Challenges for the Future*

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The dinner last night we shall all remember for a long time. We were fortunate enough to hear three Federal Reserve chairmen—each of them a giant in his own way—and a reply from Don Kohn that was not only insightful and thoughtful but moving too.

Tributes are one thing, but the Bank of England puts its money where its mouth is. Alan Greenspan originally loaned Don Kohn to the Bank, as we couldn't afford the transfer fee. But as soon as Don was out of contract, we swooped to sign him for our new Financial Policy Committee (FPC). The respect and affection in which Don is held at the Bank of England is demonstrated by the presence here of three of us from the Bank.

So what lessons have Don and we at the Bank drawn from the crisis? Let me relate these to the three topics of the conference—monetary policy, liquidity provision, and macroprudential policy, three of the core functions of central banks. The financial crisis has brought these core functions closer together, highlighting the complementarities as well as blurring the lines between them. The separation of monetary from financial stability policies no longer seems so clear-cut, and this new world presents central banks with many challenges.

1. Monetary Policy

The challenge for monetary policy can most easily be put as follows. Before the financial crisis, output growth was around trend in the

 The reader should keep in mind throughout that these remarks were delivered on March 24, 2012.

industrialized world, inflation was low and stable, and yet the balance sheet of the banking sector, and so broad money, expanded at a destabilizing pace.

In the United Kingdom growth averaged 2.9 percent in the five years to 2007, only marginally above the average growth rate from 1950 to 2002. Nor is there evidence of an output boom in other advanced economies. The International Monetary Fund estimates of the output gap for the United Kingdom, Japan, and the United States were all small, and that for the euro area saw only a short-lived pick-up in 2006–7. Consistent with the steady growth of output, inflation was low and stable: indeed UK inflation did not stray more than 1 percentage point from target for nearly fifteen years until March 2007.

Yet we saw persistent global imbalances and a build-up of leverage that led to the financial crisis. In the United Kingdom, the largest banks' balance sheets grew by an average of nearly 25 percent a year from 2002 to 2007. UK banks tripled in size in that time. The pace of growth was only a little less frantic in the euro area, where the largest banks' assets grew by 18 percent a year. The largest U.S. banks grew by less—but the shadow banking sector was a much more important part of the story there.

The question is, to what extent should monetary policy be set explicitly with a view not only to medium-term output and inflation but also to mitigating slow-burn financial stability risks? That is a challenge to the intellectual foundations of monetary policy. One natural response is to look to macroprudential policy to provide an extra instrument or set of instruments to tackle financial stability risks. I shall return to the challenges for macroprudential policy later, after saying a few words about liquidity provision.

2. Liquidity Provision

The provision of liquidity to banks remains at the heart of a central bank's role. Market operations have had to evolve during the crisis both to accommodate different types of monetary policy—such as asset purchases financed by central bank reserves—and to respond to the heightened liquidity needs of the banking sector in times of crisis. Indeed, emergency liquidity support was a crucial factor in averting a banking sector collapse and the awful consequences that would have ensued. The evidence of these changes can be seen in the huge expansion in central bank balance sheets since the summer of 2007. As Jean-Claude Trichet mentioned earlier, the Bank of England, the Federal Reserve, and the European Central Bank all expanded their balance sheets in broadly the same way.

The danger of emergency liquidity provision is that it risks creating the expectation that it will always be available. That sets bad incentives for banks and encourages excessive maturity transformation. We need a regulatory framework that provides the right incentives. International efforts to design such a liquidity regime are under way, but liquidity regulation remains a hugely challenging area. A central difficulty is in defining what constitutes a liquid asset. We have seen in the financial crisis that what might seem a liquid asset at one point in time may quickly cease to be so under different circumstances. That leads one to the position that the only truly liquid assets are central bank reserves, or assets that can reliably be converted into reserves.

The financial crisis also reminded us that liquidity can at best provide only temporary relief—it cannot substitute for the painful restructuring that is necessary to tackle solvency problems. It is better to avoid such difficulties in the first place, and macroprudential policy has a big part to play in meeting that aspiration.

3. Macroprudential Policy

There are significant challenges to overcome if macroprudential policy is to live up to its promise. In the United Kingdom we have begun to operationalize macroprudential policy through the Bank of England's Financial Policy Committee. Let me briefly explain something about the FPC, who serves on the Committee, and what we have been doing.

Set up last year, the Committee comprises eleven voting members: five from within the Bank, two from the microprudential regulator, and four external members. Among those external experts, our very first signing was the person we are celebrating today, Don Kohn. I hope this is the start of a true transfer market in central bankers.

Our remit from the government—which is yet to be enacted in legislation—charges us with taking action to remove or reduce risks which could threaten the resilience of the financial system.

The FPC expects to gain statutory powers in early spring of next year. But we have been up and running since June of last year, and have in the interim made policy recommendations aimed, among other things, at improving the resilience of the banking sector and improving disclosure of information to markets. Drawing on our experience so far, I would like to remark on three of the challenges we have faced in beginning to make macroprudential policy a reality.

The first has been to work out what instruments the FPC is going to use to meet its objectives. In the new architecture, which will come into effect in 2013, it is envisaged that the FPC will have the power first to direct the prudential and financial conduct regulatory bodies to take actions, second to recommend that those bodies take actions on a comply-or-explain basis, and third to make recommendations to other bodies.

One of our early tasks has been to set out to the government our views on the instruments over which we would have statutory power to direct the prudential and financial conduct regulatory bodies. We have been busy thinking about this for the past few months, and yesterday we published our advice to the Chancellor of the Exchequer. The Committee settled on a narrow set, comprising—for now—three instruments.

