

# Introductory remarks

Stephen G Cecchetti<sup>1</sup>

It is my great pleasure to welcome all of you to the 9th BIS Annual Conference.

Each year, we pick a topic that we hope will be both relevant to central bankers and a bit different from the topics being discussed at other conferences. On the question of relevance, I feel confident that central banks are interested in the future of central banking. And, as the mandates of central banks are in a bit of flux, the specifics of our choice seem timely as well.

But our attempt at originality has been less successful. As Masaaki Shirakawa noted at the Bank of Japan's recent symposium, that conference – and now ours – will be among many this year on the future of central banking.

Naturally, this conference brings policymakers together with academics. The reputations of academics are built on their ability to make novel observations – to teach us about something that is deep, interesting and unexpected. In contrast, monetary policymakers do not, in my experience, strive for creativity. In fact, as we have seen over the past three years, central bankers are generally unhappy about being forced to innovate. The objective of most central bankers I know is not only to make the world boring by making it stable, but to be boring themselves – at least in public. So, in the end, I can't help but think it valuable to focus over the next two days on the question of central banking's future.

Indeed, I think it is fair to say that we all need to be thinking hard about the future of central banks, central banking and central bankers. As Charles Goodhart will point out very shortly, every now and then something comes along to shake up our comparatively settled understanding, and then it is not just our understanding that gets shaken up but also our roles, and with them our relationship with the rest of society.

Now, it may seem alarmist to be talking about major changes in the nature of central banking. But given what we have seen in the past few years, I'm sure you will agree that we have no choice – we cannot go back to the status quo ante of 2006. I can think of at least two very good reasons to address the possibility that roles are changing and to welcome a series of discussions on the issue.

The first of these reasons is that we have just been through an event of a magnitude on the Goodhart seismic scale that is beyond once-in-a-lifetime. The near collapse of the financial system happened not only in our back yards, but in our front yards too. Whether or not central banks were formally responsible for all of the terrain that was ravaged, we nonetheless claim expertise in financial systems, institutions, and markets and their connection to all things monetary. And the crisis struck on our watch. It would seem discordant to suggest that there is little need for us to consider a change in approach. That would be as if BP's Tony Hayward were to tell the US Congress that his company sees nothing to change in its strategies and procedures.

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I thank David Archer for his contributions to this presentation. The views expressed here are those of the author and do not necessarily reflect those of the BIS.

The second reason we need to discuss this is that we need to understand the long-term implications of the events we are living through. That is a towering challenge. Liaquat Ahamed's marvellous book about central banking during the interwar years – *Lords of Finance*<sup>2</sup> – brings home the point that epochal changes in the policy environment are not always evident, even to those who seemed at the time to be the masters of events. The commanding figures of monetary policy in the 1920s – the heads of the Bank of England, the Bank of France, the Reichsbank and the Federal Reserve Bank of New York – did not grasp the significance of the events they were living through. Shock after shock confounded them. They clearly understood some of the connections but were blind to many others that we, in hindsight, can recognise.

May I say that I have become much more humble than I was three years ago. And realising the limitations of my earlier thinking, I must accept that, even now, I may be as oblivious to the implications of the events going on around us as were those giants of history to the events of their time.

Returning to the multiplicity of conferences on our chosen topic, I am not concerned that we may be taking several looks at the same question. Stopping to think and consider seems like a very sensible thing to do, especially when there are signs that events are outstripping our understanding. And not expecting new understanding to come immediately seems like a wise approach, even if it goes against the grain of the elected officials to whom many of you answer on a daily basis.

Liaquat Ahamed's account of the interwar years provides additional reasons to consider that we are in the early phase of a seismic shift in central banking. The tectonic forces he describes include the massive pressures created by war debts, which could not be managed by the international adjustment mechanism intrinsic to the existing monetary regime of the time. We are again seeing signs that the international adjustment mechanism intrinsic to the current monetary regime is being put under strain by cross-country payment imbalances. And again, we are seeing signs of crippling debt burdens.

Much has been said in the recent past about exchange rates – that they are a weak equilibrating mechanism and a source of volatility for small open economies. Where nominal exchange rate adjustment is held back for policy reasons, local prices should move to reignite the adjustment process. But that also seems to be a weak mechanism. Obviously, in the absence of well behaved real exchange rates, the interwar problem of international adjustment has its present day echoes.

For some people, the big central banking story is the central bank balance sheet – that story is illustrated by Graph 1, which shows the recent growth and change in composition of what central banks hold. I don't want to play down this issue – it is very important, and a number of the actions that shaped the contours in this picture have important medium- and long-term implications, both operationally and politically. Nonetheless, this picture does not frighten me because I trust everyone in this room to do the right thing when the time comes – that is, if you can.

