

Changing Landscapes for Central Banks and Financial Regulators

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ABSTRACT

This discussion note is an extended version of the introductory comments shared by the author at a CEP roundtable on “Governing Finance and Sustainability” in January 2019. It addresses in order the four issues raised in the convening’s agenda. First, what are the historical origins of the current consensus on central bank and regulatory mandates, governance and instruments? Second, what are the underlying assumptions? Third, to what extent should these assumptions be reviewed? Fourth, what are the implications of such a review for central banks and regulators?

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INTRODUCTION¹

For some years now, the Council on Economic Policies (CEP) has been concerned about the distributional implications of the ultra-easy monetary policies being followed by the developed world's most important central banks. These policies have led to sharp increases in the value of many financial assets, owned disproportionately by richer members of society. Belatedly, a number of prominent central bankers have admitted that this is, indeed, a problem. Over time, other undesired side effects of current policy settings have also been increasingly recognized².

Thus emboldened, CEP has more recently begun to raise still more fundamental questions about how the financial system works, and whether the governance provided by central banks and financial regulators remains adequate given emerging new challenges. In particular, both preventing and adapting to climate change will require vast financial resources. What should be the role of these public sector institutions in responding to this challenge? Answering this question implies questioning the current consensus on the mandate and powers of both the central banks and the regulatory community.

In this introductory session I will address in order the four issues raised in the Agenda. First, what are the historical origins of the current consensus on central bank and regulatory mandates, governance and instruments? Second, what are the underlying assumptions? Third, to what extent should these assumptions be reviewed? Fourth, what are the implications of such a review for central banks and regulators?

A. THE HISTORICAL ORIGINS OF CURRENT PRACTICES

One point to make clear is that the practice of central banking has never been static. Whether we are talking about the analytical framework guiding policy, the institutional/political framework or the underlying philosophical framework (basis for holding beliefs), evolutionary change has been constant³. By way of example, the mandate of central bankers has gone from financial stability to full employment, to reducing inflation, to maintaining inflation at some low level.

Today, the consensus is that central banks should pursue "price stability", generally meant to mean an inflation rate (CPI) of two percent or just below, and should do so through adjusting a short term interest rate to influence aggregate demand. To do this efficiently, the central

¹ This discussion note is an extended version of the introductory comments shared by the author at a CEP roundtable on "Governing Finance and Sustainability" in January 2019.

² For a seminal study see White, W R (2012) "Ultra Easy Monetary Policy and the Law of Unintended Consequences", Globalization and Monetary Policy Institute, Federal Reserve Bank of Dallas Working Paper 126, August.

³ I document all this in White, W R (2013). "Is Monetary Policy a Science? The Interaction of Theory and Practice Over the Last 50 Years", in: 50 Years of Money and Finance: Lessons and Challenges, Edited by M Balling and E Gnan, Larcier, Vienna.

bank should be “independent” from government in using the tools at its disposal. That said, governments might well set the mandate and should also find ways of holding the central bank accountable for its actions.

Admittedly, this consensus is somewhat of a caricature. Some important central banks have dual mandates (inflation and unemployment), and some even more. Financial stability has recently become a de facto, if not yet a de jure, preoccupation of central banks. The range of indicators of emerging problems (and the need to change policy) also varies widely across central banks as does their relationship with governments. In general, governments exert more influence over central banks in emerging market economies than in advanced market economies.

The regulation of financial markets and institutions has also evolved significantly over the years. Essentially, there was very little regulation prior to the Great Depression, but this event was followed by a significant tightening of regulation that continued up until the 1960’s. This in turn was followed by an accelerating process of deregulation that continued until the onslaught of the Great Financial Crisis in 2008. Predictably, reregulation then followed, until the last year or so when sentiment started to change towards rolling the regulations back once again.

As with monetary policy, the mandate of the regulators has fluctuated over time. Traditionally, regulators were concerned with the health of individual financial institutions, particularly banks. In recent years, there has been greater attention paid to the health of the financial system as whole, banks and nonbanks and markets more generally. For a while, macroprudential policies (which can change in response to changing risks) were intended to be used to “lean against” the credit cycle thus avoiding a pattern of “booms and busts” and associated macroeconomic instability. However, more recently this remit has been narrowed once more to just ensuring the stability of the financial system.

