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PIERRE
WERNER
LECTURE

Central Banks and Financial Stability
by Baron Alexandre Lamfalussy

2nd Pierre Werner Lecture
delivered in Luxembourg on 26 October 2004

Introductory remarks



Why did I pick this topic for my Pierre Werner Lecture? First, because (for reasons I propose to develop later) serious consideration should be given to enhance our crisis prevention capabilities. Not that I would attach a high degree of probability to the outbreak of a systemic crisis; but should such an unlikely event nevertheless materialise, its consequences would be devastating both for our financial system and for the «real» economy. Second, because the present institutional set-up in Europe regarding crisis prevention (and potentially also crisis management) looks to me, to put it mildly, sub-optimal. Finally, because the relative calm prevailing today in financial markets

provides a favourable climate for discussing the issues raised in this lecture without undue haste. A crisis would provide a strong incentive for reforms, but not necessarily for good reforms.

By «financial stability» I mean systemic stability – not the stability of individual institutions, nor even that of segments of the financial industry. Note, however, that the demarcation line between a systemic crisis and specific crisis manifestations is very uncertain. By the same token it is equally difficult to define when crisis prevention stops and crisis management – or, more precisely, implementation of emergency measures to avoid an open crisis – begins. Macro- and microprudential responsibilities have the irritating habit of overlapping. These observations underpin most of the arguments I intend to present.

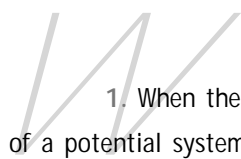
My lecture deals with the role and responsibility of central banks in preserving the stability of the financial system as a whole. First, it does so in general terms; in the second part it refers to specific European issues.



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Emergency measures to avoid a systemic crisis



1. When there are converging signs of a potential systemic crisis, central banks have a key role to play in preventing a potential crisis from turning into a real one. I think we would all agree that in such a situation they should provide liquidity to the system, so as to avoid liquidity shortages pushing otherwise solvent banks into bankruptcy. They also have to care about the smooth functioning of the payments system, which is the main channel through which contagion may spread – not to mention the fact that a payment gridlock, whatever its proximate cause (9/11, breakdown of IT or CT systems), may be at the origin of a systemic crisis.

2. The timely provision of liquidity to the system is very much a matter of judgement, moreover of a judgement which in most instances has to be made at very short notice. In order to be able to make a sound judgement, central banks have to be intimately familiar with the working of financial intermediaries in general, and of banks in particular. They must possess direct information on banks' risk-assessment methods and capabilities, on their decision-making processes and control mechanisms and, not least, on their expertise and skills in using innovative financial instruments. Such information cannot be acquired by reading second-hand reports, however lucid and transparent such reports may be.

3. There are two «macro» problems associated with liquidity creation as a crisis-avoidance action. One is the potential conflict with a price-stability oriented monetary policy. If the central bank's liquidity creation is not warranted by monetary policy considerations, it has to be reversed as soon as the crisis

