regarding support programs whose adverse spillover risks are highest, such as funding guarantees and exceptional retail deposit insurance measures. The agreement between Hong Kong SAR, Singapore, and Malaysia to set up a joint group to coordinate the exit from the exceptional retail deposit guarantees that expire at the end of 2010 is a good, practical example. Such coordination helps to resolve the potential
collective action problem, in which countries may wish to end support but may be individually cautious about doing so unilaterally because of a fear of leakage of funding to other countries. Without coordination, the distortionary policies may remain in place, when in practice bringing the countries together and implementing a common decision would achieve the first-best outcome of collective exit.

** Longer-term considerations **

Finally, it is important to recognize that besides judging how and when to exit, authorities need to address the issue that such policies have substantially magnified the moral hazard distortions arising from institutions that are too big, complex, or interconnected to fail. Indeed, until this issue is addressed, financial institutions may well act as if they have an implicit backstop, even though the support measures have been formally withdrawn. The G-20 leaders have consequently charged the Financial Stability Board to work with member national authorities, international institutions, and standard setters to identify proposals, by October 2010, to address the moral hazard risks. That work is progressing on three broad fronts: policies to reduce the probability and impact of failure; policies to strengthen national and international contingency planning and crisis resolution tools; and measures to strengthen market infrastructure to withstand failure. There is unlikely to be a single “silver bullet” to lower the moral hazard risks associated with systemically significant institutions. But it is vital that we keep this key issue very much in mind in reviewing exit policies and the redesign of the regulatory system.
This submission gives a private sector perspective on how to unwind the government interventions made in response to the financial crisis, in particular with respect to private sector financial institutions. It does not consider the question as to when this should happen, to which the best answer is, broadly, “as soon as the chance of any unwinding having to be reversed is reduced to negligible.”

This paper also addresses those aspects of the unwinding that might be best coordinated across governments and the role the IMF might choose to play in that regard.

The nature of the intervention

Governments have adopted a range of interventions with respect to financial institutions. In generic terms, they might be summarized as follows:

- Supporting the capital of the bank—in some senses the “cleanest” since it does not involve any disturbance of the institution above shareholder level. This has been adopted by the United States and a significant number of countries in Europe, the Middle East, and elsewhere.

- Supporting the asset base of the bank, either by sharing the risk on certain asset classes (e.g., TARP in the United States or APS in the United Kingdom) or by taking certain toxic assets out completely (“good bank/bad bank” solutions as in Switzerland).

- Supporting the liabilities of the bank by guaranteeing deposits beyond the level that is considered conventional to support the retail market (e.g., the United States and many European countries) and providing state guarantees for debt issued by financial institutions (e.g., Denmark, Germany, Ireland, the United Kingdom, and the United States).

- Liquidity support by creating liquidity in the market, for example by governments setting up state-guaranteed special purpose vehicles (SPVs), which provide funding to financial institutions (e.g., France) and allowing riskier assets as eligible collateral for financing purposes by the central bank (e.g., the European Union, the United Kingdom, and the United States).

To some degree (particularly after the initial stages of the financial crisis), these policies were adopted as an integrated package; however, their
unwinding can (and should) happen in stages across these different interventions.

**Beyond interventions**

In addition to their interest in unwinding interventions, governments will also wish to consider policy issues in relation to financial institutions generally, including those in which it retains an interest. Such issues might include:

- The on-going, viable structure of a particular financial institution, for example, the need to restructure it into a good bank and bad bank.

- The regulation of the sector, including pressure to enforce longer-term guidelines on governance, compensation, etc.

- The level of competition in the market place (particularly retail)—should state-supported bank X retain a Y percent share of its domestic market?

- Whether it wishes to recognize that there may well be systemically important banks that are “too big to fail” (and what does “failure” really mean?).

- The interaction between investment banking/trading and conventional banking; does any country wish to reinstate Glass-Steagall?

In addition, where the government retains a shareholding of significance, it may ask or require the financial institution to divest itself of certain noncore assets to resolve its own capital needs (in a not dissimilar way to the State Aid restructuring requirements that have been implemented by the European Union).

