



Central Banking and the **Credit Crunch**

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“There have been three great inventions since the beginning of time: fire, the wheel and central banking”

Will Rogers

Five Questions

1. Is it the Fed wot done it?
2. Should central banks take more account of asset prices in setting interest rates?
3. Is there a case for a macro-prudential overlay on bank capital requirements?
4. Do central banks need to play a hands-on role in the supervision of individual banks?
5. Does the 'social contract' between banks and the finance authorities need to be renegotiated?

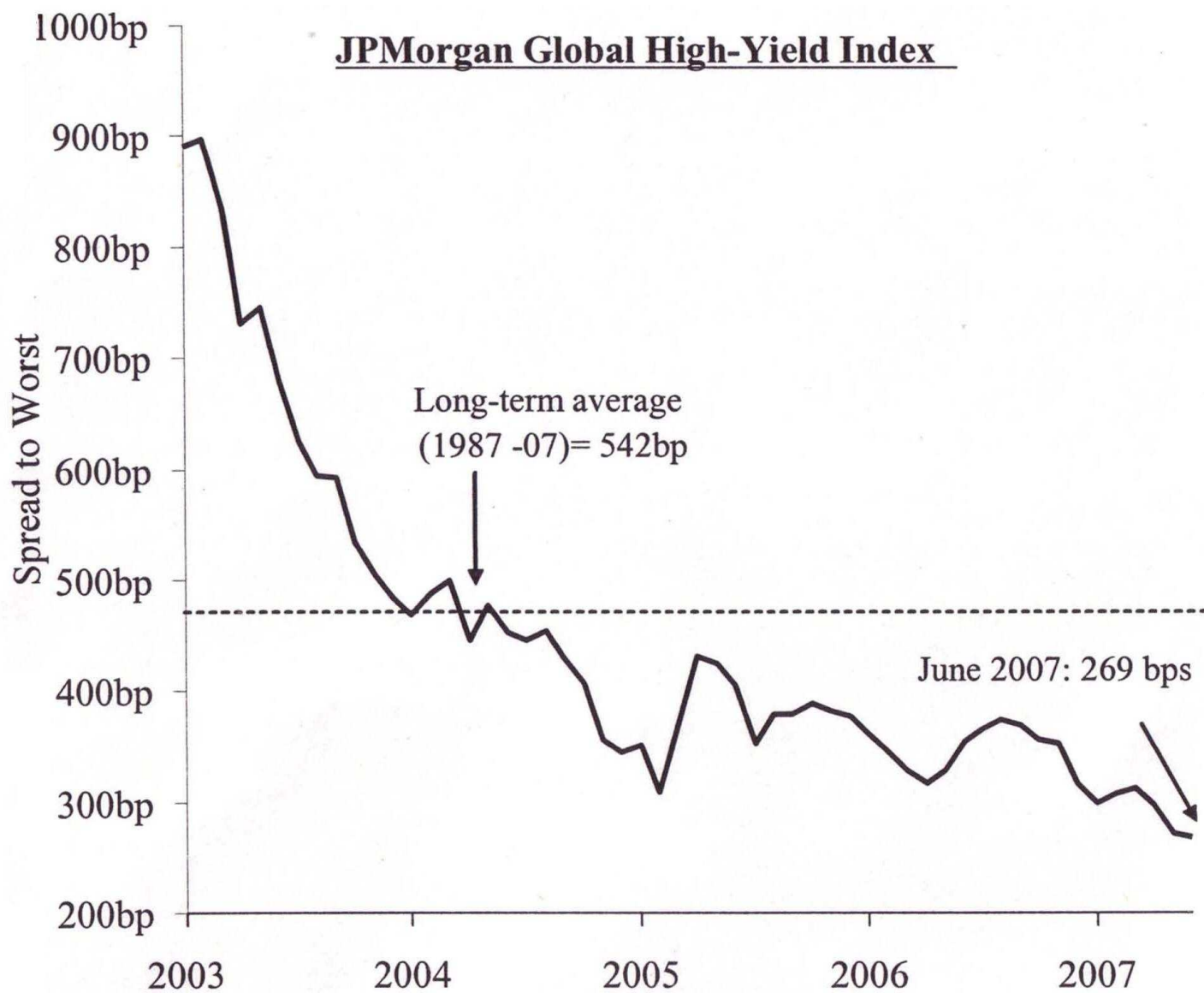
Five Questions



1. Is it the Fed wot done it?

“Central banks were asleep at the switch. The lack of monetary discipline has become the hallmark of an unfettered globalisation. Central banks have failed to provide a stable underpinning to world financial markets and to an increasingly asset-dependent global economy”

