Christian Noyer: International financial stability and the role of central banks in the crisis

Address by Mr Christian Noyer, Governor of the Bank of France, at the Plenary session: "The international economy in transition" of the Montreal Conference, Montreal, 9 June 2008.

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Ladies and gentlemen,

It is a great honour for me to take part in this conference and to set out, before such a distinguished audience, my thoughts on the role of central banks regarding financial stability in the current environment.

I should like to organise these thoughts around the following five questions:

1) Do central banks have a role to play regarding financial stability?

2) What have they done since the start of the financial turmoil in the summer of 2007?

3) Were they right to take these steps?

4) Why have they responded differently as regards their monetary policy stance?

5) What lessons can we learn for the future?

1) Do central banks have a role to play regarding financial stability?

This question might appear paradoxical when we recall that historically the *raison d'être* of central banks has been to ensure financial stability, that is, the smooth functioning of financial markets and payment systems. In this context, they play the role of the ultimate liquidity provider, in other words, of lender of last resort.

However, some people now regard this role as inconsistent with that which in the meantime has universally become the primary task of central banks, i.e. ensuring price stability. Three main arguments are generally put forward to support this view:

- The first is that central banks have only one instrument at their disposal, i.e. the interest rate, and that this instrument, by virtue of Tinbergen's Principle, can only be assigned to a single objective, that of price stability. Other means – particularly regulatory or prudential measures – would be better suited to and more effective in ensuring financial stability. But the current crisis demonstrates that central banks actually have several instruments at their disposal. Indeed, liquidity management in periods of financial turmoil needs to be separated from the issue of the monetary policy stance. To put it more clearly, the monetary policy stance simply consists in setting key interest rates at a level consistent with the central bank's macroeconomic objectives, whilst liquidity management aims to enable the money market, and financial markets in general, to function "normally" so that monetary policy impulses may be efficiently transmitted to the rest of the economy.
- The second argument is policy-based in nature and postulates that monetary stability is a necessary and sufficient prerequisite for ensuring financial stability. The latter would then be a welcome consequence of the implementation of an inflation targeting strategy, which consists in only responding to shocks that have a lasting impact on medium-term price stability. Here again, the argument does not hold up in the face of the facts since the financial crisis unfolded in an environment of low interest rates and contained inflationary pressures in spite of soaring property and commodity prices, in short, in a context where price stability seemed well secured. The same was true for the previous bubble that formed on stock markets. A low

interest rate environment, which often makes agents less vigilant about risk or makes them less able to gauge it, combined with very strong central bank credibility, is in no way a guarantee of financial stability. This is one of the manifestations of what some economists have termed the paradox of credibility.

- The third argument relates to the extraordinary transformation that our financial systems have undergone over the past few years, with a growing, if not predominant, role for market financing at the expense of bank intermediation. Yet the operational framework of central banks, by means of which they perform their role of lender of last resort, is mainly focused on banks, and retail banks in particular. Here again, the facts prove the opposite. The crisis has shown that banks remain at the heart of the financial system and that, as a consequence, the operational framework of central banks remains entirely effective. In addition, this framework makes it possible to reach other market participants, such as broker-dealers and investment banks.

2) What have central banks done since the start of the financial turmoil?

The overall impression in the press is that central banks have injected vast amounts of liquidity into the banking system in order to face up to the crisis. This is not true to reality. In volume terms, the amount of liquidity allocated by the Eurosystem has posted slow growth since the summer of 2007.

On the other hand, during the crisis, some central banks, such as the Fed and the Bank of England, have had to make adjustments to their operational framework, while others, like the ECB, have been able to rely on their existing framework, up until very recently. This has resulted in a remarkable convergence of central banks' operational frameworks and fields of intervention around four main areas:

- a lengthening of maturities for central bank lending: these maturities have been increased from a few weeks to a few months. In the case of the Eurosystem, a major share of refinancing operations have a maturity of three months, and, recently, a six-month facility has been introduced;
- a widening of the range of eligible collateral, i.e. the securities used as collateral. Securities such as ABS and RMBS, which have always been accepted by the Eurosystem, are now accepted by all other major central banks;
- an extension of the list of eligible counterparties, in particular in the United States, where investment banks now have access to the Fed's lending facility;
- a greater degree of coordination between central banks: this not only includes joint statements aimed at reassuring the markets about the provision of liquidity when the need arises, but also the signing of swap agreements between central banks. This facility enables any European bank which needs US dollars to pursue its activities to secure this funding from the ECB or the SNB.

