The Changing Face of Central Banking

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It is universally acknowledged that central banks have a crucial role in addressing the financial and economic crisis hitting virtually everywhere. So, unlike the rest of the financial sector they are growing their business, and like national governments (and the International Monetary Fund) they are leveraging their financial positions. Central banks are also making different kinds of credits and purchasing different kinds of financial assets compared to the norm. These initiatives are not only experimental but also, for now, open-ended. And they eventually have to stop and be reversed.

On a more conceptual plane central banks, and others, are beginning to absorb the roles they are likely to have to play in better managing the financial system (and to that extent the overall economy). A particular challenge will be the overlap between the various financial stability tasks into which they are now getting drawn and their more standard, tried and tested, monetary policy roles.

These are the matters I plan to discuss. And in doing so I will focus on three main questions: What policy background did central banks bring with them as the crisis began? What are the innovations they are undertaking to address it? Finally, and mainly, given the impact of the crisis, what are the policy challenges they face down the road?

What follows is also primarily generic – that is, a 'representative central bank' approach, using individual detail selectively, and for illustrative purposes. This is because central banks not only have the same fundamental characteristic – a governmental license to print money – and the same basic tools, but also face, if to varying degrees, the same challenges in the crisis. These are: a severe erosion of confidence in financial markets and the institutions linked to them; a constipation of credit; and a deepening economic recession.

The situation going in

Here, I invite you to cast back to the recent past, but before 2007, when the really stormy weather arrived.[1] And whether one views central banks as the architects or as mere managers of monetary policy, it is clear that the period from the early '90s into 2007 was remarkably successful. Contrary to the concerns of those who thought that fighting inflation would usher in subpar economic performance, the focus in the 1980s on getting inflation under control was followed by a long stretch of good growth and broad financial stability, at least in

[1] In North America, the climate in the financial sector worsened markedly for the United States in early 2007 as the decline in housing activity that started in 2006 hit home in subprime exposure, and for Canada in the summer of 2007, with the collapse of a large part of the market for asset backed commercial paper.

the developed world. Inflation targeting, and low inflation, of which Canada was a very early adopter at the start of 1991, became increasingly the norm. Even in those countries, particularly the United States, where explicit inflation targeting was not adopted, it became increasingly clear that the objective of keeping inflation down was in the front of monetary policymakers' minds.

This extended span of good performance was savoured. It has been called by observers the Great Moderation, the Great Stability (after the Great Inflation and the Great Depression, one supposes), and even as much as the Golden Decade. In comparison with the wrenching struggles earlier to establish a credible and sustainable monetary framework, the years following would have seemed gratifyingly tranquil, perhaps even a shade dull, from a central banker's point of view.

However, this encouraging run also led to a lowering of guards regarding the risks that were likely to be incurred. These could well stem, as can now be seen more clearly, from the very success in generating a steadily expanding, low inflation, low interest rate, low unemployment, economy. In its most malign form, this kind of complacency came to be popularized as based an understanding that monetary policy would focus on protecting asset prices, inasmuch as if asset prices dropped there would be prompt rescue through still easier money than before. Belief in such a guarantee was bound to lead to excessive declines in risk premia in various asset markets and excessive increases in the prices of those assets. This cosy view of the policy stance, personalized in the United States as the 'Greenspan Put,' does not seem warranted by the evidence overall. But it still remains that good, stabilizing monetary policy (that is, stabilizing for the economy as a whole, and not especially asset prices) was likely to generate optimistic feelings about the future – in this way reducing perceptions of downside risk, especially for debt-financed ventures (including here housing).[2]

The bias in financial institutions was clearly slanted in an optimistic direction, and the bets became increasingly large. That is to say, why not assume that the monetary authorities have now finally got the formula right, and that the recent period represents all relevant history as regards risk? Why not calibrate your value at risk models accordingly? Given the undeniable end responsibility, even if still vague as regards particulars, of the authorities to 'save' the system, given the natural urge to keep up with the competition, and given the patterns of short-term bonus compensation that were allowed to develop on this basis, the clear incentive in financial institutions was to err on the side of minimizing rather than being cautious about the risks involved in their rapidly expanding financial operations. Financial regulators tended to be tolerant of these developments, or even encouraging to the extent that they believed that private sector risk management had got the balance right. Customers were probably too keen on searching for yield, notwithstanding the drop in inflation.