Steve Roach, Morgan Stanley
August 2007



Five Questions

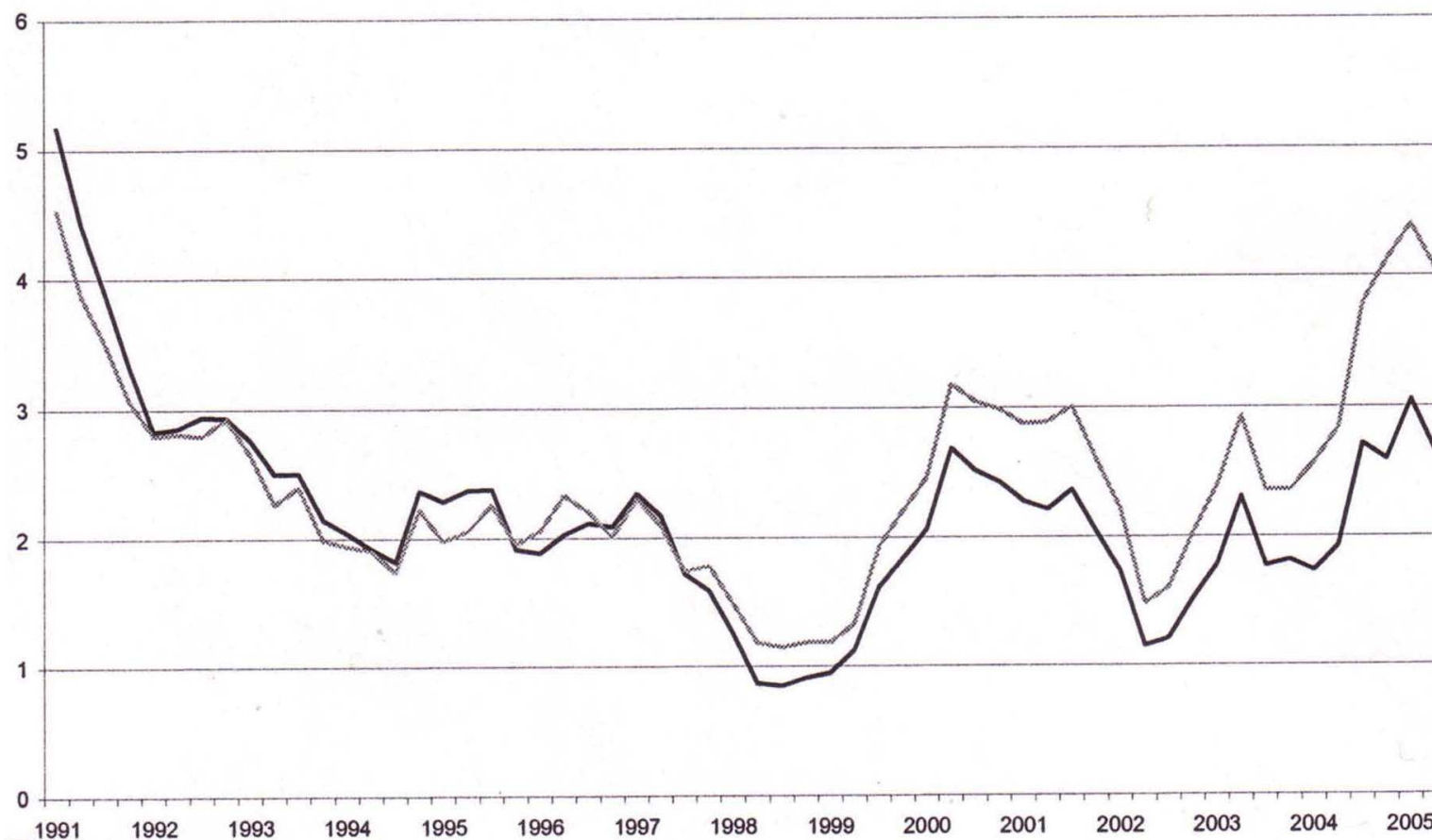


2. Should central banks take more account of asset prices in setting interest rates?

Including House Prices in the US Inflation Measure



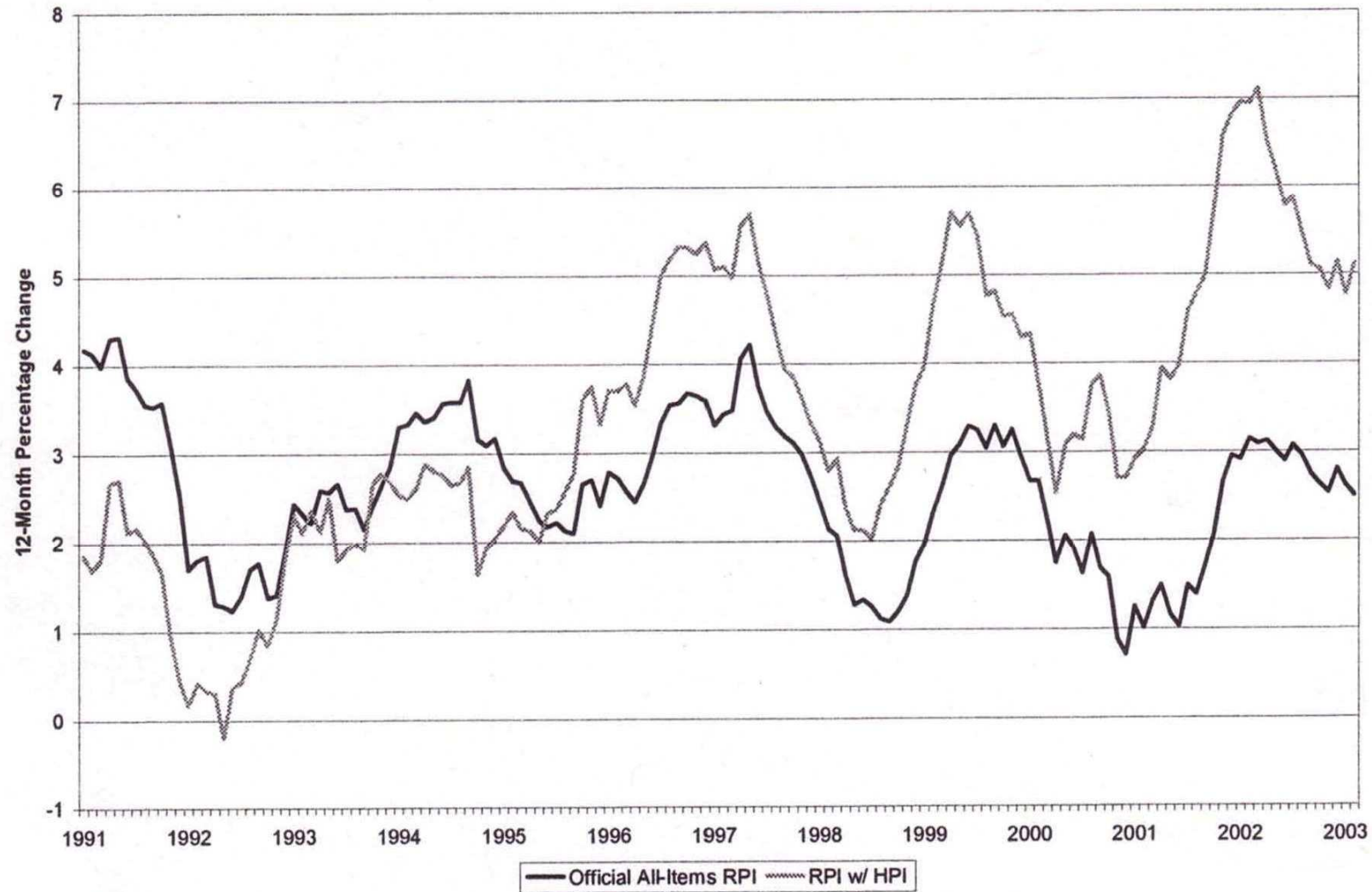
Personal Consumption Expenditure Inflation



