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The great financial crisis: lessons for the design of central banks

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It is a privilege to be asked to participate in a colloquium in honour of Lucas Papademos. Lucas embodies the qualities admired by central bankers around the world: intellectual rigour, thorough knowledge and good judgment. All of us who have served on the ECB's Governing Council during Lucas' tenure have heard him dissect difficult policy issues and summarise complex discussions clearly, succinctly and in a manner that strikes a fine balance among competing intellectual arguments. These qualities have helped him to shape our thinking about the nature of central banking, and it is this thinking that I would like to explore today.

The global financial crisis has shed new light on central banks' role in promoting financial stability. The governance arrangements needed for central banks to fulfil such a role continue to be debated. But I think three general conclusions are widely shared:

- One, central banks will almost always be the first public institution to act when a financial crisis hits. The response to recent turmoil in European sovereign bond markets is consistent with this observation. This raises the question of how to differentiate the central bank's responsibilities in a crisis from those of the government.
- Two, central banks must have realistic financial stability objectives that are consistent with their primary monetary policy responsibilities. Macroprudential policy aims to achieve these financial stability objectives, but cannot be conducted in a vacuum. It needs to take account of and be supported by other policy actions, in particular monetary policy.

- Three, central banks must have the powers and instruments to meet such objectives – or institutional arrangements should enable them to shape the actions of the supervisory authority that control such instruments.

In my remarks today I shall consider some of the implications of these three points.

1. Central banks in a crisis

The crisis showed that central banks have to act immediately when a systemic financial crisis occurs. Their responsibility for the interbank payment and settlement system puts them on the front line. Only they are able to provide almost unlimited system-wide liquidity at very short notice. During the crisis, they did so not only in huge amounts but also in innovative ways that met unprecedented needs. This exposed them to financial and reputational risks, and, in some cases, raised questions about the legal or political basis of their actions.

The statutory basis for central bank liquidity provision in a crisis varies widely from one central bank to another. As monetary policymakers, central banks have an abiding interest in the functioning of financial markets and the monetary transmission mechanism, which links the policy interest rate to term interbank rates, and to the broader money and credit markets. Almost all central banks can provide liquidity to banks against good collateral. Some have explicit powers to provide it also in other circumstances – "unusual and exigent" circumstances, to use the language in Section 13.3 of the Federal Reserve Act. In providing liquidity, central banks will of course try to avoid propping up insolvent banks. But the distinction between liquidity and solvency support is tenuous and shifts over time as a crisis unfolds.

The ability of the central bank to provide funds in its own currency in a crisis can forestall the potential catastrophe that systemic illiquidity could cause. But such actions can have unintended consequences:

- First, aggressively expanding the central bank balance sheet may substitute for markets for longer than intended. In crisis conditions, private financial institutions will prefer counterparties of unquestioned soundness, and it may be difficult to wean them of dependency on the central bank.
- The shifting boundary between illiquidity and insolvency can also lead to unintended consequences. The central bank may find that, by providing liquidity to a bank in distress, it allows some of the bank's creditors to escape before an eventual insolvency. This may increase the fiscal cost of the bank's failure.

- Third, although central banks can help to stabilise markets in the worst moments of a crisis by accepting paper shunned by the market, they could also inadvertently impair the operation of the money market if they were to drain the supply of high-quality collateral needed by market participants. For these reasons, central banks need to strike a balance between the need to protect their financial position and the broader policy objective of making markets work.

In order to be able to provide liquidity at short notice and fulfil their lender of last resort role, central banks need more information about the condition of individual banks *before* a crisis. For example, they need to know the scale of the risk-taking and maturity transformation of some banks .This may require extensive information sharing between agencies and the capacity to obtain information directly from financial firms.

But most importantly, just as central banks must react rapidly and not ignore financial disruptions during a crisis, they cannot evade the responsibility for financial stability during the build-up phase of financial imbalances. A more symmetric approach to deal with financial imbalances is needed. This would be consistent with the idea that monetary policy should act not only on the basis of a central scenario but also taking into account the distribution of risks.

What financial stability mandate would be appropriate for central banks? What powers are needed for different mandates? What mechanisms can be used to hold the central bank to account for discharging its financial stability function?

2. Central bank financial stability mandates

There is considerable diversity across central banks with regard to the source of their financial stability mandates. Sometimes the mandate is set out explicitly in legislation. Sometimes it is derived from specific provisions, such as responsibility for the payments system. Sometimes it is based on a general understanding about the central bank's responsibility for the smooth functioning of the financial system. Whatever their source, existing mandates have permitted central banks to respond flexibly to the challenges generated by the crisis. What they will need in the future is a clearly articulated strategy for promoting financial stability. This may not require new legislation, but it will require clarity of thinking and lucidity in communication about what central banks will do to promote financial stability.

