

Elizabeth A Duke: Central bank cooperation in times of crisis

Speech by Ms Elizabeth A Duke, Member of the Board of Governors of the Federal Reserve System, at the Center for Latin American Monetary Studies 60th Anniversary Conference, Mexico City, 20 July 2012.

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It is a pleasure to participate in this commemorative conference on the occasion of the 60th anniversary of the Center for Latin American Monetary Studies (CEMLA). Since its establishment in 1952, CEMLA has achieved a great deal on both the policy and research fronts to promote our understanding of monetary and banking issues in Latin America and the Caribbean.

The topic I have been asked to speak about today, “Central Bank Cooperation in Times of Crisis,” is very important. As we know, central banks typically work individually to achieve objectives for their domestic economies. In the case of the Federal Reserve, monetary policy is conducted to achieve our statutory objectives of maximum employment and price stability. And, of course, fostering a stable financial system is key to attaining these goals. But the experience of the past few years has illustrated – first with the global financial crisis and more recently with the strains in Europe – that cooperation and coordination among central banks around the world may be necessary at critical junctures to achieve these domestic objectives.

In my remarks today, I will describe the evolution of the Federal Reserve’s policies during and after the global recession and show how many of those policies were undertaken in coordination with, or in parallel to, similar actions by other central banks. I will start with the monetary policy responses of the Federal Reserve and other central banks during the financial crisis. I will then discuss the efforts that the Federal Reserve has made, often in cooperation with other central banks and international partners, to help enhance financial stability. Finally, I will focus on the challenges facing Latin American central banks, whose economies and financial systems were affected by the crisis itself, and by the responses of other central banks to the crisis.¹

Federal Reserve policies and coordination with other central banks

Although the financial crisis that emerged in the summer of 2007 initially manifested itself as a sharp deterioration in U.S. mortgage markets, the roots of the problem ran deeper. Indeed, the consequences of a credit boom combined with excessive leverage, mispricing of risk, and deficiencies in risk management became increasingly apparent. And given the international extent of these vulnerabilities and interconnections, the crisis quickly became global. Central banks around the world responded forcefully.

From the outset, the Federal Reserve vigorously used its traditional toolkit for managing short-term interest rates. The Federal Reserve reduced the target federal funds rate from 5-1/4 percent in August 2007 to a range of 0 to 1/4 percent by the end of 2008. International coordination on policy rate decisions is rare, but in October 2008, the Federal Reserve announced a reduction in its policy rate jointly with five other major central banks: the Bank of Canada, the Bank of England, the European Central Bank, the Swedish Riksbank, and the Swiss National Bank. With clear signs of simultaneous economic slowing in many countries, this coordinated action sent a strong positive signal to financial markets about policymakers’

¹ My remarks today reflect solely my own views and not necessarily those of others in the Federal Reserve System.

collective intent to mitigate the effects of the crisis on their economies. Although not through directly coordinated actions, other central banks, including those in Latin America, were also reducing policy rates.

The stresses in financial markets and liquidity shortages were severe. So, in addition to cutting policy rates, the Federal Reserve took measures designed to provide liquidity first to banks and later to other financial institutions. A third set of measures involved the provision of liquidity to address pressures in commercial paper markets and at money market funds. These liquidity programs were largely unwound when financial markets improved.

As the Federal Reserve and other central banks worked to address liquidity shortages in their own markets, it became clear that, as a result of globalization, firms were experiencing funding shortages not only in domestic currencies, but in foreign currencies as well. In particular, dollar funding shortages appeared not just in the United States but in countries around the world, which, in turn, exacerbated pressures in U.S. funding markets. The Federal Reserve already was providing liquidity to foreign financial firms operating in the United States through its discount window and other facilities. To further address pressures in dollar funding markets and support the flow of credit to U.S. families and businesses, the Federal Reserve ultimately approved bilateral currency swap arrangements with 14 foreign central banks, including two Latin American central banks.² Under these swap arrangements, in exchange for their own currencies, foreign central banks obtained dollars from the Federal Reserve to lend to financial institutions in their jurisdictions. These swap arrangements pose essentially no risk to the Federal Reserve: They are unwound (with a fee paid by the central bank drawing on the swap arrangement to the Federal Reserve) at the exact same exchange rate that applied to the original transaction, they are conducted with major central banks with track records of prudent decisionmaking, and they are secured by the foreign currency provided by those central banks.

