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Trust and Macroeconomic Stability: A Virtuous Circle

Agustín Carstens*

I. Introduction

Good morning.

It is a great honour to have been invited to deliver the Mayekawa Lecture at the Bank of Japan — Institute for Monetary and Economic Studies (IMES) Conference.

The list of past presenters of this lecture includes many influential international policymakers, among them Ben Bernanke, Jean-Claude Trichet, Olivier Blanchard and Raghuram Rajan. These distinguished individuals crafted the intellectual response to many of the key economic and financial challenges of recent times and assumed the immense responsibility of putting their ideas into practice.

It is a privilege to join their company.

For my remarks today, however, I will draw inspiration from an earlier era.

This lecture is named in honour of Governor Haruo Mayekawa. Mayekawa-san was Deputy Governor of the Bank of Japan from 1974 to 1979 and Governor from 1979 to 1984. This put him at the helm of policymaking at a time marked in much of the world by financial instability, large commodity price swings, high inflation and persistently slow productivity growth. The latter years of his tenure also saw rising tensions over global trade imbalances and exchange rate valuations.

Governor Mayekawa's legacy at the Bank of Japan extended beyond monetary policy. Notably, in 1982 he spearheaded the creation of IMES, reflecting the importance he placed on sound research as an input into policymaking. Since then, IMES has served as a bridge between the central bank, academia and the public. It has also been a forum for interaction and exchange between Japanese and international economists, a role that I know Governor Mayekawa deeply valued and championed.

Mayekawa-san's links with the Bank for International Settlements (BIS) ran deep. As Governor, he regularly participated in our meetings. Before that, he played a pivotal role in securing the Bank of Japan's re-entry into the BIS in 1970, making monthly visits to

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our Basel headquarters for several years. Today, the Bank of Japan is one of our most active members, and Governor Ueda serves on our Board of Directors.

The economic challenges Mayekawa-san faced as Governor have renewed salience today. Thanks to his steadfast leadership, Japan navigated them more successfully than many other economies. It is natural to ask whether there are lessons we can glean from that experience.

Towards the end of his tenure, Governor Mayekawa made a speech which was included in the first edition of the IMES in-house journal, *Monetary and Economic Studies*.[1] In it, he laid out what he saw as the main obstacles to global economic growth and proposed measures to address them.

He made four key points:

- First, persistently low growth reflected structural shortcomings. As such, demand management policies were not the answer. The only way to resolve structurally low growth is through structural reforms.
- Second, the best contribution that monetary policy can make to economic and financial stability is to deliver low and stable inflation.
- Third, high public debt and persistent fiscal deficits complicate the task of monetary policy and imperil long-term growth. For many economies, fiscal consolidation was in order.
- Fourth, a well functioning world trading system is fundamental to global economic prosperity. Protectionist measures, particularly those targeting bilateral trade imbalances, hinder long-run economic development.

Governor Mayekawa's policy prescriptions are as relevant today as they were four decades ago. I fully subscribe to them.

I would like to add a fifth point to Governor Mayekawa's list. Namely, that earning and retaining trust is essential for public policy to be effective.

To justify the importance I place on trust, let me first share some lessons learned during my career as a policymaker, which has now spanned more than four decades.

I have had a front row seat during numerous economic and financial crises. Early in my career at the Bank of Mexico, I witnessed the debt crisis that struck many Latin American countries in the early 1980s and the 1994 "Tequila crisis" in Mexico. I was first Mexican Finance Minister and then central bank Governor during the Great Financial Crisis (GFC), which exploded in 2008. The Covid-19 pandemic and its aftermath took place while I was in my current role at the BIS.

[1] Mayekawa (1983).

These crises were often a catalyst for important changes in policy frameworks. In many emerging market economies, the crises of the 1980s and 1990s led to the adoption of more flexible exchange rate regimes, greater central bank independence and an acceptance of low inflation as the main monetary policy objective. They also led to enhanced fiscal discipline and improved banking sector supervision and regulation. Some jurisdictions also undertook major structural reforms, including the liberalisation of product and labour markets and privatisation of public enterprises.

Similarly, the GFC and the subsequent low-inflation period led to an expansion of central bank policy instruments, particularly in advanced economies. This included the adoption of quantitative easing and forward guidance. The recent inflation surge has prompted further reassessments of policy frameworks.[2]

Economies have become much more integrated over the course of my career. They trade more with each other. And, due to the emergence of global value chains, they trade more intensively. We felt this intensely in Mexico, particularly after the adoption of the North American Free Trade Agreement (NAFTA) in 1994. Today, I see this international trade integration from the vantage point of a resident of Basel, which lies at the intersection of Switzerland, France and Germany. And it is very evident here in Asia, which is home to the world's most complex and efficient value chains.