___ PCE Inflation

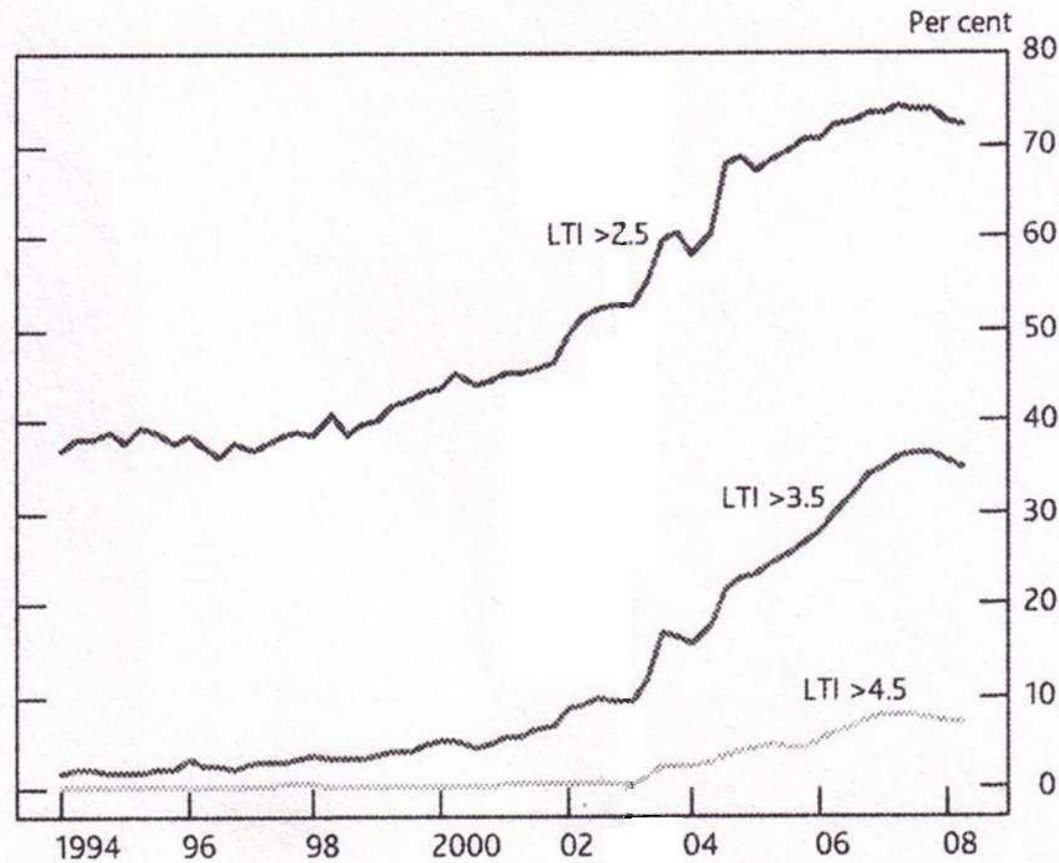
___ PCE w/OEHEO

The UK Retail Price Index



Source: UK all-items Retail Price Index, RPI housing component with Nationwide UK-wide HPI.

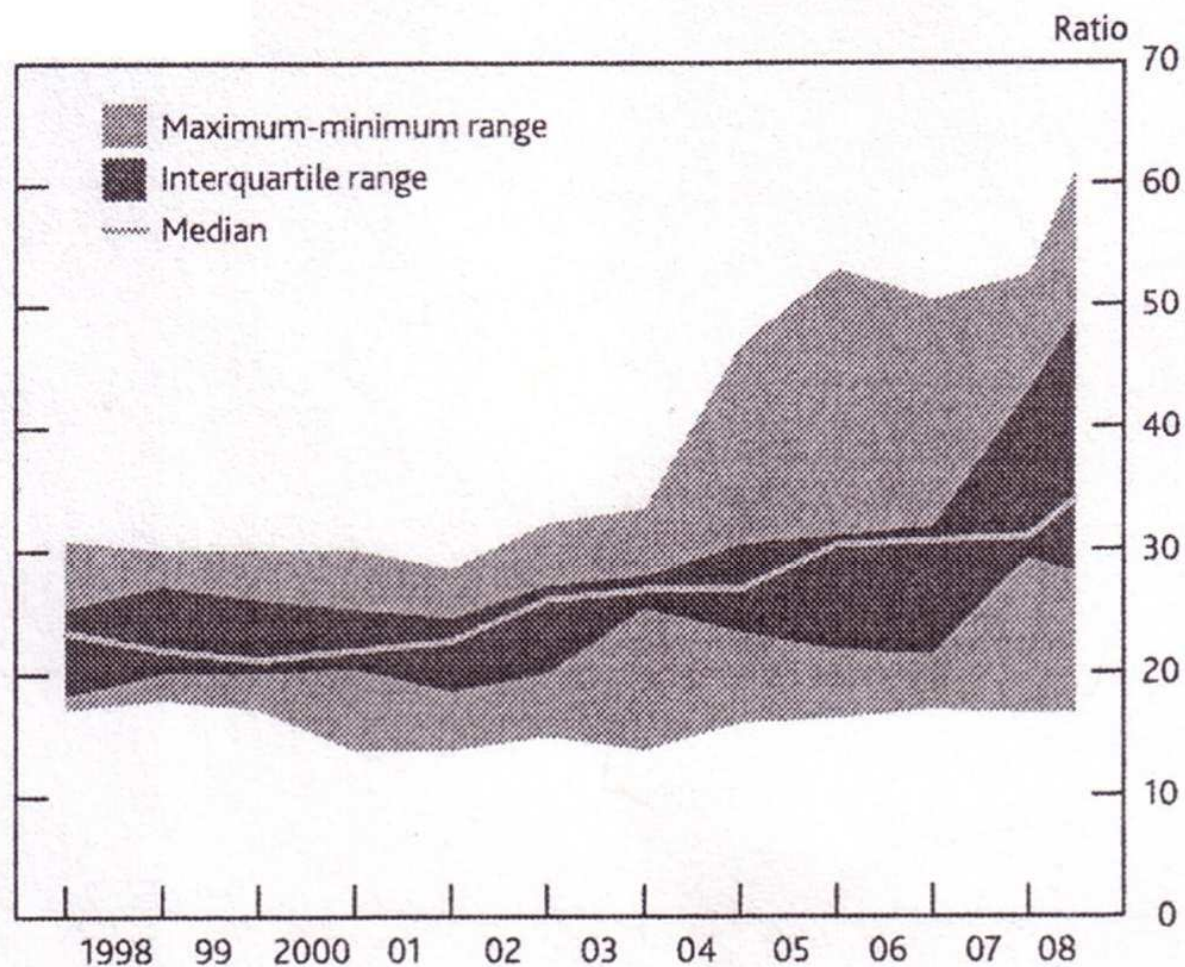
Loan to income ratios for house purchases in the United Kingdom^{(a)(b)}



Sources: FSA, Survey of Mortgage Lenders and University of Essex.

- (a) Chart shows the proportion of mortgages with loan to income ratios greater than 2.5, 3.5 and 4.5.
- (b) FSA data are used from 2005 Q2 onwards. The back-run has been constructed using the changes in the series from the Survey of Mortgage Lenders data set.

Major UK banks' leverage ratio^{(a)(b)}



Sources: Published accounts and Bank calculations.

(a) Leverage ratio defined as total assets divided by total equity excluding minority interest.

(b) Excludes Nationwide due to lack of interim data.