(i) The first of these is a *countercyclical capital buffer* to be part of a bank's capital requirement. This has the advantage that it is embedded in the Basel III international regulatory program. It provides a simple aggregate tool that could play a role in mitigating excessive credit growth during upswings, while increasing the capacity of the system to absorb losses in the downswing. It will at times be important that banks meet required increases in capital ratios by raising capital rather than through potentially damaging reductions in assets. Indeed, this is a live issue for the FPC, reinforcing the point that it is important not only to be able to alter capital requirements but also to be able to influence how those capital requirements are met.

(ii) The second is the power to vary financial institutions' *capital requirements* against *exposures to specific sectors.* In practice that means scaling up the amount of capital that must be held against certain types of exposures. That makes it possible to take a more targeted approach to dealing with pockets of risk—for example, in commercial or residential property. But there is a risk of mistaking symptoms for causes.

(iii) The third instrument is a *leverage ratio*—that is, a maximum ratio of total liabilities to capital. This has the overwhelming benefit of simplicity and transparency, and provides a (time-varying) backstop to capital ratios that rely on risk-weighted assets. I myself attach great importance to a leverage ratio because of the impossibility of constructing risk weights that can anticipate major swings in sentiment, as we have seen recently with sovereign debt.

Of course there are many other potential instruments, and in several cases, the FPC recognized the potential effectiveness of these but had reservations about their immediate practicability. For example, a good case can be made for an instrument that would tackle the build-up of liquidity risk. But it makes sense to wait to see what international microprudential standards are agreed upon before proceeding. The same can be said of the ability to vary the terms of collateralized transactions by financial institutions. In some cases a margining requirement could be useful to target risks in shadow banking or financing markets as we discussed this morning. But again, it makes sense to wait for international agreement. Margining requirements will work better as part of an international regime.

We also recognized the potential usefulness of being able to vary mortgage terms and conditions—for example, via loan-to-income or loan-to-value ratios. But such actions go further than discouraging particular types of lending. They limit the amount that any individual or business can borrow. That might better be left to the lenders to decide within an overall policy of making such lending more costly. So we concluded that further public debate was needed before those instruments could be requested by the FPC.

We will be expected to report on the use of our direction powers on a very regular basis. But there are other areas, such as market structures or disclosure requirements, where the FPC will wish to make important, but infrequent, interventions. So it is important not to forget that the FPC will be able to issue "comply-or-explain" recommendations to regulators.

This is not the final word. Risks to financial stability will change over time, in a way that we cannot hope to predict. We will learn from our own and others' experience about the effectiveness of different instruments, and we will have to be ready to react and adapt to financial innovation. An important principle is that the FPC will keep under review the regulatory perimeter, and the instruments in its toolkit. It is important that provision is made for new tools to be added quickly when required.

A second challenge facing the UK FPC is in determining how macroprudential policy interacts with the other branches of regulation and policy—in particular, the microprudential regulator and monetary policy.

Macroprudential and microprudential policies clearly share a common interest, but the dividing line is blurred, and at times the opinions of the two sets of policymakers are bound to differ. So there are questions about how this can be managed. Fortunately the institutional arrangements in the United Kingdom take care of that, to a large extent. In general, macroprudential policy is about laying down rules for how the microprudential regulator should go about its task. It can provide an important underpinning and help to ensure consistency across regulated institutions.

I have already noted that a challenge for monetary policy is the extent to which it should seek to play a role in financial stability. That goes to the heart of the question of how monetary and macroprudential policies should interact. There are clear overlaps between the two policies, since they work through some of the same channels. But, for a central bank pursuing monetary and financial stability, the addition of macroprudential instruments reduces the extent to which the two objectives must be traded off. The two policies may at times act in different directions—one tightening, one loosening—and some people worry that this is problematic. In fact, though, this is an indication that the second instrument is performing a useful function.

That raises a question about whether monetary policy and financial stability policy decisions should be made by the same group of people. In the United Kingdom the significant cross-membership of the Monetary Policy and Financial Policy Committees means that this coordination issue is of secondary importance. The more fundamental points are (i) to recognize the need for macroprudential policy instruments, and (ii) to recognize that having macroprudential tools does not preclude monetary policy from playing a role in financial stability. There may be times when the comparative bluntness but broad scope of interest rates is a positive advantage.

The final challenge for macroprudential policy is a longer-term one, going beyond the immediate issues of setting up the apparatus. That is to maintain over long periods of time the independence and legitimacy that macroprudential policy needs to do its job effectively. That means winning the battle of hearts and minds.

The FPC is charged with making decisions that are necessary but which may be unpopular at times, especially with the financial sector. In the Bank of England we now have two powerful policymaking bodies: one to take away the punchbowl as the party is getting going, and the other to turn the music down! If we are to maintain the ability to act independently and make unpopular decisions, it will be crucial to explain what we are doing and why. Setting realistic expectations for what can be achieved is an important objective. And, since these new policy instruments are to be wielded by unelected officials, the accountability arrangements need careful thought.

The financial crisis represents a great opportunity to make changes to the financial system and the way we regulate it. Capturing the lessons learned now, while they are fresh in our minds, is of vital importance. That is why we are so grateful to have the benefit of Don's wisdom and experience contributing to the FPC in the United Kingdom. Looking ahead, our best hope of making lasting changes to the financial system, and capturing the lessons learned from the crisis in an enduring way, is to build that knowledge into institutions in whose memory it remains long after the people involved have left the scene.