[2] In noting this, I should not for one moment be taken to suggest that good monetary policy was in any sense the cause of the crisis. Other factors – poor or incautious regulation, savings gluts affecting long-term real interest rates, poor risk governance in financial institutions, to name a few – were obvious important factors. Neither, as I will discuss more fully later, am I suggesting that central banks were wrong to focus, as they generally did, on nailing down an inflation performance that was significantly better than they had managed earlier.

In summary, central banks came into the crisis with clear success on the macroeconomic stability front, but with a build-up of sunny, and in many cases self-serving, expectations among private sector agents as to the dangers the future held. This led to a compression of risk premia and increases in leverage in a way all too uncanny for those aware of the work of Hyman Minsky, for example. Some quasi-official voices, from the Bank for International Settlements in Basel, consistently questioned these developments, but the noise was much louder on the other side. Again Cassandra, a gloomy unpopular figure in almost any circumstances, was not listened to, whereas Dr. Pangloss stood front and centre.

My second 'going in' comment reaches back further, to the Great Depression. Work done, notably by Milton Friedman and Anna Schwartz, and also more recently from the credit angle by Ben Bernanke (but before he joined the Federal Reserve) has demonstrated the influence of monetary policy shortcomings in deepening the economic decline in the United States, and therefore elsewhere. Canada, by the way, has little to offer in this regard because we did not get a central bank until 1935 – although the decision to create one was spurred by the fact of the Canadian depression, and the hope that a Canadian-directed monetary policy could do something about it.

In any event, and whatever any particular country did or did not do with monetary policy in the 1930s,[3] the one element that comes through very clearly now is that central banks are determined to do what they can to avoid the policy mistakes in monetary tightening in that earlier period. It also helps that flexible exchange rates are far more common and generally (except, it seems, by the Swiss) applied in the right way – that is, not as tools of policy, and not as 'beggar-thy-neighbour' – compared with the confusion of the 1930s.[4]

What have they been doing?

As just suggested, and as has been exceedingly well publicized by the media, they have, to a central bank, become very expansionary as the extent of the financial and economic plunge has been recognized.

This has of course been strikingly evident in standard central bank money market operations. The one interest rate that central banks can be reasonably held to control (as opposed to, say, 'influence') is that on overnight money market funds, and this has by now, and quite quickly, been pushed down to virtually its floor – zero.

[3] An issue admittedly complicated by the difficult decisions that nations had to take then as to what to do about the gold standard in particular, and exchange rate regimes more generally.

[4] National policymakers are also trying to encourage each other to push back protectionist initiatives in regard to trade, and to follow expansionary fiscal policies, but that is quite a different line of narrative to the 'central banking' one being pursued here.

In normal times, with normal spreads between different kinds of financial instruments, a lowering of central bank rates would induce a fairly predictable ripple response in other credit instruments – gradually less of course as you go out along the yield curve horizon. However, as became increasingly apparent, these are far from normal times. As conventional short-term interest rate easing took place, there was scant response in other interest rates. Government interest rates, say at 3 months, 2 years, 5 years, might respond to central bank actions, as well as to the well-remarked general flight to quality in an increasingly uncertain environment. But other ones, for example on mortgages, commercial paper and the like, have been stubborn. Indeed, they might rise, depending on the degree of market nervousness about the credit situation, even as overnight rates declined. Shocks like the failure of Lehman Brothers did not of course help matters. Who was next, and where were their liabilities? These were questions with highly uncertain answers. In these dramatic circumstances, when there was no consensus on what was an appropriate premium for risk (Knightian uncertainty), it was to be expected that credit markets themselves would gum up.

