

GENERAL DISCUSSION
The Financial Crisis and Global Policy Reforms

Chair: Kevin M. Warsh

Mr. Warsh: I'll start with a question for both Barry and Anil. Given the breadth of necessary reforms, are you troubled by what seems to be the preoccupation in our nation's capital and across the world with institutional regulatory design questions? Is there too much emphasis legislatively on who does what—what's the role of the Federal Reserve and other regulators, how do they meet and consult—rather than what seems to be the point of both of your discussions, which is that there are efficiencies to be had in designing a new regulatory structure? Having four bank regulators within four blocks of each other is not optimal, but it sounds as though there is more emphasis in your thinking on what exactly they do, rather than what's the emblem on their business cards. So, I'll ask that question, then allow a few more questions from the crowd.

Mr. Mishkin: I wanted to turn to the issue of inflation targeting, which is not a surprise. But I think the issue here is that we have to recognize that monetary policy can only do so much. I'm actually in complete sympathy with the issues you've raised, that in fact central banks have to seriously worry about financial fragility. It's a primary part of their activity. In the United States, we have a dual mandate which is one, control inflation, and two, worry about output stability. A third goal for central banks is financial stability, and I think that's completely appropriate. The problem here is that the monetary policy tools in themselves may not be the right way to deal with the problems of financial fragility. This came out in Anil's discussion when he said that the real issue we have to worry about is where there's a market failure that creates incentives that can blow us up. So we have to think about what can we do in terms of reversing the incentives to actually get good behavior. That does not necessarily rule out that there might be some role for monetary policy in this. I'm somewhat skeptical, but I think it's a serious issue that we have to think about. I think the issue here is not reforming the inflation targeting regime, per se, but thinking about what the appropriate role is for a central bank in terms of managing financial fragility. I think we want to separate those two aspects out in terms of thinking about them.

Mr. Warsh: Great. Question from this side.

Mr. Yang: For global policy reform, Professor Eichengreen proposed that the Chinese renminbi, along with the U.S. dollar and the euro, may become an international reserve currency in 20 years' time. I think it is a very practical possibility, but some economists also have proposed that Asia should adopt a single currency, like the euro. My opinion is we should develop the Chinese renminbi and an Asian single currency at the same time. There is no doubt that establishing a single currency will be much more difficult for Asia than for Europe. However, over the long term, it'll be worth trying to do in order to facilitate Asian financial development and promote Asian interregional free trade. This would lead to three currency blocs: the U.S. dollar bloc, the euro bloc, and an Asian currency bloc. Within each bloc, exchange rates would be fixed to each other, but exchange rates would be freely floating across blocs. This would enhance the stability of the international monetary system because Asian countries would be less concerned about international capital flows and wouldn't need to hold so much foreign exchange reserves. Also, within each bloc it would be easier to conduct policy. In turn, it would be easier to reduce global imbalances and help reduce the probability of a global financial crisis. So, I would like to ask Professor Eichengreen his opinion about an Asian single currency.

Mr. Warsh: Excellent. Let me go back over here for questions from folks who haven't asked a question so far.

Mr. Dooley: I think the first order of business should be a study that looks carefully at whether, if we had enforced the rules we already have, could we have avoided this crisis? And I think the answer is yes. What we have lacked, as Anil suggests, is the supervisors, the well-trained motivated supervisors to enforce the rules we already have. We're going off spending way too much time not only deciding who does what, but writing down a new code that's supposed to solve the problems. It's not going to solve the problems. By the time the ink is dry, financial market practitioners will figure out ways to get around it. You need people equally competent to stop them from doing that, and that's going to require money and a real focus. A related point, which I think is very important and hasn't been mentioned, is that the Federal Reserve System can become an effective lobby in Washington for financial stability. You don't have to sit back and take it every time some new housing scheme shows up in Congress, you guys should be up there testifying against it. And the only way to do that effectively is to have a really well-motivated, independent supervisory structure and well-paid people to do it.

Mr. Oshima: I have a comment on the capital issue. I understand the importance of having enough capital to absorb financial losses; however, raising too much capital may lead investors or shareholders to require higher profitability, which might cause the banks to engage in riskier activity.

Mr. Warsh: Thank you. With those questions, let me turn first to Barry and then to Anil to respond.

Mr. Eichengreen: Let me start with some of Anil's comments. Is being over your skis a good thing or a bad thing? I'm not a skier. I think it probably matters where you're headed.

I think we agree about global imbalances more than we disagree, although you go a little further than I would in dismissing their importance. Did global imbalances cause the Great Depression of the 1930s? No, but the big capital flows from the United States to Central Europe in that period were a compounding factor that contributed to the collapse of Credit Anstalt in 1931 and the blowback to London and New York. Clearly there were a number of factors that contributed to construction booms and housing bubbles in different countries. When I look at Spain and Ireland, I look not so much at global imbalances as I do at European imbalances and the sharp decline in interest rates in the catch-up economies as they adopted the euro. And clearly there was something different and special going on inside those German and Swiss banking systems to explain their high leverage ratios, to explain the behavior of the Landesbanks. I think you can tell a story that's consistent with a role for global imbalances, that with the flow of foreign capital into the United States, U.S. banks had more resources with which to lever up their bets, and then Swiss and German banks responded by thinking they had to lever up their bets to retain market share. So, I don't think these things are entirely disconnected. My last comment for you, Anil, would be that advocating higher compensation for people involved in finance is not exactly fashionable at the moment.

