

Concluding remarks

Jaime Caruana
Banco de España

M^R I. VICE-PRESIDENT OF THE GOVERNMENT and Minister of Economy and Finance, ladies and gentlemen,

It is my pleasure to participate in this concluding session of the conference and to be accompanied at this table by Pedro Solbes. I hope you found the presentations and discussions inspiring and motivating. I certainly did. We are now witnessing some profound changes in the way our societies organise their economic relationships, and these naturally pose new challenges to central banks, regarding both their role of monetary policymakers and their responsibility to preserve and foster safer and more efficient financial systems.

Over the last two days we have discussed some of the underlying forces of change and their implications for the design of sound monetary policy and financial architecture, including the question of how best to arrange payment and security settlement systems. Let me briefly elaborate on some of the issues raised at the conference which I found particularly interesting. I will first reflect on the difficult question of how monetary and financial stability relate to each other and then move to some particular issues of special interest for a currency area, such as EMU.

Monetary and financial stability

The global financial system has developed at an unprecedented pace in the last two or three decades. During this time, many countries have undergone significant processes of financial liberalisation that have contributed to deeper and wider markets, in terms of both the number of participants and the assets traded on them. In the international sphere, financial liberalisation has led to a growing number of countries gaining access to global capital markets and to a stepping up of the economic and financial links among different regions. Technological progress has also played an important role. The ability of market participants

to obtain and process vast amounts of information almost instantaneously and to conduct complex transactions at low cost has grown enormously.

In short, all these changes have significantly increased the possibilities for risk-sharing among economic agents. And, as such, there is ample consensus that this process of financial deepening brings tangible benefits for businesses, households and governments alike. There is little doubt either that this phenomenon will continue its course over the foreseeable future.

In parallel to the changes on the financial landscape, we have also witnessed a remarkable performance by our monetary policy frameworks in terms of attaining and maintaining low and stable inflation, with noticeable effects on economic welfare. I believe that those achievements are largely permanent. I further consider that, as stressed by Alan Blinder in the introduction to his insightful paper, the debate over some of the core principles for sound monetary policy practice seems to be resolved for now. For example, there is currently substantial agreement, both among academics and monetary authorities, on the need to provide central banks with sufficient formal and effective institutional independence, the superiority of interest-rate operational targets over quantitative instruments, and the pursuit of low inflation as the main objective for monetary policy.

Both trends – towards deeper and more integrated financial markets, at one end, and towards monetary policies clearly determined to deliver price stability, at the other – are important factors behind the sound macroeconomic performance recorded practically worldwide over the last decade.

Notwithstanding this positive view on the recent past, central banks must deploy their best efforts – improving their monetary policy and regulatory and supervisory arrangements – to preserve and consolidate the attainments I mentioned, since various significant risks and challenges lie ahead. As stressed by Frederic Mishkin, the final success of the processes of financial liberalisation and globalisation in developing economies hinges crucially on the ability of both policymakers and the private sector to properly respond to a rapidly changing environment. No doubt, the spirit of this proposition applies likewise to developed countries.

An increasingly liberalised and globalised financial system necessitates a re-consideration of some key inputs in our current monetary strategies. The greater relevance of markets and their evolving nature requires an ongoing assessment of the different monetary policy transmission mechanisms. This area, while critical to successful monetary policy decision-making, still remains shrouded in considerable uncertainty. Undoubtedly, the emergence of new financial assets and financial intermediaries poses fresh questions here.

Furthermore, the magnitude of the financial funds flowing across different countries at the present time and the uncertainty surrounding the sustainability and the possible effects of an eventual correction of the so-called global imbalances means that central banks worldwide must take a much broader and complex set

of indicators into consideration when formulating their policies. Moreover, we are probably at a juncture that can be best described as one of “Knightian uncertainty”, in that some of the risks we are facing, and the hypothetical consequences following their realisation, are essentially immeasurable. Consequently, good monetary policymaking requires not only a continuous reassessment of market conditions and expectations, but also forecasts and projections flexible enough to encompass a wide set of scenarios.

I share the view set out yesterday by Jean-Claude Trichet that a sound communication strategy takes on special importance in the current environment, as well. Anchoring expectations about future inflation is a valuable asset, and especially at times of financial and real turbulence. Fluent communication with market participants and the general public is also of great help in preserving credibility, especially when circumstances lead to relatively persistent temporary departures from what is sometimes called a “neutral” monetary policy stance, as some of our central banks have faced in recent times, or when specific factors push inflation rates above what the monetary authorities normally consider as satisfactory.

