Financial Stability in the Broader Mandate for Central Banks: A Political Economy Perspective

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Central Banks and Financial Stability

- 1907 Crisis: commercial banks, trust companies, commercial bank clearinghouse
  - John Pierpont Morgan played the lender of last resort, but derived private gains
- Should the allocation of public liquidity be outsourced to a private entity?
- The creation of the Federal Reserve
  - Stabilization of the inter-bank rates during crises and panics
- What the Federal Reserve does has evolved substantially over time
  - Financial stability:
    - Crises management: Lender of last resort
    - Crises prevention: Supervision
  - Other objectives:
    - Long-run price stability, employment, …

Traditional Central Banking perspective

- Time-inconsistency: It is not credible to be tough in the midst of a crisis
  - Financial sector is crucial to payments and settlements, trade, growth
  - Disorderly system-wide collapses in the financial sector socially costly
- Moral hazard: Reduces market discipline on financial sector risk / leverage
  - Crises prevention may be the best way to approach financial stability
- What tools should a Central Bank employ for crises prevention?
  - Macro-prudential regulation: Capital and liquidity requirements
    - Regulatory arbitrage: Shadow banking, Banks connected to shadow banking, …
  - Interest rate policy:
    - Leaning against the wind, reaching the corners of the financial sector
  - Regulating by function rather than form: LTV and DTI limits, clearinghouses / margins

Central banking in practice

- Central bank must operate within the law and strive for independence
  - What tools does the law grant it to conduct financial stability?
  - How freely can it operate these tools?
  - Would certain actions, even if within the law, lead to political interference and cause the central bank to lose some of its tools?
- Political system requires central banks to have democratic accountability
  - Governance
  - Accountability
  - Transparency
- However, political system may want to overly restrict central banking scope in order to ensure its own freedom in meeting political objectives

A Political Economy perspective

- Divergence in horizons and objectives create a potential tension
  - Political horizons are often short-term and objectives populist
  - Central bank horizons are relatively longer-term and objectives less populist
- Crises management:
  - Quasi-fiscal action; targeted entity assistance (13(3) exception to Federal Reserve Act)
  - Can set the stage for political interference and in future independence
- Crises prevention in good times may also fall prey to political headwinds:
  - Low interest-rate policies attractive for housing activity and housing price growth
  - Weak housing markets can slow down current growth and job prospects
  - Keeping shadow banking (money market funds, over-the-counter derivatives) out of central banking reach may achieve similar objectives

Guarding against the political headwinds - I

1. Reliance on rules in crises management policies:
    - Broad scope but limit the extent of quasi-fiscal actions
    - LOLR to market at large, but with minimum solvency requirements
    - Do not provide liquidity without addressing solvency
    - Crucially, limit the extent of ex-post political questioning of central bank actions
2. Broad scope for central banks to regulate growth / leverage in shadow banking:
    - Recognize the regulatory arbitrage incentive of the financial sector
    - This incentive can manifest as lobbying efforts to leave shadow banking unregulated
    - Without capacity to maintain minimum solvency requirements, rules in crises management cannot function well
    - Would lead to proactive regulation of shadow banking as innovations appear
    - Scope should cover state-owned and government-sponsored entities in financial sector

Guarding against the political headwinds - II

3. Explicit role for financial stability in the central banking mandate:

- Introduce an explicit long-run dimension that central banks can appeal to

- Layering financial stability as an additional responsibility with primary mandates being price stability and employment do not suffice

- Inflation and job growth measures for the long run are hard to come by

- This creates pressure not to resist financial sector excesses in boom times

- Explicit mandate can create an interest-rate policy that "leans (more) against the wind"

4. Sharing of crises management and prevention responsibilities among regulators:

- Create some manageable separation of activities among regulators, e.g., FDIC and the Federal Reserve

- The goal is to prevent cramming down of an entire agenda on regulators

- Must be balanced with the need to coordinate and avoid jurisdictional arbitrage

The Dodd-Frank Act: Hits and Misses

1. Restrictions on 13(3) exceptions:

   - Limiting targeted action for one entity desirable; but why just against non-depositories?
   - Lender of last resort to market at large desirable; but need minimum standards?

2. Financial Stability Oversight Council (FSOC) and SIFI designation:

   - FSOC a good attempt to maintain multiple regulators and at the same time achieve coordination on financial stability issues
   - Designation as SIFIs from commercial banking and shadow banking sectors a plus
   - Housing? Why aren't the GSEs designated SIFIs and regulated by FSOC?

3. No financial stability in the explicit Federal Reserve mandate:

   - Early drafts proposed financial stability as a third mandate of the Fed
   - Inexplicably dropped from the final wording of the Act
   - Desire to keep financial stability at bay in the interest of current jobs?

Are financial boom and bust cycles inevitable?

- Laws that take account of the political economy headwinds on central banking are best implemented following a crisis
  - Financial stability concerns are paramount
- Over time, however, these laws can themselves fall prey to politics
  - Repeal of Acts and laws passed in crises times once economic fortunes recover
- Political intervention in financial stability decisions
  - Direct government presence in politically attractive parts of finance, e.g., housing
- Political arbitrage of financial stability regulation can become as big – or bigger – an issue than private sector's regulatory arbitrage
- Low-frequency boom and bust cycles in the financial sector become inevitable
- Only obdurate central banking can save the day!

Conclusion

- Financial stability is key to economic growth
- Financial stability is necessary condition for transmission of central bank policies
- Financial stability should therefore explicitly be part of central banking mandate
- Tools given to central banks to maintain financial stability and resolve it should
  - Recognize the time-inconsistency and moral hazard from crises management actions ("Rules")
  - Enable the central bank to take tough crises prevention actions for financial stability even if they do not serve short-term and populist political objectives ("Discretion")
- It is a delicate balance…
- Central banks often do not undertake certain actions to maintain independence
- The smaller we can make this set of inactions, the better it is for financial stability!