Articulating a coherent financial stability strategy is not easy. Financial stability is by its very nature less amenable to precise specification and measurement than price stability. The absence of bank failures is not an objective: some degree of creative destruction is indispensable in a vibrant economy. Nor is stabilising market levels an objective, for much the same reason. We would, of course, all like to have a precise operational objective for financial stability. It would also be very tidy to separate financial stability from the price stability objective; however, recent events in European sovereign bond markets underscore that financial instability can put the monetary transmission mechanism at risk, and confirm that the two objectives are interrelated and complementary, particularly when longer time horizons are considered.

Such a tidy separation is neither realistic nor desirable. Monetary policy choices have implications for the financial system. And, conversely, macroprudential choices have implications for monetary policy. As you know, central banks are now seeking to integrate financial analysis into the macroeconomic frameworks they use to formulate monetary policy.

Another factor that militates against a precise, quantitative objective is the nature of systemic risk. The crisis has taught us that a narrow focus on the safety and soundness of individual institutions is not sufficient to secure systemic stability. The interlinkages and externalities are too great. In addition, the financial system tends to be procyclical and amplify macroeconomic or global financial shocks, or even to generate instability on its own. Those responsible for financial stability therefore need to have a broader, more systemic vision.

Two jobs central banks are already doing make them naturally suited to furthering this macroprudential agenda. Central banks have a key role in overseeing the payments and settlement infrastructure that is central to the modern financial system. They also devote considerable resources to analysing macroeconomic and financial trends.

In addition, since monetary policy actions affect financial conditions, central banks need to ensure that the two policies are mutually supportive. This will require judgment. Policy rates are adjusted more frequently than regulatory policy settings. It may be necessary to resist calls to first try regulatory measures when the source of a problem is macroeconomic. But macroeconomic measures may also need the support of appropriate macroprudential policy.

If macroprudential settings were to be adjusted in response to cyclical developments, monetary policy decision-making could face further complications. Central banks setting monetary policy would need to know how and when cyclical developments would be likely to influence macroprudential policies, which in turn would affect economic prospects. If an institution other than the central bank is responsible for macroprudential policy settings, some coordination mechanism will have to be designed.

This illustrates a more general point: financial stability, unlike price stability, is likely to be a shared responsibility. The decisions of other government agencies, such as the fiscal authorities, non-central bank supervisors and the competition authorities, affect financial stability. The implication is that we cannot define specific and quantifiable financial stability objectives for the central bank alone.

So there is no simple "one size fits all" answer to the question of how to define the financial stability mandate of a central bank. Nevertheless, the case for such a mandate – even if imprecise – is overwhelming. Those responsible for public policy often have to make do with imprecise objectives. And new policy frameworks inevitably involve a willingness to adapt in the light of experience.

3. Ensuring the central bank has the requisite powers for financial stability

Giving the central bank macroprudential responsibility would require providing it with the power and tools it needs. It would also require developing the necessary structures of accountability. So far, the precise nature of the macroprudential toolkit has yet to be specified, but in general terms it would consist of administrative or regulatory instruments used to mitigate threats to systemic stability.

Historically, central banks have had administrative powers that have permitted them to impose liquidity requirements on banks. Many central banks in emerging market economies have made active use of reserve requirements to restrain banks during booms and to help banks when market liquidity evaporates. Some years ago (when financial markets were less developed than they are today), such powers were used even by central banks in advanced economies mainly to implement monetary policy and to influence credit creation. The use of these same instruments for financial stability purposes is now being mooted. The crisis has certainly shown that banks in the advanced economies need stronger liquidity buffers. Central banks have a particular interest in the design and surveillance of such buffers.

The challenge now is to decide on the instruments that would make the macroprudential perspective operational. A recent review conducted by the CGFS/BIS revealed a very large number of instruments that had been used (or were under active consideration). But many tools have been tried in only one or two jurisdictions.

In designing macroprudential instruments, one of the key questions is what the right balance is between discretionary decisions and built-in automatic stabilisers that can dampen

systemic risk even without deliberate policy decisions. After all, fiscal policy works even in the absence of explicit changes in tax rates or discretionary changes in expenditure thanks to strong built-in stabilisers. Similarly, fixed prudential ratios can exert powerful stabilising forces. It is more difficult, although in my view desirable, to design macroprudential instruments that vary with the cycle, but there are precedents, such as dynamic provisioning and changes in reserve requirements. The current efforts to develop countercyclical capital buffers offer hope that such instruments can be deployed effectively. Certainly this would ease pressures on decision-making.

A larger toolkit has distinct advantages. Central banks can target the source of a problem more precisely. Using loan-to-value ratios for mortgage lending, for instance, might protect the asset quality of banks better than raising interest rates, which may have undesirable side effects for growth or for the exchange rate. In using an expanded toolkit, central banks will have to calibrate the effects. This will not be easy, because we have little or no historical experience of the interactions between different instruments. In deciding how much to target specific sectors, the central bank will need to avoid distorting credit allocation and inducing banks to seek ways around such measures. Remember that monetary policy in developed economies moved away from direct instruments to avoid such distortions and inefficiencies.

The conduct of macroprudential policy more generally involves the identification of vulnerabilities, the evaluation of policies to mitigate them (including a cost-benefit analysis and feasibility assessment) and the design of specific regulations. The central bank naturally has a prominent role in all these activities. Different jurisdictions envisage different roles in each phase.

