BANK FOR INTERNATIONAL SETTLEMENTS

Hitting the limits of "outside the box" thinking?

Monetary policy in the crisis and beyond

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Ladies and gentlemen,

It is a great pleasure to be here at OMFIF.

The crisis and its aftermath have posed formidable challenges for central banks. They have had to "think outside the box" to address unprecedented financial instability and provide monetary stimulus in the face of the constraint imposed by the zero lower bound of policy rates.

Looking ahead, the challenges remain daunting. Central banks have to navigate uncharted waters.

In the near term, the question is how monetary policy can best contribute to what has so far been an uneven recovery. Can't central banks do much more? Perhaps the relevant question is whether central banks can make up for insufficient action elsewhere. What monetary policy can substitute for balance sheet repair by banks and borrowers? What monetary policy can remove impediments to a worker moving from an overbuilt sector to a more promising one? These kinds of question require a medium-term perspective, and in a medium-term perspective monetary accommodation will prove only as good as the balance sheet, fiscal and structural policies that accompany it.

From a longer-term perspective, a challenge is to better integrate financial stability considerations into monetary policy frameworks. The recent crisis brought the global financial system to the verge of collapse and has had dire social and economic consequences. This has raised fundamental questions about how to integrate a modern understanding of the financial system into our traditional monetary policy models.

These are all exceedingly difficult questions, the situation is different from country to country and no one can claim to have a crystal ball that provides definite answers. Yet, experience does offer at least some pointers for the future. In the following, I will therefore start by reviewing the main insights suggested by monetary history, before turning to the current challenges.

Insights from monetary history

The past century saw considerable changes in the conduct of monetary policy. These changes were often the result of both historical events and new ways of thinking about the role of central banks.

By the end of the 20th century, there was a clear consensus that a remit of monetary policy focused on price stability had many benefits. This view reflected lessons from the painful experience of double-digit inflation rates and erratic growth that prevailed in many countries worldwide in the 1970s, and in some emerging market economies well into the 1990s.

The main reason for this dismal inflation and economic performance was that monetary policy neglected price stability. Instead, central banks pursued other goals, which turned out to be inconsistent with price stability. In many advanced economies, for example, monetary policy was too accommodative during the 1970s, and central banks ended up pushing output beyond sustainable levels. In emerging market economies, political pressures to generate seigniorage income and finance public spending programmes via the printing press were frequent sources of high inflation.

In all these experiences, the neglect of price stability did not improve economic performance. Over time, we learned, quite painfully, that there is no beneficial long-run trade-off between inflation and growth. Indeed, we learned that high and volatile inflation rates go hand in hand with erratic growth, large exchange rate swings, and even economic and political crises.

Chastened by these experiences of the 1970s and 1980s, central banks had to rethink their roles. At that time, the result was to consider a narrow mandate for price stability. To be sure, this required a very painful adjustment process. Central banks had to squeeze inflation out of their economies at the cost of recessions. But that cost was well worth the price. Those who had the courage to try were vilified then, only to be recognised as having done the right thing years later.

Another lesson learnt during this period was that central bank autonomy is critical to achieve price stability. One main underlying cause of inflation instability was the failure to shield monetary policymakers sufficiently from short-term political cycles. Some central banks, such as the Bundesbank and the Swiss National Bank, had led the way. They enjoyed a high degree of effective independence and, on this basis, consistently delivered lower inflation than their peers during the post-Bretton Woods era.

These are hard-earned lessons that should not be forgotten.

Today, central banks are once again "thinking outside the box" as new challenges have arisen. Even before the crisis, concerns among central bankers were growing that the policy environment was changing in ways that called for a further evolution of central banking. In particular, the narrow focus on near-term domestic price stability did not

seem to be enough in an environment in which the financial cycle and global spillovers were becoming more prominent.

With respect to the financial cycle, we now see that monetary policy played an important part in the build-up of financial imbalances during the 2000s. After the bust of the dotcom boom, monetary policy in the advanced economies remained accommodative for many years. Interest rates were low, and credit and house prices soared.