These are fundamental issues that need to be addressed not only on a country by country basis but also taking into account cross-border banking and capital market implications. For example, financial regulation should, ideally, be conformed across the global markets—where the IMF and the World Bank could play a role.

**Unwinding**

Reverting to the interventions themselves, Rothschild believes that there is a natural sequence for the unwinding:
Financial Crisis-Related Assets—Practical Considerations

- It is difficult to see how other unwinding steps can be taken until the financial institution is reasonably in control of, and has full understanding of, its own assets. So, the first element of an unwinding might sensibly be the unwinding of asset support packages (and, in the case of good/bad bank, the formal separation of such assets).

- Ending quantitative easing is also desirable early in the program; this is possibly best coordinated by (the relatively few) governments involved in the practice and may not necessarily involve the IMF other than as a broker of ideas.

- Ideally, too, liability guarantee schemes would have moderated toward normalized policies (e.g., retail deposits only up to just a modest level), although the greater risk probably lies in a premature phasing-out and historically the complete unwinding of such liability guarantees has typically taken five or more years.

- After the above steps, the sale of stakes in the capital of the institutions may begin.

These are general guidelines; indeed the next two paragraphs expand on how these last two might be seen in parallel.

Implementation

Rothschild strongly supports a policy initiative whereby the taxpayers of a country who have supported their financial institutions should be given an early chance to reinvest in the unwinding. In addition, we observe very strong appetite from retail investors for assets that have traditionally been seen as secure dividend generators. For example, in France, the 2005 initial public offering of EDF generated €6.7 billion in orders from 4.9 million private individuals. Similarly, the final sell-down of Telstra shares by the Australian government in 2006 generated A$7.8 billion in orders from 2.5 million individuals. Modern distribution techniques and communication media have made accessing such demand a cost effective option.

A common concern among senior politicians is that the targeting of the general public as investors relatively early in the unwinding exposes a financially less sophisticated audience to too much risk. At the same time, history teaches us that early sales in any unwinding generally bring significantly higher returns than the later ones. Rothschild therefore strongly supports the idea that retail investors might be invited to acquire government-backed securities exchangeable into the bank’s capital. Effectively this might take the form of a, say, three-year government bond,
yielding no interest (bank deposits yield little anyway) but convertible into the financial institution’s shares at a premium to current market. No downside (if held to maturity), but potentially significant upside. Such investments could well be issued before certain other unwinding has been fully implemented, particularly the guarantees.

A program

Unlike the private sector, governments do not sell individual assets, they sell programs. It is arguable that a major offering of a well-known retail bank (or other financial institution) could create a swell of enthusiasm that could, of itself, do a lot to reinstate confidence. To address this and to make sure that each sale/unwind fortifies the next, governments should consider their assets as a package as well as looking at the individual characteristics of each financial institution.

If successful, it could be that the unwinding resuscitates a large element of the confidence that has been so seriously degraded by the crisis over the past few years. This, in turn, could help influence the question of timing referred to at the outset of this paper.
I would like to preface my remarks by pointing out that The Blackstone Group’s corporate advisory business has counseled a number of companies receiving public assistance, including TARP recipients in the banking, insurance, and automotive industries. Since the crisis weekend of September 13–14, 2008, I have been part of the Blackstone team advising AIG on its restructuring and global divestiture program.

Three areas deserve more attention in the discussion of interventions and unwinding: market effectiveness, competitive effects, and public policy coherence.

**Measuring effectiveness**

Regulators need an appropriate framework for measuring the effectiveness of public interventions in private companies. Too much of the discourse on this subject has centered on investment return analysis. More attention should be paid to a proper assessment of the net impact of the interventions on overall social welfare, as measured in terms of the net economic costs and benefits to society. The problem with the investment return approach is twofold.

