BANK FOR INTERNATIONAL SETTLEMENTS

# The global financial cycle and how to tame it

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International Symposium of the Banque de France "Central banking: the way forward?"

Paris, 7 November 2014

## Introduction

I would like first to compliment Professor Hélène Rey for her thoughtful analysis of the global financial cycle and how to tame it. I am in agreement with the general thrust of her argument and in particular with her conclusion that floating exchange rates do not sufficiently insulate economies from the global financial cycle.

My four comments today will cover national and global financial cycles; the excess elasticity of the international monetary system; monetary policy spillovers; and the limits of macroprudential policy.

## Financial cycles, national and global

My first remark relates to financial cycles, national and global. This year's *BIS Annual Report* refers to the financial cycle as the self-reinforcing interactions between perceptions of risk, risk-taking and financing constraints. These interactions lead to booms and busts that span ordinary business cycles. Emphasising the frequent synchronisation of national financial cycles, the *Annual Report* measured them at the national level (Graph 1).

Professor Rey analyses the global financial cycle in terms of gross capital flows, credit creation and asset prices. She highlights its relationship with risk aversion as proxied by the VIX and with monetary policy in the centre country. The two approaches to financial cycles, national and global, are quite complementary.

We need to update our understanding of how the international transmission mechanism works. As Hyun Shin emphasised earlier, the first phase of global liquidity from 2003 to 2008 was mostly bank-driven. By contrast the second phase of global liquidity since 2010 has been bond market-driven. The current global financial cycle features rapid growth (to more than USD 5 trillion) of the outstanding amount of US dollar and euro-denominated bonds issued by borrowers who reside outside the United States and the euro zone (Graph 2, top panel), as a mix of conventional and unconventional monetary policy has pushed down term premiums (bottom panel).

## Excessive elasticity of the international monetary system

My second remark is related to the international monetary system. Since the end of the dollar's link to gold, the de facto global anchor of the system is just the aggregate of the domestic monetary policies of the major reserve currencies. These policies may serve the domestic needs of each country or currency area. But this does not mean that they add up well for the world economy as a whole. The lack of a strong anchor is a key factor behind the excessive elasticity of the system. This means its inability to prevent the build-up of financial imbalances in the form of unsustainable credit and asset price booms.

The global policy interest rate needed for the entire world is very hard to achieve given the near-zero policy rate (negative in real terms) in the G7 countries (Graph 3). In particular, the IMF's SDR interest rate in October was 3 basis points, with *negative* contributions from three-month eurepo and Japanese government bills.[1] The nominal global policy rate is currently around 2% (Graph 4). In a world growing in nominal terms by 5–6%, the global policy rate should surely exceed its current 2% level. The influence of the 3 basis-point SDR rate on this 2% global policy rate is one of the world economy's great asymmetries.

I commend the IMF for trying to integrate the global dimension in its spillover reports. But the monetary policy recommendations for reserve currencies in its Article IV or *World Economic Outlook* reports tend to take a purely national perspective. Indeed, over the past 15 years in my recollection the IMF's recommendations on monetary policy have almost always been in the direction of more easing. This suggests to me that the global perspective of the build-up of financial imbalances has been missing.

All this means that the lack of global anchor of the international monetary system, well described by Tommaso Padoa-Schioppa, remains. And so does the system's excessive elasticity and inability to constrain effectively global liquidity.

## Cross-border monetary policy spillovers

My third remark is on cross-border spillovers. Spillovers from unconventional monetary policy in advanced economies are a particular concern for emerging markets. Policymakers in many of these economies have had to cope with large capital inflows in search of yield, alternating with equally large capital outflows such as those triggered by the "taper tantrum" episode in mid-2013.