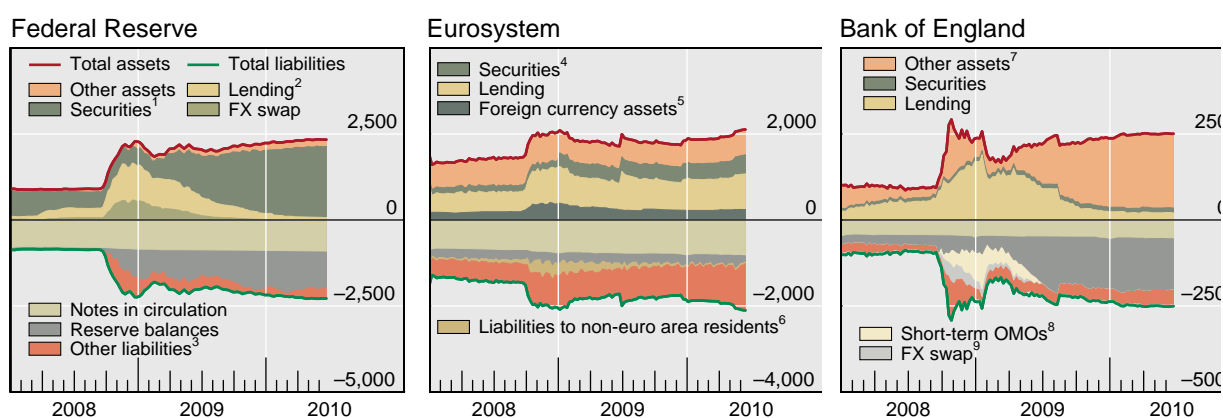
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<sup>2</sup> L Ahamed, *Lords of Finance: The Bankers Who Broke the World*, Penguin Press, 2009.

Graph 1

### Central bank assets and liabilities

In billions of respective currency units



<sup>1</sup> Securities held outright, including Term Securities Lending Facility (TSLF). <sup>2</sup> Repurchase agreements, term auction credit, other loans and Commercial Paper Funding Facility (CPFF). <sup>3</sup> Including to central banks. <sup>4</sup> Securities of euro area residents and general government debt, in euros. <sup>5</sup> Including US dollar liquidity auctions. <sup>6</sup> In euros. <sup>7</sup> Including US dollar liquidity auctions and asset purchase facility. <sup>8</sup> Open market operations, including issuance of Bank of England sterling bills. <sup>9</sup> Swap lines with the Federal Reserve.

Sources: Datastream; national data.

Which brings me to the key point I wish to make. As many of you know, in my view and that of the BIS, not enough attention is being devoted to the ominous trajectory of public debt in a number of advanced economies. Let me show you the most frightening picture I have seen for some time (Graph 2). It was produced for the paper I wrote with Madhusudan Mohanty and Fabrizio Zampolli this past February, entitled “The future of public debt”.<sup>3</sup> The lines on this picture are projections of debt over the next 30 years under three scenarios:

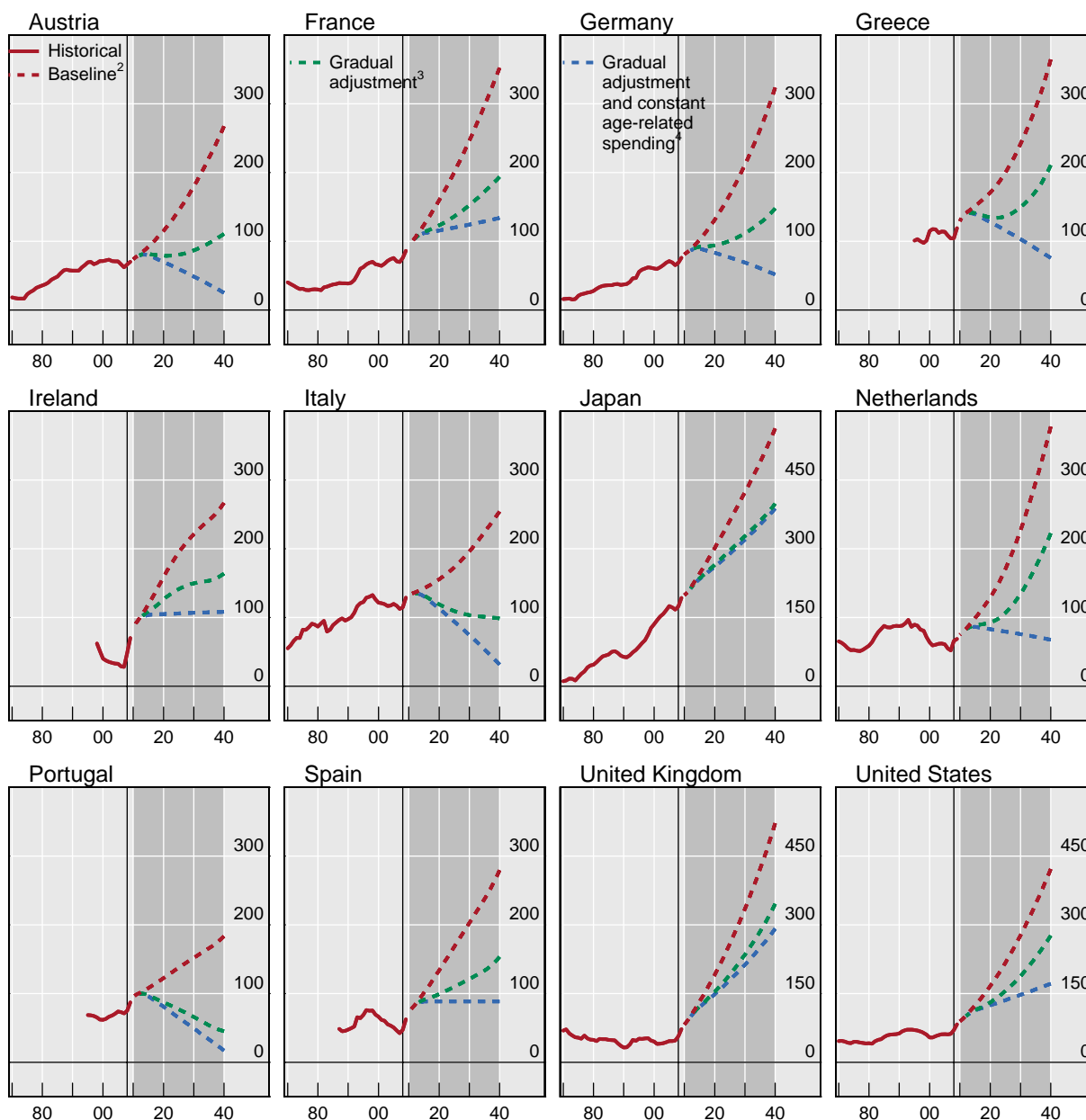
1. The red line:
  - Revenue and non-age-related expenditure constant at the 2011 percentage of GDP
  - Real interest rate at its 1998–2007 average
  - Growth of potential GDP at its OECD-projected post-crisis level
2. The green line: gradual adjustment, in which the primary fiscal balance excluding age-related spending improves by 1 percentage point of GDP per year for five years.
3. The blue line: the gradual adjustment shown by the green line is coupled with a freezing of age-related spending as a share of GDP at its 2011 level.