First, because there was no market source of capital to fund some of these private company interventions (e.g., AIG on September 16, 2008), the imputed “subsidy” was arguably the entire amount of the assistance rendered. Put another way, the private cost of capital for these firms was infinite, since no one would invest on any terms. So comparing the investments made by governments with private market securities does not capture the whole story.

Second, the exclusive focus on investment returns has enabled the large Wall Street banks to take the position that they have repaid their debts to society by returning the government’s capital with a positive return (IRR) to the government. This misses the external costs to society of unbridled risk-taking and widespread financial failure. The public has borne this cost, restored these institutions, and is now rightly frustrated that bankers propose to enjoy the fruits of the public intervention through high profits and equally high bonuses. (Public monetary policy favoring low interest rates in the aftermath of the crisis also may have the effect of exaggerating this profitability.) The financial sector needs to be held accountable for its overall impact on the economy, which requires a broader analysis of the costs and benefits of public intervention.
Measuring the effectiveness of public interventions is a difficult econometric task of course, but important. It probably requires both a top-down and bottom-up analysis, looking at the impact on GDP and employment on the one hand, and interconnections between institutions on the other.

**Impact on competition**

European authorities seem to be much more concerned than U.S. regulators about potentially disruptive competitive effects of public interventions. The European Commission has acted on the concept of “too big to fail” by breaking up institutions and imposing penalties to compensate for receipt of public assistance. In the United States, the focus has been almost exclusively on addressing systemic risk and short-term job losses, regardless of second-order competitive impact.

**Importance of public policy**

Public interventions and exits must be executed within a coherent public policy regime rather than on a deal-by-deal basis. Perhaps too many bankers and not enough economists have been on the front lines of company-specific interventions. For example, efforts to shrink or split up AIG and Citibank have seemingly contradicted the simultaneous encouragement for the combination of Merrill Lynch and Bank of America. This apparent incoherence is explainable in light of the need to make decisions quickly in a crisis, particularly when existing statutes do not provide all the right tools for regulators to intervene effectively.

Nevertheless, regulators and legislators need to determine what the future regulatory environment looks like as soon as practical so that they and private companies can build a bridge from here to there. For example, it is clear that financial institutions that benefit from the public safety net should be required to hold a larger capital buffer. During the crisis, however, they were permitted to operate with relaxed requirements. Since private companies are making real-time decisions now in planning for the future, they need to know what target levels they will need to satisfy. Similarly, they need to know what the standards or limitations on size will be relative to the concept of “too big to fail.” It may be that institutions in that category are simply too big and need to be regulated more aggressively or forced to shrink in size or scope.
Concluding Remarks by John Lipsky

Today’s session made it clear that many issues require further consideration. I will mention just three of those already noted:

First, judging the appropriate pace regarding fiscal consolidation and the withdrawal of monetary stimulus lies at the core of the exit strategy decision. Many of you have raised the issue of the appropriate use of indicators to guide these decisions and have put forward some interesting suggestions. We need to consider these issues further and share information about (1) refining and monitoring these indicators and (2) the scope for sharing high-frequency information on the aggregate fiscal and monetary stance.

Second, another core element is the issue of whether the withdrawal of fiscal stimulus should precede monetary tightening. The advantage of first removing fiscal stimulus is the speed with which the benefits are realized, with the return coming through both lower deficits and lower interest payments. The potential counterargument is the risk of encouraging an outsized rise in asset prices. This trade-off needs to be examined further, to consider the likelihood of such episodes as well as the scope for using regulatory and related policy measures to curb the risk of excessive asset price increases.

Third, many speakers raised issues related to financial sector supervision, notably the question of what to do about institutions that are “too big to fail.” This creates particularly thorny issues in a cross-border context, where various approaches to cooperation are being explored.

We would very much like to continue working closely with you on these and other matters. Where there are potential cross-country spillovers during the exit process, including in emerging market economies, an exchange of information and better communication with both the public and private sectors can help promote international consistency.

Here are some ways we are working on these issues:

- We plan to report our current thinking on exit issues to our full membership through the Executive Board. The views you expressed in this seminar will provide a valuable input. In January, we are hosting a high-level seminar in Paris on issues of crisis-related fiscal exit.

