Challenges to Central Banking From Globalized Financial Systems Conference at the IMF in Washington DC, 16-17 September 2002

Session 5: Should Financial Stability be an Explicit Central Bank Objective?

Comments by André Icard, Deputy General Manager of the BIS,

on Mr Roger W Ferguson's paper

Introduction

"Should Financial Stability be an "Explicit" central bank objective?"

This question looks simple if it is considered from the strict point of view of the existing or the suitable institutional arrangements as suggested by the use of the terms "explicit objective".

But the question becomes much more complex when it is considered in a broader perspective in which the debate is enlarged to include the delicate topic of the interrelations between monetary stability and financial stability.

It is one of the many merits of Roger's paper and presentation to have considered the topic in this broader term. In doing so, Roger draws mainly on the Federal Reserve experience but provides also some interesting comparisons with the objectives in the other G7 countries, plus New Zealand and the Riksbank.

Among the many interesting questions raised by Roger one merits special attention: the appropriate degree of "activism" that central banks should consider when pursuing financial stability objectives through the monetary policy levers. When raising this point Roger makes an explicit reference to a study presented by two BIS colleagues Claudio Borio and Philip Lowe at a conference held in Basel in March 2002 and published in July as a BIS working paper. As the authors argue that "a monetary policy response to (financial) imbalances as **they build up may be both possible and appropriate in some circumstances**", this in my view does not characterise a highly activist approach to the problem.

I agree with Roger that hyper activism would be damaging, but I am sure that he would agree with me that a total disregard of financial stability issues would also be seriously counter-productive.

So, I could easily subscribe to a sentence written by him on page 8: "The real question may not be so much whether financial stability should be a central bank objective, but rather how policy makers should weight that objective in reaching policy decisions". The question thus lies not in the domain of principles but rather in the realm of emphasis and judgement.

I. What lessons can be drawn from the existing institutional arrangements?

As a starting point, I would like to make a remark regarding the concept of "financial stability". This concept is almost impossible to define per se and Roger was perfectly right when he approached it by its opposite: financial instability. Financial stability can best be defined as the absence of instability, just as good health cannot be anything else than the absence of illness. However, this rigid distinction between stability and instability is still too simplistic. In between one can identify a large variety of financial vulnerabilities which could well constitute the instabilities of the future.

Owing to the imprecision of the concept, it is hardly surprising that no central banks, to my knowledge, makes an explicit reference in its statutes or objectives to “financial stability” as such. But there is another very good reason for that: central banks cannot address alone all facets of “financial stability”. Even those that are most closely involved in these issues cannot address domains such as tax and fiscal policies or legal aspects of the financial system; even the central bank most active in bank supervision does not control insurance companies or pension funds, not to speak of hedge funds, and those which are most advanced in market surveillance very rarely address the functioning of the stock market and the derivative markets. Other institutions are involved in the surveillance of the sectors which are outside the central bank mandate. Financial stability is thus a shared responsibility.

It is widely recognised that a central bank objective should be clearly defined, easy to communicate, and fully achievable by the monetary authorities. Financial stability in its broad concept does not fulfil these conditions and, thus, cannot easily become an explicit central bank objective.

However, historically and to varying degrees central banks have had the dual objective of safeguarding both monetary and financial stability even if their concern has been limited to certain aspects of the latter. The broader terms used in central bank charters or objectives to describe their responsibilities in this domain are “stability of the financial system” (UK, NZ, ECB, HK, Singapore), a concept clearly narrower than “financial stability”.

Let us consider in greater detail the nature of the central bank involvement in financial stability issues and describe what I would call the various aspects of a **central bank’s financial stability-related tasks**.

Leaving aside the links between monetary policy and the macroeconomic dimension of prudential regulation, which will be addressed in section 2, central bank involvement can be classified with reference to the three building blocks of financial stability: institutions, markets and infrastructures of which payment and settlement systems are the element closest to central banks. In addition, a reference should be made to the role of central banks in crisis management.

