

PROTECTING FINANCIAL STABILITY – HOW GOOD ARE WE AT IT?

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Introduction

1. In the words of a 1970s Joni Mitchell song “you don’t know what you’ve lost til it’s gone”. What I’m going to explore today is:
 - whether we have (and have had for a decade or so) a high level of financial stability and
 - second, if so offer some thoughts on what we can do to retain it, so that we avoid expressing the same thoughts as Joni Mitchell.
2. In the process, I am not going to be offering any claims to particular insights about the future. My years as a macro economist makes me agree with the Danish physicist Neils Bohr when he said that “prediction is very difficult especially about the future”.

What does “stability” mean?

3. It occurred to me that one ought perhaps to look at both monetary and financial stability, to understand what the “stability” bit means. In fact, and maybe I just read the wrong publications, it seems that much less has been written about the latter than the former.
4. If I were to ask an audience like this to define the term “*monetary stability*”, there would probably be broad agreement as to its meaning. We have all, over the last 10 years, come to understand that the term refers to the *stability of the value of money*. It is also received wisdom that the authorities shouldn’t aim “simply” for a 0% change in the overall price level. Otherwise, there is too great a risk that the authorities will undershoot the target and aggregate prices will fall. Also, it is generally agreed that an average zero price rise target actually implies deflation, because estimates for the “value” of improvements in the quality of goods over time have been put as high as 1-1 1/2% a year.
5. It would also be generally agreed I think that monetary stability is an important (many would say vital) ingredient for sustainable real economic growth. And, if we have any sense of history, we know it shouldn’t be taken for granted; monetary stability has constantly to be fought for.
6. A third point of agreement would almost certainly be that monetary stability does not require **all** prices to rise in line, at a modest rate, each year. Relative prices of individual goods can and will fluctuate far more than the average, according to swings in demand or in supply.

7. In contrast, I suggest there would be rather less agreement about what constitutes *financial stability*, though we would probably regard it, like monetary stability, as a “good thing”.
8. A quick search of the literature certainly suggests no easy definition of financial stability, save for the homely definition of a financial *crisis* for the UK by Walter Bagehot in the 1870s. This was that you have a financial crisis “when the Bank of England is the only institution in which people have confidence”.
9. Nor was there much help when I turned to the burgeoning literature on financial crises (the antithesis of financial stability) – because most authors seem to assume that what constitutes a crisis is so obvious that it doesn’t need definition.
10. Barry Eichengreen (an author for whom I have great regard and whose work in this area I shall comment on later) is typical in this respect¹ - there is basically no definition. Senior IMF economists with whom I had the pleasure of working many years ago come only a little closer.² Again there is no definition, though (because they are interested in emerging economies where banking plays a key intermediation role) there *is* an explicit proposition that *financial* stability requires *banking system* stability.
11. A 1997 symposium organised by the Federal Reserve Bank of Kansas is explicit in recording that a galaxy of central bank, academic and other talent couldn’t agree on “how a financial crisis is defined and under what circumstances governments and other official bodies should intervene.”³ However, in his contribution to the symposium, Andrew Crockett then of the BIS provided what I find a helpful distinction between two types of financial instability – first of institutions and second of markets.
12. The former, he noted, tends to be thought of primarily in terms of *bank* instability. This is because:
 - bank failures tend, like buses to come in convoys. (One failure causes knock-on losses to others and threatens the confidence that banks need if they are to retain their deposits. Both results tend to promote the convoy effect),
 - and because such a convoy can in most economies have immediate and significant adverse effects on the real economy. A credit “crunch” can follow as banks cut back on lending to preserve their liquidity and the credit that is available tends to cost more, as the banks themselves have to pay up for deposits.
13. In the case of the instability of *markets*, the link is between the volatility in asset prices and the consequent flows through to the real economy. Sharp volatility in (for example) equity prices and/or house prices can feed through into the real economy (in ways I shall briefly enumerate later). The problem is in distinguishing between an “unsustainable price bubble” and “a rise justified by some change in the fundamentals”. Typically, whenever a sharp movement in asset prices occurs, one finds proponents of both schools of thought. Thus, in

¹ Barry Eichengreen “*Financial crises and what to do about them*”2002

² IMF staff team led by David Folkerts-Landau and Carl-Johan Lindgren, “*Toward a framework for financial stability*”Jan 1998

³ Federal Reserve Bank of Kansas “*Maintaining financial stability in a global economy*” 1997

1999-2000, the majority obviously thought that the sharp rise in most TMT equity prices was justified, but a minority wrote about “price bubbles”! With hindsight, we *now* know the minority was right; but hindsight is not a good basis for either getting rich or for making policy.