Moreover, alignment of market expectations with the central bank’s own targets, through fluent and transparent communication, allows monetary policy to exert a stronger influence along the entire yield curve. Yet notice that this latter channel becomes most relevant if central bankers approach markets from the sort of leadership position emphasised by Professor Blinder. I agree with him on this important point: central bankers should continuously monitor markets and should extract from them as much information as possible. But they must not put themselves under the thumb of what is sometimes erratic market sentiment.

In any event, one of the most robust lessons we can extract from the recent period of global monetary and output growth stability is that low inflation may well be consistent with episodes of high financial volatility. Cases of financial stress have been recorded both in industrialised and in emerging market economies over the last few years without noticeable inflationary pressure. Even in countries whose financial system has proved more resilient, financial cycles have become wider and more volatile.

Indeed, a long period of monetary stability coupled with low interest rates, as has been the case for some years now, may arguably be conducive to certain types of imbalances in asset markets. In such an environment the poor returns on low-risk investments and the softening of lending standards may lead investors to take on increasingly riskier projects. As economic agents underestimate the total risks of their positions, the volume of investment in financial – and, in some cases, also real estate – markets rises at a strong pace, and with it, asset prices and the overall level of credit, perhaps, with both being further fuelled through the feedback mechanism operating between collateral value and credit capacity. In that situation, there is a risk that a sharp asset price reversal might have a size-

able impact on the stability of the whole system. Therefore, an otherwise beneficial context of price stability and low financing costs might sometimes sow the seeds for the emergence of financial imbalances.

This latter, somewhat ironic conclusion has spurred a recent debate on the role to be assigned to monetary policy as an instrument of use in correcting financial and real estate market excesses. Should central banks react to asset prices over and above their direct effects on purely monetary goals, such as inflation? The answers vary depending mainly on the confidence that one places in the ability of central banks to detect price misalignments early and to undo them without causing major damage to the economy.

I tend to think that while in normal conditions monetary policy should react only to changes in economic variables insofar as they bear some influence on inflation dynamics, there are exceptional circumstances in which policymakers have enough signals to conclude that the economy, as a whole, is facing significant risks, thus warranting a more pre-emptive policy approach. This pragmatic view is consistent with the idea that monetary policy decisions should be based not only on the most likely scenarios but also on other, less probable ones which, however, may have far-reaching implications for the entire system should they materialise. Certainly, an abrupt asset price correction pertains to this class of low-probability event that may ultimately entail significant costs for a country's welfare.

More importantly, to place this approach to monetary policy in its right place, it is critical to recognise that some of the risks inherent in the financial sphere should first be the subject of an appropriate prudential framework. It is no exaggeration to say that any concern about unbalanced market developments is, at core, a concern about a problem of inappropriate risk management. This statement applies to the case in which, due to over-optimism or short-sighted behaviour, market participants fail to appreciate the true risk of their investment or lending strategies. Yet even if their behaviour can be thought as being fully rational from an individual perspective, nothing ensures that the final outcome will not convey important risks at a systemic level that are not properly internalised by single agents. As a result, a portion of the marked volatility and procyclicality of some key financial variables, like asset prices and credit, may be understood as a reflection of individual and collective risk misjudgement.

Hence, there is much to be gained in terms of greater resilience and efficiency of the financial system through the design of regulatory and supervisory frameworks aimed at combating the factors that underlie a poor assessment of risks at their root. In this sense, a sound prudential framework should provide financial institutions with the right incentives to properly assess and monitor the risks of their investment and lending policies, incorporating them accordingly into their pricing decisions. Increased awareness of risks, and how these evolve along the business

cycle, favours earlier reactions to changing conditions and smoother adjustments in the flow of credit, thus reducing the likelihood of episodes of abrupt liquidity and credit contraction.

The New Capital Accord, known as Basel II, is an example of a prudential framework that makes the foregoing principles I have outlined its centrepiece, since it seeks to strengthen the stability of the international banking system by promoting the implementation of more robust and comprehensive risk management practices. It does so mainly by establishing a more precise and sensitive system to link banks' real risks and the minimum regulatory capital requirements, and by imposing higher levels of transparency in banks' financial reporting, hence fostering closer scrutiny by market participants.

