Looking (appropriately) in the rear-view mirror

Colloquium in honour of Claudio Borio

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I have to admit that during my long career at the Bank for International Settlements (BIS) I never imagined I would be here, standing in front of you at a special event on the occasion of my retirement from this institution. Obviously, I did expect I would retire at some point – I am not that naïve – but definitely not this way. It never crossed my mind even for an instant!

It is only natural and appropriate that I start with a big "thanks". Thanks to my colleagues, who came up with the idea of the colloquium in the first place and who went to all the trouble of organising it. And thanks to all of you for having accepted the invitation. Actually, when Hyun [Shin] first mentioned the idea to me, I was more than … a bit concerned: what if no one turns up? How embarrassing would that be! Not just for me, but for the organisers! What a relief now! I never expected to see so many of you here and despite the terrible weather conditions at that! My heart can only fill with boundless appreciation and warmth because of your presence. A special thanks goes to those of you who have come from so far away. And let me also thank those who could not be here but went out of their way to send me messages explaining why they couldn't. I was especially looking forward to seeing Lars [Svensson], with whom I sparred so often, and who had to cancel at the last minute.

The idea was to bring together some of the people with whom I interacted more closely over the years – a kind of enlarged family. Of course, with one huge regret: and that's because Andrew Crockett, to whom I owe so much, is unfortunately no longer with us. And I would also have loved to see Alexandre Lamfalussy, with whom I worked quite closely as a young economist and who exposed me to the DNA of the institution.

After the thanks, an apology. Hyun kindly invited me to use the occasion to make some big statement about policy: a perfect stage for that! But I felt uncomfortable, for several reasons. First, I feel I have little new to say! I had plenty of time to do so and did use it. Second, last week in London I had a platform to put forward my views on one of the topics on which I spent a lot of my professional career – monetary policy frameworks. The speech has been released.[1] Finally, we have already covered a lot of substance today, and you have done it better than I could.

[1] Also available as C Borio, "Whither inflation targeting as a monetary standard?", *BIS Working Papers*, no 1230, December 2024.

Rather, I will take opportunity to reflect on my journey at the BIS and with all of you, looking very much in the rear-view mirror – but in this case, I hope, appropriately so. I will just say a couple of things about the future at the end.

The professional journey at the BIS

The first point to make is that this has been a heck of a ride!

When I joined the Bank in the distant October 1987, I could not have anticipated a ride like this even in my wildest dreams! And this, quite apart from the fact that I did not know whether I would stay here for long. When offering me the job, the BIS set the condition that I stay for at least … two years. Believe it or not, hearing that condition made me think it over. What can be so terrible about this place? I wondered.

In an interview a couple of weeks ago I was asked "Why did you stay so long?". It's like being a dinosaur these days! Only Phil [Lowe] has beaten me, having joined the Reserve Bank of Australia in his teens.

My answer? This is a great place. For three reasons.

First, of course, I love the subject matter – at the intersection of money, finance and the economy. But I am intellectually curious – this cannot be the deciding factor. Moreover, I could have pursued the subjects elsewhere, not least in academia.

Second, the clear sense of purpose. For one, I wanted to be closer to policy. You have to work harder for that if you are in academia. In addition, the BIS is unique among international organisations. We know very well who our clients are – we work for the central banking community. And they know that the BIS is *their* institution; in effect, they run it. This also means that we are extremely close to them. We have a very good sense of how they think, of the problems they face, of what is common and what differs among them.

Finally, the intellectual environment. We have at least *some* time to think about how to do things better and surprising freedom to do so. We have first-hand exposure to all aspects of money and finance; the BIS is also a bank; and regulation and supervision are here, too. I tried to take full advantage of this, seeking to cover in depth just about every area of central banking.

I hope my colleagues fully appreciate how privileged we are. It is often too easy to take it for granted.

Part of this intellectual environment is a distinguishing feature of central banks among policy institutions – proximity to the academic world. This event is yet another confirmation.

I have to admit that sometimes I wonder whether that link may become too tight: occasionally, central banks may appear all too eager to follow the latest intellectual fashion.

