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The Role of Central Banks in Ensuring Financial Stability

This chapter⁷⁶ addresses three questions:

- Do central banks have a natural role in ensuring financial stability?
- If there is a role, what does a central bank need (in the way of information, authority, and tools) to execute it effectively?
- What have central banks actually done to safeguard financial stability?

Despite a long history of central banking and of the management of financial crises, considerable controversy remains over the role of central banks in ensuring financial stability. The following two examples illustrate this point.

First, in 2000 the United Kingdom moved responsibility for banking supervision from the Bank of England to the Financial Services Authority as part of the process of creating a single financial regulator. The creation of a single financial regulator is one way of rationalizing or merging disparate organizations that are responsible for parts of the financial regulatory or supervisory framework. With the creation of the Financial Services Authority, the Bank of England, which is the lender of last resort and the insurer of financial as well as monetary stability, relinquished its responsibility for banking supervision. An important issue raised by this example is, what kind of information does a central bank need to fulfill its mandate for ensuring financial stability and effectively providing lender-of-last-resort protection against instability?

⁷⁶This chapter is based on Schinasi (2003), which was adopted from a recorded transcript of a one-hour lecture to a group of legal counselors from the central banks of selected emerging-market and transition countries.

A second example is the European Central Bank (ECB). This central bank (newly created in 1998), which is supranational, manages the monetary policy of the euro zone, composed of 12 countries. In many ways, Deutsche Bundesbank was the model for designing the ECB, both in statute and in practice. As explained more fully later in the chapter, the Bundesbank, as it existed prior to the creation of the euro zone, could be characterized as a central bank based on a “narrow” concept of central banking. The Bundesbank had a single objective—the stability of the deutsche mark—which, in domestic terms, meant price stability. In practice, the Bundesbank was a bank supervisor as well, even though there was a separate Federal Supervisory Office. The Bundesbank was responsible for collecting all the information required for good banking supervision, and it provided that information to the Federal Supervisory Office, which legally was the supervisor. The Bundesbank had a very direct and central role in banking supervision. By contrast, the ECB does not. The ECB appears to be the ultimate narrow central bank; it has a mandate for price stability only and a very small role in ensuring financial stability, confined to ensuring the smooth functioning of the TARGET⁷⁷ payments system, not the whole financial system.

Do Central Banks Have a Natural Role in Ensuring Financial Stability?

This section argues that central banks do have a natural role in ensuring financial stability. Specific features of central banking make central banks a natural contender. Consider the traditional definition of monetary stability from Henry Thornton’s classic monograph, *An Enquiry into the Nature and Effects of the Paper Credit of Great Britain*, published in 1802:⁷⁸

To limit the amount of paper issued, and to resort for this purpose, whenever the temptation to borrow is strong, to some effectual principle of restriction; in no case, however, materially to diminish the sum in circulation, but to let it vibrate only within certain limits; to afford a slow and cautious extension of it, as the general trade of the kingdom enlarges itself; to allow of some special, though temporary, enquiries in the event of any extraordinary alarm or difficulty, as the best means of preventing a great demand at home for guineas; and to lean to the side of diminution, in the case of gold going abroad, and of the general exchanges continuing long unfavorable; this seems to be the true policy

⁷⁷TARGET stands for the Trans-European Automated Real-time Gross Settlement Express Transfer System—the real-time gross settlement system for the euro.

⁷⁸See also Capie (2000).

of the directors of an institution circumstanced like that of the Bank of England. To suffer either the solicitations of merchants, or the wishes of government, to determine the measure of the bank issues, is unquestionably to adopt a very false principle of conduct (Thornton, 1802, p. 259).

In this definition, one can see the traditional monetary policy role of a central bank. It has all the ingredients of managing monetary aggregates and interest rates. It has embedded in it the monetary transmission mechanism and references to monetary targets.

