Maintaining Financial Stability*

E A J George

Governor of the Bank of England

MONETARY STABILITY

Gerhard (de Kock) took a close interest in our experiments (at the Bank of England) with intermediate monetary targets in the late 1970s and first half of the 1980s. In the event, unpredictable changes in the velocity of circulation — at a time of financial deregulation and intensifying competition — meant that monetary growth proved to be an unreliable short-term guide to monetary policy, though we still pay very careful attention to underlying trends in the growth of money and credit.

The focus of monetary policy now in the UK is an explicit target for retail price inflation, not simply as an end in itself, but as a means to the end of sustainable growth. Inflation is in effect regarded as a measure of the balance between aggregate demand, which we can influence through monetary policy, and the underlying, supply-side, capacity of the economy — determined essentially by its structural characteristics — to meet that demand. So what we are, in fact, doing, in seeking to achieve our inflation target, is to keep demand growing more or less continuously in line with the growth in capacity — thereby avoiding the exaggerated inflationary booms, and inevitable, consequential busts that we experienced all too often in the past. We cannot contribute much directly through monetary policy to underlying, supply-side, capacity growth. But if we are successful in maintaining monetary stability in this broad sense, that will provide the context for more rational and longer-term economic — industrial, commercial and financial — decision-making and so contribute indirectly to the underlying growth of potential output.

Gerhard de Kock would, I think, have approved of what we are trying to do in the UK. The basic underlying philosophy of macroeconomic, monetary, stability and

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supply-side reform is, as I understand it, essentially the same as that which underlies your own GEAR strategy to promote sustainable growth here too in South Africa. He would have approved too, of the fact that the Bank of England has now been made operationally independent.

FINANCIAL STABILITY

In my conversations with Gerhard we did not much discuss the other essential purpose of central banks everywhere — maintaining the stability of the financial system. As if to make up for that, I should like to take financial stability as the subject of my lecture this evening.

Of course the two core central banking purposes — monetary and financial stability — are inextricably bound up with each other. Failure to maintain monetary stability provides a very uncertain operating environment for financial intermediaries, which is largely outside their control.

But this causality may sometimes run the other way. Just as monetary instability can undermine the stability of financial institutions, so too the emergence of weakness in the financial system can disrupt monetary stability. You cannot easily maintain a stable monetary policy if the banking system in particular is collapsing about your ears!

Financial intermediaries are in the business of taking and managing financial risk — that is their economic function, for which they are paid. Banks, of course, classically take on the particular risk of maturity transformation. Their liabilities represent "money" because they are typically immediately available on demand to make payments or to be turned into an obligation of the central bank. On the asset side, banks are still the overwhelming providers of, mostly non-marketable, loans to the economy, which involves them not just in credit risk but also liquidity risk, because most loans cannot in practice be called on demand. This service — converting immediately liquid liabilities into less liquid loans — is still in fact what distinguishes banking from other forms of financial intermediation.

In the normal course of events a bank will maintain a sufficient proportion of its assets available, to meet withdrawals of deposits, in the form of liquid assets which may be realised in the money market or which are acceptable to the central bank in the conduct of its regular money market operations, as well as sufficient capital to act as a cushion against loan losses. But driven by competition — which is vitally important for the efficiency of the system — a bank may overextend itself and be faced with failure. In principle the potential failure may be a result either of illiquidity or of insolvency — but in practice initial illiquidity may well lead on to insolvency — if the bank in question has to realise illiquid assets at a loss.

Individual bank failures are not necessarily serious in themselves — at least from a systemic or macroeconomic standpoint. The possibility of failure is an intrinsic feature of a market economy and indeed an essential part of market discipline. But in the case of bank failures there is a danger that the initial failure will bring down other — otherwise healthy — banks. The reasons are plain. Banks typically have substantial direct exposures to each other, as a result of their involvement in payments and settlements systems, on their own account or on behalf of customers And they have direct exposures to each other through interbank credit lines. But even where there is no direct exposure to the failing bank, other banks — particularly those with a similar business profile — may be affected by a loss of confidence on the part of their depositors or other creditors, and a drain on their liquidity. So bank failures can be contagious, and once contagion starts it can be difficult to stop.