Five Questions

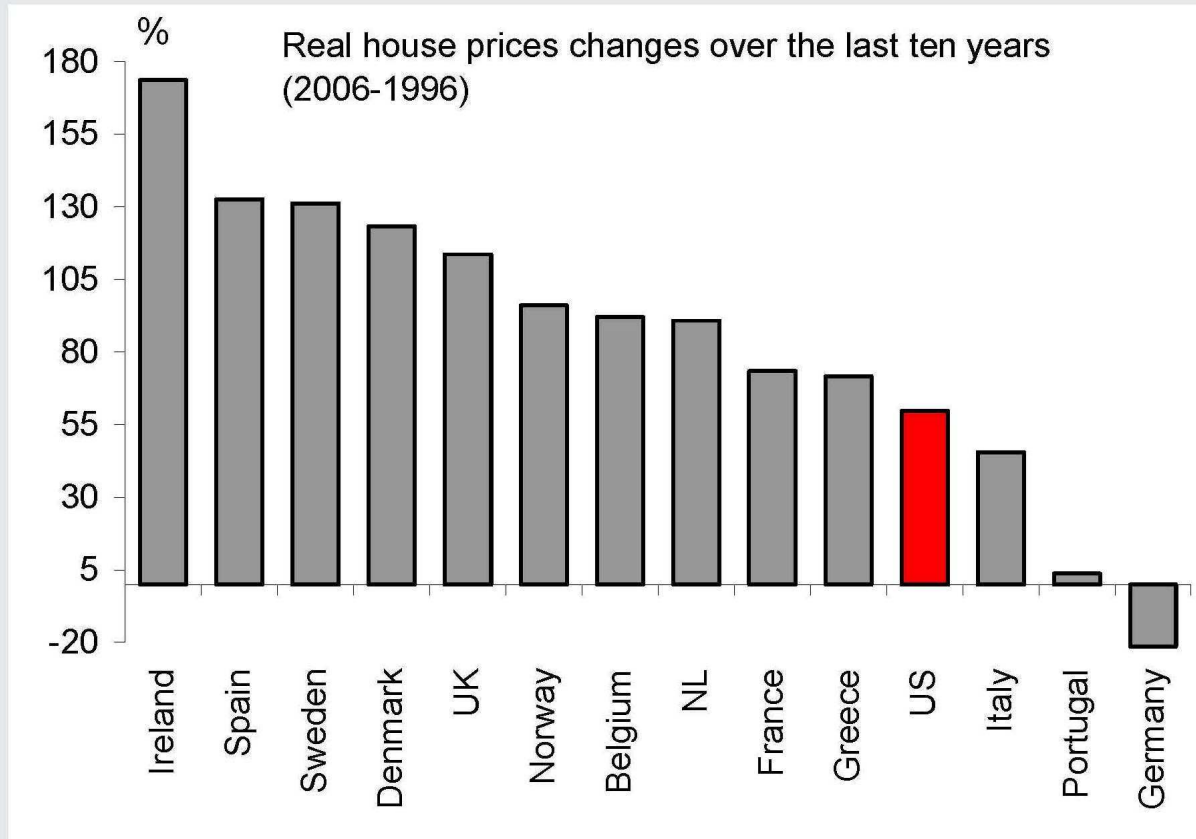


3. Is there a case for a macro-prudential overlay on bank capital requirements?

“ Bank failures are caused by depositors who don’t deposit enough money to cover the losses due to mismanagement”.

Dan Quayle

Real increase in house prices over the last decade



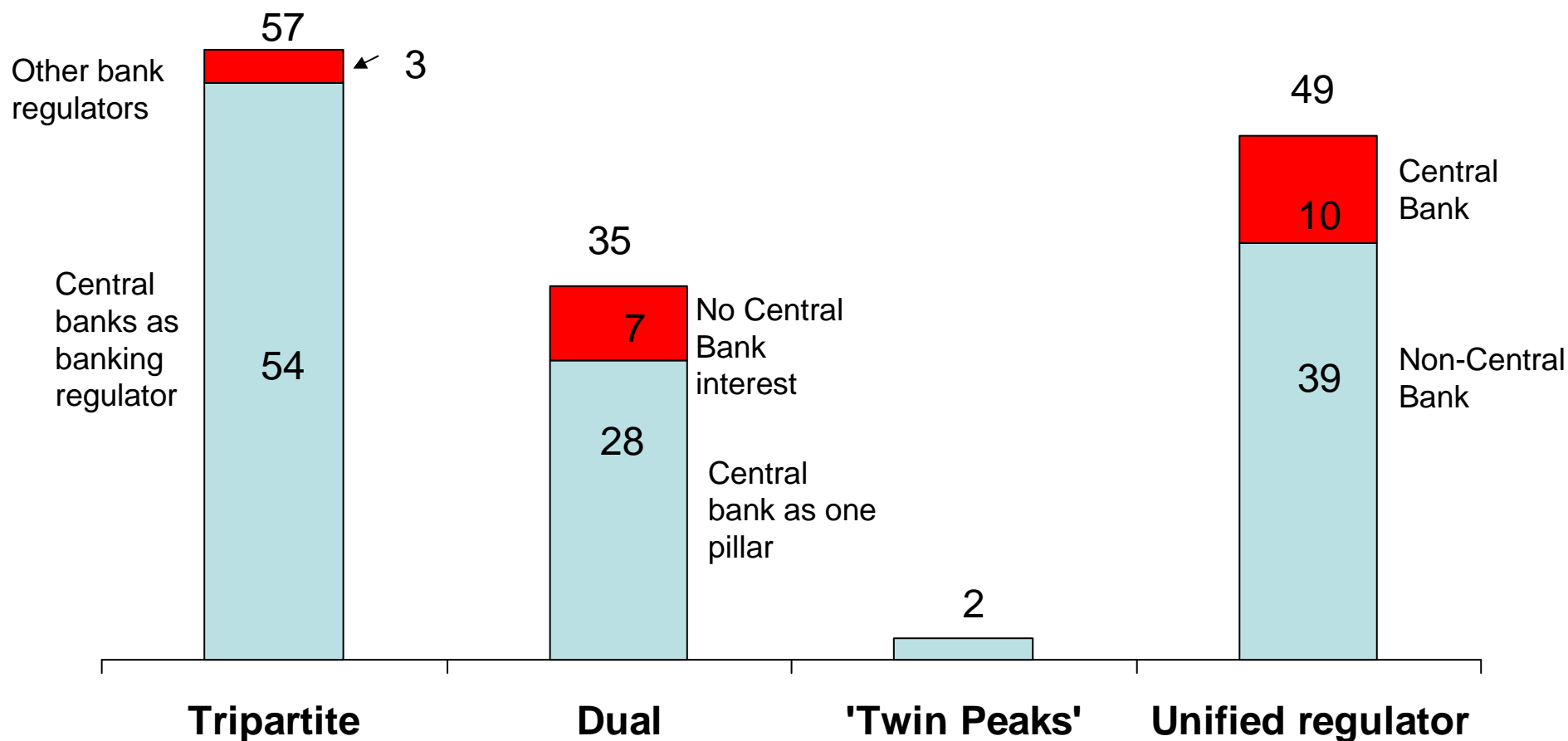
Source. ECB, National Statistical Offices, IMF, EMF, Italian Ministry of Infrastructure, Morgan Stanley Research