A more risk-sensitive capital framework tends to make banks more watchful of the actual risks of lending policies focused on short-run targets, such as market share or portfolio size, which presumably are important ingredients in periods of credit booms sustaining speculative activities. Furthermore, greater transparency in the information provided by banks on their balance-sheet and risk position must help alleviate the informational asymmetries among shareholders, lenders and borrowers that arguably lie behind most episodes of financial distress.

Yet despite the recent advances in the design of a banking supranational prudential framework, much remains to be done, especially with regard to other financial institutions and markets. From my personal experience as governor of a central bank with supervisory and regulatory responsibilities, member of the Governing Council of the ECB and member of the Basel Committee on Banking Supervision, I strongly believe that there is much merit in central banks playing an active role in the pursuit of prudential policies that rightly respond to the challenges posed by the current process of intense financial deepening. I would agree that one specific institutional model is unlikely to fit all. Moreover, the operational separation between prudential and monetary policies should in any event be preserved. However, it is in the general interest of societies to take advantage of the institutional strength and the valuable information and analytical expertise held by most central banks in order to safeguard the soundness of financial systems.

Reflections on challenges in EMU

The challenges faced by a central bank are certainly not smaller if it has to conduct a single monetary policy for a multinational currency area.

We have seen that in the new economic and financial landscape, central banks should explore ways to fully internalise the close links between financial and macroeconomic stability. The Eurosystem is well suited to take into account the ex-

isting synergies. The Treaty itself establishes price stability as a primary objective while at the same time calling on the ESCB to contribute to the smooth conduct of prudential policies and the proper operation of payment systems.

Nonetheless, central bank policies must deal with a heterogeneous economic scenario where national economies retain distinctive features both in terms of exposure to specific shocks and as a consequence of the different functioning of domestic policies and allocation mechanisms. Moreover, while markets are increasingly integrated there are still frictions impeding sufficiently flexible flows of products, capital and labour. Even in the financial services area, and although progress in developing the single market is already evident, some transactions involving agents in several euro zone countries are still penalised in comparison with purely domestic operations.

Against this background, the Eurosystem has had to face the challenges posed by economic heterogeneity and imperfect integration in two ways. Firstly, by complementing the monitoring of euro-wide aggregate variables with the analysis of relevant national developments in order to identify the policy that best helps ensure price stability in the euro area as a whole. Secondly, by promoting a better integration of markets, particularly financial markets, in the euro area.

Regarding this latter issue, the role of payment systems is crucial. As we have heard this morning, the Eurosystem is making a significant contribution by developing a wholesale payment system, known as TARGET2, which will provide for safer and more efficient large-value payment flows within the euro area. I would agree that more has to be done by the competent authorities to achieve higher integration for retail payments and securities transactions. However, the Eurosystem, together with the European Commission, is actively supporting the Single Euro Payments Area initiative and has devoted much effort to promoting more efficient and safer securities settlement systems and to facilitating the cross-border use of collateral.

In any event, I have the impression that in years to come the Eurosystem will have to strengthen further both aspects of its policy approach. As EMU is not likely to become a much more homogenous area in the foreseeable future, the need might be felt to pay more attention to key national economic developments on the basis of the contribution by NCBs, therefore making more intensive use of the federal organisation of the European monetary authority. My feeling is that country-specific analysis is proving increasingly informative for fully understanding the situation, prospects and policy needs of the euro area as a whole.

Similarly, I would not be surprised if the ECB were to find it appropriate in the future to raise its profile somewhat in defending a more integrated and liberalised market for financial services in Europe.

Conclusions

In sum, our economies are now experiencing some important changes, both with regard to how goods and services are produced and traded, and the possibilities that agents face to organise their economic decisions over time. Most of the underlying forces causing these changes must be judged as largely beneficial *per se*. Yet as occurs with any new situation, we face much uncertainty that requires a comprehensive learning effort. As central bankers, we have learnt that price stability should be deemed as a highly valuable but insufficient achievement to promote financial stability. We have also gained some understanding as to why this is so, and, hence, on the need to take some steps towards making the goals of monetary and financial stability compatible and sustainable. Admittedly, our knowledge is still scarce in some important areas. However, as the interaction between the two objectives is becoming more pronounced, the role of central banks is probably more complex but also more relevant.