Now none of this is new. In fact maintaining the stability of the financial system was increasingly recognised as a key responsibility of the Bank of England, following a series of systemic disturbances during the 19th century; and it has since become a core function of central banks everywhere. What has changed is the financial environment. New technology, increased competition, and financial deregulation have progressively transformed the financial services industry over the past twenty years or more. The result has been a blurring of traditional boundaries between different types of financial intermediaries, the emergence of complex financial groupings, and the development of new financial markets, new instruments and new techniques. These changes have brought huge benefits to consumers of financial services, which translate into benefits to the macroeconomy. They provide new opportunities, too, to the financial intermediaries themselves— if they choose to take advantage of them — to diversify their risks and to manage them more effectively. But they equally provide new opportunities for financial intermediaries to take on additional risk. If such additional risk is mismanaged, it can add to the danger of financial instability and increase the risk of its spreading through the banking system, which remains especially vulnerable to contagion.

So the task of preserving systemic financial stability has become a good deal more complex. It goes without saying that a key condition is macroeconomic, monetary stability. But, beyond that, it breaks down essentially between accident prevention and damage limitation — which I will discuss briefly in turn.

Accident prevention

(i) Infrastructure

New technology can, of course, be turned to advantage in the task of maintaining systemic stability, and applied to accident prevention, most obviously by reducing interbank risks in payments and settlements systems.

Until quite recently in the UK — and we were by no means unique— our core sterling payments system involved end of day net settlement, in which the settlement banks did not even know the size of their intra-day exposure to each other. Now sterling interbank payments are made, definitively, in real time, on a gross basis across accounts at the Bank of England, so that interbank payments exposures have effectively been eliminated. From next year similar national Real Time Gross Settlement Systems for payments in the new euro currency will be linked together through a system, called TARGET, allowing euro payments to be made in real time throughout the whole of the European Union. In principle RTGS payments systems can be linked with securities settlements systems, or with foreign currency payments in settlement of foreign exchange transactions, to provide simultaneous delivery against payment. With sufficient application, nationally and internationally, payment and settlement risk could eventually become a thing of the past as a potential cause of systemic instability — though we do need to sort out the millenium bug first!

(ii) Supervision and regulation

Helpful though it is, improving the payments and settlements infrastructure addresses only a part of the risk of systemic instability. Our main defense against accidents will, of course, remain supervision and regulation of individual financial intermediaries.

Financial regulation in fact has a dual purpose. It evolved originally, in the UK at least, in the context of the Bank of England's concern for systemic stability, which led us to exercise informal and non-statutory surveillance over key elements of the banking system. But the purpose, and scope, of financial regulation has over the past twenty years or so been extended to include a degree of consumer protection, against financial loss in the event of the failure of financial intermediaries, and also against business misconduct.

For the most part these conceptually distinct purposes of financial regulation sit reasonably comfortably alongside each other. The prudential supervision or regulation is essentially the same and there are practical advantages in conducting the regulatory oversight for both purposes as a single operation. The important thing is that the twin purposes be kept in balance. Systemic stability does not mean that the aim of prodential regulation should be to prevent the failure of each individual financial intermediary. Indeed it would overconstrain the capacity of the financial system to perform its essential risk-taking function, and weaken market disciplines, if that were to become the aim. The protection of individual consumers, on the other hand, does point more in that direction, but it would similarly create "moral hazard" and undermine market discipline if authorisation of a financial intermediary came to be regarded as an implicit guarantee against failure.

Limited protection schemes — for depositors or investors — can help to square the circle. They recognise that many smaller, often financially less sophisticated, depositors cannot realistically know enough about their reliability. But such schemes in the UK are deliberately — and in my view wisely — limited. If users of financial services were relieved of all responsibility, their money would simply flow to the highest bidder, regardless of risk, which would distort competition and actually encourage systemic fragility. The message of limited protection is unmistakable. Financial intermediaries <u>can</u> fail and consumers <u>can</u> lose at least a part of their money.

