Keynote speech

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By way of introduction

It is a great honour – and a challenging one – to have been asked to be your keynote speaker this evening. Given the high standards achieved by these BIS conferences, this would have been the case even in ordinary times. But now we are living in anything but ordinary times.

Six months ago most of us believed that, with the improvement in the real economy and in the functioning of financial markets, the time had come to begin implementing, at a measured pace, exit scenarios for central banks and governments alike. This of course remains a valid objective, but now the immediate concern of our policymakers is to handle the ramifications of the Greek drama, which has led financial market participants to focus exclusively on the shift of indebtedness from the private to the government sector. This sudden and violent reaction says a lot about the wisdom of markets: after all, this shift represents the realisation of an explicit policy objective, and for about two years its impact on public sector deficits and the explosive growth of public debt have been a well known fact to anybody who cared to look at macroeconomic forecasts.

It is not my intention to comment on this new situation, except to acknowledge that it has injected a great deal of uncertainty into the current environment.

However, despite these uncertainties, I do believe that the past three years have thrown up well identified problems for the central banking community which are unlikely to go away – even if we manage to extricate ourselves from our present predicament sufficiently to minimise the risk of a systemic meltdown. It is to these problems that I propose to turn, by asking you to swallow simplifications which are unavoidable in a speech of half an hour (of which I have already consumed three minutes).

The pre-crisis environment

As a starting point, let's have a look at the pre-crisis situation, by which I mean prior to August 2007.

By the end of the 1970s, it was becoming increasingly obvious that the demand-boosting policies undertaken to offset the deflationary impact of the oil shocks had failed. Inflation had gained the upper hand – without preventing the gradual rise of unemployment. This set in motion an evolutionary process which was influenced by three propositions, strongly supported by a highly activist component of the academic community. The first was that inflation is essentially a monetary phenomenon, and therefore should be kept under control by monetary policy. The second was that in order to put in place the appropriate policy, central banks should be assigned the primary objective of securing price stability. And the third was that central banks should be protected from government interference in the design and implementation of monetary policy.

With ups and downs, this evolutionary process had matured by the late 1980s, producing two results: in the developed world predominantly, but also in a number of emerging economies, central banks were indeed assigned the duty to conduct their monetary policy with the primary objective of reaching price stability; and, simultaneously, they were granted independence from government interference. This independence concerned their monetary policy operations, and was defined in various ways – remember its US definition: independence not so much from, but rather "within" the government. Or the British solution which left the definition of price stability in the hands of the government. At the other end of the spectrum, the independence granted to the Governing Council of the ECB was the most explicit both in writing and in practice.

As regards prudential supervision, there was far less homogeneity within the central banking community. It was fairly generally agreed that central banks should play a role in maintaining financial stability, by assuming (what we would today call) a macroprudential responsibility. But there was not much precision in defining the mandate given in this field to the central banks. The position in this respect of the ECB – or indeed of the ESCB – is quite instructive. The Treaty says: "The ESCB shall contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system." This remarkably vague wording reflects the fact that a number of national central banks, as opposed to the ECB, are directly involved in microprudential supervision. The Statute of the ECB is barely more illuminating: "The ECB may offer advice to and be consulted by the Council, the Commission and the competent authorities of the Member States on the scope and implementation of Community legislation relating to the prudential supervision of credit institutions and to the stability of the financial system."

Retrospectively, it looks remarkable that the indubitable success of the stability-oriented monetary policies combined with the decent growth performance in the developed world – and the spectacular "emergence" of a number of very large countries – did go hand in hand for quite a long time with the preservation of financial stability. Certainly, danger signals were beginning to flash well before 2007, but in many respects the financial system appeared to be resilient. I myself aired my misgivings in my Bank of Greece Zolotas Lecture in 2006, under the pretty explicit title: *Monetary policy and systemic risk prevention – challenges ahead for central banks.* I argued there that while central banks have been strikingly successful both in maintaining the purchasing power of money and in contributing to the preservation of systemic stability, the sustainability of this success story should not be taken for granted. My concern was explicitly about financial stability rather than inflation, although I was far from expecting the eruption of a financial crisis of the intensity and generality we are now experiencing.

Central banks operating in a crisis situation

After this short historical reminder, let me now turn to the present and the future. The key question on which I shall focus my remarks is whether the active involvement of central banks in crisis management puts at risk the two main achievements of the pre-crisis years: the priority given to stability-oriented monetary policy, and independence of the central banks.

