Financial system and macroeconomic resilience

Opening remarks

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May I begin by welcoming you all to Brunnen and to this sixth annual BIS conference for central bankers and academics. This conference seems to me to have been growing steadily in quality and reputation, as indicated by the participation of those here today and the papers that will be presented both today and tomorrow. Obviously, my first thanks must be to you all, but I would also like to thank my BIS colleagues for having put it all together: in particular, Claudio Borio, but also Andy Filardo and Kostas Tsatsaronis. And, on the logistical side, Melanie Sykes has been working overtime on this for many months. I do hope that you will get as much out of this conference as we have tried to put into it.

The topic we will be discussing highlights a set of issues in which the BIS has had a long-standing interest. For many years now, we at the BIS have been focusing on the reality of constantly changing economic structures, with a view to understanding the implications for public policy and for the central banks who are our clients. In recent years, globalisation and technological advances have altered significantly how the real economy, including the inflation process, functions. Similar forces have transformed the financial system in the industrial countries, but are increasingly affecting emerging markets as well. And finally, the increased focus of central banks on controlling inflation, together with an increased willingness to explain their modes of thinking, constitutes a further important change with feedback effects on both the real economy and the financial system. In sum, the world has changed substantially and continues to do so.

But to be more specific about the subject matter of this conference, “Financial system and macroeconomic resilience”, the implicit question being asked is whether the massive changes we have seen in the financial system in recent years have been unequivocally welfare-enhancing. On the face of it, the facts seem to shout out “yes”. The big macro variables have been so well behaved that they have earned the name “the Great Moderation”. Real growth rates at the global level have for some years been at record highs, and the variance of growth rates has been markedly reduced. In the United States, where financial developments have been among the most advanced, the recession of 1990 was small, and that of 2001 smaller still. Global inflation has also come way down, as has its variance. And that is by no means all the good news. Consider that this has happened against a backdrop of significant shocks that could conceivably have had macroeconomic repercussions: the failure of LTCM, a number of large corporate bankruptcies, the collapse of the Nasdaq and other stock markets in the late 1990s, and the events of 9/11 in 2001.

And to look at financial markets today, the prevailing view seems to be that this good news will continue. While long rates have recently moved up a little, they still seem low relative to prospective growth rates, reflecting what appears to have been a longer-term trend downward in term premia. Equity markets have hit new record highs almost everywhere, with price increases in many emerging markets verging on the spectacular. Spreads on high-risk corporates have fallen to unusually low levels, while spreads on sovereigns have been maintained at record lows. Moreover, to judge from the implicit volatilities drawn from option markets, the market seems unusually certain about this view as well. Finally, the fact that the price of houses almost everywhere has risen to record levels, along with the prices of fine wine, art, antiques and even stamps, must also constitute good news, at least to the people who already own them

Of course, just looking at facts and simple correlations, however striking, does not provide proof of causality. We must get behind the facts to look at the theory. What are the specific channels through which identified changes in financial markets might have contributed to the welcome set of macroeconomic circumstances just identified? This line of reasoning leads to two different schools of thought. One is essentially supportive of the hypothesis, while the other is also supportive, but only to a point. Moreover, the latter also cautions that some of the good news to date might be at the cost of significantly worse news looking forward. Both schools stress the interaction of monetary policy and recent structural changes in the financial system. Evidently, however, they come to quite different conclusions as to what macroeconomic outcomes these interactions might produce. Let us characterise them as the “first best” and “second best” schools of thought.

The “first best” school looks at monetary policy over the last two decades and concludes that it has done an excellent job. The growing commitment to price stability and associated policy actions produced price stability and an associated credibility. The firming of inflationary expectations, around a low level, allowed economic upturns to go on longer than would have been normal earlier. It also allowed a rapid easing of monetary policy whenever growth seemed under threat for whatever reason.

For this school, financial developments have also played an important role in explaining events. As markets have become more complete, the “bang for the policy buck” as policy has eased seems to have increased. Upturns have been strengthened as corporations and households have obtained access to credit that would not otherwise have been available. New ideas have been allowed to come to fruition, productivity has been encouraged and intertemporal optimisation has been allowed. Moreover, the system has been made more resilient to downturns, with risk being increasingly transferred to those who can best bear it, and with the availability of multiple sources of credit making credit crunches less likely. Further, the growing importance of market-based intermediation implies less exposure for the banking system and less likelihood of disruptive bank failures potentially affecting the payment system. Add to this much better and cheaper information to assess risks, and much more attention being paid to doing so, and both recent and prospective developments have to be seen in a bright light.