The underlying question is just how much risk we wish to tolerate in the financial system. There can be no definitive, precise, answer. It emerges in practice out of the decisions of the regulator, and as a result of public and political reactions to particular events. But there is little doubt, it seems to me, that rising public expectations, in the context of the rapid evolution of financial markets, are causing the tide to run in favour of greater protection.

These same developments — the pace of financial change, including particularly the blurring of traditional boundaries between different types of financial intermediary, and increased emphasis on protection — raise major questions about the appropriate structure of financial regulation. They explain the recent decision in the UK to consolidate all the various separate financial regulators, of particular types of intermediary or activity, under the single umbrella of the new Financial Services Authority. The FSA is in the process of taking on responsibility for the regulation of <u>all</u> forms of financial activity in the UK — banks, building societies, securities businesses, insurance and so on — including both the prudential supervision of individual intermediaries and regulation of their business behaviour. This includes responsibility for banking supervision which has up to now been with the Bank of England — although the Bank remains responsible for the overall stability of the financial system as a whole.

There are compelling reasons in the British context for making this change. It will in particular facilitate the effective, consolidated, oversight of multi-functional financial businesses — including banking businesses. And it provides clearer lines of responsibility, both for the regulated intermediaries themselves and for the consuming public. We will in fact have a one-stop regulatory shop.

From the Bank of England's perspective it relieves us — and it is a relief of a growing involvement in consumer protection, which is not our natural habitat. It allows us to focus more single-mindedly on systemic stability. For that purpose, of course, we will need to maintain a very close and continuous working relationship with the FSA — as we certainly will.

Whatever the regulatory structure, the pace of financial change has major implications, too, for supervisory techniques. Just as some — I'm tempted to say many — financial intermediaries themselves are having to struggle to keep up with changes in the market place — in terms of risk management and controls, so too are the supervisors. The setting and monitoring of minimum standards for capital, liquidity and concentration of risk — to ensure that intermediaries have a cushion against emerging pressures giving them time to respond — is still at the heart of it. But their financial condition can now change so rapidly that supervisors too are having to focus increasingly on systems and processes rather than on balance sheets. It is a trend that I expect to continue.

Damage limitation

Prudential supervision of individual financial institutions is a powerful defense against systemic instability — and can be used pro-actively to encourage them to prepare — by strengthening their liquidity, for example, or scaling down their business — ahead of an approaching storm. But accidents will inevitably happen. The central bank's concern then is to ensure that it does not spread to other parts of the financial system.

This may involve providing liquidity on penal terms, outside the central bank's normal money market operations, against high quality assets to a particular institution, that does not want to appear in the market because it is under a cloud.

Or it may mean standing between an intermediary and the market place, to facilitate payments or settlements which might not otherwise be completed, which could then cause gridlock. Such involvement would not normally involve the central bank in significant financial risk.

But in more difficult — and mercifully rare — situations, where the failure of one institution could bring down other — otherwise viable — institutions, the central bank may need to consider acting in the role of "lender of last resort" to the failing institution, against poorer quality, less liquid, assets which might expose the central bank to financial loss.

The key phrase here, of course, is "where its failure could bring down other — otherwise viable — institutions". The central bank safety net is not there to protect individual institutions from failure. It is there to protect the stability of the financial system as a whole. In the absence of a serious systemic threat, the right course would be to allow the institution to fail. If any institution felt that it could rely on being bailed out if it ran into real difficulty, that, too, would introduce "moral hazard", encouraging excessive risk-taking and financial fragility in the system as a whole. There can be nothing automatic about "lender of last resort" assistance — and, when it is provided, it should always be on the most onerous terms that the borrower can bear : it is not provided to protect the shareholders who should be looked to first. Nor is it there to protect the management. "Lender of last resort" assistance involves the commitment of public money — taxpayers' money — and it needs therefore to be justified in terms of the damage that would otherwise result to the financial system and to the wider economy. For this reason we at the Bank of England would always seek the Chancellor of the Exchequer's explicit prior approval wherever circumstances allowed, or at least his tacit prior approval, in emergency situations and where the risks were manageable in relation to the size of our capital.

GLOBAL FINANCIAL STABILITY

So far I have discussed financial stability implicitly in a national context. But there is of course a read-across to international financial stability, to which I now turn.

