Roger W Ferguson, Jr: The role of central banks in fostering efficiency and stability in the global financial system

Remarks by Mr Roger W Ferguson, Jr, Vice-Chairman of the Board of Governors of the US Federal Reserve System, at the National Bank of Belgium Conference on Efficiency and Stability in an Evolving Financial System, Brussels, 17 May 2004.

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It is a great pleasure for me to open this conference. Our agenda is filled with addresses by distinguished speakers and research papers of uniformly high quality on topics of keen interest to central bankers. Indeed, few subjects are more important for central bankers than the efficiency and stability of the financial system.

Many of the papers to be presented and discussed over the next two days focus on the behavior of private institutions operating in financial markets. I thought I could complement these presentations by discussing the efforts of an important class of public institutions--central banks--to foster efficiency and stability in the financial system. Before proceeding, I should note that my remarks today represent my own views, which are not necessarily shared by my colleagues on the Federal Reserve Board or on the Federal Open Market Committee.

In previous discussions, I have found it useful to offer a working definition of financial instability that seems most relevant from a public-policy perspective. Although difficult to define precisely, financial instability, in my view, connotes the presence of market imperfections or externalities in the financial system that are substantial enough to create significant risks for real aggregate economic performance. Over the past few decades, economic research has identified a variety of imperfections inherent in markets, such as moral hazard, asymmetric information, and externalities. On occasion, these imperfections can become so widespread and significant as to result in outcomes that threaten the functioning of the financial system and adversely affect real economic variables. History suggests that these imperfections reach this advanced and disruptive stage when they are exacerbated by large external shocks. Such outcomes include panics, bank runs, severe market illiquidity, and excessive risk aversion. These outcomes are highly undesirable for society because they can be accompanied by a variety of economic distortions: Financial prices can diverge sharply and for prolonged periods from fundamentals, and their correction is likely to impose great cost on society; the availability and pricing of credit may be too lax at times and at other times too restrictive relative to underlying macroeconomic conditions. As a result of these distortions, spending and real activity may undergo much wider swings than would otherwise be the case.

I would hasten to add, however, that this definition of financial instability does not encompass failures of financial firms due to poor management or poor luck; nor does it include fluctuations in asset prices or credit conditions as a consequence of the normal evolution of economic circumstances, nor occasional substantial losses of individual counterparties. Indeed, such failures and losses, as well as accompanying market volatility, are the unavoidable and even necessary features of dynamic market economies. In my view, market volatility and institutional stresses need to be addressed by public-policy action only when they are symptomatic of, and interact with, more-fundamental market failures that have a high likelihood of impairing real macroeconomic performance. Indeed, public policies that rely too heavily on regulation of financial institutions, instruments, and markets with the aim of avoiding any period of financial stress almost surely entail a significant cost measured in terms of increased moral hazard, lower economic growth, and financial markets that do not always allocate resources to their most productive use.

In my experience, central bankers as a rule have an almost instinctive aversion to financial instability as I have defined it. Those instincts are no doubt rooted, at least partly, in the historical efforts of many nations to overcome structural defects in financial markets that left their economies prone to boom-and-bust cycles. In some cases, central banks were seen as part of the solution in addressing the results of such market imperfections. The Federal Reserve, for example, owes its existence in large measure to the financial panics in the late nineteenth and early twentieth centuries in the United States that increased public recognition of the need for a lender of last resort, for more-effective bank supervision, and for greater efficiency in the payment system.

In the modern era, central banks' association with matters relating to financial stability has become broader and more formalized. To be sure, many central bank charters give primacy to broad macroeconomic objectives such as price stability and full employment. And, indeed, I concur with those who argue that conducting monetary policy over time so as to achieve stable prices and sustainable economic growth is the single most important contribution that central banks can make in promoting financial stability. However, many central bank charters also recognize financial stability as an important and distinct objective, and these statutory objectives have been prominently discussed in the time since I joined the ranks of central bankers in 1997. Over that relatively brief span, the global financial system has weathered many storms--the market turmoil in the fall of 1998, the preparations for Y2K, devastating terrorist attacks in 2001 and a recognition of the threat of future attacks, and major accounting scandals in 2002. As I will discuss in more detail shortly, these developments have been important in shaping the international central banking policy agenda.