Turning to Thornton's views on what may be interpreted as the role of the Bank of England in ensuring financial stability at that time, three passages from his classic work appear relevant:

If any one bank fails, a general run upon the neighboring ones is apt to take place, which if not checked in the beginning by pouring into the circulation a large quantity of gold, leads to very extensive mischief (p. 180).

[I]f the Bank of England, in future seasons of alarm, should be disposed to extend its discounts in a greater degree than heretofore, then the threatened calamity may be averted through the generosity of that institution (p. 188).

It is by no means intended to imply that it would become the Bank of England to relieve every distress which the rashness of country banks may bring upon them: the bank, by doing this, might encourage their improvidence. There seems to be a medium at which a public bank should aim in granting aid to inferior establishments, and which it often must find it very difficult to be observed. The relief should neither be so prompt and liberal as to exempt those who misconduct their business from all the natural consequences of their fault, nor so scanty and slow as deeply to involve the general interests. These interests, nevertheless, are sure to be pleaded by every distressed person whose affairs are large, however indifferent or even ruinous may be their state (p. 188).

The first passage describes a process of contagion that is likely to occur with a run on one bank. The second describes the role of the Bank of England in a crisis. The third passage describes the concept of moral hazard, which is taken up in Chapter 8 of this volume. The three passages together show clearly that Thornton had a working definition of the role of central banks in financial stability.

Consider a more modern view of the role of central banks in ensuring financial stability, which is consistent with Thornton's view. The following view was expressed by Paul Volcker in 1984, when he was Chairman of the Board of Governors of the U.S. Federal Reserve System:

A basic continuing responsibility of any central bank—and the principal reason for the founding of the Federal Reserve—is to assure stable and smoothly functioning financial and payments systems. These are prerequisites for, and com-

plementary to, the central bank's responsibility for conducting monetary policy as it is more narrowly conceived . . . To these ends, the U.S. Congress has over the last 70 years authorized the Federal Reserve (1) to be a major participant in the nation's payments mechanism; (2) to lend at the discount window as the ultimate source of liquidity for the economy; and (3) to regulate and supervise key sectors of the financial markets, both domestic and international. These functions are in addition to, and largely predate, the more purely "monetary" functions of engaging in open market and foreign exchange operations and setting reserve requirements; historically, in fact, the "monetary" functions were largely grafted onto the "supervisory" functions, not the reverse (Volcker, 1984, p. 548).

According to Volcker, the Federal Reserve System was first the ensurer of financial stability and secondarily the manager of monetary stability. Certain key points made by Thornton and Volcker establish the reasons for central banks to have a natural role in financial stability.

First, the central bank is the only provider of the legal means of payment and of immediate liquidity. That is, only the central bank provides "finality of payment."

The second natural role for the central bank is to ensure the smooth functioning of the national payments system. It is within the context of the soundness and stability of national payments systems that policymakers have traditionally and naturally considered systemic risk. Traditionally, systemic risk has been viewed as the possibility that problems at one bank would create problems at other banks, in particular, banks that make up the core of the national payments system. In this view, problems at one bank would cascade through the payments system and perhaps lead to bottlenecks in payments and the possibility of a widespread domino effect. The payments system, being the core of the financial market, has been the subject of much discussion, policy, and reform. Through Group of Ten efforts, there now exist real-time gross payments settlements systems that try to prevent the failure of one institution from cascading through the payments system and affecting other institutions within the payments system. So, again, the central bank has a natural role to play in financial stability—even if it is confined to the payments system.

The third natural role relates to the fact that the banking system is the transmission mechanism through which monetary policy has its effect, in the first instance, on the real economy. If the banking system is experiencing distress, the central bank will find it difficult to provide the liquidity necessary to achieve its monetary objectives. For this reason alone, central banks have a natural interest in sound financial institutions and stable financial markets. Central banks have, therefore, an interest in maintaining the stability of the banking system, in having the ability to see problems at an early stage, and in being in a position to influence corrective actions.