(i) Individual institutions

The task of promoting the stability of individual institutions can have two components: prudential regulation and supervision, on the one hand, and deposit protection schemes on the other. However, I will comment mainly on the former, while just noting that, as regards deposit insurance, the degree of involvement of central banks varies greatly across countries, with at one end of the spectrum the Nederlandsche Bank which effectively runs the scheme, and at the other countries like Germany, Sweden, Switzerland and the UK where central banks hardly play any role.

The question of whether banks’ supervisory function should be placed in the Central Bank or outside is heavily debated. Those in favour of central bank involvement in Banking Supervision argue that direct and reliable access to information helps the authorities to better calibrate monetary policy, facilitate rapid action in case of a crisis, and assess and respond to the buildup of system risks. They also argue that the central bank tradition of independence helps to implement rigorous prudential policies.

By contrast, those in favour of a separate financial supervisory agency argue that information exchange is not incompatible with a separation, that central banks should not be too powerful and should focus on their main task of monetary stability, that conflicts of interest could occur between the two functions and that entrusting the supervisor with lender of last resort powers can add to moral hazard.

My guess is that the debate will not come to an end soon and that the answer depends mainly on country-specific circumstances. However, arguing on the basis of the importance of independence and the scarcity of relevant skills, Charles Goodhart[*] comes to the conclusion that the case for combining within central banks supervisory and monetary policy responsibilities will generally be stronger in emerging markets. I share this view.

(ii) Regulation and surveillance of markets

Here again, the degree of involvement differs considerably across central banks. The three markets that are most often identified as object of surveillance are the money market and foreign exchange market, given their close link to the monetary policy function, and the bond market, whenever the central bank acts as an agent for the issuance of government securities. Equity markets as well as those for real assets, such as commodities, are monitored by the central bank only in very specific cases. When the central bank regulates or monitors derivative markets — a situation which is not very frequent – it is mainly with regard to interest rate and foreign currency instruments. Except when monetary policy considerations are at stake, the central bank action generally aims at ensuring a smooth functioning of markets and not at limiting their volatility.

(iii) Oversight of payment and settlement systems

As the ultimate providers of liquidity to the financial system, central banks have always played a pivotal role in payments and settlements systems. This is why central bank responsibilities in this domain are frequently formally recognised in their statutes. These responsibilities commonly apply not only to a monitoring function but also, more significantly, to their role in the regulatory framework. Over the past decade, central banks have devoted increasing time and effort to these activities, as there has been a tendency to consider the risks in payment and settlement system a core form of systemic risk for which central banks should be responsible.

(iv) Crisis management

The role of central banks as lender of last resort has been extensively studied in the academic literature. It is also one about which central banks generally prefer to remain silent. However, the very important role played by the Fed in recent episodes of financial crises is well recognised and documented.

The signs of financial distress can come from a variety of sources: supervisory information, either obtained directly or from another agency, payment and settlements systems, monetary policy operations, market surveillance etc. Granting emergency liquidity support is arguably the most classic tool in the armoury of central banks to deal with financial distress but central banks can also act as honest broker, assisting in arranging mergers or take-overs, influencing the decision whether to close an institution or to reorganise it. The failure of Barings in the UK and of LTCM in the US are prime examples of this.

Summarising this first part of my remarks, I would say that central banks play a significant role in financial stability but this role is never to the exclusion of other forms of action coming form other Agencies.

---

[*] CAE Goodhart “The organisational structure of financial supervision” - FSI occasional paper N° 1 BIS Basel 2000.

A good example of this situation is provided by the composition of the Financial Stability Forum. In this forum, the G7 countries are represented by three members each, one representing the Treasury, one the supervisory authorities and one the central bank. This clearly shows that financial stability is by nature a shared responsibility. However, one year after the FSF was created four additional countries were admitted as members with only one representative each: the Netherlands, Australia, Hong Kong and Singapore. In the four cases the chosen representative has been the Governor of the central bank; this is a clear indication of the significance of central bank action in the domain of financial stability.

