Urban Bäckström: Some reflections on financial and monetary stability

Speech by Mr Urban Bäckström, Governor of the Sveriges Riksbank and Chairman of the Board of Directors and President of the Bank for International Settlements, at a seminar in Bangkok hosted by the Bank of Thailand, on 24 August 2000.

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Your Excellencies, Ladies and Gentlemen,

I would like to thank my dear colleague, Governor Sonakul at the Bank of Thailand, for the invitation to visit Bangkok and for the opportunity to address this distinguished audience this evening.

In recent years, significant progress has been made in putting the global economy on a path towards sustainable growth. The world economy entered the year 2000 in considerably better shape than many of us would have expected just a year ago. And after recovering to near its long-term average in 1999, global growth is forecast to go on accelerating in 2000.

It is especially noteworthy that performance has improved in almost every region of the world. Southeast Asia, Russia and Brazil have all rebounded from their recent crises more strongly than expected. Many of the world's poorest countries, including some in Africa, are posting respectable growth rates. The US economy is enjoying its longest recorded expansion ever. Growth in continental Europe is picking up - especially in the larger economies where growth had been relatively weak. And there are signs of an incipient recovery in Japan.

It is an indication of how far we have come that the weaknesses and uncertainties which so preoccupied policymakers and market participants in 1997, 1998 and early 1999 have given way to concerns about overheating in some parts of the world. The acceleration in global growth has refocused attention on inflationary pressures and on sustaining the monetary stability that economic policymakers have strived so hard to achieve in recent years.

Steps are also being taken nationally and internationally to improve the working of the financial system. Ensuring financial stability has indeed become an important task in the light of events in the past decade - years that saw financial problems in a number of European countries as well as in Mexico and Asia, the devaluation of the rouble and suspended payments in Russia, the collapse of the hedgefund Long Term Capital Management, considerable turbulence in western financial markets and financial unrest in Brazil. The crisis in the international financial system developed, to cite President Clinton, from being "just a few small glitches in the road" into "the worst financial crisis in fifty years".

Although the momentum of the world economy and the policy actions taken to date to ensure financial and monetary stability give grounds for optimism, there are still challenges ahead of us. In my talk tonight I will discuss a few of these challenges.

Financial stability

The transition to a more global financial system has certainly not been free from problems. It should not be forgotten that extensive capital regulations entail a mispricing of risks. Deregulation then leads to desirable price adjustments. But it is during these transitional corrections that financial problems are liable to occur. Changes have often outstripped the ability of the system, including the institutional infrastructure, to keep pace. In most cases, neither the banks nor the public authorities had the necessary prerequisites for adapting to the new conditions that a freer capital market created. The expansion of lending had too free a rein in many countries and the authorities did not adequately monitor what was happening at either micro or macro level.

Due to a rapid expansion of credit, the deregulation and opening up of the domestic financial system was often followed by economic overheating. Asset prices rose sharply and imbalances developed. Furthermore, in countries with a fixed exchange rate system, extensive short-term borrowing abroad was stimulated. A large proportion of these funds was often channelled through the domestic banking system and rendered this rather vulnerable. When capital flows subsequently reversed, the adjustment was often dramatic. Production fell, unemployment rose and both the currency and the banking system faced an acute crisis.

Although several factors may have played some part in the run-up to recent financial crises, it is important to bear in mind that a deregulated financial system with free capital movements is not the basic problem. Modern international financial markets have possibly contributed to an earlier appearance of crises and to their spread, but financial crises almost always originate in an unsuccessful domestic economic policy and in the structure and regulation of the domestic financial system.

It is striking that several countries most affected by financial turbulence in the 1990s were relatively new participants in the international financial system without having first established a sound domestic financial system and a sound economic policy. That applies to my own country, Sweden, which experienced a severe crisis in the early 1990s.

One obvious insight is, and I quote Fed Chairman Alan Greenspan, "that participation in the international financial system with all its benefits carries with it an obligation to maintain a level of stability and a set of strong and transparent institutions and rules if an economy is to participate safely and effectively in markets that have become highly sensitive to misallocation of capital and other policy errors".

