Masaaki Shirakawa: The role of central banks in the new financial environment

Remarks by Mr Masaaki Shirakawa, Governor of the Bank of Japan, at the International Monetary Conference, Kyoto, 9 June 2009.

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Introduction

Let me first thank the hosts for inviting me to the International Monetary Conference. The IMC has a very long history of providing not only its private sector members, but also the public sector with an excellent opportunity to frankly discuss a broad range of issues regarding financial institutions, financial markets and the financial system.

We are unfortunately still in the midst of an unprecedented financial crisis, although hopefully the worst is behind us. The topic the organizers have given to us central bankers, "The Role of Central Banks in the New Financial Environment", is clearly a very timely one, something which is on our minds everyday. The fundamental role of a central bank remains unchanged, but its functions have gradually changed with the passing of time. In the case of the Bank of Japan, on-site examinations of financial institutions were introduced in 1928 based on the experience of the financial crisis after World War I. The Bank of Japan Act was revised in 1998 to strengthen the independence of monetary policy. This reflects, among others, the lessons learned regarding the conduct of monetary policy during the bubble period of the latter half of the 1980s. At that time, our on-site bank examination was also given a clear legal backing.

How will the role of the central banks around the world change in light of the current global financial crisis?

In considering this issue, I would like to first pose two questions to the top executives that are here with us today. First, in the years heading up to the crisis, especially the five year period between 2003 and 2007, did you recognize that risks were building up in your institution and/or in the financial system? Second - this is a question about the now famous quote regarding dancing with the music - if we were in the future to experience a similar benign economic period of high growth, low inflation, low interest rates and low market volatility, would you choose a different business strategy? If you were to choose a different strategy, what would be your expectations on the path that senior executives of your rival institutions would choose?

While you are responsible for making your bank both profitable and resilient to shocks, the role of the central banks is to assure that your endeavors lead to a sound financial system conducive to economic prosperity. What we central banks need to understand is that the behavior of market participants will be influenced by human nature and competitive pressures in the markets.

Without trying to paint a complete picture, let me raise a number of issues with respect to the role of central banks which I believe are important in the new financial environment.

Role of central banks

Assessing risks on a system-wide basis

First, central banks need to assess risks on a system-wide basis taking into consideration the linkages between the real economy and financial markets as well as among financial institutions. Such assessment will be the basis for policy actions regarding financial system stability. Of course, this is a typical example of something that is easier said than done.

Before the current crisis, central banks issued warnings regarding the build-up of risks through financial system reports. However, issuing warnings are not so difficult. Senior bank executives and other market participants themselves, to some extent, recognize such risks. If we seriously wish to reduce such risks, remedial action is required. But in order to go beyond analysis and take remedial actions, a proper assessment, a strong will, together with a robust legal framework which enables effective action, are all necessary. In any event, without a system-wide assessment, no actions are possible. I believe central banks are in a natural position to take up such an assessment role. As the entity responsible for monetary policy, central banks focus on macro economic conditions, have close contacts with financial market participants, and our institutional culture emphasizes the importance of research.

Reconsidering the conduct of monetary policy

Second, we need to reconsider the conduct of monetary policy. When one looks at market participants and senior bank management collectively, their incentives are also influenced by macro economic and financial conditions. The most typical example would be the search for yield witnessed during the so-called Great Moderation. This incentive issue evolves into a difficult challenge for monetary policy when asset bubbles emerge. The problem is often debated simply as whether monetary policy should lean against the wind or excessive asset price increases. However, I believe that such a formulation of the issue confuses the discussions on monetary policy. No central banker believes that bubbles can or should be prevented just through monetary policy. A more practical formulation of the issue for central banks would be, "how should monetary policy be conducted in an environment where asset prices are rising, credit and leverage are increasing and the economy is growing, strongly signaling a need for policy tightening, while only general prices remain stable?" In such a bullish atmosphere, raising policy rates somewhat would have little short-term effect in dampening bubble-like economic activity. On the other hand, if the central bank maintains very accommodative monetary policy, this would amplify the expansion of credit and leverage. When we debate the relationship between monetary policy and bubbles, we can neither be too optimistic nor too pessimistic. The build-up of excesses cannot be constrained by monetary policy alone. We need a combination of policy measures. At the same time, if monetary policy is inappropriate, the bubble will grow even more, eventually bursting and causing a sharp contraction of the economy.