Of course, the relevance of the financial cycle for central banks is not an entirely new insight. The forging of many central banks, such as that of the Federal Reserve in 1913, was the direct result of the banking crises of the 19th and early 20th century. It became less relevant in the early postwar period against the background of tightly regulated financial systems put in place after the Great Depression and the Second World War. But the far-reaching financial deregulation pursued since the 1970s allowed the financial cycle to re-emerge as a major macroeconomic force that grew ever stronger.

Globalisation, too, has been changing the policy environment in significant ways. In addition to the growing influence of global factors on domestic inflation dynamics, globalisation appears to have added fuel to the monetary easing in the run-up to the recent crisis. The unusually low policy rates prevailing in the major advanced economies affected others via a resistance to currency appreciation pressures. Many emerging market economies kept interest rates lower than would have been suggested by domestic macroeconomic conditions alone. In turn, their accumulation of foreign exchange reserves put additional downward pressure on yields in the advanced economies. The net result was unusually accommodative global monetary conditions. Real interest rates averaged a mere 1.5% globally between 2002 and 2007 while output grew robustly at roughly 4%.

Managing the post-crisis recovery

While the pre-crisis period already gave central banks much food for thought, the crisis has given them still more to chew on.

The financial crisis has tested the crisis-management readiness of central banks, and the subsequent phase their ability to nurse the economy back to growth. Central banks have responded in an unprecedented way in both scale and scope. They have provided ample liquidity in their lender of last resort functions, have committed to low – often effectively zero – interest rates, have engaged in large-scale balance sheet policies, have augmented this with enhanced forward guidance linked to real-economy outcomes, have put in place targeted lending schemes, have purchased risky assets and so on.

The response of central banks has had important benefits. There is no question that in the most acute phase of the crisis it prevented the financial system from imploding, which would have brought the real economy down. Low policy rates and the

unprecedented deployment of balance sheet policies boosted confidence and improved financial market conditions. And as doubts re-emerged in financial markets more recently, central bank measures effectively reduced perceived financial tail risks.

And yet, despite these unprecedented actions, the global recovery has been lacklustre. Five years into the recovery, economic performance is lagging previous ones at the same stage. Economic activity is well below its pre-crisis trend in the major advanced economies and unemployment is stubbornly high.

There is, understandably, frustration about this apparent lack of traction. This frustration has led some to call for ever more monetary policy activism. But is it really justified?

If a medicine does not work as expected, it's not necessarily because the dosage was too low. Maybe instead the overall treatment, and the role of the medicine within it, should be reconsidered. Most likely something else is needed.

Balance sheet recessions are special: it is less clear than often thought that monetary policy can foster a quick and robust recovery in a balance sheet recession. When private sector balance sheets need repair, accommodative monetary policies are less effective. When the problem is too much debt and agents are in the mood to retrench, it is unrealistic to expect monetary policy to revive strong growth by lowering interest rates. When financial institutions are weak, it is equally unrealistic to expect them to effectively transmit monetary impulses.

Moreover, it is well known by now that growth tends to be weaker after financial crises than after ordinary economic downturns. This is not just, or even primarily, a question of deficient demand. It reflects the need for the economy to reabsorb the aggregate and sectoral real imbalances that built up during the preceding unsustainable expansion, hidden under the froth of the financial boom. Such booms typically leave in their wake not only too much debt, but also too much capital and labour in the wrong sectors. Therefore, the challenge for countries in the next few years will be to reallocate labour and capital among sectors both within and across national borders. Structural reform to remove rigidities, not monetary policy, is the way to facilitate this.

True, monetary policy can buy time to implement the necessary balance sheet repair and structural reforms. But it cannot substitute for them. After five years of buying time, one has to ask whether that time has been – or will be – used wisely. Refocusing the policy mix to rely more on repair and reform and not to overburden monetary policy is crucial because the balance of risks of prolonged very low interest rates and unconventional policies is shifting. The costs are growing in relation to the benefits, for a number of reasons:

