BANK FOR INTERNATIONAL SETTLEMENTS

Comments on “Bubbles and Central Banks: A Historical Perspective” by Brunnermeier and Schnabel

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Introduction

- Sea change in thinking about role of asset price bubbles in the conduct of monetary policy

- The modern study of bubbles has been relatively narrow and often maligned…but there is nothing like a crisis to re-invigorate the research debate

- Key question today is whether history can inform the current policy debate…this paper may help change the minds of sceptics

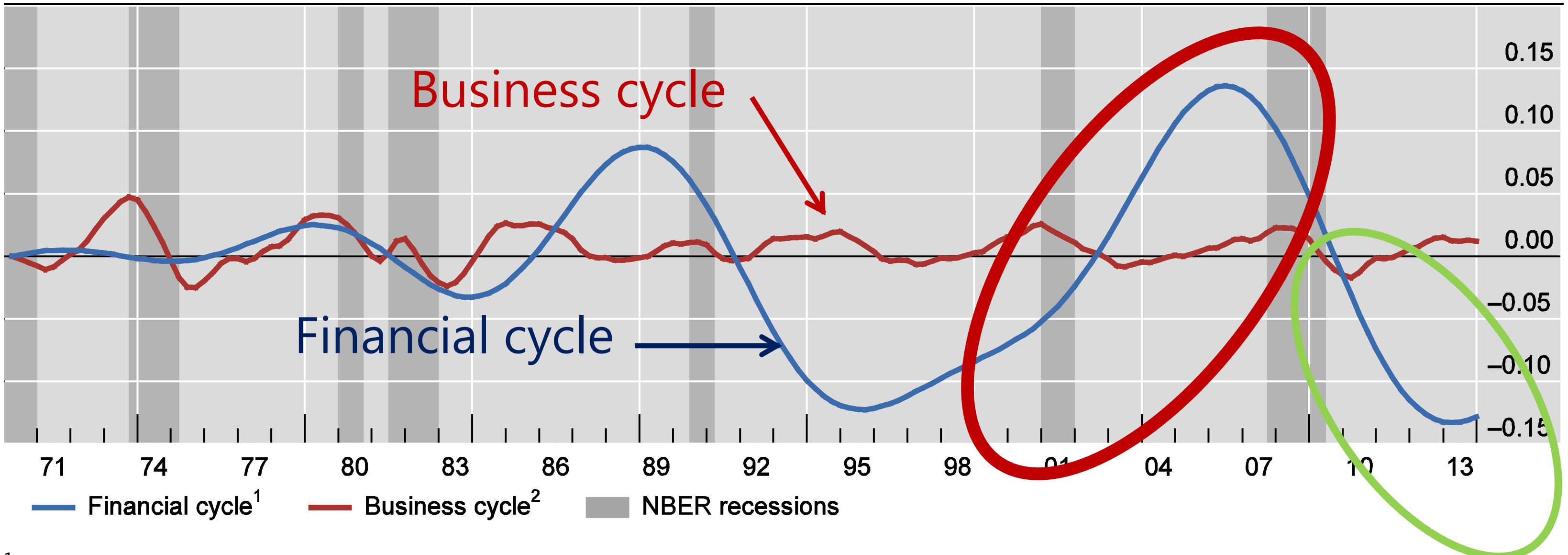
Kindleberger revisited

- What to the authors do?
  - Case studies spanning 400 years on bubble episodes with a focus on the policy responses (fantastic chronologies!)
  - Key conclusion: **bubbles matter**, especially the form of financing (leverage, lending booms & liquidity mismatches)
  - Policy implications
    - Benign neglect is costly (why didn't we know this?)
    - Late interventions problematic
    - Policy rates and macroprudential policies complements
- Sound and insightful methodology
- Clearly, asset price bubbles are an important part of the historical record of cyclical fluctuations

Bottom line: History shines a bright light on the financial cycle

Back from the wilderness

The financial and business cycles in the United States



[1] The financial cycle as measured by bandpass filters capturing medium-term cycles in real credit, the credit-to-GDP ratio and real house prices [2] Business cycle bandpass filter for real GDP.

Source: Borio, Drehmann and Tsatsaronis (2012), "Characterising the financial cycle: don't lose sight of the medium term!", *BIS Working Papers*, no 380, June.

1. Complex systems and antibiotics

- Capitalist economies are **complex systems**; the historical record warns us bubbles are inherent in all types of economies
- Bubbles are like some diseases which can become dormant but can be revived
- **No silver bullets** – there is no easy way to eradicate bubbles, and we shouldn't try! Indeed, trying to squeeze all uncertainty out of the system via policy backstops and interventions is likely to aggravate the problem of bubbles over time.
- Antibiotic view of central banks:
  - Antibiotics, like the central bank balance sheets, are very powerful tools for addressing pathologies
  - However, overuse has adverse side effects
  - And, more importantly, too much reliance on them opens up catastrophic possibilities later

Beware of overburdening central banks in the pursuit of stability

2. Addressing complacency risk over time

- Historical record: why do we keep forgetting the lessons?
- What are the implications for central banking today?
  - Relevance: many economies face bubbly environments
- Two approaches to reform central bank frameworks
  - ***Evolutionary*** – how to build in the "clean vs lean" tradeoff?
    - E.g. Norges Bank "Monetary Policy Report: with financial stability assessment":

$$L_t = (\pi_t - \pi^*)^2 + \lambda(y_t - y_t^*)^2 + \gamma(i_t - i_{t-1})^2 + \tau(i_t - i_t^*)^2$$

    - 'One small step for modelers, one giant leap for central banking'
  - ***Revolutionary*** – build institutional memory with multi-pillar approach (principles-based, not rules-based governance)

3. Multi-pillar approach to monetary policy frameworks

- Conceptual implications
  - Pillar 1: Short-term macroeconomic stabilisation pillar
    - Basically, traditional Taylor-rule approach
  - Pillar 2: Financial stability oriented monetary policy pillar
    - Low probability, high impact (tail) risks for the medium-term outlook
    - Incorporates financial boom-bust dynamics into a monetary policy framework
    - We need to avoid false hope from use of macroprudential/capital flow management tools
- Institutional implications: modelling, mandate, CB structure, communications approach

Inflation targeting, as we have known it, is simply not enough!

Conclusions

- Historical record is informative and contributes to the renewed interest in the global financial cycle approach in central banking
- To me, it underscores the enduring role of human behaviour in complex, capitalist systems that is not going away
- Policy regimes should confront this complexity, not try wish it away
- And, we need to focus on the whole cycle not just boom and bust phases – the post-bust phase is important too!
- Left wondering if the historical record can shed additional light on:
  - how to prioritise the pillars
  - how to think of the trade-offs amongst central bank balance sheets tools, policy rates, macroprudential tools etc (i.e. are they substitutes or complements)

Thank you

Open question: What does history tell us about prioritisation?

- How should the pillars be prioritised?
  - Lexicographical preferences?
  - Smooth trade-offs (Filardo (2007)[1])?
- And, what should a central bank do if other policymakers are unwilling or unable to do their part? Is monetary policy too blunt or is it the tool that "gets in all the cracks"?

1 "Asset Price Bubbles and Monetary Policy: A Multivariate Extension, BIS Working Papers.