Christian Noyer: Central banks in the financial crisis – a European perspective

Speech by Mr Christian Noyer, Governor of the Bank of France and Chairman of the Board of Directors of the Bank for International Settlements, at the Bank of Korea International Conference, Seoul, 1 June 2010.

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Introduction

Ladies and gentlemen,

It's a great pleasure for me to address such a distinguished audience. First, let me thank the organizers of the conference for giving me the opportunity to open this second day of the conference. Yesterday's contributions have been outstanding and, in view of our program I have very high expectations for our discussions of today.

From the outset, Central Banks have been major actors in fighting the financial crisis. Overall their actions have been broadly successful. In the period to come, however, steering the economy may prove more challenging and new risks can weigh negatively on the recovery underway. A case in point is the brutal reassessment of sovereign risks by market participants. The euro-area has been at the epicentre of this phenomenon. Some market segments have become dysfunctional to a point that jeopardized the transmission of monetary policy. The Eurosystem has therefore resorted to new steps to contain those tensions and prevent their spill over to the real economy. The sovereign debt turmoil is the most recent episode of a crisis that started already more than two years ago. It reminds us if need be that crisis management is a difficult and potentially long lasting task and that we should always keep in mind that our policies have effects not only the current course of events but also through the expectation of the private sector that they may be repeated in the future.

It is therefore timely to reflect upon the past, present and future course of Central Banks' actions.

I – The seeds of financial instability

It is paradoxical that the crisis took place after a protracted period of nominal and real stability. In particular, inflation had remained low and remarkably stable for nearly two decades. This unprecedented degree of price stability mostly reflects a combination of central banks' credibility and the effects of a benign economic environment.

This macroeconomic stability has however not prevented deep imbalances – macroeconomic and financial – to grow in parallel, reinforcing one another. The abundance of savings in the world, specifically in emerging economies, prevented real long term interest rates from rising and stimulated the pace of credit expansion, especially in the US. Indeed, when policy rates were raised in 2004 in the US and late 2005 in the euro area, long term rates responded much less than in previous interest rate cycles and the yield curve flattened unexpectedly.

Over the same period, financial markets have gone through deep structural changes. Financial innovation and extensive financial engineering fuelled a "search for yield" through increased risk taking. The development of securitisation has spurred the demand for new types of instruments. This demand led the financial system to generate new assets even at the cost of extending credit to ever riskier sub-prime borrowers. This, for a time, helped sustain a rapid increase of real estate prices which in turn stimulated the growth of mortgages.

The main causes of the crisis therefore lie in the growing "real" imbalances and the uncontrolled development of financial innovations. Overall, these combined evolutions led to a generalized increase in leverage and financial fragility.

Against this background, it is quite unlikely that too accommodative monetary policies played a central role in the crisis. Some analysts have pointed out to what they see as an "asymmetric response" by monetary authorities to asset price increases: Central Banks would not lean against asset price bubbles, but were prepared to clean the consequences after they burst. However, we need to ask ourselves whether the unusually rapid credit growth in the years preceding the crisis should not rather have called for complementary policy actions on the supervision side. Some attempts were made in the Eurosystem. In particular, the Bank of Spain enforced dynamic provisioning to curb domestic credit expansion. But the crisis hit globally nevertheless and it raises several challenges for authorities in charge of macroeconomic policies.

II –Managing the crisis

Starting in august 2007, Central Banks were confronted with major and unprecedented tensions. Increasing uncertainty led to liquidity hoarding by financial institutions. Banks severely limited the maturity, the scale and the number of counterparties to whom they would lend. This liquidity freeze further deteriorated after the bankruptcy of Lehman in September 2008. Central banks intervened massively in order to tame the liquidity crisis and prevent its spill over to the real economy. This intervention took various forms across countries, reflecting the specificity local financial markets.

In the Euro area financial intermediation occurs mainly through the banking system. Most of our actions, therefore, aimed at providing banks with sufficient liquidity through repo operations to ensure that the flow of credit to the economy would not be severely disrupted. We have been fortunate to enter the crisis with a very appropriate set of tools. From the outset, our operational framework was based on a very broad list of eligible counterparties and collateral. So, we could adjust to the shocks in money and credit markets without creating new facilities, with the small exceptions of the covered bonds and, more recently, government bonds purchases.

