Urban Bäckström: Financial cycles

Speech by Mr Urban Bäckström, Governor of Sveriges Riksbank, at the Philadelphia Fed Policy Forum on Crises, Contagion and Coordination: Issues for Policymakers in the Global Economy, Philadelphia, 22 November 2002.

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First I want to express my thanks to the organizers for inviting me to this very interesting conference. Let me especially thank Tony Santomero for everything he has done in his previous capacity in inspiring and assisting us at the Riksbank over the years as an academic adviser. I wish you, Tony, every success as president for the Philadelphia Fed and as an important policy maker here in the U.S.

I think one can say that central bankers around the world have never before had such a central and well respected position as they have had during the past decade. Their task seemed to be well defined and the job to deliver price stability has worked rather well. Much of the mystique that typically surrounded central banks has gradually disappeared. Openness and transparency have become the key words of the day. Moreover, research concerning monetary policy has made good progress during the past decade. The world of central banking has indeed undergone positive changes.

However, it would be most dangerous for us, central bankers, to just sit down and relax in the belief that all the important problems in the field of monetary policy have been resolved and need no further consideration. One aspect that indeed needs further thinking is the issue of financial cycles and how they could be mitigated and whether monetary policy should play a role in doing so. Let me say a few words about this.

Before I became involved in central banking I was state secretary in Sweden's Ministry of Finance in the early 1990s and dealt, among other things, with the management of our nation's banking crisis. Being in the middle of a crisis like that was indeed a frightening experience.

Financial crises would seem to evolve from excessive optimism. That is, credit expansion (domestic or foreign), which feeds into asset prices, lowers the cost of capital, stimulates investment and subsequently leads to an economic boom. Eventually, the investments are found not to be sustainable in that they do not generate profits. The whole structure may ultimately collapse, the economy moving from boom to bust, often followed by banking or currency crises or a combination of the two. The most severe bubbles have historically been those that involve rapid credit expansion in the banking system.

Economic history books are full of examples of this process. Also, the 1990s provided many illustrations of similar events. The discussion about financial cycles is far from new. One example is the major debate of the 1920s and 1930s between the Austrians (Hayek, etc.) on the one hand, and Keynes on the other. Keynes was focusing on the demand side and on how to get out of the bust, whereas Hayek was focusing on the supply side and on how an economy got into the bust in the first place.

While a great deal has been done to understand the reasons behind financial instability, many questions remain unsolved. So the discussion continues and when it comes to crises prevention, two conventional pieces of policy advice seem to emerge.

The first line of defense is moral suasion. The central bank could warn market participants in various ways that they are becoming overly optimistic in their expectations about future cash flows, if we are talking for instance about stocks or real estate. The problem with moral suasion is that it is difficult to calm down a market that is rushing to new highs. Talk rather than action is often not enough. Still, if a bubble is starting to build up, it may be worth a try. This is one reason why several central banks have began to publish financial stability reports. In this way one can perhaps broaden the public discussion about what is happening.

The second line of defense is prudential regulation. However, the way prudential regulation is done in practice raises two, interrelated problems. The first has to do with the fact that most financial crises stem not from individual banks getting into difficulties and affecting others by contagion. Rather, in most cases, many institutions act more or less similarly, encouraged by overoptimistic expectations that macroeconomic conditions can be extrapolated uncritically into the future. The second problem with prudential regulation is that the tools are themselves often based on perceptions of risk which are not independent of the credit and asset price cycle itself. On the one hand, underlying actual risk builds up as expansion and leverage continue and the financial cycle proceeds On the other hand, apparent risk declines with the rise in collateral values. This causes difficulties for supervisors who tend to concentrate on individual institutions and treat risks as exogenous. This is not to deny that by improving prudential regulation, setting international standards (for example Basle II) etc, the risk of financial instability can be significantly reduced.

Supervisors are also recognizing the shortcomings I just mentioned and are increasingly focusing on developments that generate systemic macroeconomic risks and on constructing built-in mechanisms to dampen the financial amplification of the business cycle. For example, supervisors are trying to encourage stress-testing by private sector risk managers to enable them to better see through asset market misalignments. Another way is to make provisioning practices more forward-looking than at present and to adopt more conservative, less cyclically sensitive measures of value. The idea is to build capital cushions in good times that can be used in bad times. Hence financial cycles could be milder.

Whether improved prudential regulations, supervisory practices and risk management techniques will suffice to avoid financial cycles in the future remains to be seen. Our experience so far does, however, leave some doubts about this.

This brings us to a possible third line of defense that could at least in principle be used to prevent large financial cycles. I am of course thinking about monetary policy The argument is that since we live in a fiat money system, there is no exogenous constraint on the supply of credit except through monetary authorities. If those reactions are geared exclusively to controlling inflation, then the monetary anchor may not counter a build-up of credit that does not immediately lead to inflation in the price of current output. Hence, there is little to prevent the emergence of cycles in the prices of real and financial assets that are not included in the measure of inflation. In addition, experience has taught us that price stability is not, by itself, sufficient to ensure financial stability.

So why don’t central banks simply change the way they conduct monetary policy and also try to prevent financial cycles? Well, the conventional view is that they should not. There are some very powerful arguments against a central bank trying to respond to credit expansion and “misalignments” in asset prices that do not lead to inflation in goods and services. First, how do we know that a bubble is a bubble and not a reflection of fundamental values? Second, even if the central bank does recognize the emerging bubble and wants to prevent it from building up, by the time it could form a judgement about this, it would be to late. Third, if a central bank is fortunate with both the recognition and the timing, there is still a risk that it will cause an economic recession. To have any effect on excessive optimism about future returns on financial assets, the monetary response might have to be.

Nevertheless, the costs of financial cycles are sufficiently large to warrant an exploration of several avenues for mitigating them and this should, to my mind, not exclude the possibility of monetary policy actions. I’m not saying that a central bank should target asset prices per se. Stock prices and real estate prices rise and fall for many reasons. In my view, however, a central bank needs to be observant when notable increases in asset prices are one of several imbalances that are building up even if inflation in goods and services does not show any sign of rising. Such imbalances could be a combination of strong credit growth, rapidly rising investment and a marked deterioration in the private sector’s financial balance. I do not mean to imply that determining when such a situation is on the way is particular easy. My point is that monetary policy should not be excluded a priori in a scenario like this. There are many other difficult assessments that central banks have to make. Here I am thinking about variables like the economy’s potential growth rate, the output gap and the NAIRU etc. Why should identifying asset market misalignments, excessive credit growth and a rapid decline in private financial balances be more difficult than forming an opinion about variables such as these?

My view about monetary policy in this respect is of course closely bound up with my experience of the Swedish banking crisis, but it is also in line with a central bank’s mandate to achieve long-run price stability. If anything, a financial crisis substantially increases the risk of outright deflation after some time. The central bank could manage this risk in two ways: by at least trying to prevent the bubble from building up by tightening monetary policy at an early stage, and then by loosening monetary policy aggressively if a bubble builds up and bursts anyway. To my mind, both such actions would be in line with focusing on long-run price stability, whether the central bank follows an explicit or an implicit inflation targeting approach.

Although I will be leaving my job as governor of the Bank of Sweden towards the end of this year, I have no qualms about forecasting that financial stability will remain on the agenda and be a key challenge for financial authorities for many years to come.