

General Discussion: Policies to Stabilize Financial Markets

Chair: Mario Draghi

Mr. Weber: I had a remark to Charles Goodhart, who talked about the lower limit of the deposit rate being negative and referred to the Swedish examples.

In my view, this really risks curing the symptoms, but not really getting to the causes of the underlying problems. The main driver of the recourse to the deposit facility is the cost of raising capital in the market to basically underwrite credit to the economy. This is from Basel II.

We see that in our case. Basically, banks that don't even repo are building up huge amounts of deposits, because they now have a very different level of, I would say, comfort—emergency liquidity they would like to hold. I don't really see that, unless you raise the cost of the deposit facility a lot—and there is clearly the problem that zero is a limit that is imposed by cash—you can cure this problem.

Second, it may have very unintended consequences, because what we are seeing is banks de-leveraging, strengthening their capital buffers, they are building up higher emergency liquidity buffers. In all of that process, of course, the deposit facility as a transition device plays a role.

I am not sure whether at this stage the liquidity policy that central banks can do has all the potential of also solving other problems. We cannot solve solvency or counterparty problems. This is why the deposit facility is there. It is simply a new indicator that I always take, in addition to the amount of repos that is tendered, on how is the new level of liquidity buffers that banks want to hold. The fact that this has gone up and our tenders were so hugely subscribed for me is a clear signal the counterparty risk is still there in the market and still evaluated relatively highly, and this is why we see the deposit facility being used so much.

I am not sure raising the cost for that we are really curing the problems. It may just simply produce problems at a different end.

Mr. Blinder: Both Charles and, especially, Brian talked a lot about the Bagehot principle. Let's put it this way: Behavior suggests that central banks think Bagehot was wrong in the following sense. According to Bagehot, the lending—and Charles said this explicitly—was only supposed to go to solvent institutions.

I don't think there were too many people in September 2008 who thought AIG was going to pull out of this thing all fine, and that the shareholders would come out with something at the end, without massive government help (and maybe even with). The Fed received a lot of criticism for not lending to Lehman, and one of its stated reasons was exactly that Lehman did not have good collateral.

If you take seriously the protection of the overall system and the macroeconomy, as Charles was saying, why shouldn't there be lending to likely insolvent institutions in order to put them to rest peacefully rather than violently, which I think is what was wanted in the Lehman case and what happened in the AIG case. That seems to be a non-Bagehot sort of lending. The kicker question to that is, of course, if you do that, you are making a quasi-fiscal transfer. You don't actually expect to get your money back. What does that say about the relationship between the central bank and the Treasury—or more broadly, the political world?

Mr. Makin: I have a question for Brian. Your summary statement is that it is not prudent to severely circumscribe the potential scope for central bank lending in a financial panic. How do you distinguish that from simply admitting that, in a panic, the reaction of the central bank is really ad hoc and you have to do whatever it takes, and that may include bailing out AIG and making Goldman and Morgan Stanley into banks from nonbanks?

The problem with that is that the message seems to me to be if you think the system may get back into a panic, you have to be sure you are systemically important and that you've taken a lot of risk. Goldman Sachs since March comes to mind.

Some thought has to be devoted to preempting. We don't want to get to September 2008. We would rather try to deal with the problem in September 2007. The point that Brian raised about the difficulties of the discount window stigma suggests to me—just to make a suggestion, which is that the Fed be empowered to require use of the discount window when it designates an institution that really ought to be doing it.

It certainly would have been better if Citibank and Bank of America had been required to draw on the discount window instead of saying, "Oh, we are not going to the discount window, because there is a stigma attached and we're really not that badly off," when, in fact, they were. The failure to recognize that and to force decisions at those institutions that move toward some solution to the problem would have been a good idea.

Just to reinforce this, I suggest that reading the stories about how Chuck Prince discovered the problems at Citibank in October 2007 would reinforce the need for the central bank to step in early and say, "You really need to use the discount window"—sort of a dunce cap mechanism that might operate early on in the system.