Finally, monetary stability and financial stability are explicitly linked. In Anna Schwartz's definition of a financial crisis, she refers to the propensity for the money supply to collapse (Schwartz, 1986). One simple equation makes this clear. Basic money-and-banking courses often begin with an equation called the money multiplier, which establishes a relationship (some would even say an identity, if these parameters are fixed) between central bank money B held as bank reserves by the banking system and the money supply M . Formally,

$$M = mB$$

that is, the money stock (M) is equal to high-powered money or the monetary base (B) times the money multiplier (m). This can be written explicitly as follows:

$$M = \left[\frac{1 + \frac{C}{D}}{\frac{C}{D} + \frac{R}{D}} \right] B,$$

where C/D is the currency to deposit ratio of the public, and R/D is the cash (or reserves) to deposit ratio of the banks.

It has not been made clear in the above discussion whether M is a narrow monetary aggregate (comprised only of base money and demand deposits) or a broad monetary aggregate (comprised of base money, demand deposits, and time deposits, and perhaps even money-market mutual funds): that will depend on what the ratios C/D and R/D are. Regardless, the money supply of the economy is directly linked to what the central bank provides in the way of central bank money. In the midst of a financial crisis, a run on liquidity could occur. Everyone will demand liquidity (and the finality of payment), and everyone in the system understands that the only liquidity that really exists is central bank money, that is, base money B . In this rush for central bank money, the money supply shrinks because the ratio C/D increases very rapidly as everyone increases C and reduces D . If the money supply (M) is shrinking very rapidly in the presence of financial instability, it will not take long before the central bank will have to supply liquidity, or (B), to restore monetary stability as the monetary aggregates collapse, because monetary stability objectives (unquestionably the central bank's responsibility) are less likely to be achieved, even in the short run, without more central bank money. So when financial instability occurs, monetary instability is likely to follow. This establishes a link

between the natural role of the central bank as the provider of payment finality and its role in financial stability.

What Does the Central Bank Need to Execute This Role Effectively?

There are competing views on the question of what the central bank needs to execute its role. The first view might be characterized as the “open market operations view,” which holds that the conduct of monetary policy inherently conflicts with the conduct of broader financial policies. If a central bank has responsibility for achieving monetary objectives (keeping inflation in some target range, for example) and also has responsibility for banking supervision, the question that arises is whether the central bank will face a situation in which the viability of several large banks critically depends on interest rates but at the same time the central bank needs to tighten monetary policy to achieve its monetary objectives. What then does the central bank do? Does it raise interest rates by 300 basis points to achieve its monetary objectives, thereby risking the viability of some large banks? Or does it relax its commitment to its monetary objectives, thereby saving these banks and presumably the financial system?

The open market operations view argues that the central bank should maintain its commitment to its monetary objectives (for example, a monetary-aggregate or interest-rate target), because it contends that the tools the central bank has to implement monetary policy—open market operations—can also be used to inject liquidity into the financial system appropriate for safeguarding the financial system from the collapse of large banks and from any contagion that might occur.⁷⁹ The argument rests on first, the central banks’ ability to obtain good collateral in return for the central bank money it provides to banks through its market operations, and second, the belief that the market itself can distinguish quickly between solvent and insolvent institutions; that is, the market can distinguish between those institutions that have liquidity needs but are otherwise solvent and viable institutions, and those institutions that are having difficulties obtaining liquidity because they truly are insolvent. The relevance of collateral in this argument is that if a bank has good collateral, it is not illiquid, and if it is insolvent it will not have good collateral.

⁷⁹See Prati and Schinasi (1999a) for a fuller discussion of these views and references to original sources.

