

Global Issues in Central Banking

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Good evening. When Marshall Goldman asked me to speak to you, he gave me free rein in terms of topic, adding that you could be relied upon to raise any issues I hadn't covered in the question period. So I decided to talk about a subject of major importance to the U.S. economy, and one which I've spent the last 30 years or so studying first hand -- the challenges of central banking. I would argue that while this subject has always held some fascination, in recent years it has assumed global importance both for countries individually, and for the economic health of the world as a whole.

Economic outcomes here and around the world are being driven, to an unprecedented extent, by the policies and perspectives of central banks. Once, central banks received little scrutiny; now, their goals are the subject of public debate; their successes and failures are the focus of the attention of both financial markets and the popular media; and their independence is often considered the first measure of a transitional or developing country's emergence into the modern world. Central banks have become the primary macroeconomic game in town for many countries, and the only game in others. Tonight, I want to share some thoughts on why this is so, and give you my perspective on three issues

of key importance to every central bank around the world: achieving price stability in an environment of sustainable growth; keeping banking systems healthy; and developing resilient payment systems.

To start, let's consider why central banks exist, and some of their essential characteristics. Then let me suggest two reasons why global economic trends have in essence required central banks to become so prominent.

First and foremost, central banks are banks. They are wholesale financial intermediaries -- banks for banks -- which act as control valves on the amount of money and credit in an economy. Their primary task is to ensure a country's monetary and financial stability, its ongoing resiliency in the face of economic cycles and periodic financial disturbances or crises. This is a complex job and not every central bank uses the same tools to accomplish it. Central banks in one way or another all focus on controlling inflation; many central banks, especially in small open economies, try to manage exchange rates at least for a time; most central banks have some insight or authority over banking system regulation, and many, if not most, now have a hand in payment

systems, both from a policy perspective and increasingly on the operational side.

But successful central banks have another, common characteristic -- a large degree of political and operational autonomy. Ensuring monetary and financial stability often requires that tough decisions be made in a timely way; decisions that must be made in an environment that is as free as possible from short-term political influence.

Legislatures can and often do set long-term goals for central banks. But the way those goals are met, and the short-run tradeoffs inherent in achieving them, in a world of cyclical economic flows and powerful external destabilizing forces, is generally left to the discretion of the central bank itself, subject, of course, to norms of accountability that apply.

I would argue that this aspect of central banks -- their autonomy -- has made them the natural focus of economic policy-making in nearly every country. Two trends account for this heightened focus: First, the emergence of markets as the driving force in economic behavior. And second, the related recognition that in many countries, in part because of the burden of existing infrastructure, fiscal policy no longer can play

the role of a counter-cyclical policy instrument that Lord Keynes and his followers anticipated.

For at least the past two decades, there has been an increasing recognition worldwide that closed and government-dominated -- much less planned -- economies do not work. Market-oriented economies that allocate resources to their most productive use, while far from perfect, are the best answer to the problem of ensuring a country's growth and rising standard of living. But market-oriented economies are prone to cycles of excess and overshooting that can be damaging to economic growth. Central banks exist to provide at least a first line of defense here. They are the only instrumentality of public policy that operates in, and is a part of, markets on a daily basis. In the United States, this involves buying and selling securities--supplying or contracting liquidity--in the open market. In other countries, developed and developing, the specific mechanisms can vary. For example, buying short-term central bank deposits can provide a mechanism for affecting liquidity and interest rates in the absence of capital markets. The market presence and flexibility of central banks is key here. Market-

oriented economies, and central banks, must work together effectively to promote economic growth.

But central banks and monetary policy, while necessary, are not sufficient for growth and stability. As recent crises in Asia, Russia and Brazil have shown, events can overtake monetary policies--even those policies that ex ante seemed defensible. Clearly, central banks cannot solve every economic or financial problem.

They can create an environment conducive to economic growth if they are successful in keeping inflationary growth low, but they cannot on their own guarantee that result. Nor can central banks outmuscle bad fiscal, structural, or other policies without huge costs to society. Conversely, putting flexible monetary policy on hold--through a currency board, for example--is not the answer to market turmoil either, at least in my view. Currency boards may be helpful at certain times to certain countries, but the automatic response required by their operation can be extremely costly indeed. If market economies are the best way to ensure world-wide growth, and I certainly believe they are, then there is no substitute for strong, autonomous central banks, and flexible monetary policy.