The instruments used by financial regulators have also changed over the years. In the immediate post War period, regulations covered all aspects of bank lending, liquidity requirements and rules about who could borrow and with what leverage. Then this heavy apparatus fell away (as regulations generally were eased) but may now be coming back again under the new name of macroprudential policies.

Finally, the institutional structure of financial regulation across countries is wildly different. A recent study by the IMF found seven basic models and fifteen sub models. In most cases, there was no attempt to establish an “optimal” structure. Rather, current structure was essentially determined by previous, evolutionary developments: in short, an accident of history.

B. UNDERLYING ASSUMPTIONS BEHIND CURRENT PRACTICES

Rather than “current” practices, it would be better to say the practices of central banks and regulators prior to 2008. Since then, there has been a significant questioning of previous beliefs, but no “paradigm shift” towards a new set of beliefs. That is because there is far from consensus on whether the previous beliefs should be rejected, and also no consensus on what the new set of beliefs might be.

What were the assumptions underlying the actions of central bankers and regulators? Again, at the risk of caricature, both felt the economy (including the financial system) was a machine that was both understandable and controllable. Moreover, control was facilitated in that the economy as a whole gravitated automatically to “equilibrium” (full employment). The financial system also did its part in that it automatically allocated all available resources to their most efficient use.

Of course, for central bankers to say that the economy was understandable meant constructing models that were gross oversimplifications of reality. The return to “equilibrium” was quick. Financial markets were a “veil” and could be ignored, as could the buildup of stocks of credit and debt. Heterogeneous economic agents could be replaced by a “representative agent” who was assumed to have perfect knowledge of how the economy worked, and who viewed the central bank’s target for inflation as totally credible.

Perhaps most importantly, the behaviour of inflation was taken to be the critical variable to be monitored to determine whether the current growth rate of the economy was “sustainable” or not. Crucially, these simplified models left out the possibility that inflation might fall below target because of the influence of positive productivity shocks. Rather, all such deviations were deemed to be due to a dangerous lack of demand that could culminate in another Great Depression. This approach justified the aggressive easing of monetary policy over the last decade, and even before, which has had such negative effects on so many aspects of the economy ignored by the simplified model. Debt levels have risen as has wealth inequality. Resource misallocations and zombie companies have reduced the growth of productivity. Low intermediation margins and the search for yield have fostered financial instability.

Financial regulators also oversimplified, although for different reasons. Subject to resource constraints, they focussed their attention almost entirely (Basel 1 and 2) on the capital adequacy of banks. Thus, they missed the liquidity crisis of 2009, largely affecting European banks short of dollar funding, and the dangerous level of bank lending to the peripheral countries in Europe. They also missed the pre-crisis buildup of the “shadow banking system” which gave the impression of having turned long term, illiquid and unsafe assets into assets that were short term, liquid and totally safe. That this was an illusion only became clear after the event.

C. NEED FOR A REVIEW OF BASIC ASSUMPTIONS?

The very fact of the GFC, which could not happen in the world of the models, would seem to call for such a review. The added fact that official predictions of growth exceeded actual outturns for nine years in a row should have led to the same conclusion. The assumed, rapid return to “equilibrium” simply has not happened. However, to date central banks have responded only by “tweaking” their old models rather than thinking more fundamentally about how to change them. A more fundamental fact, also indicating the absence of change in their analytical structures, is that post crisis policies have essentially been “more of the same” pre-crisis policies. Policy continues to be based on two false assumptions. First, monetary easing will be effective in quickly restoring aggregate demand and inflation. Second, any prospective negative side effects will be small and can be ignored.

As for the regulators, they have responded to some degree to the fact of the GFC. Capital requirements for banks have been raised, and more attention has been paid to liquidity requirements, to non-banks, and to the functioning of markets themselves. Yet, as with monetary policy, there is a strong flavour of “more of the same”; more buffers, more supervisors and above all, more detailed regulatory prescriptions. While there is much talk of a new regulatory focus on systemic stability, in practice little has been done to reduce the ties and institutional interrelationships that are most responsible for systemic instability.