In this fragile dysfunction, central banks have not limited themselves to bank liquidity supply and overnight interest rate operations. Given the problems with market spreads and even before running out of scope for action on overnight interest rates, they have also been engaging in credit or asset purchase operations designed to relieve the pressure on particular areas of the market. This in turn has meant accepting a wider range of collateral for central bank lending than before, and taking unusual types of financial assets onto their balance sheets. In some cases, including Canada, this has required changes in legislation.

With central banks coming to act more like regular financial intermediaries, a number of consequences are worth highlighting.

One is that their involvement alongside the fiscal authority, something that 'independent' central banks tend to avoid, has intensified. Operations have taken on a joint quality, with risks shared and backstops provided by governments as deemed appropriate to the situation that the central bank was being called upon to address. Of course, for the Eurozone one has to hope that such coordinated efforts are not required, if only because the European Central Bank has no proper European fiscal authority to share such involvement.

Another consequence is that central bank balance sheets have expanded greatly – including, I might add, that of the European Central Bank, even though it does not have a fiscal counterpart and fiscal support – as credit operations have multiplied in number and size.[5]

Let me emphasize 'credit operations.' That is to say, what central banks have been doing in the main until very recently is engage in lending or particular asset purchase operations that have had the incidental effect of expanding their total stock of assets. They have in part financed less conventional operations by selling off their traditional holdings of

[5] A particular additional complication for the ECB is that it will be finding it awkward to acquire government paper in special operations, given that there are many governments to keep happy.

government paper (in the main Treasury bills). But there are obvious limits to this, given that the very most they can do is substitute the entire portfolio that they hold. In any event, the net result has been an overall expansion in their assets, but not really, at least until very recently, any quantitative easing as such – that is to say, a deliberate move to expand the monetary liabilities, above all bank reserves, that they supply to the market. After all, until now their first line of attack, the overnight rate, could be brought down significantly further.

But now they are moving from the 'piggy bank' phase to one that has a more cornucopian ring to it. And with this shift, one difference, besides any 'excess reserves' effect, is that any further balance sheet increases will be accompanied by some kind of direct impact on interest rates beyond the overnight rate. These rates are also, by definition, longer term. Of course, what happens depends to a degree on what kinds of debt central banks buy and how much of it they buy. However, the general picture is cloudier than that. What we also know is that impacting interest rates on these 'other' debt instruments —quantitative easing or not – is hugely less assured under any circumstances than it is for the overnight rate. Yields on these instruments by no means depend centrally on how much the central bank might absorb, but on a wider range of factors. In particular, I emphasize, in current circumstances expectations (or perhaps 'concern' as a better word) about what monetary policy path central banks will be taking in the future will matter increasingly for the level of rates in general. Furthermore, those expectations are bound to be less sure now than they used to be, particularly if 'quantitative easing' comes to be associated with direct central bank financing of government deficits.

Policy challenges down the road

This brings me to the policy challenges.

One obvious challenge is that this central bank balance sheet inflation, while appropriate to current dire straits, will eventually have to be reversed if central banks are to re-exert proper monetary control. But as every central banker knows, it is always more difficult to pull back than to give out.

Another, related, concern is the quality of the assets that have eventually to be unloaded. In particular, will they hold their value? If not, what does that mean for a central bank?

And if this wasn't enough, there are further substantial matters. One is the extent to which central banks might need to get more involved in the management of the overall financial system, as opposed, say, to analyzing it. The other is how emerging central bank responsibilities regarding financial stability overall might have to get factored into their decisions about monetary control and monetary objectives – assuming of course that the central bank's balance sheet is more fit for that purpose than it is now.

Balance sheet size

Being at the financial epicentre of the crisis, the Federal Reserve has also gone furthest in balance sheet expansion[6] – with its total assets now approximately double what they would be in more normal times, and more promised to come.[7] This, allied with a rapidly ascending U.S. fiscal deficit – already an issue before the recession – has raised concerns as to whether inflationary fuel is being stored up, and indeed whether an inflationary response to the U.S. fiscal burden might force itself onto the policy agenda.