Five Questions



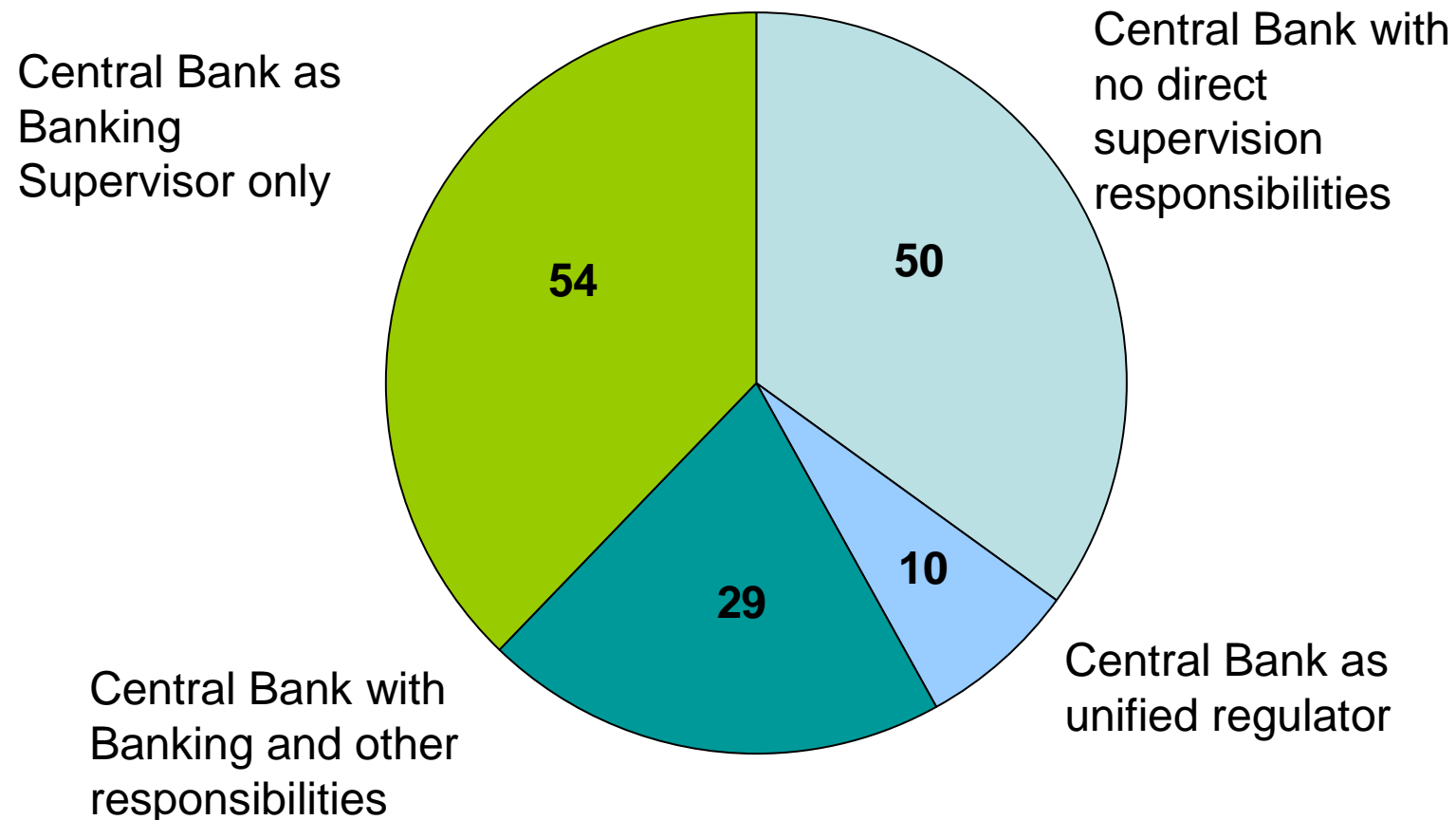
4. Do central banks need to play a hands-on role in the supervision of individual banks?

National Regulatory Structures



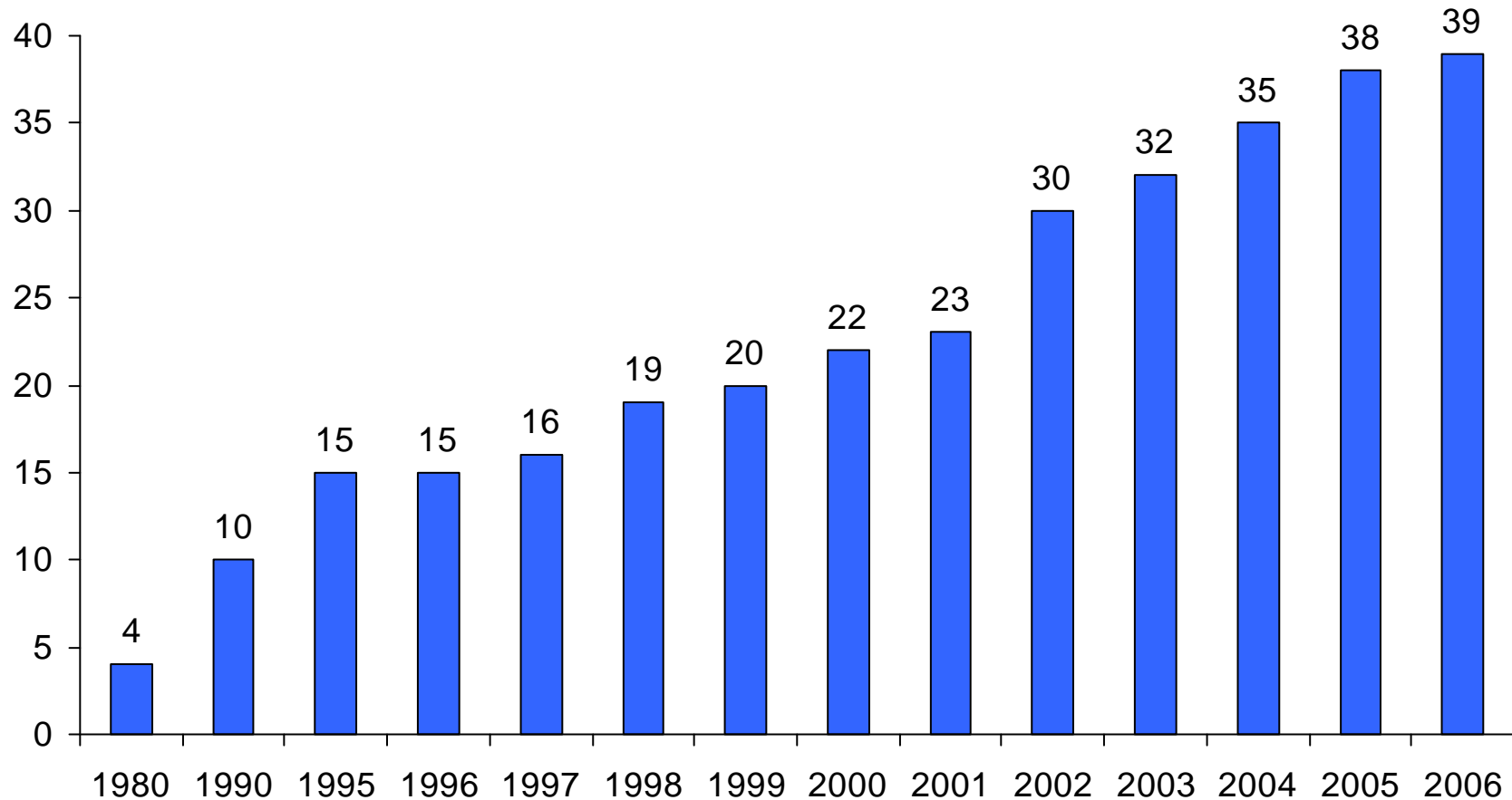
Source: How Countries Supervise their Banks, Insurers and Securities Markets
2007: Central Bank Publications

