15 May 2006

Remarks on financial stability taking as cue the paper by Rick Mishkin on "Financial stability and globalisation: getting it right"

In "Central banks in the 21st century", Bank of Spain,

Madrid, 5-6 June 2006

Malcolm Knight

General Manager, Bank for International Settlements

The first years of the new century resemble closely the first of the old: we are living through the second wave of economic globalisation and enjoying an era of remarkable prosperity. This is quite an extraordinary "ricorso storico", as the Italian historian philosopher Gianbattista Vico would put it, especially if we recall the epochal events that have occurred in between.

That the previous era did eventually end, first interrupted by a world war and later under the blows of a major economic catastrophe following the roaring twenties, should keep us alert and humble. Alert, so that we do not take this prosperity for granted but, on the contrary, work hard to safeguard it. Humble, so that we do not fall into the trap of thinking that we have finally found the answers to the fundamental economic questions that we face.

In his paper, Rick Mishkin has reminded us of how important it is to ensure that countries embrace globalisation, both real and financial, and of how tall the corresponding challenges are. Nuances aside, Mishkin has retraced many of the very useful lessons that the international community has drawn from the sequence of financial crises that have engulfed EMEs since financial liberalisation.

In my remarks, taking the cue from Rick's paper, I would first like to stress some of the dilemmas that countries face when seeking to embrace globalisation. I will then seek to provide some personal reflections on the challenges ahead for central banks, focusing on the relationship between monetary and financial stability. And in the spirit of humility, I will be raising more questions that provide answers.

I – Globalisation and institutional reform: lessons learned

Let me first of all highlight three crucial points on which I agree completely with Mishkin.

First point: embracing globalisation, in both its real economy and financial dimensions, is a highly desirable goal for individual countries. The enormous benefits it brings in terms of resource allocation and long-term growth potential are well-known. Probably not sufficiently appreciated are its indirect benefits, particularly as a catalyst for implementing those domestic structural adjustments that are good in their own right. In a nutshell, being able to sustain the challenges of globalisation is an unmistakable "signal" of institutional maturity.

Second point, in effect a corollary of the first: being able to enjoy the benefits of open financial borders does require the presence of important institutional underpinnings: putting these in place is a major challenge that cannot be done overnight. Rick lists them in detail. They range from property rights and legal systems, through adequate prudential regulation and supervision, to sound macroeconomic policies, monetary and fiscal.

Third point: Institutions that work well in certain countries at a point in time need not always be well suited to others. This reflects, in part, different legal, cultural and historical traditions, and, in part, sequencing issues. Rick again provides several examples I would highlight, for instance, that the Basel Committee has for some time emphasised in its core principles the legal and institutional preconditions that need be in place for regulation and supervision, and hence instruments such as capital standards, to be effective.

From all this, however, a number of dilemmas follow, which I think could have been highlighted more in Rick's paper.

First, there is a catch 22 regarding the link between institutional reforms and financial globalisation. Waiting for all the preconditions to be in place could actually slow the pace of their adoption, as openness can be an important catalyst for change. But not waiting is quite likely to lead to very costly episodes of financial stress.

The implication is that the process is bound to be very long or quite painful, unless countries are already mature enough. And we have been fortunate so far that that the crises that have occurred have actually strengthened, rather than weakened, it. Just think of the macroeconomic and structural reforms that emerging market economies have embarked upon following the Asian crisis, as reflected in the widespread improvement in credit ratings since the crisis broke. It is comforting that history has shows it took a crisis at the core, not just at the periphery, to reverse the previous globalisation wave.

This puts a premium on efforts by the international community to hasten the process. Ultimately, progress can only be based on enlightened self-interest and a sense of ownership of the reforms.

Second, there is a clear tension between the call for uniformity demanded by a global capital marketplace and country-specific circumstances: this is a hard call to make. Think, for instance, of the balance between principles-based vs. rules-based accounting, with the latter finding an unreceptive soil in the United States, given its legal tradition. Likewise, recall the obvious difficulties for major banks in many countries in adopting the more advanced variants of Basel II.

To my mind, all this put a premium on soundness over uniformity per se, and patience over haste: to travel off-road, an old but reliable jeep is more helpful than a Ferrari. I therefore fully endorse the view taken by the Basel Committee and IFIs, for instance, that countries should adopt Basel II only when ready, even though this naturally complicates cross-border issues.