The alternative view is the “banking policy view.” The banking policy view also recognizes this inherent conflict between achieving both monetary objectives and broader financial policy objectives. However, it is more transparent, and therefore more pragmatic, about how difficult it is to distinguish illiquid from insolvent institutions and, in particular, how difficult it is for private stakeholders with limited information to discriminate between illiquid and insolvent institutions. For example, a bank may have assets it could use as collateral but they may be illiquid collateral, such as a commercial building. In this case, even a solvent bank may not be able to trade its collateral for the cash it needs to conduct its business. Therefore, the banking policy view holds that the central bank has a role to play by helping the market to distinguish between illiquid and insolvent institutions. In the banking policy view, the central bank has a banking supervisory function. This function helps the central bank know the banking system and know the banks through which it conducts its monetary policy so that when uncertainty arises about the liquidity or solvency of a large (systemically important) bank, it has current and useful information about the strength and soundness of each of the institutions it supervises. In this view, the distribution of liquidity injections matters as well. Open market operations may not be sufficient to deal with bank runs and financial crises and the central bank does have a natural role in banking supervision and the broader financial policy–financial stability function.

The Central Bank and Prevention

Regardless of what role the central bank plays, as examined in previous chapters of this study, a financial system should have in place both self-correcting market mechanisms—which work mostly because of effective market discipline—and an infrastructure for identifying vulnerabilities, preventing those vulnerabilities from leading to crises, and dealing with crises should these other safeguards of financial stability fail. The key elements of prevention consist of the following:

- market discipline
 - internal incentive systems within financial institutions
 - risk management and control systems
 - market transparency and effective disclosure of financial information
 - stakeholder governance (shareholders, counterparties)
- banking supervision
- market surveillance (both on-exchange and over-the-counter markets)

Market discipline is one of the first lines of defense against systemic problems. If market discipline is working, individual financial institutions

that make mistakes will pay for those mistakes early on. The four critical components to market discipline identified above all play an important role.

Are there reasons to believe that private market discipline alone would be insufficient to prevent problems from arising? Yes, and one of the most important of these reasons is the existence of a financial safety net. In return for access to the financial safety net, each institution is subject to banking supervision and required to hold a minimum amount of capital and conform to regulatory requirements, including best practices regarding accounting standards and business conduct. The required capital acts as a cushion to absorb losses—losses that the taxpayer will not have to bear. Prudent management also requires adherence to strict accounting standards. The accounting standards are in place so that whatever losses are suffered will be reported and disclosed quickly. In some cases, disclosure occurs within a month, in most cases, within a quarter. Shareholders have access to that information and can act as a disciplining force on the institution.

An example of market discipline at work is the way in which some financial institutions were affected after the near collapse of Long-Term Capital Management (LTCM) in the autumn of 1998. (A more extensive explanation of the LTCM crisis can be found in Box 9.1.) Internationally active financial institutions were the major counterparties of the hedge fund LTCM in the autumn of 1998. Even though no one fully understood how large or small the losses of these institutions would be, the behavior of stock prices was telling. The share prices of some of these institutions declined by up to 40 percent within a week. The institutions that suffered those equity price losses received a clear message that shareholders disapproved of their behavior in the period leading up to the LTCM problem. Thus, shareholders have a role and the only way that shareholders can really exact an accurate penalty on firms is if there is good accounting disclosure—which circles back to the best practices requirements for access to the financial safety net.

Banking supervision and market surveillance also provide important defenses against systemic problems and are part of the infrastructure that facilitates effective market discipline. As noted in Part I, because finance is a fragile process owing to its dependence on trust and confidence, there are negative externalities associated with it. But because finance facilitates important economic processes (such as resource allocation, savings and investment, and growth), there are also positive externalities, and finance provides public goods. Financial infrastructures (rules, laws, and regulations) are required to ensure that finance provides a maximum of benefits and a minimum of costs to the economy. Financial safety nets, such as deposit insurance and taxpayer-financed payments and settlement systems, are an important part of this infrastructure and are designed to encourage

risk-taking and financial activity beyond a certain minimum threshold to create efficiency gains for society at large.