Doing so, we have been able to maintain a clear separation between monetary policy and liquidity provision. A major step was taken in October 2008 when we moved to a regime called in our jargon "full allotment fixed rate", which basically means that banks were given unlimited access to liquidity at the prevailing policy rate. Over the course of the crisis, we made several downward adjustments to that policy rate. But we never committed to any specific path or trend. We always kept the possibility, while providing the banking system with unlimited amounts of liquidity, to change the interest rates of all our facilities. And, obviously, this remains true today.

Because asset purchases played a very limited role in our operational framework, the unprecedented expansion in our balance sheet was never a source of concern. By essence, repo facilities are self expiring and self exiting. A vivid illustration will come in July when our one year long term operation expires and our balance sheet will contract by a third. A very useful complement comes from the systematic sterilization of our more recent asset purchases.

Our interventions have had significant effects on monetary and market conditions in the Euro zone. Liquidity conditions improved markedly. The decrease in policy rates, from 4.25 % in September 2008 to 1 % in May 2009 was largely passed-though to bank lending. This return to more favourable conditions has supported economic recovery.

During this period, four main factors have contributed to the success and efficiency of our operations:

- First, our credibility. At no time during the crisis have inflation expectations significantly deviated from our definition of price stability. This was most apparent, and crucial, during those months when headline inflation stayed in negative territory, the output gap was itself strongly negative and the risks of deflation could have materialized.

  With inflationary expectations strongly anchored around 2%, the "zero lower bound" never really was a problem. Short term real interest rates were brought at negative levels, with sufficient speed to stabilize the economy despite the unprecedented shock which followed the Lehman failure.

- second, the flexibility of our operational framework
- third, the strong and efficient cooperation between all Central Banks, which materialized through the speedy implementation of swap agreements and, most visibly, in the coordinated reduction in interest rates which occurred in October 2009
- Finally, for France, we drew important benefits from having the Central Bank taking important responsibilities in banking supervision and financial stability. At any single point in time, we could efficiently draw on our knowledge of the banking sector, our broader vision of financial markets and our macroeconomic expertise.

III – Challenges for the future of central banking

In the past, financial crisis have always triggered important changes in the organization and practice of Central Banking. Will this one be an exception? Two interrelated but different questions are currently debated: should Central banks take more responsibility in fostering financial stability? And should monetary policy itself be conducted in a different way? These are deep and difficult issues which may take many years to elucidate. Here, I will try and give some preliminary – and personal – insights.

1/ – Few people would discuss that Central Banks should have a bigger financial stability role in the future. They have a strategic stake in the functioning of financial markets. Financial conditions, such as developments in asset prices or in the quantity of credit affect the transmission of monetary policy. Central Banks also have the expertise needed to address these issues.

In many countries, the Central Bank is already formally recognized as the systemic supervisor. In Europe, the ECB will play an essential role in the future European Risk and Stability Board. There are big advantages in keeping financial supervision close to the Central Banks. Central Banks need to have an intimate knowledge of the banking system. And, on the other hand, bank supervisors benefit when they can complement their unique vision of individual situations by a broader perspective on financial and macroeconomic dynamics.

2/ – Even when pursued by Central Banks or under their aegis, financial stability should be first maintained by specific tools. The general objective is to strengthen the financial system's resilience to downturns and limit activities that increase systemic risk. Three approaches are currently pursued:

- increasing robustness and strength of individual banks through hardening capital and liquidity requirements. This is the purpose of adjustments considered to the Basel II framework. A BIS and Central Banks' working group is currently assessing the macroeconomic implications of the reforms.

- mitigating the pro-cyclicality of financial systems. Accounting rules have an essential role to play, in this regard, both to allow for early recognition of risk through expected loss provisioning and avoid excessive volatility through adequate valuation principles.
- systemic risk should be contained via the creation of resolution mechanisms for financial institutions as well as promoting more resilient market infrastructures, such as CCPs for clearing and settlement of derivatives products.