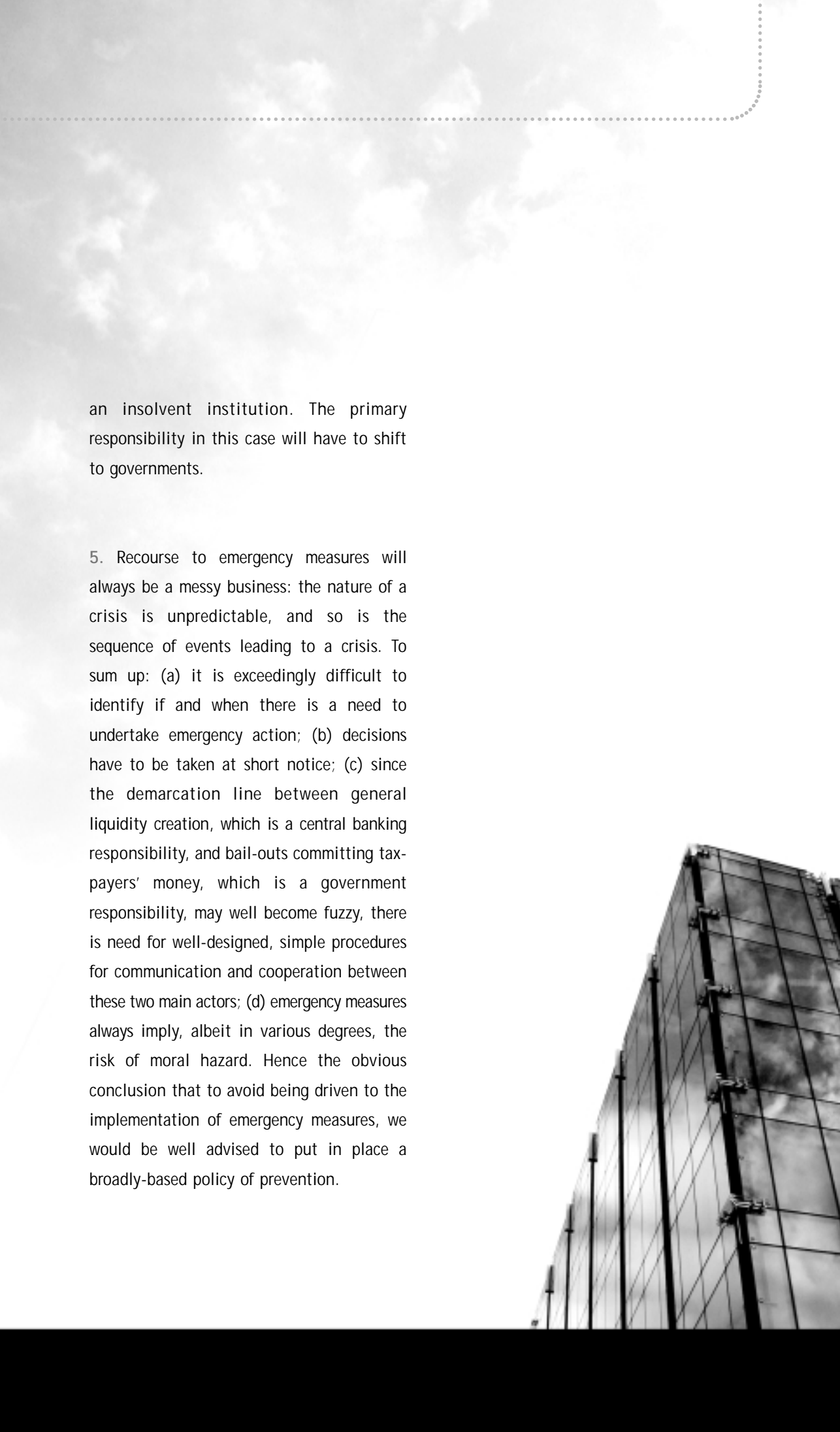
manifestations are brought under control. This is technically feasible, but – again – the right decision has to be based on sound judgement. The other one is moral hazard: pre-emptive liquidity creation is likely to



have, as a side-effect, the «bailing out» of holders of risky assets. If a radical relaxation of the monetary policy stance takes place

when equity prices are plunging, the central bank's action is likely to be interpreted as a support for the equity market.

4. Additional complications may arise when it appears that the provision of liquidity to the banking system as a whole does not eliminate the risk of a systemic crisis. When it becomes clear that direct liquidity assistance to a specific institution is required, an emergency credit granted by the central bank is only one of several options. Moreover, this is an option which has to be handled with care: in a crisis situation it is close to impossible to know whether the illiquid bank is also insolvent. Yet we would all agree, I believe, that a central bank should not lend to insolvent institutions. One other option is a lifeboat arrangement whereby a group of banks come to the rescue of a specific institution. The central bank may play a role in organising such rescue operations. This could, however, imply the risk of moral hazard, i.e. precisely what lifeboat arrangements are supposed to minimise. Another option is the explicit use of taxpayers' money to bail out



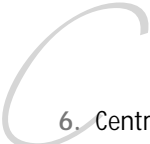
an insolvent institution. The primary responsibility in this case will have to shift to governments.