In the approach being considered in the EU, central banks would play a prominent role in diagnosis and prescription, but a more limited one in implementation and resolution. The process of identifying systemic risks and determining the most effective means for mitigating them will be assigned to the European Systemic Risk Board (ESRB), with representatives primarily from central banks and supervisors. The ESRB will lean heavily on the expertise of central banks and supervisors, and the ECB will provide the secretariat. The ESRB will not have direct authority over any policy instruments, but will instead have the power to make recommendations and to warn the competent authorities. Such recommendations will be difficult to ignore if they are made public and contain a “comply or explain” obligation.

A different role for the central bank is envisaged in the mainstream proposals for a macroprudential framework in the United States. According to these proposals, the central bank would be responsible for the regulation and supervision of systemically significant institutions. Because of its macroeconomic perspective and its understanding of the

operation of financial markets, the central bank is better placed than other authorities to design and implement regulations that will address the risks that arise from the size, business models and the interconnectedness of systemically important financial institutions. The central bank would also be one of a number of members of the multi-agency council with macroprudential responsibilities.

What are the implications for accountability and autonomy?

A wider financial stability mandate will have significant implications for central bank accountability. Financial stability decisions require greater interaction with the government than monetary policy decisions. Determining how to organise such interaction will not be easy because the boundary between monetary policy and financial stability objectives is inevitably rather blurred. The wider the scope of the central bank's financial stability mandate, the greater the scrutiny in the political process, and indeed by the public itself, will be. It is not a coincidence that the frequency of interaction between the central bank and the government is greater in countries where the central bank has a wider financial stability mandate.

Greater interaction with the government need not compromise central bank autonomy. But it does mean that the mechanisms for coordination must be well specified. Indeed, the arguments in the area of monetary policy in favour of making the central bank independent from short-term political pressure apply with equal force in the area of financial stability. In addition, there is a need to shield day-to-day decision-making from the commercial interests of the financial industry. In fact, one argument for assigning financial stability responsibilities to the central bank is that it already has independence to conduct monetary policy.

Greater clarity about the central bank's financial stability mandate and strategy will help promote accountability. Although it is not possible to set out measurable financial stability objectives, it is possible to require clarity about actions and the decision-making process. A clearly articulated strategy for promoting financial stability will make this form of disclosure meaningful. The central bank can then be held to account. Accountability for decisions can be achieved by disclosing information to the public or in reviews by the legislature. Both procedures are widely used for both monetary policy and financial stability policy. To date, however, the disclosure of information on financial stability actions has been less extensive and less frequent than the disclosure of information on monetary policy. This probably needs to change.

The way decision-making arrangements are structured affects both accountability and autonomy. Because macroprudential policy is in its infancy, it is not clear whether it is better to have a single board that decides on both monetary policy and financial stability matters or to have separate committees each making decisions in their own areas. The former facilitates coordination; the latter permits dedicated expertise to be brought to bear and separate accountability mechanisms to be applied. Both approaches are found in about equal measure in the central banking world. Brazil, Sweden and the ECB all have a single board for policy decisions, though particular meetings may be dedicated to monetary policy decisions. By contrast, financial stability and monetary policy decisions are made by separate but overlapping bodies in Malaysia, Thailand and the United States. Joint membership by the Governor and other senior officials helps to ensure the separate decisions are consistent.

Japan has dealt with the issue of accountability and autonomy by adopting double veto arrangements for financial stability decisions. For example, the prime minister and the Minister of Finance may, when they find it necessary for the maintenance of the stability of the financial system, request the Bank of Japan to provide loans. The central bank, however, retains the ultimate discretion as to whether to lend and has articulated the principles it will follow when making these decisions.

Conclusions

The financial crisis will have significant implications for central banks as public policy institutions. They will need to pay greater and more symmetric attention to financial considerations in framing their monetary policy. The synergies and complementarity that exist between monetary policy and financial stability are so great that these policies are often difficult to separate in practice, as recent events in European sovereign bond markets underscore. Central banks will have an important role in any macroprudential policy framework – even when they are not solely responsible for its detailed implementation. The crisis has also shifted the balance of arguments about the locus of supervision, at least with respect to systemically important financial institutions.

But wider responsibilities require greater accountability. Financial stability actions are by their nature more political than monetary policy decisions. The challenge will be to refine and develop the governance mechanisms for central banks so that they retain the independence needed both to conduct monetary policy and to discharge its responsibilities for financial stability. This will require greater clarity about their financial policy strategies. It will also

require well articulated mechanisms for cooperating with other public authorities and the flexibility to address new types of financial risk.

None of this will be easy. There will be no lack of public criticism – particularly when central banks decide on restrictive policies. Higher interest rates are almost never popular. The inherent uncertainties both in measuring systemic risk and in any quantification of the impact of new preventive measures are bound to make it challenging for regulators to justify their policies to the public. This new world of central banking will require that central banks show the professional skills, acumen and integrity that Lucas Papademos has demonstrated in such ample measure throughout his career.