To say that the key to avoiding future crises in emerging markets must be found in domestic reforms is not to deny that part of the solution may still lie in measures that change the way in which international financial markets sometimes operate. While financial liberalisation and international financial integration bring unquestionable benefits, they can also be subject to episodes of excessive risk-taking. In recent years, there does seem to have been imprudent lending, and not just to emerging market economies but also to borrowers within the industrial world.

In part this has been spurred by competitive forces. That such forces will diminish as financial restructuring accelerates seems unlikely. Information asymmetries lie at the heart of market failure, and the market's way of resolving them can give rise to unpredictable outcomes. Ensuring that markets have adequate information about national economies, the strength of financial systems, aggregate positions and the financial standing of counterparties is important. Equally important, if not more so, is to ensure that market participants' approach to risk management reflects the full balance of costs and rewards implied in their decisions.

Given the costs and the difficulties of managing the successive crises over the past decade, we must continue to devote considerable efforts to avoiding future crises and try hard to understand the kinds of vulnerability that lie behind them. The work now being carried out in various international fora is thorough and can be summarised under three headings: crisis prevention, crisis containment and crisis resolution. Much of this work involves international institutions like, for instance, the International Monetary Fund, the World Bank, the Bank for International Settlements, the Basel Committee on Banking Supervision, and the OECD, as well as the Financial Stability Forum.

However, it is with national authorities that the often hard work of implementing policies and codes lies. The measures will contribute to better financial stability only if countries actually adopt and implement them. A crucial ingredient in achieving this is of course to involve countries, formally or informally, in the development of the policies, codes and standards. But even if that is achieved, I know from my own experience how difficult the actual implementation sometimes can be, not least for political reasons.

The events of the past decade have made it clear that greater efforts are needed to strengthen the functioning of markets. I would like to make the point that today's favourable trends in the world economy should not lead us to conclude that the danger is over. We have witnessed too many crises in the last decade not to know that market confidence can suddenly shift. Instead, policymakers throughout the world must continue to work on forestalling new problems both because some evident threats to international financial and economic stability still remain and because there may well be vulnerabilities that are less evident. But the chances of the global economy continuing along the path towards sustainable growth without disruptive financial instability can be enhanced by implementing appropriate reforms.

Monetary stability

Let me now turn to monetary stability. In the last decade a growing number of countries have chosen to conduct monetary policy with an explicit target for inflation. One reason behind this choice has no doubt been these countries' poor experience with a fixed, but adjustable, exchange rate regime.

The first country to formally adopt a policy of targeting inflation was New Zealand in 1990. Canada did the same in 1991, followed by the United Kingdom, Sweden and Australia. Other countries have also introduced some variant of inflation targeting since then.

It is interesting to note that before the 1990s the predominant view was that a floating exchange rate regime was not suitable for a small open economy. Today, I believe that experience has been exceptionally good among those countries that are targeting inflation. In fact, even some emerging market countries are now building the same kind of regime. In recent years countries such as South Africa, Brazil, the Czech Republic, Poland and Thailand have been inspired to introduce a similar strategy. Consequently inflation targets are now introduced in quite a number of countries.

Let me take this opportunity to commend the Governor of the Bank of Thailand and the bank's staff for the first excellent Inflation Report that was presented in July. The report is very impressive and it has given me quite a few new ideas.

The challenge during the 1990s for the inflation targeting countries has been to build a rigorous framework around the new regime. Questions like the choice of rate and index to be targeted, the usefulness of bands around the target and the degree of transparency all needed to be answered.

It has also been important to formulate a monetary policy reaction function, that is, to define the balance between inflation variability and output variability. The reason why central banks do not aim for maximum short-term stability in either inflation or output is that attaining only one of the targets would be costly for the economy.

