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News release

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National balance sheets and macro policy: lessons from the past – speech by Paul Tucker

Speaking in London today, Paul Tucker – Deputy Governor, Financial Stability, Member of the Monetary Policy Committee and Member of the Financial Policy Committee – discusses some lessons learned from the financial crisis about the appropriate macro policy framework, and in particular from the over-stretched and vulnerable balance sheets households, firms, banks and governments across the Western world had accumulated prior to the crisis.

Paul Tucker highlights two possible international macroeconomic explanations for the period of pronounced credit growth and asset price appreciation prior to the crisis. "First, a fall in the world safe real rate, due to excess savings in the East. Second, increasing Global Liquidity, transmitted through expansive cross-border lending, kicked off by prolonged accommodative monetary policy." Both of these, he notes, "…involve shifts in risk premia driven by changes in the supply and demand for financial assets." He stresses that changes in risk premia can be key drivers of fluctuations in asset prices, and probably have substantial influence over macroeconomic fluctuations.

His analysis suggests that macroprudential policy can play a key role in containing excess and ensuring resilience in future. This leads him to suggest a number of policy lessons:

- We must not rely entirely on central banks 'mopping up' after financial crises. Not only does it strain our capabilities ex post, it is counterproductive ex ante. If central banks are perceived as writing deep-out-of-the-money put options, then the market, believing it is protected by those tail-risk puts, will itself take more risks than otherwise. We need overall macro regimes that aim to make chronic imbalances and over-indebtedness less likely and less threatening.
- The transmission of monetary policy can be affected by risk appetite, and can itself affect risk-taking behaviour, domestically and globally. We need to be alive to that in forecasting the path of nominal demand, and in assessing global liquidity conditions.
- We also, therefore, need macroprudential regimes to ensure that these mechanisms do not lead to stability-threatening indebtedness or otherwise endanger the resilience of the financial system. We need, in particular, to be ready to contain private sector liquidity creation even when it is not driving excess nominal

demand growth. That will amount to arresting occasionally the expansion or leverage of the banking system and shadow banking sectors.

- Given its special role in international finance, the UK owes a special responsibility to the rest of the world to maintain the safety and soundness of the UK-resident financial system. It is therefore very welcome that the IMF has reached precisely that view in its new work on Spillovers. The Fund must ensure that we stick at it.
- Reciprocally, the Fund needs to go back to the Draghi Report and incorporate its lessons into Article IV and FSAP reports.
- As the Draghi Report stressed, we must try to identify and remove microeconomic incentives that distort risk-taking behaviour into dangerous channels. And given the interconnectedness of global finance, we – especially in the UK – must be alert even to such distortions elsewhere. US housing finance was a domestic system whose structure led to problems with global spillovers.
- The public finances should be managed with an eye to the nature and extent of risk exposures elsewhere in the economy.
- It is the precise pattern of capital flows, and the resulting composition of the resulting balance sheets, that matter to the stability of the financial system. All macro policymakers – monetary, macroprudential and fiscal – should, therefore, pay attention to the national balance sheet; and to the pattern of gross as well as net capital flows.
- But, in doing so, we and our peers must avoid financial protectionism just as a previous generation learned to oppose trade protectionism. And we must not leave anyone thinking that we can eradicate economic problems.

Emphasising that macroprudential policy alone cannot be a cure for everything, Paul notes that "even if we had avoided the worst consequences of seriously suboptimal *gross* capital flows – a badly overlevered banking system dependent on flighty wholesale funding – there would still have been the problem of unsustainable global current account imbalances."

In conclusion, Paul Tucker asks what financial and monetary policy can do today to ease the adjustment of overstretched balance sheets. He notes that the lingering threat of a severe crisis in the euro area leaves banks operating in an extraordinarily risky environment. As a result, "While in other circumstances it might have been possible to relax [banks'] capital requirements if the worst had passed, it is not a sensible course when the worst might still lie ahead. In current circumstances, gradually building resilience through retained earnings is best for stability and recovery, because it helps preserve the capacity to lend 'the day after tomorrow'."

This, however, he acknowledges, leaves the burden on monetary policy to underpin demand. "That stimulus can be sustained only so long as medium-term inflation expectations remain anchored to our target of 2%. We must be alert to the need gradually to withdraw stimulus as and when recovery builds. And we must be alive to the possibility that the alleviation of current macroeconomic problems could sow the seeds, somewhere in the financial firmament, of the next set of imbalances. Where risks to stability do emerge, we

must use what other instruments we have to try to temper them. This can never be perfect, but it can be better."

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