Our current experience has confirmed something that *was* to be expected: that, whether they like it or not, central banks are in the front line when it comes to keeping crisis manifestations under control. They have the resources, and their traditional banking operations give them a proximity to the money and financial markets which finance ministers or supervisors not connected with central banks do not possess. As long as this expertise was confronted with well circumscribed crisis manifestations in terms of geography, markets or sectors – as has been the case in a number of instances over the past 30 years – the central banking involvement could be kept within manageable limits.

What *is* new in the current experience is that central banks have had to carry out their liquidity-boosting operations in an environment where the liquidity shortage turned rather quickly into solvency problems of frightening dimensions – for which there has been no precedent since the 1930s. Nor has there been any precedent for the speed of contamination at the global level. The result has been an increasing variety of "non-conventional" central banking interventions, ranging from the lengthening maturity of liquidity support to quantitative easing of all shapes and sizes. In a number of instances, this has led not only to the spectacular expansion of the balance sheets of central banks, but also to the radical change in the composition of their assets, which implied the acquisition of risky assets. As a result, the key central banks have started navigating in uncharted waters, in terms of both operational techniques and their relations with governments.

Looking ahead

Allow me to have the luxury of standing back a little and discuss the pros and cons of giving a clear mandate to the central banks to assume a well defined responsibility in the preservation of systemic financial stability.

Let me start by making the assumption that the central bank has, or should have, a more or less well defined macroprudential mandate both in preventing the emergence of a systemic crisis and in participating in the management of such a crisis in case its preventive endeavours fail. Does this mean that it should also be in charge of microprudential supervision? Or, if not, what kind of relations should it have with the distinct microprudential authority? The positive answer to the first question would amount to what I would call an "integrated" model. The negative answer would lead to a "cooperative" model on the assumption that, willy-nilly, a form of cooperation has to be established between the micro- and macroprudential activities. There is no convincing empirical evidence, neither in the case of this crisis nor in that of earlier ones, which would help us to decide which of these two models has superiority over the other. Hence we are left to theorise.

There are two powerful arguments in favour of the integrated model, which reinforce each other. The first is the one I have already referred to. Whenever there are signs of an emerging crisis, the central bank is always in the front line: remember early August 2007. To be able to act swiftly and efficiently, it needs information, and the privileged source of information (so runs the argument) is, or should be, bank supervisors. Hence the need to ensure that such information flows freely and speedily from the microprudential supervisors to those who inside the central bank are in charge of the macroprudential responsibility.

The other argument is that the central bank is an operating bank, rather than a public administration, and has at the same time an oversight responsibility for clearing, settlement and payment systems. This means that it has access to direct market information, although it has to be kept in mind that when such information is provided, it might be rather late in the day. As a result, this privileged position does not make superfluous the forward-looking macroprudential vigilance. But it does mean that the central bank can give considerable help to the supervisors to encourage them to focus on the right questions in the accomplishment of their supervisory duties. Thus if the central bank is properly organised – a condition not so easy to satisfy – there can be mutually beneficial two-way traffic between the macro- and microprudential segments of the institution.

At the same time, there are two arguments against entrusting the central bank with a microprudential responsibility. The first is the danger of "polluting" the central bank's monetary policy decisions – an argument of weight when the central bank's primary objective is unquestionably price stability, as it is in the case of the ESCB. The second is the moral hazard argument: how can a central bank refuse emergency liquidity assistance to a bank over which it has supervisory authority?

In my "meditation" (I apologise for borrowing this suitable expression from Jean-Claude Trichet) on trying to find a way out of these conflicting arguments, I propose to submit to you three sets of considerations.

The *first* is to disagree with the argument that by necessity, or at least frequently, there is likely to be a conflict between the pursuit of the objective of price stability and the central bank's crisis prevention, or crisis management, macroprudential duties. It would be disingenuous to exclude the possibility of such conflict, but in matters of this kind we have to live with probabilities, not with certainty. I have two reasons supporting my disagreement.

