Panel Remarks on

"Boom-bust cycles, interest rates, and the global financial system"

2017 Andrew Crockett Lecture

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I am honoured to be part of this very distinguished panel to discuss Professor Rey's insightful presentation. Let me first note that I can think of no better place to discuss this topic of boom-bust cycles and the global financial system than here at the BIS. It is here that the extremely valuable data on cross-border bank lending is compiled and disseminated, allowing us to see and understand critical developments in the global financial system like we saw in the excellent presentation this morning.

Building on Professor Rey's remarks, I would like to pick up on the theme of the global financial cycle and focus on **three key limitations in our ability, specifically the EMs' ability to deal with its consequences**. The three limitations are: 1) limits in policy tools, 2) limits in analytical framework, and 3) limits in policy coordination frameworks.

1. **Limits in policy tools**

As an emerging market country on the receiving end of much of the spillovers from sustained monetary easing in advanced economies over the last decade, we are very familiar with the challenges they pose. **Capital flow volatility, large co-movement in asset prices, and sudden shifts in investors' risk appetite translate into arbitrary movements in domestic financial conditions that complicate macroeconomic management.** The set of tools available in emerging markets to deal with this have important limitations.

The policy interest rate is a very blunt tool for offsetting the effects of financial spillovers and inevitably creates other difficulties elsewhere in the economy. I would not go so far as Professor Rey's in her remarks that the Mundellian trilemma has turned into a dilemma in which independent monetary policy is possible if and only if there is capital control.

I don't believe that monetary autonomy has been lost and countries cannot insulate themselves through their exchange rates, but I would agree that **the trade-offs to setting interest rate policy has certainly become much more difficult.** And here, for us at least, there are two important trade-offs.

The first is the trade-off between growth and financial stability rather than between growth and inflation, which has become more challenging when interest rates have been low for long and search for yield behavior could create pockets of fragility in our financial system.

The second is the trade-off between increasing our exposure to global risks, especially through central bank's Net Foreign Assets, and allowing the currency to appreciate. **Flexible exchange rates have limited insulation properties**, because it cannot shield or fully offset the impact of external factors on domestic asset prices or credit growth. Indeed, **exchange rate movements themselves can cause problems** when they fluctuate excessively, driven by portfolio flows. Moreover, as the BIS has noted, exchange rate fluctuations can **amplify the impact of capital flows** through balance sheet effects.[1] **Thus, there is a useful role for exchange rate intervention.** Of course, this tool should not be employed to resist underlying trends, but experience has shown that even portfolio flows can be persistent. At some point though, central bank balance sheet concerns place limits, not so much on the ability, but the willingness to intervene. Lately, we have had to deal with increasing public concerns over the BOT's FX valuation losses, which raised questions on our exchange rate policy. Perhaps, this is similar to having the "*curse of the regional safe asset provider*" in Professor Rey's research. This curse is not limited only to advanced economies.

The other tools that have become popular are **macroprudential and capital flow management measures**. While they are appealing in theory, operationalizing them in practice has proved challenging. This is in part because limited experience makes **calibrating the measures difficult** and that the **interaction among different policy tools is hard to predict.** Moreover, there is a risk that application of these tools may **push activity**

[1] For example, exchange rate appreciation may strengthen the balance sheets of borrowers with foreign currency debt, thereby encouraging further borrowing.

to the corners of the financial market that do not fall under the regulatory umbrella, or shadow banking. All of which is becoming easier to access with the rise of FinTech platforms**.** I should also note here that the idea that these tools can be used to offset the impact of low policy interest rates goes against the traditional belief that macroprudential tools should be used to **compliment rather than substitute for the broader monetary policy stance.**

All in all, there is a genuine concern that financial integration has amplified the vulnerability of domestic financial conditions to external shocks while limiting the effectiveness of the tools that policymakers have for addressing those shocks. This is not solely an emerging market problem. Indeed, the degree of co-movement in bond yields appears to be even stronger for advanced economies. Nevertheless, there are important reasons why capital flow volatility and exchange rate fluctuations may **present more challenges for emerging market countries.**

For one, **less developed and relatively shallow financial markets** means that asset prices will move more in response to capital flow volatility. Secondly, **greater reliance on exports as an engine of growth** implies more resistance to currency movements. Thirdly, many emerging market countries have had a long history with stable exchange rates, which translates both into **less familiarity with FX hedging instruments as well as greater political pressure in the face of exchange rate fluctuations.** Finally, **weaker governance, regulatory framework, and institutional capacity** mean that inflows may be more likely to cause imbalances during booms. These very same weaknesses also tend to make investors more fickle to exit when things turn sour or global financial landscape changes. And, they also make it harder to implement policy interventions with large distributional, and hence political economy, impacts such as macroprudential measures.