II. What interactions between monetary stability and financial stability?

The relationship between the twin goals of price stability, on the one hand, and the stability of the financial system, on the other, is a key issue for central banks as they need to ensure that arrangements for the pursuit of price stability do not inadvertently destabilise the financial system. Conversely central banks also need to ensure that financial system weaknesses do not influence negatively the stance of the monetary policy.

Over the last decade or so, inflation has largely been brought under control but financial instability has become more widespread and severe, rising to the top of the International policy agenda. Among the topics discussed by central banks one can observe a gradual shift away from concerns with monetary stability towards financial stability. More recently, an increasing attention has been paid to the relationship between the two.

However, two schools of thought lead to profound different approaches to the problem: the traditional view is that the best contribution a central bank can make to financial stability is to ensure that inflation is low and stable, that the financial infrastructure is sound and meets international standards, and that adverse financial events are addressed in a timely fashion.

This vision fits perfectly well with the idea that a central bank must focus mainly on its price stability objective, especially in the case of inflation targeting regimes. If a crisis occurs, then financial stability concerns enter into consideration, crisis management techniques are activated and the stance of the monetary can be revised accordingly in a transparent manner. This kind of black and white approach to financial stability by a central bank was recently advocated by Lars Svensson in his contribution to the Jackson Hole conference, as Roger noted.

An alternative view is that while the conditions of price stability and sound financial infrastructure are absolutely necessary for the maintenance of financial stability, they are not sufficient. In particular, even in a situation of low inflation, financial imbalances may develop. This is, in broad terms, the view taken by my colleagues Borio and Lowe.

Independently from the quantitative approach provided in their study, the argument finds a justification in the interpretation one can make of past episodes of financial instability.[1]

The traditionally held view is that financial distress arises mainly from the failure of individual institutions at the micro level. The failure then spreads through various contagion mechanisms linked to payment and settlement systems and the interbank markets. The reactions of market participants can further amplify this process.

This scenario, presented here in very simplified terms, explains rather well various episodes of financial instability such as Herstatt, Drexel Burnham Lambert, BCCI, Barings, LTCM, etc.

[1] Claudio Borio "Towards a macro-prudential framework for financial supervision and regulation?" CES ifo Summer Institute 2002 Venice 17-18 July 2002.

It is, however, of little help in explaining the crises in the Nordic countries in the late 1980s, in Mexico in 1995, episodes in Asia in the late 1990s and the more prolonged one in Japan. In these cases systemic risk arose first from unbalanced macroeconomic conditions: rapid growth, weak financing constraints, benign risk assessments, buoyant asset prices, but frequently limited inflation in the good and services sector. In these cases, the systemic risk was not linked to a specific firm or a group of institutions; rather, it arose primarily from common exposures to macroeconomic risk factors. Once triggered by change in market perceptions regarding the sustainability of macroeconomic conditions, the crisis tends to spread throughout the financial system which has become extremely vulnerable through excessive risk taking.

The possibility of financial vulnerabilities to developing during a low inflation period raises important issues about the attitude a central bank should adopt when confronted with such a situation and more broadly about the design of the monetary policy framework. At this stage, the main question we have to clarify is why act? and when and how to act?

(i) Why act?

If financial imbalances can build up in an environment of low inflation, it is likely that a monetary policy reaction function that does not respond to these emerging imbalances can, in fact, accommodate an unsustainable and disruptive boom of the economy. The end result of this is not necessarily inflation; on the contrary, it could well be a contraction in economic activity, possibly accentuated by a deflationary process amplified by large financial strains. The Japanese experience is very instructive in this respect.

Having said that, three possible difficulties come immediately to mind when considering a preventive action:

- its compatibility with existing monetary regime;
- the difference of time horizon between the monetary objective and what appears to be another objective — at least implicit — in the domain of financial stability;
- the risk of moral hazard raised by Roger Ferguson.

