

26.2.2013

The Changing Role of Central Banks

Fourth Future of Banking Summit. Economist Conferences/
The Economist/Paris

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Ladies and Gentlemen,

It is an honour, and a pleasure, to address such a distinguished audience as is gathering today in this conference. I would like to thank The Economist for giving me the opportunity to analyse some of the changes affecting central banks policies.

I will organize my talk around the two main areas of Central Banking: monetary policy and banking regulation.

Firstly, I will address the changing role of central banks in monetary policy, before the crisis and after the crisis.

Up until August 2007 -before the global financial crisis-, the general mood prevailing among academics and policymakers was that there existed a well defined, so to say, "science or model of monetary policy". There was a kind of consensus among central bankers about most elements of monetary policy strategy; and monetary policy was perceived as being highly successful in developed countries, with low inflation and low variability of inflation and output.

According to this consensus, macroeconomic stability was achieved through rule-based monetary policy, delegated to an independent central bank with an implicit or explicit inflation target and with very little role for discretionary fiscal policy.

Conducting monetary policy was considered to be relatively straightforward: the central bank controlled the short-term interest rate with effects on the real economy, mainly through three channels: long-term interest rates, inflation expectations and asset prices.

The credit channel of monetary policy was deemed weak; and the banking sector was ignored by most macroeconomic models used in Central Banks: banks were believed to work well and most market failures were attributed to product and factor markets.

Financial markets were assumed to be efficient at distributing and pricing risk. Financial innovation was welcomed as it promoted gains in efficiency and welfare, leaving a reduced role for central banks on this area.

One of the main implications of this consensus was that price stability was considered to be sufficient for macroeconomic stability. This led most Central Banks to limit themselves to a predominantly micro-prudential approach to regulation and supervision, focused mainly on the soundness of individual institutions. There was a certain neglect of the importance of the stability of the system as a whole.

After the crisis

In 2007, and especially after September 2008, the world was hit by a global financial crisis which not only produced the most severe worldwide economic contraction since the Great Depression, but also put into question our confidence on the "science of monetary policy".

It is probably still premature to identify the new model that will emerge from the crisis. It is clear that some of the old beliefs will remain more or less intact: for instance, the idea that fiscal policy is limited as a stabilization tool.

There are, however, two areas where I see more changes.

First, the conduct of monetary policy, through the implementation of non-conventional monetary policies; and, second, the monitoring of the efficiency of financial markets and the banking sector, and their interaction with macroeconomic stability. Let me comment on these two issues.

Non-conventional monetary policies

At the outset of the crisis, all central banks reacted using conventional monetary policies. First, they reduced interest rates in a rather aggressive way to prevent the disinflationary process from translating into deflation. The outcome of these decisions is that official rates in the main developed economies (Euro area, United States, Japan and United Kingdom) stand now at values very close to zero.

At the same time, faced with the freeze of interbank markets, the main central banks, including the Fed and the ECB, had to take on, directly, the task of redistributing liquidity. In the early stages, the Fed and the ECB provided a generous monetary base to meet the gross needs of banks. The ECB used its flexible array of financial instruments, while the Fed was forced to adapt its operational framework to introduce new forms of intervention.

However, when the crisis worsened after the Lehman Brothers crisis, it became necessary to take stronger action. This required the use of new, non-conventional, monetary policy measures.

According to the academic literature, when interest rates are close to zero, non-conventional monetary policy may come in three different forms: first, management of agents expectations through a commitment by central banks to keep interest rates low for a long period of time; second, increasing the balance sheet of the central bank; and, third, changing the composition of assets in the balance sheet of the central bank.

The FED, the Bank of Japan and the Bank of Canada, have made use of the first kind of instruments aimed at managing expectations. Therefore, they have made announcements about the future path of interest rates to affect the agents' expectations about long-term rates.

However, the non-conventional monetary policies more widely used since 2008 have been of the second and third kind, that is, the ones affecting the size and composition of the central bank's balance sheet.

In the euro area, the ECB changed its liquidity tenders to a fixed-rate system, with unlimited amount. In order to remove uncertainty, it increased their maturity up to three years. It also set up a program to purchase covered bonds and introduced the Securities Market Program and the Outright Market Transactions Program to ensure proper

transmission of monetary policy during the shocks of the sovereign debt crisis. The Securities Market Program was not a quantitative easing instrument, since purchases were later sterilized. In the US, by contrast, the Fed's asset purchases reached a significant scale with the successive rounds of quantitative easing, aiming at lowering the cost of financing over the whole of the yield curve.