5. Recourse to emergency measures will always be a messy business: the nature of a crisis is unpredictable, and so is the sequence of events leading to a crisis. To sum up: (a) it is exceedingly difficult to identify if and when there is a need to undertake emergency action; (b) decisions have to be taken at short notice; (c) since the demarcation line between general liquidity creation, which is a central banking responsibility, and bail-outs committing taxpayers' money, which is a government responsibility, may well become fuzzy, there is need for well-designed, simple procedures for communication and cooperation between these two main actors; (d) emergency measures always imply, albeit in various degrees, the risk of moral hazard. Hence the obvious conclusion that to avoid being driven to the implementation of emergency measures, we would be well advised to put in place a broadly-based policy of prevention.

II



Prevention



6. Central banks often argue that their most effective contribution to crisis prevention is the conduct of a monetary policy whose primary objective is the preservation of price stability. This implies the avoidance of both inflation and deflation – for the obvious reason that both provide a favourable breeding ground for crisis manifestations (not to mention that this is especially true when inflation is followed by deflation). I have no doubt that a stability-oriented monetary policy significantly reduces the risk of a systemic financial crisis, but it does not eliminate it. A problem may

indeed arise from the fact that price stability is usually defined (and I don't see how it could be done otherwise) as, say, an X percent rate of increase in the index of consumer prices (or of the GDP deflator). Achieving price stability thus defined does not imply, however, that nothing could go wrong with asset prices. May I refer to a «stylised» summary of the recent US experience? An unexpected increase in the rate of growth of labour productivity, combined with a decline in the «natural» rate of unemployment, may well keep a lid on the prices of goods and services (and do so lastingly), even though the rate of increase of broad money points to the development of excess liquidity. If this excess spills over into asset markets and creates asset price bubbles, and if this is accompanied by a rise in corporate and household indebtedness, the bursting of the bubbles is apt to create a propitious environment for the emergence of a systemic crisis. Hence the awkward question: should central banks worry about bubbles, and if not, who could or should? My short answer is

that they should – but I acknowledge that this is more easily said than done. Identifying an asset price bubble, while never an easy exercise, may be the easier part of the assignment. The genuine difficulty lies in

price cannot, and should not be targeted. But, in that case, what happens to the accountability of a central bank? Add to this that fighting an asset price bubble is unlikely to win popular support in the same way as

inflation fighting can.


But what is the alternative? If a central bank does not try to discourage «irrational exuberance», it may well fall into the trap of asymmetrical policy reactions, with obvious moral hazard implications. For how could it not undertake policy relaxation when the



the fact that it would seem hopeless to try to agree on what should be the right level of an asset price. We may agree that the current price is by far too high, but this does not mean that we can pretend to know by how much. Hence the obvious conclusion that, as opposed to the rate of inflation, an asset

bursting of the bubble raises the risk of a systemic crisis?

7. The traditional recipe for prevention is the micro-prudential regulation and supervision of financial intermediaries. But which



intermediaries? The focus should clearly be on banks. The specificity of banking deserves a few comments, especially in the light of two developments which could be interpreted as leading to the erosion of this specificity. One is the blurring of demarcation lines between traditional commercial banking and other financial intermediaries, even including non-financial enterprises. The other one is the declining importance of banking intermediation relative to the role played by market transactions. However, despite these developments, banks have continued to play a central part in the potential emergence of a systemic crisis as much as in its prevention. There are several reasons for this. By their very nature, they are highly leveraged institutions. Via their deposit base and credit-granting activities, they are the providers of liquidity to the system: it is through the banks that the central bank's ultimate liquidity creation affects the full range of financial intermediaries as well as the real economy. Moreover, they play a key role in the payments mechanism, which is the channel through which specific

crisis manifestations are liable to develop into a full blown general crisis. Because of these specificities crisis management means, in essence, preventing the collapse of the banking system, and crisis prevention means taking prudential measures with a two-fold objective in mind: to keep a rein on banks' crisis-generating proclivities and to enhance their crisis-resistance capability.