The financial crisis also gives us the opportunity to think about Central Banks fundamental task: the making of monetary policy. Amongst the many questions currently asked in academic and policy making circles I will select four:

1/ – ***the mandate***: recent proposals have been made to assign monetary policy additional financial stability objectives, possibly by amending Central Banks mandates. I see those proposals as misguided. First, adding a financial stability objective at the same level as price stability could weaken the latter. Second, if price stability is not a sufficient condition to ensure financial stability, it is certainly a necessary one. And, finally, current mandates seem absolutely appropriate to allow Central Banks to fulfil all their responsibilities. Looking, more specifically at the Eurosystem we have a "hierarchical" mandate, giving clear and unambiguous priority to achieving price stability; and, once this objective has been met, it allows us to pursue other goals. Financial stability easily fits into the set of those "secondary" objectives. This clear priority was understood by the markets. It was most apparent in our decision to raise policy rates in July 2008. It was essential to give us the necessary leeway to act decisively later – when the financial system was in danger of paralysis – without compromising our credibility.

2/ – the operational framework: most Central Banks conduct monetary policy through changes in interest rates. Many do not pay close attention to monetary aggregates. The Eurosystem stands alone in developing a formal monetary analysis through its "second pillar". At the very least, however, the crisis has shown that liquidity matters. The assumption of permanent liquidity allowed the shadow banking system to develop and proper. Excessive maturity transformation has fueled the growth in leverage. Liquidity premia were all but eliminated for a long period of time.

It is legitimate question whether those evolutions have implications for monetary policy. Recent research tends to show that even small changes in policy rates could have had non-negligible implications forcing some intermediaries to close leveraged positions and, potentially, to partially correct some financial imbalances. Those issues may still be relevant today when in face of uncertainty, liquidity provision remains important. This is why, even for monetary policy purposes, Central Banks should keep actively monitoring asset prices, credit flows and liquidity conditions.

3/ – a closely related question pertains to the transmission mechanism. Evidence tends to show that risk appetite tends to increase when interest rates stay low and liquidity is perceived as abundant. This is called the "risk taking channel" of monetary policy. Risk taking behaviors are amplified when monetary policy is permissive. Ultimately, this channel creates a link between the levels of interest rates and risk premia. And this, of course, means that movements in interest rates have, everything equal, a bigger (and may be less predictable) impact on the financial system, credit aggregates and asset prices. A lot of work remains to be done to precisely quantify that channel and disentangle its effects from those of the more "traditional" credit channel. Nevertheless, it is clear that, in the future Central Banks will need to pay greater attention to that specific impact of their decisions on the financial system and the economy. The risk taking channel provides the best rationale for "leaning against the wind" when financial imbalances tend to grow.

4/ – the last question is especially topical here, in Korea. How much should we care about the "global monetary stance"? This is not an easy concept to define, or to use from an operational point of view. On the other hand, we know that some determinants of price stability are global: they depend on the combined effects of our national policy stances. Put it differently, there are externalities associated with our different monetary policies. For instance, divergences in monetary policies, however justified by national circumstances, can fuel capital flows and create financial imbalances. In theory, those problems can be dealt either with total exchange rate flexibility or , on the contrary, fully sterilized interventions and the dynamic use of foreign exchange reserves. Neither of those polar solutions appear fully attractive or feasible. This is why the search for new “financial safety nets” i.e. ways to delink reserves creation from monetary policies and exchange rate management appear promising and, although very complicated, should be encouraged. These are extremely difficult issues. But I want to pay tribute to the leadership taken by Korea on this question during its G20 Presidency.

Conclusion

To conclude, I would like to outline what I see as the main lessons central banks should draw from the crisis.

First, financial crises are a pervasive feature of modern capitalism. While the exact timing of a crisis is hard to predict, situations of financial fragility, when some sectors have increased their debt and leverage in parallel to asset prices, reduce the resilience of financial systems to asset price reversals.

Second, timely and determined interventions of central banks can quench the thirst of financial markets for liquidity and limit the spill over of liquidity squeezes to the real economy. Central banks have demonstrated that their international cooperation could be relied upon even under extreme stress in financial markets that have become integrated at the global level.

Third, central banks should both prepare to manage future financial crises and design their policies in order to minimise the risks of future financial crises. For the least, central banks should avoid that their policies stimulate potential excessive risk taking, which although benign in good times, increase the scale of insolvency in the event of an asset price reversal. This is the best way to limit the risks to price stability over the longer run.

Thank you for your attention.