

Mr McDonough discusses the role of central banks in the global financial markets

Remarks by the President of the Federal Reserve Bank of New York, Mr William J. McDonough, before the Economic Club of New York, New York City, on 14/12/98.

Good evening, ladies and gentlemen. I am delighted to be here tonight and to share the podium with my good friend Dick Grasso. Dick and I have worked together for many years now, and I have come to value greatly both his warm friendship and his thoughtful counsel.

Dick has spoken eloquently about how equity markets have developed globally over the past several years and some of the concerns he has going forward. For my part, I will focus on the global debt markets and the interests of central banks in the stability of these markets.

The role of central banks in the fixed-income and related capital markets may not be immediately obvious because, one can argue, debt markets are a zero-sum game. One side of a trade gains what the other loses. If only it were as easy as that! In fact, trading in the global debt markets serves an important purpose and it does not follow that central banks have no interest in the stability of these markets. Quite the contrary. Central banks are and should be deeply concerned about the functioning of these markets, their dependability, their liquidity, and their transparency. Before explaining why I hold such a view, and therefore why we at the Federal Reserve were so concerned when these markets faltered this past summer, I would like to stand back for a few moments and highlight how the global capital markets have changed over the past several decades.

No one doubts that there has been a sea change in the global capital markets in recent years and the ways business is transacted in these markets. These changes are, of course, rooted in the remarkable technological advances we have been witnessing. Today, the technology for processing information and making this information widely available has fundamentally altered the way the world channels saving into investment. No longer does the global economy rely primarily on loans from commercial banks to meet its financing and investment needs. Rather, more than ever before, the global economy of today looks to funds from the fixed-income and related capital markets to intermediate its credit needs.

Because the global capital markets have become so important in the credit intermediation process, the economic well-being of us all depends on the orderly flow of funds in these markets. The flow of these funds, in turn, increasingly relies on price signals generated by trading activity that takes place daily in these markets. The reliance on secondary market trading for price discovery constitutes the fundamental difference between funds from securities markets and loans from banks.

Let me be a bit more specific. In securities markets, investment decisions are driven by prices that arise from a trading process that reconciles differential information from a diverse group of investors. In bank loans, investment decisions are based on the bank's private information about specific borrowers. While a bank makes its own investment decisions, securities markets rely on the consensus of a multitude of investors.

When securities markets work well, they provide efficient ways of aggregating information and allocating risks among a wide range of investors. In order to function well, however, these markets require a trading infrastructure. This infrastructure may consist of an exchange, a network of brokers and dealers, and a clearing system. These markets also rely on a cadre of relatively well-informed investors, who confidently judge asset prices and take positions on the

strength of their judgments. If the trading infrastructure fails or investors lose confidence, trading will grind to a halt.

The global fixed-income markets are unlike equity markets. In equity markets, everyone knows something about the trading infrastructure, which is centralized in exchanges. Thus, there is no question as to the focal point of trading information. But the importance of fixed-income markets, which are multiple-dealer, over-the-counter markets, is sometimes hard to appreciate because they are so decentralized.

In the United States, the bond market is where companies have been raising most of their funds in recent years. During the last ten years, for example, U.S. nonfinancial corporations borrowed a net amount of \$785 billion in the form of bonds, three times the net amount they borrowed from banks. Over this same period, these companies as a group spent \$600 billion more to retire stock – through buybacks and mergers – than they raised in new offerings.

Accompanying these increased levels of debt market activity has been a continuous process of financial innovation. This innovation has served to unbundle different kinds of risk and, thereby, to enlarge the menu of risks that investors may choose to bear. For example, interest-rate swaps, futures and options help reconfigure various interest-rate risks. Total return swaps and credit-spread options are tools for reallocating the payment risks primarily of emerging market debt. Credit-default swaps and credit-linked notes are ways to redistribute default risks.

In practice, this unbundling of risk means that a broad range of financial institutions today performs the credit intermediation process, eroding the historical comparative advantage of banks in bearing credit risk. At various times, some institutions will be underwriting issues, while others will be making bridge loans, providing credit enhancements, writing derivative contracts and taking up riskier components of securities.

Within the United States, the fixed-income market is today a market of some \$13 trillion, roughly the same size as the total equity market. Trading activity in fixed-income instruments is concentrated in Treasury securities. On an average day, over \$150 billion in Treasury securities changes hands, about seven times the value of stocks traded daily on the New York Stock Exchange.

All of this trading activity serves the very important function of price discovery. More than any other securities market in the United States, the Treasury market responds forcefully to new information about macroeconomic fundamentals. The days when the most intense trading activity takes place are also the days when major reports are released on such indicators of U.S. economic performance as the employment report, the consumer price index or the producer price index. These releases allow market participants to digest important new information and to review their expectations about where the economy is going. The interest rates on Treasury securities of varying maturities are the market's most important signals about the U.S. economy's prospects for growth and risks of inflation.

In the rest of the fixed-income market, trading in corporate bonds, mortgage-backed securities and sovereign debt also serves the price discovery process. This trading activity acts to differentiate, for example, a triple-A risk against a triple-B risk, the prepayment risk of mortgages against the prepayment risk of credit card receivables, and OECD country risk against emerging market risk.

What then is the role of central banks in this new financial landscape, where institutional investors and other nonbank financial institutions hold a larger share of assets and a larger share

of credit risk than they ever have before – and where an increasing share of conventional credit risk is intermediated through the capital markets? I would argue that the role of a central bank in this new environment is very much in keeping with its traditional responsibilities. Central banks in all countries fundamentally care about the flow of credit in their economies, whether this credit flows from banks, nonbank financial institutions, or institutional investors.