3) Were central banks right to take these steps?

The fast spillover of the US subprime crisis to other market segments, and subsequently to other countries through the seizing up of the commercial paper market and the major strains on money and interbank markets, called for rapid central bank intervention. This not only included providing liquidity to the market as a whole but also, in some countries, granting emergency liquidity assistance to systemic institutions.

These interventions have raised a number of questions: did not central banks, by adapting their operational framework to fit the circumstances, increase moral hazard? Did they not unduly save institutions that did not deserve to be saved, in particular those which had taken excessive risks? Did they comply with the traditional principles expounded by Bagehot many years ago, i.e. lend to temporarily illiquid but solvent financial institutions, lend at penalty rates against sound collateral, and provide liquidity to any institution satisfying the aforementioned solvency and collateral criteria?

These essential questions are, however, mainly academic. Today, they take on different dimensions. Indeed, all financial crises cause a downward spiral in asset prices, which before long transforms a temporarily illiquid institution into an insolvent institution, making Bagehot's initial distinction difficult to apply. This situation is exacerbated in our developed financial systems by the joint application of new accounting standards requiring fair value measurement for financial assets and prudential arrangements that may prove partly pro-cyclical. In this context, central banks have the clear duty of preventing the market from seizing up, with incalculable consequences for other financial players and more generally for the real economy.

However, it should be borne in mind that the central banks' criteria for accepting assets as collateral for their refinancing operations are particularly restrictive and penalising, and comply with the traditional principles that I have just mentioned. In particular, the value of these securities must be at least equal to the amount lent and the accrued interest, after applying a haircut to take account of a possible decline in their market value during the repo.

4) Why have the central banks responded differently as regards their monetary policy stance?

As regards the central banks' response to the crisis, although they converged in their short-term liquidity management methods, they nonetheless responded differently in terms of monetary policy.

The underlying reasons for this divergence are both due to the nature of the shocks that the economies are facing and the mechanisms of their propagation to the real economy and to nominal variables.

Over the recent period, the industrialised economies have undergone three common shocks: rocketing real-estate prices at least in a number of countries, soaring commodity prices and finally the financial crisis triggered last summer.

They have also experienced specific shocks: the real-estate crisis in the United States in a context of household overindebtedness, for example. In the latter case, the economic slowdown already underway since mid-2006 and the expected consequences of the credit crisis on economic activity over the medium term has led the US monetary authorities to change their monetary policy stance. The very different situation in the euro area, where activity remained favourable, has led the ECB to keep its monetary policy stance unchanged in spite of the uncertainties generated by the financial crisis in a context also characterised by persistent inflationary tensions.

5) What lessons can we learn for the future?

At the current juncture, financial turmoil is still affecting the markets. However, after more than nine months, I think it is already possible to draw first conclusions in three main areas:

- First, the close co-operation between central banks on the one hand and between the supervisory authorities and central banks on the other hand seems, in my opinion, to be a determining factor for efficient crisis management. This point was indeed underscored during the recent work carried out by the Financial Stability Forum. I must say in this respect that the French model of banking supervision, in which banking supervisors have close ties with the central bank, has once again proven its worth in the current context. The necessity of this proximity has also been increased by the new accounting and prudential standards which have proven to be pro-cyclical and in which liquidity and solvency are intertwined. In this context, when in a financial crisis, it is crucial to cross-check, at every moment, information on the evolution of banks balance sheet and data on money market functioning in order to assess the risks to financial stability. Such an assessment enables to adapt, as far as needed, the refinancing policy of the central bank, in order to alleviate tensions in the market; those tension being a threat both to financial stability and to the effectiveness of the transmission of monetary policy.

- Second, with regard to monetary policy, let me reiterate that one must carefully distinguish between the monetary policy stance on the one hand, which should remain focused on the macroeconomic objective of price stability in the medium term, and the refinancing conditions of the banking system on the other hand, that may have to be adapted in times of financial turmoil. Moreover, a solid anchoring of inflation expectations seems to me particularly crucial in a period of economic and financial uncertainty.
- Last but not least, in my view, regulatory issues related to the increase of financial innovation over the recent period of rapid market growth should now be a matter of primary concern. Moreover, the return of greater market discipline, closer monitoring of risks by market participants and quite simply the use of commonsense principles, such as acknowledging that there is no such thing as low risk/high return assets, are in my view prerequisites for a return of confidence to the markets.