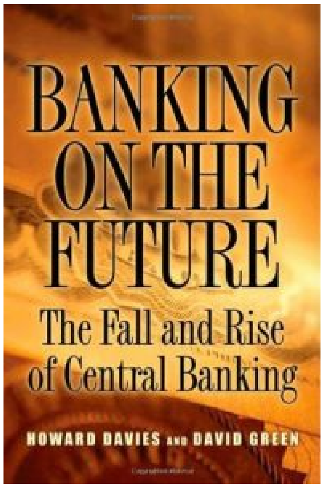

Book Banking on the Future

The Fall and Rise of Central Banking

Howard Davies and David Green
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Recommendation

After the 2008 financial crisis, the world's central banks had a lot of explaining to do. Housing prices had bubbled and burst, major financial institutions teetered (and some fell), and the global financial system came to a screeching halt. While central bankers were instrumental in preventing all-out economic Armageddon, none foresaw the magnitude of the crisis, nor were many armed with the right tools to fix it. Courtesy of their front-row seats at the parade of central banking's modern evolution, Bank of England veterans Howard Davies and David Green, present a thorough insider's parsing of the state of the field, and offer ideas for how the world's top bankers can better prepare for – and maybe even avert – the next crisis. The authors' subject matter is often prosaic, but they give it some much-needed livening up with their behind-the-scenes, sometimes gossipy, revelations about the personalities of the (almost all) men who helped keep the economic world spinning. *BooksInShort* recommends their exposé to policy makers and bankers who want to take lessons from what went wrong and understand how to make it right.

Take-Aways

- The world's central banks missed the impending signals of the 2007 crash. That calamitous oversight prompted calls for change.
- A tight focus on limiting inflation kept many central bankers from acting to rein in soaring credit and housing markets.
- The first central bank was Sweden's Riksbank, established in 1668; between 1950 and 2000, 118 of the world's 162 central banks came into being.
- Central banks perform many different functions, and some do more than others.
- Setting monetary policy to fight inflation defines the "narrow model of central banking."
- Central banks also manage government debt, monitor foreign exchange, regulate financial institutions and ensure that payment systems work.
- The US Federal Reserve Bank's balance sheet more than tripled, from $800 billion to more than $3 trillion, during the 2007-2008 financial crisis.
- Central banks should "lean against the wind" to moderate excessive financial activity.
- The European Central Bank makes "monetary policy for a country that does not exist."
- Central banking secrecy and opacity must give way to transparency and accountability.

Summary

The Mighty Have Fallen

Blame for the financial crisis that began in 2007 landed easily and plentifully at the feet of the world's central banks. Few had drawn attention to the build-up in asset prices – particularly housing prices – and to the inherent flaws of derivatives, instruments intended to mitigate risk that instead amplified and spread contagion throughout the financial system. When sparks flew in the summer of 2007, central banks had little in the way of firefighting equipment to douse the monetary flames. Central bankers were caught flat-footed with interest rates close to zero, bank reserves insufficient and a "shadow banking" system out of their control. Yet how could the world's monetary authorities have missed the signals of an impending crash? How was their "radar...not connected to the missile defenses?" Did their focus on inflation management and monetary stability blind them to the changing economic picture? Should they have focused on asset prices along with interest rates? Were they out of touch with rapidly advancing financial innovation? Were they ill-prepared to collaborate in a crisis, not only among their cross-border confreres but with their own governments' treasuries?

> "The global credit crisis that began in the summer of 2007 threw a large rock into the calm waters of central banking."

These concerns have shaken global central bankers' once-solid reputations. For decades after World War II, monetary authorities learned from crises that popped up in disparate corners of the world – runaway inflation, exchange rate speculation, sovereign defaults – and by the end of the 20th century, banking leaders and their institutions had settled into a comfortable sense of mastery. As long as financial officials tended to interest rates in order to moderate inflation – so the thinking went – the private capital markets would ensure prosperity in growing economies.

What Stability?

From the founding of Sweden's Riksbank in 1668 to a 118-bank boom in new central banks from 1950 to 2000 to today's 162 such institutions, central banking's role has been to protect society from financial systems' intrinsic weaknesses, since banking's "fragile financial infrastructure" is, after all, based on public trust. Central banks give banks funding mechanisms, act as a bank's bank, and set monetary policy through interest rates or bank reserves. In some nations, central banks manage government borrowing, monitor currencies and foreign exchange, regulate financial institutions, and ensure that payment systems function smoothly. Developed nations have cut central banks' responsibilities to handling monetary policy or targeting inflation, in a "narrow model of central banking."