Central Banks in Regulation

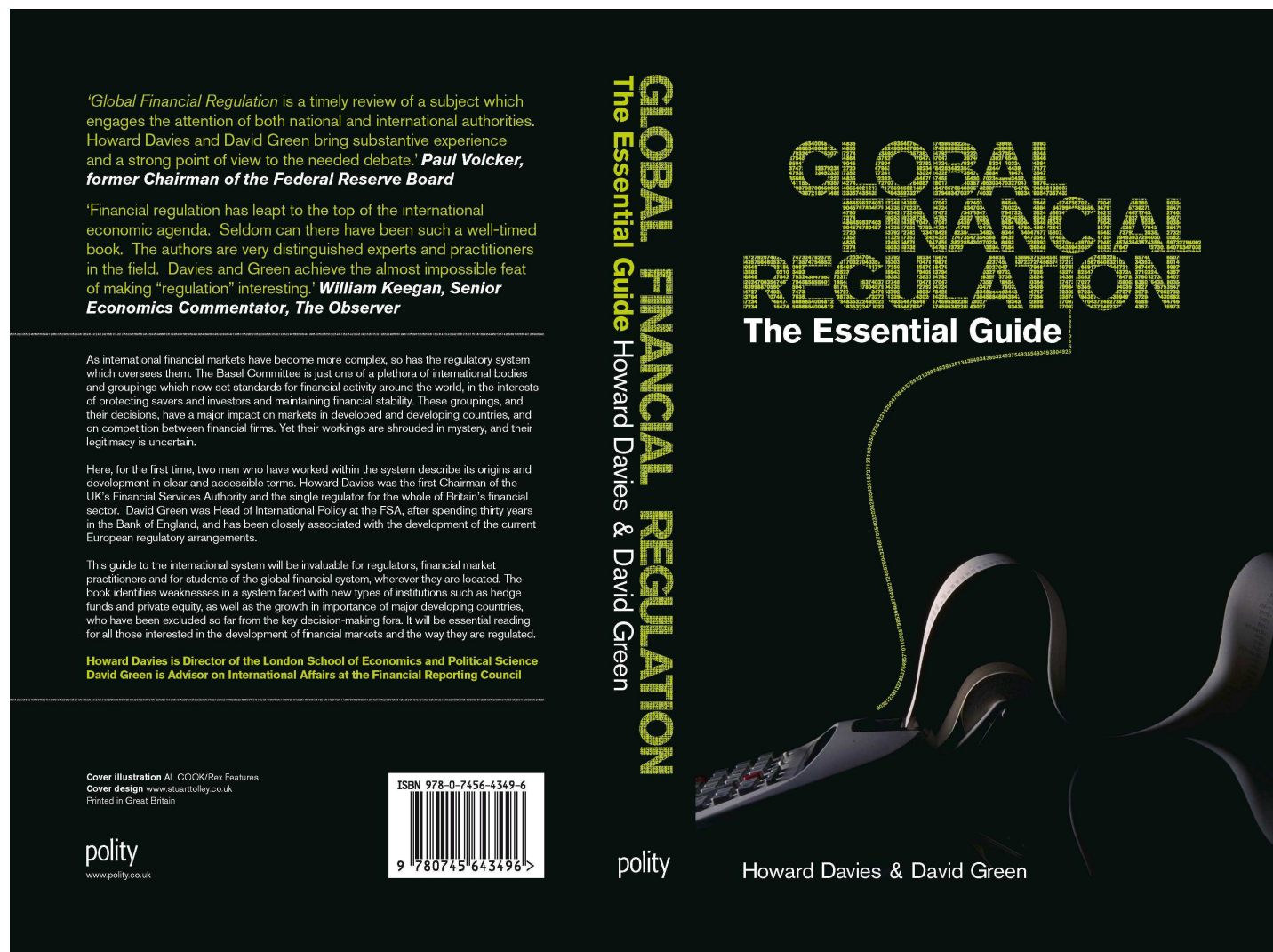


Source: How Countries Supervise their Banks, Insurers and Securities Markets
2007: Central Bank Publications