Mr. Sinai: This is for Brian, in the spirit of your paper in which traditional central banking and Bagehot's framework were applied in the current situation. It is still relevant in the current situation, which is what Alan Blinder and John Makin have said.

When does the financial or banking crisis end? When does the central bank remove the “lend freely with good collateral and high interest rate” dictum, and how does the traditional central bank guide withdrawal?

Mr. O'Brien: An irony here is this crisis arose, not because of too much instability, but too much stability. We had a nice game going, where we thought we were stabilizing the economy that allowed financial markets to take more leverage, which then reduced volatility further. And the vicious cycle took volatility too low and stability too low.

Now, I wouldn't suggest central banks randomize policy to add risk or volatility, but there needs to be some positive sense of the right amount of risk. We have a nominal anchor for monetary policy, but we don't have some sort of volatility anchor for regulatory or prudential policy, so we don't let financial markets get too confident relative to the world we live in, which we know has a certain amount of irreducibility risk that we have to live with.

If any of the panelists have an idea of how to craft such a policy, it would be interesting.

Mr. Madigan: I think my response to Alan Blinder and John Makin is largely the same and that is with the general question of how to distinguish lending to institutions like AIG and others from lending to solvent institutions. The Federal Reserve has argued a number of times that the resolution of systemically important nonbank institutions is a severe gap in the U.S. financial structure and one that needs to be remedied. It probably shouldn't be situated in the central bank because of the fiscal issues that entails, so there should be some sort of authority to deal with such situations, other than the central bank.

Rather, what I was referring to, and not overly restricting the central bank's authority to lend, was lending to solvent institutions in cases in which there is a systemic threat to the financial system that doesn't arise solely from the potential insolvency of a single institution.

In terms of Allen Sinai's question, to at least a certain degree the exit strategies are built into the programs. We've already seen because they have been priced at penalty interest rates and on penalty terms more generally that the usage of the facilities has declined fairly substantially.

Mr. Goodhart: Can I start with Axel's question or comment? You will all have noticed that the statistics for commercial bank reserves of the central bank show that they have recently risen dramatically, and that has very largely short-circuited the effect of quantitative easing in virtually all of our countries. It is certainly the case that liquidity management cannot solve everything.

The cost of capital and the shortage of capital remain enormously important. Anything that can gently induce the banks to use some of this huge buildup of reserves to buy not-risky assets—I am not suggesting or intending that they would go out and make loans to, say, German car companies—but that they would buy secure public sector debt.

I agree entirely with Alan Blinder, and his is a very useful suggestion. I would like to end my responses by indicating what I regard as the difference between Brian's point of view and my point of view. I understand Brian's point of view. It was, "Bagehot is actually right, but we've been forced by all kinds of terrible things and crises to get really away from Bagehot, to lend on terrible collateral to terrible institutions. But we'll get back to Bagehot when we can."

My view is that actually the past has been sold. It's perfectly clear that in any future crisis, central banks will behave in exactly the same way as they behaved in this crisis. Therefore, you have to think about restructuring the whole way you look at liquidity to take account of the fact that the Bagehot paradigm, in my view, is dead.

Mr. Rochet: Maybe it would be useful to introduce a distinction between normal times, where Bagehot principles will hold, and crisis times, where the Treasury would have to intervene. The question is, of course, Who decides that we are in a crisis time and how do you define the different responsibilities of the central bank and the treasuries in those circumstances?

I do believe it would better to set up in advance a clear responsibility rather than react *ex post* when the next crisis shows up.

Mr. Fraga: I have a quick question and a comment, both inspired by our experience in Brazil, for the panel.