In this light, it is not surprising that even now, and even with the economic downturn still grinding away, Chairman Bernanke has devoted substantial space in recent speeches to what he has termed an 'exit strategy.' He has highlighted directly various techniques (built-in credit runoffs, the placing of Treasury funds with the Federal Reserve) that can help the process of exit and return to normal.

However, what he was also careful to point out amidst his description of various operational techniques available, and appropriately so, was that the principal factor behind the timing and pace of the unwinding process would be the Federal Reserve's assessment of the condition of credit markets and the prospects for the economy. But how would that assessment proceed? Well, he also said, and this seems very important, that the Federal Reserve would be putting out longer-term projections of inflation. Even more significantly, he said (somewhat convolutedly perhaps but necessarily so in the light of the Federal Reserve's constitutional position) that these projections "may be interpreted, in turn, as the rate of inflation that FOMC participants see as most consistent with the dual mandate given to it by Congress." In other, shorter, words – the Federal Reserve has embraced inflation targets in the most open way yet. And just to be more specific about this, the <u>long-term</u> (an important first) inflation projection supplied by the Federal Reserve's Open Market Committee at its January meeting was a range of 1.7—2 percent.

While this move might conceivably be seen as a way of helping to mitigate fears of <u>deflation</u>, a better interpretation would be that it is a move to counter concerns over any attempt to engineer an <u>inflation solution</u> (that is, in this context, an inflation tax) for U.S. deficit and debt problems. Any coalescing of expectations around such an outcome would tend to push U.S. bond interest rates up. This would be far from helpful. A truly perverse, but not inconceivable, dynamic would be where the central bank buys lots of government debt under the aegis of quantitative easing, but where the action of buying in quantity shifts inflation expectations in an adverse direction – thereby pushing interest rates up, not down. So the central bank then has to buy more ... . This is not a good story, and it may not be a coincidence

[6] Though the Bank of England is close behind.
[7] The Bank of Canada's total assets are up by about three-fifths and in its March 3 press release announcing a cut in the overnight rate target to ½ per cent, the Bank noted that additional monetary stimulus through credit and quantitative easing might be required. The ECB's is up by about a third.

that at the same time the U.S. administration has been emphasizing its determination to attack down the road the now rapidly mounting fiscal deficit. Note also that I can tell this story without even mentioning China.

Of course, the proof will be not in what is said now but in the actual follow-through, when the happy time eventually comes that the economic outlook calls for a more positive Federal Funds rate. This in turn will need a run-off or sell-off of assets on the Fed's balance sheet. Still, an honest pre-commitment now, through a well-publicized marker, cannot hurt.[8]

Balance sheet quality

Now let me turn to those central bank assets. Not too many North American economists will be conversant with the term 'quasi-fiscal deficit' – either by itself or as applied to a central bank. But in Latin America and South East Asia the term would be familiar. It refers in this context to the situation, not common but frequent enough, into which a central bank can fall if it acquires sufficient poor quality, or merely depreciating, assets. Besides incurring a deficit, a central bank, which tends not to have so much capital by private sector standards in the first place, can easily become technically insolvent.[9]

No doubt we will see central banks around the world falling more into this situation as the crisis takes its toll. This does not do much for a central bank's reputation as an independent source of sobriety and stability. And an ongoing central bank loss, if severe enough, could hamper monetary policy operations. But this situation is not, by itself, terminal. The Central Bank of Chile, for example, has been in a negative capital position for years but manages to produce a quite respectable monetary policy. As for any running deficit, the usual important concern is that it be properly accounted for as part of the overall fiscal position. The International Monetary Fund will be happy to give advice on how to do this.

Closer to our border, the Chairman of the Federal Reserve has recently made a point of emphasizing how the Fed aims to minimize credit risk in its lending and asset purchase transactions. He assured his audience that "the Federal Reserve's interest earnings have always been, <u>and will continue to be</u> (my underlining), a significant source of income for the Treasury." The Bank of Canada's regular earnings also help finance the federal budget. This support currently comes in at close to one per cent of total government revenues.

A role in securing financial stability?