> "Occasionally, unpleasant reminders resurface abruptly that the financial system is fundamentally fragile."

Managing monetary, or "domestic price," stability presents serious, often conflicting, challenges to central bankers. Governing the complex interplay among money supply, interest rates, market activity and prices, and being able to manipulate those relationships to smooth out economic conditions, requires astute judgment and an encompassing grasp of economic issues. After the Great Depression, central bankers used employment and inflation as their two meters for gauging the economy. Given political pressures, maintaining as full an employment level as possible took on greater importance, so targeting interest rates became a central bank mandate. But when inflation raged across the developed world in the 1970s, monetarists advocated controlling the money supply to bring down prices. By the 1990s and the Great Moderation, central banks focused on maintaining the period's strong growth by keeping prices in check.

> "Central bankers often inhabit buildings that not only inspire confidence in their soundness and stability but also seek to impress the visitor."

This inflation orientation monopolized central bankers' attention; for example, the US Federal Reserve Bank, under Chairman Alan Greenspan, disregarded the frenzied growth of financial markets and asset prices. Unlike former Fed Chairman William McChesney Martin, Greenspan didn't believe it was up to the Fed to "take away the punch bowl just as the party gets going." Some economists warned that financial innovations and globalization linking major free market economies made boom-and-bust cycles more likely given their "transmission mechanisms."

> "The mere prospect of a summons to the central bank can influence the frame of mind, especially if reinforced by a cup to tea in an impressive, historic parlor, as in England, or a gilded gallery, as in France."

Clearly, if central bankers switched to maintaining "financial stability," they might require a greater mandate with more authority and duties. Currently, most central banks do not "hold all the levers for delivering financial stability." For instance, not all central banks regulate their nations' banking systems. They lack power beyond voicing assessments of how innovative instruments cause potential systemic stress and they know that public reaction to their concerns can lead to unintended consequences. Aside from issuing "financial stability reviews" (FSRs) commenting on markets and offering statistics, most central banks wield few real tools to ensure stability.

Lessons from the Edge

The 2007-2009 crisis changed all assumptions, as central banks found that their formerly reliable tools – dropping interest rates and funding bank assets – were not having the intended effect of calming the markets and unfreezing credit. For example, the Federal Reserve's balance sheet more than tripled – from $800 billion to more than $3 trillion – during the crisis as lending confidence dwindled among bankers and the Fed became the "systematic central counterparty for the private banks." As the Fed agreed to buy corporate commercial paper and fund investment banks – until then, not in its regulatory purview – it effectively moved into the private sector.

> "The creation of a monetary union between 11 of the member states of the EU in 1998 was perhaps the most ambitious central banking project ever contemplated."

The Bank of England and the European Central Bank (ECB) made similar credit extensions, adding to the threat of rising inflation, and the crisis further illuminated the gaps in current central bank policy and structure. Recommendations for addressing those weakness included creating "a robust set of indicators of financial stress" to make FSRs tougher, coordinating better with other central banks and external entities like the International Monetary Fund (IMF), and staying on top of market activities to ensure that unsupervised financial institutions don't present systemic risks.

> "All central banks contribute to financial stability through their influence on banking regulation."

The most glaring failure was that many central banks ignored soaring asset prices, especially in real estate. Satisfied that inflation was sidelined, many, especially the Fed, overlooked the economic thrust that nations like China provided. China's liquidity kept global consumer prices low while providing credit to drive up land and property values. This shortsighted focus on the wrong indicator – consumer inflation – went with the conviction that efficient markets would never allow asset prices to bubble, a mistaken instance of groupthink that encouraged market participants to carry on without fear of central bank interference.

> "Central banks were asleep at the switch. The lack of monetary discipline has become the hallmark of unfettered globalization." (Steve Roach, former Morgan Stanley chief economist)

In the future, central banks should "lean against the wind" by moderating economic activity based on more parameters, including asset prices. Central banks should consider housing prices in their inflation calculations (the UK and euro zone central banks do not). The US uses a proxy of rents for its housing factor, but if it had used "an index of home sale prices," its projected inflation rate would have been "three quarters of a percent higher"; in the UK, it would have been 2% to 4% higher. Such restated inflation assumptions might have led fiscal authorities to raise interest rates, potentially dampening the unrestricted boom and tempering the inevitable bust.

> "Perhaps the fiercest controversy in the world of central banking in the last few years has centered on the extent to which monetary policy should respond

to changes in asset prices."