First, prolonged monetary accommodation gives borrowers, financial institutions and policymakers an incentive to keep "kicking the can down the road", delaying necessary repair and reform. Certainly, progress has been made in a very trying environment. But more needs to be done. Indeed, the slow progress in the implementation of structural

reforms and in the deleveraging process may signal that this delaying mechanism is at work. Persistent high unemployment rates in many advanced economies indicate the challenges of labour rigidities and sectoral rebalancing that still face us. At the same time, although some private sector deleveraging is occurring in some countries, and the financial system is better capitalised, the total debt figures are not reassuring. Since the end of 2007, total debt of the G20 non-financial sector, both private and public, has risen by more than 30 trillion US dollars, which runs counter to deleveraging, at least as I understand the term. It is noteworthy that over the same period global central bank assets have increased by roughly 10 trillion US dollars.

Second, prolonged accommodation can produce other unintended side effects. In the 1970s, the desire to lift output and employment back to pre-crisis levels resulted in surging inflation. One might argue that the situation today is quite different from then. Inflation has remained low in most jurisdictions and close to central bank targets. However, monetary stimulus may find its way into asset prices and leverage before influencing goods and services price inflation. Moreover, prolonged very low interest rates can distort market signals, mask underlying balance sheet weaknesses and undermine the earnings capacity of banks, the business models of life insurance companies and the solvency of pension funds. This may further misallocate credit, weaken financial institutions' balance sheets and encourage excessive and unwelcome risk-taking.

Another significant side effect arises from global monetary policy spillovers. Persistently low interest rates in the major advanced economies generally encourage capital flows to fast-growing emerging market economies and put upward pressure on emerging market exchange rates. This can complicate the ability of emerging market central banks to pursue their stabilisation goals. On the one hand, if central banks in emerging markets keep policy rates very low, capital inflows would be discouraged, but domestic credit growth would be encouraged. If, on the other hand, they raise policy rates, the risks of destabilising capital flows would rise. So far, we have been seeing a combination of these forces at work. Despite some slowing of capital flows over the past year, private sector credit and property prices have been surging in a number of these economies, as well as in some open advanced economies.

Finally, prolonged accommodation raises risks to central banks themselves. If economies remain weak and structural problems unresolved despite repeated rounds of further monetary stimulus, the credibility of central banks may suffer, and credibility is important for effectiveness. Let me insist here that results in the real economy will depend on the extent that needed repair and reforms are carried out. Results will depend to a large extent on factors that are not under central banks' control. A vicious circle can develop, with a widening gap between what central banks are expected to deliver and what they actually can deliver. This may ultimately undermine their credibility and, with it, their legitimacy and effectiveness.

All this underscores the importance of being prepared for the eventual exit from the extraordinarily accommodative monetary conditions that have prevailed for the past several years. While central banks surely have all the tools available to technically engineer an exit, it cannot be taken for granted that it will be smooth. The global bond market crash of 1994 is a cautionary tale of the risks involved in exiting from a prolonged period of low interest rates.

At the same time, we also have to recognise that the situation today is rather different from back then in at least one critical dimension: central banks are much more transparent about their policy intentions now and their communication is much better. This should reduce the risk of major policy surprises. That said, the policy environment central banks have to grapple with today is also much more complex in some important dimensions. Record levels of debt have been issued at very low interest rates. Central banks, at least for now, are playing an important, if not dominant, role in key financial market segments. So, as interest rates rise and central banks pare back and eventually reverse large-scale asset purchases, financial markets will have much to digest. Different national conditions will require unsynchronised exits, which may raise additional complexities. Even in the current environment of enhanced central bank transparency and credibility, a choppy exit is a material risk. It goes without saying that I would love to be proven wrong about this, and that a lot of work is being done to reduce exit risks.

Monetary policy and the financial cycle

As we peer further into the future, one key challenge central banks face is how to better integrate financial stability considerations into their monetary policy frameworks. The economic and social damage of the recent crisis has painfully shown what is at stake. And central banks must reflect on how they can forge a new consensus about the way forward. This is not just a narrow operational issue, for example about how to respond to credit and asset price booms and busts. It raises the much broader conceptual question of how to shift our traditional purely macroeconomic perspective towards a new, fully integrated macro-financial perspective.