Financial change has become increasingly global in scope. Information technology knows no national boundaries, and competition — including the provision of financial services abroad — has been as much a cause as an effect of deregulation and increasingly free international movement of capital.

All this has brought huge economic benefits, not just to the emerging countries of Latin America and Asia, or the transition economies of Eastern Europe, through faster growth of the world economy as a whole. At the same time it has also brought greater risks of global instability, as we have seen most recently in Asia.

These recent crises are unusual. Typically in the past international payments problems have had their origins in some evident macroeconomic policy failure. At least in hindsight there are usually clear tell-tale signs of expanding fiscal deficits and/or lax monetary policies, accompanied by evidence of imbalance in the form of accelerating inflation or a rapid deterioration in the external current account. There were such signs in some of the Asian countries involved in the recent crises; but they were not, for the most part, particularly pronounced. In fact through the earlier part of the 1990s, and in some cases for very much longer, the countries in question were remarkably successful, so much so that they attracted, by their very success, huge inflows of capital from the rest of the world, in search of higher returns than were available in the more mature industrialised countries.

With the benefit of hindsight the increasing scale of the capital inflow, and particularly the form that it took, became an important part of the problem. It was not all effectively employed. There was overinvestment in some production sectors; much of it went into ambitious property development; and much went into financial rather than real assets.

Again, with the benefit of hindsight, one can identify a number of structural weaknesses in the financial structures of the recipient countries which contributed to this misallocation of capital. There was, for example, a general lack of reliable financial information, and a lack of transparency in relation to the financial position of both the public and private sectors. Financial markets were not well developed, leaving the system heavily dependent upon the banks. There was inadequate regulatory oversight — especially over the banking system. And there was widespread government influence over the allocation of finance which contributed to a perception that much of the borrowing was effectively underwritten.

A key part of the problem was the seemingly unrecognised build-up of unhedged, increasingly short-term, foreign currency debt as an apparently cheap alternative to domestic currency borrowing. The borrowers — variously the local banks and non-banks were obviously convinced that exchange rate pegs against the dollar would be maintained even when the dollar strengthened as they had been earlier during the period of dollar weakness. The result was that the Asian economies were extraordinarily vulnerable to a change in sentiment and a withdrawal of foreign currency credit lines. There was little that the national authorities could do once this started. They can in principle create their domestic currency through the national central bank — if they choose to do so, even if it may lead to inflation; but they cannot simply create foreign currencies out of thin air in the same way. So, once the run started, it was violent and contagious.

Accident prevention

Clearly in this international context, too, accident prevention is infinitely better than damage limitation.

That certainly means continuing emphasis on disciplined national macroeconomic policies and on international macroeconomic policy surveillance through the IMF.

But the particular lessons of Asia are that we must pay far more attention to international capital flows, the forms they take and the uses to which they are put. That means greater emphasis on the structure and efficiency of the financial system, including the development of more transparent and open capital markets. It means more effective financial regulation, including regulation of the banking system in line with the "Core Principles" developed by the BIS. And it means, crucially in my view, collecting and monitoring, and preferably publishing through the IMF, more comprehensive data on the foreign currency assets and liabilities, both on and off balance sheet, and their maturity structure, of both the public sector and the banking system. The IMF and World Bank have a key role in bringing about these changes.

Meanwhile, from the creditor side, it was clear, well before the Asian crisis, financial globalisation means we must be able to exercise more comprehensive umbrella or consolidated oversight over multinational financial firms. That might ultimately involve changes to the international structure of regulation. It certainly means greater international regulatory co-operation — between regulators and financial market authorities — both multilaterally, through the relevant international institutions, but also through the expanding network of bilateral relationships. It is a huge agenda given added urgency by recent events.

Damage limitation

Immediate attention in the Asian crisis has nevertheless necessarily focused on damage limitation.

Essentially there are two broad options for dealing with the sort of crisis that suddenly broke over Asia. One is simply to allow financial markets — exchange rates, interest rates and stock and bond prices — to take the strain, and to seek to restore confidence, and moderate the impact of market movements, by restrictive macroeconomic policy adjustment. The second is to limit the financial market impact and the extent of the associated macroeconomic adjustment by providing or arranging alternative external financing. In practice these options are not, of course, mutually exclusive and the real question is the appropriate balance between them.

