Alexandre A Tombini: Central banking – the next 50 years

Introductory remarks by Mr Alexandre A Tombini, Governor of the Central Bank of Brazil, at a panel discussion to celebrate the 50th anniversary of the Central Bank of Brazil, Rio de Janeiro, 10 June 2015.

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Today's panel discussion is part of a series of events to celebrate the 50th anniversary of the Banco Central do Brasil. Other events in the series have looked backward. Today we'd like to take advantage of the collective wisdom and experience of our distinguished guests to look forward: what can we expect in the next 50 years of central banking?

This is an ambitious question, but an appropriate one as the art and science of central banking is currently in flux, and the outcomes of today's policy debates and institutional innovations will shape central banking for many years to come.

The global financial crisis has had a major impact on how we think about central banking. Before the crisis, there were, naturally, a number of unanswered questions and challenging issues for central banking, but the prevalent view was that the major pillars of the field were largely settled. In a growing number of countries, the operational regime for monetary policy was inflation targeting; monetary and financial stability objectives could be safely addressed separately; and floating exchange rates, coupled with robust international reserves and access to multilateral funding facilities, were often seen as sufficient to protect financial stability from excessive international capital flow volatility. Naturally, macroeconomic stability was and still is a necessary condition for the framework to operate properly.

The crisis has led to a reexamination of some issues we thought were settled and to the emergence of some new questions. Even though Brazil was not at the epicenter of the crisis, we were affected by the crisis itself and by the policies that were put in place in its wake. Furthermore, we have been actively participating in the international central banking debate in order to offer our views and to learn from the experience of others.

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In my opening remarks, I will focus on three topics that have provoked particularly intense debate and that I believe will shape central banking for some time to come. In each of these topics, the global financial crisis prompted a rethinking that is still underway, although some initial conclusions can already be drawn.

First, maintaining financial stability was reemphasized as a core function of central banks.

Central banks have always been concerned with financial stability, particularly through their lender-of-last-resort role. But in many jurisdictions, central banks progressively downgraded the importance of the financial stability goal in the post-war period. The supervision of banks was progressively split off from central banking, and a gap emerged in that, in some jurisdictions, nobody was tasked with looking at the vulnerabilities in the system as a whole.

This is less true for emerging markets, including Brazil, where central banks tended to keep a strong focus on financial stability even before the global financial crisis. In part, this reflects the fact that financial crises were relatively more common in emerging markets in the late 20th century.

There was also an old and important academic and monetary policy debate in the decade leading up to the crisis on whether we should *lean against* a financial bubble or *clean up* after it has burst. However, the lack of consensus on this issue resulted, in practice, in a mostly laissez-faire policy stance.

Today, I think it is safe to say that there is general agreement that proactively maintaining financial stability, by taking appropriate action against the buildup of vulnerabilities, is a proper goal for central banks. The high cost of "cleaning up" after the global financial crisis will serve as a reminder against excessive complacency for some time to come.

The current debate is about the policy tools for the goal of maintaining financial stability. Macroprudential policy is widely seen as the first line of defense against systemic risk, but there is still uncertainty about its effectiveness. There is also disagreement on whether monetary policy should take financial stability considerations into account at all.

On this latter issue – the use of monetary policy to deflate potential financial bubbles – there are two views. One is that monetary policy is likely to be particularly effective because it affects all financial markets. Another view, that has been stated most forcefully by Lars Svensson, is that monetary policy is an inefficient and potentially even harmful tool for financial stability, since it is too unfocused and may have counterproductive macroeconomic effects.

This is far from a theoretical matter: there is currently a lively debate on whether the current low interest rates in major jurisdictions are leading to "search-for-yield" behavior in certain financial market segments, potentially threatening financial stability, and whether this provides an additional motivation for normalizing monetary policy sooner rather than later.

The view that seems to be gaining strength, and to which I subscribe, is to use macroprudential policy to maintain financial stability and allow monetary policy to focus on price stability.

However, the definitive answer to this question will depend on the progress in the development of macroprudential policy tools and frameworks. Despite some positive experiences, including in Brazil, macroprudential tools are still insufficiently tested and the theoretical literature is in its infancy. The degree of success in using these tools will help determine whether there is a role for monetary policy in helping to achieve the financial stability goal.

