



Financial Market Turbulence

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Monetary Policy, Incentives and Financial Stability

It may appear as a kind of paradox that a speaker from a small emerging market economy that has so far been almost perfectly insulated from the global financial turmoil, has been invited to a panel discussing that very issue. Nevertheless, there are two broad reasons why my participation may bring some added value. Firstly, just 10 years ago, my country was just in the middle of major financial crisis. The way how we got out of it may provide some useful lessons. Secondly, the global financial environment, prior to the turmoil as well as during it, has been presenting very challenging conditions especially for small economies such as the Czech one.

The deep financial crisis that hit the Czech economy during the period from 1997 to 1999 was caused, not surprisingly, by a mix of flaws in the financial system and suboptimal steps in monetary policy. To fix the problem properly, deep changes in the regulation and supervision of banks on the one hand and in monetary policy making on the other had to be implemented. The way how it was done was not based on more detailed regulation and tighter monetary control. Better supervision and smarter monetary policy was the approach. A similar approach should also be applied to the current financial turmoil, even though the monetary policy part of it seems to have been somehow neglected thus far.

The Czech financial crisis that occurred at the end of the 1990s was resolved well. The period since 2000 has been characterized by renewed economic growth, low inflation, stable and low interest rates and an appreciating currency. It is not only due to the fact that from the outset of the economic transition until the present time the Czech currency has appreciated in nominal terms by 73% against the dollar and 43% against the euro, that the koruna has gained the status of a safe haven currency. However, with this status it has also become quite sensitive to the changes in global financial markets. The shifts in policies of the key central banks have been increasing the volatility of the Czech koruna in rather asymmetric way – i.e. most of the time the koruna has exhibited a tendency to appreciate, sometimes quite sharply. The Czech currency has thus gained a very specific position – international investors have been buying it as a high-yielding asset from a successful emerging market economy and some have been borrowing and selling it because it has served, similarly to the Swiss franc or the Japanese yen, as a funding currency for the carry trades. Not surprisingly, after the outset of the financial

¹ The speaker would like to state that everything contained in this presentation represents his own views and not necessarily those of the Czech National Bank.

turmoil last August, the koruna has appreciated sharply again (so far by 12% against the euro and 28% against the dollar). With the safe haven status you cannot be sometimes sure whether you're a winner or just a victim when the global headwinds start to blow.

Despite the fact that the Czech economy is export-oriented and has a large manufacturing sector we openly adopted the position that we could not and would not try to artificially soften the terms for domestic producers. We were repeatedly explaining that these were the global pressures that a small economy could not avoid and that businesses had to learn how to weather them. This kind of approach contributed to the flexibility of the economy – something that a small economy in the current global world crucially needs. The exporters learned how to live with tough exchange rate conditions and factored in their future development into their expectations. The labour unions realized that currency appreciation improves the purchasing power of workers' wages which helped to discipline the wage dynamics.

The macroeconomic and financial environment that contributed to the development of trends leading to the financial turmoil in the developed economies has been creating risks for financial stability in small and emerging market economies as well. Due to the fact that the major central banks were keeping policy rates at a very low level after September 11, in the face of appreciation pressures, the Czech National Bank naturally had to keep its policy rate also at a similar or even a lower level. Your first impression might be that such a policy must be suboptimal since it will lead to a credit boom. However, in reality this policy has served more as a shield against the risks coming from the external environment. Unlike in some other countries, households do not have any incentive to borrow in foreign currency which makes their balance sheets insulated from exchange rate risk. In addition, with low interest rates the currency does not look like an attractive target at least for some classes of speculators. And what is very important, sustained exchange rate appreciation has been working against the formation of overly optimistic expectations in the corporate sector² and has been also shifting part of existing domestic demand from nontradeables to tradeables along the long-term trend towards higher consumption for non-tradeables thus contributing to a more balanced macroeconomic and structural dynamics.

There are many initiatives that have resulted from the current financial turmoil which are aimed at preventing the same problems arising in the future. However, it is highly unlikely that the financial institutions will make the same mistakes again since they will surely have learnt the lessons. They will of course make mistakes of another kind in the future. Most of the flaws that caused the current turmoil had already been removed. In my view, there is no strong need for immediate action. We need to carefully design deeply-thought

² In a country with a high share of tradeables on production (export-oriented economy with a strong manufacturing sector), the monetary conditions and financial constraint of the corporate sector may be significantly influenced by the changes in the external value of currency. Especially, trend nominal appreciation or a prolonged period of a "strong" currency will create monetary and financial constraint for the relevant sectors and reduce thus the risks of executing the investment projects with relatively low profitability (i.e. the project profitable only under the expectations of very low interest rates). In other words, the expansionary effects of low short-term interest rates may be partly curtailed by nominal appreciation of domestic currency.

reforms that would provide the incentives for financial institutions to behave in a more prudent way. All of us agree that regulation has to consider a broader view of risk in financial institutions including for example off-balance sheet exposures. The discussion whether or not the financial institutions should build stronger capital buffers during the expansionary phase of the cycle might also be relevant. In Europe, we should openly discuss how to establish the effective regulation and supervision of cross-border financial groups. However, in designing reforms it is crucial not to increase significantly the cost of regulation and supervision and not to prevent the financial system from creating innovative and competitive products.

Not so surprisingly, the role of past monetary policies in the financial turmoil as well as the changes in their future conduct that would not compromise the goal of financial stability are much less discussed. Nevertheless, we have to admit that besides global forces exogenous even to the key central banks their policies of keeping short-term interest rates very low for a very long time contributed to excess liquidity, a decline in risk aversion and an explosion of leverage. In other words, without the incentives provided by low short-term rates, the patulousness and size of risky investments would not have reached the levels observed. The monetary policies of central banks in large countries also contributed to the higher volatility of financial markets in smaller and emerging market economies whilst restricting the array of choices of central banks in these economies. Therefore, it seems to me that the current focus on changes in regulation and supervision might be excessive. It is also desirable to discuss how to adjust world-wide monetary policy-making in a way that would lead to a reduction in the volatility of markets and contribute to financial stability in the long run.

I am aware that such a discussion is particularly difficult. Nevertheless, it's just the right time to make a start. Over the past decade the central banks have achieved a lot in terms of transparency, predictability and accountability. Now it's time to turn our attention to the issue of symmetry in monetary policy-making. Cutting rates hastily when the economy goes down while hesitating at length when it goes up does not sound like a well-balanced recipe. And even though keeping short-term interest rates persistently at a very low level may not, under some circumstances, lead to high inflation, the negative impact of such an unnatural environment on the efficiency and adaptability of the economy will occur with nearly absolute certainty.