Third, judging the state of readiness of a country has proved extremely difficult. In particular, how many times have we thought that countries were ready only to be proved wrong? Crises have often appeared inevitable only ex post. And the bar keeps rising. Mexico had just been upgraded before the crisis broke out in 1994. And in Asia, fiscal probity, high investment levels and low inflation had been thought to insulate the region from difficulties. We should not, therefore, be lulled into a false sense of security and should redouble efforts to strengthen institutional underpinnings.

II – Central banks: some certainties and one open question

So far, central banks have not come into the picture. However, they clearly have a key role to play in strengthening the institutional set-up. They are the guardians of payment and settlement systems, depositories of know-how in financial matters, those responsible for monetary policy and, where relevant, in charge of supervisory functions. Here, let me just highlight two certainties and one open question.

First certainty: financial stability is a very complex task, central banks are an important, but by no means the only, players, as made abundantly obvious by the previous discussion. Moreover, in a number of countries they have been losing some key responsibilities, notably in the prudential area. This makes it all the more important for them to retain influence, based on their know-how and competence, and to strengthen the coordination with other authorities, nationally and internationally. This would help strengthen further the macro-, as opposed to micro-prudential, orientation of current efforts to secure financial stability. The establishment of international fora like the Financial Stability Forum, in which central banks play a prominent role alongside prudential regulators and ministries of finance, has been a step in the right direction. At the BIS, we have been working hard to support such analytical and operational cooperation. The fact that the Basel Committee now reports to a joint group of central bank Governors and Heads of Supervision is one concrete such example.

Second certainty: *over the longer term*, from a macroeconomic perspective, securing *sustainable* price stability is the best contribution that central banks can make to financial stability. Countries have learned the hard way the enormous economic and social costs of inflation during the historically anomalous Great Inflation era. Conversely, looking further back, the Great Depression was marked by a very painful, if historically equally anomalous, precipitous price deflation.

The open question, however, is whether we have indeed fully learned the lessons from the past. And here I beg to differ from Rick, who does not quite mention these aspects in the section of his paper on monetary policy. To be intentionally provocative, a common, though not unanimous, stylised lesson that seems to have been drawn from the past is that focusing on *short-term* inflation control, over a one-to-two year horizon, and paying little attention to monetary and credit aggregates, is sufficient to ensure stability over the *longer term*. The political economy of a number of inflation targeting regimes, in which short horizons help to strengthen accountability, has favoured such a shift.

To my mind, this is not fully appropriate.

First, history indicates that subdued inflation, and hence short-term inflation control, is not necessarily sufficient to prevent the emergence of macroeconomic instability. Inflation, for instance, did not rise to any significant extent during the run-up of the Great Depression or of Japan's lost decade. Nor was it a problem in the run-up of the Asian crisis. Indeed, looking back to the Gold standard period, financial crises were typically not preceded by rising inflation.

Second, some of the most pregnant mistakes in monetary policy history were the result of not paying sufficient attention to monetary and credit expansion. The episodes I just highlighted were indeed preceded by unusually strong cumulative expansions in "liquidity", broadly defined, typically alongside equally unusual increases in asset prices, not least real estate. The same is true for the Great Inflation. And on the downside, failure to focus sufficiently on the contraction in such aggregates resulted in an overly timid response to the Great Depression, seriously exacerbating the crisis.

Third, recent formal empirical evidence, including some carried out at the BIS, has confirmed this observation. In particular, it has found that unusually strong cumulative expansions in credit aggregates alongside similar increases of asset prices herald serious financial stress, economic weakness and *disinflation* over horizons beyond the one-to-two year horizons common in monetary policymaking.

All of this acquires greater significance at the current juncture. For the world economy is emerging from an unusually long period of historically low inflation-adjusted policy rates, unusually strong expansion in global liquidity, exceptionally buoyant asset prices and strong global growth. And this has occurred at a time when globalisation should, if anything, have raised the world's natural interest rate, by boosting global growth potential, while helping to keep a lid on inflation. But just because inflation has remained remarkably quiescent so far, should we assume that all is fine?

I say this in that spirit of humility that should underpin all policies. We should always remain alert and avoid complacency. The major policy mistakes in history that I highlighted before were made precisely when policymakers felt they had finally come to master the secrets of the economy. Preserving macroeconomic and, with it, financial stability is essential. We should not forget that it was precisely financial stress at the core of the global economy, and its international ramifications, that proved fatal to the first wave of globalisation. I certainly do not have the answers. But these questions are worth asking.