The success of these swap lines in alleviating funding pressures and reducing interbank borrowing rates is a testament to the benefits of central bank cooperation. Moreover, in addition to easing funding shortages, these swaps also helped to allay market fears – they had a preventive as well as a curative role. For example, four of the central banks that participated in these arrangements – Brazil, Canada, New Zealand, and Singapore – did not end up drawing on the facilities, but it is generally believed that the existence of the lines helped prevent stresses that could have otherwise developed. As the financial crisis receded, the swap lines were closed in February 2010. However, swap lines with several foreign central banks were reopened in response to financial strains that developed in Europe.³

In many countries, policy rates fell to nearly zero. With substantial economic slack remaining, these central banks faced the challenge of finding ways to further ease monetary policy. The Federal Reserve expanded its balance sheet through the purchase of longer-term Treasury securities, agency debt, and agency mortgage-backed securities. The idea was to put downward pressure on longer-term yields to spur demand and also to encourage some portfolio rebalancing toward riskier assets and loans to the private sector. More recently, the Federal Open Market Committee decided to extend the average maturity of its holdings of securities by selling shorter-maturity Treasury securities and buying longer-maturity Treasury securities. This maturity extension program created additional downward pressure on long-term rates without expanding the size of the Federal Reserve's balance sheet.

In addition to using conventional monetary policy and balance sheet tools to provide monetary accommodation, communication is an important tool used by central banks to

² The 14 central banks were those in Australia, Brazil, Canada, Denmark, the euro area, South Korea, Japan, New Zealand, Mexico, Norway, Singapore, Sweden, Switzerland, and the United Kingdom.

³ These swap lines have been renewed several times since then, with the current authorization running through February 2013.

enhance the effectiveness of policy. At the conclusion of each meeting, the Federal Open Market Committee issues a statement of policy actions taken and the rationale for those actions. Detailed minutes are published three weeks later, and lightly edited transcripts are made public with a five-year lag. In 2011, the Chairman began holding press conferences on a roughly quarterly basis to discuss economic projections submitted by participants and actions taken at the meeting. In August 2011, the Committee statement included forward guidance that economic conditions are likely to warrant exceptionally low levels of the federal funds rate at least through mid-2013 – a date that was later extended to late 2014 – which put further downward pressure on longer-term interest rates. In January 2012, the Committee released a statement of its longer-run goals and policy strategy. At that same meeting, the Committee also began including participant projections of the appropriate path of the federal funds rate in the Summary of Economic Projections. The Committee continues to discuss ways in which communication can be used to enhance policy.

While these policy moves of the Federal Reserve were not coordinated with other central banks, other central banks shared these challenges and responded in broadly similar ways to expand their balance sheets. For example, the Bank of England and the Bank of Japan also used large-scale purchases of medium- and long-term government securities to provide stimulus. In addition, several other foreign central banks, including the Bank of Canada and the Bank of Japan, also more actively used forward guidance about the path of policy rates.

Finally, the common challenges and problems of the past few years reinforced the importance of open discussion among the world's central banks. Central bank leaders draw on collective experience through discussion in such diverse international forums as the Bank for International Settlements (BIS), Group of Twenty (G-20), and CEMLA. CEMLA is an excellent example of what can be achieved by central bank cooperation through such means as courses and seminars, international meetings, technical assistance, publication of research studies, and exchange programs.

Cooperation in areas of supervision and regulation

Central banks around the globe have focused not just on responding to the crisis, but also on working to minimize the risk of future crises by improving the soundness and stability of the financial sector. Indeed, the global financial crisis has underscored the importance of the financial stability objective of central banks. Given the global nature of financial markets and large financial institutions, coordination and cooperation among central banks and bank supervisors and regulators more generally is crucial in achieving this goal. Let me provide a few examples of such efforts.

First, the crisis highlighted shortcomings in capital and liquidity requirements. Central banks with bank supervisory responsibilities have been heavily involved in designing and promoting international frameworks to address these shortcomings. The Federal Reserve has supported the Basel Committee's adoption of improved capital requirements that include raising risk-weightings for traded assets, improving the quality of loss-absorbing capital through a new minimum common equity ratio standard, creating a capital conservation buffer, and introducing an international leverage ratio requirement. The Federal Reserve has also supported the Basel Committee's work on quantitative liquidity requirements and its work on capital surcharges for banks of global systemic importance.

