

Perspectives on the Recent Financial Turmoil

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It is a pleasure to be here today to speak at this forum on regulatory and industry approaches for dealing with recent market strains. Even as the current financial crisis in subprime lending and structured products continues to unfold, we should be turning our attention to what changes in financial market structure and regulation may be appropriate to prevent a repeat of this type of crisis in the future.

Let me begin with a point that is obvious but that has very significant implications for how we should proceed in the future. The point is that while the current crisis originated in a small part of the financial system – the subprime mortgage market – it has revealed some very large deficiencies in the functioning of the overall financial system. Thus, solutions to the problem need to go far beyond repairing the subprime market and are likely to require sweeping changes in the business methods of financial institutions as well as in prudential supervision and regulation. My own views on how we should proceed are likely to differ from many of you in this room, but I hope that they may help sharpen the debate as we move forward.

It may be helpful to start with a brief summary of my main points. As I look at the current crisis and other financial crises in recent years, I am struck by the heavy burden that has been placed on monetary policy to cope with the crisis and its potential spillover effects to the broader economy. As someone who has been active in both the monetary policy and supervisory spheres, I have come to the view that we are placing too much burden on monetary policy in dealing with financial crises. Thus, going forward, we need to focus more attention on measures aimed at reducing the likelihood of financial crises, and we need to place more emphasis on other macro policy options to

deal with the economic consequences of these crises. In addition, while I am very supportive of industry efforts, including the IIF initiatives, to improve market practices, I remain skeptical that markets and market participants can be counted on to solve these problems without an important role for prudential supervision and regulation. At the same time, I understand that there are no simple solutions given the need to strike a proper balance between financial innovation and financial stability across a range of different financial institutions that operate in an increasingly global financial marketplace.

Central banks' roles in financial stability

Let me start with some thoughts about the roles that central banks play in financial stability. As the current crisis has evolved, central banks have provided substantial amounts of funds to the banking system to meet the heightened liquidity demands of individual institutions, and some have also adjusted the stance of monetary policy.

The Federal Reserve has been especially active on both fronts. Early on, it became clear that liquidity demands in this crisis differed in significant ways from previous crises, and that established lending facilities were not adequately addressing the problems. Both the Federal Reserve and the European Central Bank developed creative ways of dealing with the liquidity pressures including, using greater flexibility in the conduct of open market operations; modifications to existing lending facilities; and the auctioning of term credit by the Federal Reserve, ECB, Swiss National Bank, and the Bank of England. Indeed, I believe we need to consider whether some of the changes that the Federal Reserve has implemented, such as the Term Auction Facility, should be made permanent. Of course, this will require a more thorough assessment of the

effectiveness of these programs and possible longer-term ramifications on bank and financial market behavior.

The Federal Reserve has also adjusted the stance of monetary policy significantly to limit the potential spillover of these financial disturbances to the broader economy. In fact, the reduction in the federal funds rate target from 5 ¼ percent in early September last year to 3 percent today is quantitatively similar to the aggressive easing of policy in the first half of 2001. As you know, policy was also eased in a number of previous financial crises in which there was concern that there might be significant effects on the broader economy. These episodes include the 1987 stock market crisis, the banking credit crunch in the early 1990s, and the LTCM/Russian debt default crisis in 1998.

While monetary policy can play a key role in responding to a financial crisis, my own view is that we should be cautious in our expectations of what monetary policy can accomplish and consider some of the longer run consequences of excessive reliance on monetary policy. This is especially true when policy is eased a lot and easier policy remains in place for an extended period of time.

One of the principal advantages of monetary policy as compared, say, to fiscal policy is that monetary policy can react quickly. Even with the surprising speed that a U.S. fiscal stimulus package was enacted in this crisis, and even with the longer transmission lags of monetary policy, monetary stimulus will be affecting the economy long before the fiscal stimulus comes into force.

However, monetary policy also has some significant limitations that, I believe, should lead us to question how much we should rely on it when dealing with financial crises. First, there may be a build up of inflation pressures if monetary policy remains

too easy for too long. As I noted earlier, an advantage of monetary policy is how fast it can be put into effect. However, historically, I believe it has been more difficult to remove policy accommodation in a timely fashion, which may have consequences for a central bank's longer-term inflation objective.

Second, the monetary policy transmission mechanism relies heavily on a well-functioning financial system and operates through the relatively narrow channel of sectors that are sensitive to the cost of credit, such as housing. In the current situation, monetary stimulus is facing significant headwinds from the weak condition of some of the interest-sensitive sectors, as well as restrictions in credit availability and a repricing of risk. In these circumstances, a central bank may have to ease policy more in order to achieve its desired effect. Third, there is a risk that an extended period of low interest rates may distort long-run investment decisions; lead to a search for yield that results in excessive risk-taking; and contribute to the development of asset price bubbles.

In my view, these limitations are significant, and they lead me to believe that we should look to fiscal policy to play a more important role in responding to the economic spillovers from a financial crisis. In contrast to monetary policy, fiscal policy can work effectively even when the financial system is impaired, and its effects are felt more broadly across the economy. My own view is that monetary policy may be a good first line of defense, but should not be relied on too heavily for too long. Of course, we would have to rely less on monetary policy to respond to financial crises if we could, instead, take measures that would reduce the likelihood or severity of financial crises. I would like to turn next to a discussion of some of these options.