The main question we have to ask ourselves is whether a monetary regime focused exclusively on controlling short run deviations of inflation from some desired average level is likely to deliver the right combination of monetary and financial stability. Admittedly, there are solid reasons to believe that regimes such as inflation targeting promote financial stability as well. But this result is not certain and there are significant risks that they might fail to respond in a sufficiently timely manner to emerging threats to the financial system. Then a slightly modified monetary regime under which the central bank would respond not only to short term inflation pressures but also occasionally to financial difficulties or imbalances may eventually deliver a better combination of monetary and financial stability than a regime purely based on monetary stability.

It is not exceptional for emerging countries to have to abandon an inflation-targeting regime in order to avoid a crisis in their financial system. Peru is one of these cases as it was discussed yesterday. In order to avoid such abrupt changes in monetary regimes which impair the credibility of the central bank, why not recognise a duality of objectives with a clear primacy given to monetary stability, as is frequently the case between price stability and output support (Fed) or support to the economic policy of the Government (ECB, Bank of England, etc.)? The Bank of Finland gives a good example of this kind of arrangement.

In fact, the debate is entirely in the domain of balance of risks and time frame. Roger recognises (p. 13) that “it is possible ... that attaining long run goals for sustainable growth may require some sacrifice of output in the near term”. Similarly there could be a trade off between less stability in the short term (curtailing or ending the boom) and more stability in the long run (avoiding a bigger recession later).

In the same vein, one should consider whether the one to two years horizon generally retained for price stability objectives is not too short to be compatible with financial stability concerns

Roger rightly raised the moral hazard question in case of duality of objectives. I share this concern but moral hazard is mainly a question of market perception, and accordingly, of interpretation of central bank action. Clarity and good communication on the rules of the game are essential to prevent such a phenomenon. Well-conducted and well-explained action is unlikely to generate moral hazard. By contrast I recognise that excess is always dangerous but this is true both ways and in many aspects of central bank activity: too much emphasis on financial stability could easily reduce the degree of risk perception, too little attention to it in a situation of financial imbalances can foster over optimistic expectations of growth. This could be equally dangerous.

(ii) When and how to act?

The research work at the BIS supports the view that the combination of unusually rapid credit expansion and asset price growth should ring alarm bells concerning future generalised financial stress with potentially real macroeconomic costs. These signals look relatively simple to monitor and to operate and the conditions under which such overheating could be contained are not dissimilar from traditional ones: the central bank will move interest rates and one would indeed expect and wish the economy to slow down as interest rates are raised. Whatever the reason, price stability or financial stability, the action will be the same.

Of course, central banking is not an exact science and it is not excluded that the signal in some cases will be difficult to detect with great confidence.

The reference to credit expansion makes a lot of sense as it is widely recognised that financial imbalances — not to mention bubbles — have generally an origin in credit excess. However, a preventive action is recommended and it is not certain that credit statistics will be sufficiently explicit to support action at an early stage.

Similarly, asset price growth could be difficult to assess: property price statistics are still largely lacking and the level of the equity market could be misleading if not complemented by an analysis of the equity premium, which is rather difficult to assess.

* * *

To conclude, I very much enjoyed reading and commenting on Roger's contribution to this conference. When referring to the research conducted by my colleagues at the BIS, he said that their paper was "thought-provoking" and I would be tempted to say that his own paper had the same character.

What differentiates his vision from mine is the way the dynamics of the economy and the associated balance of risks are interpreted. This, in turn, implies differences in the degree of "activism" judged appropriate to take into account financial stability concerns in the conduct of monetary policy.

But it is essential to keep in mind that there is still a lot of empirical and analytical work to do in order to provide a sounder operational basis for the detection of financial imbalances. Similarly, more analytical work is needed into the relationship between financial imbalances, business cycles and monetary policy to provide a sounder intellectual basis for policy actions.

Indeed financial stability has long been a significant concern for central banks. But the dynamics of its interaction with monetary policy in a globalised environment are still largely uncharted territory.

*   *   *