Sources of Financial Instability: Challenges for Monetary Policy in the 21st Century | Claudio Borio

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INTRODUCTION

Claudio Borio has served as Head of the Monetary and Economic Department at the BIS for the past six years and has been at the BIS since 1987, having held various positions in the Monetary and Economic Department (MED), including Deputy Head of MED and Director of Research and Statistics as well as Head of Secretariat for the Committee on the Global Financial System and the Gold and Foreign Exchange Committee (now the Markets Committee). From 1985 to 1987, he was an economist at the OECD, working in the country studies branch of the Economics and Statistics Department. Prior to that, he was Lecturer and Research Fellow at Brasenose College, Oxford University. He holds a DPhil and an MPhil in Economics and a BA in Politics, Philosophy and Economics from the same university. Claudio is author of numerous publications in the fields of monetary policy, banking, finance and issues related to financial stability.

WHY DO I CARE?

In preparation for this conversation, I poured over many of Dr. Borio’s academic papers, including one going back to 2002, which raised concerns about some of the risks that would later materialize as the Great Financial Crisis. There was one paper in particular that enunciated concerns that I currently share and which I think are often misunderstood by academics and policymakers alike. Below are a series of relevant excerpts from that paper, titled “Revisiting Three Intellectual Pillars of Monetary Policy Received Wisdom”:

The Great Financial Crisis has triggered much soul-searching within the economic profession and the policymaking community. The crisis shattered the notion that price stability would guarantee
macroeconomic stability: financial markets are not self-equilibrating, at least at a price that society can afford. And it showed that prudential frameworks focused on individual institutions viewed on a standalone basis were inadequate: a more systemic perspective was needed to avoid missing the wood for the trees. Hence the welcome trend of putting in place macroprudential frameworks. 

**But has this soul-searching gone far enough?**

Today I shall argue that it has not. More specifically, I would like to revisit and question three deeply held beliefs that underpin current monetary policy received wisdom. The first belief is that it is appropriate to define equilibrium (or natural) rates as those consistent with output at potential and with stable prices (inflation) in any given period – the so-called “Wicksellian” natural rate. The second is that it is appropriate to think of money (monetary policy) as neutral, i.e. as having no impact on real outcomes, over medium- to long-term horizons relevant for policy – 10–20 years or so, if not longer. The third is that it is appropriate to set policy on the presumption that deflations are always very costly, sometimes even to regard them as a kind of red line that, once crossed, heralds the abyss.

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But how can we tell whether market rates are at their equilibrium level from a macroeconomic perspective, i.e. consistent with sustainable good economic performance? The answer is that if they stay at the wrong level for long enough, something “bad” will happen, leading to an eventual correction. It is in this sense that many economists say that the influence of central banks on short-term real rates is only transitory. 

But what is that something “bad”? Here the two perspectives differ. In the received perspective, it is the behavior of inflation that provides the key signal. If there is excess capacity, inflation will fall; if there is overheating, it will rise. This corresponds to what is often also called the “Wicksellian” natural rate, i.e. the rate that equates aggregate demand and supply at full employment (or, equivalently, the rate that prevails when actual output equals potential output).
The perspective developed here suggests that this view is too narrow. Another possible key signal is the build-up of financial imbalances, which typically take the form of strong increases in credit, asset prices and risk-taking. Historically, these have been the main cause of episodes of systemic financial crises with huge economic costs. Think, for instance, of Japan and the Nordic countries in the late 1980s; Asia in the mid-1990s; and the United States ahead of the Great Financial Crisis or, going back in time, ahead of the Great Depression (e.g. Eichengreen and Mitchener (2003)).

The reasoning is straightforward. Acknowledge – as indeed some of the proponents of the received view have – that low interest rates are a factor in fueling financial booms and busts. After all, intuitively, it is hard to argue that they are not, given that monetary policy operates by influencing credit intuitively, it is hard to argue that they are not, given that monetary policy operates by influencing credit expansion, asset prices and risk-taking. Acknowledge further that financial booms and busts cause huge and lasting economic damage – in fact, no one denies this, given the large amount of empirical evidence (see below). Then it follows that if we think of an equilibrium rate more broadly as one consistent with sustainable good economic performance, rates cannot be at their equilibrium level if they are inconsistent with financial stability.

This can contribute to a kind of “debt trap” (Borio and Disyatat (2014), BIS (2014)). Over time, policy runs out of ammunition. And it becomes harder to raise rates without causing economic damage, owing to large debts and the distortions generated in the real economy. It is as if the whole economic system adjusted to such low rates and became less tolerant of higher ones, at least without some transitional pain. This process gives rise to a new, insidious form of “time inconsistency”, whereby policy steps may appear reasonable when taken in isolation but, as a sequence, lead policy astray.