One concerns asset price bubbles. It is of course true that asset price bubbles *have* coexisted with periods of price stability, but this does not mean that such bubbles would have had no medium- or longer-term upward influence on the price level. The likelihood of such influence seems to me quite high. But even if this were not true, using monetary policy tightening to lean against the developing bubble, or regulatory measures to fight the bubble – a difficult and politically surely not very popular exercise – would be unlikely to go against a (price) stability-oriented monetary policy stance. The exception would be the coexistence of nascent bubbles with a deflationary situation, which would seem to me to be an unlikely occurrence. A deflationary danger is more likely to arise when nothing has been done to try to stop the development of the bubble, retarding its bursting with the distinct risk of a "hard landing". And when the bubble does burst, an easing of the monetary policy stance would go in the right direction. As we saw with the US experience, a dilemma may arise when one type of bubble (the dotcom crisis) bursts, but another one – the real estate boom – continues to grow. The asymmetrical Fed reaction prepared the ground for our current crisis, but this asymmetry was not the result of an unavoidable conflict between stability-oriented monetary policy and the central bank's macroprudential duties, but of the Fed's benign neglect (or miscalculation) of the crisis-breeding potential of the real estate boom.

The other reason for my disagreement is that there are ways and means of separating the conduct of monetary policy from the liquidity support given to the banking system during a crisis. The example of this has been provided by the ECB, which has never missed an opportunity to insist on this dual practice and to forcefully deny its participation in unsterilised quantitative easing.

My *second group of considerations* is about the sources of information which should enable macroprudential supervisors to detect early signals of a potentially systemic crisis. Bank supervisors – the micro supervisors – are, or at least can be, a very valuable and reliable source of information on emerging financial stability problems. But how is it that (almost) none of them rang the bell in time? We should not be unfair to them. They are not without excuses for having remained silent on the emergence of systemic risk. Their mandate is of a microprudential nature. Their main job is to check the compliance of specific supervised institutions with existing prudential regulations and with their own risk management systems. They have not been mandated, and have not be trained, to ask themselves whether the changing nature of banking entails a systemic stability risk, or indeed whether non-banks are beginning to perform highly risky quasi-banking operations on a large scale. These are queries of a macroprudential nature, and you should not count on supervisors to respond to them.

This is far from being a new problem. During my "prehistoric" BIS years, when I tried to promote a dialogue between the bank supervisors of the Basel Committee and the central bankers working in the Eurocurrency Standing Committee (this misleading title hid a macroprudential mandate), the success was, to put it mildly, patchy and uncertain. During the late 1970s, some key central bankers were getting uneasy as they watched the wild enthusiasm and generosity with which banks lent to developing countries, notably in Latin America. I met little concern among the bank supervisors, who insisted on the floating rate arrangements, which were supposed to protect the banks' margins, and on the "highly liquid" nature of the banks' claims. Fortunately, we had at our disposal global statistics on bank claims on these countries, which were held in the banks' portfolios and were increasing at an alarming pace, and much of which were very short-term indeed. This carried the argument, since it was obvious that the liquidity of these claims was an illusion, and that the protection of the margins in case of rising interest rates would have the perverse effect of pushing the debtor countries towards the unilateral suspension of their debt service – which in fact was beginning to happen in 1982. This was an interesting early demonstration of the unintended consequences of a major (but by today's standards very primitive) financial innovation.

It is this experience that triggered my conviction that asking bank supervisors to detect the potentially systemic impact of new practices, of changing management models or of innovative new products is to ask something that may well appear alien to the accomplishment of their prime microprudential duty. It may even distract them from carrying out their – not particularly easy – duty. I have no doubt that this duty (especially in the case of large cross-border institutions) is a very demanding one. We have an expression in French: "il vaut mieux ne pas mélanger les genres".

A possible solution that has occurred to me is that the supervisors should be accompanied in the accomplishment of their core mandate by macroprudential supervisory colleagues in charge of detecting the emergence of potentially systemic dangers. These persons should have full access to whatever would have been detected during the supervisory activities, but should in no way be prevented from having their own contacts, at whatever level of responsibility, in the bank. And if they came across facts and figures that might warrant closer inspection, it would be their prime duty to explore with the rest of the macroprudential team whether the combined information should trigger macroprudential concerns, or even action. Their task would also include gathering information on what might be happening in the broader markets. The large cross-border institutions typically cover a wide range of activities, as a result of which they are a precious source of information on such developments as the emergence of new types of financial intermediaries, the changing business model of existing ones, and, naturally, new innovations. Acquiring such information, cross-checking it and adding it up would help the central bank to obtain a prospective view of what might happen in the future, rather than having to fight the last war.

My *third* point is to stress that if central bankers wish to minimise the risk of being pushed, by circumstances, towards the use of "non-conventional" intervention tools, it is in their prime interest that the reforms under discussion to improve crisis *prevention* be effectively implemented. It is my absolute conviction that, in this respect, *structural reforms* should receive priority treatment. This, unfortunately, is more easily said than done. There are two reasons for this. On the one hand, such reforms have to be implemented globally – and financial structures vary considerably from country to country (look at the well known differences between Europe and the United States). On the other, they touch substantial vested interests, and you can count on the fierce opposition of the beneficiaries of those interests.

