LSE public lecture

Banking on the Future: The Fall and Rise of Central Banking

David Green
Former Head of International Policy, FSA

Lord Burns
Chair, LSE

Howard Davies
Director, LSE
Banking on the Future - the fall and rise of Central Banking

Howard Davies
David Green

LSE
12 May 2010
12 Topics

1. What is Central Banking
2. Monetary Stability
3. Financial Stability
4. Financial Infrastructure
5. Asset Prices
6. Structure, Status and Accountability
7. Europe: EMU
8. Central Banking in Emerging Markets
9. Costs of Efficiency
10. International Cooperation
11. Leadership
12. An Agenda of Change
But just two this evening:

- Asset prices, credit, macro-prudential regulation, and monetary policy (Davies)

- Economic and Monetary Union: Unfinished Business (Green)
“We conclude… that the time is now ripe to redress the balance and bring financial institutions back into the heart of monetary economics”

Adrian and Shin – Princeton

“We need to put credit back into macroeconomics in a meaningful way”

Charlie Bean – Bank of England
John Plender
INSIGHT

Blame the central bankers more than the private bankers

No doubt the flak directed at all those private bankers who “don’t get it” about bank bonuses is well deserved. Yet I cannot help thinking that the central bankers are escaping very lightly in the post-crisis dust-up. For while incentive structures in banking exacerbated the credit bubble, they were a much less potent cause of trouble than central bank behaviour across the world.
US interest rates diverged sharply from the Taylor rule from 2001 onwards

Deviation of policy rates from Taylor rule (%), 2000 – 2009

Bank Balance Sheets expanded

Large-cap banks’ aggregate assets rose to 43x tangible book equity, 2000 – 2007

Source: Silverlake, Capital IQ.
In the UK, bank leverage grew from 2002

Major UK banks' leverage ratios*, 1998 - 2008

*Leverage ratio defined as total assets divided by total equity excluding minority interest. Data excludes Nationwide.

Risk became seriously mispriced


Source: JP Morgan research.
Real house prices (Q1 1980 = 100), 1980 - 2008

Source: Bank for International Settlement.
Household debt rose sharply

Household debt as % of GDP, 1987-2007

Source: FSA, ONS, Federal Reserve, Eurodata, Datastream
There has been no shortage of financial stability literature

The number of countries publishing FSRs, 1995 – 2005

But it has lacked candour and penetration

How do existing FSRs compare to the proposed criteria?

Financial stability is much less tangible than price stability

Contrasts between Price and Financial Stability

<table>
<thead>
<tr>
<th></th>
<th>Price Stability</th>
<th>Financial Stability</th>
</tr>
</thead>
<tbody>
<tr>
<td>a) Measurement and Definition</td>
<td>Yes, subject to technical queries</td>
<td>Hardly, except by its absence</td>
</tr>
<tr>
<td>b) Instrument for control</td>
<td>Yes, subject to lags</td>
<td>Limited, and difficult to adjust</td>
</tr>
<tr>
<td>c) Accountable</td>
<td>Yes</td>
<td>Hardly</td>
</tr>
<tr>
<td>d) Forecasting Structure</td>
<td>Central tendency of distribution</td>
<td>Tails of distribution</td>
</tr>
<tr>
<td>e) Forecasting Procedure</td>
<td>Standard Forecasts</td>
<td>Simulations or Stress Tests</td>
</tr>
<tr>
<td>f) Administrative Procedure</td>
<td>Simple</td>
<td>Difficult</td>
</tr>
</tbody>
</table>

To make financial stability a reality, the central bank needs

- A robust set of indicators of financial stress
- To identify systematically important firms
- To patrol the regulatory frontier
- To monitor scope for regulatory arbitrage
- To contribute to the assessment of the need for counter-cyclical capital requirements
Leaning against the wind

- Should central bank target asset prices? No
- Should the measure of inflation targeted include an element of house price inflation? Yes
- Is it possible to identify bubbles and misalignments? No harder than other judgements
- Does the central bank need another tool? Yes
Macroprudential mechanism: The new, new thing

BIS Report on Macroprudential Policy

- There can be no guarantee that increased efficiency of intermediation at the individual firm level will necessarily improve economic welfare...

- A major source of concern derives from difficulties in pricing new instruments… the presumed superior liquidity of securitised assets may turn out to be a mirage… new instruments transfer risk from one economic agent to another, but do not eliminate that risk… there is the possibility that credit risk is becoming more concentrated within financial structures...

- An important question is whether innovation has added to, or subtracted from, the degree of volatility in financial markets… a further question is whether financial innovation leads to growth in overall debt.
Macroprudential mechanism: The new, new thing

BIS Report on Macroprudential Policy

- There can be no guarantee that increased efficiency of intermediation at the individual firm level will necessarily improve economic welfare…

- A major source of concern derives from difficulties in pricing new instruments… the presumed superior liquidity of securitised assets may turn out to be a mirage… new instruments transfer risk from one economic agent to another, but do not eliminate that risk… there is the possibility that credit risk is becoming more concentrated within financial structures…

- An important question is whether innovation has added to, or subtracted from, the degree of volatility in financial markets… a further question is whether financial innovation leads to growth in overall debt.

ConDem Coalition Agreement (12 May)

“The parties agree that reform to the banking system is essential to avoid a repeat of Labour’s financial crisis…
…we agree that a banking levy will be introduced…”

The parties agree that the regulatory system needs reform to avoid a repeat of Labour’s financial crisis. We agree to bring forward proposals to give the Bank of England control of macro-prudential regulation and oversight of micro-prudential regulation.”
An end to Deviant-Brown-Ballsite-Single-Targetism?

- Macroprudential policy within the Bank of England
- Will only make a difference through material changes in the volume and price of credit as banks adjust their spreads
- A change in the monetary stance through a different route
- So macroprudential regulation must be considered alongside monetary policy.
Conclusions

1. A narrow focus on retail price inflation can deliver sub-optimal outcomes.

2. There is a persuasive case for leaning against the wind of asset price bubbles, but more work is needed on the practicalities.

3. Financial stability should be a statutory objective for the central bank.

4. The inflation target regime should be interpreted in the light of that objective.

5. A macro-prudential mechanism is a useful addition to the toolkit, but must be considered alongside the short-term interest rate.

6. The case for the central bank to be also an institutional supervisor is, at best, unproven, and a strong central bank role may result in less regulatory integration than is desirable. There is also a risk of ‘accountability contagion’ which can affect independence.
Policy Responses to the Financial Crisis

Dr Ben S Bernanke
Chairman, US Federal Reserve
The Challenges for Central Banking in the aftermath of the Global Financial Crisis

Howard Davies
Director, LSE

LSE Alumni Lecture Series
Sheikh Zayed Theatre, New Academic Building
9 February 2010