The bottom line is that, over sufficiently long horizons, low interest rates become to some extent self-validating. Too low rates in the past are one reason – not the only reason! – for such low rates today. In other words, policy rates are not simply passively reflecting some deep exogenous forces; they are also helping to shape the economic environment policymakers take as given (“exogenous”) when tomorrow becomes today.
Let me first try to restate the “three beliefs” that Borio thinks represent the current, received monetary policy wisdom: (1) The natural rate (target rate) is that consistent with the optimal growth performance with minimal inflation. (2) It is appropriate to think of monetary policy as having no meaningful effect on real economic outcomes, over the long-term (10, 20, or more years), and thus long-term impacts can be ignored. (3) It is appropriate to set policy on the presumption that deflations are always very costly and sometimes lead to paradoxes of thrift and self-fulfilling prophesies.

Because the prevailing view sees inflation as the signal for economic overheating, interest rates can be pushed below the natural rate for as long as inflation seems normal or low, leading to a buildup of credit, malinvestment, and financial instability. The destabilizing effects of monetary policy may not show up for decades, which makes them lagging indicators for policymakers. This is something that we covered on my old television show Capital Account (excerpt from the episode’s introduction):

We have openly wondered on this show if the extraordinarily low interest rates charged to the US treasury for its borrowing needs have been the result of the Fed’s voracious appetite for fixed income securities in the past 4 years. That yields have been eviscerated by Fed policy there is no question. The only question for us, is if this is the result of Fed policy past or present...in other words, is it the seemingly obvious presence of the Fed in the bond market today as the major buyer
of Uncle Sam’s IOU’s which is keeping rates low, or was it the Fed’s accommodative monetary policy during the boom years and the subsequent urge by the private sector to relieve itself of overpriced assets in the bust that has kept yields from rising?

So, if Central Bankers are looking at the wrong indicators – if the models they use to gauge the health of the economy and by consequence guide their own policy decisions and choices – how can we trust them to get it right the next time? Why should we feel confident that the latest theories are any more effective?

This brings us to another question which Borio attempts to answer in his papers, and that is: “Why has the amplitude of financial cycles grown since the early 1980s, thus raising their importance for economic activity?” (i.e. Great Moderation)

The reasons are not yet fully understood, but arguably changes in policy regimes may be partly responsible. Three such changes deserve particular attention:

1. First, financial markets were liberalized starting around that time. Without sufficient prudential safeguards, this change likely allowed greater scope for the self-reinforcing interactions at the heart of the financial cycle to play out.

2. Second, starting roughly at the same time, inflation-focused monetary regimes became the norm. And the evolving thinking of central banks led them to gradually downplay the role of monetary and credit aggregates. This meant that central banks had little reason to tighten policy if inflation remained low, even as financial imbalances built up.

3. Third, from the 1990s on, the entry of China and former Communist countries into the world economy, alongside the international integration of product markets and technological advances, boosted global supply and strengthened competitive pressures. Coupled with greater central bank credibility, this arguably made it more likely that inflationary pressures would remain muted even as expansions gathered pace. It also meant that financial booms could build up further and that a turn in the financial cycle, rather than rising inflation and the consequent monetary tightening, might trigger an economic downturn.
Research Focus — Q: What’s been the focus of your research? Q: What is your primary focus today?

Evolution of Central Bank Policy Models — I’m curious to learn how central banks have evolved their understanding of markets, how the things they deem to be most important have changed, and what sorts of “game plans” they’ve developed for intervening in markets and the economy. Q: Can you walk us through a history and evolution of central bank policy, perhaps, starting after WWII?

Prevailing View — Q: What is the prevailing view today, among central bankers about how the economy works and why policymakers have been unable to restart growth despite record low – and in some cases nominally negative interest rates? (secular stagnation hypothesis & financial cycle drag hypothesis)

Debt Financing — I’m interested in your findings on how financial cycles have become larger drivers of the business cycle and how economists still target inflation as though this was pre-1985 when ramping inflation tended to be a leading indicator of recession. Q: Are financial cycles becoming larger drivers of the business cycle because businesses are more credit driven than they used to be and the economy is more reliant on debt financing than ever before? Q: How does this impact policymakers? (i.e. if there’s lots of debt in the economy, what does that mean for raising interest rates?) Q: If stable prices (lack of ramping inflation) are no longer sufficient indicators of financial well-being, what is a good indicator?

Natural Interest Rate — Knut Wicksell, in his book “Interest and Prices,” defines the term “natural rate of interest” as the interest rate which is compatible with a stable price level. If the interest rate falls short of the natural rate, inflation is likely to arise; if the interest rate exceeds the natural rate, this will tend to produce deflation. Interest rates that coincide with the natural rate ensure equilibrium in commodity markets and produce price stability. This theory was adopted by the Austrian School, which theorized that an economic boom happened when the interest rate fell short of the natural rate. Q: What is the origin of the natural rate and is it misleading as an indicator for financial health?

