Jarle Bergo: Nominal and financial stability in a new economic world

Speech by Mr Jarle Bergo, Deputy Governor of Norges Bank (Central Bank of Norway), Valutaseminaret, Sanderstølen, 1 February 2008.

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Thank you for inviting me once again to this venerable institution - Valutaseminaret. It is a pleasure to be here with you. This morning I will discuss with you some issues under the broad heading of "Nominal and financial stability in a new economic world".

Introduction

The general economic environment has changed dramatically over the past 30-40 years. When I started my career as an economist in the late 1960s, a belief had evolved that the economy could and should be controlled and steered in considerable detail. A widespread view was that markets should be regulated and coordinated by authorities. Furthermore, the Phillips curve was embraced as proof that a long-run trade-off between inflation and unemployment existed. By merely accepting somewhat higher inflation, it was thought possible to reduce unemployment in the medium and long term. The economic policy of the 1970s and 1980s, which was based on these views, led to high and variable inflation and wide fluctuations in the economy.

In the face of the disappointing experience from this period and advances in economic theory, put forward by among others the Nobel Prize winners Phelps, Friedman, Kydland and Prescott, views have now changed. We have learned that low and stable inflation is the best contribution monetary policy can make to high and stable growth. The absence of a nominal anchor was one of the main reasons behind the pronounced swings in the real economy in the 1970s and 1980s. It was demonstrated that a long-run trade-off between inflation and unemployment does not exist. Today, monetary policy aimed at price stability is the norm, and in most countries monetary policy has been delegated to independent central banks.

We have also learned that very high policy ambitions are not compatible with the way the economy really works. Attempts to control all the quirks of the economy will eventually undermine the intentions. In fact, by scaling back on overly high policy ambitions the overall outcome will be better. Today the beneficial effects of making full use of markets in resource allocation are again widely recognised. State ownership and "dirigisme" have been reduced. Competition has increased in most markets, though lapses do occur from time to time. Trade barriers have generally been lifted or reduced. Well developed financial markets help move capital across borders and between industries.

Today's economic environment has in many respects risen from the ashes of failed paradigms. In a sense, today's regime resembles the one we had 100 years ago. From the mid-19th century until the outbreak of the First World War, capital markets were integrated across countries that had adopted the gold standard. Markets were largely deregulated. Cross-border financial capital movements were subject to little or no regulation. There was solid confidence in the gold standard as a nominal anchor. Inflation was low and stable, supporting economic growth.

The links between countries today are even stronger and broader than was the case 100 years ago. The number of countries taking part in the global exchange of goods and capital has soared. China, India, Russia and many other emerging markets have during the past twenty years opened their borders and embraced capitalist reforms. The economic world has become larger. What we have seen is, to use the words of Federal Reserve Chairman Ben

Bernanke, *"a wave of worldwide economic integration and increased economic interdependence"*.[1]

Economic developments the past 15 years have been extremely favourable. Inflation has generally been low and stable. At the same time, compared to the 1970s and 1980s economic growth has been higher and recessions shallower. Better monetary policy and a firm nominal anchor are in my view vital factors behind this "great moderation". But intensified competition and increasingly deeper and more integrated markets for goods, services, capital and labour have also contributed to containing inflationary pressures and to making economies more resilient to shocks. Even more importantly, globalisation and a better economic framework have lifted hundreds of millions out of poverty, an achievement that far surpasses anything development aid has ever accomplished.

In his book *"The age of turbulence"*, former Federal Reserve Chairman Alan Greenspan states that *"…we are living in a new world – the world of a global capitalist economy that is vastly more flexible, resilient, open, self-correcting, and fast-changing than it was even a quarter century earlier. It's a world that presents us with enormous new possibilities, but also enormous new challenges."*[2] In my presentation here today I will, not surprisingly, take a central banker's view and ponder the challenges this new world might raise for a central bank trying to achieve both financial and nominal stability.

Financial stability

The last decade or so, we have witnessed increased financial integration and competition across national borders. The unleashing of international competition in financial markets is a positive development. By spreading and diversifying risk, financial markets have become more efficient and stable. Deeper and more mature markets tend to be better equipped to deal with uncertainty and distress.

We have also witnessed the forging of new and ever more complex financial instruments. Increasing the set of available financial instruments creates more complete markets. It enhances the opportunities for households and enterprises to decouple consumption and investment from current income. Investors can take on or load off risks in a more tailored fashion than before and actively manage their exposures and relocate risks to those best equipped to bear them.