Non-Central Bank Unified Financial Regulators

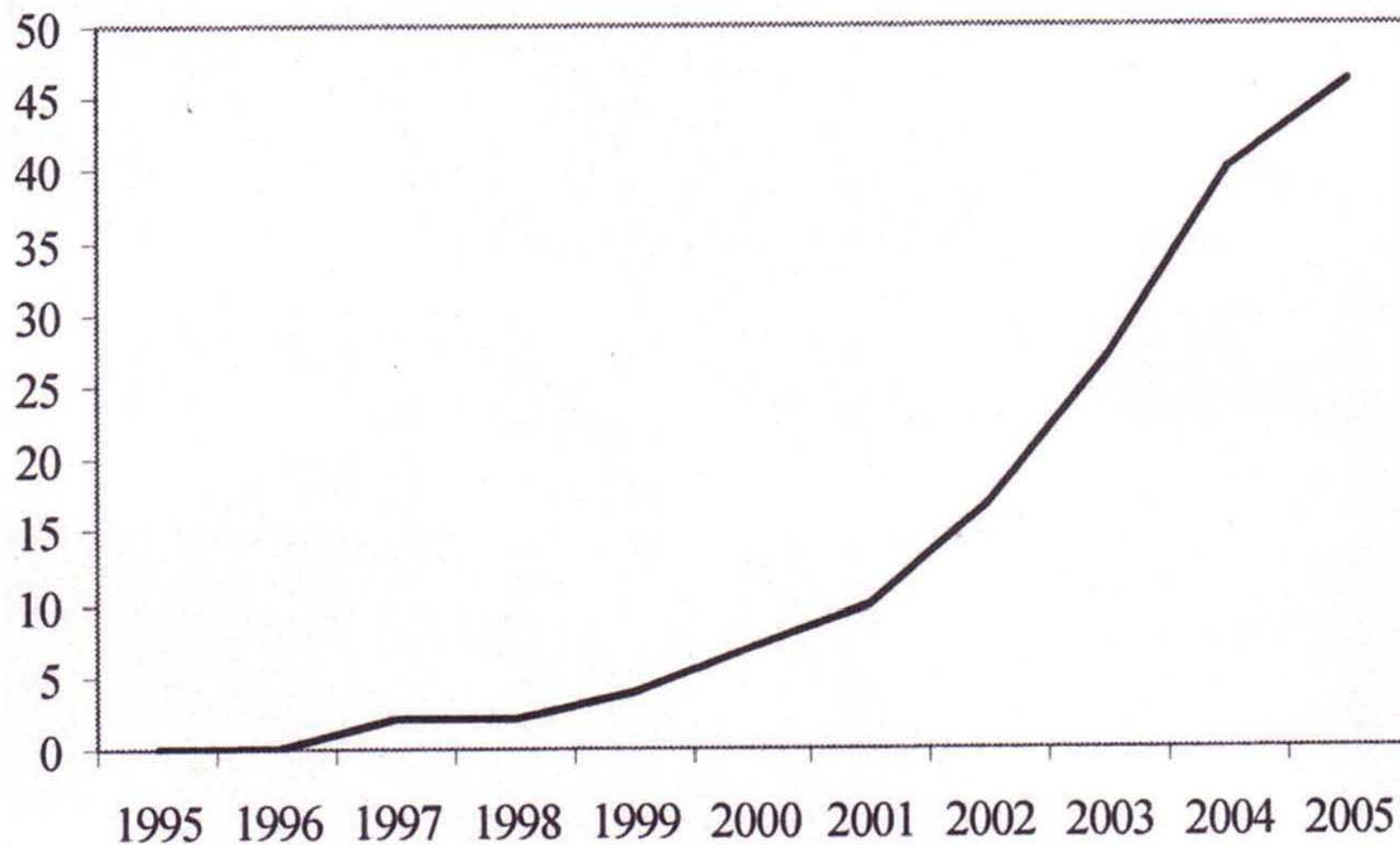


Source: How Countries Supervise their Banks, Insurers and Securities Markets
2007: Central Bank Publications

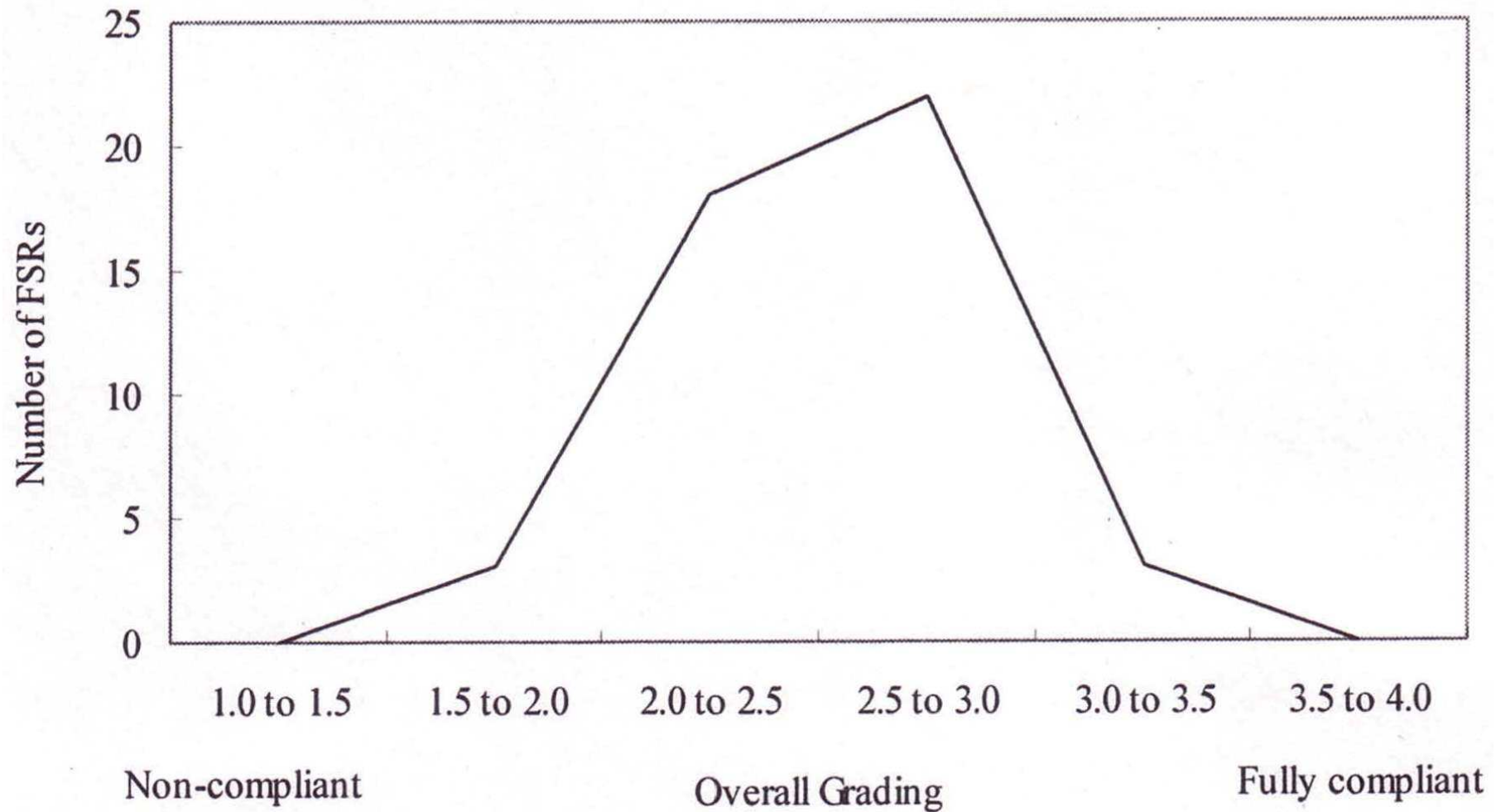


“Financial stability assessment as currently practiced by central banks and international organisations probably compares with the way monetary policy assessment was practiced by central banks three or four decades ago – before there was a widely accepted, rigorous framework”

The Number of Countries Publishing FSR's 1995-2005



How Do Existing FSRs Compare to the Proposed Criteria?



“Interestingly, gradings are on average higher for central banks not directly involved in day-to-day supervision, partly reflecting that the overall assessments in these reports are more candid”

Martin Cihak
IMF
December 2006

“ The Fed’s ability to deal with diverse and hard to predict threats to financial stability depends critically on the information, expertise and powers that it holds by virtue of being a bank supervisor and a central bank”

Chairman Ben Bernanke
January 2007

“The US system is at odds with the increasing convergence of financial service providers and products...(in future) the Fed’s role would continue through traditional channels of implementing monetary policy and providing liquidity to the financial system...(this role)... would replace the Fed’s more limited role of Bank Holding Company supervision”