The supervision of individual financial institutions, especially banks, and the surveillance of markets together help to ensure that the incentives for risk-taking and financial activity provided by safety nets do not lead to excesses. Such excesses can occur, in part, because they can be exploited by the institutions and market participants that benefit directly from them. Banking supervision provides safeguards against a bank exploiting deposit insurance by taking undue risks with government-insured deposits. Market surveillance helps ensure that market rules and regulations are enforced, that financial institutions with direct access to payments systems do not exploit them to the detriment of their clients or counterparts, and that market forces do not lead to the accumulation of detrimental market imbalances. In effect, banking supervision and market surveillance are vehicles through which the authorities can detect weaknesses in institutions and markets before they become significant enough to threaten the stability of the banking system, financial markets, and the financial system as a whole.

The IMF's 1999 *International Capital Markets* report includes a chapter on managing global finance, in which the authors tried to step back from the turbulence in the mature markets in the fall of 1998 to draw lessons. There were certainly failures in private risk management and shortcomings in disclosure and other aspects of market discipline. However, weaknesses in banking supervision and market surveillance also contributed. How could the kind of vulnerabilities that built up in the two years preceding the LTCM crisis not be detected at individual institutions through internal risk management and control systems and banking supervision, and in the markets through market surveillance? The report does not provide definitive answers, but it does provide analyses about what banking supervision and market surveillance can do to identify these vulnerabilities before they build up to the point where a crisis occurs. In particular, more proactive (but not necessarily more intrusive) banking supervision and more proactive market surveillance can be useful in identifying vulnerabilities before they become financial crises.

The Central Bank and Crisis Resolution

Key elements for crisis resolution include the following:

- a legal framework for bankruptcy and closeout procedures for financial contracts

- exit strategies for insolvent institutions (large and small)
- lender-of-last-resort function in the central bank

First, crisis resolution requires a clear and effective legal framework for bankruptcy, and requires closeout procedures for financial markets and contracts. Closeout procedures are, in effect, a last resort, credit-risk mitigation technique. If all else fails, closeout procedures allow a claimant to make good on at least part of the claim against a defaulting party. One of the lessons from LTCM was that even in the most advanced financial markets in the world, closeout procedures could not be relied on. Nor could netting arrangements.

The second part of crisis resolution is an exit strategy for insolvent institutions. To the extent that fiscal and monetary authorities become engaged with insolvent institutions, exit strategies for public agencies are required as well. As is well known, Japan has supplied a significant amount of public funds to its banking system in return for restructuring. It has structured those injections of public monies so that it can exact governance, either by ultimately taking over the banks and their management or by selling the banks' shares in the market. Whenever a government intervenes in a bank directly, it needs to have an exit strategy. One of the most practical exit strategies would be holding publicly traded shares in the company (which can be sold, to exit).

Another key element of crisis resolution is the lender-of-last-resort function of the central bank. As suggested earlier in this chapter, and as examined in detail in Part I of this book, financial crises often involve a loss of trust in counterparty relationships, a loss of confidence in the stability of markets, and a significant increase in the demand for central bank money—the surrogate for trust and the source of liquidity in an economy. The central bank is the ultimate and immediate provider of liquidity either through its market operations or directly to institutions that are deemed to be illiquid but solvent. Market participants must feel confident that when a crisis occurs, that either self-correcting market mechanisms will continue to function or the central bank will stand ready to help facilitate market activities until confidence is restored and self-correcting market mechanisms are able to function normally again. In having the ability—and in most countries, the obligation—to help maintain smoothly functioning markets, in part through the provision of liquidity when it is needed, the central bank is a vital element of crisis resolution. When providing temporary liquidity during a crisis, the central bank must also be aware of the implications of these temporary actions on its ability to continue to achieve its monetary objectives. This often requires “mopping up” the liquidity once confidence is restored.

