Mugur Isărescu: The future of central banking

Address by Mr Mugur Isărescu, Governor of the National Bank of Romania, during the plenary session "The future of central banking", 8th World Policy Conference, Montreux, 20 November 2015.

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Parts of this address have been presented by Governor Mugur Isărescu during the plenary session "The future of central banking", which also featured as speakers:

- *Jean-Claude Trichet – former President of the European Central Bank*
- *Jacob Frenkel – Chairman of JPMorgan Chase International, former Governor of the Bank of Israel*
- *Marek Belka – President of the National Bank of Poland*

Ladies and gentlemen,

It is a great honour to address the audience during this symposium on the future of central banking, although I must confess from the very beginning that the topic itself is not easy to tackle. We all know that economists seldom reach a consensus when analysing the past. It is all the more difficult for them to agree on the future, especially when we refer to central bankers, who are known to be among the most cautious economists...

Personally, I think I have enough reasons to be wary of any predictions of what is in store for us, particularly over the medium and long term. I started my career as an economist in a research institute back in August 1971, when the Bretton Woods System was just collapsing. In 1990, shortly after the fall of communism, I became Governor of the National Bank of Romania, having to put into practice the transition from a monobank-type system to a two-tier system, while the country's economy was going through major changes from the ruinous central planning to a market economy. As a matter of fact, in retrospect, I can say that my entire career has spanned several decades marked by truly ground-breaking policy and paradigm shifts. Some of the recent ones, such as quantitative easing and close to zero or even negative monetary policy rates, would have been inconceivable even a few years (not decades) before they occurred!

The experience acquired through the years, both as a researcher and as governor, makes me reluctant to engage in speculations on the future of central banking in 10 or 20 years' time, particularly at the current juncture when the global economy is in a state of flux. Nevertheless, there are a few old and new things about central banking which I believe will continue to be relevant in the future.

I would start by pointing out that, in the extremely complex post-crisis economic and financial environment, the mission of a central bank cannot be simple. There are so many transformations going on right now, after the global crisis not only invalidated certain elements of mainstream economics, but also changed the order of priorities on policymakers' agenda.

Still, I do not believe the crisis has shattered the consensus on what central banks should be pursuing – central banking has always been about the preservation of, to quote Charles Goodhart, "the three aspects of stability", namely price stability, (external) currency stability and financial stability. Nor has the crisis brought about the sudden realisation that these aspects of stability do in fact condition each other – central bankers, maybe even more so emerging-market central bankers, have long been keenly aware that failure to ensure one kind of stability is bound to jeopardise the achievement of the others. What the crisis has indeed challenged is the widespread conviction that meeting one particular stability criterion, while necessary in order to achieve the others, is also a sufficient condition to do so – after all, maintaining price stability, while valuable in itself, has proved insufficient to ward off major financial or macroeconomic instability. As a matter of fact, Andrew Crockett claimed ever since 2003 that the "peace dividend" yielded by the successful war against inflation had not lived up to expectations and therefore the battlefront against financial instability should not be overlooked.

Nevertheless, it is widely accepted that price stability should remain the overriding objective of a central bank and I do not see this approach changing in the future, at least in Europe. It is expected, however, that central banks will make more explicit their concern for all the "three aspects of stability" in their policy decisions, realising that price stability and financial stability are much more intertwined than we used to think. I believe this development has farther-reaching consequences when it comes to the future of central banking. I can easily imagine, some years down the road, a more "normal" world in which unconventional monetary policy tools are a thing of the past, since their relevance is ultimately circumstantial, but I cannot imagine a future where the explicit concern for financial stability and the macroprudential policy are not central banking fixtures.

To be frank, the NBR has never had the luxury of being concerned exclusively with price stability and interest rate setting in the belief that financial stability and exchange rate stability will follow. In a world with freely moving capital, the idea of being able to manage aggregate demand exclusively via interest rates would have been an illusion: the interest rate hikes required to manage aggregate demand and anchor expectations would have entailed further capital inflows and an unsustainable nominal appreciation, thus boosting foreign currency lending and creating vulnerabilities on the financial stability front.

That is why, when introducing inflation targeting in 2005, the NBR opted for the "light" version of the strategy, which meant retaining the managed float feature of the exchange rate regime. The actual form inflation targeting took in Romania thus matched the "managed-floating plus" concept introduced by Goldstein in 2002, considered the most suitable choice for an emerging-market economy involved in the global capital market, as it combines the managed float part, allowing for FX market interventions in order to smooth out excessive volatility, with an inflation targeting monetary policy strategy and an active pursuit of measures to limit the degree of currency mismatches in the economy.