These divergences in the use of non-conventional tools reflected not only the specific characteristics of the respective financial systems – the banks predominant role in the euro area compared with a greater importance of capital markets in Anglo Saxon countries - but also the institutional framework and the differing perceptions and assessments of the risks that may be assumed by central banks.

Thus, I would say that the Euro system's response has been more complex, adapting itself to the difficulties that have arisen at the different stages of the euro area crisis, seeking to act on the segments of the transmission monetary policy mechanism that were seen to be most impaired. On the other hand, the US strategy involved some blurring of the boundary which separates monetary policy from fiscal and financial stability policies. This entailed risks for the monetary authority's independence that the ECB, as the central bank of 17 countries with full sovereignty in other non-monetary policy areas, could not assume.

In short, the financial crisis compelled central banks to adopt, along with robust monetary policy responses, exceptional measures and an unprecedented expansion in their balance sheets. Their joint, coordinated action stopped the dangerous spiral of financial deterioration and economic contraction in which the world economy found itself at the end of 2008 and in the first few months of 2009.

However, whatever the changes in implementation, there is one main principle that remains. I refer to the belief that monetary policy -conventional or not- cannot solve the ultimate causes behind the loss in investors' confidence or the tensions in financial or banking markets. In fact, its main role is to provide time to adopt the necessary measures to reform and/or adjust.

Macroprudential policy

The other area in which I see more changes for the role of central banks is in the oversight of efficiency of financial markets and their interaction with macroeconomic stability.

One of the main lessons of the crisis is that price stability, without financial stability, does not guarantee macroeconomic stability. Therefore, there is an emerging consensus on the need to develop a specific new area of economic policy, with a preventive focus and the explicit objective of ensuring the stability of the financial system as a whole. This has been named "macroprudential policy" and together with monetary policy, is bound to become one of the main elements in the policy set in the foreseeable future.

Macroprudential policy is articulated around two dimensions.

The first one, looks at how risk is distributed in the financial system at a given point in time. It requires instruments that impose tighter standards for individual institutions whose

contribution to system-wide risk is larger, the so called Global Systemically Important Financial Institutions (G-SiFis), whose list was last updated by the Financial Stability Board (FSB) in November 2012.

The second one, looks at how aggregate risk evolves over time. This requires the use of instruments that contribute to moderate the typical pro-cyclicality of the financial system. I will come to that later on, when commenting on the new Basel III capital framework.

Before this, allow me to mention the Spanish experience with the so-called “dynamic” or “statistical provisions” which were introduced in 2000. This can be considered a pioneering case of a macroprudential response. The tool proved to be useful in Spain during the financial crisis in the two dimensions identified earlier: mitigating the build-up of risks —even if to a limited extent— and providing capacity of loss absorption to the banks. But the Spanish experience also showed that “dynamic provisions”, although, in my opinion, well targeted and designed, should have been complemented with other instruments.

In order to develop and implement this new policy, the main developed economies have created new authorities in charge of macro-prudential supervision, such as the Financial Stability Oversight Council in the United States or the Bank of England’s Financial Policy Committee. In France, in December 2012, the Government approved a draft Law on the reform of the banking sector that, among other things, envisages the establishment of an equivalent authority, the “Conseil de la Stabilité Financière” (CSF). At the Bank of Spain we are also currently looking at the way a Spanish Macroprudential Authority should be set up.

Changes in bank regulation

Ladies and Gentlemen, I would like to turn now to the changes that have occurred in the regulatory field

The crisis we are still going through was triggered, on the one hand, by the extraordinary loose monetary and financial conditions – and the expansion of credit – of the period between 2000 and 2007. On the other hand, inadequate rules – result of two decades of deregulation, and sometimes bad deregulation - compounded the problem and facilitated high leverage.

The Basel capital ratios of the time were low or, in some cases, not applied. There was excessive reliance on internal bank models. The way VaR models were defined by Basel and applied by banks underestimated what we call tail risks, that is, risks associated to events with low probability of occurrence but extremely high cost.

Therefore, there was a need for a regulatory response after the crisis. Since the main elements of this response are well known, I will limit myself to a few remarks.

