SPEECH

# Panel Remarks at Bank for International Settlements' Annual General Meeting

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**Remarks at the Bank for International Settlements' Annual General Meeting, Basel, Switzerland**

As prepared for delivery

Let me start by thanking Jens Weidmann and the Bank for International Settlements for the opportunity to respond and comment on Professor Hélène Rey's thoughtful remarks and on the issue of international spillovers associated with U.S. monetary policy. As always, what I have to say today reflects my own views and not necessarily those of the Federal Open Market Committee (FOMC) or the Federal Reserve System.[1]

As is characteristic of her work, what Hélène has to say is well-argued and provocative. It is also very relevant to the conduct of monetary policy and the functioning of the international monetary system. I mostly agree with the major points she makes.

First, I wholeheartedly agree with her on the hazards of financial booms. Rapid increases in credit and capital flows, asset prices, and leverage can lead to potentially severe corrections that can impose great stress on financial systems. As we have seen repeatedly, this stress can impair the ability of the financial system to perform well in intermediating credit between savers and borrowers, and in helping households and businesses manage their financial risks. When a financial system becomes impaired, there can be dire consequences for economic activity and the ability of central banks to achieve their macroeconomic objectives.

Hélène's work highlights an important global dimension to financial cycles, showing that gross capital flows, asset prices and credit often move in a synchronized way across countries as perceptions of risk change. As we now know all too well, the global financial crisis dramatically underscored the fact that instability in the U.S. financial system and those of other advanced economies imposed extraordinarily high costs on the entire global economy.

Making the global financial system more resilient and less procyclical has been a key focus of policymakers since the financial crisis, and most countries have made substantial progress on this front. This is evident in stronger capital and liquidity buffers for banks, lower reliance on wholesale short-term funding, reforms of over-the-counter derivatives markets, and the development of resolution and recovery regimes for banks and key financial market infrastructures, among other efforts. Nonetheless, we must continue to work on these issues.

In particular, the U.S. financial system—the epicenter of the crisis—has been considerably strengthened. Here, I would highlight additional reforms such as the Comprehensive Capital Analysis and Review (CCAR) regime, which imposes annual capital stress tests on systemically important banks; tri-party repo reform; and money market mutual fund reform. Policymakers globally have also made good progress on strengthening supervisory oversight, and are making headway—albeit more slowly—in developing effective macroprudential frameworks and toolkits.

But, more work remains to be done in several areas. I would put particular emphasis on the tasks of completing the creation of a credible bank resolution regime that will work on a cross-border basis, and developing effective recovery regimes for key financial market infrastructures.

I also agree with Hélène that monetary policy in the United States—given the size of its financial markets and the U.S. dollar's status as a reserve currency—can have a significant impact on global financial conditions, including exchange rates, and that shifts in U.S. monetary policy can lead to consequential shifts in global capital flows. However, it is also important to note that the impact of U.S. monetary policy restraint on emerging market economies (EMEs) has varied widely across tightening cycles. The impact depends on many factors, including EME fundamentals, asset valuations, and the extent and composition of prior capital inflows to those economies. Importantly, the impact has tended to be more benign when U.S. yields rise in response to good U.S. growth prospects. In contrast, spillovers have tended to be more adverse when increased monetary policy stringency is associated with a deteriorating U.S. economic outlook.[2]

These observations point to the need for the United States to keep its own house in order. Promoting economic growth and financial stability in the United States, I believe, is the most important contribution we can make to promoting growth and stability worldwide.

Like nearly all central banks, the Federal Reserve has a domestic mandate set for it—in our case, by the U.S. Congress. It cannot subordinate its legal mandate of maximum employment and price stability in the United States to alternative international goals. But, given the role of the United States and the U.S. dollar in the global economy and financial system, the Federal Reserve is—and indeed, needs to be—mindful of the international effects of its policy. That is because those consequences can have important potential spillbacks to the U.S. economy and financial markets.

The bond market "taper tantrum" of 2013 highlighted that prospective changes in U.S. monetary policy could affect the EMEs—particularly those with existing vulnerabilities—and how those consequences, in turn, could spill back to the United States. This episode underscored the need for clear communication and transparency around U.S. policy so that expectations can adjust smoothly and be appropriately calibrated to what is likely to occur.

As you know, the Federal Reserve has become increasingly transparent in recent years, in part to mitigate such risks. Good communication and transparency is always important during periods of conventional policy normalization. But, good communication and transparency may be even more important when one begins to unwind unconventional monetary policy actions, such as balance sheet policies with which we have little prior experience. Moreover, I would surmise that adjustments to balance sheet policies undoubtedly affect asset prices in ways that differ from changes in short-term interest rates.