Evolving Issues about the Role of the Central Bank and Financial Stability

Several issues are still evolving regarding prevention and resolution of financial crises and the role of the central bank. These issues include the role of the European Central Bank in ensuring financial stability in the euro zone; the relationship between the Bank of England as lender of last resort and the U.K. Financial Services Authority as the relatively new single regulator and supervisor; and the 1999 U.S. banking law, the Gramm-Leach-Bliley Act, which shifted the emphasis of supervision and regulation for U.S. financial conglomerates in the direction of the Federal Reserve System.

Issues concerning the role of the central bank focus on three key elements. One is, can market participants who are the agents of market discipline distinguish illiquid from insolvent institutions during a crisis and thereby continue to perform a useful market disciplining role during that crisis? A conclusion that can be drawn from the turbulence that followed the collapse and private rescue of LTCM is that in a panic, there is no market discipline. It is a situation akin to a panic in a full movie theater that has only three or four exit doors, and when all patrons smell smoke and rush for the exits at the same time. Even if there is no fire, some people get hurt because everyone is rushing for the exits simultaneously. During the LTCM crisis, there was good reason for everyone to try to exit the markets.

Given that there is a role for some official participation in crisis resolution, and given that the central bank is the only provider of payment finality—of central bank money—the central bank is the only practical lender of last resort. Even if it is not the lender of last resort (which might ultimately be a Treasury), it is the immediate provider of liquidity during a crisis. This leads to the second key issue. In fulfilling its role as lender of last resort, can the central bank clearly distinguish illiquid from insolvent institutions while in the middle of a crisis (and while market participants fail to provide market discipline)?⁸⁰ A corollary to that question is whether the central bank really needs to distinguish between illiquid and insolvent institutions. Going back to the open market operations view, the central bank often only needs to provide liquidity to the market, rather than to specific institutions. The market will then sort out how to distribute that liquidity. It can be argued that this would be the case if a relatively limited

⁸⁰As discussed earlier, whether the central bank can distinguish illiquidity from insolvency depends importantly on whether or not the central bank has timely access to the information necessary for analyzing the soundness of a financial institution.

number of smaller institutions are experiencing difficulties, in which case liquidity provided to the market might be sufficient. If larger institutions are involved, institution-specific injections of liquidity (not capital) might be required. In these cases the central bank would need to have information to distinguish illiquid from insolvent. If it is known that a bank is insolvent, the authorities would probably use an alternative mechanism to resolve the problem. The central bank would not want to rely on a lender-of-last-resort role.

The third key element is what kind of information a central bank needs to effectively execute its role as lender of last resort and whether it needs to be directly involved in banking supervision. In considering this question it is helpful to study the actual practices of central banks, which vary across countries. First is the concept of central banking adopted by the U.S. Federal Reserve System (as discussed in the Volcker quote). The U.S. Federal Reserve's responsibilities could be identified, in both its monetary policy and financial policymaking mandates, to be those of a broadly conceived central bank. It has many mandates, only one of which is the conduct of monetary policy.

At the other extreme is the role of the European System of Central Banks (ESCB) in financial stability in the euro zone, which is difficult to discuss concretely because the euro zone has only been in existence since January 4, 1999. The ESCB is composed of the ECB and 12 national central banks. Some of these national central banks have responsibility for banking supervision, and some do not. Separate national agencies are responsible for banking supervision in the countries in which the central bank does not have that authority. The ESCB decision-making body has 18 votes, 12 of which are distributed among the national authorities, and six of which are retained by the ECB Executive Board. Even if all national central banks had responsibility for banking supervision, there might be a conflict in the presence of a crisis. What to do? Who gets the information? How quickly does the ECB get information, so that its votes can carry accurate information to the board table?