First, the response took a predictable pattern: the strengthening of capital requirements, both as regards levels and quality of capital. Basel III is first of all about this.

Second, as already mentioned, the crisis highlighted the need to introduce a macroprudential perspective in financial regulation. The new counter-cyclical capital buffer in Basel III is an important step in this direction. However, the implementation of this instrument will not be easy. The right time for its activation will be difficult to determine and there is uncertainty on the appropriate size of the buffer.

Third, another important element of the new regulation is the introduction of a new leverage ratio. The result is that two different approaches, one risk-weighted based and the other one non risk-weighted, will coexist under the roof of Basel III. This, I believe, introduces some tension in the regulation.

Fourth, it is worth noting that, while Basel III brings in convergence in the numerator of capital ratios - which is a positive development - improvements will be needed in the calculation of its denominator. Available evidence - that is now being considered by the Basel Committee - points to differences in the measurement of risk weighted assets across jurisdictions, which are not always easy to justify on the basis of differences in the nature of risks.

And, fifth, Basel III introduces liquidity standards aimed at addressing the deficiencies in liquidity risk management that became evident during the crisis. Even though maturity transformation is indeed intrinsic to banking activity, an excessive mismatch between assets and liabilities increases the vulnerability of banks to negative liquidity shocks. However, this is the first global regulation of liquidity, and our experience in this area is limited.

Recovery and resolution frameworks

The last component of this regulatory overhaul is the treatment of the systemic institutions. Much attention has been paid to the capital surcharge that will be imposed, as mentioned earlier, on the so-called Global Systemically Important Banks. However, key to dealing with problems posed by systemic - and non-systemic - banks will be the setting up of effective recovery and resolution frameworks as recommended by the Financial Stability Board (FSB).

In this connection, let me note that Spain has just established a new resolution regime, strengthening the powers of our resolution agency, the Fund for Orderly Bank Restructuring (FROB), which was set up in 2009.

Are further measures needed?

Summing up, on the whole, capital requirements have been considerably strengthened. The largest banks, for instance, will have to hold at least seven times as much capital as before the crisis. These measures have undoubtedly strengthened the whole banking system.

However, it is to be noted, and regretted to some extent, that while Basel III capital requirements had been carefully planned to be implemented gradually until 2019, markets and, in some cases, regulators have accelerated this process. In Europe, banks are

generally already recording ratios of Common Equity Tier 1 of 9%. Banks have achieved this not only by raising capital in the markets but also by contracting credit and deleveraging. This raises a concern about the impact the regulatory “overhaul” may be having on credit and growth.

At the same time, however, we are engaging in the discussion of a possible “structural reform” of the banking sector which might come on top of all the regulatory changes.

It is argued that the measures adopted so far do not deal with the risky trading activities of banks profiting from financing with favorable conditions on the basis of the implicit subsidy associated to deposit insurance. These concerns have led to different responses worldwide, such as the Volcker rule in the United States, the proposals of Sir John Vickers in the United Kingdom and, more recently, the draft banking reforms in France and in Germany. At the European Union level, a high-level group chaired by my colleague Erkki Liikanen has prepared a report on the convenience of implementing structural reforms in Europe.

The most relevant proposal of the Liikanen report is to separate into a distinct legal entity risky trading activities of banks where such activities are significant. However, the two entities –the retail bank and the trading bank- may form part of the same banking group, hence preserving the universal banking model.

I believe that this proposal is well oriented, as it addresses an issue that is not tackled by the current regulation, although its effectiveness will depend on the details of its implementation.

There might be scope for improving or further specifying some technical aspects of the proposal. For instance, a distinction should be introduced between “proprietary trading” and “market making” in line, by the way, with the draft banking sector reform that is being currently discussed in France.

Concluding remarks

Ladies and Gentlemen, let me conclude.

Central Banks have played a crucial role in the economic and political response to the financial crisis of 2007/2008. Their use of new and non-conventional tools was decisive to control the financial deterioration and economic contraction that the world was confronting at the beginning of 2009. In so doing, central banks have moved away, to a certain extent, from the old monetary policy model. It might be said that a new one is emerging where central banks will use two sets of policies – monetary and macroprudential policies – to ensure a broadly defined financial stability objective.

Thank you very much for your attention.