"Macroprudential oversight" – fine-tuning capital requirements to keep banks from overlending – also may offer monetary authorities a useful tool. Currently enforced capital ratios derive from individual banks' risk standings and portfolio quality; macroprudential oversight would slow bank lending when market conditions signal an overheating. Researchers and central bankers are developing indicators to assess such conditions and establish increasing reserve requirements to slow lending, thus avoiding excesses like those in the mortgage market before the crisis.

Central Banking Around the World

The globe's central banks differ in their ownership, structure and mandate. For example, while the Fed is partly privately owned and has some regulatory responsibilities, the Bank of England is a state entity that cedes its supervisory role to the Financial Services Authority (FSA). The European Union's financial authority, the European Central Bank, is unique in that, as stated in an article in *European Union Policy*, it "provides a monetary policy for a country that does not exist." The ECB sets monetary targets, provides liquidity for the union and presides over the national central banks (NCBs). The NCBs serve as financial regulators for their home banks and as an "economic observatory" for the ECB. Some NCBs, like the Dutch, also supervise their nation's insurance industry.

"Central banks seeking to smooth output and inflation can do so more successfully if they set rates with an eye toward assets."

Monetary authorities in less-developed nations tend to have more discrete responsibilities than their developed-nation counterparts. They often manage government borrowing and maintain exchange rate regimes, as well as being their bankers' banks. In Latin America, freedom from government control played a strong part in allowing central banks to tame inflation, but both "political interference" and inflation rates grew with the new "populist regimes" in Venezuela, Bolivia, Argentina and Ecuador.

"How could an institution like the Federal Reserve...have presided over the biggest and most costly crash in 80 years?"

Political and economic roles are more intertwined in African nations, many of which cooperate in "currency unions." In Asia, the People's Bank of China's modernization and reforms led to much-improved bank balance sheets, but its independence from political authority is less clear. The Reserve Bank of India, too, is struggling to define its autonomy from government. Islamic finance, which bars interest on transactions, offers a challenge in guiding monetary policy without a targeted interest benchmark. Yet Iran, Sudan and Pakistan are committed to shifting their economic activities to comply with Islamic law. Islamic and "conventional finance" mostly coexist in the Middle East, though "pressure for complete Islamicization is...in its most extreme form a potentially serious threat to monetary and financial stability in Muslim countries."

"The Central Banker's Psyche"

Despite the differences among their countries, central bankers tend to resemble one another in their characters and behaviors. Their traits include "secrecy, a belief in quasi-papal infallibility, caution, over-analysis and 'constructive ambiguity'." The ability to operate in strict confidence establishes trust; it also allows bankers to execute critical maneuvers without affecting the markets unnecessarily. For example, "one of the largest concentrations of gold on Earth" is stored in the depths of the Bank of England, but few are aware of its size and ownership. Even in economically challenged countries, central banks occupy grand facilities, the better to impress outsiders with the banks' importance and authority. Painstaking inquiry and study precedes any central bank action, because a central banker cannot afford to be wrong. Because economies operate amid uncertainty and variability, bank pronouncements tend toward the opaque and obscure; in their public statements, "ambiguity can be seen almost as a virtue."

"The new model central bank will be more accountable, transparent and frank about the limitations of its powers."

A central bank governor is enormously influential in how others perceive the bank. Mostly men, governors set their individual bank's tone and are among the most-quoted and most-observed public figures. Greenspan "bestrode the financial world like a colossus," but current chairman Ben Bernanke, though just as eminently qualified, takes a softer, less-autocratic approach. The ascension of Bank of England governor Mervyn King marked the return of an economist to the role following many bankers. His perceived aloofness and distance from key market players led to criticism of his handling of the crisis, particularly his hesitation to bail out Northern Rock bank. Jean-Claude Trichet, head of the ECB, carries "the financial fortunes of 400 million Europeans in the palm of his hand." He earned kudos for his rapid, capable response to the crisis.

"There is a clear risk that the central bank will forecast 10 of the next three crises, and will gain a reputation as a little boy who cries wolf."

The more technocrats who enter central banking's upper ranks, the less connection bankers have with on-the-ground market participants, and the less ability they have to maneuver in fast-change environments. The "ideal governor" is "a first-rank macroeconomist who also understands financial markets" and is "open-minded [with] a stubborn streak [and] a silver tongue."

"An Agenda for Change"

Still reeling from the crisis' aftereffects, central banks are implementing policy and operate changes, like focusing more on indicators, on credit markets and instruments, on stability, and on shoring up their financial capabilities. Greater transparency and accountability will hasten central bankers' inevitable "cultural transition."

About the Authors

Howard Davies is director of the London School of Economics. **David Green** is a Bank of England central banker and financial regulator.