- Questions related to exit from financial sector interventions are on the agenda of the Financial Stability Board, the G-20, and the IMF. We will work together on these issues in a collaborative manner.
Broader macroeconomic policy coordination through the “Framework” mutual assessment process is an innovative part of the G-20 agenda, and the IMF is actively engaged in providing technical support for this process. Results of our analysis will be disseminated to our membership through the Executive Board.

We will consider sponsoring a high-level seminar on the outcomes of the unwinding of crisis-related macroeconomic stimulus and financial intervention at the time of the IMF’s 2010 annual meeting. Ahead of that, we could organize—in partnership with you—complementary meetings on some of the technical issues that have been raised today, especially those involving macroeconomic policy and regulatory policy coordination.

Finally, I see clear merit in having these engagements involve relevant private sector constituents to help ensure the needed communication and understanding between policymakers and financial market participants.

Once again, thank you very much for your participation. We look forward to your feedback and to any further suggestions you may have on issues that would benefit from international coordination and closer monitoring.
Annex: Agenda, Participants, and Summary of Deliberations

This annex provides the agenda, a list of participants, and a summary of the main themes discussed at each of the four sessions of the conference.

Session 1. The Financial Crisis—Where Are We Now, and What Are the Prospects for Unwinding Public Interventions in the Financial Sector?

Moderator
José Viñals, Financial Counsellor and Director, Monetary and Capital Markets Department, IMF

Panelists
Christine Cumming, First Vice President, Federal Reserve Bank of New York
Hervé Hannoun, Deputy General Manager, Bank for International Settlements
Malcolm D. Knight, Vice Chairman, Deutsche Bank
Antonio de Lecea, Principal Advisor, European Commission
Georges Pineau, Permanent Representative of the European Central Bank in Washington, D.C.
Manuel Sánchez González, Deputy Governor, Bank of Mexico

The session explored the current state of the financial system and capital markets, prospects for a systematic move toward unwinding public sector support in the financial sector, and the existence of preconditions required to balance risks to financial stability during unwinding. Discussions highlighted how these might affect (1) the timing and speed of unwinding, (2) market functioning, and (3) asset prices.

Timing and speed of unwinding
Too soon or too late? Trying to gauge what this means in practice will be much more art and judgment than it will be science.

The dominant view was that it is too soon to be implementing exit strategies, but it is not too soon to be planning them. The view that it is too soon to tighten fiscal policy was questioned by some participants. Although it is too soon to tighten interest rate policy, central banks need to gradually restore normal liquidity provision and conditions while publicly keeping open the option to tighten policy at any time so as to avoid any perception of unconditional commitment.
Exit strategies should not be used as a means of going back to “business as usual.” Basic preconditions for durable and safe exit should include at least the following three elements: (1) verification that support is no longer needed by the intermediaries, as evidenced by decreased demand for it, access to funding in the markets, and reconstructed balance sheets; (2) macroeconomic stability guaranteed in terms of sustainable monetary and fiscal policies; and (3) sustained economic recovery.

**Market functioning and impact on asset prices**

The goal of the exit process is to allow markets to function, as opposed to the government being the funding market for financial institutions and strongly influencing their decisions, if not actually making those decisions. Many of these interventions are winding down by themselves because the initial pricing for each program (e.g., liquidity provision, asset relief, recapitalization) was set to be less expensive than the cost of funding at the most extreme part of the crisis but well above the level of normal market rates.

The banking crises of the 1990s provide relevant reference. The rehabilitation strategy employed by the authorities at the time had three elements: (1) banking institutions identify all their problems—in a financial income statement sense—and allocate them into work-out groups; (2) they raise capital and improve their liquidity; and (3) they present a credible, forward-looking plan. In the aftermath of the present crisis, the third element is still a work in progress; to create such a plan, financial institutions need to have a sense of what the regulatory and legal landscape is going to look like as well as be able to operate under good macroeconomic conditions.