This brings me to BIS's role as a think tank. I always felt that, as a think tank, we had the responsibility of exploiting the two degrees of freedom we enjoyed relative to academia and central banks. For one, we are shielded from the "publish or perish" culture, which, understandably, exists within academia. In addition, we are shielded

from the huge political economy pressures central banks face when "pressing the button". This allows us to tackle bigger questions and to do so from a somewhat more detached perspective, sometimes outside the chorus. And we should be outside the chorus as long as we are intellectually convinced and draw on rigorous thinking.

Here, I have to praise central banks for practising what they preach. When all is said and done, they have allowed us to retain an important degree of independence to exploit that degree of freedom, even when the messages, at least initially, were quite uncomfortable. Think, for instance, of when we advocated a macroprudential approach to regulation and supervision when Basel II was moving in the opposite direction. Jaime [Caruana] was Basel Committee on Banking Supervision chair at the time, so he knows. Or think when we suggested – to use Bill's [White] phrase – that "price stability may not be enough".

The intellectual journey

This brings me to the intellectual journey that has accompanied my professional journey. What factors brought me to think the way I did? What shaped – some might say "distorted" – my thinking? What role did the institution play? I hope some of this may be of some interest to you.

It may not have escaped your attention that my perspective on things has been deeply influenced by a couple of beliefs. One is the fundamental monetary nature of our economies; the other is the need for solid anchors in the monetary and financial spheres … if I am allowed to use these two somewhat ill-defined terms.

Those beliefs have naturally been shaped by my experience and by key episodes that characterised it. Some precede my BIS years, but most took place during those years. Let me just mention three.

First, as an undergraduate and graduate at Oxford, I studied "money". This included Charles's [Goodhart] books! I recall, for instance, *Money, information and uncertainty* – a great book but with the smallest typeface that you can imagine! And I studied with someone as my supervisor whom some of you know; a very special character – Tony Courakis – who taught me a lot in terms of substance and mindset, always encouraging me to think from first principles and not to be afraid of asking critical questions: I owe him a lot.

You can see that, with that intellectual baggage – and having studied Politics, Philosophy and Economics (PPE) as an undergraduate – I would be ill at ease with the New Keynesian paradigm that has gained so much ground since the 1990s. That paradigm started from the other end, as it were – a real business cycle core – adding to it some, I would say misnamed, "nominal frictions". I am looking at my good friend Frank [Smets] here …

Second, at the BIS, an (obvious) defining moment was the banking crises of the early 1990s – the full-blown crises in the Nordic countries and Japan; and the serious strains in the United States. This highlighted to me the importance of credit and asset prices (especially property prices) – what later became "the financial cycle". And at least from Japan, it drove home the clear lesson that price stability is not sufficient for financial and macroeconomic stability – by the way, something that would have been

evident simply by looking further back in history, to the Gold Standard and the first globalisation era.

I recall a central bank meeting following the crisis in Norway when I asked Swedish representatives whether they were not worried about their country: the credit and asset price boom there was even larger than the one Norway had just experienced before its own crisis. They replied as quick as a flash: "not at all: our banks are much more profitable and much better capitalised". Well, we know how it ended! How could an experience like this one not leave a mark on your thinking?

That view simply grew stronger during my stint as secretary for the Committee on the Global Financial System (CGFS), and during my close interaction with Masaaki [Shirakawa] and Yutaka Yamaguchi. Japan was not – *could* not be – an outlier among advanced economies.

Third, (and less obvious) my work on operating procedures – how central banks go about controlling short-term interest rates to make the policy stance effective on a daily basis. This goes back to the time when I became secretary of the so-called Contact Group, which brought together those in charge of domestic operations. I'm sure Don [Kohn] recalls this because he was a member.

I understood then that I had to throw away all I had learnt in textbooks, centred on notions such as the monetary base and reserve requirements. And that the ultimate monetary anchor of the *whole* monetary sphere was just an overnight rate, and hence the central bank reaction function. This belief was reinforced by my work on payments systems, and the realisation of just how credit hungry our modern financial systems are, even just to execute intraday payments.