Whatever opinion one may have about the desirability and feasibility of the Volcker package, there is no doubt in my mind that the questions to which the package attempts to supply an answer are the right ones. Has the financial sector grown in size beyond a level that would be justified by providing services to the "real" economy? It so, what to do? Has the size of individual financial firms (and not just of banks) grown to the extent that it makes it hard to bail them out, and perhaps even harder to let them fail? If so, what to do? And what are the merit and feasibility of the narrow bank argument?

And, most importantly, *how can we extricate ourselves from the unappealing moral hazard trap*? The widespread belief that systemically important financial institutions will always be bailed out has two devastating consequences: it encourages reckless risk-taking by such institutions, and provides them with an unfair competitive edge over the rest of the financial industry by ensuring cheaper financial resources for them. To avoid this happening, it has to be made clear that no financial firm, and especially banking firm, should count on being protected from failure. But no such statement will appear credible unless ways and means are found to ensure that the absence of a bailout has no systemically disruptive consequences. Trying to find and agree "globally" on such crisis resolution processes should rank very high on the political agenda. It should also receive strong support from the central banking community.

Concluding remarks

To conclude, let me briefly sum up these lengthy remarks by trying to reply as explicitly as possible to the question raised earlier: is there a danger that the active and innovative involvement of central banks in crisis management will put at risk the two major achievements of the pre-crisis years, namely the priority given to (price) stability-oriented monetary policy and the independence of central banks? I propose to submit to you four specific conclusions.

Conclusion no 1. I do believe that central banks should be given an explicit macroprudential mandate as regards both crisis prevention and crisis management. One reason for this recommendation is my conviction that our globalised, competitive and highly innovative financial markets will continue to breed financial disturbances of a size and nature that could lead to systemic meltdown. Another reason is that I have doubts about our ability to correct global imbalances, which therefore will continue to nurture a crisis-friendly environment. My last reason is that, with or without a mandate, central banks will find themselves in the first line of defence. It would seem to me preferable to give them a well defined framework within which they should operate, rather than rely exclusively on improvisation. We will always need improvisation, but we also need an operational framework.

Conclusion no 2. For reasons I tried to spell out in some detail, I believe that we should not attach excessive weight to the argument that such a mandate would "pollute" the implementation of a (price) stability-oriented monetary policy. On the other hand, I believe that the macroprudential mandate should carefully avoid giving implicit approval of asymmetrical policies regarding asset price and/or debt bubbles. Any perceived asymmetry would sooner or later be detrimental to financial stability, and might also cause damage – although not with the same degree of certainty – to price stability.

Conclusion no 3. Should central banks be entrusted with microprudential supervision? I doubt the wisdom of raising this question in abstract terms. I have tried to say this evening that what really matters is the flow, quality and speed of information between micro- and macroprudential supervision and acknowledging that these are two distinct, but very complementary functions. Depending on the specifics of organisation, on tradition and on the "human factor", ensuring the appropriate flow of information may succeed – or fail – in both the integrated and the cooperative model.

Conclusion no 4. Is central banking independence at risk? Yes, it is. The risk arises from the obvious fact that having to comply with two distinct mandates pushes the central banks into a much more complex world. The modalities of their independence in their monetary policy function may be debatable, but, once agreed, the terms of independence can be reasonably well defined. In the case of the macroprudential mandate (in both models), this is much more difficult. Once it appears that an initial liquidity problem is mutating into a solvency problem, and especially when the latter implies the risk of a systemic meltdown, the central bank has to operate hand in hand with the government. But hand in hand can mean very different things – this is why I am pleading for a reasonably well defined operational framework. The macroprudential mandate implies for the central bank a type of relationship with, and therefore a type of independence from, the government that is different in substance from the one governing monetary policy. The rules of the game on both sides have to be spelled out.

How to conclude? All the actors – central banks, governments, international organisations and, naturally, market participants – are navigating in waters uncharted by reliable historical experience. The complexity of the current situation is without precedent. But there is no way of “opting out” of this complex world. Wishing that we could go back to the professional and intellectual comfort of the pre-crisis years is a pipe dream. This does not make me a pessimist. At a time when europessimism is fashionable, I derive quite some hope from the progress being made towards setting up a European Systemic Risk Board, under the auspices of the ECB, which, if properly implemented, will respond to many of my queries.

Thank you for your attention.