Revamping prudential regulation

Third, central banks need to contribute to the on-going debate in revamping prudential regulation. Central banks may or may not be the regulatory body depending on each country's legal framework. Nonetheless, regardless of the legal framework, central banks, which are responsible for the stability of the financial system, can and should play a constructive role in designing prudential rules. The behavior of financial institutions is strongly influenced both by the macro economic environment and by prudential rules. As a specific example, prudential rules such as regulatory capital requirements and bank practices such as provisioning need to be reviewed with the aim of reducing pro-cyclicality. A framework whereby banks build up buffers during good economic conditions so that they can use such buffers to maintain their financial intermediation function during difficult macro conditions is essential.

Strengthening the provision of banking services

Fourth, the banking services central banks provide need to be strengthened. In recent years, central banks have taken multiple steps to enhance the stability and efficiency of the payment and settlement system, such as steps to minimize settlement risks emerging from time zone differences in foreign exchange transactions and enhancing payment and settlement system oversight. During this crisis, in the area of money market operations,

central banks have expanded the range of collateral and counterparties, and major central banks have conducted coordinated operations to provide US dollar liquidity. These measures have helped bring back stability to financial markets.

However, in ever-changing financial markets, challenges remain. It is often mentioned that financial markets are gradually becoming seamless in a figurative sense. But, it is far from seamless even if it were limited to financial transactions and their settlement. During the day, incoming payment instructions and outgoing payment instructions are not completely synchronized, and thus the need for intraday credit emerges. This is most typical in foreign exchange transactions, although such risks have been reduced through the introduction of CLS. Additionally, market volatility can suddenly increase short-term funding needs, as financial institutions require additional collateral under margining arrangements. As a result, in the process of financial transactions, leakages of liquidity or temporary storage of liquidity become inevitable, and seams emerge. In times of crisis, the shortage of liquidity caused by such seams can aggravate the situation. Central banks will need to continuously review how our banking services can fill such gaps.

Enhancing organizational culture and human capital

In concluding I would like to emphasize the importance of the organizational culture and human capital at both central banks and the private sector. Organizations cannot flourish without a rich culture emphasizing fundamental aims and without a deep pool of human capital embodying such a culture.

First, both central banks and financial institutions need to cultivate a culture emphasizing the importance of maintaining a long-term perspective. Otherwise, both cannot attain their goals on a sustained basis: long-term macro economic and financial stability for central banks and long-term profitability for the private sector, respectively.

Second, in the case of central banks, we need to be in a position to help fill the gaps of incomplete contracts and markets. Financial transactions are concluded using various forms of contracts, and it is impossible to prepare a contract which can cover each future state. Using economics terminology, "complete contracts" do not exist. A central bank can, for example, function as an honest broker or a catalyst, in supporting the development of a market-based solution to a newly emerging issue. In order to be in a position to fill such gaps, it is critical that central banks are sensitive to changes in the financial markets and financial industry. However, since central banks are not profit motivated organizations, there is the risk that we do not promptly recognize such changes. On the other hand, individual financial institutions and other market participants do not necessarily have the incentive to internalize the possible effects of their behavior on the overall financial system. Maintaining stability in the financial system would not be possible without cooperation between central banks and the private sector. Central banks need staff who have excellent people skills to cultivate constructive relationships with financial institutions and market participants, understand the details of business practices, and honed their macro perspectives. One of the important roles I have as governor of a central bank is to cultivate such an organizational culture. In a similar vein, I hope you can foster a culture within your institutions that recognizes the importance of our collaborative efforts and would support our work by informing the public sector in a timely manner of possible buds emerging in the economy or financial markets which may harm the stability of the financial system. As I mentioned at the outset, the IMC provides an excellent opportunity for such dialogue.

I will stop here. Thank you.