BANK FOR INTERNATIONAL SETTLEMENTS

Rising to the occasion: central banking in a financially integrated world

Opening remarks by Agustín Carstens
General Manager, Bank for International Settlements

Joint Danmarks Nationalbank–BIS conference on "Monetary policy spillovers in a financially integrated world" to mark the 200th anniversary of Danmarks Nationalbank

Copenhagen, 7 September 2018

Introduction

Good afternoon, ladies and gentlemen,

It is a great pleasure to welcome you to this policy conference marking a historic milestone for the Danmarks Nationalbank – the 200th anniversary of its founding. To put this in perspective, the BIS is looking forward to celebrating its 90th anniversary later this decade. Ninety might be an impressive age but, truly, it pales in comparison with the anniversary that we are celebrating today.

I would like to give special thanks to Governor Lars Rohde and his colleagues for including the BIS in this celebration. In many ways, our collaboration reflects the excellent long-term relationship between the Danmarks Nationalbank and the BIS in pursuit of enhanced central bank cooperation.

In this type of event, we naturally look to the past to help us navigate the future. And, let me note that the Danish central bank's history is a long and remarkable one.[1] Established just after the Napoleonic Wars, the Bank was charged with one of the enduring mandates of central banking – to establish public trust in the monetary system after an episode of runaway inflation.

Today, of course, the world is a very different place, but trust remains an essential – if not foundational – principle of central banking. It is, after all, a precious commodity that can never be taken for granted. History has taught us that building trust takes time and hard work. And, once broken, it is difficult to earn back.

In my remarks today, I'd like to highlight the importance of building on past successes. I will argue that price and financial stability is the best way central banks can preserve trust and confidence, but delivering this will continue to be challenging in an increasingly financially integrated world.

1 See K Abildgren, *Danmarks Nationalbank, 1818–2018*, Danmarks Nationalbank, July 2018.

Looking back

Looking back, it is important to remember that greater financial integration has delivered significant benefits. Yet, it must also be recognised that greater openness has created challenges for central bankers. Globalisation has exposed economies – especially small open economies – to policy spillovers.

While I was at the Bank of Mexico, we faced many difficult situations relating to capital flows, exchange rate pressures, financial stability and inflation, especially ones arising from developments in our large neighbour to the north. As in other emerging market economies, non-linear exchange rate dynamics arose at times, resulting in global capital flows that threatened to overwhelm the short-run absorptive capacity of domestic financial markets. And this despite the best efforts of monetary policy.

Mexico's experience is certainly not unique. In Europe, banking and sovereign stresses earlier in the decade had serious consequences for the euro area and its neighbours. The situation called for bold ECB actions in the form of unconventional monetary policies, efforts that are still paying off. At the same time, smaller, non-euro economies were not immune to these developments in the form of policy spillovers.

In particular, both Denmark and Switzerland faced strong exchange rate appreciation pressures, as international investors sought less risky environments. Strong capital inflows left these economies facing unfamiliar monetary policy trade-offs. In 2012, for example, the Danmarks Nationalbank found it challenging to maintain its peg to the euro with positive interest rates, and eventually took a truly innovative decision to implement negative policy rates. This Danish experience led many to fundamentally rethink what we used to call the "zero lower bound" on nominal interest rates.[2]

In the case of Switzerland's flexible exchange rate system, capital inflows contributed to rapid currency appreciation, taking the exchange rate to levels not reached in previous decades and threatening price stability.[3] The Swiss National Bank surprised market participants in 2011 when it set a floor on the franc/euro rate, a policy that was eventually dropped.

These experiences highlight the spillover challenges that central banks from small open economies can face from their larger neighbours in a financially integrated world. So the policy environment has become more complex. But central banks have responded flexibly, creatively and effectively. In doing so, central banks have continued to build trust and confidence despite the difficult times in the past decade.

Current challenges

Looking at the current policy environment, it is important first to remember how far the global economy has come since the dark days of the Great Financial Crisis. It has been a long and winding road, but central banks should take some comfort from successes over the last decade. The revival of global economic activity can be seen as the dividend for a decade of supportive macroeconomic policies, aided by unconventional monetary policies.

Now, major central banks face an unprecedented policy normalisation challenge. How smooth will it be? Well, it is difficult to predict. But in my view, "so far, so good". The transparent, gradual approach

---

2 See M Bech and A Malkhozov, "How have central banks implemented negative policy rates?", *BIS Quarterly Review*, March 2016, pp 31–44.

3 See https://stats.bis.org/statx/srs/tseries/EER/M.R.N.CH?t=i2&c=&m=N&p=201807&i=55.16.

has helped markets adapt and has kept the global economy by and large on track, while at the same time addressing the negative side effects that can accumulate when policy rates are kept too low for too long.