What are the challenges of adding explicit concern about financial stability to the standard objective of price stability? Should monetary policy lean against the wind sooner and possibly harder than it would normally? Even though now, with the benefit of hindsight, one could say that higher interest rates in the run-up to the crisis may have alleviated some of the issues that led to it, I believe that it is best to let monetary policy focus on price stability and deal with the objective of financial stability via dedicated macroprudential policy instruments – doing otherwise is likely to severely complicate communication with the public, complicating expectations management and ultimately undermining monetary policy credibility and effectiveness.

It is indeed of critical importance to make sure that the tasks entrusted to the central bank are feasible. Not as clear-cut or simple as before the global crisis, but feasible! Otherwise, if the monetary authorities are overburdened with possibly conflicting goals, the major risk is to render them inefficient and unable to deliver a single one of their objectives.

Before the crisis, when talking about the policy mix anyone would think of the coordination between monetary and fiscal policies. Afterwards, when financial instability has undermined macroeconomic stability, despite low and stable inflation, it became obvious that additional tools are needed in complementing monetary policy in countercyclical management. As macro-prudential tools emerged as the most important candidates, it makes sense to assign the objective of financial stability to the central bank, if the central bank is given control of the supervisory and regulatory instrument.

In the recent period some economists have asserted that central banks tend to fuel speculative bubbles by keeping monetary policy rates too low. This behaviour can create incentives for banks to overleverage or reduce efforts in screening borrowers, or can lead other economic agents to seek more risks in order to yield higher returns. The effects are likely to be worse if monetary policy is too accommodative for too long during expansions. This led to the conclusion that other instruments, which can directly affect leverage or risk taking, are required.

Because the cost of cleaning up after an asset-price bubble burst can be very high, as proved by the recent financial crisis, early interventions by the central bank might be needed when a severe bubble is identified. In this context, macro-prudential instruments are the best option, without excluding *de plano* the recourse to monetary policy instruments.

Given the fact that the policy rate is an inadequate tool to deal with overleverage, excessive risk taking, or apparent deviations of asset prices from fundamentals, there are other instruments at the policymaker’s disposal: countercyclical regulatory tools. Thus, if leverage appears excessive, regulatory capital ratios can be increased; if liquidity appears too low, regulatory liquidity ratios can be introduced and, if needed, increased; to dampen housing prices, loan-to-value ratios can be decreased; to limit stock price increases, margin requirements can be increased.

As I said earlier, the NBR has always had to juggle the “three aspects of stability” and that called for the deployment of alternative instruments, such as the full use of the reserve requirement ratios and recourse to administrative measures. Reserve requirement ratios were increased up to 20 and 40 percent for lei- and forex-denominated liabilities respectively, and the list of administrative measures included: enforcing a maximum loan-to-value ratio, introducing debt service ceilings relative to households’ monthly disposable income, setting limits on banks’ forex exposure vis-à-vis unhedged borrowers, using differentiated coefficients in stress tests (higher for exposures to EUR than lei, with even stricter coefficients for CHF- and USD-denominated credit).

Even though at the time our modus operandi was seen as deviating from the orthodoxy of central banking, during the global crisis or in its aftermath, macroprudential instruments are now part of the mainstream and forex interventions re-entered the arsenal of many central banks, including some of those using a free floating regime before the crisis.

If the importance of macro-prudential instruments was revealed by the global crisis and the forex interventions of central banks went back in fashion during the same period, there is a fact well known from the conventional economic wisdom, but highlighted once again by the crisis: the countercyclical stance of both monetary and fiscal policies is essential for ensuring a smooth trajectory of the economy. We all saw how unsustainable public finances and high levels of debt have impeded the effectiveness of a stability-oriented monetary policy. This was also the case of Romania, where the fiscal impulse was positive during the period of rapid growth before the financial crisis, contributing to the overheating of the economy and fuelling the imbalances accumulated in the economy. Moreover, the pro-cyclicality of the fiscal policy during the pre-crisis period exhausted the fiscal space needed to stimulate the economy in recession, leading to the need to reduce the budget deficit during the crisis (primarily due to financing constraints) and to perpetuating the pro-cyclicality of fiscal policy. As stated by Fritz Zurbrügg (2012), successful monetary policy is predicated on healthy fiscal policy, and vice versa, and to achieve stability and prosperity in the long term, fiscal and monetary policies must both focus on sustainability.

