Mojmír Hampl: Theory lagging behind practice

Speaking points by Mr Mojmír Hampl, Vice Governor of the Czech National Bank, for the Central Bank of Malaysia (Bank Negara Malaysia) Conference "The Future Direction on Monetary Policy Frameworks and Strategies in Emerging Market Economies", Kuala Lumpur, 21 May 2014.

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Ladies and gentlemen,

Thank you for your kind invitation to this conference. It is an utmost pleasure to be here today and to speak in front of such a distinguished audience.

The issues being discussed here are important and I will echo many of the points already raised. It seems to me that we all to some extent share a feeling that there are many good questions, but sometimes we don't have that many good answers to them. And because I don't either, I will use the standard escape tactic of those who find themselves intellectually in dire straits – if you don't have a smart answer yourself, use a quote by someone really smart and you might look smarter.

So I will begin with one of the famous quotes by Albert Einstein: "In theory, theory and practice are the same. In practice, they are not". Yes, exactly. And it is true not only in physics, but also in the areas of monetary policy and financial stability.

In *theory* we central bankers believe we can control inflation, or the sustained growth of the general price level. But in practice we tend to say that there are prices that are beyond the control of monetary policy, that are somehow disconnected from the conduct of monetary policy, or that are "completely different". Real estate prices, asset prices etc. Interesting, isn't it?

And conversely, in *practice* we know what financial instability looks like and what it is. But in theory we haven't created a rigorous operationalised theoretical system for achieving financial stability, or even for defining financial stability. There is no single, universally accepted definition of *financial stability*, as quantifiable as the definition of price stability. And what is worse, many believe there will never be one. Again, quite interesting.

So this, in my eyes, is the first constraint we face. At least in the area of financial stability, theory lags behind practice. Inflation targeting is a formalised, practical and handy system, while "financial stability targeting" is not, despite huge steps forward recently. And I can't resist dreaming of a day when we have a system in the financial stability area that is as operationalised as inflation targeting.

After all, back in 1978, the U.S. economic historian Charles Kindleberger, in his now classic book "Manias, Panics, and Crashes: A History of Financial Crises", pointed out that financial upheavals had virtually always been preceded by credit booms, property price and asset price booms and increased leverage in the financial system. All these are, in a sense, monetary phenomena. So why couldn't we go further here as well?

The second constraint is that smaller economies, both emerging and developed ones, are quite often in the position not only of monetary-policy takers, but also of *regulatory-takers*. So, they have to face the consequences of regulatory debates and decisions made by "big guys" somewhere else – debates and decisions they can influence only to some extent, if at all. And the emphasis in the world debate is now being put more on regulation on the micro level and less on these big questions I am discussing, despite the hard work of Michael Woodford and others here.

I understand that micro-regulation is easier to create and to explain to the public, and sometimes also easier to implement. But it can also have faster adverse impacts. An example from Europe – the harmonisation of deposit guarantee schemes (DGS) within the

EU. It is generally a brilliant idea to have single DGS rules in the single market, but in the Czech Republic it has led to the abolition of the previous well-established practice of co-payment when a depositor received an insured deposit from a failed financial institution. Our practice was 10% co-payment, so that depositors never got back 100% of their insured deposits. The harmonised DGS rules established a different unified practice – deposits are insured up to 100% of the equivalent of 100,000 euros. This, of course, means a bigger incentive for moral hazard behaviour on the part of depositors. In the Czech Republic, depositors very soon started searching for higher interest rates, or higher yields, in smaller "saving unions" with inherently riskier business models, as these institutions are also covered by the DGS and suddenly became to a given limit riskless for savers due to the disappearance of co-payment. Some of these institutions had to leave the market recently, eating up large sums from the pre-paid funds of the domestic DGS. I'm fairly sure that without this moral hazard behaviour induced by the harmonisation of the DGS rules the impacts on the system would not have been so pronounced.

Or take another example. The regulatory debate on financial benchmarks in the world (and within the EU) influences sometimes adversely the willingness of banks to contribute to the benchmarks also in the markets where no improper behaviour of contributors has been proven or even detected so far.

So it is great to harmonise and to coordinate. But you always have to bear in mind that you should not harmonise and coordinate towards rules that are riskier than the previous uncoordinated rules were on average.

The third constraint is the one Claudio Borio of the BIS calls the "time inconsistency of financial stability policies". He says: "Policies that are too timid in leaning against financial booms but that are then too aggressive and persistent in leaning against financial busts may end up leaving the authorities with no further ammunition over successive financial and business cycles"[1] Yes, this is the case in many countries, including the Czech Republic now we have reached the zero lower bound. So, to put it more bluntly: the problem also might be that we central bankers are sometimes more procyclical and less symmetric in our thinking than we should be.

And the fourth constraint is our own disbelief in the power of monetary policy. Our experience – even in a small open economy – is that autonomous monetary policy can be very much of help, if not key, in stabilising the general macro-environment compared to the situation where monetary policy is just being passively accepted from abroad.

And I say that despite the fact that inflation stabilisation in the current circumstances is a necessary but not sufficient condition for long-term financial stability. As the debate today shows, what this sufficient condition for long-term financial stability is, is not entirely clear and remains to be determined. But I would tend to believe that if there is any way forward in the area of financial stability, monetary policy will have to play an absolutely key role – a bigger role than many now think or admit.

Thank you.

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1 Borio, C.: Monetary policy and financial stability: what role in prevention and recovery?, BIS Working paper No. 440, January 2014