If one takes the ECB as the central body of the ESCB, the ECB has little responsibility for ensuring financial stability. The following four passages describe the ESCB's functions related to prudential supervision and the stability of the payments and financial systems:

- First, Article 25(1) of the ESCB Statute envisions a specific advisory function for the ECB in the field of European Community legislation relating to the prudential supervision of credit institutions and the stability of the financial system. Whenever the European Union proposes legislation that directly bears on financial stability issues, a draft

of the legislation goes to the ECB for comment. The ECB can exert whatever influence it has, but it has no specific role.

- Second, Article 105(5) of the Maastricht Treaty stipulates that “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” [emphasis added]. Thus, the Maastricht Treaty establishes that the ESCB is not the competent authority, either for prudential supervision of credit institutions or for the stability of the financial system.
- Third, Article 105(6) of the Maastricht Treaty states that “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.” This mechanism allows the EU Commission to recommend to national parliaments and the European Parliament (in consultation with the ECB) to provide responsibilities for banking supervision to the ECB, thereby confirming that the ECB has no banking supervision or financial-stability mandate.
- Fourth, the ECB is given a more explicit role in relation to the working of the payments system. Article 105(2) of the Maastricht Treaty stipulates that one of the basic tasks of the ESCB “shall be to promote the smooth functioning of the payments system.” Article 22 of the ESCB Statute is more specific, stating that “the ECB and national central banks may provide facilities, and the ECB may issue ECB regulations to ensure efficient and sound clearing and payments systems within the Community and with other countries.” As this passage indicates, the ECB has a mandate for ensuring the smooth functioning of the target payments system within Europe. A rigorous reading of the Maastricht Treaty and the ECB Statute or the ESCB Statute would suggest that this is the ECB’s only tangible mandate in the financial stability area—to ensure the smooth functioning of the payments system. This mandate is not insignificant, but it does not truly encompass financial markets stability.

To summarize, the broad central bank as in the United States contrasts sharply with a narrow central bank as in the European Monetary Union. The U.K. system lies somewhere in between, in that the central bank has the lender-of-last-resort role and has a role in ensuring financial stability, but has no mandate for banking supervision. A memorandum of understanding between the Bank of England, the U.K. supervisor, and Her Majesty’s Trea-

sury ensures that the Bank of England will have free and open access to whatever information it needs to carry out its mandates (Bank of England, 1997).

How Far Have Central Banks Gone to Ensure Financial Stability?

The final question is to what extent central banks have exercised their powers in safeguarding financial stability. As noted, these powers might be limited to market surveillance, or might be as broad as encompassing responsibility for banking supervision. In most cases, central banks are the immediate provider of liquidity to institutions with adequate collateral (if not the lender of last resort). In deciding whether collateral is adequate, central banks may have to decide, on behalf of taxpayers, whether it is necessary to incur financial risk—such as liquidity and credit risk—when it lends to financial institutions in need of lender-of-last-resort assistance. Three examples serve to shed some light on this question.

Barings plc

Barings plc, the oldest merchant banking group in the United Kingdom (established in 1762), was placed in “administration” (a court-supervised reorganization) by the Bank of England on February 27, 1995, because it experienced losses exceeding its entire equity capital—estimated to be around US\$850 million at the time. The losses resulted from, among other things, inadequate risk-management controls surrounding very large accumulated unhedged trading positions in futures contracts on the Nikkei 225 stock index.⁸¹ In this case, the Bank of England, along with other official bodies including Her Majesty’s Treasury, probably decided that Barings was not systemically important. It was a small, at best medium-size bank, and it was not central to the U.K. payments system. The Bank of England, because of its banking supervisory role at the time, apparently understood the relationships Barings had with U.K. counterparts and with other European counterparts and over a weekend was able to determine, and then to decide, that Barings could be allowed to fail. If a ready and able buyer would have acquired Barings over the weekend, the Bank of England probably would have been very receptive, but that did not occur. In this case, the financial-stability role of the central bank was to decide how important the institution

⁸¹For further details and analyses see IMF (1995).

was for the U.K. financial system and the European financial system, and the central bank decided Barings was not important enough to save.

