

Overview

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The discussion that we've had over the last couple of days has defined financial stability very widely, and that has made the discussion interesting but makes it almost impossible to give anything like a comprehensive overview. But let me try to draw out some common themes.

What we are basically interested in are the relationships among four economic groupings—the macroeconomy as a whole; the financial sector, which can be usefully split between financial markets and financial intermediaries; and the nonfinancial sector at the micro-level, particularly depositors and investors. And we're interested in both the national and international dimensions.

And we're interested in how these different groupings are inter-related in the sense that economic and financial influences, which may be either stabilizing or destabilizing, can flow in either direction between them.

In focusing on financial stability, what most of us immediately think of is the public policy interest in protecting the macroeconomy on the one hand and depositors/investors on the other from destabilizing/negative influences originating within the financial sector. No one questioned that as a legitimate public policy interest, for reasons Andrew Crockett gave.

But we also know that the financial sector can have a powerful positive influence both on the macroeconomy (through efficient allocation of financial resources) and through the provision of a widening range of financial services to nonfinancial customers. So there is equally a public policy interest in promoting this positive influence of the financial sector.

So what we're looking for then are techniques or mechanisms that can help to prevent serious financial disturbance without too much damage to the capacity of the financial sector to perform its positive social role. The problem is that almost anything you can do to help ensure financial stability, whether through preventive, prophylactic techniques or through damage limitation when a problem does nevertheless arise, is likely to distort competition and decisionmaking within the financial sector and by those who use the financial sector, by introducing some kind of moral hazard, which weakens the positive influence that the financial sector might otherwise have. The trick is maintaining an appropriate balance between these at least potentially conflicting objectives.

Now, even if we agree that's what we're trying to do, it doesn't tell us much about how to go about it. There was a wonderful quote given this morning by Barry Eichengreen, who said that "Every family is unhappy in its own way." And we were reminded by Frederic Mishkin that economies differ. But there can also be differing judgments about the right balance between stability and efficiency. And each problem has its own characteristics. There are no absolutes, just difficult judgments.

But let me offer a few general thoughts. Take first the relationship between the macroeconomy and the financial sector. My impression is that destabilizing influences more typically flow from the macroeconomy (as a result of policy weakness or real economic shocks) to the financial sector, rather than vice versa. Macroeconomic risk is still a major—possibly the major—risk affecting the stability of financial intermediaries, at least where they are acting as principals. And it is unusual in my experience for financial markets to generate serious or lasting disturbance out of a clear blue macroeconomic sky.

If anything, the markets are too tolerant for too long, though they may snap back as evidence of imbalance accumulates.

To the extent that this is true, it points to preventive action by the macroeconomic authorities rather than to attempts to suppress financial sector signals. Better policies move attention to asset prices, to the financing of public and private deficits, to greater transparency of the policy process, to better information to enable markets to make better—and earlier—judgments, and to efforts to encourage broader, deeper financial markets. And there was an interesting discussion of indicators that might help the authorities and the markets to detect emerging macro problems. I was left with a sense that some of us would like to find more direct ways of influencing financial markets but no one really saw how this could be done. Nor can I. We can't be successful unless the underlying macro situation is stable. In discussing the international dimensions of the macrofinancial sector nexus, there was a good deal of nervousness about the complication that is introduced by fixed nominal exchange rates—and how to secure a timely exit from fixed-rate regimes. Pedro Pou and others recognized that they required acceptance of greater constraints on domestic policies (including requirements for higher foreign currency liquidity), which has not perhaps been so readily accepted elsewhere.

It was generally accepted, I think, even by Jeffrey Sachs, that there were situations in which damage limitation through official international support was appropriate, especially where the banking system was in turmoil. But, as with lender-of-last-resort support in domestic situations, it was important that this should not become a softer option on which either the borrowing country, or its creditors, can rely, as the effect would be to encourage future indiscipline and disturbance.

But destabilizing influences certainly can originate in the financial sector, and flow back to the macroeconomy, hence the case for preventive mechanisms to reduce the risk of financial instability. One of those preventive mechanisms discussed by Robert Litan is secure payments and settlements arrangements, and by that I mean

real-time gross everything. The case for that is self-evident, and I am glad we're now making progress in this area, though we still have a long way to go.

But most of the discussion of preventive mechanisms in this area centers on prudential regulation and supervision of financial intermediaries with the dual purpose of both helping to reduce systemic risk, which would disrupt the macroeconomy, and helping to protect depositors and investors at the micro-level, partly to prevent runs but increasingly as an objective in its own right. I'm not sure in practice how much difference in the field of prudential regulation there is between the prevention-safety net paradigm and the competition-containment paradigm that Robert Litan described. Robert Litan made it clear that the contrast in his paper was somewhat overdrawn. Don Brash suggested that getting the right balance between stability and efficiency is especially difficult in the context of regulation. Oppressive prudential regulation clearly could emasculate the positive influence of the financial sector in relation to the macroeconomy or to the nonfinancial users of financial services. But at what point does it become oppressive? It certainly cannot sensibly be designed to prevent all failures of financial institutions.

On the substance of prudential regulation, like others I think that if we are not to distort the process of financial intermediation unnecessarily, we have no sensible alternative in a world of rapid financial innovation but to be guided by evolving best market practice for the measurement, management, and monitoring of risk. But the public policy interest must necessarily mean that the regulator positively endorses the market practice and sets the minimum level of capital to be held against the risk.

One issue that wasn't discussed fully is the effect of innovation and globalization on the structure of financial intermediaries and the implications of this for the structure of regulation. Again like others, I think commercial banking activity still has special characteristics, which distinguish it from other forms of intermediation and make it particularly relevant in the context of systemic financial stability. But the boundaries are blurring, and already we have seen the

emergence of multifunctional, multinational groups. That must at some point have implications for the organizational structure of financial regulation—and it was indeed one of the considerations behind the U.K. government's decision to create an all-embracing financial services regulator, including banking supervision. But short of that, there is a mismatch between the legal structure of many of these firms, the way they are in effect managed, and how they relate to the existing structure of regulation, which, in the context of preventive action, cries out for at least some form of consolidated or umbrella regulatory oversight which ensures that the key regulators have a continuous view of the risks being run in the firm as a whole. The absence of arrangements of this sort in relation to multinational, multifunctional firms in particular seems to me to be one of the major weaknesses in current international regulatory arrangements.

One final comment concerning the relationship between financial intermediaries and their nonfinancial customers: In the United Kingdom, we have only rather limited deposit protection because anything close to a guarantee would be likely to distort competition as depositors switched to whoever paid over the odds. Banking supervision, on the other hand, since it was formally introduced only eighteen years ago, has been directed to depositors' protection; and public expectations in this respect, and in relation to the business conduct of financial intermediaries, as in other areas of consumer protection, have remorselessly increased. That is a further, more immediate reason for transferring banking supervision to a financial services regulator, because although, of course, I agree that you cannot divorce concern with systematic financial stability from concern with monetary stability, consumer protection is not a natural habitat for a central bank. If you are going to do that, though, the working relationship between the financial regulator and the central bank becomes critical, so that the central bank's ability to use its balance sheet for damage limitation when preventive supervision fails is not impaired.

We may not have come up with generally applicable solutions, but I have no doubt that we have framed better informed questions.