This, of course, is an oversimplification. We have to watch carefully the development of financial structures and the steady flow of financial innovation which may compel us to extend prudential supervision to new segments of the financial industry. One major, worrying, example pointing in this direction occurred in September 1998 when LTCM, a prestigious hedge fund, came close to bankruptcy but in the last minute was rescued by a banking consortium under the auspices of the Federal Reserve Bank of New York. LTCM was not a bank, yet the US authorities decided to «facilitate» the rescue operation because «fire sales» of the fund's government bond

portfolio could have created a major upheaval in the US Government debt market. There had indeed already been signs of a potential liquidity crunch: remember the dramatically increased demand for liquidity protection, well illustrated by the surprising surge in the illiquidity premium for the off-the-run Treasury securities. The rescue was successful, and markets returned to business as usual. But we cannot take it for granted that the stream of financial innovations will not throw up other «surprises».

8. The role of central banks in bank regulation and supervision is a highly controversial topic. To the best of my knowledge there is no clear empirical or historical evidence, nor conclusive theoretical arguments, in favour or against their operational involvement in this activity. Those who favour such an involvement point out (a) that central banks, by being banks themselves, are eminently well equipped to fulfil such function; (b) that they need the operational experience of bank

supervision for being able to discharge their unquestionable duty in undertaking emergency crisis-avoidance measures; and, not least, (c) that they are capable of looking not only at a bank in isolation – but also at the broader picture of the interbank market and of relations between segments of the financial



industry which gives them insight into both macro and micro prudential issues. Those who are against fear (a) the «pollution» of

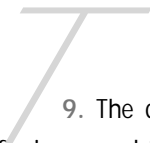
monetary policy decisions by prudential considerations as well as (b) the likelihood of enhancing the risk of moral hazard (how could a central bank, which is acting as supervisor, resist a request for emergency lending?).



III



Beyond generalities: the case of Europe



9. The queries and concerns raised so far in general terms have to be set against an institutional set-up in Europe which is very peculiar indeed. Here are its most striking features:

- (a) The ECB's role and responsibility in global liquidity creation is well defined; its other responsibilities in crisis management and prevention are not; ¹
- (b) Regulation of the financial industry (including banking) is carried out mostly at the European level, but with the active participation of national authorities;
- (c) Supervision, including that of banks, is carried out at the level of member states;
- (d) As regards banking supervision, some NCBs have a clear operational role, others have some operational involvement, a few have practically none;

- (e) In some countries the whole financial industry is supervised by one single authority, in others there are authorities with sectoral responsibilities, while some countries follow the « twin peaks » model;
- (f) Euroland \neq EU – and Europe's main financial centre is not in Euroland;
- (g) There is no single, « federal », finance minister – although commendable efforts are under way to endow the so far « informal » Eurogroup with an institutional status, including a President with a mandate going well beyond the traditional six months.

10. Looking at this mind-boggling patchwork one might be tempted to suggest a global overhaul. A rational mind would begin by trying to answer the following questions:

- (a) Should there be a single supervisor for Euroland? the EU?
- (b) If so, should this single supervisor bring together under the same roof all the sectoral responsibilities?
- (c) If not, should we at least try to harmonise the national supervisory structures?
- (d) In case of centralisation what role should be left to the national authorities?
- (e) How would the ECB and the NCBs fit into a new structure?

¹ Article 105/5 of the Maastricht Treaty: « The ESCB shall contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system ».

Given the observations made above under 9., I would find any such global approach hopelessly unrealistic – at least at this stage of Europe's history.

11. Yet at the same time I do believe that there are good reasons for enhancing our crisis-prevention and crisis-fighting capabilities. Let me elaborate.

