The Bulgarian National Bank at 140: central banks and the financial cycle

Opening remarks by Agustín Carstens

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Conference on the occasion of the 140th anniversary of the Bulgarian National Bank (BNB):

"The current global and European financial cycle: where do we stand and how do we move forward?"

Jointly organised by the BNB and the BIS

Sofia, 8 July 2019

Introduction

Thank you, Governor Radev.

Ladies and gentlemen, it is a great pleasure and privilege for the BIS to co-organise this conference celebrating the 140th anniversary of the Bulgarian National Bank. We congratulate our host on being the 13th oldest central bank in the world![1] The BIS is a bit younger – next year we will be celebrating our 90th anniversary. But our two institutions have worked closely ever since the founding of the BIS: the Bulgarian National Bank was one of the first 12 central banks invited to subscribe for BIS shares after the founding members did so in 1930.[2]

Your institution has ably navigated its way through some extremely challenging circumstances that have confronted the Bulgarian economy and Bulgarian society since 1879: periods of war and political instability, systemic transformation and institutional change, hyperinflation and remonetisation, financial booms and collapses.

This rich history ties in nicely with the main theme of our conference – the current global and European financial cycle. Tomorrow we will hear how our keynote speakers assess the current state of financial cycles at the global and euro area levels, as well as in European countries such as Bulgaria that are not part of the euro area. What I would like to highlight in my opening remarks is the central bank's role in safeguarding macroeconomic and financial stability. My own experience from Mexico, as well as lessons from Bulgaria's recent economic history, suggest that maintaining that role is essential in dealing with the financial cycle.

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1 See F Capie, C Goodhart and N Schnadt, "The development of central banking", in F Capie, S Fischer, C Goodhart and N Schnadt, (eds), *The future of central banking: the tercentenary symposium of the Bank of England*, Cambridge University Press, 1994, p 6.

2 See G Toniolo and P Clement, *Central bank cooperation at the Bank for International Settlements, 1930–1973*, Cambridge University Press, 2005, p 69.

Central banks encounter the financial cycle…

The concept of the financial cycle is relatively new in central banking circles, but the phenomenon it describes has been with us for quite a while. My predecessor Andrew Crockett used the term for the first time in a speech in 2000.[3] Despite much subsequent research at the BIS and around the world, Andrew, already 20 years ago, captured some essential features of the financial cycle.

The core idea is the notion of ebbs and flows in risk-taking. In a boom phase of the cycle, these manifest themselves in a rapid credit expansion, increased leverage and rising asset prices. Peaks in the financial cycle are typically followed by periods of financial stress – or worse, by financial crises.

The ebbs and flows of risk-taking are not necessarily driven by exogenous risk factors or shocks, which typically underpin banks' risk management models and central banks' stress tests. Instead they arise endogenously, from interactions in financial markets. One reason is that financial intermediaries are not as good at projecting the evolution of risk over the entire financial cycle as they may be at assessing relative risks at a point in time. Another is that global and domestic financial conditions interact with each other, often in unpredictable ways. For instance, easy global financial conditions coupled with domestic currency appreciation encourage external borrowing, including by banks. This in turn reinforces domestic credit growth and leverage. The mechanism seems obvious ex post, but may be hard to discern ex ante.

While I was at the Bank of Mexico, we faced many difficult situations relating to capital flows, exchange rate pressures, financial stability and inflation, often arising from developments in the United States. As in other emerging market economies (EMEs), capital inflows at times threatened to overwhelm the absorptive capacity of our markets – and this despite the best efforts of monetary policy.

And while I was Deputy Managing Director at the IMF, I witnessed a tide of global capital flows rising between 2003 and 2006 and flooding into central and eastern Europe (CEE), including Bulgaria. By 2007, capital inflows to CEE exceeded 15% of combined GDP − per year. This brought strong output and employment growth to the economies in the region, but also led to macroeconomic overheating, large current account deficits and massive bubbles in credit and real estate markets.

With the abrupt halt in capital flows in late 2008, the boom ended and CEE economies had to undertake extensive macroeconomic and financial sector adjustment. But by and large, banking systems remained stable and growth resumed relatively quickly. This stands in contrast to the financial collapse that Bulgaria experienced in 1996–97, when institutional foundations were much weaker and the policy framework inconsistent with underlying cyclical developments. I will return to this point shortly.