On the one hand, the central bank's legitimacy among the general public could suffer if short-term interest rates have to move sharply, causing output to fluctuate widely while inflation is held stable and exactly on the target. Maximum stability in output could, on the other hand, result in sharp fluctuations in the rate of inflation and erode the credibility of the monetary regime. A point somewhere midway between the two extremes must therefore be found.

Let me also stress the importance of central bank independence. In order to be successful with the implementation of an inflation target approach, the central bank must be able to act independently of day-to-day party politics and to set interest rates continuously according to the specified inflation target. Otherwise a credibility problem arises because it will be hard for policymakers to convince the general public of monetary policy's long-term nature. Lack of credibility, in turn, means that the central bank has to set its interest rates higher than otherwise would have been the case.

Looking ahead, I believe there are at least two major questions that central banks have to address more thoroughly.

First, how should monetary policy react to asset prices, such as equity and/or real estate prices? We know from history that the development of asset prices can have a significant impact on both inflation and real economic activity. We need to establish whether or not there are actions that central banks can and should take to minimise the likelihood of macroeconomic instability arising from extreme fluctuations in asset prices.

Second, how should monetary policy react to structural changes in the economy?

Monetary policy and asset prices

Let me start with the question of monetary policy's response to movements in asset prices. This depends in turn on how the central bank chooses to use the information contained in asset prices.

In a regime that explicitly targets inflation, asset prices are taken into account via the effects on aggregate demand. Rising share prices increase household wealth and that would raise consumption for a given level of income if these increments to wealth are considered to be of a permanent nature. At the same time, consumer confidence boosted by higher share prices could potentially make individuals more prone to spend their increased wealth.

An increase in share prices also makes investment more attractive to firms since it increases collateral values and lowers the cost of new capital relative to existing capital. If share prices predict higher expected output growth, this could also lead to more investment.

If the asset prices on which households and firms base their consumption and investment decisions prove to be too optimistic, this would create inflationary pressure in the short term. An important question in this context is how sensitive households' and firms' consumption and investment responses are to changes in asset prices.

Via the effects on inflation, asset prices are thus taken into account in the formulation of monetary policy, although they do not feature explicitly in the target variable.

However, the simple use of financial asset prices as indicators is not a panacea for the central banks' forecasting problems. Asset prices can move for a variety of reasons. Understanding those reasons is important in determining the appropriate monetary policy response. For example, if a rise in share prices stems from increased productivity and thus from expectations of higher future profits, the implications for monetary policy would be very different from a case with no such fundamental reason for the higher share prices.

This raises a number of questions. One pertains to the relative informativeness of different kinds of asset prices. Another is how to integrate the information obtained from asset prices with other macroeconomic information. Notwithstanding the empirical evidence of the indicator properties of asset prices, the *causal* relationships between asset prices and real macroeconomic variables have proved to be more difficult to understand and model. But, as I have just illustrated, the answers to these questions can be very important for monetary policy. It seems quite clear that central banks cannot afford to adopt a view of asset markets as merely "side-shows".

There can be other, sometimes less straightforward, situations where monetary policy has reason to react to movements in asset prices even though the effect on inflation is negligible. One such reason is the central bank's responsibility for the financial system's stability.

If asset prices have been driven up to unsustainable levels that do not correspond to the underlying fundamentals, we are faced with a special kind of problem. We know from experience that speculative asset price bubbles eventually burst. When they do, collateral values will fall and balance sheets deteriorate, potentially threatening the stability of the banking system. To avoid this kind of development, the central bank needs to closely monitor the potential for excessive credit growth and the possibility of asset price bubbles building up.

It seems that historically the forming of speculative price bubbles has been closely linked to an excessive expansion of credit. But we need to operationalise both the concept "excessive" and the difficult concept of an asset's "fundamental value". As history has shown us, judging to what extent rising asset prices reflect strong fundamentals, rather than the "irrational exuberance" of investors, is easier said than done.

Nevertheless, certain important risks related to asset prices need careful watching in today's world.

The *first* risk is that imprudent lending could fuel unwarranted asset price increases - as so often in the past. Although there is little evidence to date of a general lowering of credit standards, credit growth has been very rapid and loans to finance equity purchases have risen sharply in some countries.