Long-Term Capital Management

LTCM was a \$4 billion hedge fund—relatively small for advanced markets, certainly small for the U.S. financial market. (The notional value of outstanding derivative contracts in the world, as of the end of 1998, was estimated to be \$80 trillion. The U.S. repurchase market had an outstanding daily value of \$1 trillion.) LTCM was not federally “bailed out” because no public monies were used; it was a private rescue. A coordination failure among 17 major counterparty financial institutions of LTCM prompted the U.S. Federal Reserve to become involved to facilitate the rescue. As it turned out, 17 institutions did not participate in the rescue, only 14 institutions did. There appear to be two main reasons for the Fed’s actions. One was to maintain financial stability; even with the private rescue and the 75 basis point reduction in interest rate, tremendous turbulence occurred in the deepest and most liquid markets in the world. The second reason the Fed may have intervened and, in particular, the reason the Fed lowered the interest rate 75 basis points, was that there was a real future threat to monetary stability—if risk-taking was not restored to at least a normal level, it is conceivable that even small businesses, viable businesses, thriving businesses, would not have been able to receive the credit needed to conduct day-to-day operations, posing a threat to monetary stability. In short, one can make the argument that the Fed acted for both monetary and financial-stability reasons. (See Box 9.1 for a detailed explanation of the events surrounding the near failure of LTCM.)

Hong Kong Equity Markets

The third example is that of the Hong Kong Monetary Authority (HKMA) intervening in the Hong Kong SAR equity markets during the Asian crisis in 1997. It is extremely unusual for a central bank to intervene in an equity market, especially in a sophisticated international financial center such as Hong Kong SAR. But the HKMA was confronted with very unusual circumstances, which it apparently viewed to be near life threatening for the Hong Kong SAR economy. This assessment was based on objective factors at the time, but was also influenced by the experiences of other countries in Asia that had suffered severe financial and economic distress during the Asian crises in 1997–98.

In particular, beginning in mid-1997, Thailand, Indonesia, and the Republic of Korea in rapid succession all experienced the beginnings of

severe financial crises and economic crises. By the end of 1997 all three countries were in the throes of economic depressions. Other economies in the Asian region also experienced pressures in financial markets and on their economies, in part because of the financial and economic links within Asia. In addition, global investors were running for financial security, cutting their losses, and rebalancing their portfolios in light of perceived heightened risks. As in all episodes of market turbulence, there were, allegedly, speculators who were trying to profit from the asset-price declines occurring on some of the currency markets and equity markets, including the HK\$, which came under severe pressure.

Between August 14 and 28, 1998, the HKMA bought a total of some US\$15 billion in stocks and futures in the Hong Kong SAR equity market, constituting 7 percent of the capitalization and between 20 percent and 35 percent of the free float of the Hang Seng index. The authorities explained their intervention as being targeted toward a specific group of speculators that were manipulating equity and foreign exchange markets for profit in what was then called a “double-play,” that is, a simultaneous attack on equity and currency markets. One possible reason for the intervention was for financial stability; the second reason was for monetary stability. The Hong Kong SAR economy was likely to be subject to widespread systemic problems if the equity market collapsed, and the HKMA came to the decision that it was necessary to take some risk and intervene in the equity market to restore stability to markets and sustain the stability of the Hong Kong SAR economy.

Conclusion

The experience of the advanced countries drawn on in this chapter suggest that in the realm of financial stability—as opposed to monetary stability—central banks

- have a natural role to play in ensuring financial stability;
- at times may require supervisory information to execute this natural role;
- have incurred risks to their balance sheets to ensure financial stability.

A key issue in deciding how far central banks can go in intervening in financial markets to ensure financial stability is the amount of risk a central bank should shoulder in its activities with the market, either on its balance sheet or in its off-balance sheet pursuits.

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