Over the period in which market-based economies have emerged, there has been a related diminution in the efficiency of fiscal policy that has contributed to the influence of central banks. In the developed world, the large social safety nets built during the 1930s, and then expanded first after the Second World War and then during the '60s and '70s, created an overhang in terms of both current deficits and future liabilities, that increasingly leaves governments with less flexibility with which to affect cyclical economic trends. Moreover, market-based economies value savings, which are the fuel for investment and growth. To the extent that a government is a significant source of dissaving, markets will drive interest rates higher and create disincentives to growth in that economy. Developed and developing countries alike are in the process of absorbing this lesson. Deficits are coming down, and mechanisms for channeling private savings are the focus of attention almost everywhere.

The size of government on a world-wide basis seems on the verge of becoming smaller in relation to global GDP, and choices are being made everywhere to keep it smaller going forward. Some have argued, in fact, that a basic cause of the turmoil in apparently market-driven

Southeast Asia, Korea, and Japan, involves too much government control over the economy, which must change if markets are to work efficiently. This may not be to everyone's liking from a social point of view, but it is a logical outgrowth in an increasingly market-driven and competitive world economic climate.

Thus, central banks have become the focus of most countries' efforts to achieve short-run economic control, and they have had a modicum of success. But there is an inherent tension in this trend. As economies evolve toward a market base, most are turning to more democratic governments, with all that implies about popular referendums and policy accountability. Central banks must be accountable, but they cannot do this by being subject directly to political will, for that would destroy the very independence that makes them effective. So the issue becomes how to balance the need for central bank autonomy with the very real obligation to be responsible and responsive to the public. In the end, of course, the public has the upper hand through representative governments. True failures to be accountable can result in legal changes to limit or remove a central bank's autonomy.

In this country, the balance between autonomy and accountability is achieved by frequent testimony to Congress, other forms of legislative oversight and an increasing level of transparency about what the Federal Reserve does. Other countries have chosen similar paths, but whether this is sufficient at any point in time is open to question. The fact is that the price central banks must pay for their increasingly central role is thorough and continuing scrutiny.

Some forms of scrutiny have always existed. I can imagine that William McChesney Martin felt "scrutinized" as he rode in LBJ's car around the Texas ranch shortly after the Fed raised interest rates in 1965. But somehow the current level of scrutiny seems different in both its scope and intensity. All of a sudden--or so it seems at times--every aspect of how central banks operate is open to debate. These debates nearly always involve some fundamental aspect of a central bank's activities. They center most often on the three areas I mentioned earlier--the movement toward price stability, banking system regulation, and payment system development. Let me discuss each of these briefly.

Many would argue that the only goal of a central bank should be price stability. Clearly, low rates of inflation are vital to a stable economy. Inflation distorts economic decision-making, and accelerating rates of inflation impede growth by creating incentives for speculative short-term activity rather than investments aimed at long-term progress. But the pursuit of price stability is fraught with questions. How accurate are our measurements of inflation? How low can it realistically go? These are issues that have prompted a lot of debate not just here in the United States, but also around the world. And this debate is intensified by the realization that, at least in the short term, the central bank's policy of inflation control will affect economic growth. Clearly, governments must be partners in answering the questions related to achieving lower rates of inflation, but how to do so without sacrificing central bank autonomy is a primary issue. The trend increasingly is to favor legislatively-set targets for very low inflation rates, as measured by indices of consumer prices, and to hold central banks accountable for achieving that rate virtually to the exclusion of all other objectives.

In my view, much of this emphasis on reducing rates of inflationary growth is right on the mark. Just look at the current rosy U.S. domestic economic scenario as proof--a 28-year low in unemployment, millions of new jobs created, GDP growing at a pace faster than most any forecasters predicted and few signs of inflation. The central bank must be vigilant here--temporary factors may be a key reason why inflation remains so low--but I think in part we may also be reaping the rewards of more than 15 years of bringing inflation down steadily through each economic cycle over that period. Businesses and consumers alike now expect costs and prices to be relatively stable and move to change things when that is not the case. We compete domestically and globally more effectively now than we have since the '60s, and this is, in part, due to the success we've had in controlling inflation. Should the central bank keep inflation at its current very low levels? That's an interesting question right now since given the current state of resource utilization keeping inflation low may exact some short-term costs. For now, a good deal of monetary policy vigilance is in order to continue the current track record.