The question first: From all this discussion and years of looking at crises and situations like the one we are dealing with but on a smaller scale, one must conclude that liquidity is mispriced, among other reasons because of lender-of-last-resort, availability, deposit insurance, and so on, in addition to externalities of all kinds. Perhaps it would be a good idea to do something against this. Many ideas have been floated. One would be to have high reserve requirements against short-term deposits. We've had that in Brazil and it worked out well in this recent episode. It was a good cushion and, in a way, you are taxing the system itself.

The suggestion is a quick one. I find the desire to move things or transactions into organized, centralized clearing environments to be a good one, but we must not forget that in a way we are transferring the risk. But the risk will still be there. We have also experienced quite a bit of tension with such arrangements in Brazil, and that led us to make sure the central bank had the authority to supervise and manage risk from a systemic point of view and had the power to do that in this case.

Mr. Shirakawa: I am interested to know Charles' view on the relative effectiveness of interest rate policy, as opposed to liquidity provision in the aftermath of busting a bubble. The difficulty the economy confronts in the aftermath of the busting of the bubble has two elements conceptually: One element is a balance sheet adjustment to wind down excesses, which build up during the bubble period.

The second is the liquidity crisis and the collapse in confidence, which accompanies it. Conceptually, the former is a chronic illness, which would reduce the rate of growth, while the latter is, so to speak, acute pain. In this regard, the liquidity provision is quite useful for acute pain. But I wonder to what extent reduction in interest rates can cope with the pain stemming from balance sheet adjustment. Of course, it is effective in boosting expenditures for the entities that are not troubled by excess debt. It is also effective in boosting asset prices to some extent. Still, it is not that effective. I'd like to know your view on the interest rate policy in the aftermath of a bubble.

Mr. Meltzer: Earlier this morning we discussed the question of who is going to bear the risk. Now we are on to the question—a much more difficult question in practice—of how are we going to get that risk borne. Charles thinks we need more regulation. Brian Madigan says, “Well, we sort of adopted Bagehot, but not quite all the way, because we haven’t found a way yet to have failure without chaos.” Finally, we have Jean-Charles, who really does want to go back to an incentive system like the Bagehot system.

One of my problems with what Charles talks about is that we shift more of the responsibility to the public sector. There are lots of proposals, like the one that the Treasury and the Obama administration has put forward, which shifts the responsibility to the public sector, or, whether we go the other way, which is Jean-Charles’ way (my way) of putting more responsibility on the bankers and financial institutions by allowing failure.

My objections to the regulation are at several levels. First, the first law of regulation, I say, is, “Lawyers write regulations, but markets learn to circumvent them.”

Related to that is that the markets are very dynamic. The regulations are not. If the regulations are appropriate today, they will probably be circumvented tomorrow. That’s one problem.

A second problem with what Charles has proposed is a political economy problem. How are you going to get the public to understand that you can bail out, or do things for, banks and financial institutions but not for automobile companies and airlines and other people who have trouble? We don’t have an answer for that in this country.

And the second part of that problem is that the public decidedly does not like the system in which the risk is being assumed by the public sector. There is a strong feeling reflected in the Senate Finance Committee, but certainly reflected in the public, that says, “You’ve gone too far. You bailed out too many people. Why are you saving automobile companies and financial institutions, but not others? And why are you putting the expense of doing that on us?”

That's a political economy problem, which I will say we will not continue to be able to do that very much longer. If we have another crisis, the answer is going to be not to bail them out. That's the public response.

I believe we have to work to the other way, that is, to shift the risk back the way Bagehot saw it, where we have incentives for handling that risk, rather than regulations for handling that risk. That is going to be a central issue, I believe, in all of the future discussion of this issue. Who is going to bear the losses and how are we going to get the incentives so that they are borne by the people who take the risk?

I would just close with one last comment, that is, the world that Bagehot discussed was a world in which banks held a great deal more capital than they have been willing to hold in recent years.