In other words, the ability of financial institutions, markets, and the private sector to adjust to the authorities’ exit from their extraordinary initiatives depends fundamentally on the ability of both the authorities and the private sector to create an appropriate environment of macroeconomic conditions and restore market competition and discipline.

Some participants were more skeptical about the collective ability to plan but rather confident about the ability to respond to whatever happens as events unfold. In that context, there was a bias in favor of getting back as soon as possible to proper functioning of the markets’ price signals and mechanisms.

**Role of macroeconomic and financial indicators**

Policymakers need to look at real-world data, and therefore thinking critically about the properties of various indicators is crucial. The properties of economic activity indicators (aggregate and disaggregate) and measures of financial conditions (prices and quantities) might have changed during the crisis.

Moderator
Carlo Cottarelli, Director of the Fiscal Affairs Department, IMF

Panelists
Mitsuhiro Furusawa, Senior Deputy Director General, Ministry of Finance, Japan
Simon Johnson, Professor, Massachusetts Institute of Technology and Peterson Institute
Christian Kastrop, Deputy Director General, German Federal Ministry of Finance
Nigel Ray, Executive Director, Fiscal Group, Australian Treasury

This session emphasized the poor condition of the fiscal context in which the unwinding of public interventions will take place, especially in the advanced economies, where debt levels relative to GDP are expected to be 40 percentage points higher in 2014 than they were before the crisis. Moreover, that increase, unprecedented in peace time, will occur from a fairly high starting level (about 60 percent of GDP in advanced economies, compared with 16 percent of GDP in the United States in 1929). Further, consolidation efforts will also need to take into account long-term developments, such as the aging of the population and the costs associated with addressing climate change.

In regard to unwinding fiscal measures, participants emphasized four key issues: (1) no single policy objective will fit all countries equally well, (2) communication policies are important in anchoring expectations, (3) contingent liabilities must be managed in a transparent way, and (4) reversing the alarming trend of debt growth is a major challenge.

Determining the appropriate policy objective
Establishing long-term budget projections will be helpful in setting the targets toward which a country would seek to converge in the unwinding process. In determining the specific long-term fiscal policy target, one should take into consideration existing macroeconomic parameters, such as the saving rate of the economy, the exposure to current account shocks, and the sensitivity of the economy to global financial markets. Most important, long-term demographic factors are likely to take priority, as their prospective impacts dwarf those of public interventions in the financial sector. With regard to implementation, some argued for a flexible approach, allowing for changes in strategy when warranted by economic developments.
Communication policies
The fiscal strategy for the unwinding process needs to be well communicated so as to establish fiscal credibility and foster public support and market confidence. Communications should clearly specify the fiscal risks and contingent liabilities and how these will be managed. Eventual changes in the fiscal targets also need to be well explained to support the credibility of the strategy. The communication strategy also needs to be educational to properly anchor the expectations of groups affected by the unwinding strategy.

Contingent liabilities
Contingent liabilities must be accounted for transparently even if methodologies for doing so are still under development, otherwise the public and policymakers may have the impression that the risks are insignificant. For instance, assuming it is not fully addressed, the authorities may need to clearly recognize the too-big-to-fail issue, have an assessment of its potential size, and possess sufficient fiscal flexibility to respond if the risks are materialized. Other solutions were also proposed, such as reform of the bank resolution regimes and guarantee fees that are commensurate with the systemic importance of the covered financial institutions.

Reversing debt trends
All panelists acknowledged that the rate of accumulation of public debt is presenting a challenge for unwinding and for long-term fiscal policy. In particular, the primary balance adjustment may need to be unprecedented in some cases to restore debt sustainability. However, there was some debate regarding the level to which debt ratios need to converge in the medium term. On one hand, restoring debt ratios to precrisis levels may have adverse implications for economic recovery given the substantial fiscal adjustment implied. Aggressive debt reduction may also not be politically feasible. On the other hand, solely ensuring debt sustainability may not be sufficient to provide flexibility to deal with future contingencies.