Preventing financial crises

As we look to actions that would make financial crises less likely and less severe, there is considerable scope for improvement along many dimensions. These include actions that may be forthcoming from the private sector as well as by policymakers. I would like to offer a few thoughts on some of these alternatives.

Market discipline and market best practices

One theme that has come up in discussions of how to prevent future financial crises is greater market discipline. My views on the role of market discipline are somewhat different from most in the regulatory and academic communities. In principle, market discipline is a powerful corrective to the risk-taking incentives of financial institutions. In practice, however, it does not work well in a system of large and complex financial institutions. For market discipline to work, investors and creditors need good information, but more importantly, they need to believe that their money is truly at risk. Undoubtedly, poor information and complexity contributed to the current crisis, and steps toward greater transparency and standardization will be helpful going forward. However, I think it is naïve to think that creditors will view their investments in the largest financial institutions as truly at risk. Consequently, I do not think that increased market discipline is likely to be the panacea that some believe.

I do think, however, that there is considerable scope for industry efforts to improve best practices. The rapid pace of financial innovation during the past two decades has made it difficult for both market participants and regulators to stay abreast of the changing financial landscape. However, I think there are limits to what can be

accomplished here, and I don't think markets can solve these problems without support from prudential supervision and regulation. We have all heard discussions of how poor management, lack of investor knowledge and fraud may have contributed to the current crisis. In my view, the problems go much deeper to the incentives built into the market place by regulation, accounting standards and industry practices. These incentive problems must be dealt with if we are going to move toward a more stable financial system. Finally, we need to continue to recognize that there are significant externalities in financial markets that cannot be internalized adequately by the private sector and that will continue to require a significant role for supervision and regulation.

Scope for supervision and regulation

In thinking about the scope for supervision and regulation in preventing future financial crises, I would offer an analogy between a financial crisis and a fire in a home or business. A fire can have serious effects on individual structures, but like a financial crisis, is also subject to contagion that allows it to spread to other institutions. One way of dealing with fires, is to have a fire department to provide liquidity to put out the fire and help contain its spread. The role of a central bank in responding to a financial crisis is not unlike the role of the fire department.

However, most communities do not rely exclusively on a fire department to put out fires after they start, but to have policies and procedures designed to prevent fires or contain them at a very early stage. These policies and procedures include building codes that require sprinkler systems, fire doors and flame retardant materials, and also include fire inspectors to ensure that these regulations are being followed. Again, the analogy with regulation and prudential supervision is clear. My take on this analogy is that in the

policy sphere we are relying too heavily on the fire department to put out financial fires and, going forward we need to focus more on fire prevention.

In the area of supervision, I would offer two thoughts. First, the current financial crisis reinforces the importance for a central bank to have accurate and timely information on the condition of all institutions that might make use of its liquidity facilities. Personally, I believe this is most likely to happen when the central bank has ongoing supervisory responsibilities for all institutions eligible to use its liquidity facilities. Thus, I am not a supporter of the removal of supervisory responsibilities from central banks as has happened in a number of countries. If this separation is in effect, or segmented as it is in the United States, I believe a central bank must have the legal authority to require this information from the supervisory agency on terms set by the central bank. A voluntary exchange of this important information is no more likely to be effective in a financial context than it was in the U.S. intelligence community prior to 9/11.

As to whether increased supervision can be relied upon to prevent financial fires, I have some doubts based on my years in an examination and supervisory capacity. A key feature in the current crisis is how well known the build up in leverage and risk-taking was in a variety of financial markets in recent years. When times are good, as they have been for many years and banks appear well capitalized, it is very difficult for bank supervisors to convince bankers to heed warnings that they need to behave differently. Indeed, in many situations, there may be no legal basis for requiring a change in business or lending practices. Thus, I don't think we can expect expanded supervision to prevent the types of financial excesses we have seen in recent years. Consequently, while there

may be improvements in supervision practices that can be implemented as a post-mortem to this crisis, I think we need to be realistic about what we can expect in this area.

Where we might be more successful in preventing future financial conflagrations is in the regulatory sphere. My own view is that we should consider hard wiring more sprinkler systems into financial markets and institutions. One obvious area to look is whether we can improve the risk-based capital approach embodied in Basel II. If capital is to function effectively, it needs to rise as risks increase and be depleted as losses materialize. I think we need to look especially at how we can limit the procyclical behavior of leverage that we have observed in some large financial institutions. In addition, I believe there may be merit in considering formal liquidity requirements, and perhaps loan-to-value ratios for banks and other financial institutions, especially the large institutions that provide liquidity and risk-management products to other financial institutions and to financial markets. I also think that it is time that we extinguish some of the off-balance sheet fictions that have developed to excess in recent years.

Concluding comments

In conclusion, let me stress again my belief that the response to this crisis should be fundamental reform, not Band-Aids and tourniquets. I also think both the private sector and government will have key roles to play in articulating needed reforms and ensuring they are implemented. The task is made all the more complex, of course because of the broad scope of our modern financial system that encompasses many different types of institutions across a variety of regulatory and national boundaries. We also need to strike an appropriate balance between the many benefits that can come from

an innovative and dynamic financial system and the tremendous costs to people and institutions that result when financial fires rage out of control.