Yet, the flip side of increased financial integration and diversification is the potential for more widespread contagion if something goes wrong. Furthermore, rapid innovation and increased complexity can make it difficult to assess the real underlying risks of the new instruments. It takes time for borrowers and lenders to learn the true characteristics of new instruments. This increases the possibility that some investors – and issuers, for that matter – misunderstand the riskiness of an instrument. As a consequence, expected return may not appropriately reflect the true risk. When the true risk of an instrument starts to reveal itself, sharp corrections in the market may follow.

The recent subprime crisis is one example of how new and complex instruments can give rise to global financial turmoil. Problems stemming from over-optimistic price expectations for the US housing market have spread to investors and financial institutions all over the world. The wide dispersion of the financial turmoil took many of us by surprise. Not to mention where problems turned up; in German Landesbanken, in large investment banks and in Norwegian hydro-electricity-rich municipalities, to name but a few.

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[1] Ben S. Bernanke (2006): "Opening remarks" at "The new economic geography: Effects and policy implications", A symposium sponsored by the Federal Reserve Bank of Kansas City, Jackson Hole, Wyoming.

[2] Alan Greenspan (2007): "The age of turbulence", The Penguin Press, New York.

One lesson from the current financial turmoil is that the expected advantages of securitisation have been somewhat exaggerated. Securitisation was believed to make markets deeper and more liquid and – most importantly – to provide continuous pricing. Recent events have shown that this is not necessarily true for all markets at all times. In times of distress and uncertainty, some financial market segments can cease to function. When no trading takes place, no updated prices are quoted. This represents a challenge for institutions, auditors and regulators trying to mark assets and liabilities to the market.

This has amplified the impact on the financial sector of the defaults on subprime mortgages. In the absence of pricing, the balance sheets of financial institutions holding such instruments became opaque. Uncertainty about the potential loss of other banks and about their own future liquidity needs has made banks reluctant to lend to each other. To the surprise and dismay of many, the extremely efficient and well-functioning money market ground to halt. Central banks had to step in and provide liquidity to the banking system. When money markets go into gridlock, it is appropriate for central banks to ease banks' liquidity problems, but they should do so at a price that maintains the incentive to restore the smooth functioning of the market.

Losses and evaporating liquidity then hit the capital base of many financial institutions. So far, the most severe problems have been local or national, like the British bank Northern Rock and the Norwegian brokerage house Terra Securities. These problems were resolved by means of national remedies. But with increased integration and the emergence of cross-border banks, sooner or later we are bound to encounter a problem in a bank or financial institution that may be systemically important in several countries (but not necessarily in the home country). The existence of cross-border institutions makes crisis management more challenging, as it necessitates close cooperation between central banks, supervisory authorities and finance ministries in different countries. With one global financial market, one could wish there were one supervisory authority, one liquidity provider and one public treasury with a common script for handling crisis situations. We are far from this point. At the recent Davos World Economic Forum the head of the BIS, Malcolm Knight, stated that the *"major challenge"* for regulators was *"the Balkanisation of regulation – fragmented across market segments, across national jurisdictions and yet we want to have a global financial system."* [3]

A single financial market is one of the EU's objectives. Against the background of growing integration, crisis management has been moved up on the agenda within the EU. Norway is participating in extensive discussions on this topic under the auspices of the EEA agreement and in separate talks with the other Nordic countries. As an example, the Nordic central banks have agreed on a Memorandum of Understanding on crisis management that provides guidelines for information sharing and gathering, coordination of decision-making and so on.

The surprisingly wide dispersion of the subprime crisis has led to calls for an international overseer charged with keeping a complete account of the financial flows and pipelines that transfer contagion across borders in order to provide an early warning system to identify emerging crises. In a speech two weeks ago, British Prime Minister Gordon Brown proposed a new role for the IMF: *"…its role should be to prevent crises and not simply manage or resolve them as in the past. And in a wider role the IMF, working with the global financial stability forum, should be at the heart of what we need – an early warning system involving regulators and supervisors in all countries for financial turbulence affecting the global economy."*[4]

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[3] Financial Times January 26, 2008.

[4] Speech at the Chamber of Commence in Delhi, 21 January 2008.

Obviously, there are pipelines that are not on our present maps. Also, our knowledge of what flows through the known ones is scarce. But would it help us if we knew? Would we be able to predict a looming crisis and thus prevent it? I do not have the answer to this, but I think it is fair to raise the question.