Key financial trends

Before exploring some of these issues in a bit more depth, it seems useful to consider some of the longer-run trends that have set the backdrop for much of the work of central banks in international forums dealing with financial efficiency and stability. One clear trend in many countries is an increase in market concentration in the banking sector and in other sectors of the financial services industry. In the United States, for example, the share of assets held by the top ten commercial banks has risen from about 30 percent in 1995 to about 45 percent today. Outside the commercial banking sector, consolidation has resulted in a small number of financial firms doing much of the equity and bond underwriting throughout the world.

A second trend is the steadily increasing share of total credit provided directly through markets rather than through intermediaries like banks. For example, in the United States, the share of bank loans in the total outstanding debt of domestic nonfinancial corporations has declined from about 21 percent at the end of 1990 to 12 percent at the end of last year. The growing importance of market-based finance has not, however, signaled a decline in the commercial banking industry. U.S. banks, for example, have enjoyed record profits that stem, in part, from their activities in securities markets and in the development of new instruments. Indeed, banks' development of sophisticated risk-management techniques helped to fuel the growth of new financial instruments. More generally, by providing lines of credit and assuming other off-balance-sheet exposures, banks support the advancement and ongoing operation of financial markets and lower the costs of market-based finance for many market participants.

Another important trend has been the expanding scope and availability of financial instruments. The global financial system is still well short of the theoretical ideal of complete financial markets, but clearly it is moving in that direction. Market participants now use an array of financial instruments that, twenty years ago, were not actively traded and, in many cases, did not even exist. The growth of derivatives is a useful example of this trend. According to the December 2003 survey of derivatives conducted by the Bank for International Settlements (BIS), the notional and market values of all over-the-counter foreign exchange and interest rate derivatives contracts - rough measures of market activity - have nearly doubled in just the past two years. The credit derivatives market is still in its infancy, but data gathered by the International Swap Dealers Association suggest that this market has registered even more spectacular growth in the past two years. All of these new instruments allow more-effective management and pricing of risks, so the growth of these markets has surely been positive, on net, for market participants. But the increasing complexity of these instruments also raises a host of policy questions regarding, to name just a few items, accounting treatment, disclosure policy, netting provisions, capital charges, and the enforceability of netting and collateral arrangements in bankruptcy proceedings.

A final trend worth singling out is the steady increase in global financial integration. Borrowers today raise funds in multiple financial centers and in multiple currencies; commercial lenders and retail investors regularly take on international exposures; and arbitrageurs establish leveraged risk positions across currencies and markets. Data collected by the BIS, for example, suggest that the volume of debt outstanding that was issued in international credit markets has more than doubled worldwide in the past four years. Likewise, the international positions of banks worldwide have increased almost as markedly over the same interval. For the most part, these developments suggest that global financial markets are becoming more efficient and more integrated. But increased global financial integration carries with it some new risks. As we learned all too well following the Russian debt default in August 1998, financial difficulties in one corner of the world can now spread in unpredictable and potentially disruptive ways to every major financial center.

In the remainder of my remarks this morning, I will draw out some of the implications of these long-run trends for the core responsibilities of many central banks, which include the conduct of monetary policy, bank supervision and regulation, and crisis management and liquidity assistance.

Monetary policy

The steadily increasing importance of markets and nonbank instruments as the primary vehicles for borrowing and lending has several important implications for monetary policy transmission and strategy. It seems plausible, for example, that a financial system dominated by market-based finance has likely reinforced the status of the market for financial assets as the most important channel of monetary policy transmission.

This simple observation has some rather profound implications for the conduct of monetary policy. Typically, central banks directly control a short-term interest rate, but the forward-looking nature of financial markets implies that long-term interest rates and other asset prices are determined importantly by expectations about future policy. These expectations, in turn, are informed (one hopes) by a clear understanding of the objectives of the central bank and how it will choose to set policy in the future in response to economic developments. Central banks have long recognized the effect their words and actions can have on interest rates and asset prices and, as a result, have increasingly moved toward greater transparency in the policy process. The sharpened focus on transparency has been motivated in part by a desire to avoid short-run misperceptions about policymakers' intentions that can distort financial asset prices and ultimately prove detrimental to the real economy. But central bankers have also discovered that transparency, broadly writ, can lead to improved economic performance. Market expectations are more likely to remain anchored in the face of various shocks when investors understand that central bankers are committed to key long-run objectives such as price stability and sustainable economic growth. Moreover, by operating in a predictable way in response to economic developments, central bankers can foster an "automatic stabilizer" of sorts in financial markets. For example, recognizing that the central bank will seek to counter adverse demand shocks, investors will anticipate an easing in monetary policy if they observe aggregate demand weakening; in turn, that anticipation would soon be reflected in lower long-term interest rates that would cushion the drop in demand even before a change in policy is made. This market dynamic suggests that gauging the overall effect of monetary policy requires an assessment of broad financial conditions, including policy rates, long-term interest rates and foreign exchange rates.