Monetary & Financial Stability — Q: First, to what extent does monetary stability – defined as “low and stable inflation” – contribute to financial stability? Q: Second, what type of monetary policy regime is likely to deliver the ideal combination of monetary and financial stability? Q: Why do we need central banks to set interest rates?

Interest Rate Volatility vs. Financial Instability — Q: Has anyone looked at the correlation between interest rate volatility and financial stability? Q: If misperception of risk is what is ultimately responsible
for causing financial instability, is the answer to increase risk perception? Q: Is there an ideal amount of volatility that we should want to see in interest rates (and in expectations about future rates) that would lead to more appropriate assessments of financial risk by market participants? Q: How do you not overdo it and incentivize risk aversion and setting rates above the natural rate? *Paul Volcker’s “Saturday Night Special”

Minsky — Q: Are price stability and financial stability impossible to achieve simultaneously because “stability begets instability” as Minsky wrote?

Origin of Inflation Targeting — Q: Did the post-Bretton Woods period, particularly the 1970s stagflation lead economists to theorize that inflation caused financial instability? Q: What is the origin of this theory? (i.e. why are central bankers so obsessed with inflation targeting?)

Inflation vs. Deflation — Q: Is the way that we think about inflation and deflation totally wrong? Q: If we had today’s federal reserve setting interest rates during the post-bellum period in the United States, what do you think would have happened? Q: Would we have had a cataclysmic depression by the end of the expansion and would that depression have come later and lasted longer?

Data Availability — Q: Has the availability of useful data improved markedly over the years? Q: Can useful indicators be constructed using only information available to the policymaker at the time that the policy decision is made? Q: Can signals be made more accurate by jointly considering asset prices, credit and investment? Q: How can data help policymakers achieve higher levels of financial stability in the economy?

Credit Gap — In your 2002 paper, you identify a credit boom as a period in which the ratio of credit to GDP deviates from its trend by a specified amount (credit gap). Q: Aren’t we in a secular “credit gap” by historical standards, going back to the mid-1980’s?

Modern Monetary Theory — Modern Monetary Theorists believe that government spending should be constrained by inflation, but your work shows that when inflation is low (monetary stability) financial instability can be very high. Q: What are your thoughts on this theory?

ANNUAL REPORT: NO CLEAR SKIES

“Multiple forces exerted downward pressure on growth” in the second half of 2018, according to the BIS Annual Report: First, quite prominently, political factors left their imprint on the economy and weighed on the minds of economic decision-makers. Besides some country-specific political factors, trade tensions loomed large. Doubtless, related uncertainty and concerns inhibited activity, especially investment. Second, China slowed as the authorities sought to bring about the
much-needed deleveraging of the economy to make growth more sustainable. Given China’s heft and tight interconnections in the global economy, the slowdown quickly spread around the world. Global value chains acted as a powerful transmission channel. Third, financial conditions tightened somewhat in parts of the world as US monetary policy continued to normalize until late 2018 and the US dollar strengthened. While holding up remarkably well by past standards, emerging market economies (EMEs) came under some pressure, given the heavy reliance of their firms on dollar financing. Finally, in several advanced small open economies and a number of EMEs, financial cycles – best captured by the joint behavior of credit and property prices – appeared to shift from expansion to contraction, weighing down on expenditures.

The slowdown would have been sharper without resilience elsewhere that served to buffer weakness from manufacturing and trade. One supporting factor was the continued strength of labor markets, accompanied by a modest pickup in wage growth. Employment expanded further, pushing unemployment rates to multi-decade lows in several economies. Other than in economies where the housing market began to falter, consumption was thus a relative strength. Another factor, at work in some of the large economies at the heart of the Great Financial Crisis (GFC), was the financial cycle upswings, most notably in the United States. In those cases, the post-crisis household deleveraging provided room for the corporate sector to re-leverage, to the point of creating some vulnerabilities.

**LONGER-TERM FORCES AT WORK**

Your latest annual report that came out a month ago identified four long-term, systematic “forces” at work behind the regular, business fluctuations we have been seeing more generally.

**Inflation Process** — **Q:** Why has inflation remained subdued despite many economies operating close to, or above, standard estimates of economic potential, with record low unemployment, rising wages, and ultra-accommodative monetary policy? **Q:** Why has the transmission between wage inflation and higher consumer price inflation been so muted thus far in the recovery?
Finance and its Expanded Role in the Economy — It seems that many of today’s policymakers are working off models developed decades ago, when sharply rising inflation, and subsequent monetary policy tightening, ushered in downturns. Since then, financial expansions and contractions seem to have played a more prominent role. Q: How challenging has this been for policymakers and how has the academic profession evolved to meet this challenge in the last ten years in particular? Q: What does this mean for the effectiveness of monetary policy going forward and how confident are central banks that they will be able to tame inflation if it is to emerge?