We must expect turmoil in financial markets to occur from time to time. There will always be stupidity and greed, fear and euphoria (and some scoundrels). Accidents will happen. Authorities should strive to establish regulatory frameworks that give the right incentives for prudent behaviour. It is important to avoid overregulation that severely restricts markets and stifles innovation. We must of course make sure that obvious shortcomings in existing regulations are corrected. One such loophole was the possibility for banks to provide short-term guarantees without having to set aside regulatory capital. The new capital adequacy framework, Basel II, rectifies this situation. It is also important to encourage market discipline and counterparty surveillance, crucial elements to the well functioning of financial markets. Basel II is enhanced through the so-called Pillar III, which requires banks to publish information on key parameters of their business profile, risk exposure and risk management. The recent episodes have also reminded us of the importance of vigilance and competence in supervision.

In general, the markets themselves are the best regulators as long as economic agents follow the advice of Sir John Gieve, Deputy Governor of the Bank of England: *"Financial markets … can only work well if investors and firms expect to live or die by their own decisions and do not come to rely on a safety net to mitigate their losses."*[5] That is a good advice also with respect to safeguarding financial stability in a rapidly changing world. We might not be there quite yet. With reference to the banking industry, as Martin Wolf so eloquently put it in the Financial Times: *"No industry has a comparable talent for privatising gains and socialising losses. Participants in no other industry get as self-righteously angry when public officials – particularly, central bankers – fail to come at once to their rescue when they get into (well-deserved) trouble."*[6]

Nominal stability

Let me now turn to challenges to nominal stability.

The entrance of new, large emerging economies into the world trading system has strongly influenced relative prices and the prospects for nominal stability. The potential labour supply available for the global economy has doubled[7] and increased relative to the supply of capital. Wage shares have fallen and profit shares have risen, both globally and in Norway. Firms in high-cost countries increasingly offshore activities to low-cost countries. Imports of goods in industrialised countries have shifted from high-cost to low-cost countries. Furthermore, the collapse of the Soviet Union and the accession of Central and East European countries to the European Union have played a significant role for the labour market in Europe. Labour migration has increased. Off-shoring and outsourcing – or merely the threat of it – may have, at least temporarily, reduced the bargaining power of trade unions and employees. Increased competition, both in product and labour markets, has probably motivated productivity-enhancing measures. Productivity growth has been unusually high.

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5 John Gieve (2006): "Practical Issues in Preparing for Cross-Border Financial Crises", at the Financial Stability Forum Workshop: "Planning and Communication for Financial Crises and Business Continuity Incidents", 13 November.

6 Financial Times January 16 2008.

7 See Richard Freeman (2006) "Labour Market Imbalances: Shortages, or Surpluses, or Fish Stories?" presented at the Federal Reserve Bank of Boston's Economic Conference, June.

Lower import prices, intensified competition and high productivity growth have been important disinflationary forces both in Norway and elsewhere. As a result, many countries have been able to bring down inflation at virtually no cost. In this respect, we can probably talk about some degree of endogeneity in inflation. However, it is still the non-trivial task of monetary policy to ensure that inflation remains low and stable on a more permanent basis. In a country with its own national currency, inflation is not something that just drifts in with the wind from abroad. It is the monetary policy choices we make that determine price developments over time. As Ken Rogoff, professor of economics at Harvard University, has so aptly phrased it: *"…any central bank, no matter how small or open its economy, can always stabilise domestic prices at medium- to long-term horizons, should it choose to do so…Globalisation may affect the parameters of central bank models, but independent central banks still control their own inflation destinies…"*.[8]

For some years now, the short-run trade-off between inflation and economic growth has been extraordinarily favourable. Inflation has been low and economic growth high. We have been hit by massive and long-lasting positive supply shocks thanks to the globalisation process. To accommodate a higher growth potential and to maintain the nominal anchor, central banks worldwide for a long period held short-term interest rates well below what can be regarded as a normal level.

Furthermore, long-term real interest rates have declined markedly since the 1980s and the beginning of the 1990s and have been especially low in recent years. A fall would seem reasonable since expectations concerning future inflation in our economy and the world economy have become far more stable, thus reducing the inflation risk premium.[9] But it seems unlikely that this is the whole explanation. Two theories are often invoked to explain the low real interest rates in recent years: The saving glut theory and the liquidity glut theory.

The saving glut theory posits that some countries for various reasons have very high propensities to save[10] and lack sufficient domestic investment opportunities. Current account surpluses, particularly in Asian countries and oil-exporting countries, have increased the world's total savings, thereby exerting downward pressure on long-term interest rates to bring capital markets back into balance.[11] In this case, low real interest rates globally can be understood as a natural response to the preferences of welfare-maximising economic agents. For a given country, these interest rates might seem uncomfortably low, but monetary policy-makers' scope for influencing this is limited.