Ensuring that investors are not sheltered from the consequences of their sometimes misguided investments is important for maintaining prudent lending standards. It is important that the message from central banks is clear: investors should not count on monetary policy underwriting any particular valuation of equity markets.

A *second* and related risk is that high asset prices might lead to complacency about debt levels. Household and corporate balance sheets may look healthy when asset prices are stable or increasing, but what if prices fall? Similarly, debt servicing ratios for some emerging market countries may look sustainable when market access is improving, but what will happen if interest rates rise?

Rising levels of household and corporate indebtedness in some industrial countries, as well as rising levels of external indebtedness in a number of emerging market countries, are based on expectations of continued strong growth in income and production. Earlier I remarked that the momentum of the world economy and the policy actions taken to date give reason for optimism. However, volatility is intrinsic to financial markets. Our experience during the 1990's clearly demonstrates the danger of basing decisions solely on a single central scenario, rather than on a range of possible - including worst case - scenarios.

Monetary policy and structural changes

Let me now briefly touch upon the question of how monetary policy should react to structural changes in the economy? Quite a lot of thinking has already been done on this issue, both among academics and policymakers. Nevertheless, I believe that more must be done in this field, especially since at least some parts of the world economy have seen something of a productivity shock in recent years. I am deliberately avoiding the buzzword "new economy" here, since history has been full of expressions like that ever since the turn of the 19th century.

The discussion about monetary policy and a productivity shock is taking place mostly in the United States, in the light of the impressive economic performance there and the acceleration in the rate of productivity growth. So one could certainly ask: what about the rest of the world? The possibility of a productivity breakthrough also in other parts of the world cannot of course be ruled out.

Higher - or accelerating - productivity growth does indeed pose new challenges for monetary policy. It could set in motion a complex of effects on aggregate supply and demand, on inflation, equity prices and interest rates. Just to give a few examples, let me briefly mention the following effects.

First, a positive productivity shock raises the economy's potential growth rate. It also affects aggregate demand through new, profitable investment opportunities, higher equity prices and expectations among households of higher permanent income. One question for policymakers is whether the demand effects are so powerful that they have the potential to outpace the growth of aggregate supply in the short and medium perspective.

Second, there could be temporary disinflation effects at work if the increase in productivity is unexpected initially. If wages are slow to adjust, higher productivity growth lowers unit labour costs and thereby reduces price inflation. Here again there are important questions for policymakers. Should this effect be allowed to result in a temporary reduction of price inflation or unemployment?

Third, an increase in the trend rate of productivity growth could also result in a higher equilibrium real interest rate, when the output gap is closed, in order to balance saving and investment. Fiscal policy and the development of public financial balances could at least partly offset this effect, as could the economy's degree of openness.

All this implies that monetary policymakers could face quite a few challenges. One of them is to identify structural changes and distinguish these from cyclical variations. Another challenge is to detect the magnitude of the effects. Furthermore, looking ahead in monetary policy is hard when the economy is going through major changes that make it difficult to forecast the future path of the economy and inflation.

It is quite clear that this demands a great deal of forecasters as well as of those who construct macro models. The forecasts concern inflation one to two years ahead, which calls, for instance, for reasonable precision in the measurement of the output gap and the relationship between the output gap and inflation.

It is already evident, for example, that inflation forecasts were frequently on the high side in many countries in the 1990s. I believe that the best we can do, at least at this stage, is to pay close attention to incoming data in the forecasting process, and examine how consistent they are with historical relationships. We have to deal more successfully with the fact that forecasts of economic developments can never be completely accurate and still allow monetary policy to be forward looking.

Final words

Let me now conclude. When discussing financial and monetary stability, we must remember that we have come a long way. The world economy shows strong growth coupled with low inflation and monetary policy has contributed to this development. However, there are interesting, though somewhat difficult, challenges ahead that must be met if we are to preserve this bright picture of the world economy.