Euro50 Group meeting
"Central banks and financial markets"

Concluding Remarks

By

William R White

There was a significant degree of overlap in the points made at the various sessions. It would therefore seem useful to organize them under a set of themes that would seem familiar to any seasoned essay writer. First, what is the character of the problems faced by central banks today? Second, what has caused these problems? Third, how much more difficult might such problems become?. Fourth, how might these problems be resolved? And fifth, what preventive measures might be taken both to alleviate the costs of resolving such problems in the future and to reduce the likelihood of such problems emerging again?

What problems do central bankers face?

Given the chose theme of this meeting, it is not surprising that most commentators focussed on the spreading turmoil in financial markets. However, various speakers referred as well to two other emerging complications for policymakers. On the one hand, inflation is rising globally with the emerging market economies (EME's) most affected in spite of continuing heavy subsidies for fuel in many countries. On the other hand, global growth is slowing sharply, with the advanced market economies (AME's) at the forefront of this trend. Clearly, the financial turmoil and slowing growth will interact. The former will lead to tighter credit conditions which will impede spending. The latter will lead to to more bankruptcies with further effects on the profits of financial firms, more tightening etc.. A few commentators speculated that this dynamic process could eventually lead to unwelcome deflation, albeit after a more welcome period of decelerating inflation.

What caused these problems?

A number of speakers noted the role played by deregulation and changes in technology in allowing and even encouraging the speculation and leverage in the financial system that is now unwinding. Others noted the role played by "bad incentives", including the lack of due diligence encouraged by the originate-to-distribute model, pay structures that gave inadequate attention to risk taking, and the encouragement given by Basel 1 to the use of off balance vehicles. One commentator singled out the role of "modern finance theory" which simply assumes both market efficiency and permanently liquid markets. When these assumptions proved wrong, many market participants were caught by complete surprise.

In addition to these micro explanations, a number of commentators proffered some macro explanations. One point made repeatedly was that the biggest problems were emerging at regulated institutions indicating that both the central banks and the supervisory agencies were "asleep at the switch". How could the massive expansion of the ABS and CDS markets, and the equally massive increase in the use of off-balance sheet vehicles have elicited so few official statements of concern?

Another point made repeatedly was that central banks bore a particular responsibility for the various problems they now face. They had held policy rates “too low for too long”, which eventually culminated in rising inflation, but also generated various imbalances including unjustified increases in asset prices (not least housing), trade imbalances, unsustainably low household saving rates in many countries, and an unprecedented degree of exposure of financial institutions to risky assets. These imbalances are now unwinding, which accounts for the current financial turmoil as well as sharply slowing global growth.

None of these suggestions led to any negative reactions on the part of participants. If it can then be concluded that participants thought all of these causes played some role, then a summary of their views might be the following. Liberalized financial and economic systems are inherently procyclical, and this procyclicality failed to meet any significant regulatory or monetary resistance over the last few years. As a result, according to one participant, “we are in a big mess” and there is plenty of blame to go around.

How bad could it get?

A number of participants noted that the financial crisis had unfolded surprisingly rapidly over the last few weeks. This underlined the great degree of uncertainty about the health of the financial sector looking forward. One participant noted that the CDS market remained the “tranquillized 800 lb gorilla in the cage”. Another suggested that highly leveraged European universal banks might be subject to runs, and that “the market could run longer than banks can stay solvent”. Two participants suggested that the next week in financial markets would be particularly difficult.

A number of participants noted that financial woes were not the only problem. Consumers in many countries were overextended and debt ridden and declining asset prices would be a further drag on spending. In some European countries, house prices had risen even more than in the United States and were equally vulnerable. Generally, the mood of the meeting was that there was a lot of downside risk still out there.

What could public policy do to support the economy?

A number of commentators noted with satisfaction the speed, size and creativity of the procedures adopted by central banks to inject **liquidity** into the world’s money markets. In contrast, a surprising number of participants questioned the efficacy of what had been done to date. Some noted that OIS- Libor term spreads were still huge, and there seemed no immediate prospect of their declining. In short, the liquidity injections “had not worked”, and some felt that they would never work because the underlying problem was not a shortage of liquidity but rather concerns about counterparty risk. . Worse, some participants suggested that these liquidity projections might even have been counterproductive. One person referred to the moral hazard generated by constantly easing the terms of access to central bank money. Another noted, without providing an explanation, that even non financial corporations were now having trouble raising money.