Another example of international cooperation on the regulatory front is the Financial Stability Board (FSB), which consists of key financial regulators around the world, including the Federal Reserve. The FSB has identified a number of challenges that international cooperation among central banks and financial regulators are helping to address. One such challenge regards over-the-counter (OTC) derivatives. To reduce the systemic risk of OTC derivatives, the G-20 leaders have agreed to require that standardized OTC derivatives be cleared through a central counterparty. Another challenge is that of cross-border resolutions, and the FSB has undertaken analytic work on how to improve the resolvability of

financial firms that have a substantial international presence. The FSB has also identified and spurred cooperative work on gaps in financial data and on the so-called shadow banking system.

As a bank supervisor, the Federal Reserve has cooperated with foreign bank supervisors (including other central banks) through participation in supervisory colleges, which are multilateral standing working groups of supervisors formed for the purpose of enhancing effective consolidated supervision of an international banking organization. Supervisory colleges enhance the information exchange and cooperation of home and host supervisors to help them develop a better understanding of the risk profile of a banking organization.

Lastly, at the Federal Reserve we have also been working closely with other U.S. agencies in the recently established Financial Stability Oversight Council on the implementation of the financial stability reforms laid out in the Dodd-Frank Act. One key aspect of this act is the focus on a “macroprudential approach” that pays attention to the financial system as a whole, in addition to individual financial institutions and markets. The greater emphasis on macroprudential tools has been widespread. Indeed, the Federal Reserve has participated in analyses of macroprudential tools and policies undertaken with other G-20 central banks at the BIS and with bank supervisors on the Basel Committee.

One of the reasons that coordination is required for supervision and regulation is the substantial cross-border operations of many financial firms. The deleveraging of some global financial institutions with a significant presence in Latin America and the potential effect on economic performance serves as a stark reminder of the interlinkages of financial institutions and economies. The deleveraging of these institutions also highlights the need to coordinate across regulators and acts as a catalyst to spur greater action and information sharing.

Latin American central banks: crisis response and challenges

Earlier I mentioned how central banks around the world, including those in Latin America, lowered policy rates in response to the global financial crisis. Although the crisis developed in advanced economies, Latin American central banks, such as those in Brazil, Chile, Colombia, and Mexico, cut policy rates in 2009 as their economies were being hit hard through trade and financial linkages with advanced economies as well as through commodity price channels. Their capacity to follow countercyclical policies was in striking contrast to many previous times of stress, when policy rates could not be lowered for fear of frightening off international investors. The fact that these Latin American economies were able to respond by lowering policy rates and also by boosting fiscal support is a testament to the decisive steps taken to strengthen macroeconomic policies and financial systems, including improvements in the monetary frameworks under which their central banks operate.

Many Latin American economies staged quick and strong recoveries from the global recession and subsequently started to raise policy rates to try to ward off overheating pressures. Conversely, many advanced economies, with their prolonged soft recoveries, needed to continue to follow expansionary monetary policies. Accordingly, as was also the case in emerging Asia, the monetary policy stance of several central banks in Latin America, such as Brazil and Chile, diverged from those of advanced economies. The resulting rise in interest rate differentials, on top of the generally stronger growth in Latin America, helped to fuel capital inflows, which, at times, have proved challenging for the policymakers of these economies to manage. Of course, more recently, with intensification of the crisis in Europe, some Latin American countries, most notably Brazil, have again lowered their policy rates in response to concerns about slowing growth.

Even within Latin America, however, the experience of economies has not been uniform. In particular, Mexico, with its stronger ties to the United States, was hit earlier and harder than many other economies in the region. Even though Mexico’s recovery in the second half of 2009 was strong, it had less momentum and considerable economic slack remained in the

country. As such, the Bank of Mexico did not consider it necessary to raise policy rates during its recovery period, unlike many other Latin American central banks.

These developments underscore an important point – that while central banks may benefit from coordination and cooperation, taking the same policy stance at the same time typically will not be the best choice for all central banks. Accordingly, it is imperative for each central bank to have monetary policy tools to appropriately address domestic objectives independent of the actions of other central banks.

Conclusion

In this age of global financial integration, the Federal Reserve and other central banks often must cooperate to achieve their individual mandates. This need for coordination has been especially true during the recent crisis, when the actions of central banks working together proved very helpful in easing financial strains and boosting confidence. Indeed, closer ties and more-open lines of communication across central banks are some positive outcomes of these difficult times. This spirit of cooperation should continue as our respective central banks work to pursue monetary policies appropriate for our own economies while supporting stable financial systems around the world.