Of course, this does not mean the normalisation will be uneventful – either for those normalising policy or for economies on the receiving end of the effects of those decisions. It is important not to underestimate the potential for financial markets to act as triggers or amplifiers of stress. Macro-financial stresses from monetary policy spillovers may increase and be intensified by financial markets. We have already seen some of these effects in Turkey and Argentina. These risks will remain elevated during the normalisation process, and be particularly relevant when the major advanced economies find themselves normalising at different speeds.[4] Also, disruptive snapback risks cannot be ruled out, especially in economies with prolonged compression in spreads due to persistent capital inflows.

Indeed, recent BIS research suggests that monetary policy spillovers via exchange rates and cross-border financial flows are a significant risk, especially for emerging and small open economies.[5] For the latter, non-linear exchange rate dynamics and capital flows may make it difficult at times for them to decouple their monetary policy from that in the advanced economies, even when domestic fundamentals call for policy rate divergences.

Our research also indicates that spillover dynamics do not lend themselves to simple one-size-fits-all policy prescriptions. They will depend on, among other things, investors' perception of country risks, domestic economic and financial conditions, and policy frameworks. Whatever the case, it will be important to monitor financial stability and capital flow developments closely, especially when the wedges between domestic and policy rates at major central banks widen.

In addition to the normalisation challenge, I would just note that the threat to global trade is another key risk for the global recovery. I recently discussed this at the Federal Reserve Bank of Kansas City's Jackson Hole Symposium.[6]

Looking beyond normalisation

As we look further into the future – that is, beyond monetary policy normalisation – it is not too early to focus our eyes on the ultimate prize: sustainable, stability-oriented growth. This requires consideration of the policy frameworks that are well adapted to the evolving policy environment.

One way to make economies resilient to spillovers is to put one's own house in order. In this respect, central banks have been strengthening their stability-oriented frameworks. Considerable progress has been made by most central banks in adopting sound, credible monetary policies focused on price and financial stability.

Similarly, significant progress has also been made in terms of improved supervisory and regulatory frameworks – not least because of the efforts of the Basel-based standard-setting bodies, such as the Basel Committee on Banking Supervision and the Committee on Payments and Market

---

[4] See C Buch, M Bussière, L Goldberg and R Hills, "The international transmission of monetary policy", *Federal Reserve Bank of New York Staff Reports*, no 845, March 2018.

[5] See Bank for International Settlements, *BIS Economic Report*, 2018. BIS research finds that an increase in global risk appetite, as measured by the VIX, predicts an increase in EME sovereign yields. There is evidence that a US dollar appreciation also produces the same effect, arising from these countries' foreign currency borrowing and global investor balance sheets.

[6] See A Carstens, "Global market structures and the high price of protectionism", Overview panel remarks at the Federal Reserve Bank of Kansas City's 42nd Economic Policy Symposium, Jackson Hole, Wyoming, 25 August 2018.

Infrastructures. Of course, as the financial system evolves and becomes even more integrated, regulatory frameworks must evolve too. The impact of technology on financial integration will be critical, as recent discussions of digital currencies and fintech suggest.[7]

But central banks and regulatory agencies cannot do it alone. Other national policymakers also have key roles to play. Fiscal policy must be a priority. Policymakers should take advantage of the stronger global recovery to bolster fiscal sustainability.

Microeconomic and structural policies also need strengthening. The list of reforms is long but certainly must include (i) boosting investment in human capital; (ii) enhancing competition; and (iii) nurturing the open multilateral trading system. More needs to be done.

And, of course, greater international cooperation is critical. In this respect, the BIS and its members have essential roles to play. Our mission of promoting global monetary and financial stability through international cooperation is a tried and true one. And it is as relevant now as when the BIS was first established.

Let me conclude. If we want to foster an environment in which 200-year anniversaries for central banks become the norm rather than the exception, we have some work to do. We need to strengthen the ability of central banks to respond to the type of spillovers that arise in a financially integrated world by building on the successes and learning from the lessons of the past. But we also have to be humble. To quote a famous American saying "we need to accept the things that cannot be changed, courage to change the things which should be changed, and the wisdom to distinguish the one from the other".[8] Luckily, we have brought together here a distinguished group of the world's experts to help us think through the challenges ahead.

---

[7] See Chapter V in *BIS Economic Report*, 2018; and Committee on the Global Financial System, "Fintech credit: Market structure, business models and financial stability implications", report prepared by a Working Group established by the CGFS and the Financial Stability Board, 2017.

[8] *Bartlett's Familiar* Quotations, 18th edition, Little, Brown and Company, 2014.