Further, the decision to narrow their regulatory mandate to the stability of the financial system (together with the narrow central bank focus on price stability) implies that no agency has been focussing on the continued build up of debt outside of the financial system. This overhang of debt, in both the public and private sectors, now constitutes the biggest, near term threat to sustained economic growth going forward. And to this challenge must now be added another, of even more existential importance, that of climate change.

A paradigm shift in the thinking of central banks and regulators would begin with a rejection of the current belief that the economy is understandable and controllable. It would be replaced by the idea that the economy is a complex, adaptive system (CAS) like so many others in nature and society. In terms of their basic assumptions, these systems are at the other end of the spectrum from most of the economic models currently in use. They assume a wide variety of heterogeneous agents, each acting according to simple rules, but interacting on a constant basis. Behaviour can change in response to changing circumstances and the capacity of agents to learn from others. The interactions between the agents can lead the system as a whole to have “emergent properties” that commonly bear no resemblance to the behaviour of the agents themselves. These systems evolve in a path dependent way, and show no tendency to “equilibrium” except in death.

Systems of this sort have been widely studied by other disciplines. Moreover, they exhibit certain common characteristics, implying that the insights of other disciplines might be useful

in the study of economic systems as well. If economists could develop the humility to accept such help from non-economists, this would be a crucial first step on the road to a paradigm shift.

D. WHAT WOULD BE THE IMPLICATIONS OF SUCH A REVIEW?

It is ironic, but embracing the economy as a CAS leads directly to some simple policy lessons for both central banks and financial regulators. These lessons could help policymakers to prevent crises, to better monitor the buildup of stress within the system, and to better manage crises when they do happen.

Better efforts to prevent and minimize the costs of crises

CAS break down regularly according to a Power Law. However, the stability of the system can be improved by building in redundancy, by relying on modular development and by stripping out unnecessary complexity. Efficiency is important but it is not everything.

Since CAS cannot be fully understood, policies directed to maximizing benefits are not feasible. Rather policy should be directed to avoiding really bad outcomes: minimaxing not maximizing.

Since CAS are path dependent, stocks matter. Both fiscal and monetary policies should be conducted in a more symmetrical way over the cycle to avoid the buildup of sovereign debt (fiscal policy) and private debt (monetary policy). Small economic downturns, which redress stock imbalances, should be tolerated as the price to pay to avoid bigger problems (both economic and political) later on.

Adaptive behaviour in CAS implies that the transmission mechanism of monetary policy will change constantly. For financial regulators, adaptation implies constant attempts at evasion. More emphasis should be placed on principle-based regulation, on self-discipline (including criminal penalties) and market discipline (requiring better accounting and auditing).

In CAS the interacting behaviour of heterogeneous agents is crucial. Central banks and financial regulators need to pay more attention to the distributional implications of their policies.

Better monitoring for signs of systemic stress

In CAS the “trigger” for a crisis could be anything. Focus less on possible triggers than on identifying signs of growing systemic stress.

That said, new evolutionary developments should be monitored carefully as possible sources of financial stress.

In CAS there are likely to be numerous indicators of growing stress. Observing that inflation is under control does not mean that all is well. Similarly, a healthy financial system is not

sufficient to ensure overall macroeconomic stability. Imbalances can accumulate in other sectors of the economy as well.

Adaptive behaviour in CAS implies that tomorrow's crisis will unfold differently from the previous one. Expect the unexpected.

Better management of future crises

Accepting that CAS always break down, in spite of best efforts at prevention, implies always being prepared. This has both an ex ante and an ex post component.

Ex ante, it is important to ensure that LOLR facilities are assured, that deposit insurance is in place, that MOU have been signed and that war games have been played. Adequate attention needs to be paid to insolvency procedures for all economic agents, including financial institutions.

Ex post, given that in CAS all crises are different, the authorities need to have sufficient flexibility to adapt to new circumstances.

CONCLUSION

CEP is to be commended for raising these fundamental questions about how central banks and financial regulators go about their business. It is always possible that what has been done has been based on a set of false beliefs. Revisiting the issue is a healthy way to find out. It is also possible that new challenges, such as the need to manage climate change, might call into question old ways of doing things. This too needs the serious analysis that CEP proposes to give it.