T T Mboweni: Central banks in times of turmoil

Address by Mr T T Mboweni, Governor of the South African Reserve Bank, at the Gordon Institute of Business Science, conducted in conjunction with the Helen Suzman Foundation, Johannesburg, 28 May 2008.

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1. Introduction

The global financial landscape has changed dramatically over the past twelve months, with global financial markets experiencing a financial crisis of note in the history of the world economy. The impact has been severe, with some of the world's largest and most credible financial institutions reporting large consecutive quarterly losses. By the end of March 2008, the market capitalisation of banks globally had declined by USD720 billion. These developments prompted the former US Fed Chairperson, Mr Alan Greenspan, to remark that "the current financial crisis in the US is likely to be judged as the most wrenching since the end of the Second World War".

Financial market asset prices have also echoed these extremely distressed circumstances and volatile conditions, in some instances requiring unconventional responses by central banks and other international institutions. Recent events again put into full perspective the crucial role of central banks in times of turmoil. In particular, the dual responsibility of central banks to implement monetary policy as well as contributing to financial stability has become much more challenging.

2. Causes of the crisis

The financial market turmoil, which started around July 2007, was initially triggered by huge losses on US sub-prime loans, disclosures of delinquencies and foreclosures by households, as well as a number of major hedge funds which reported substantial losses.

Exceptionally benign macroeconomic and financial market conditions between 2004 and mid-2007, as reflected by robust economic growth and low inflation and interest rates, however, fostered an underlying search for yield over recent years. At the same time, decades of vigorous financial innovation facilitated a deepening of capital markets, easier access to credit by households and enterprises through a variety of new and complex instruments. In recent years, however, financial innovation has been increasingly associated with complacency in risk management. In particular, the lack of transparency of these complex products may have made it easier for investors to underestimate the risks they take on, as well as the under-pricing of risk in some key asset markets. In addition, with prudential regulation sometimes lagging behind financial innovation, some institutions may not have been sufficiently transparent about their exposures to complex structured financial products on and off their balance sheets.

In these circumstances it is not surprising that the most recent Triennial Survey of the BIS showed that the credit derivatives market has witnessed substantial growth, from USD118 billion in 1998 to USD52 trillion in 2007. The main participants in credit derivatives, comprising about 80 per cent of the total market, are banks and hedge funds.

The announcement of losses by hedge funds exposed to US sub-prime mortgages in mid-July 2007 triggered the reappraisal of asset prices, and excessive market volatility with a general flight to quality or less riskier assets. Credit risk evolved into liquidity risk and banks struggled to obtain funding as interbank liquidity dried up, causing sharp increases in money-market rates in the major financial centres of the world.

3. How deep and widespread?

What began as a fairly contained deterioration in portions of the US sub-prime market has evolved into severe dislocations in broader credit and funding markets that now pose risks to the global macroeconomic outlook.

In April 2008, the International Monetary Fund (IMF) estimated that declining US house prices and rising delinquencies on mortgage payments could lead to aggregate losses related to the residential mortgage market and related securities of about USD565 billion, including the expected deterioration of prime loans. Adding other categories of loans originated and securities issued in the US related to commercial real estate, consumer credit market and corporations, total losses are estimated at almost USD1,0 trillion.

Tighter credit conditions imposed by banks, the erosion of consumers' spending power due to rising inflation and continuous increases in energy costs have impacted severely on the US economy. According to the IMF, the continuing correction in the US housing market and the unresolved problems in the financial sector have led the US economy to the verge of recession. The IMF has downgraded its forecast for GDP growth in the US in 2008 to 0,5 per cent, while the Fed, in its latest FOMC minutes released on 22 May 2008, expects the US economy to expand by between 0,3 and 1,2 per cent. This has serious implications for global growth, particularly for countries whose economic performance depends heavily on exports to the US.

One of the interesting developments I would like to mention is that, whereas previous crises originated from emerging-market economies, developed markets were essentially the epicentre of the crisis. So far emerging markets have also proved relatively resilient to the financial turmoil. Improved fundamentals, abundant reserves and strong growth rates have all helped to sustain flows into emerging market assets. However, there are macroeconomic vulnerabilities in a number of countries that make them susceptible to a deterioration in the external environment – in particular countries with current account deficits financed by private debt or portfolio flows, and countries in which domestic credit has grown rapidly. There is also a risk that banks in developed markets may pare back funding to their subsidiaries in emerging markets, particularly in circumstances where external imbalances are large. Emerging markets are, therefore, by no means isolated from the turmoil in developed markets.

4. The role of central banks

Central banks assume a crucial role when market liquidity dries up and funding constraints cast doubt on the solidity and safety of financial institutions. Central banks have to prevent or limit systemic risks. In essence this entails addressing adverse dynamics and preventing the collapse of financial intermediation.

During normal times, central banks provide sufficient liquidity to the banking system to keep their policy rates effective. Generally, a reliable relationship links the short-term policy rate and longer-term money-market rates and counterparties effectively distribute liquidity to the wider market. However, in mid-August 2007, the pattern of banks' liquidity demand in the US changed: the short-term yield curve steepened and became more volatile, the gap between secured and unsecured rates widened, and the broader interbank market that distributed liquidity throughout the system was disrupted.

At the immediate onset of the crisis, there was a strong increase in demand for central bank liquidity (i.e., reserves at the central bank), but as the crisis unfolded, commercial banks desired increased liquidity beyond central bank balances. Initially, both the ECB and the Fed provided additional funds, while the Bank of England allowed banks' increased demand for reserves to be reflected in higher reserve targets. As uncertainty over the financial soundness of counterparties increased, trading of unsecured term interbank funds dwindled because banks – and other clients – wanted to borrow long-term funds but lend only in the

short term. Hence, term funding dried up and longer-term yields rose sharply. Central banks were able to increase the volume of longer-term refinancing to the market without expanding their balance sheets by withdrawing liquidity at other maturities or periods. This approach helped to achieve the twin goals of executing monetary operations while addressing financial stability concerns.