Why worry when we have just witnessed the remarkable resilience of our financial systems at the time of the stock markets' meltdown between early 2000 and the spring of 2003? Between March 2000 and March 2003 the P/E ratio of S & P 500 declined from 38 to 20, and that of US technology stocks literally dived from 65 to 18.² That this did not produce a systemic crisis can be explained to a large extent by the resilience of the developed world's banking systems which in turn can be attributed to three facts. To Basel I, which enabled our banks to enter this period of turbulence with a very strong capital base; to the widespread and skilful use of risk-hedging techniques by bank managements in general; and, in particular, to the transfer of credit risks, via the market for credit derivatives, to non-bank intermediaries and institutional investors. These have undoubtedly been

reassuring developments, but they do not tell the whole story.

For one thing, another – perhaps even more important – key influence was also at play: household consumption and investment held up remarkably well, especially in the United States. The decisive factor in this respect was the simultaneous administration to the US economy of a powerful dose of monetary and fiscal stimulus, the speed and size of which was without historical precedent. As a result, the «real» economy suffered only a short and shallow recession and then entered into a fast recovery. There is, however, a question mark hanging over the sustainability of this recovery, which has to do with the level and with the unpredictability of asset prices. The late 1990s were dominated by the steady deepening of «flow» imbalances in the US economy: a growing public sector deficit, a rising current account deficit and a very low rate of saving by the household sector. None of these imbalances were corrected by the recession; and with the recovery they have continued to deepen. Sooner or later, however, they have to unwind. This unwinding has so far been prevented by the high level of real estate prices, combined with low interest rates: property wealth has as a counterpart a significant debt burden in households' balance

² BIS, 73rd Annual Report, June 2003, p. 105.



may be of the highest sophistication, but the empirical evidence is often very recent and therefore may turn out to be unreliable.

sheets, of which a non-negligible part is based on adjustable interest rates. This asset-price domination of the US economy constitutes a major challenge to the Federal Reserve's monetary policy – especially if the public sector deficit continues to deepen.

I also have some broader, less «cyclical» or macro-policy concerns. They have to do with the consequences of the steady flow of highly sophisticated financial innovations. As I just have said, by using these innovations as hedging devices, banks have managed to come out of a period of market turbulence without much damage. But the system as such cannot «insure» itself against the meltdown of asset prices or the bankruptcy of large non-financial firms which represent a genuine, global, loss. All that insurance does is to redistribute this loss, by transferring risks from risk-averse market participants to willing risk-takers. To the extent that these risk-takers know what they are doing, and properly assess their risk-resistance capabilities, the system as a whole gains in stability. But the assessment of risks in financial markets is a tricky business. The instruments

Regularities observed in the asset price behaviour – co-variances – may easily break down in a world subject to radical changes. There is a world of difference between these kinds of insurance contracts and those based on mortality tables reflecting information provided over centuries. Finally we have to bear in mind that those in charge of maintaining systemic stability possess only incomplete information on which segments of the financial industry act as risk-takers, and even less on the intricate set of interconnections established through the use of derivatives. Our highly innovative financial system has not gained in transparency. It has become remarkably opaque. Let me give you just one example. In 1982, at the beginning of the Latin American crisis, we were reasonably well informed about the external claims and liabilities of western banks, thanks to the statistics collected by the BIS. These statistics still provide useful information, but their importance is dwarfed by the risk-interconnections created by the derivatives markets, for which, for obvious reasons, no such «simple» information is available.

All this boils down to saying that we are navigating in waters uncharted by reliable historical experience. Given this situation, strengthening our crisis prevention capabilities deserves to be regarded as a worthwhile undertaking. Could we not make progress in this direction by being less «globally» ambitious, but rather more pragmatic?

12. I would start from the assumption that the group of financial intermediaries whose regulation and supervision deserves to be reconsidered are a limited number of very large banks which have become actors at the global level and are key players in the European interbank market. Their problems could have directly systemic consequences. Conversely, to the extent that these banks do not encounter major difficulties, the likelihood of a systemic crisis is substantially reduced. Some of them have already undertaken intra-European cross-border ventures; others are considering it. Their cross-border integration could have a beneficial influence on the broader integration process – but such integration is surely not helped by the complexity of our current regulatory/supervisory arrangements.