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[8] And a few days ago, yet another marker was laid down in the form of a Fed—Treasury Joint Statement – very reminiscent of the famous 1951 Fed—Treasury Accord – that aimed to spell out the "appropriate roles of the Federal Reserve and the Treasury," both in the current crisis and looking ahead.

[9] The Bank of Canada, with assets of close to $80 billion, has total capital and reserves of only about $200 million. Don't tell OSFI!

While it has been generally recognized, not least by central banks, that they have a role in managing the financial system, what they are actually supposed to do besides providing liquidity as the case arises has remained decidedly indistinct. Now, however, the matter has come into much sharper focus as a matter of active policy debate.

The reason for this is of course the general disappointment, especially in the United States and the United Kingdom, with the regulatory/supervisory performance regarding financial institutions and financial markets.[10] In turn, this disappointment is spurring a search for ways in which the performance might be improved. In particular, central banks are now commonly seen as having a significant, even perhaps leading, role to play in this.

But how, exactly? That is a big question.

It has always been obvious that central banks, given their unique monetary powers, cannot be taken out of the financial system management equation altogether. They are, after all, the acknowledged lenders of last resort to large parts of it. So at least they will have to be there at times of banking, and now it seems shadow banking, difficulties.

In this regard, It may be useful to sketch some features of the Canadian scene.

In Canada we don't have so many banks, and therefore so many banking crisis episodes. However, some may recall the failures of two western Canada banks in 1985, and the prominent role the Bank of Canada had to play – especially the substantial liquidity support it had to supply to these two banks, and as well to other smaller-sized banks that were caught in the confidence downdraft that ensued. But liquidity supporter was not the Bank's only role.

Contrary to the supposition of many, the Bank of Canada was, and still is, neither a banking supervisor nor regulator. However, it was and is (for example in the resolution of the recent ABCP near disaster) seen as a leader. In his public report into the 1985 failures, Justice Estey summed up nicely the Bank's uncertain situation when he observed:

> *The governor of the Bank of Canada was seen as the leader of the banking system. Naturally, therefore, he was looked to for leadership in this time of crisis. Indeed, it was taken for granted by all participants that the Governor of the Bank of Canada was the appropriate person to preside over the 22 and 24 March meetings to determine the fate of the CCB. Unfortunately, the Bank of Canada is not clothed with the necessary statutory powers or staff to select the appropriate program in such circumstances and to guide its performance.*

To be sure, Canada has improved its act since then in a number of ways, including its bank supervision. Also, and as a direct result of the 1985 episode, Ottawa has set up a Financial

[10] In the Eurozone, an added concern is the unresolved challenge of crossborder supervision in what is supposed to be, if not one country, at least a common market.

Institutions Supervisory Committee (FISC). This committee, of which the Bank of Canada is of course a member, is supposed to ensure that information on federal financial institutions is shared for the benefit of the supervisory function – of which the Superintendent of Financial Institutions is in charge. At the end of the day, FISC will work as well as the Superintendent really wants it to.

Now let me generalize on this by emphasizing that information, whether statistical, anecdotal, or merely suggestive, is a vital part (along with the ability and will to act that Justice Estey took pains to emphasize) of the supervisory and oversight process. At the same time, supervisory and oversight responsibilities may be dispersed across agencies. And anyone who is familiar with how agencies that process information are likely to behave knows that it is foolish to assume that information (a key component of power, and perhaps also of dirty laundry) will be shared in a socially appropriate way. You can lead an agency to water, but you can't readily make it throw up.

One way of dealing with this is to cut back the number of agencies across which information needs to travel. This is embarrassingly necessary in the United States, where many, often overlapping, agencies have a precious piece of the supervisory and regulatory pie.[11] To this end, the U.S. Treasury has made over the years various slimdown proposals to Congress, but which have gone nowhere. Still, one constant in these proposals has been the removal of any supervisory authority from the Federal Reserve. The Fed remains to this day responsible for bank holding companies, which in fact hold the major part of total banking system assets, and into whose ranks there have been some important immigrants recently (notably Goldman Sachs and Morgan Stanley). It also supervises some state chartered banks. The Federal Reserve has consistently resisted moves to lessen its supervisory authority, as did, and would, all other existing supervisors.