Earlier this month, we announced an addendum to the FOMC's Policy Normalization Principles and Plans.[3] In this addendum, we spelled out how the balance sheet normalization program would work. This was another step in a long chain of communications about the balance sheet—incremental steps that highlight the evolution of our communication practices.

I hope you would agree that we have taken a very measured and careful approach.

This process started with the initial release of the Policy Normalization Principles and Plans in September 2014, which indicated that the FOMC planned to reduce securities in a gradual and predictable manner. Related comments followed in the minutes of the July 2015 FOMC meeting and the December 2015 FOMC statement. Subsequently, FOMC participants discussed potential long-run frameworks for monetary policy implementation as detailed in the November 2016 FOMC minutes.

Next, the March 2017 FOMC minutes reaffirmed that a change in balance sheet policy would be gradual and predictable, and achieved primarily by changing the reinvestment policy. These minutes also noted that most participants judged a change in reinvestment policy would likely be appropriate this year, should economic data develop as they expected. Then, in the May 2017 minutes, it was noted that nearly all participants had a favorable view of a phased-in, cap approach whereby reinvestments would be decreased gradually. Participants favored this strategy because a preannounced schedule would be gradual and predictable, limiting the magnitude of the runoff could help mitigate any adverse market effects, and the strategy would be relatively easy and straightforward to communicate.

Finally, as I noted earlier, we followed up in our last FOMC meeting with the release of an addendum to our Policy Normalization Principles and Plans that outlined how our balance sheet normalization plan will work when it is implemented. We also said clearly in the FOMC statement that if the economy evolves in line with our expectations, we expect to begin this process this year.

In response, market participants have progressively increased the probability assigned to a change in reinvestment policy this year. Yet, Treasury and agency MBS markets have responded little at the time of these announcements—including those undertaken most recently. To me, this suggests that these communications have generally been effective in fostering an orderly adjustment in expectations about how we are likely to normalize our balance sheet.

I also agree with Hélène about the important role of financial conditions in influencing economic activity. As I see it, financial conditions are a key transmission channel of monetary policy because they affect households' and firms' saving and investment plans and thus influence economic activity and the economic outlook. If the response of financial conditions to changes in short-term interest rates were rigid and predictable, then there would be no need to pay such close attention to financial conditions. But, as we all know, the linkage is in fact quite loose and variable.

For example, during the mid-2000s, financial conditions failed to tighten even as the Federal Reserve pushed its federal funds rate target up from 1 percent to 5¼ percent. Conversely, at the height of the crisis, financial conditions tightened sharply even as the Federal Reserve aggressively pushed its federal funds rate target down toward zero. As a result, monetary policymakers need to take the evolution of financial conditions into consideration. For example, when financial conditions tighten sharply, this may mean that monetary policy may need to be tightened by less or even loosened. On the other hand, when financial conditions ease—as has been the case recently—this can provide additional impetus for the decision to continue to remove monetary policy accommodation.

While I agree with Hélène in most respects, there are a few points where I am less convinced. While the global financial cycle complicates policymakers' ability to guide financial conditions in their own economies, I'm not persuaded that the trilemma has been replaced by a dilemma—that is, essentially an "either/or" choice between an independent monetary policy versus an open capital account.

While there is no panacea to insulate countries from financial spillovers—particularly when policy in some areas is constrained by the effective lower bound on interest rates—I think a combination of exchange rate flexibility, a credible monetary policy framework, sufficient foreign exchange reserves, and a strong financial system can help mitigate the effects of such spillovers. Moreover, it strikes me that market participants have become more discriminating over time about the circumstances of different countries, rather than painting all EMEs with a similar broad brush.

That said, I accept Hélène's suggestion that there may be other good alternatives, such as operating with less financial leverage and the increased use of macroprudential policy, including more aggressive stress testing. Also, the current regime—in which countries mostly have to self-insure against external shocks—seems inefficient. I believe that a regime with more risk-sharing across countries could be beneficial for the global economy.

Thank you for your kind attention.

The Andrew Crockett Memorial Lecture, 2017

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[1] John Clark, Gerard Dages, Linda Goldberg, Eric LeSueur, Jonathan McCarthy, and Joseph Tracy assisted in preparing these remarks.

[2] See "Spillovers from Unwinding Monetary Support in Advanced Economies," IMF, *2014 Spillover Report*, Chapter 2. See also, "On the Receiving End: External Financial Conditions and Emerging Market Growth Before, During and After the Global Financial Crisis," *World Economic Outlook*, April 2013, Chapter 4.

[3] See FOMC issues addendum to the Policy Normalization Principles and Plans.