Should one not consider exploring the desirability and the feasibility of entrusting

the ECB with an operational responsibility in the supervision of this limited number of banks?



There are some weighty arguments in favour of such course of action. First and foremost, this would go a long way towards providing the ECB with the first-hand information it needs to discharge its unquestionable macroprudential duties in the case of an impending systemic crisis. Second, it would not need to imply by necessity the overhaul of the banking supervisory arrangements at the national level: the ECB would have to share its responsibility with the national authorities – be they the NCBs or other agencies. Third, it would simplify the procedures for communication and cooperation between the main actors in two respects: at the global level (in relation with the US and

the UK authorities) and within Euroland (with the Eurogroup of finance ministers). Finally, cumbersome treaty changes could be avoided by having recourse to Art. 105/6 of the Treaty or to a similar disposition of the draft Constitution.³

Some may object that submitting a limited number of very large banks to a special supervisory regime would amount to a revolutionary innovation. I do not think that this would be a valid objection. The distinction does exist in the United States. Moreover Basel II makes a clear distinction between banks with relatively simple operations and banks with more complex activities; and even more important, it picks out of this second group «advanced» banks which will be in a special position.

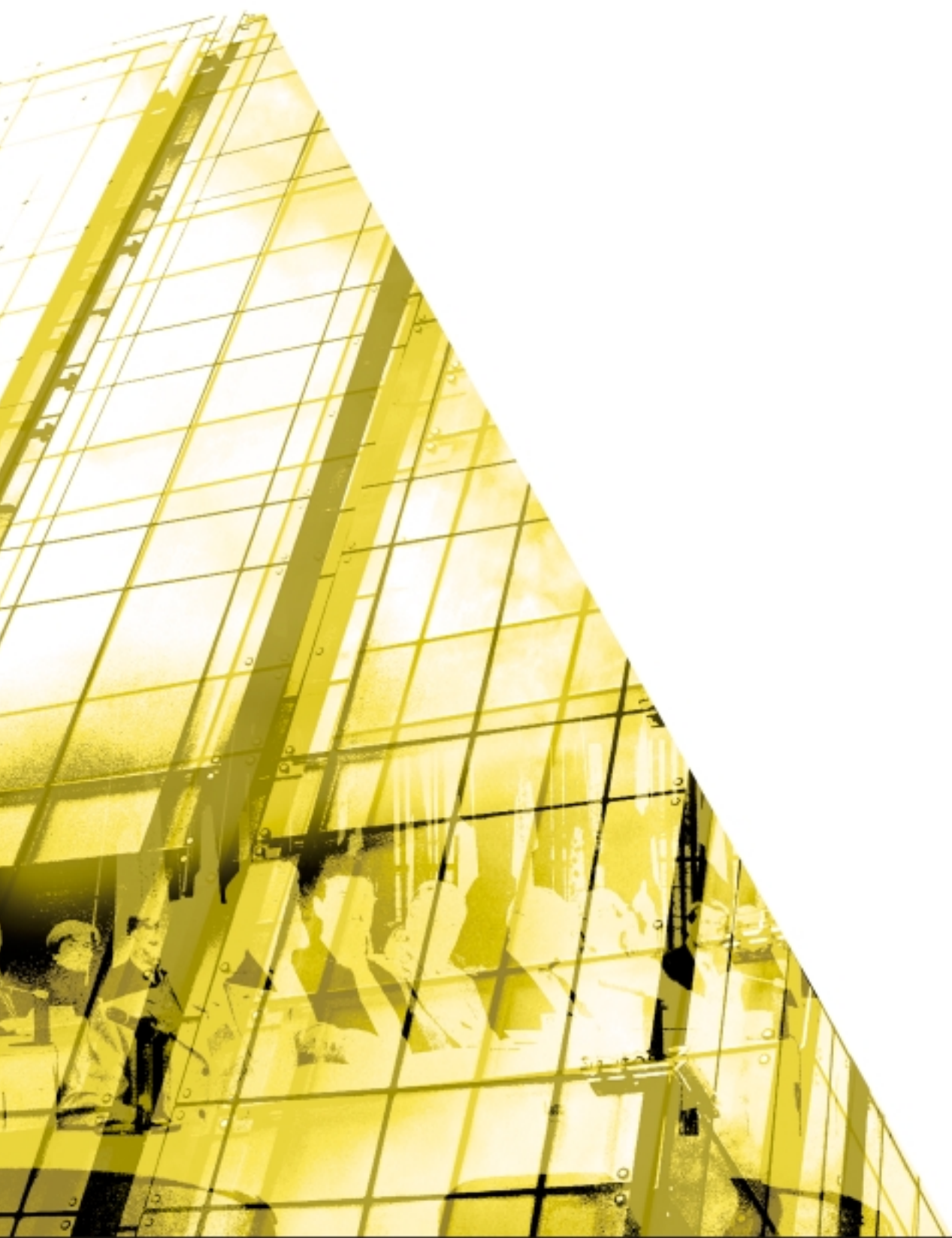
One final remark: the effectiveness of any such mandate given to the ECB would only be enhanced by the Eurogroup moving towards a solid and efficient institutional structure.