The latest Treasury proposal, or "blueprint," was released in March 2008. While that blueprint proposed, as before, that the Federal Reserve be extracted from direct supervisory responsibility for financial institutions – just as is the case in Canada – the Fed was also tasked explicitly (given the financial disaster that was by then unfolding) with promoting the overall stability of financial markets. This received at the time a polite, but clearly dusty, response from the Chairman of the Federal Reserve. He suggested that in order to undertake such an all-encompassing and unprecedented task, his institution would require more direct supervisory access, not less. More recently, as the whole question of U.S. supervisory architecture has gathered momentum in Congress, the Fed has come back to the issue in a broader, more measured, way. However, it has stuck to its basic position. It emphasized that any systemic risk authority, whoever that might turn out to be, would need "broad authority to collect information," "appropriately calibrated measures to address identified risks" and a role "in

[11] Consolidation, but of a much simpler kind, did happen in Canada in the aftermath of the 1985 western bank failures, when the federal banking and insurance supervisory offices were combined into the Office of the Superintendent of Financial Institutions. However, Canada is still left with 13 different regulators in regard to securities, as well as diverse provincial supervision of <u>non-federal</u> financial institutions. Probably, however, none of these non-federal institutions is, at least for now, too big, or too systemically connected, to fail.

setting standards for capital, liquidity, and risk management practices." In the circumstances envisaged, this is not too much to ask for.

On the other side, it has commonly been contended in the past that endowing central banks with supervisory responsibility is unnecessary or even undesirable. Indeed, while the Estey inquiry did canvass the possibility of involving the Bank of Canada more fully in supervision, it found little support, including at that time from the leadership of the Bank of Canada. Arguments that were used then for not having Bank of Canada as supervisor included:

- the financial industry has a variety of elements, many overlapping across institutions, and it is a stretch for a central bank to properly supervise all its manifestations (e.g. in the case of a central bank, insurance), so it is better to have a separate supervisory body that can take a more focussed account of differences and overlaps;
- giving supervision to the central bank would dilute its capacity to run monetary policy by providing a responsibility to nurture the financial sector, or at least parts of it, that could run counter to monetary policy imperatives;
- since supervision's successes are generally hidden and failures are given prompt and wide publicity, a central bank can only lose reputation (very important for monetary policy) by doing it;
- finally (and certainly noted at the Bank of Canada), the political/fiscal authority would in any case not stand for this because it would make the central bank, especially an 'independent' one in the sense of thinking for itself, too powerful.

In any event, the U.S. Treasury was following a trend in regard to supervisory design. Namely, where there has been around the world a change in supervisory arrangements in recent years, that change has tended to be to remove such authority from the central bank and consolidate it elsewhere. The most notable example of this has been the U.K., where, back in the 1990s, at about the same time that the Bank of England was endowed with operational independence in regard to monetary policy, its supervisory responsibility was removed and consolidated in a new, quite separate organization – the Financial Services Authority (FSA).

However, that was then, and the crisis has brought into severe question earlier received approaches to financial system management and leadership. The various national authorities are anxiously casting around for better ways. This involves looking at central banks, and what more they might do – not less.

And indeed, central banks around the world have for some time been quietly improving their understanding of financial market and financial stability questions. One focal point for many years has been regular meetings of central bank representatives (some supervisors, some not) at the Bank for International Settlements, where the focus has been on what have come to be termed 'macro-prudential' issues – that is, ones relating to the financial system that any central bank, even if it wasn't a supervisor, was reasonably entitled to delve into. Picking up from this, and perhaps also from the initiative of the International Monetary Fund, which started issuing its regular international capital markets reports back in 1980, many central banks have been issuing financial stability reports on a regular basis. The Bank of England kicked off this trend in 1996, just before it surrendered supervision, and the Bank of Canada began to publish them in 2002.