The paper has been pretty popular, but I’m not sure the 45,000 people who have downloaded it are taking away quite the right message. First, I think that we should have titled it “The *impossible* future of public debt” because our idea is not that this *will* happen, it is that this *cannot* happen. Second, our message is also that even fairly big adjustments are not enough to stabilise debt for a surprisingly large number of important countries. For most

<sup>3</sup> See Graph 4 in S Cecchetti, M S Mohanty and F Zampolli, “The future of public debt: prospects and implications”, *BIS Working Papers*, no 300, March 2010.

countries in fact, recent crisis-related spending plus the coming onset of ageing pressures mean that brutal policy choices will have to be made if we are to get public debt under control.

Graph 2  
**Gross public debt projections<sup>1</sup>**  
 As a percentage of GDP



<sup>1</sup> Refers to general government debt; the shaded area covers projections by the OECD (2010–11) and BIS (2012–40). The vertical line corresponds to 2008, the first full year of the crisis. <sup>2</sup> Based on the following assumptions throughout the BIS projection: constant growth of potential real GDP at the rate estimated by the OECD for 2012–25, constant real effective interest rate at the 10-year pre-crisis average, 2011 revenue and non-age-related spending (both as a percentage of GDP) held constant. <sup>3</sup> The baseline primary balance excluding age-related spending (as a percentage of GDP) improves from the 2011 level by 1 percentage point per year for the first five years of the projection and remains at that level for the remaining period (all other assumptions as in the baseline scenario). <sup>4</sup> Gradual adjustment scenario with the additional assumption that age-related expenditures as a percentage of GDP remain constant at the 2011 level.

Sources: European Commission; IMF, *World Economic Outlook*, April 2007; OECD; US Congressional Budget Office; authors' projections.

It doesn't take a genius to see that investors are not going to overlook the need to make these choices – they are not going to ignore the risk of debt repudiation, of debt restructuring or of debt depreciation through inflation. Clearly, central banks could be caught in the middle if fiscal authorities do not live up to their responsibility.

I find this challenge to be a remarkably loud and clear echo of the interwar problems that so confused our central banking forebears and that ultimately led to significant changes in the role and character of central banks.

To wrap up, here is my message. Charles Goodhart might well be correct that the tectonic plates underlying central banks are now shifting, and with effects that are nearly impossible to predict. We can't know for sure if the rumbling we feel is of seismically historic proportions, but I do think we should take the possibility seriously.

Let me close with a short story. When I arrived at the BIS two years ago, I realised that a key symbol of the devastating changes in the interwar period no longer seemed to be visible. That is, nowhere could one actually look at the Dawes and Young bonds that represented not simply the founding of the BIS but German hyperinflation, the collapse of the Weimar government and the rise of the National Socialist Party. I asked whether any of the actual certificates existed in the archives. Original specimens of each are now hanging on my office wall. I look at them every day because, well ... let me just say that there isn't any space left on the wall for more such bonds, and I don't intend to make any.

Thank you all for coming, and I look forward to the next day and a half of presentations and discussion.