Mr. Dugger: Two thoughts: First, to everybody in this room and beyond who in the past year has contributed months of work and endured unrelenting stress, my personal thanks for everything you've done. Yes, there were a thousand ways that it could have been done better, but there also many more thousands of ways it could have been done a whole lot worse. The key is, for many American households, including mine, things are a lot better as a consequence of the work by a remarkable community here in the United States and worldwide. My warm thanks to all of you for all you did.

Second, I feel personally embarrassed. In the 1980s, I was a senior staff member of the Senate Banking Committee and, in the late 1980s and early 1990s, policy director at the American Bankers Association, working closely with Congress. We drew heavily on the lessons of the 1980s in designing a strict, prompt corrective-action procedure to close the door on bailing out too-big-to-fail institutions.

In 1988, in the middle of the legislative conference between the House and Senate on deposit insurance reform, I was asked to draft a short sentence called "The Systemic Risk Exemption"—a kind of escape hatch. This exemption went unused for nearly 20 years, until it was almost invoked in the Wachovia case. As I watched the Congressional staff carry that exemption into the conference, I knew the too-big-to-fail door had opened up again. The agreements that had

been reached between large banks and small banks in the United States were going to be breached. There were going to be systemically large institutions, and they were going to be exempt from the prompt corrective-action process.

That's where we are now. I have personally little patience for most of the new mechanical suggestions about what to do to prevent the current crisis again, unless we have an answer to this question: Why is it that we, as a community, held so long and so tenaciously to our belief that everything was going to work out all right, despite steadily accumulating evidence that risk was mounting in our economy and in global imbalances? What was it that caused us to be so surprised about what happened?

I think there are deep political economy questions to which Jean-Claude and others have referred. There are also collective incentive issues here. Maybe there are answers in the newer complexity and non-linear economic theories. But somehow or other, as a community, before we begin to pursue specific solutions to prevent future crises, we have to understand why it is we were so surprised by this one.

Mr. Carney: I want to support Jean-Charles' approach on the importance of systemic markets. Too often we get down into the institutions and do not focus on market structure. I would also say that it is less conceptual than maybe you put it across. There is a lot of work that is being done—and Arminio just referenced it—particularly on repo markets. The core of this is basically good collateral could not be discounted.

Even those institutions that ultimately were going to go, they went a lot quicker because they couldn't discount good collateral. We all know why. Haircuts spike. People used trailing VAR. And moving things on to clearinghouses that, in most of our jurisdictions, are already systemic payments systems and therefore are the subject of regulation of central banks is a way to very quickly accomplish part of your objective. Now, I would suggest that it starts with repo—potentially we are looking at it in Canada—maybe it goes to OTC derivatives. Obviously, that is a bigger discussion. But it is less conceptual, and I just wanted to support it.

Mr. Ingves: To reflect on the issue of lending to solvent institutions, in bad times it's pretty hard to figure out who is solvent or not and for how long you stay solvent. That means, particularly when it comes to large institutions, it needs to be understood that central banks will always be first in line, but that doesn't mean they should be the only ones in line. You need to have a system of passing on these banks to others, so that you can line them up in an orderly way. Without that kind of a system, eventually central banks are just going to be stuck with this problem, and that creates a number of other problems for central banks.

A second reflection is that, if you end up operating a system where you call something liquidity support and you provide such support in one form or the other for several years, it's highly likely that liquidity support is a substitute for something else. What you really need to do in order to get out of the position you are in is actually to go and get the lemons, find out where they are and deal with them, and deal with them in a transparent way. Because, without doing that, uncertainty stays within the system in one form or the other. As long as that uncertainty is there, banks don't want to lend to each other, and all of them come to the central bank.

Mr. De Gregorio: Two comments: The first one is with the strong statement by Charles: Bagehot is dead.

I think we have to distinguish between a huge crisis and normal times (or normal crisis). I think in normal times the Bagehot principle is reasonable. What's happened in the current juncture is that we have faced a crisis where many reasonable principles, like moral hazard and those of Bagehot, were set aside to avoid a complete financial meltdown. I hope, and think, we won't see this kind of crisis very often, so Bagehot principles should work well. In order to allow for an active interbank market, central banks must be lenders of last, and not first, resort.