Alternatively, or additionally, low long-term real interest rates can be seen as a consequence of excessive liquidity creation. Central banks may have fuelled the markets with low short-term rates and very generous supplies of liquidity to prop up growth or to keep inflation from falling below target. But financial intermediaries also create liquidity.[12] As financial markets in

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[8] Kenneth S. Rogoff (2006): "Impact of globalisation on monetary policy", A symposium sponsored by Federal Reserve Bank of Kansas City, Jackson Hole, Wyoming. Uncertainty about future inflation generates uncertainty as to the real value of investments and investors may require an extra compensation – a risk premium – for this.

[9] Uncertainty about future inflation generates uncertainty as to the real value of investments and investors may require an extra compensation – a risk premium – for this.

[10] E.g. because of inadequate public pensions and safety nets or the desire to make inter-generational transfers of proceeds from non-renewable resources.

[11] The saving glut theory has been emphasised by Ben Bernanke (2005), now Chairman of the Federal Reserve, in the speech "The Global Saving Glut and the U.S. Current Account Deficit", see www.federalreserve.gov. Since then the list of references discussing this issue is unlimited, but the IMF World Economic Outlook September 2005, "Global Imbalances: A saving and investment perspective" offers a discussion.

[12] One proponent of the liquidity glut theory is Richard Duncan "The Dollar Crisis", John Wile & Sons, 2005. See also the survey of the world economy in The Economist September 16TH – 22ND 2006 (Unnatural Causes of Debt) for a discussion.

different countries have become more integrated and new financial instruments have been introduced, liquidity and credit flow more easily between borrowers and lenders across borders. More than ever before financial intermediaries are driving the global credit- and liquidity creating process, and today, financial intermediaries have a substantial impact on global monetary conditions. In a recent article in the *Financial Times*, Mohamed El-Erian observes that: *"Central bankers now operate in a world where monetary policy influences only a small part of the fluctuations in overall liquidity in the economy. Endogenous liquidity, or the extent to which the market itself expands and contracts liquidity, has taken over as the main driver."*[13]

This may well be so but it is far from obvious why abundant liquidity, which is necessarily short-term, and low short-term interest rates should keep long-term rates very low over protracted periods of time. There might have been elements of both a saving glut and a liquidity glut in recent years. It seems fair to conclude, however, that in the global economy there is limited scope for the individual central bank to influence long-term real interest rates. In a Wicksellian sense this might be awkward. In a way we can argue that the root cause of these challenges to monetary policy is the global macroeconomic imbalances.

While improved monetary policy and the globalisation process have contributed to lower inflation and lower output volatility, asset price and exchange rate volatility seem to have been unaffected.[14] In fact, some argue that with a credible nominal anchor and stable inflation expectations, low interest rates and hence higher liquidity first and foremost translate into higher asset prices – not higher inflation as measured in the conventional way.[15] Rapidly rising property prices and debt over long periods can be a source of future instability in the real economy. This has fuelled a debate as to whether monetary policy should give weight to developments in property and credit markets beyond their impact on consumer price inflation, and react in a precautionary manner to prevent an excessive surge in asset prices.

Surely, expansionary monetary policies have contributed to the rise in property prices and debt accumulation. Asset prices generally will react to changes in short-term interest rates, but one would expect such movements to more or less even out over the cycle. But more fundamental forces have also been at play. First, the neutral real interest rate has probably fallen substantially over the past 5-10 years, maybe as much as 2 percentage points. Such a fall in the discount factor should have a large impact on asset prices like property and land. Second, Norway has recently experienced very strong, positive income shocks. For capital and labour that flow freely across borders, prices primarily reflect global growth and competitive conditions. The price of fixed capital, such as land, however, will be influenced by expected future income in a country. In periods with sharp increases in income and income expectations we would therefore expect land prices to rise at a faster pace than other prices. This is a real economic effect, which monetary policy over time cannot eliminate.

It is very difficult to establish whether rapidly increasing asset and house prices are bubbles, or whether the price increases are driven primarily by economic fundamentals. If we were convinced of the existence of a bubble and had the necessary instruments available, we should act. But it is not our conviction that monetary policy can in any meaningful way control asset price developments. Low and stable consumer price inflation is the operational target of monetary policy. There is, however, an ongoing discussion on how best to capture the cost of housing in the CPI. It might very well be that our present methods could be improved.