More generally, the global economy has become extremely dynamic. Information flows are unfettered, and firms and consumers increasingly sophisticated. Perhaps most importantly, financial markets have become much larger, more integrated and faster-paced than they were when I started my career.

A consequence of all this is that the scope to sustain flawed policy frameworks has shrunk. Global financial markets' immense size and speed discipline policymakers and, at times, force policies to realign.

To be sure, financial markets do not read everything right. They can miss important signals and remain calm in the face of rising vulnerabilities. This can be a serious problem. It is precisely in tranquil times that the seeds of future distress are often sowed.

But when financial markets smell weakness, they can move very quickly. To quote the late Rudiger Dornbusch: "Financial crises take much, much longer to come than you think and then they happen much faster than you would have thought".[3] When that happens, policymakers need to react fast, often amidst great uncertainty and with their credibility dented. Unsustainable policies disappear swiftly.

What are the key lessons that I take from my experience?

[2] See, for example, Carstens (2025).
[3] Dornbusch and Fischer (2003).

The first is that crises are costly and best avoided. However, while adopting sensible policy frameworks can make crises less likely, sooner or later they will occur.

The second is that economies and financial markets always evolve. Policy settings and frameworks that seem appropriate today will ultimately need to change, perhaps very quickly.

Thus, it is critical for policymakers to have the nimbleness and flexibility to adapt, both to crises and to evolving economic and financial circumstances.

This takes me to the core issue that I would like to address: the value of trust in policymaking. It is much easier to make the necessary changes in a dynamic and uncertain environment — the theme of today's conference — if the public trusts policymakers and their policies. But the importance of trust goes beyond enabling change. Without trust, public policies cannot succeed.

II. Trust in Public Policies

What does "trust" refer to? Essentially, it refers to society's expectation that public authorities will act predictably in the pursuit of predefined objectives and that they will succeed in their task.

Why is trust so important? If the public trusts authorities' actions, they will incorporate those actions in their own behaviour. This makes it more likely that the authorities will achieve their objectives. Moreover, if the public trusts public policies, they will be more willing to accept measures that call for short-term costs but deliver long-term benefits. Trust underpins the effectiveness and legitimacy of policies.

Policymakers acquire trust by achieving their objectives over time. Hence the importance of setting clear goals, which provide a benchmark against which to evaluate policies and assess their success. But setting targets alone is not enough. Policymakers must also pursue them decisively, particularly when circumstances change.

There is a positive feedback loop in the dynamics of trust. Effective and legitimate policies make it easier for the authorities to achieve their objectives. This, in turn, builds trust, producing a virtuous circle.

However, this dynamic can also work in the other direction and, at times, very quickly. In the extreme, if trust evaporates, the capacity to make effective public policies disappears. Preserving credibility is a constant challenge. It requires consistency in public policies over time. Institutional arrangements, like independent central banks, can support this purpose.

To establish, preserve and enhance macro-financial stability, it is essential for the public to trust all of the key macro policy dimensions — monetary, financial and fiscal policies — individually and as a group. This requires coherence between them.

Let me elaborate.

I will begin with the most fundamental aspect of central banking: the nature of money. The social convention of money is based on the trust placed in it by the public. As money is the basis for the entire financial system, the system's stability ultimately rests on that trust.

Fiat money has no intrinsic value. Its worth derives from the social convention that underpins it, and from the institution that allows it to function: the central bank. Money only has value if people expect that others will honour that value, today and in the future. That is why the issuer of money is so powerful. This power comes with great responsibility. Those who abuse their ability to issue currency deprive money of its value and forfeit the trust of the public.

The consequences of losing trust in money can be disastrous. These can range from high inflation and sharp exchange rate depreciations to the substitution of the national currency with a foreign one. In the extreme, for example in hyperinflationary episodes, there could even be a return to barter. Such events typically go hand in hand with financial instability, sharply lower economic growth, widespread job losses and soaring inequality.

Central bank autonomy emerged to prevent such developments. After all, autonomous central banks are institutions within the state vested with a mandate to act in the public interest and preserve the purchasing power of the national currency. Their autonomy is the social engineering that solidifies society's trust in money.

In recent decades, many central banks have adopted monetary arrangements that allow them to anchor expectations and preserve money's purchasing power. Inflation targeting regimes are the most common framework to ensure this.