I guess you can see where all this is going. Our economies are crucially dependent on the "elasticity" that money and credit provide. The dividing line between these two notions – money and credit – can become exceedingly fine. As Piti [Disyatat] and I convinced ourselves in our long discussions, in many ways credit is more fundamental and primitive than money – logically and historically.[2] This elasticity needs to be constrained over longer horizons: credit and purchasing power grow endogenously and potentially in an unstable manner. Risk perceptions, asset prices and credit feed on themselves – the core of the "procyclicality" problem, as we argued in detail with Phil. And the real and financial sides of the economy are inextricably linked. Hence the notion of a financial cycle that is closely linked to, but distinct from, the business cycle, as traditionally measured. Constraining this elasticity calls for a monetary anchor. But that anchor may be too flimsy if monetary policy, which sets the "universal price of leverage" – I think Phil [Lowe] was the first to use the expression – does not care about what happens in the financial sphere and is only guided by the prices of goods and services.

Can one constrain the process by placing anchors on the financial sphere alone – ie on the balance sheets and risk management of institutions? This, of course, is the role of prudential regulation and supervision. I have always felt uncomfortable about this option. Why? Because balance sheets are ultimately based on valuations and risk perceptions that are subject to one of the self-reinforcing processes I just mentioned.

[2] See C Borio, "On money, debt, trust and central banking", *BIS Working Papers*, no 763, January 2019.

As we wrote with Andrew Crockett so many years ago: "prudential anchors ... can be no better than the ground in which they are planted. And that ground could, at worst, turn out to be quicksand."[3]

It was not entirely surprising to me that ahead of the Great Financial Crisis (GFC) supervisors were quick to brush aside concerns. They would say again and again: "the system has never been as well capitalised as it is now"; "banks are extremely profitable"; "risk management has improved in leaps and bounds since the Long-Term Capital Management (LTCM) crisis". Does all this ring a bell?

As an important aside, everything I have said so far sounds as if it is about an individual economy. But there is a critical international or global dimension, for a world in which – as Hyun likes to put it the "triple coincidence" does not hold – that of national borders, economic activity and currencies. This magnifies the "excess elasticity" to which national systems are subject and means that an "excess elasticity" is a property of the international monetary and financial system as well.

What about inflation and price stability, you might ask? Clearly, the monetary elasticity of the economy can accommodate both financial instability and price instability – with, I would argue, a strong *in*flationary bias: the monetary anchor is essential for both. But, as I see it, price stability is probably one step further removed from the influence of monetary policy. Since monetary policy operates through the financial sphere, price stability is also more closely influenced by real factors. Think, for instance, of the deep-seated forces that shape the bargaining power of labour and firms, of which globalisation has been one. This greater distance, coupled with the big influence of monetary policy on the financial sphere, clearly complicates the setting of policy – an issue we have examined in more detail with colleagues in our work on the "two-regime view of inflation".

Looking ahead, let me make just one observation. A key preoccupation over my career has been the excesses coming from the private sector – the financial cycle and private debt. But, as we have argued at the BIS, the unsustainability of fiscal trajectories probably represents the biggest threat to macroeconomic, price and financial stability as we look into the future. Concerns with public debt now loom much larger than in the past. Don't get me wrong: taming the financial cycle is still a serious challenge; the financial cycle has not gone away, by any means. In contrast to what happened in the wake of the Great Depression, and in contrast to what I feared, the GFC "earthquake" did not prove to be such a regime change and decisive historical moment. But the unsustainability of fiscal positions has added a whole new dimension to the challenges that policymakers face. Now, the root cause of the problem is similar, but elaborating on the issue would take me too long at this stage. For those who might be interested, it is explained in work I did with Piti and in a chapter of the BIS Annual Economic Report 2023.[4]

3 C Borio and A Crockett, "In search of anchors for financial and monetary stability", *Greek Economic Review*, autumn 2000, vol 2, no 2, pp 1–14.

4 See C Borio and P Disyatat, "Monetary and fiscal policy: privileged powers, entwined responsibilities", *SUERF Policy Notes*, May 2021, no 238 and Bank for International Settlements, "Monetary and fiscal policy: safeguarding stability and trust", *BIS Annual Economic Report*, June 2023, Chapter II.

Conclusion

Enough of the intellectual journey!

I would like to conclude very much the way I started: with a big "thanks". Here, I would like to thank, in particular, all my colleagues. First, the many great coauthors I've had over the years. But, beyond them, all the colleagues from whom I have learnt so much and to whom I am so hugely indebted. I have no doubt that under Hyun's capable leadership they will continue the tradition and, as he mentioned in a recent interview, "take it to the next level"![5]

[5] D Hinge, "The past and future of BIS economics", *Central Banking Journal*, 19 November 2024.