In the past, the high fiscal deficit has resulted in the fiscal dominance of monetary policy with its inevitable monetisation of the government debt, but nowadays most central banks no longer directly finance government expenditure. Today, this kind of dominance is manifested through the inability or unwillingness of fiscal authorities to control long-run expenditure/GDP ratio.

The recent period has outlined a different form of dominance: financial dominance, defined as the inability or unwillingness of the financial sector to absorb its losses. The presence of financial dominance constrains the manoeuvre room of both fiscal and monetary policies, due to the fact that fiscal authorities and/or central banks have to bail-out the financial sector. As pointed out by Benoît Cœuré (2015), for monetary policy, the problem stems mostly from inadequate supervision, at both micro-level (if supervisors show too much forbearance to under-capitalised banks, they can end up effectively shifting the burden onto monetary policy) and at macro-level (if supervisory policies allow banks to grow too rapidly, and then deleverage too slowly, it can also push the central bank into doing more), which can turn out in the ineffectiveness of monetary policy transmission mechanism.

Let me say a few words about the issues of central bank independence in the context of required cooperation with the government in the post-crisis world. As we all know, from a historical perspective the prevalence of central bank independence is a relatively new institutional development, seen as a solution to the problem of time inconsistency of monetary policy and the stagflation of the ’70s. Is the post-crisis reality likely to dissolve the consensus about central bank independence? After all, the danger of inflation is hardly a pressing concern nowadays (but rather the lack of it) and the pursuit of financial stability is ultimately a shared responsibility, since it implies close cooperation with the government and other authorities and may ultimately involve recourse to public funding.

I share Stanley Fisher’s view that it would be a costly mistake to give up central bank independence. That would mean “the benefits of having a central bank that can take a longer term and apolitical view of what is good for the economy and take actions in support of that view will be lost”. If a long-term perspective and a shield against political pressure are required for achieving price stability, these may be even more important if explicit concern for financial stability is added. And frankly, I do not see the need for close cooperation with the government as something that implies abandoning central bank independence, but rather as a pre-requisite – which has always been there – for promoting effective policies. Irrespective of how well-designed the policies of the central bank may be, they cannot substitute for a consistent macroeconomic policy mix, and in the absence of this consistency they are likely to achieve at best sub-optimal outcomes.

Having said that, I think there are a few questions worth asking – I must confess I do not have the answers, but I believe that the future of central banking hinges upon them.

- ***Would it be necessary to promote a certain tactical flexibility in the conduct of monetary policy, so that central banks might carry out adjustments in terms of objectives as well, not only instrument-wise?*** Such an approach would diminish the predictability of monetary policy, but would allow, when need be, for financial stability considerations to prevail over the inflation objective.
- ***Is the reassessment of the desirable level of inflation suitable? How low is too low?*** The same as for capital inflows, we can ask ourselves in the case of price stability as well: how much of a good thing is too much?
- ***Will the policy instruments which have been resorted to in the context of the global crisis become an integral part of the new conventional framework?*** If macroprudential tools are here to stay, the future of non-conventional monetary policy instruments is less certain. Will the central banks keep using these instruments or will they abandon them at some point in time? I fully share the belief of the Governor of Banco de España Luis Linde (2013) that monetary policy – conventional or not – cannot solve the ultimate causes behind the loss in investors’ confidence or the tensions in financial or banking markets; in fact, its main role is to provide time to adopt the necessary measures to reform and/or adjust.

- ***How much room for trade-off among different goals is available?*** I believe that we should try to learn as much as possible from the past mistakes. And I refer here not only to the recent past! The lessons of the last 7 years, while important, should not make us forget the lessons of the last 50 years, among which, to name but three, are the following:
  - Accommodating other objectives should not put in danger price stability on the medium-run;
  - Inflation expectations cannot be ignored;
  - The independence of central banks is connected with their performance in delivering price stability.

Irrespective of how we see now the future of our profession and institutions, it is apparent that the central bankers cannot afford to live in an ivory tower. They have to stay open-minded and to keep close contact with the shifting economic and financial reality in order to be able to articulate and implement efficient policies. And if you still want me to foretell the future, I will end my speech by making a prophecy: what a central bank can or cannot do will remain a topic of heated debate for many decades.

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