Whether **monetary policy** should be eased further was also mentioned. One participant noted that we were entering into “a negative bubble” and that sharply easier policy was required. Others however disagreed. Some felt that with inflation rising and above targets almost everywhere, and with real rates in most countries still negative, further easing was not desirable. Others felt that, given the headwinds of excessive debt and dysfunctional markets, easing would not have the desired effect on spending in any event.

Other policy issues received less attention. There was no reference to the desirability of fiscal easing, except to the extent this was implied by **measures to support the financial system.** The Paulsen plan for the US was generally thought desirable, although there were many impediments to its successful implementation. Some noted that house prices were still falling and were also dependent on the state of the failing economy. For various practical reasons, negotiated workouts for mortgages in the US would be difficult and the losses to financial institutions accordingly larger. As for European financial institutions, one participant suggested the need for a capital injection coordinated across countries. Another participant noted, however, that there was no institutional framework for this and that it therefore seemed more likely that each country would continue to act in its own self interest. This was hardly optimal.

What might be done to avoid such serious problems in the future?

Assuming that it will not be possible to avoid all future crises, the question arises as to how their severity might be attenuated by actions taken ex ante. The actions discussed included the need for establishing a European forum for crisis management. Some were sympathetic, while others noted that a number of institutional crises (Fortis and Dexia) had in fact been well handled without such a forum. One participant noted the need for a burden sharing agreement in advance of a crisis. He felt that, without real money to spend, the proposed forum would be nothing but a talking shop.

A wider ranging discussion took place about how the likelihood of future crises might be reduced. A number of participants seemed to feel that the analytical framework underlying the setting of monetary policy needed to be completely overhauled; in effect a paradigm shift was needed. Neither the IS/LM framework (with the authorities assumed to set the policy rate), nor its increasingly popular modern spin off, DSGE models, gave enough importance to money and credit growth. In addition, there was no reference in such models to imbalances in the real and financial sectors. Still more fundamentally, some participants stated that the assumption of efficient markets and rational expectations was simply wrong. Needless to say, these attacks on “orthodoxy” elicited a strong defence on the part of others.

There seemed quite general support for the proposition that both regulatory and monetary policies should be used to try to resist the natural procyclicality of the financial system. One aspect of this is that more attention needs to be paid to the build up of systemic exposures, by both the regulatory and monetary authorities. A second aspect is that their needs to be more cooperation between the various authorities. A repeated theme was the necessity for the exchange of information in Europe, particularly about systemically important financial institutions. At least one participant noted the legal and other impediments to this happening. Supervisors have no “culture” of interest in macroprudential issues. Moreover, it was suggested that they are often too badly paid (relative to financial institutions) to attract top rate staff capable of keeping up with new developments.

Participants generally agreed on a third requirement to resist procyclicality; namely, that policies should be applied more symmetrically over the credit cycle. Leaning against the wind was possible, whereas cleaning up after a bubble burst could prove very difficult. For regulatory officials this meant tightening macroprudential controls (higher provisioning, accumulation of capital, liquidity ratios etc.) in the upswing of the credit cycle. For monetary policy, this meant that interest rates might sometimes have to rise even when inflation and near term forecasts of inflation seemed under control. In effect, it would be better to do this and undershot the near term inflation objective a little, rather than let a bubble build and burst with potentially deflationary implications over a longer horizon. This latter proposition concerning monetary policy was not universally supported, however, with some participants suggesting (à la Tinbergen) that the monetary instrument should continue to be allocated to near term inflation control.

Their was significant interest in institutional issues; who does what? Some participants felt that the ECB should be "coresponsible" with regulatory authorities for the largest 40-50 European banks. Others, however, were worried that this would end with the "politicization" of the ECB. The need for greater cross-border cooperation of supervisors in Europe also seemed generally supported. Finally, it was noted that Treasuries should support crisis prevention and should be intimately involved in crisis management. This reflected the fact that crises normally put a significant burden on taxpayers.

The need for broader international cooperation to resist global bubbles was mentioned only briefly. Reference was made to the implications of emerging market countries pegging to the declining US dollar. The upshot was that excessive credit growth in the industrial countries had spread to these other countries as well, with potentially similar implications.. While the IMF and other institutions had warned of these dangers, they had no leverage to induce sovereign countries (most with large holdings of foreign exchange reserves) to change their policies.