Now, the relative success in the United States in bringing down inflation in an environment of relatively stable growth has by no means exempted the Federal Reserve from scrutiny and debate. Over the past several Congressional sessions, bills to alter the structure of the System have been submitted; the Reserve Banks and Board remain subject to almost constant audit and oversight by Congressional Committees, the GAO, and both outside and internal auditors; there are demands for increased transparency, and for adherence to strict inflationary targets on one side, and for increased accommodation to higher levels of short-term growth on the other. There have even been suggestions that the Open Market Committee meetings be televised on C-Span.

Certainly, the Federal Reserve System should be accountable for its actions and should be as open about its policies and perspectives as is consistent with a responsible discharge of its duties. However, it is not always easy to discern how to achieve that degree of openness.

Let me raise just a few questions that arise from this debate. Should the Fed System be much more transparent in providing information -- or will this make already volatile markets even more so? Should the System set a particular target for inflation, or should such a

target be set by Congress, or will setting a target in itself create greater rigidity in monetary policy than is desirable? And how broad-based should the central bank's activities be -- strictly limited to monetary policy, or, as was envisioned by the original architects of the Federal Reserve System, more broadly focused on economic stability as well?

That brings me to the second area of world-wide debate involving the role of central banks: how to keep banking systems healthy. I noted before that central banks use different combinations of tools to achieve their tasks. There are some who do not believe that it is a central bank's job to regulate or supervise the banking system. And in the majority of countries where bank regulation is a central bank task, it is shared in one way or another with the Ministry of Finance or its equivalent, providing a system of checks and balances that is often useful.

To some extent, the "religion" of price stability among central bankers and others has encouraged the view that any other concern -- such as bank regulation -- will cause central banks to veer off the straight and narrow path. However, it is clearer than ever that healthy

banking systems are a prerequisite to economic growth. We should have learned that lesson in the late '80s and early '90s in this country. Similarly, consider the situations of the Mexican banking system after the peso crisis; the Argentine banking system under the combined impact of the "tequila" effect and the rigidity imposed by a currency board; and the banking problems in Japan and throughout much of Asia, and the relationship of the health of a banking system to the economy's ability to bounce back after adversity strikes becomes clear.

Banking system fragility can both raise the cost of monetary restraint and limit the effectiveness of monetary stimulus. Healthy banks must be a central bank concern, particularly when those banks are of such a size and geographic reach that they could threaten financial and economic stability. Central banks are the natural regulator for those institutions, no matter how the overall regulatory process might be shared. Moreover, a central bank's role in the larger economy makes it a desirable participant in the regulatory process -- impartial, independent, and with a breadth of perspective that a single-purpose regulator may not have.

Beyond the question of whether central banks should have a role in bank supervision and regulation, how should that process occur in a market-based economy? Clearly the trend is toward less regulation. Regulation can create a level of bureaucratic overhead that stifles the competitive position of a country's banking system. Moreover, as we have seen in this country, it is difficult to keep a formalized regulatory process in harmony with rapidly changing technology and the emergence of many new nonbank competitors. However, strong banking institutions are more than ever necessary; market forces can cause some failures -- indeed here in New England we lost fully a quarter of our banking institutions in the early '90s -- but they cannot be allowed to undermine public confidence in the banking system. So we try to ensure safety and soundness in the banking system without distorting market discipline, and without imposing undue burdens.

This process has been made more difficult by the advent of sophisticated new financial instruments, the global geographical presence of domestic financial institutions, and the advent of new technology that has made possible instantaneous movement of vast sums of money worldwide. Bank regulators used to rely at least in part

on a review of bank records and balance sheets. They would come away with an evaluation of liquidity, capital, asset quality, earnings and management that were a reasonably accurate picture of the organization for the period until the next examination, assuming that was done within the following year or so. But now, balance sheets change instantaneously; some of the largest exposures are off-balance sheet, and it is less clear what level of capital or liquidity provides an appropriate backstop. What is clear is that the process an institution uses to manage and control risk exposure at a point in time has to be the focus of both senior management attention, and supervisory oversight.

Risk-focused supervision thus has become the mantra of regulators worldwide. That must include an in-depth look at the way risks are managed by an institution, which involves sophisticated mathematical tools to measure value at risk and the probabilities of loss given certain market conditions. These tools provide insights as to the level of capital, reserves, and liquidity that are needed, but such insights are far from precise. For that reason, I believe that supervisors must not abandon their focus on the simple, old-fashioned controls related to

separation of duties, frequent audits, and even required vacations for key trading and back-office personnel. The spectacular instances of financial difficulty -- Barings, Kidder-Peabody, Orange County, Daiwa, just to name a few -- were all the result, not of highly complex financial products, but of the failure of simple, common-sense controls.