As I see it, the crisis has not discredited the core elements of pre-crisis monetary policy frameworks. The credibility of central banks as guarantors of price stability has been instrumental in anchoring inflation expectations, on both the downside and the upside, during the crisis and its aftermath. A strong, credible anchor helps to counteract the destabilising forces hitting the economy and financial markets.

At the same time, the pre-crisis monetary policy frameworks did not prevent the crisis from happening. The experience in the run-up suggests that central banks need to better appreciate their role in influencing the financial cycle. For this purpose, by financial cycle I refer to the combined endogenous behaviour of credit and asset prices, particularly house prices.

Regulatory reform obviously plays a key role in mitigating financial cycles, and we have already seen significant progress in this area: better and higher buffers, the introduction of countercyclical capital buffers under the new Basel III framework and the development of macroprudential frameworks and tools.

To be sure, prudential and macroprudential measures are clearly necessary. But they alone will not be enough and can also be circumvented by regulatory arbitrage. This is why monetary policy has a complementary role to play. The policy rate represents the universal price of leverage in a given currency and cannot be bypassed easily.

In this respect, central banks will need to reflect on how best to respond to financial stability concerns in the future. The crisis has clearly shown that financial stability is essential for lasting price stability. One lesson is that monetary policy may need to respond more symmetrically to the financial cycle than in the past – tightening more strongly in booms and easing less aggressively, and persistently, in busts. In practice, this means paying more attention to policy challenges beyond the conventional policy horizons of two or so years. When financial stability concerns grow, policy horizons need to be lengthened to take account of the fact that the financial cycle is considerably longer than the business cycle.

Analytical frameworks also need to better reflect the characteristics of financial cycles and their interactions with financial and macroeconomic stability. Central banks' pre-crisis workhorse models generally assigned no meaningful role to macro-financial linkages. The financial crisis has demonstrated that such analytical perspectives are woefully inadequate.

Another dimension along which central banks need to reflect is a better appreciation of global monetary policy spillovers. Global feedback effects amplified the pre-crisis financial boom, and we might be seeing this mechanism at work again. In a highly globalised world, keeping one's own house in order surely is not enough.

What does this mean in practice? It does not require central banks to coordinate their policies closely. But, at a minimum, it does call for them to appreciate better the global side effects and feedbacks that arise from their monetary policy decisions. This is in each central bank's own interest, especially if the spillovers have the potential to foster regional financial instability that ends in crisis, with significant global repercussions that swing back to the originating countries, like a boomerang. A precondition for this shift in perspective is a more global analytical approach that factors in interactions and feedbacks appropriately.

Finally, I do not want to leave you with the impression that fiscal policy is irrelevant in this discussion. Indeed, fiscal policy plays an important role in financial stability, too. The financial crisis has demonstrated the importance of having the fiscal capacity to support the financial sector through bank rescue packages and the real economy through fiscal buffers. But the financial crisis has pushed fiscal policy in many economies onto an unsustainable path. This is a lesson that we have to keep in mind

for the future. Accumulating budget surpluses in good times provides governments with the ability to respond flexibly to a financial crisis without putting fiscal sustainability at risk. In other words, governments need to factor in the financial cycle and to build up additional fiscal buffers during good times that can be drawn down to provide support in bad times.

Summing up

Let me sum up. There is little disagreement that the past five years have been unusually challenging. Central banks have played a critical role in managing the crisis and its aftermath. They are now under huge pressure to promote a sustainable recovery under difficult circumstances. And, looking ahead, they will continue to find themselves confronting major challenges. I have suggested that monetary history provides a valuable compass to navigate these tricky waters: a clear focus on lasting price stability, a more symmetrical approach to the financial cycle, and a better appreciation of global spillover effects – these would appear to be the key elements of stronger monetary policy frameworks.

At the current juncture, there is also a premium on central bank communication. Central banks need to clearly communicate the limits of monetary policy, both to the public and to other policymakers. The private sector and policymakers, who have been facing their own set of daunting challenges in extraordinarily difficult times, will have to play a larger role in the next leg of the global recovery. Crucially, this would also allow central banks to normalise monetary policy in a manner consistent with a return to sustainable and balanced growth.

Thank you.