U.S. Treasury
March 2008

Five Questions



5. Does the 'social contract' between banks and the financial authorities need to be renegotiated?

The Social Contract



Banks

Maturity transformation

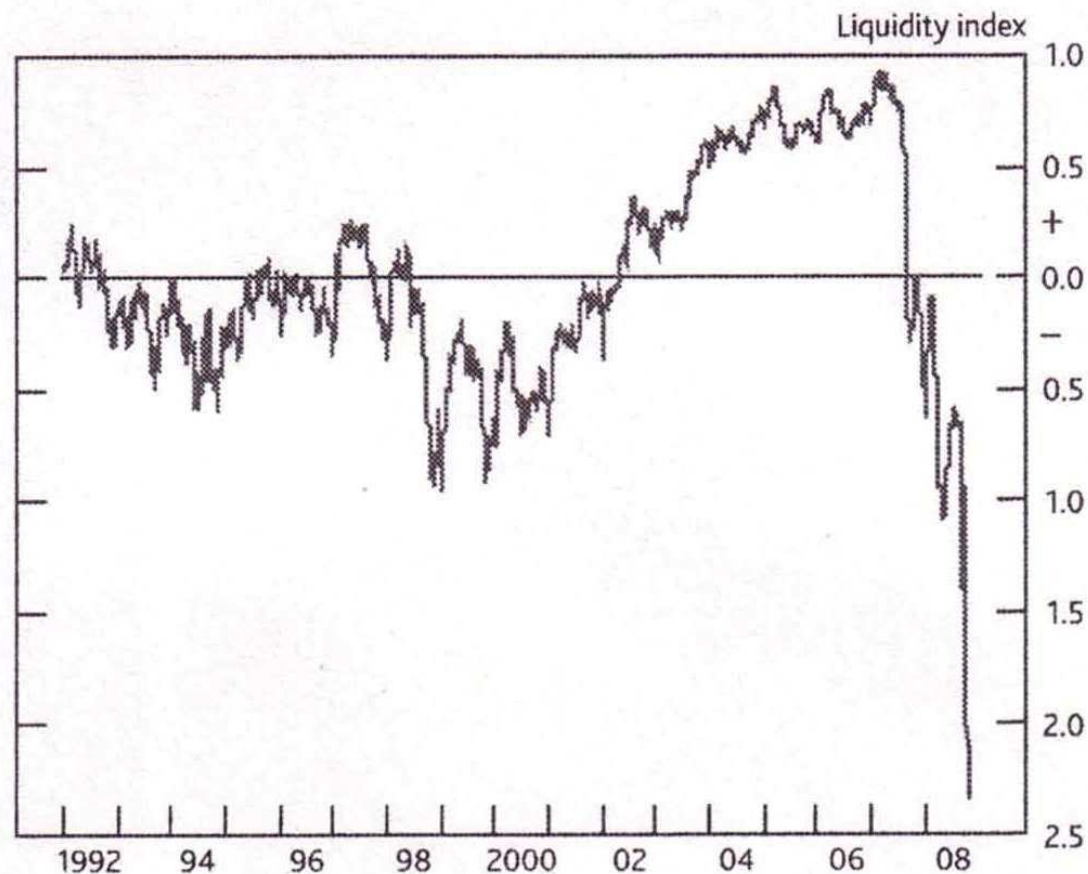
Government

Prudential Regulation

Deposit Insurance

Central Bank Liquidity
(lender of last resort)

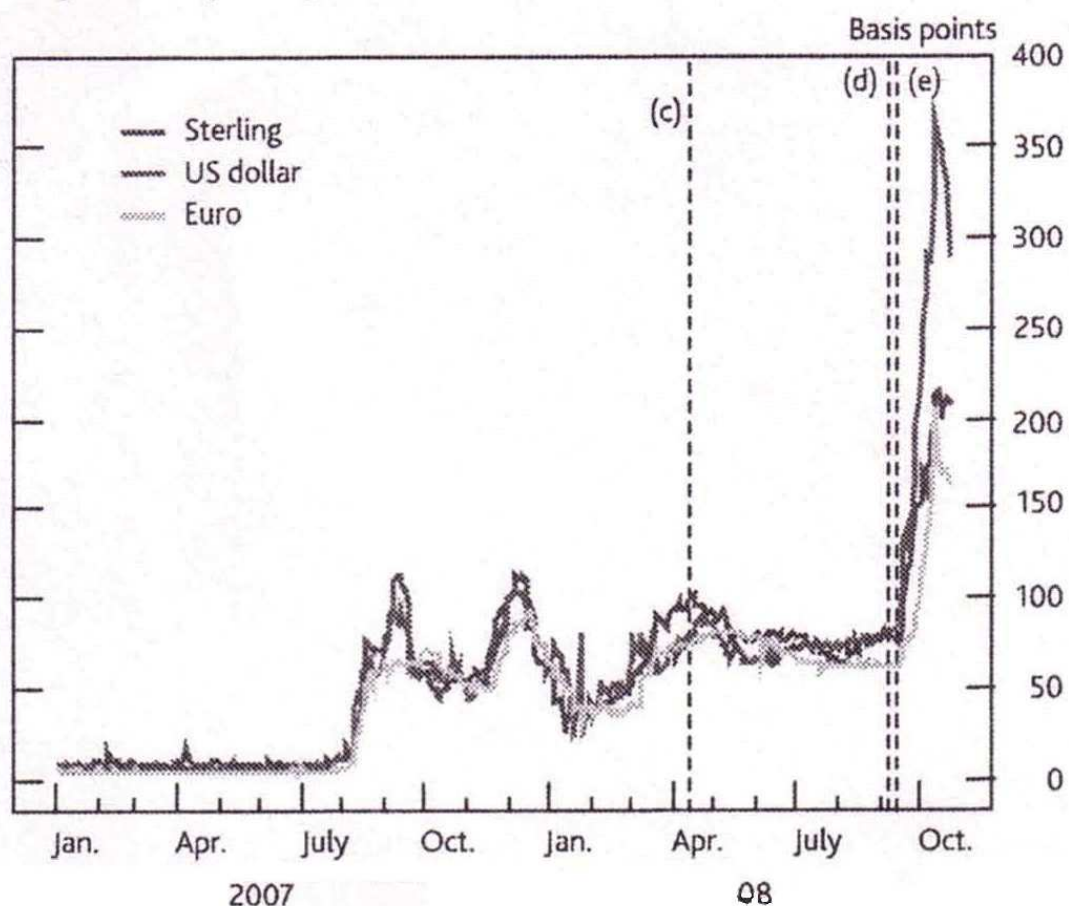
Financial market liquidity(a)



Sources: Bank of England, Bloomberg, Chicago Board Options Exchange, Debt Management Office, London Stock Exchange, Merrill Lynch, Thomson Datastream and Bank calculations.

- (a) The liquidity index shows the number of standard deviations from the mean. It is a simple unweighted average of nine liquidity measures, normalised on the period 1999–2004. The series shown is an exponentially weighted moving average. The indicator is more reliable after 1997 as it is based on a greater number of underlying measures. The recent fall in the indicator is largely due to a sharp decline in the interbank market liquidity measure.

Three-month interbank rates relative to expected policy rates^{(a)(b)}



Sources: Bloomberg and Bank calculations.

- (a) Spread of three-month Libor to three-month overnight indexed swap rates.
- (b) Data to close of business on 20 October 2008.
- (c) April 2008 Report.
- (d) Fannie Mae and Freddie Mac taken into conservatorship.
- (e) Lehman Brothers Holdings files for Chapter 11 bankruptcy protection.

“If the fundamental evolutionary criterion of success is that an organisation should reproduce and multiply over the world, and successfully mutate to meet the emerging challenges of time, then central bodies have been conspicuously successful”.

Capie, Goodhart and Schnadt
The Future of Central Banking



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