These reports are of a generally high quality and therefore a valuable read for anyone interested in the detailed functioning of financial markets. However, preparing such reports is one thing. Moving from words to executive action, that is, analyzing and taking concrete steps to forestall developments that might lead to unacceptable instability in the financial system is a huge leap, and a huge responsibility. And as already suggested, given the past tendency to take central banks out of the supervising function, one obvious risk is that the central bank, as a single, or even joint, financial stability regulator, might have only indirect access to important information for this, when a direct line would be better.[12]

The task itself is inherently difficult, and any central bank taking it on will want the necessary tools. Information that is timely and full is crucial. And the obvious risk, given the way matters tend to be set up now, is that there may be bureaucratic barriers to the central bank getting it. One possibility is that immediate supervisors will avoid giving up information until it is 'too late' – perhaps being concerned that the information being surrendered will be used to judge the quality of their own performance. The risk here for a central bank is like that of the canary down the coal mine – a huge and insidious threat, questionable power to manage it, but a well-defined career-ending prospect squarely in its face.

In conclusion on this particular topic, let me emphasize that while the difficulties in framing a proper financial stability mandate are large indeed, given the frequency and increased intensity of financial sector blow-ups around the world in recent years, culminating in the present one, there is a crying need for a direct, sustained and authoritative approach to systemic financial risk. Also, central banks appear to be easily the best positioned of all existing institutions to lead that effort. One important consideration is their strong record of

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[12] Stanley Fischer, current Governor of the Bank of Israel, has the following trenchant view of this matter, and one that is very worth heeding because he has obviously been there:

> *The question of whether financial supervision, or some parts of it, should be located in the central bank, or rather separated from the central bank, is controversial. Following the establishment of the FSA, it became fashionable to argue for complete separation. I do not believe that is the best approach. Certainly, in managing the current crisis we have gained enormously from having the banking supervisor at the table with us throughout, playing an integral part in every discussion, with all the data as needed. Those who have not worked in bureaucracies might argue that all this can be achieved through better coordination. The world does not work that way. Information flows between organizations are simply less efficient than those within organizations. Decision-making that has to be coordinated between organizations is slower and less clear-cut than when the decisions are made within a single organization. It is very likely that prudential supervision will return to central banks when the lessons of this crisis are drawn.*

international cooperation. This is particularly valuable in lessening the risks posed by financial institutions engaging in international regulatory arbitrage in what is still a world of determinedly national supervisory agencies. Another consideration is the fuller realization now that risk assessment as practiced by individual institutions, whatever other shortcomings it may have, is by its very origin not attuned to the network aspects of the financial system and the probabilities for contagion and adverse reciprocal interactions. Also, to join the above two points, we have seen as well that nowadays contagion and interaction are as much international as national.

The effort obviously needs a lot of thought and a lot of careful negotiation – as well perhaps as some cracking of heads if, as seems obvious, direct supervisory access is really needed to do a proper job. It is also, under the best of circumstances, a huge responsibility – as is that of the little canary in its own sphere.[13]

Overlaps between financial stability concerns and monetary policy objectives

This issue, also broad and complex, has already been touched upon in various places in this commentary.

In the recent, pre-crisis, past, a particular concern for debate among central bank practitioners and commentators was the wisdom, or otherwise, of pre-emptive action by the central bank to pop what might be speculative bubbles – stock market bubbles, real estate bubbles being the most probable candidates for action. A particular concern for inflation targeters, and one that has had some focus in the United Kingdom and Canada, would be the extent to which they should deviate from their target path in order to fight a bubble – that is, tighten policy and in the process risk pushing inflation below target. This also would risk price

[13] While not directly germane to the general line of argument here, the reader might reasonably wonder whether any of this really applies to Canada – given that the Canadian financial system has to date come through the crisis in decent shape. Also, the reader may recall, OSFI did take timely measures to increase banks' capital requirements. The reader might also note that others look to our system now as something of a model, possibly to be emulated.