Banking systems connect to the wider economy through the payment system, the third critical function of central banks. Indeed, payment systems have been likened to the "plumbing" of an economy, and, like plumbing, are usually only noticed when they break down. An example from the early '90s may help here. When Drexel Burnham failed, it held a large trading portfolio of GNMA securities, which at that time were traded in paper form. To complete a trade, the holder of the security had it physically delivered to the trading partner, and took a receipt for the security. Then, later in the day, funds would be transferred to cover the trade. In the Drexel case, trading partners lost confidence that funds would be forthcoming, and refused to deliver securities. Drexel, in turn, could not deliver out what it didn't have and gridlock occurred -- gridlock that over a short period grew to represent about a \$2 billion overhang on the market. And it wasn't just Wall

Street that was affected -- school districts, trust funds, and small communities all had GNMA's in their portfolios, or were awaiting funds from selling them, and the gridlock caused by Drexel affected many of these investors.

The solution to this crisis was to implement a system that increased the confidence of Drexel trading partners that either money or securities would reliably be there if trades were completed. The Federal Reserve Bank of New York developed a temporary "Rube Goldberg" process to provide that assurance, but ultimately a private-sector purchaser acquired the portfolio and gradually the gridlock eased. But this was a clear instance in which payment systems were less than resilient in a time of financial crisis. And this was also a case, I would argue, that central bank hands-on expertise in the payments system was invaluable, both in recognizing the problem and in working to resolve it.

The particular problem related to GNMA securities couldn't happen again, because they are no longer traded in paper form, and the delivery of the security electronically is tightly coupled with the movement of money. However, there are countless potential issues facing the

payment system, and central banks must be deeply involved in them. Traditionally, the Federal Reserve has had more of an operational, as well as a policy making role in the payment system than have most other central banks. But this is rapidly changing, especially in the electronic, wholesale systems that transfer funds from one financial institution to another. These so-called real-time, gross settlement systems typically rely on intraday central bank credit, collateralized or uncollateralized, and provide for instantaneous central-bank-guaranteed finality -- the best measure of security for both the sender and receiver of the payment. The development of these new systems is underway everywhere -- in Britain, Australia, in the European Monetary Union, and in almost every developing and transitional country. And they are clearly the province of central banks.

As you may expect by now, this development is not without debate. Large financial institutions, particularly global institutions, have long made sizeable profits from the transactions and credit involved in payment systems. Moreover, these institutions have benefited from the large net settlement systems -- such as CHIPS here and CHAPS in London -- which they helped develop and operate. Net settlement

systems can be highly efficient, particularly for large-volume players, but they are also less transparent and more subject to problems if there is a loss of confidence in a particular institution. Through concerted international effort by both central banks and the financial institutions themselves, netting systems have been made more resilient, and they undoubtedly will continue to play a large role even as the central-bank-sponsored, real-time systems become more prevalent. But the tension between the two will undoubtedly remain.

In the United States, a second form of tension between the private and public sector also exists. Reserve Banks play a role not only in wholesale payments, but in retail as well, collecting checks and providing cash. They do so as providers of services, as the catalysts for change, and as regulators. Is there any central bank purpose in doing so, a purpose sufficient for the regional Fed Banks to be willing to defend this activity in the constant barrage about the power and influence of the central bank? I think so, and I also believe that without Reserve Bank involvement, this country's retail payment system would not be as effective as it is today, nor will the challenges inherent in improving it in the future be as easily met.

Such challenges are not inconsequential: Over 64 billion checks are written and collected each year in this country, a vast tide of paper that should be converted to electronics. How can incentives be created so that this occurs? What are the risks and opportunities presented by electronic cash, and how should its provision be regulated, if at all? What about virtual banks -- are there safety and soundness issues if reliance for payments is placed on non-bank service providers in a process that literally runs on credit? The Federal Reserve must play a role in addressing these and other questions and its ongoing operational presence in the payments system will help it in doing so. But I confess to some bias here.

In closing, let me return to my original point: Central banks have become the primary intermediate-term macroeconomic policy makers, in the U.S. and most everywhere else. Central banks, whether by design or default, have more influence. It follows, therefore, that they must also be subject to higher standards of accountability. Accountability is one thing, however; political control is quite another. The goals of achieving price and financial stability, which are shared by all central banks, can only be achieved by those banks having a fair degree of

autonomy. But this independence must be earned by central banks through the effectiveness and integrity with which they discharge their responsibilities.