Monetary policy in the major currencies transmits itself to the rest of the world through five channels, three price channels and two quantity channels (Table 1). Looking at the price channels, first, there is followership in policy interest rates: central banks set lower policy rates than they otherwise might to avoid capital inflows and currency appreciation (Graph 5). Second, major central banks' unconventional policies lower yields in globally integrated bond markets, including emerging local currency bond markets. Third, emerging market currencies appreciate as core central banks seek to out-ease each other. When it comes to the quantity channels, the growing $11.5 trillion in offshore dollar and euro credit to non-residents also transmits ease, regardless of where that credit originates. And, last but not least, there is the channel of capital flows to EMEs.

Do these spillovers require some form of coordination at the global level among monetary policymakers to take them into account – or "internalise" them? Professor Rey considers this simple idea

[1] As from 24 October a floor of 5 basis points was introduced by the IMF.

to be unrealistic as it would conflict with domestic mandates of the major central banks, and Bill Dudley has assented to this view.

That said, the President of the New York Fed has also said that "given the role of the US dollar as the global reserve currency, the Fed has a special responsibility to manage policy in a way that helps promote global financial stability". This is, I think, an important statement.

## Limits of macroprudential policy: no substitute for monetary policy

My last point is to highlight the risk of excessive expectations of how much macroprudential policies alone can tame the financial cycle, be it global or national.

Professor Rey concludes that short-term policy rates will not be enough to tame the financial cycle. Instead she advocates the use of a diversified macroprudential toolkit.

When at the BIS we developed and strongly advocated the macroprudential concept, well before the crisis, we always referred to a macroprudential approach to banking supervision and regulation. Strengthening this macroprudential orientation was intended to lessen procyclicality and mitigate systemic risk. We sought to remedy certain limitations in prudential policy, not to offer a substitute for monetary tightening during financial booms.

After six years of near-zero interest rates, normalisation of monetary policy has not started, as the major central banks are still waiting for irrefutable evidence, from a myriad of high-frequency and often revised indicators, that the recovery is firmly established. In this context it might be tempting to assign to macroprudential policy the role of taming the financial cycle and curbing excessive risk-taking, while focusing monetary policy on the "normal" business cycle. Thus, macroprudential measures would become the preferred instrument for policy tightening while monetary policy could remain ultra-easy.

If the objective is to tame the financial cycle, there is an inevitable tension here. In the end, both policies operate largely by influencing incentives for risk-taking. To be sure, macroprudential measures can be more targeted. But by the same token, they are more limited. Macroprudential policy cannot substitute for monetary policy. It would be a mistake, for instance, to believe that a higher bank leverage ratio (which is, by the way, needed) could allow central banks to keep policy interest rates (the broad price of leverage) near zero.