More recently, there has been another wave of capital inflows to emerging markets and to CEE, largely reflecting spillovers from extremely easy monetary policies in the United States and the euro area. In Bulgaria, for instance, growth of consumer and mortgage credit has rebounded to nearly double-digit annual rates since 2017, and has again been accompanied by rapid house price increases. But the banking sector has strengthened and macroeconomic imbalances are smaller than a decade ago, making a repeat of the 2009 downturn and financial instability unlikely.

[3] A Crockett, "In search of anchors for financial and monetary stability", speech by the General Manager of the BIS and Chairman of the Financial Stability Forum at the SUERF Colloquium, Vienna, 27–29 April 2000. See also A Crockett, "Marrying the micro- and macro-prudential dimensions of financial stability", remarks by the General Manager of the BIS and Chairman of the Financial Stability Forum at the 11th International Conference of Banking Supervisors, Basel, 20–21 September 2000.

…and start learning how to deal with it

The experience of CEE and other EMEs demonstrates that central banks *can* over time learn how to attenuate the consequences of the financial cycle. Policies along three dimensions are worth highlighting: institution-building for monetary and fiscal stabilisation; strong banking supervision and macroprudential policies; and developing international supervisory cooperation.

The banking and foreign exchange crises that led to the near collapse of the financial system in Bulgaria in 1996–97 resulted from a lack of the basic institutions required in a market economy. These would have imposed hard budget constraints on public and private enterprises, prevented monetary financing of fiscal deficits, and avoided runaway inflation. Once these institutions were put in place, the authorities could shift from improvised firefighting to normal macroeconomic management. In your case, the introduction of the currency board in 1997 helped stabilise exchange rate and inflation expectations as well as the fiscal situation. In the financial sector, stability was gradually restored after the privatisation of state-owned banks, the strengthening of banking supervision, and the introduction of bank bankruptcy legislation. Accession to the European Union has further boosted institutional reforms.

By the start of the Great Financial Crisis of 2007–09, macro and banking stability frameworks in the region were thus approaching international standards. However, supervisors were not sufficiently attuned to the risks associated with the rapid credit growth. In particular, risks associated with carry trades and foreign exchange lending to unhedged borrowers were not adequately priced.

Interestingly, awareness of these risks was greater in countries with fixed exchange rate regimes. Where interest rates could not be hiked to tighten credit, prudential tools were quickly recognised as an alternative. Bulgaria was thus one of the early practitioners of macroprudential policy, deploying the tools ranging from higher capital requirements to differentiated reserve requirements and prudential credit ceilings. Other CEE central banks issued guidelines on household lending standards, or used various capital flow management tools. Separately, but importantly, most CEE governments did not ride the wave of higher boom-related revenues, keeping public spending and deficit growth within limits.

But even relatively prudent monetary and macroprudential policies, and some support from fiscal policy, were not sufficient to tame the financial cycle. One reason is that the activities of foreign banks in CEE did not receive enough scrutiny from supervisors in their western European home countries. In the context of consolidated supervision, those banks were subject to home country oversight, leaving CEE supervisors with the impression that the subsidiaries were monitored adequately at the home country level. But individual CEE subsidiaries were mostly small compared with the overall size of the home country institutions, which limited the extent and intensity of their supervision.[4] And home country supervisors in CEE had little knowledge of local market conditions in host countries in western Europe.

Luckily, the need for supervisory cooperation was quickly recognised in the immediate aftermath of the crisis. Initially, regulators in a number of home countries pressed for deleveraging from investments in CEE. But following intense international negotiations, notably in the context of the Vienna Initiative, home countries recognised the potential dangers, for both home and host countries, of forcing banks to deleverage too fast. This agreement prevented a sudden withdrawal of western European banks from CEE, and helped stabilise banking systems in both parts of the continent. It also gave banks in CEE

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[4] See B Bakker and A-M Gulde, "The credit boom in the EU new member states: bad luck or bad policies?", *IMF Working Papers*, no WP/10/130, May 2010.

time to run down the high stock of non-performing loans from the crisis, and thereby avoid a repeat of the pre-crisis credit boom in an environment of very low interest rates.

In sum, your experience with stability-oriented institutional reforms, macroprudential policies and international supervisory cooperation is a good example of our need for both consistent policies at home and close cross-border cooperation to deal with the financial cycle.

Closing

In closing, let me thank you all for taking the time to join us here today. Many thanks in particular to our speakers, discussants and session chairs. I wish everyone a productive day, with insightful discussions both on and off the podium. And thanks again to Governor Radev and his colleagues at the Bulgarian National Bank for their cooperation and hospitality.