Kevin asked whether I'm troubled by the emphasis in current discussions on institutional design and how many regulators there should be. No, to the contrary, I'm reassured because I think the problems we're going to have to face will be changing and what we have to do is try to put in place mechanisms, call them institutions, with the capacity to address those problems. I would argue that trying to think about whom the regulators should be, how many there should be, their relationship to the central bank, and so forth is directly on the mark. I think Mike Dooley's point about the need to enforce the regulations we have is consistent with this emphasis. As a sidebar, I agree that we should enforce the regulations we have, but I do bridle when I see this invoked as an

argument against reform. I'm sure Mike didn't mean it this way, that we don't need additional regulation or improved regulation in addition to enforcing the ones we have.

Regarding Rick Mishkin on inflation targeting, I'm not certain there's a substantive disagreement here. We see the same first-best world in which the regulators deal with problems inside the financial system. I may see a different second-best world in which these problems regularly end up in the lap of the central bank. A hundred years of U.S. history point in that direction, and longer spans of history in other countries suggest likewise. You asked the question that, if the central bank has to deal with these problems after the fact, does it need to use more systematically the limited instruments at its disposal to address these problems before the fact, especially in the case of liquidity crises where we know who the liquidity provider of last resort is? Does the central bank have to worry about the danger of the development of liquidity crises on a day-to-day basis when it thinks about the level at which it's setting its interest rates? To my mind, the answer is yes, leaving open the question of exactly how.

My final comment will be about the future of the international reserve system and the renminbi versus a single Asian currency. Usually the way the argument is framed is as "either/or." It was pointed out, I think correctly, that in principle, it's possible for Asia to move along parallel tracks where the renminbi is internationalized and plays a more important role in the settlement of trade and in the reserve system, while Asia continues to move forward to build toward a single currency. Consistent with this view is the fact that from the 1960s, the deutsche mark became more important as a reserve currency and an international unit, and that this didn't prevent Europe from ultimately moving to a single regional currency. Europe is special, just like Asia is special. Europe could do it because Germany faced some very special, peculiar circumstances in 1989–90 that left it prepared to make a commitment to abandon the deutsche mark. When I think about circumstances under which China might contemplate making a similar step, I conclude that the path to a single Asian currency will be a very long and winding one.

Mr. Kashyap: I think the answer to your question, Kevin, about institutional design is, yes, who wears what hat matters. Committees aren't going to do as well as other designs, but I think that getting the right to resolve an institution, dealing with qualified financial contracts, making sure that the information technology sub that's part of a holding company that goes bankrupt continues to function—that's all plumbing. And every day the politicians ought to answer why they won't fix the plumbing. So, I think we ought to get that figured out.

There are other marginal changes, but I think Mike's right, we could have done better.

I don't disagree with what Rick said about inflation targeting. I do think that once you take the agency issue seriously and you say you're going to commit to low interest rates for an extended period, you invite more risk taking that interacts with bad incentives inside the institutions. That's another thing you ought to keep your eye on. Now the supervisors are the ones that have to monitor these risks, but the central bank should be thinking a little bit about them as well. We shouldn't assume that the supervisors are going to be perfect in making their decisions, so you have to take out some insurance.

Finally, on the question of whether financial institutions will take on more risk if they raise capital, that was one of the reasons the contingent capital proposal that Jeremy [Bulow], Ragu [Rajan], and I made was framed the way it was. If you're worried about whether if you give banks more equity they'll seek more return, then issue debt and force them to pay out the cash flow to the debt holders when times are good and only convert into equity to absorb losses when times are bad. That's the best argument for contingent capital. You'd flunk a corporate finance exam question if you were asked, if you give more equity, what does that do to expected returns?—that doesn't make any sense when the Modigliani-Miller assumptions hold. But as soon as you break them, you're going to change the incentives for risk taking and that might be a first-order concern.

Mr. Warsh: Thank you, Anil. I think the remarkable surprise upside from the March [2009] lows until now with respect to financial institutions and capital-raising is how wide these capital markets have opened. In the U.S. and abroad, financial institutions have been seeking high quality capital, both to offset losses on their balance sheet as well as to put them on better footing in order to pursue future opportunities. And though I haven't subjected this to a ton of empirical work, I would say that those firms that raised more capital have seen their share prices increase, so more capital has been rewarded in the marketplace. I think the question for 2010 will be whether markets remain as open as they are today. Let me thank Barry and Anil for a great final session.