2. Limits in analytical framework

If we are to make progress in finding solutions to the challenges posed by the global financial cycle, we better have the right analytical framework. Our current analytical framework tends to **focus on current accounts or net flows. Perhaps we should shift our focus towards *gross* capital flows.** This is a point that the BIS has long emphasized and is echoed in some of

Professor Rey's remarks on the role of countries' gross asset and liability positions.[2] Yet, references to "global imbalances," by which people mean the global configuration of current account imbalances, are still common and drive much policy discussion, especially in multilateral organizations.

In a world of tremendous cross-border financial transactions and relations, **financial imbalances matter more than current account imbalances.** With global gross capital flows exceeding current account flows by over 10 times, analysis of cross-border exposures and drivers of asset prices based on current accounts are bound to be incomplete and misleading. **The exchange rate is a case in point.** Multilateral assessments of external balance, such as those conducted in Washington DC that attempted to identify the appropriate levels of exchange rates, are based mainly on current accounts.

Thus, even though in Thailand, for example, we have received a lot of financial inflows that have steadily strengthened our currency in recent times, the fact that we have a large current account surplus owing to sharp decline in domestic demand, especially in private investment, while exports were stagnant, has led to the conclusion that the Baht is undervalued and we should allow the Baht to be driven up by financial inflows.

Definitely if we wish to have a better understanding of the global financial cycle and a better capability to deal with the cycles and their boom-bust consequences, we need to have a more comprehensive analytical framework. I would like to commend Professor Rey and BIS's research team for your work in this area.

3. Limits in policy coordination frameworks

At the system level, the current global monetary arrangement suffers from a **coordination and cooperation failure.** With each central bank focusing on its own domestic mandates, financial conditions collectively for the world as a whole is a residual. **There is no effective anchor for the global financial system as a whole. We are like an orchestra without a conductor. And, some have louder instruments than others.** But, while US monetary

[2] Borio, C (2015): "On the centrality of the current account in international economics," Keynote speech at the ECB-Central Bank of Turkey conference "Balanced and sustainable growth - operationalising the G20 framework", Frankfurt.

policy heavily influences financial conditions globally, the US does not and cannot be expected to set their policy for the world. Here, I doubt that **having a more multi-polar world with more than one dominant currency would be the solution.** Two loud musicians do not substitute for a conductor.

Obviously, we cannot expect to have a conductor for our collective central banks' orchestra, I would suggest that a more implicit form of coordination holds important promise–that is the **coordination of monetary policy frameworks.** This echoes John Taylor's argument that much of the gains from cooperation can be attained if countries individually follow the "right" policies.[3] Indeed, it is the "coordination" with no explicit cooperation. If all the musicians in the orchestra have the same score, at least there is a good chance that we produce a stable tune, even without a conductor. Thus, we should **revisit current monetary policy frameworks and ask how they can be improved upon.**

Here, I agree very much with the BIS that we should move towards **a framework that takes financial stability more systematically into account.** Given the long drawn-out nature of financial cycles as well as their long-lasting impact, such a framework would better **internalize the cumulative effects of policy** and limit some of the excesses that we have witnessed. Just as the proliferation of inflation targeting frameworks starting in the 1990s helped to bring down the level and volatility of inflation rates worldwide, **a generalized adoption of monetary policy frameworks that leans more systematically against the financial cycle, especially among advanced economies, could yield significant benefits for the world as a whole by limiting adverse consequences of the boom-bust cycle.**

I hope we all agree that making progress in tackling the negative effects of the global financial cycle matters. At this juncture, we are facing an **upsurge of popular discontent against globalization** and should financial spillovers result in real economic harm, the sentiments against trade liberalization and financial openness will only worsen. **If this prompts a return to a more closed system, the consequence of which would be harmful for living standards around the world.** So far, we have been largely reactive,

[3] Taylor, J (2013): "International monetary coordination and the great deviation", Journal of Policy Modeling, vol 35, no 3; Taylor, J (2015): "Rethinking the international monetary system", Cato Institute Monetary Conference on Rethinking Monetary Policy, November.

responding to the adverse impacts as they occur. I think we need to become more proactive in assessing whether our individual actions are taking us collectively to a place we want to go.

Specific questions

Before I end my discussion, I would like to ask Professor Rey two questions regarding her remarks on the relation between the consumption-to-wealth ratio and real interest rates during the 1920s episode and the recent episode. Your results are fascinating, but I wonder how would you take into account two factors into your analysis?

1) The surge of consumer finance and the ability that consumers can leverage for their consumption should affect marginal propensity to consume. Increasing and very high household debts have become challenging in many countries. How would that affect consumption to wealth ratio?
2) What are roles of monetary policy in determining interest rates, especially with declining risk-free rate? Central bankers hope that we can somehow influence consumption, but monetary policy seems to disappear from your analysis.