Session 3. Financial Sector Interventions—Identifying Preconditions and Practical Considerations for Unwinding Liquidity Support and Guarantees

Moderator
Olivier Blanchard, Economic Counsellor and Director, Research Department, IMF

Panelists
Charles Bean, Deputy Governor, Bank of England
Matt Carter, Managing Director, Head of Sovereigns and Agencies, RBS Global Banking and Markets
Dino Kos, Managing Director for Equity Research, Portales Partners, LLC
Haruyuki Toyama, Director General of Financial Markets Department, Bank of Japan
Edwin M. Truman, Senior Fellow, Peterson Institute

This session considered market factors key for a successful unwinding process. Among other issues, it explored (1) the role of market indicators that could guide an active process of unwinding, (2) technical aspects relating to the unwinding of liquidity provisions and guarantees, and (3) factors that could have an effect across markets and therefore would require close agency and cross-border coordination. The session also discussed interdependencies among various intervention measures.

**How to unwind public support to banks**
Unwinding public support to banks will be easier where policies were well designed in the first place. The demand for liquidity support from central banks is going to decline as markets recover, if it is provided at penal rates. In fact, there has already been some drop-off in the use of such facilities. Similarly, if funding guarantees are priced relatively expensively, the demand for them is going to wane as risk appetite returns to unguaranteed funding markets and unguaranteed funding starts looking more attractive.

It will be more problematic to withdraw liquidity support that was not provided at penal rates or was provided against illiquid collateral that central banks do not normally accept. Such support includes nonpriced guarantees, like those on retail deposits, that were introduced by many countries during the crisis. No obvious signals may appear to withdraw the support even as markets recover, and banks receiving it will have an incentive to say its continuance is essential.

**How to deal with risky assets purchased by central banks**
Different views were expressed on how to deal with risky assets purchased by central banks. Some argued that dealing with them should be treated as a fiscal operation: assets with uncertain market values could be transferred to the Treasury and replaced in the balance sheet of the central bank by government bonds. That approach could lead to a clearer demarcation of risk and allow the central bank to operate in a more independent way. However, there was no consensus on this approach.

**How to raise interest rates in the presence of large excess reserves**
Two broad strategies are available for exiting from monetary ease while large reserves are still in the system. The excess can be drained and then interest rates raised, as the Bank of Japan did in 2006. Alternatively, excess reserves could be kept in place while interest rates are raised along with the interest rates on reserves.
In the United States, one approach to draining excess reserves would be to sell the mortgage-backed securities purchased by the central bank during the crisis, but that could undermine the housing recovery. Another approach could be to execute reverse repos, although there may not be enough counterparties with adequate balance sheets for the amount of such transactions needed. Finally, there has been some discussion of the Federal Reserve’s issuing securities to drain liquidity, but the Federal Reserve currently does not have the legal authority to issue such securities.

What will the new financial landscape look like?
The current support facilities offered to the financial sector should be seen as representing a bridge to a new, sustainable equilibrium. Some business models developed before the crisis will certainly not be sustainable afterward, including those heavily reliant on short-term wholesale funding associated with securitization. Similarly, certain asset structures, such as some types of mortgage-backed securities and complex structured financial assets, may not be sustainable in the future without ongoing public support. It is important that policy does not end up supporting unviable business models or unsustainable asset structures unless there is a very clear market failure that needs to be corrected.

What indicators should govern the pace of withdrawal?
The pace of exit should be guided by several factors, including (1) macroeconomic indicators, (2) measures of credit risk, (3) the solvency of financial institutions, and (4) general measures of risk appetite. The macroeconomic indicators, such as growth, unemployment, and inflation, will provide the background to the exit process. Indicators on the state of funding markets and measures of credit risk, in particular the terms on which banks can issue unguaranteed debt, will also be critical. Credit default swap spreads are going to be important indicators; but CDS spreads may give a misleadingly benign impression if they reflect the market’s belief that the public sector will provide support if institutions get into trouble. Indicators related to the solvency of financial institutions, such as measures of expected losses and capital leverage ratios, would also be a key element in deciding the right time to withdraw support. Finally, general measures of risk appetite as reflected in financial markets will be important.