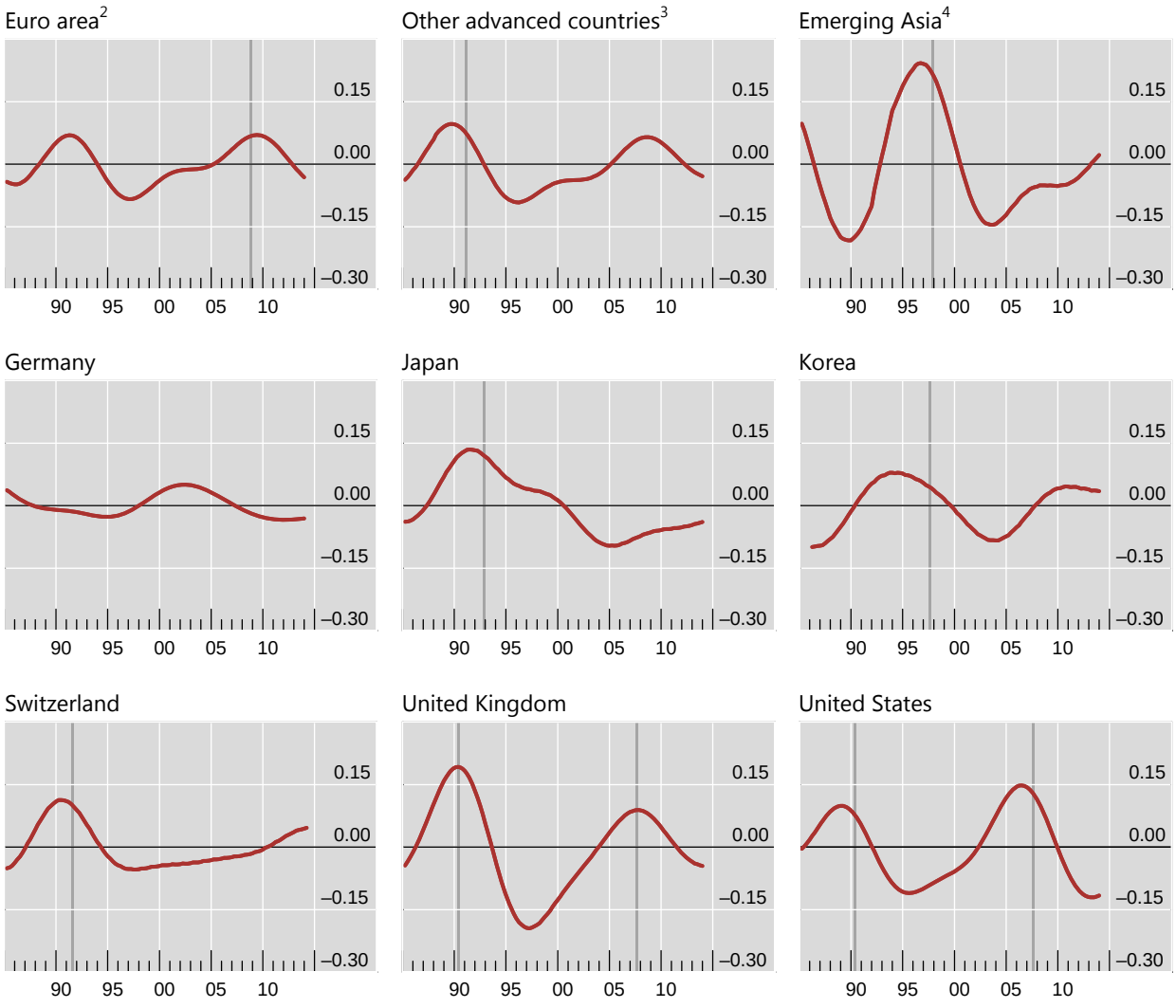
In my view, combining macroprudential tightening and monetary easing is not the right way to go about leaning against a financial boom: the macroprudential tool is most effective when it works *with* monetary policy, not *against* it. Monetary and macroprudential policies should pull in the same, not in opposite directions. Using the brake and the accelerator simultaneously is not to be recommended, at least in conventional driving.

To conclude, I would say, that, in the aftermath of the global financial crisis, policymakers have been successful in tightening the (macro)prudential policy through the global regulatory reform in an effort to make the next crisis both less likely and less severe. At the same time, they have aggressively and persistently eased monetary policy, thereby amplifying the risk-taking channel of transmission. Arguably, the net effect of prudential tightening and monetary easing on systemic risk is ambiguous.