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[13] Financial Times January 17 2008. El-Erian is co-chief executive and co-chief investment officer of Pimco.

[14] Kenneth S. Rogoff (2006, see footnote 8) and M. Lettau, S. C. Ludvigson and J. A. Wachter (2004) "The declining equity premium: What role does macroeconomic risk play?" NBER Working paper 10270.

[15] Proponents of this view are Claudio Borio and Philip Lowe in some BIS studies, se for example Working Paper 114/2002 "Asset prices, financial and monetary stability: Exploring the nexus" and Working Paper 216/2006 "Monetary and prudential policies at a crossroad? New challenges in the new century."

While monetary policies aimed at nominal stability have stood us in good stead, and can continue to be pursued also in a world where markets are truly global, the sailing might very well be less smooth ahead. As Ken Rogoff puts it *"…the greatest challenge ahead for central banks is to make sure that their institutional mechanisms for preserving low-trend inflation are robust to possible setbacks in the future course of globalisation…"*[16]

As I pointed to earlier we have been greatly helped by positive supply-side shocks in recent years. Fighting inflation has been almost costless. This may change in future.

One could argue that the process of disinflation will ebb, and downward price pressures from cheap imported goods abate. What initiated the process of disinflation in the first place was the integration of labour-abundant developing countries into the world economy. In the course of time these countries will "catch up" and achieve a production and income level per capita more similar to that of industrialised economies. They will experience a real appreciation. This can happen through a nominal appreciation of local currencies, or by higher wage- and price inflation. Either way, it will have inflationary consequences for the rest of the world.

With easing disinflation pressures, and if prices for energy, other raw materials and food remain high, the positive supply shocks we have faced during the last decade may fade away, posing new challenges to monetary policy. Our dismal economic history from the 1970s and 1980s clearly shows that maintaining nominal stability is of the utmost importance. So inflation must be fought, also if it should rear its head in periods of low growth. Real interest rates may need to be higher than what we have seen in the period of "great moderation". The costs will certainly be felt, but compared with the situation 30-40 years ago, the macroeconomic framework is now well established and central banks have accumulated credibility over a number of years as witnessed by fairly stable long-term inflation expectations. In this sense, the economy is now more robust to shocks and costs should be smaller.

There is reason for us all to be braced for a negative supply shock of considerable magnitude in the years to come. If global warming is a threat to mankind – and much evidence suggest it is – then carbon dioxide (and other) emissions must be reduced. That will entail costs, real costs. Our future consumption path will be lowered, perhaps sharply. But as compensation we should have improved prospects for mankind.

We have a choice however in how we go about reducing emissions: The efficient way, taxing emissions (or auctioning permits) and using the markets; or the truly costly one of trying to subsidise away the problems with highly uncertain results. The debate and actual efforts so far give only moderate hope of a good outcome. But let us be optimists – at least for the time being.

To combat climate change, the relative price of fossil fuels must increase. This can be regarded as a negative cost-push shock. Is there a role for monetary policy here? Yes, as in the case of other negative supply shocks: Keeping inflation low and stable must be the over-riding objective. And with regard to reducing emissions, keeping inflation low and stable is perhaps even more important, as this will help make changes in relative prices more visible.

Concluding remarks

Globalisation has so far given us the best of two worlds, high growth and low inflation. But looking ahead there might be challenges to both nominal and financial stability.

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[16] Kenneth S. Rogoff (2006, see footnote 8).

We must preserve a nominal anchor, even when times may become more difficult. History has shown us that low and stable inflation is the best contribution monetary policy can make to growth and macroeconomic stability. A new, globalised world does not change this paradigm.

Financial stability is enhanced by "smart" regulations that provide the right incentives. It is important to encourage innovation and to avoid overregulation. We must expect losses to occur and the losses should be borne by investors and financial institutions themselves to the fullest extent possible.

Some might argue that I am behind the curve and that I should rather be discussing the breakdown of the global financial system. George Soros has argued that *"This is not a normal crisis, but an end of an era."*[17] I do not subscribe to this view, though I admit I might be proven wrong. I would rather regard the present turmoil as evidence of the self-correcting properties of our system. Yes, corrections can be costly. Thus, we should aim at organising the system to be even more resilient and well-functioning. I remain convinced, however, that we would be wise to continue to base our economic system on open borders, competition and increasingly deeper and more integrated markets for goods, services, capital and labour.

Thank you for your attention!

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[17] Financial Times, January 25, 2008