Consistent with this line of thinking, asset prices are high because the risks are low. Growth will buoy equity returns, and will also keep down bankruptcies, thus favouring bonds. Sovereigns also will benefit from a better global growth environment, aided as well by much better macroeconomic policies and choices of exchange rate regimes. As for low implied volatility, if the risks have been much reduced, it is not surprising that the cost of insurance is down as well.

The “second best” approach agrees with much of the above, but asks whether there might not also be some downsides, in a world where neither markets nor our understanding is yet complete. Consider an alternative view of monetary policy over recent years. Perhaps low inflation, and low inflation expectations, actually owe more to positive supply side shocks than to the credibility of monetary policy. After all, the growth rates of financial and monetary aggregates have been enormous in recent years. Moreover, real rates of interest have generally gone down, even as the potential growth rate of the global economy seems to have gone up. From a Wicksellian, or natural rate, perspective, this would imply the potential for either accelerating inflation in the future, or the build-up of dangerous “imbalances” in the economy, or perhaps both. The clear implication of this view is that the future could look like the past, but it need not.

This rather darker perspective also conditions the assessment of structural developments in the financial sector. More complete markets might allow intertemporal optimisation, but if this implies more spending up front, it must by definition imply less spending later. Indeed, access to more diverse sources of credit might even have encouraged “excessive” spending, which could eventually lead to a sharp rebound in the saving rate at some future date. To my mind, the illusion of “wealth” created by higher asset prices, and associated access to collateral, makes this quite likely. It could also be significant that the countries with the most advanced financial systems often seem to have the largest external deficits, a further source of concern for some, although clearly not all.

As for risks being transferred outside the banking system to those who can better bear it, this assertion needs to be qualified. Banks remain hugely important, and their balance sheets continue to expand amid significant uncertainty as to how much risk they might have retained, either by design or inadvertently. Nor do we even know where the risk that has actually been transferred has gone, or the assessment capabilities of those who might have bought it. Indeed, the “originate and distribute” model which has become so fashionable could actively discourage due diligence. Together with the search for yield on the part of purchasers, this might have led to a systematic mispricing of risks that will only become apparent in a downturn.

And finally, it is worth noting that we face a whole host of new players, new instruments and new markets, whose future behaviour cannot easily be predicted. Everything has grown larger, more complex, more opaque and faster moving. Unexpected interactions are always possible, but the likelihood is increased by the dominant role played in some markets by just a few large firms, or by a set of hedge funds potentially exhibiting herd behaviour. Clearly, in such an environment, a sudden loss of liquidity could not be ruled out. And, all of this financial activity depends on a vast complex of computers and software, with associated exposure to operational risk.

Well, which is it to be? Is the bottle half full or half empty? Indeed, it may be that the answer is both: our developing financial system could have made the economy more resilient to small shocks, but potentially less resistant to big ones. Indeed, an interesting test could be coming up if global inflationary pressure proves more persistent and substantial than markets currently anticipate. Similar to the more powerful effects of policy easing referred to a moment ago, the “bang for the policy buck” might also be greater as policy tightens. As low household saving levels and high debt levels collide with higher interest rates, and overvalued asset prices retreat in turn, the implications are not so easy to predict.

Most of the papers prepared for this conference deal with aspects of these issues, in effect the functioning of the financial system under normal conditions. But some attention will also be paid to how changes in financial structure have affected the capacity for crisis management. In a nutshell, the time seems long past when Bill Rhodes or Bill McDonough could make material progress by putting 20 top bankers in a room and appealing to their collective self-interest. Today there are simply too many players and too many divergent interests for that to be possible. It remains to be seen what the alternatives are, but it is certainly appropriate that policymakers and academics should be asking themselves such “what if” questions. Indeed, it is only prudent.

Again, let me welcome you all here to this beautiful spot. And let me thank you again for the contributions already made, in the form of the papers, as well as for the active participation I hope we can count on in the discussions over the next two days. Let us learn as much as we can from this interaction between the central banking and academic communities.