But what does inflation targeting consist of?

Central banks do not control inflation directly. But their policy tools can influence it. By adopting an inflation target, a central bank commits to use its tools to achieve that target. If the public trusts the central bank, then the inflation target, rather than current inflation, becomes a key reference point for price and wage decisions. This contributes to low and stable inflation. Inflationary episodes are usually short-lived, reflecting changes in relative prices. Inflation becomes self-equilibrating and ceases to materially influence the behaviour of households or businesses.

That is why the inflation outbreak that followed the Covid pandemic in many countries was so concerning. The trust central banks had gained over many years could have been lost if society had started to doubt their commitment to price stability. Some generations experienced the risk of the economy transitioning to a high-inflation regime for the first time. Once that transition starts, it can be hard to stop.

Faced with this risk, it was necessary and appropriate for central banks to tighten policy forcefully to restore price stability. The value of doing so is reflected in the relatively modest impact on output and employment, compared with the significant costs incurred during the 1970s and 1980s, when many central banks responded slowly to rising inflation and expectations de-anchored.

Let me now turn to my second example.

It is well known that the money issued by the central bank, known as primary money, is not the only money that circulates in a modern economy. Households and businesses rely instead on commercial bank money — in the form of bank deposits and credits — for the bulk of their day-to-day transactions.

It is thus essential that trust in money extends to commercial bank money.

At the same time, primary and commercial bank money are indistinguishable for most people. That is by design.

Over time, institutional arrangements have evolved to extend society's trust in primary money to commercial bank money within a two-tiered monetary system. The cornerstone of that system is that interbank payments ultimately settle on the central bank's balance sheet, through the exchange of primary money between commercial banks. This guarantees the finality of payments and the singleness of commercial bank money. The central bank's ability to create liquidity by lending to the banking system makes ultimate settlement of the banking system at the central bank possible. At times of great instability, the central bank can also provide liquidity through its lender of last resort function. In doing so, it safeguards public trust in the entire monetary system.

The value of the two-tier monetary system is particularly evident when contrasted with recent failed attempts to issue private forms of money through technologies based on decentralised ledgers. These alleged forms of money operate without central bank intervention, a lender of last resort or a robust regulatory and supervisory framework. They have led to the proliferation of so-called cryptocurrencies, which cannot guarantee payment finality, or maintain stable value, and so clearly lack the essential characteristics of money. In addition, the absence of regulation to guard against money laundering or counter terrorist financing means that these assets are widely used for illicit purposes. These developments highlight the critical point that the value of fiat money lies in the institutional framework and social conventions that support it.

The mere existence of a two-tier monetary system is not enough to guarantee trust. The banking system must also remain solvent. Strong, safe and solvent banks help to support the economy. Because banking crises have large social costs, the system requires adequate regulation and supervision. A complement is deposit insurance, which exists to forestall potential bank runs. Together, these layers of protection safeguard the public's savings and foster trust in both primary and commercial bank money.

Banks have become much more resilient since the GFC. Society reaped the benefits in the Covid pandemic, as banks played a vital role in keeping economies and businesses afloat, helping to support jobs. Even during the banking stress of 2023, the post-GFC reforms, combined with authorities' swift deployment of crisis management tools, limited the fallout to only a handful of institutions.

Nonetheless, more should be done do to bolster the banking sector's resilience. Make no mistake, the core responsibility lies with banks themselves. There is no substitute for sound business models, strong risk management and effective governance. But, in order to keep them on a sound footing in a more volatile and dynamic financial system, banking supervision must continue to up its game to identify and remedy problems at banks proactively.[4] And timely, full and consistent implementation of banking reforms and regulations, including Basel III, remains essential.

The non-bank financial system has grown rapidly in recent decades. This sector comprises many activities involving securities, including debt instruments and broader forms of intermediation performed by insurance companies, private credit, investment service companies and hedge funds, among others. In many jurisdictions, non-bank financial intermediation has for some time now accounted for over half of the financial system.

Recent episodes of extreme instability have highlighted the need for greater supervision and regulation of the non-bank sector. One reason is to prevent harmful arbitrage between regulated and unregulated financial activities. Moreover, the sector's links to the traditional banking system and the tendency of non-bank intermediation to generate opaque and excessive leverage and liquidity mismatches can pose systemic risks.

In recent years, some central banks have had to act as "market-makers of last resort" to defuse crises which threatened to spill over into the wider system. In doing so, they upheld trust in the broader financial system. Because such interventions may conflict with measures to preserve price stability, greater regulation and supervision of the non-bank financial sector are called for.