Two points can be made. One is that it is not clear to what extent Canada's good fortune depends on supervisory actions and to what extent it owes itself to the relative conservatism of Canadian banks – in part perhaps because they have faced less external competition than their U.S. counterparts, for example by virtue of the fact that they control among them an extremely large part of Canadian securities and investment banking business. The other is that the ABCP collapse in 2007 was something that did occur, and also occurred, as the Superintendent has emphasized, outside the mandate of OSFI. So the question remains, who if anyone is to be tasked with paying direct attention to such possibilities – and how?

deflation – a situation to be concerned about even if the likelihood of it happening in a way that really would matter – that is, sustained and expected general price declines – tends to be greatly exaggerated in popular exposition.

Back in pre-crisis times, one side (with important institutional support from the BIS) was arguing that it was sensible to act directly against emerging bubbles as a precaution against financial and economic dislocation down the road. The other, led by the Federal Reserve, took the position that: first, genuine bubbles, that is, unwarranted speculative fever pushing up asset prices, would be difficult to distinguish from more soundly based economic and financial spurts (for example, from upward shifts in productive efficiency in the economy); and second, given the chances of mistaken intervention against favourable developments, it would most likely be less costly to the economy to let the phase continue, to see a bubble continue on and burst itself, and then pick up any pieces through policy easing.[14]

What can now be safely ventured, given what we are now experiencing as an aftermath, is that this debate has clearly shifted in favour of those who consider that central banks have to add asset bubbles to the factors to be considered explicitly in their monetary policy scenarios. This is so even if it does complicate their lives, and especially even if, as I believe likely under current arrangements, realistically feasible interest rate moves to curb bubbles will not be enough by themselves. In fact, the 'bubbles' question will surely be subsumed into a whole examination of central banks' role in securing financial stability, the tools they should have for such a role, and the interplay of such a task with regulatory change aimed at limiting the chances of financial bubbles and meltdowns generally. Last but not least, central banks will be having to integrate anything from the above into their articulation and communication of monetary policy objectives.

And in this latter regard, let me emphasize that there is no particularly convincing reason, unless it is, incredibly, really believed that the world can readily inflate its way out of its difficulties, why those fundamental monetary objectives, policies clearly designed to promote confidence in the future value of money, should not stay as they were when the crisis erupted – or even be improved upon.

Furthermore, as I read and have lived this history, the real danger here is not so much that governments and legislatures will be so crude as to follow a policy of deliberate inflation, as that fiscal pressure will build up on central banks to be 'team players,' to delay timely reversal of today's heroic measures, and that this will cumulate into what is in effect an inflationary path. This would be a repeat of the monetary policy mistakes of the 1970s, and which, I can assure you, were so difficult to correct in the 1980s.[15]

[14] As an interesting historical event in this regard, it is worth noting that the Federal Reserve explicitly tightened in 1928 to act against a stock market boom. The stock market crashed, and some observers have tended to see that event as the start of the Great Depression. However, 'start' is not the same as 'cause' – for which a much wider set of factors needs to be considered, including, one might note, the credit bubble of the 1920s.

[15] In Canada, by the way, these started with pressure on the central bank to run monetary policy so as to keep the exchange rate down.

Considerations such as these give added significance to the fact that the Bank of Canada has announced (back in November 2006), and after many years of promising to undertake such a review, a wide-ranging programme of research designed to re-examine the inflation targeting framework that has been in place since the early 1990s. This re-examination, as it was explained then, was to focus on the value of lowering the current, 2 per cent, inflation target, and on the desirability of price level targeting. A price level approach, as a way of engineering a credible, limited inflation, was advocated, but not actually tried, some years ago for Japan. Its role then would have been to shift expectations away from deflation. But in the Bank of Canada's case the intent was, and still should be, to provide the best assurance it can about the level of prices well into the future.

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I often hear these days that with all that is happening, a former central banker must be glad to be out of the business. What I will say to this is that it is good to have interesting and challenging work. It was very interesting and not a little challenging when I was there, and it has recently become extremely interesting again. So Mr. Carney is a lucky guy though not, yet, as lucky as Mr. Bernanke.