My second point is about the interesting discussion by Jean-Charles. I fully agree that remuneration policies were very important in explaining the high risk-taking and the road to the crisis. But I am skeptical about whether regulators can have a role in terms of overlooking

remuneration policies; it is extremely difficult, and it could also be extremely politicized. I would much rather prefer a system in which there is much more information disclosure and clear responsibilities of a bank's board, in particular about the risk-adjusted measures of performance. I am a skeptic that regulators can perform this task efficiently.

Mr. Trichet: Only two remarks: In our case, the distinction between the responsibility of the central bank and the responsibility of the executive branches and parliament is a little bit clearer. I understand it is perhaps more difficult to disentangle exactly the responsibility of the central bank and the responsibility of the executive branch and parliament in the United States or in the United Kingdom or in Japan. In our case, it was absolutely clear that it was at our own risk and within our own responsibility that we had to act. To sum up the position of the euro system, vis-à-vis 16 governments, I would say that at the moment of the explosion of the crisis we used to say, "We are trying to take care, within the limits of our own possible risk, the systemic liquidity crisis, which is absolutely traumatic."

Now we cannot do anything for the systemic solvency crisis, which is there. It is up to you. We have been in this context, I have to say, very proactive in telling governors, "You have to step up. It's about time."

By the way, of course, at the global level, what was decided by the G-7 and the G-20, namely, these political commitments of first importance, which was that we will take care that no systemic institution would go under, was a commitment of governments, certainly not a commitment of the central banks. Not at all.

Perhaps, again, it is clearer in our case, because the institutional framework permits it to be a lot clearer. But it seems to me that it is extremely important that we know where the border is between the systemic liquidity risk and the systemic insolvency risk. It is absolutely essential.

Mr. Goodhart: It was an extraordinarily wide-ranging set of comments. Can I start with Allan, who raised some of the political economy points? His interpretation of the political economy is rather different from mine. I see the political economy point as the taxpayers' concern, which is a proper concern, by the amount of money they

have had to effectively pay out. It is not aimed so much at the Fed and the Treasury. It is aimed particularly at the bankers, who took the risk and are getting unconscionable remuneration. In my view, the political economy attack on the Fed and the Treasury is that they let Lehman go. That you have to accept. The world is such that we're going to have a condition in which central banks from now on—and treasuries—are not going to feel able to get large, interconnected systemic institutions to go. We have to deal with that. That is the issue effectively at hand.

Now, I'm entirely with you about trying to improve incentives and to make financial intermediaries more capable of being made insolvent. But, again, we have cross-border issues. The problem of dealing with legal insolvency difficulties around and between countries is just enormous and will take forever to handle that. In the meantime, while we're trying to get insolvency problems sorted out, we're going to have to undertake a wider range and a reconsidered range of dealing with liquidity issues.

You may not like having to give central banks greater powers or coordinating institutions greater powers, but that is going to be a fact of political life.

Mr. Madigan: I think there was just one question directed to me and that was Arminio's comment and question about liquidity requirements. I don't really know how to react to the thought that perhaps liquidity is mispriced, but certainly the general issue of liquidity is a characteristic or hallmark of this crisis. One lesson that we all learned—and that market participants learned—and that may have been difficult for economists to accept is that a market simply can disappear and become very dysfunctional. That is something we need to think through—the reasons why that can happen and the implications of that observation.

Mr. Rochet: Briefly on the notion that markets circumvent regulations, that is the name of the game. It has always been like that. I believe by acting on the remuneration of bank managers you might limit the stakes of regulatory arbitrage.

On the question Jean-Claude Trichet made, the commitment of governments to bail out any large institutions, it was probably necessary for the management of the current crisis, but it might be very costly for the future. I really share the view of Allan Meltzer that maybe the taxpayers will not accept that again in the future.