# Graphs and table to accompany the panel remarks

## Financial cycle peaks tend to coincide with crises[1]

Graph 1



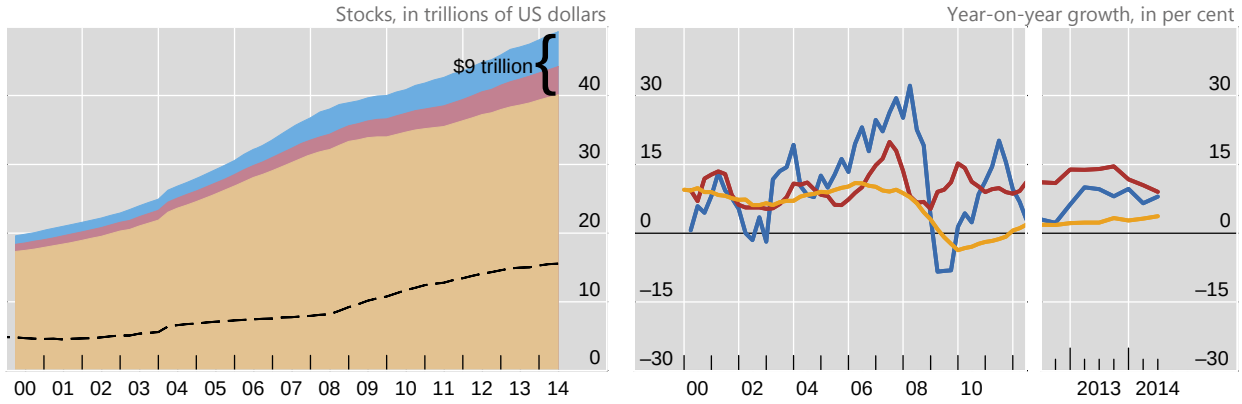

[1] The financial cycle as measured by frequency-based (bandpass) filters capturing medium-term cycles in real credit, the credit-to-GDP ratio and real house prices. Vertical lines indicate financial crises emerging from domestic vulnerabilities. [2] Belgium, Finland, France, Ireland, Italy, the Netherlands, Portugal and Spain. [3] Australia, Canada, New Zealand, Norway and Sweden. [4] Indonesia, Hong Kong SAR and Singapore.

Sources: National data; BIS; BIS calculations.

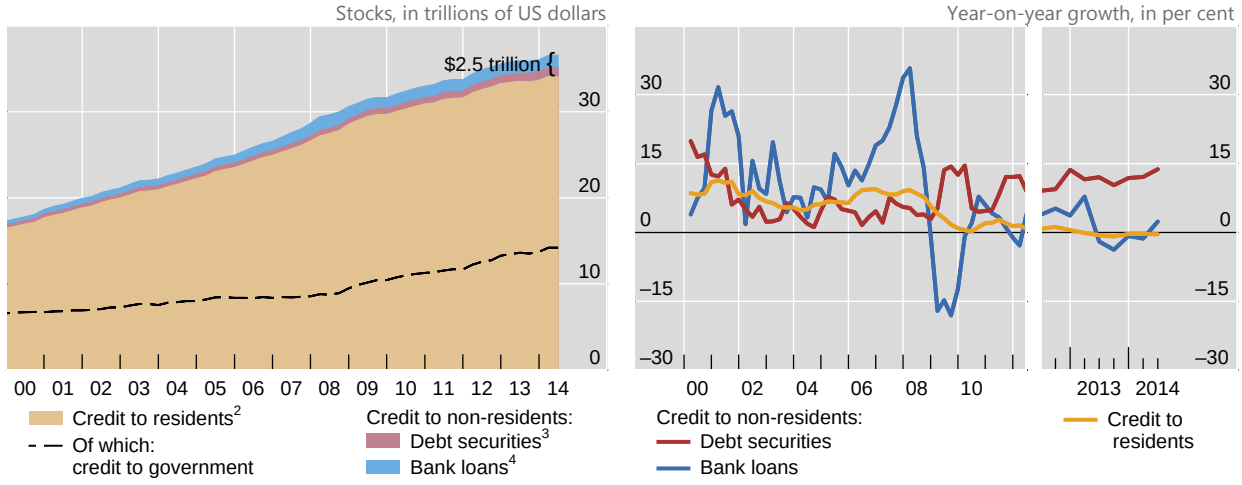
## Global dollar and euro credit to residents and non-residents