A second issue that has been the subject of considerable debate is the nature of monetary policy regimes. Before the crisis, there was a strong consensus on inflation targeting (or IT) as the most adequate monetary policy regime, due to its flexibility and transparency.

After the crisis began, major central banks were soon forced to lower interest rates to the effective zero lower bound. Or so we thought at the time: some central banks are now testing the bound by bringing interest rates further and further below zero. Even so, it is clear that there must be some effective lower bound on interest rates. Furthermore, negative rates, if maintained over a significant period of time, may result in financial market distortions; for example by causing lasting damage to the money market fund business model.

Central banks responded to this new challenge through a variety of unconventional measures which included what is known now as quantitative easing (or QE). However, there is still no full agreement about the effectiveness and the collateral effects of these unconventional policies. (I will speak about some of its side-effects a bit later).

Even before the debate about the limits of IT frameworks at a zero-lower bound, many economists, particularly in academia, proposed innovative monetary policy regimes such as price-level or even nominal GDP targeting. These regimes were seen as more powerful in the zero lower bound because they would effectively require central banks to make up for periods of below-target inflation or nominal GDP growth by keeping rates lower than required under IT after the economy recovers. Since monetary policy primarily affects the economy through long-term real interest rates, and therefore through agents' expectations for the future paths of the policy rate and of inflation, the end result would be more accommodative policy during the downturn than recommended under the IT regime.

A more modest proposal was to keep the IT regime, but increase the targeted level of inflation. The crisis and the bubbly period that preceded it convinced many that the modern macroeconomy is more prone to shocks that previously believed, and therefore the 2% target level that prevailed in mature economies before the crisis was perhaps too low to keep the economy from repeatedly hitting the zero lower bound.

My take on this debate is that, at the end of the day, inflation targeting emerged even stronger from the crisis. No major central banks abandoned inflation targeting, and some central banks that were not inflation-targeters adopted elements of the framework.

There are several reasons for the resilience of the IT regime:

- Central banks found that inflation targets were actually helpful in explaining the need and the room for unconventional policy measures to the general public.
- Furthermore, inflation targets helped anchor inflation expectations, keeping deflation at bay despite the large output gaps prevalent at the height of the crisis.
- The proposed new monetary policy regimes suffer from a number of practical deficiencies. They are too complex for the general public to understand and follow. And nominal GDP targeting relies too heavily on an unobserved variable, potential GDP growth.
- Finally, changing the regime, or even just raising the inflation target, in the middle of a crisis risked damaging the credibility that central banks have gained under the IT regime.

However, if the secular stagnation hypothesis that has been revived by Larry Summers and Paul Krugman is to be believed, this debate may be far from over. The argument is that there may be a tendency for a chronic excess of savings relative to investment, for various reasons including slower population growth and a less capital-intensive economy. If so, real equilibrium interest rates will be lower than in the past and the zero-lower-bound will be a recurrently binding constraint.

I am still unconvinced by this hypothesis, however. As has been pointed out by Ben Bernanke, the secular stagnation arguments tend to ignore the global nature of today’s economy. As long as there are profitable investment opportunities somewhere in the world, capital will tend to flow from economies with excessive savings to those with excessive investment demand. The resulting exchange rate depreciation would increase aggregate demand and therefore neutral interest rates in the economies with excessive savings.

And indeed, there are abundant high-return, capital-intensive investment opportunities in many emerging economies including Brazil, particularly in infrastructure.

However, if the hypothesis does turn out to be realistic, the zero lower bound will recur, and the shortcomings of the inflation targeting regime under those conditions may lead to a renewed search for alternatives.

The third and final issue I will address today is how to deal with capital flows. Of course, the potential for destabilizing capital flows was well understood even before the crisis. In fact, after the various financial crises of the 1990’s, emerging markets began to accumulate international reserves in order to build a buffer of foreign exchange liquidity. The combination of floating exchange rates and robust foreign reserves, it was hoped, would be sufficient to protect economies and financial systems from destabilizing capital flows.

The resort to unconventional monetary policies in the wake of the global financial crisis resulted in an unprecedented level of global liquidity. Emerging markets were buffeted by unusually intense and volatile capital flows.

Exchange rate appreciation and FX market intervention were insufficient to maintain financial stability. The policy response in many emerging markets included macroprudential policies to dampen the effects of capital inflows on domestic credit and capital markets. These policies included both measures that aimed at domestic markets and measures that directly targeted capital inflows.