Policy Makers Losing Control — Q: If endogenous forces are driving economic and market fluctuations, does this mean that policymakers are losing control?

Productivity Growth (lack thereof) — Productivity growth has fallen off dramatically from where it was in the late 90’s and early 2000’s, and the slowdown became more marked following the GFC. Q: What role has an impaired financial system played impeding the allocation of resources to their best use?

GFC and Global Trade — The report states that it “is no coincidence that trade has lagged behind output and that investment has been correspondingly weak.” Q: What impact has the great financial crisis have on trade and investment?

Political Backlash — From a historical perspective, it is not unusual to see such surges of sentiment in the wake of major economic shockwaves. The Great Depression marked the end of the previous globalization era. Q: How seriously are global policymakers taking rise of populism, isolationism, and protectionist policies, particularly in open, democratic societies? Q: How will policymakers adjust if this becomes the new reality?

SHORT-TO-MEDIUM-TERM FORCES

From Households to Corporates — While household debt in relation to incomes has declined after a long phase of balance sheet repair in countries hit by the GFC, the corporate sector has levered up.
**Leveraged Loans** — Perhaps the most visible symptom of potential overheating is the remarkable growth of the leveraged loan market, which has reached some $3 trillion. While firms in the United States – and, to a lesser extent, the United Kingdom – have accounted for the bulk of the issuance, holdings are spread out more widely.

**Collateralized Loan Obligations (CLO’s)** — For quite some time, credit standards have been deteriorating, supported by strong demand from yield-starved investors. Structured products such as collateralized loan obligations (CLOs) have surged – reminiscent of the steep rise in collateralized debt obligations that amplified the subprime crisis. Should the leveraged loan sector deteriorate, the economic impact would depend on the potential amplification mechanisms. Q: Could CLO’s act as an amplification mechanism for the $3 trillion-dollar market in leveraged loans? Q: How important is the larger context of a deteriorating environment of corporate credit quality in advanced economies, evidenced by a larger outstanding stock of BBB securities (junk bonds)?

**State of the Banking Sector** — Q: What is the condition of the banking sector in the United States and Europe? Despite being better capitalized due to post-crisis regulatory reforms, asset growth among the major banks has slowed sharply since the GFC. Q: What has driven the slow growth in book equity? Book equity growth has been similarly lackluster. The slow growth of book equity reflects, in part, banks’ chronically low profitability, particularly in many euro area countries. Q: What accounts for the low levels of profitability for banks? Q: Why do profits matter? Profits are the first line of defense against losses and, as by far the primary source of capital, they are the foundation for banks’ ability to lend and support the economy. Some of the reasons for low profitability can be traced to legacies from the GFC and the macroeconomic environment, most notably persistently and unusually low nominal interest rates. Others reflect more structural factors, especially excess capacity in a number of key banking systems.

**EME’s** — After the strong credit expansion, these countries are now saddled with historically high household debt levels, and some with high corporate debt as well. A specific feature of EMEs has been the rapid growth of FX debt, mostly in the corporate sector. Q: What are the biggest risks to
emerging market economies at present? Q: How important has dollar financing been for these economies and how vulnerable are they to financial market shocks and to a rising dollar?

**Debt Dependent Growth Model** — It feels to me that, in Western countries at least, we are moving more and more towards having managed economies and what we are managing are our long-term liabilities to each other and to the planet. Q: Are we financing a world that we can’t afford to live in?

**POLICY CONSIDERATIONS**

**Intertemporal Tradeoffs** — The Report refers to “intertemporal trade-offs” to monetary policy where short-term benefits can have long-term costs. Q: What evidence do we see for excessive risk-taking and debt accumulation that has been exacerbated by monetary policy during and since the crisis? (FOMC Impact on Term Premia (Including Language)) Q: Have financial markets become overly dependent on not only loose monetary policy, but on an atmosphere of certainty and assurances cultivated by forward guidance, press released, and other forms of abundant communication from central bankers? (i.e. Can central banks talk too much?) Q: How might these short-term trade-offs impact long-term options for maneuverability?

**Macroprudential Policies** — Q: What are some of the macroprudential, structural reforms that policymakers have taken? Q: Which nations or banking systems have made the most progress, in your view?

**EME’s vs. Developed Economies** — Q: How do EME’s compare to developed market economies in terms of steps that they have taken post GFC?

“Challenges for Monetary Policy,” Chair Jerome H. Powell

“Can Central Banking be the Primary Tool of Macroeconomic Stabilization?,” Lawrence Summers

“The Fed Shouldn’t Enable Donald Trump,” Bill Dudley