Although central bankers can use predictable policy actions and the forward-looking nature of financial prices to their advantage, they must also be mindful of the potential market reactions to policy actions that are not fully anticipated or that may be misinterpreted. This, too, is an aspect of monetary policy that may have become more prominent given the evolution of financial markets in recent years. Monetary policymakers evaluate the probabilities as well as the costs and benefits of the full range of potential economic and financial outcomes in arriving at a policy decision. One such risk to be evaluated is the potential, particularly during times of stress, for outsized and unintended changes in interest rates and asset prices after an unexpected policy action. Of course, the response of central banks to this risk should not be to avoid taking policy actions that are necessary to achieve macroeconomic objectives. But central banks can mitigate the potential for unintended market reactions by communicating their goals and economic outlook as clearly as possible to inform market expectations and thereby avoid possible misperceptions about the future path for policy.

The record shows that on occasion monetary policy has been used to counter financial instability. These incidents arise when financial instability is so great that the financial markets themselves seem to become incapable of intermediating effectively and, partially as a result of these market weaknesses, the economic outlook has been revised down sharply and the downside risks to that outlook have become quite large. Naturally, at those moments, asset prices as well as market functioning become a focus for policymakers. However, this does not mean that policymakers have particular targets for those asset prices--that they seek to place a floor under such prices, as some have inferred. Rather, in those situations asset prices are evaluated in the context of all the factors bearing on the economic outlook, just as when markets are orderly, though financial market conditions in all their aspects play a particularly prominent role in such an evaluation when markets are stressed.

Bank supervision

The concentration in banking structures that I referred to earlier, coupled with the growing scope of permissible bank activities paralleling the evolving nature of the world's financial markets, has had some profound effects on bank supervision. For one thing, supervisors worldwide have increasingly shifted the emphasis of their concern toward large banks' internal risk-management policies and systems and relatively away from individual bank positions and transactions. Much of this shift in emphasis has reflected changes in banks' own internal policies, as increases in the scale and scope of operations have required different control and management systems to maximize risk-adjusted profits. In addition, the change has reflected the need to alter supervisory strategy to address the reality that earlier techniques are inadequate for large, complex entities, especially given supervisors' limited resources.

The same motivations have induced U.S. and other supervisors to emphasize transparency and disclosure by the largest banks in order to exploit the potential market discipline as a supervisory supplement. Market discipline, in turn, requires not only disclosure, but also the expectation that bank counterparties face a risk of loss. Government guarantees in the name of stability may actually pose a greater risk of bank difficulties by reducing market discipline, or, alternatively, could require more intrusive supervision, reducing the innovative market dynamics I mentioned earlier.

If you see in these developments the seeds of Basel II - in their requirements for better risk-management systems and greater disclosure - you understand the objectives and approach of the Basel Committee on Banking Supervision. The same factors are driving the proposal of the U.S. authorities to require the supervisory application of Basel II only to the largest, most complex banks, in which scale and scope imply that the necessity of continued investment in improved risk-management techniques and greater emphasis on disclosure are particularly appropriate. These factors are, I believe, also behind the suggestion of my colleague Chairman Powell, of the Federal Deposit Insurance Corporation, that perhaps the United States ought to consider a different supervisory policy for smaller banks than for the complex entities.

I cannot leave the subject of supervision without a brief comment on the trend to remove supervision from the responsibility of central banks and to create an overarching single supervisory authority for all financial institutions and markets. Such a structure may well be appropriate for the jurisdictions that have adopted such regulatory frameworks, given their history and institutional development. I certainly respect the decision of countries that have adopted the Financial Supervisory Authority model, and have thus excluded their central banks from the direct supervision and regulation of their banks. However, I believe that such a decision has the potential to undermine a central bank's ability to manage financial crises.

