SPEECH

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# Notes for AGM Panel Discussion on "Boom-bust cycles, interest rates, and the global financial system"

*Notes prepared for AGM Panel Discussion following the 2017 Andrew Crockett Memorial Lecture by Professor Hélène Rey.*

First of all, let me start by thanking professor Rey for a stimulating lecture. I have followed Hélène's previous research on the financial cycle and policy spillovers with great interest. In a general way, I can also relate to the results Hélène showed today on the consumption-wealth ratio and what it can tell us about boom-bust cycles. Hélène's data start in the 1920s. I haven't been around quite that long, but I have experienced and dealt with boom-bust cycles in one capacity or another during my entire working career, starting with our home-made financial crisis in Sweden at the beginning of the 1990s.

As the governor of a central bank in a small open economy I can also testify to the constraints on domestic monetary policy from the external forces that Hélène has described. Let me give you an example of this from the Riksbank's point of view. In 2014 it became evident that monetary policy in the euro area and the U.S. was moving in different directions. The Fed tapered its asset purchases and there were expectations of a raise of the policy rate a year ahead. The ECB, on the other hand, cut its policy rate, announced a support package for companies and decided on substantial asset purchases at the start of 2015.

At the same time, the Riksbank was grappling with an inflation below the target of 2 per cent and inflation expectations that were falling. Since the Swedish krona was expected to appreciate against the euro, it was important to avoid this appreciation going too fast and the krona becoming too strong. We therefore cut our policy rate further, to a level below zero per cent, and started a program of government bond purchases. In other words, even with a floating exchange rate Swedish monetary policy was not insulated from monetary policy pursued abroad.

What are the practical implications of this for a small central bank like the Riksbank, conducting an independent monetary policy next to a colossus like the ECB? Well, like my example from 2014 shows, when you are standing next to an elephant, and the elephant uses its trunk to squirt water around, it is difficult to avoid some of it spilling over on you.

That said, I don't think we are *totally* at the whim of the elephants. I don't think the spillovers from the forces driving the global movements of capital have made smaller economies unable to pursue an independent monetary policy, even with a floating exchange rate. There is still a bigger menu of choices for the policymaker than if the exchange rate was fixed. But, as Maurice Obstfeld put it, there is no guarantee that those choices will be pleasant.

Case in point: In 2014, the Riksbank had to choose between letting the spread between the Swedish and the euro area interest rates increase, and keeping the spread by making monetary policy even more expansionary. One choice would risk entrenching inflation below our target. The other choice would add to the risks posed by excessive credit growth and rapidly increasing housing prices. Ultimately, we needed to focus on maintaining confidence in the inflation target since we were in a situation where the long-run inflation expectations were on an alarmingly negative trend.

Since then both inflation and inflation expectations have moved back towards our target. But we are not out of the woods yet and the focus still has to be on safeguarding the inflation target's role as the nominal anchor. And in doing that, since at least 2014, we have had to deal with the elephant in the room, so to speak. So, spillover effects can certainly limit the degrees of freedom of monetary policy. The question is then, how should we tackle these effects?

One possibility is policy coordination, like Hélène mentioned. There have been examples of coordination of monetary policy. One example is the coordinated interest-rate cut made by a number of central banks, including the Riksbank, during the financial crisis. But special circumstances aside, I am personally not particularly optimistic about the practical possibilities of formally coordinating monetary policy on an international level. Ultimately, national central banks have the task of fulfilling national mandates. If larger central banks were to try to take into account spillover effects of their policy abroad, they would have to set aside these national objectives, at least temporarily. It would probably be difficult to get domestic support for such a policy.

Since the spillovers limit the degrees of freedom of monetary policy, a more realistic way of tackling the effects is to try to increase the central bank's room for manoeuvre. One way is to introduce measures that restrict the supply and demand for credit by, for example, macroprudential policy. Of course, such measures are not new to central bankers. Many of the prudential measures that we focus on now were already in the arsenals of central banks before the deregulation wave of the 1980s. What is new is the emergence of macroprudential policy as its own policy area.

Sometimes there is a tendency to take this *institutional* separation of the macroprudential from the monetary policy area to imply that the two policies can be viewed as close to orthogonal to each other – one policy to deal with financial stability and one to deal with price stability. In practice, of course, the two policy areas are closely intertwined; the transmission of their respective instruments going through the same channels and modifying the effects of each other.

So while prudential and supervisory policy measures will help us deal with the financial stability risks, they cannot be viewed as a panacea. Yes, effective and timely-implemented macroprudential measures would let off some of the pressure put on monetary policy. But they could also reduce the effectiveness of monetary policy, for example reducing the transmission through different segments on the financial markets. There is also the problem of timing the implementations and getting the policy mix right – particularly if the body charged with the responsibility for macroprudential policy is outside the central bank.

Also, the prudential measures might not be that effective. Hélène has talked about the Triffin dilemma and the classic Mundell-Fleming trilemma, but there is also the financial trilemma of Schoenmaker which says that you cannot have national control over financial policies, financial integration with the global market and financial stability all at the same time. So, with globally integrated financial markets you would expect outside forces weakening the effectiveness of prudential policies. And we know that there are international spillovers from prudential policy as well.

For measures to be more effective and to avoid spillovers, reciprocation of macroprudential policy will be important in regions with intense cross-border banking activities performed in a branch structure. This issue is especially important in the Nordic-Baltic region, which is characterized by a high degree of cross-border banking activities, increasingly performed by way of branches.

Through the work in the Nordic-Baltic Macroprudential Forum we have gained a better understanding of the materiality of cross-border exposures and the need for reciprocation. The European Systemic Risk Board has also put forward a recommendation with respect to the reciprocation of macroprudential policy. This way, host supervisors implementing measures can ask the ESRB to recommend reciprocity. The home supervisor of the branches in the country implementing the measure will have to comply or explain the reason of not reciprocating.

So, international cooperation has been instrumental in bringing about a framework that will help to make macroprudential policy implementation more effective. But it is important to recognize that it is still in its infancy. And we should realize that – while the toolkit for macroprudential policy now has been in place for a few years through the CRR/CRDIV in Europe – we do not have that much empirical experience with the actual implementation of macroprudential policy.

What does this all mean for monetary policymaking? I think one lesson, which is corroborated in many ways by Hélène's research, is that financial stability and monetary policy are so closely interlinked that it is difficult to draw a clear boundary between them. This needs to mark our thinking to a much larger extent than it did prior to the financial crisis. It is not just our models that need to be adapted – which they do – but I would argue that it needs to be reflected in our strategies and in our mandates as well.