Graph 2

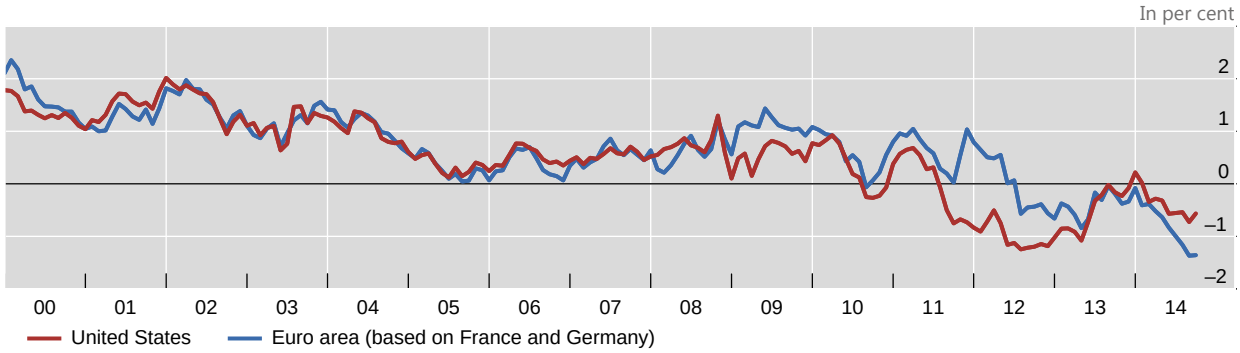
### US dollar credit




### Euro credit[1]




### Ten-year nominal term premium[5]

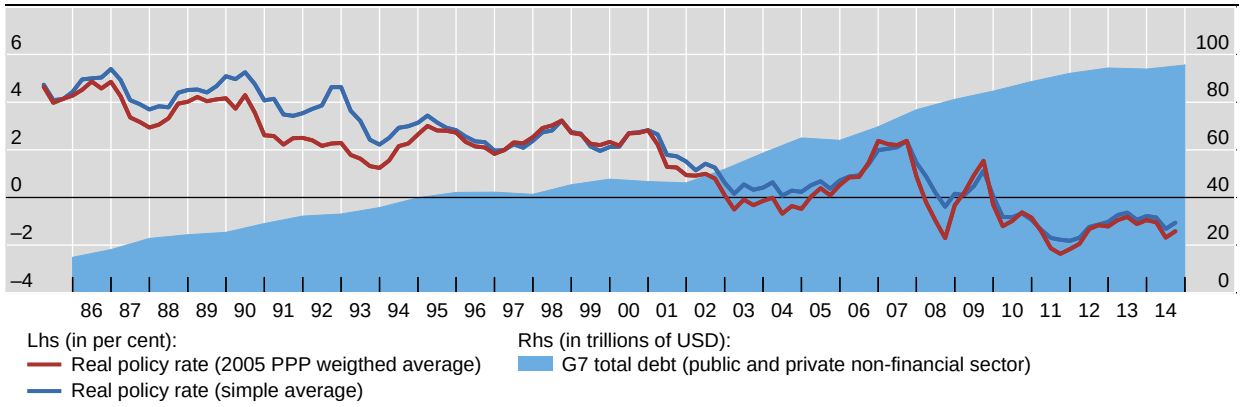



[1] At constant end-Q2 2014 exchange rates. [2] Credit to the non-financial sector in the United States/euro area from national flow of funds, excluding identified credit to borrowers in non-domestic currencies (ie cross-border and locally extended loans and outstanding international bonds in non-domestic currencies). [3] The US dollar-denominated debt securities aggregate also includes bonds issued by non-financial corporations via their financial subsidiaries. [4] Cross-border and locally extended loans to non-banks outside the United States/euro area countries. For China and Hong Kong SAR, locally extended loans are derived from national data on total local lending in foreign currencies on the assumption that 80% are denominated in US dollars. For other non-BIS reporting countries, local US dollar/euro loans to non-banks are proxied by all BIS reporting banks' gross cross-border US dollar/euro loans to banks in the country, on the assumption that these funds are then extended to non-banks. [5] Sum of the real risk premium and the inflation risk premium as derived from econometric term structure models.

Sources: IMF, *International Financial Statistics*; Datastream; BIS international debt statistics and locational banking statistics by residence.