Where a country has transparently been pursuing an undisciplined and unsustainable macro-economic policy, most people find it easy to accept that that country should bear the burden and adjust, painful though that may be. Many people find that harder to accept where, as in the present case, conventional macroeconomic policies had, for the most part, been relatively responsible and the immediate severity of the problem arose largely from weak financial structures and, immediately, from a lack of foreign currency liquidity. There were certainly adjustments to macroeconomic policy that needed to be made. And, once the capital outflow had started, macroeconomic retrenchment needed to be more abrupt than might otherwise have been necessary, in order to shore up confidence. But there are real dangers in extreme market movements or in excessively severe macroeconomic adjustment to contain them. That could cause a vicious circle of domestic default and aggravate systemic financial weakness. And it would have seriously adverse implications — in terms of both financial and economic knock-on-effects — for the global economy.

That, essentially, is why it was in the self-interest of the international community to attempt to mitigate the market and macroeconomic adjustment pressures in Asia by providing official financial support. It is why the international community — acting effectively as international lender of last resort — promptly offered very large amounts of official assistance — \$17 bn in the case of Thailand, \$43 bn for Indonesia and \$57 bn for South Korea.

But, as in the domestic context, official last resort assistance cannot be unlimited and it cannot be provided without strings. It, too, has real dangers. If it were too readily forthcoming it could encourage "moral hazard", especially by encouraging commercial lenders — particularly foreign currency creditors — in the belief that they will be bailed out if things go wrong. That would be likely to add to the problem of potentially volatile capital inflows next time around. Not surprisingly, too, there is strong political resistance in many countries, including notably the

United States, to the idea that public — taxpayers' — money should be used to bail out private creditors, especially foreign creditors, without clear demonstration that it is in their own national as well as the international interest.

Alternative external financing need not come solely from the public sector. Private finance would, in principle, serve the same purpose, and in many situations moderate market price adjustments may be sufficient to attract back private inflows. But given the extent of the loss of confidence in Asia it would have been optimistic to think that other private lenders would volunteer to stand in place of those that are rushing for the exit. In practice in the present situation private support meant persuading existing creditors that their assets would be better protected if they were prepared to leave them in place, especially if other major creditors agreed to do the same, and if official support were being made available in parallel. But in this case, too, difficult judgments have to be made. There are powerful arguments for somehow or other making the provision of exceptional official support in a foreign currency liquidity crisis, dependent upon forbearance on the part of private foreign currency creditors as a matter of course. But that is not the situation we are currently in. In the absence of such arrangements, there is a danger that, if private creditors have in effect to be coerced into staying put, they will immediately cut their positions elsewhere, before they become locked in there too, adding to the international contagion.

Achieving a reasonable balance between market and macroeconomic policy adjustment and official and private financing was never going to be easy. It depended upon the good sense and judgement of key players all around the world — the governments and central banks as well as major market participants in both the major creditor and the debtor countries, as well as the international organisations. My impression is that after the initial shocks, in which market adjustments have been massively overdone, the key players are now co-operating more effectively to bring about stabilisation. Within the constraints imposed upon it, the IMF in particular is playing a very positive leading role. I especially welcome the constructive part which the major commercial banks, from all the main creditor countries, are now playing in extending the maturity of their loans to Korean banks and in finding workable solutions to the debt problems of Indonesian corporations. This has already helped to stabilise the situation in the region more widely and, I believe, now provides the basis for convalescence. There will nevertheless be a very significant price to pay in terms of slower world economic activity for some time to come — particularly, but not only, in Asia. In that light we clearly need to review international arrangements for handling such crises in the future to see if there are ways in which the economic costs could be reduced.

CONCLUSION

There is something of an irony in the fact that financial stability — nationally and internationally — should come to the top of the agenda, as a result of the rapid changes in the financial services industry and deregulation of domestic and external capital flows, at a time when we are making relatively good progress towards sustained monetary stability. It means I think that central banks — and financial regulators — will continue to find plenty of work to do. It is a challenge which Gerhard de Kock would have relished.