There is currently widespread agreement that a multipronged approach, including macroeconomic, structural, and macroprudential policies may be necessary in order to deal with capital flow surges. More recently, academia, central bank researchers and the IMF have endorsed a judicious combination of capital flow management measures with strong macroeconomic policies, including using exchange rate flexibility as the first shock absorber. However, these measures have costs, including market distortions, administrative burden, and negative market reactions.

Furthermore, there are still a number of open questions. What combination of policy instruments should recipient countries use in order to minimize costs? To what extent should the burden of adjustment also be on source countries? Is it possible to improve on the decentralized outcome through international policy cooperation?

I am still unconvinced that there is room for much greater international policy coordination – central banks have domestic, not global mandates. However, it seems to me that there is some scope for cooperation at least in identifying potential cross-border and financial stability risks and adopting, when necessary, targeted macroprudential policies – either in recipient or in source countries – in order to prevent capital flows from fueling unsustainable financial bubbles.

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I've raised a number of open issues in central banking that I believe will shape central banking for some time to come:

- Financial stability is once again a core function of central banks, but macroprudential policies and frameworks are still in their infancy, and a proper role of monetary policy in ensuring financial stability is still under discussion.
- Inflation targeting remains the dominant monetary policy regime, but if growth skeptics are correct and the zero-lower-bound recurs, there will be renewed calls for moving to innovative regimes or at least higher inflation targets in mature economies.
- A laissez-faire approach to capital flows is off the table. There is still disagreement, however, on how to deal with flows, on who bears the burden of adjustment, and on the scope for global policy cooperation.

However, there is perhaps a deeper lesson to be drawn from the global financial crisis. The crisis came largely as a surprise; not because we did not see the bubbles forming, but rather because the central banking community as a whole failed to fully take into account the vulnerabilities resulting from the growth of the shadow banking sector, the opacity of the novel financial instruments that helped fuel the bubble, and the complex domestic and international linkages between different financial sector intermediaries.

A fundamental lesson to be drawn from the global financial crisis is the need to develop an integrated, forward-looking approach to central banking that brings together:

- Comprehensive, granular (and perhaps "real time") financial sector surveillance that focuses on identifying systemic risk and develops adequate market infrastructure and reporting systems;
- Market intelligence that captures short, medium and long-term trends in the financial system, including, for example, the potential impacts of the rapid evolution of electronic trading platforms and algorithmic investment strategies; and

- Research and analysis that spans monetary, exchange rate, and macroprudential policies.

We have made some progress in this direction here at the Central Bank of Brazil, but we expect to continue to develop this integrated approach to central banking for some years to come. Hosting discussions like this one we are having today is part of this process, so I'm looking forward to hear from our panelists, which do not require any introduction. But nevertheless let me say a few words to introduce them to you.

Our first panelist is Jacob Frenkel. Dr. Frenkel taught international economics at the University of Chicago before serving as Governor of the Bank of Israel between 1991 and 2000. He then moved to the private sector, where he is currently the Chairman of JPMorgan Chase International and he also serves as Chairman of the Board of Trustees for the Group of Thirty.

I'd also like to introduce Jean Claude Trichet. Mr. Trichet had a long and successful career in the public sector where he was assigned to various posts in the French government, including Governor of the Banque de France. In 2003 he was appointed President of the European Central Bank, in which capacity he served for eight years. He is currently the Chairman and CEO of the Group of Thirty.

Our third panelist is Axel Weber. After a distinguished career in academia, Dr. Weber was president of the Deutsche Bundesbank between 2004 and 2011. After leaving the Bundesbank, he was a Visiting Professor at the Booth School of Business at the University of Chicago. He is currently Chairman of the Board at UBS.

I have enjoyed throughout these many years, in a variety of forums and debates their always-to-the-point sharp remarks and so I hope that we can today benefit from their thoughts, thank you for being here Jacob, Jean-Claude and Axel.

Ms. Adriana Arai will moderate the discussion. Ms. Arai joined Bloomberg News in 2004, and currently is executive editor for local language content and chair of the Bloomberg São Paulo Office Committee. Previously, she worked for Dow Jones Newswires in São Paulo, Brasília and London.

Adriana, the floor is yours.