Why is this so? The answer is simple. It is because the credit intermediation process is ultimately what determines how well our economies function and therefore how well our economies are able to grow and allow their citizens to prosper. When the credit intermediation process does not work well, when there are disruptions to the supply of credit to the economy, as history has amply shown, the costs for our businesses and our people can be enormous in terms of lower output and fewer jobs. A well-functioning credit intermediation process is, in short, critical to the sustainability of any economy's success.

It is for these reasons that central bankers are interested in the flows of credit from the global securities markets, just as we have needed to know about the flows of credit from the banks whose operations we are charged with overseeing. At the end of the day, the flow of credit from securities markets has the same impact on our respective societies as that from banks. Therefore, central bankers have an obligation to understand the nature of these flows and the risks that they raise. Crucial to our obligations to our citizens is the need to be certain that these credit markets work smoothly and that credit flows efficiently from those most willing and able to bear the risks to those most able to put the funds to good use. This is as true for the United States as it is for any other country, developed or developing.

Does this mean that central banks believe that capital markets should be supervised in the same ways banks are overseen? Clearly the answer to this question is no. This is not our role.

In my view, central banks broadly have two main responsibilities with respect to the global debt markets. The first is to enhance the price discovery process by promoting transparency in their own actions. The second is to ensure that the banks, as providers of liquidity, perform their proper role in supporting the trading process by making sound credit decisions.

In the United States, the Federal Open Market Committee or FOMC has a pronounced effect on the fixed-income market, both through its policy decisions and in the way the Federal Reserve conducts monetary policy. Indeed, an important part of the price discovery process is the anticipation of the Federal Reserve's future actions. Because the Federal Reserve is such a critical player in the market, it is important that it not create unnecessary uncertainty. That is, the Federal Reserve has a responsibility to be as transparent as possible in the conduct of its monetary policy. Since February 1994, there have been direct and immediate announcements following FOMC meetings of the Committee's policy decisions, which, in my view, have helped remove uncertainty.

In addition, in implementing monetary policy through its trading role, the Open Market Desk has made numerous changes in recent years to add clarity and transparency to its day-to-day market interventions. The thrust of these changes has been to reduce uncertainty and enhance the price discovery process in the Treasury market.

As to the Federal Reserve's responsibility for ensuring that banks support the trading process by making sound credit decisions, let's not forget that, despite the increase in market players, banks in the United States, as elsewhere, continue to play an extremely important role in the financial markets. Not only do banks often underwrite bond issues and structure hedging instruments for

these bonds, but they also provide much of the financing that allows market makers to take positions. Dealers in the U.S. bond markets finance themselves through repurchase agreements with bank counterparties. In many cases, banks are also the source of backup liquidity. It is in these ways that bank credit supports the price discovery process.

In its role as a bank supervisor, the Federal Reserve has the responsibility to see to it that this credit support does not dry up at critical times. One of our primary tasks is to be certain that nothing interferes with the credit intermediation process of banks. This is why bank soundness is so important to us.

The events of last August illustrate what can go wrong with financial markets and why we were so concerned when the global credit markets seemed to seize up following the announcement by the Russian government of an effective devaluation of the ruble and a debt moratorium. These actions were so unexpected that they shocked investors all over the world.

In the United States, the correction of stock prices in the wake of Russia's announcements was not of exceptional size or concern, and had even been anticipated by some astute observers. But the abrupt and simultaneous widening of credit spreads globally for both corporate and emerging market sovereign debt was an extraordinary event beyond the expectations of investors and financial intermediaries. The abrupt shift in investor behavior, in fact, served to intensify price movements and to undermine confidence in market dynamics. It was not just the rebalancing of portfolios that was of concern in the days and weeks following the Russian government's announcements, but also the rush away from risk altogether. In short, it was this seizing up of the credit intermediation process that was of most fundamental concern to us as central bankers.

What we learned as a result of this experience was, among other things, that years of historic data on fixed-income market yields and spreads could not have anticipated the size of the movements in credit spreads that in fact occurred in August and September. We also learned that markets that did not previously move together can suddenly do so, that trends that were under way for several years can abruptly come to an end, and that spreads that have been consistently narrow for years can suddenly widen. In the wake of these events, we have become all too aware that liquidity can be illusory – that individual traders may be able to exit a position when they wish but that not all traders can exit their positions at the same time. For many, these lessons have been humbling.

Going forward, it is important to bear in mind that there most certainly will be further instances when the credit intermediation process is disrupted, when we will face other threats to the well-being of our market positions, our institutions and the global economy. These risks are in the nature of the intermediation process itself.

As the global capital markets continue to grow and become ever more sophisticated – as I believe they will – what is most important for us as central bankers is to operate with a disciplined sense of priorities. It is clear that we as central banks cannot be responsible for any single bond holder, any single bank or any single financial institution. Nor can we control the functioning of the global debt markets or become the regulators of all financial market intermediaries.

What we as central bankers can do, however, is to understand the dynamics of the global debt markets – how they are evolving and whether they are sufficiently liquid and transparent. We can also ensure that banks perform their proper role in supporting the trading process through making sound credit decisions. Furthermore, we can enhance the price discovery process by promoting transparency in our own actions. Finally, and most importantly, we can help create conditions in

our own economies that will support sustainable, non-inflationary growth. In these ways, we as central banks can encourage the efficient functioning of the credit intermediation process in our countries, and in so doing, promote the welfare of the world economy, of which we are all a part.

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