Exit from quantitative easing: The experience of Japan
The Bank of Japan had three types of tools to drain excessive reserves: sale of central bank bills, reverse repo operations, and outright sale of treasury bills. But it did not have to make substantial use of these tools, as its quantitative easing (QE) had been carried out through accumulation of short-term assets. Rather, the most difficult part of the exit for the central bank was determining how it would ensure that funds would be efficiently allocated among market participants after the direct provision of funds had receded—it was not sure whether the market would smoothly resume
functioning after a five-year QE period in which the money market remained inactive. Moreover, market conditions had significantly changed: a series of mergers and acquisitions had significantly reduced the number of large financial institutions; market participants scaled back resources for engaging in money market transactions; and the central bank had changed its settlement mechanism from designated settlement to real-time gross settlement.

Session 4. Financial Crisis-Related Assets—Practical Considerations for Restoring Private Control

Moderator
Reza Moghadam, Director, Strategy, Policy, and Review Department, IMF

Panelists
Aerdt Houben, Director, De Nederlandsche Bank
Nigel Jenkinson, Advisor, Financial Stability Board
Simon Linnett, Executive Vice Chairman, Rothschild
Thomas D. Stoddard, Senior Managing Director, The Blackstone Group

Panelists extensively discussed (1) the need for a coherent exit strategy, (2) the sequencing of exit, and (3) the problem of systemically important institutions. Participants agreed that the current environment remains very fragile: short maturities, huge refinancing needs, poorly functioning secondary markets, and closing liquidity windows. Exit and unwinding therefore must be cautious and gradual, with the costs (political and economic) they will impose clearly calculated before the moves are initiated. Panelists also discussed the need for an appropriate framework for measuring the effectiveness of public interventions, acknowledging that it is not straightforward to balance their benefits and costs in terms of social welfare. It was noted that support measures in the crisis have added substantially to moral hazard.

Need for a clear and coherent exit strategy
Panelists emphasized that exit requires a coherent public policy regime rather than a case-by-case approach. Before it is executed, the blueprint for exit must reflect agreements on broad structural issues (for example, which types of banks will be saved?) and be transparent and credible. One of the most critical aspects of unwinding is the need to push the residual risk of acquired assets away from the central bank’s balance sheet. The remaining objectives need to be clearly spelled out.

By way of example, one of the panelists discussed prudential considerations related to privatizing nationalized banks, repaying government shares, and unwinding public asset protection schemes. He raised some practical criteria for financial institutions repaying public capital:
The private capital in the operation must be of at least the same quality as the public capital it will replace.

The capital ratio of a supported bank should be comfortably above the regulatory minimum both before and after the repayment.

Financial institutions must have shown their ability to access equity and debt markets.

Financial institutions should have taken measures necessary for their restructuring.

However, the apparent heterogeneity across countries highlights the need for flexibility in exit strategies across countries and limits the possibilities for developing a common rule for exit.

**Sequencing of exit**

Regarding sequencing, panelists suggested the need to take account of the interrelationships among different facilities and noted that the sequencing of exit from various public support measures is unlikely to be clear-cut. One problem is that the tools used for interventions are largely substitutes for each other, which makes it difficult to think about sequenced exit from them. Other panelists stressed the importance of a clear sequencing for issues regarding financial structure, unwinding asset support, and capital sales.

Also stressed by panelists was the need to factor in potential retail demand when planning the sequencing of exit. Doing so could create competition for the sale of assets. It was also suggested that market-motivated exits, where possible, should be encouraged.

**Problems of dealing with too-big-to-fail institutions**

Panelists admitted that no clear-cut policies exist for dealing with systemically important financial companies. One panelist indicated the need to set up a system in which individual institutions bear all of their burdens in the case of failure. But all agreed that no “silver bullet” is available to resolve the problem of systemically important institutions, and the issue remains in the forefront of the international regulatory agenda.