At the outset of my remarks, I emphasized that financial market stability and efficiency do not require an absence of volatility and loss and indeed may require some degree of financial stress. But, my experience also suggests that at certain times - genuine crises, particularly those with a global dimension - the central bank must act to avert disaster. The history of the Federal Reserve in the last couple of decades suggests that central bank effectiveness requires that it have a deep and practical understanding of how banking works and, what is more, genuine credibility with bankers. This kind of understanding and credibility can only be gained by direct interactions with banks and bankers. In turn, such interactions, which develop the knowledge of institutions and markets that is needed for crisis management, can in my view be gained only by hands-on supervision of banking organizations. Indirect knowledge is simply not a substitute.

In the United States, the Congress has recognized the relationship between supervision and crisis-management capability. In its most recent review of the banking law - the Gramm-Leach-Bliley Act - the Congress gave the Federal Reserve umbrella supervisory authority for the new financial holding companies as well as preserving its authority for bank holding companies and for member banks chartered by the states. To continue to fulfill its central bank role as crisis manager, I believe the Federal Reserve must continue to have a deep, meaningful, and, most important, practical, understanding of the largest, most systemically important, banks operating in the United States, as well as an understanding of the markets in which they operate. I believe that it can do so, in its role as umbrella supervisor of banking organizations and direct supervisor of state chartered member banks, while respecting the prerogatives of the primary supervisors of banks and other holding company subsidiaries that are not under its direct supervisory authority. And, an important point given the U.S. institutional structure, such an approach continues to be consistent with a healthy dual banking system--in which banks chartered by the federal government and by the respective states exist and compete side-by-side. The value of the dual banking system has withstood the test of time.

Crisis management and liquidity assistance

The global trends toward market finance, consolidation, and global integration has expanded the range of liquidity and other crisis scenarios that central banks may need to confront. The market turmoil in the autumn of 1998 and the extreme risk-aversion that pervaded credit markets in 2002 amid accounting scandals in the United States may suggest that major market disruptions are probably more likely today to originate from shocks to financial markets that are outside the banking sector. Of course, if such shocks and the attendant market stress appear to pose risks to a central bank's macroeconomic objectives, policymakers can make appropriate adjustments to the stance of monetary policy. In addition, if policymakers are particularly concerned about improbable but highly costly events, they might well wish to consider market stress in their monetary policy deliberations even when the modal forecasts for macroeconomic variables such as inflation and economic growth have not changed much.

Central banks can also be a calming influence on markets in a crisis simply by standing ready, as I noted earlier, to provide liquidity assistance if necessary. Although shocks may originate in global debt and equity markets, they may well reverberate in the banking sector. For example, in 1998, banks were faced with a surge in loan demand from borrowers with reduced access to their usual market funding sources. Assistance from the central bank may involve expanding the liquidity of the entire financial system through open market operations, or it could entail direct loans through the discount window to meet the liquidity demands of specific institutions. On the latter point, I would note that the Federal Reserve has recently restructured its lending programs so that credit can be routinely provided to borrowers in sound condition at an above-market rate but with few other administrative criteria. These changes should help to make the discount window even more effective in a crisis.

The trends toward consolidation and worldwide operations in the financial sector also raise some important practical questions of coordination among central banks in providing liquidity assistance should there be a situation that requires it. For example, there are basic questions regarding arrangements among central banks on matters of collateral - the types of collateral that are acceptable, details of cross-border pledging arrangements and so on. These seemingly simple questions are not always easy to answer in international settings, but central banks should be actively working to resolve these and other such issues that bear on their ability and preparedness to meet cross-border liquidity needs.

Conclusion

Central banks have a long history of working to foster efficiency and stability in the global financial system. That traditional role has become more complex over time as the institutional and market realities of the financial system have evolved. Fortunately, central banks are aware of these changes and have made great progress in appropriately adapting their approaches to the execution of monetary policy, supervision, and crisis management. In our evolving financial system, however, much remains to be done. I can assure you that, as public servants, central bankers will continue to pursue these matters vigorously.