13. Could the advantages of such course of action not be outweighed by its disadvantages? They could indeed. These disadvantages are those implied, in general, by the operational participation of central banks in banking supervision (see 8. above). To which I may

add that in the case of the ECB it would be regrettable if the clarity of its mandate for running monetary policy – «the primary objective of the ESCB shall be to maintain price stability» – would be diluted. The balance of the argument critically hinges on the answer given to two questions. First: how serious is the risk that we would have to deal with a systemic financial crisis? May I repeat my answer: it is hopefully not very high, but in the unlikely event of such a crisis nevertheless materialising, its consequences could be devastating. We should therefore err on the side of prudence. Second: what sort of practical and credible alternative could be envisaged?

³ «The Council may, acting unanimously on a proposal from the Commission and after consulting the ECB, and after receiving the assent of the European Parliament, confer upon the ECB specific tasks concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings».





Baron Alexandre LAMFALUSSY

Alexandre Lamfalussy was born in Hungary in 1929.

1949-1976

Mr. Lamfalussy left his native country in 1949. After he studied at the Catholic University of Louvain in Belgium, he spent two years on post-graduate studies at Nuffield College, Oxford, where he obtained a doctorate (D.Phil.) in economics. He was visiting lecturer at Yale University in 1961 and 1962. From 1955 to 1975 Mr. Lamfalussy worked with Banque de Bruxelles. In 1975 he became Executive Director of Banque Bruxelles Lambert.

1976-1997

Mr. Lamfalussy joined the Bank for International Settlements (BIS) in Basle in 1976 as Economic Adviser and Head of the Monetary and Economic Department. Between 1981 and 1985 he served as Assistant General Manager, before being appointed **General Manager of the BIS** in May 1985. He held this post until the end of 1993. From 1st January 1994 until 30th June 1997, Mr. Lamfalussy was **President of the European Monetary Institute** in Frankfurt, which was the predecessor of the European Central Bank.



Baron Alexandre LAMFALUSSY

1997-2001

Since 1997 Mr. Lamfalussy has been teaching and doing research at the « Institut d'études européennes » of the Catholic University of Louvain in Belgium. In August 2000 he published a book on « Financial Crises in Emerging Markets – An essay on Financial globalisation and Fragility » (Yale University Press, New Haven and London). He was **Chairman of the Committee of Wise Men on the Regulation of European Securities Markets**, set up by the European Council. The Committee released its first report on 9th November 2000, and its final report on 15th February 2001. Its recommendations are now being implemented and its four-level approach extended to banking and insurance, in fact, to the whole of the financial services industry.