## G7 total debt and real policy rate

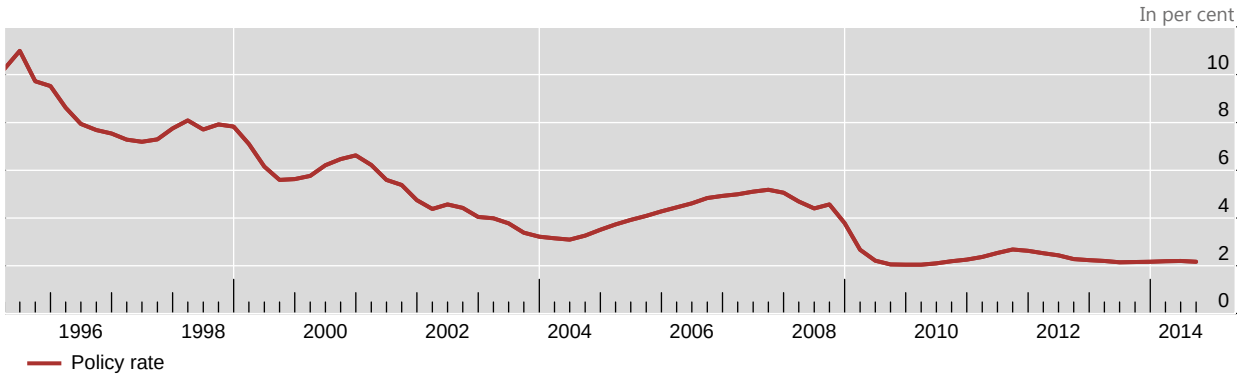
Graph 3




Sources: IMF; OECD; BIS private credit database; national data.

## Global nominal policy rate[1]

Graph 4

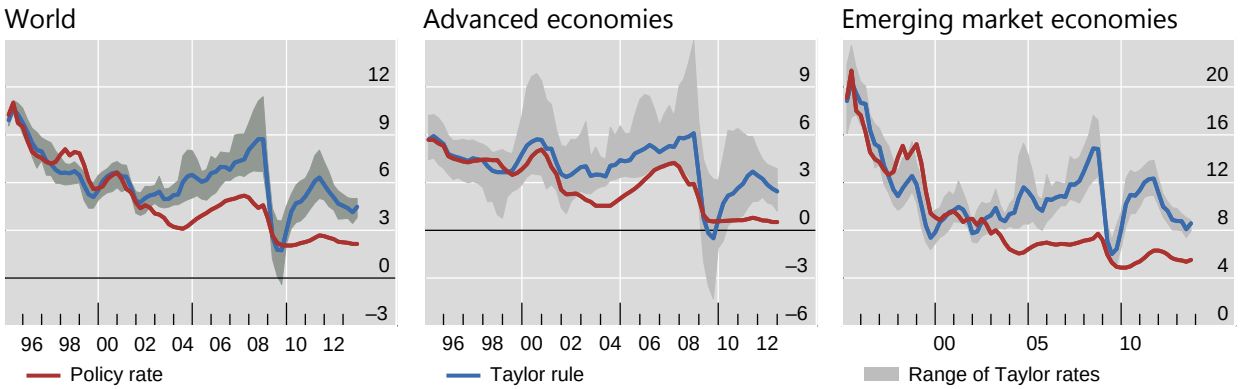



[1] Weighted average based on 2005 PPP weights. "Global" comprises the economies listed here. Advanced economies: Australia, Canada, Denmark, the euro area, Japan, New Zealand, Norway, Sweden, Switzerland, the United Kingdom and the United States. Emerging market economies: Argentina, Brazil, China, Chinese Taipei, the Czech Republic, Hong Kong SAR, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Peru, Poland, Singapore, South Africa and Thailand.

Sources: Bloomberg; Datastream; national data.

## Taylor rules and policy rates

Graph 5




Source: *BIS Quarterly Review*, September 2012, pp 37–49.

## Five monetary spillover channels from major currency areas to emerging markets

Table 1

| **Price channels** | **Quantity channels** |
|---|---|
| Followership in policy rate setting | Capital flows |
| Global bond market yields | Credit in US dollar and euro extended to borrowers who reside outside the United States and the euro zone ($11.5 trillion) |
| Exchange rate changes | |