Let me now turn to my third example.

4 See Carstens (2023).

Within the universe of debt instruments, public debt is of particular importance. If used appropriately, public debt allows governments to successfully function. But, from a macro-financial point of view, it is important that any public debt is, and is seen to be, sustainable. Investors must trust the government to meet its financial obligations, without resort to central bank financing.

Public debt plays a strategic role. As the instrument with the lowest credit risk, it is essential for grounding the risk of asset portfolios, particularly those of banks. Furthermore, public debt serves as the main reference for valuing other forms of debt, such as corporate debt. Hence, defaults on public debt can destabilise the whole financial system.

They also threaten monetary stability since the central bank, even if it is formally autonomous, may be compelled to finance debt service with primary issuance, leading to fiscal dominance over monetary policy. The result would be rising inflation and sharp exchange rate depreciations.

In the light of these considerations, it is essential for fiscal authorities to curb the relentless rise in public debt. The low interest rate environment that followed the GFC flattered fiscal accounts. Large deficits and high debt seemed sustainable, allowing fiscal authorities to avoid hard choices. But the days of ultra-low rates are over. Fiscal authorities have a narrow window to put their house in order before the public's trust in their commitments starts to fray. Markets are already waking up to the fact that some paths are not sustainable. As I mentioned before, financial markets can remain calm in the face of large imbalances until suddenly, one day, they no longer are.

That is why fiscal consolidation in many economies needs to start now. Muddling through is not enough. In many countries, current policies imply steadily rising public debt in the coming decades. Pressures for more public spending will only increase, not least due to population ageing, climate change and, in many jurisdictions, higher defence spending. Fiscal authorities must provide a transparent and credible path to safeguard fiscal solvency, ideally underpinned by stronger fiscal frameworks. They must then follow through on their commitments. Central banks cannot be the only game in town.

Trust in the various aspects of macroeconomic policy — monetary, financial stability and fiscal — is closely interrelated. Monetary instability imperils financial stability, erodes investors' willingness to hold public debt and hammers public confidence. Financial crises have large fiscal costs. And loss of confidence in public finances compromises the stability of the whole financial system and can undermine price stability. All of this ultimately costs people in terms of lost opportunities, jobs and social and public benefits.

Thus, it is essential to preserve trust in all pillars of a country's macro-financial frameworks, and to ensure consistency between them. This represents a great challenge due to the involvement of multiple authorities and the existence of unavoidable political motivations, particularly in fiscal policy. While this is not an insurmountable issue, it highlights the value of coordination among the various arms of public policy.

Let me add a further reflection on the credibility of fiscal and monetary policy today, one that echoes the prescriptions of Governor Mayekawa four decades ago. Recent experiences should prompt a reflection on the appropriate role of monetary and fiscal policy and greater realism about what they can deliver. Fostering unattainable expectations about policymakers' ability to smooth out every economic pothole will ultimately lower trust in public policies.

For monetary policy, it would be prudent to avoid excessive "fine-tuning". Central banks should not be expected to stabilise inflation at very short horizons and within narrow ranges. This is particularly important because, as recent events have shown, inflation will partly depend on factors that are not under central banks' control.

Fiscal policy should seek to allocate its scarce resources to measures that can raise future growth. This can include investment in areas such as infrastructure, education and health systems. Nonetheless, we must remember that structural reforms are the best tool to sustainably increase a country's growth potential.

As a final remark, I would like to stress the importance of predictability in building and sustaining public trust. Predictability does not mean inertia. When circumstances change, or when frameworks are clearly flawed, policies must adapt. However, the public has a right to expect a degree of continuity and transparency about basic policy objectives, their development and the procedures for guiding any shifts in course.

III. Conclusion

Let me conclude.

Policymakers have faced frequent and intense challenges in recent decades. In the face of extraordinary strains, they strived to preserve the value of money, and keep their economies and the financial system functioning. Their successes illustrated the importance of maintaining public trust, which was a prerequisite for their decisive actions. And policies worked better when they were each part of a coherent whole.

If the events of the 21st century so far are a guide, we should not expect plain sailing in the coming decades. Building resilience will require policymakers to apply an appropriate policy mix and communicate it effectively.

I would like to leave you with this last thought. Part of preserving trust is to know the limits of what policies can deliver. Expecting policymakers to deploy extraordinary macroeconomic policies to respond to every challenge is a sure way to erode the public trust.

Building resilient and robust economies and financial systems is the best way to ensure that policies remain effective, so that they can be deployed when they are needed the most.

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