Central banks had to face a number of challenges in addressing financial system stress. Firstly, they had to deal with the breakdown of standard distribution channels for liquidity, both nationally and internationally. This was because the provision of sufficient liquidity to a small group of intermediaries no longer guaranteed that it would either flow through the system, or to those in need of funding in specific currencies, as stress in money markets spread to foreign exchange swap markets. Secondly, some banks lacked direct access to open market operations (OMOs), either because they did not belong to the list of eligible counterparties, or lacked the eligible collateral. Finally, central banks had to project liquidity demands at different time horizons, as demand patterns changed rapidly and unexpectedly, and the impact of factors such as year-end effects became increasingly unpredictable.

The decision by central banks whether or not to provide additional liquidity to markets and to bail out failing banks has its own set of complexities. Clearly central banks have to be concerned about systemic risk. The provision of overall liquidity is probably more clear cut, as such provision is generally done against appropriate collateral, although this requirement was relaxed in a number of instances.

With regard to bailing out failing banks, there are more difficult issues. Firstly, there is the issue of moral hazard to consider. Should a central bank under all circumstances bail out a bank – even when it has been mismanaged? How does the central bank ensure that its lender-of-last-resort assistance doesn't result in excessive risk taking and poor risk management by banks?

Secondly, the issue of timing and the degree of intervention required has to be considered. Acting too soon can increase the risk of moral hazard and favour bad firms over good ones. Acting too slowly can exacerbate the consequences. The Bank of England, for example, was accused of delaying too long in attempting to save Northern Rock. In my view, there is no such thing as the perfect handling of a bank failure. A bank failure is a financial disaster, and the most central banks can do is damage control. It is a very difficult call to make whether or not to try and save a failing bank, when to intervene and to what extent to intervene. Whatever decision is taken is normally criticised by some or other group of stakeholders. In addition, central banks can usually not disclose the information upon which their decisions were based.

However, even central banks that focus primarily on price stability sometimes face possible conflicts of objectives. The most obvious one is probably the potential conflict between maintaining price stability and financial stability. The issue may be complicated by the fact that there could be a negative feedback loop from financial instability to macroeconomic instability, which in turn feeds back to the financial sector.

Central banks potentially have conflicts of interest, being at the same time a participant and regulator of financial markets. Banks that are supervised by the central bank are often also counterparties. This has the potential of complicating decision making, unless properly governed. I am sure that this is not a major issue affecting the role that central banks play in maintaining financial stability: it is generally well managed and control through segregation of duties and firewalls between operational, supervision and policy departments or divisions. However, it is something that central banks should remain sensitive to and manage diligently.

5. Other role players

In all of their activities, central banks have to be very sensitive to changes in the structure and functioning of the financial markets. These changes take place on an ongoing basis, and

a trend normally becomes visible only after it has progressed fairly significantly. One such change that is occurring is the bigger role played in global financial markets by a number of new players, in particular sovereign wealth funds (SWFs), private equity funds and hedge funds. The role of SWFs in the current crisis is particularly of note, and it is also interesting to see how the activities of these funds occurred complementary to those of central banks.

Sovereign wealth funds appear to have played a stabilising role during recent times, alleviating capital constraints and absorbing some of the market volatility. These institutions contributed USD41 billion of the USD105 billion capital injected into major financial institutions since late 2007. There are several factors that facilitate the ability of SWFs to act as a stabiliser in times of market stress. These include the fact that they have a long-term investment horizon and limited liquidity needs and they have a stable funding base and no capital adequacy or prudential regulatory requirements that could force it to liquidate positions. However, the long-term impact and the potentially stabilizing role of SWFs as major institutional investors will require a broader set of data and assessment, and you may well be aware that some SWFs are regarded with quite a bit of suspicion as regards their long-term motives for investment.

A number of other institutions also played important roles during the current turmoil, and several initiatives were announced to improve regulations and enforce disclosures, aiming to restore and improve financial stability. At the national level, the US Department of Treasury issued a blueprint for regulatory reform in the US during April, part of which has come into effect, with the US Securities and Exchange Commission announcing its plan to require top Wall Street firms to publicly disclose their liquidity and capital positions.

At a broader level, the Bank for International Settlements (BIS) has also been active. From mainly focusing on capital adequacy over past years, the Basel Committee on Banking Supervision is now also devoting more time and resources to the analysis of risk and liquidity management of banks. It will require wisdom and insight to draft and implement the most appropriate regulatory reforms. In addition, the Financial Stability Forum (FSF), an international body under the auspices of the (BIS) has established a Working Group on Market and Institutional Resilience.

6. Concluding comments

We have been relatively fortunate in that the Bank did not have to deal with the same financial stability issues that confronted central banks in Europe and the United States. The impact of the current turmoil in global financial markets affected South Africa indirectly, through changes in share prices, bond prices and the exchange rate, rather than directly, as South African banks had almost no direct exposure to the US subprime market. Not surprisingly, given the state of the international banking environment, international credit lines are more difficult to access and the domestic securitisation market is much tighter. Our banks however have not had any interbank or liquidity problems of the type experienced in Europe and the US, and the South African Reserve Bank has not had to intervene with any unusual liquidity provision.

The fact that we have not had to be concerned about liquidity and financial stability issues has allowed the Bank to continue focussing on its objective of bringing inflation back to within the target range. As you are aware, our inflation rate is significantly above our target of 3-6 per cent, and we remain committed to bring inflation back to within this range.