My definition of financial stability

14. To progress, we need a definition of financial stability. Let me offer one, which is that we have financial stability where there is:
 - a) monetary stability (as defined above)
 - b) employment levels close to the economy’s natural rate,
 - c) confidence in the operation of the generality of key financial institutions and markets in the economy.
 - and d) no *relative* price movements of either real or financial assets within the economy that will undermine (a) or (b).
15. The first three elements of this definition are, I hope, non-contentious. In respect of (a) and (b), it seems implausible to define financial stability as occurring in a period of rapid inflation, or in a mid-1930s style period of low inflation but high unemployment.
16. Similarly in respect of (c), it would be strange to argue that there was financial stability in a period when banks were failing, or when normal conduits for long-term savings and borrowing in either the personal or corporate sectors were seriously malfunctioning. Such circumstances would mean the participants had lost confidence in financial intermediaries. It would mean, almost certainly, that economic growth was being damaged by the unavailability or relatively high cost of financial intermediation.
17. This leaves us with (d) which requires a little discussion. In particular we need to address the question “how can asset price changes threaten financial stability?”
18. I would say that there are four main channels by which changes in asset prices might affect the real economy:
 - **By changing household wealth and thereby consumption.** [The most common example I suppose in the UK is the effect of house price rises (and falls). These are typically associated with a strengthening (weakening) of consumer demand through for example changes in the willingness of banks to lend as the value of collateral changes.]
 - **By a change in equity prices.** [These affect the market value of the corporate sector’s assets relative to their replacement cost and thus the appetite for investment. If the changes are large enough they may also affect personal sector spending directly too.]
 - **By their impact on firms’ balance sheets which can then affect corporate spending.** [A topical if painful example here in the UK currently might be the effect of falling equity prices on company final salary pension funds.]
 - **By their impact on capital flows**, with for example inflows of capital – as during the dot.com boom in the US - strengthening the domestic currency.

19. There is not time now to talk through how the financial sector transmits (and often amplifies) a shock to the economy – the literature does that well enough for those who are interested.⁴ Also, in the UK, we all have personal experience of periods in which rapidly rising (and falling) house or equity prices have affected our attitudes and those of financial intermediaries, tending in the process to accentuate the swings in asset prices. For now, I want to focus on the question of how fast asset prices (and which asset prices) need to rise or fall to constitute a threat to financial stability.
20. Now, here, as with monetary stability – *financial* stability surely does not require the price of all assets (real and financial) to go up or down at roughly the same (modest) rate. Technology, geopolitics and attitudes to risk all change. It would, for example, have been impossible to imagine that the development of the internet would not have led to a re-evaluation of many asset prices, real and financial. It's clear with hindsight that we got some of these re-evaluations seriously wrong first time round; but, for this purpose, that is neither here nor there.
21. But, at some point, the relevant asset prices *will* rise or fall so fast that what was a local phenomenon starts to affect the real economy and thus potentially to affect financial stability. People have argued fiercely in recent years about what pace of price change of these key assets (such as housing and equities) threatens financial stability. I have no particular insight into that. But this area of work is now getting the further intensive research it deserves; and the latest “empirical” instalment covering the 2 most obvious asset classes (housing and equities) across a wide range of countries was in fact published a couple of months ago by the IMF.⁵
22. This work has the merit of confirming my own prejudice – namely that:
- in most developed countries booms and busts in housing have a considerably greater wealth effect on consumption than do equity price changes
 - the biggest dangers come when both key asset prices (for housing and for equity) are rising (or falling sharply) “in synch”.
23. This latest work also has some interesting things to say about the relative impacts on and through bank-based and market-based channels (to revert back to the distinction made by Andrew Crockett that was described earlier). In particular, bank-based financial systems appear to suffer larger output losses than market-based systems during **housing** price busts, while market-based systems tend to suffer larger output losses than bank-based systems during **equity** price busts.⁶

Is financial stability the norm or the aberration?

24. Just because I have been talking about house and equity prices, it should not be forgotten that, for most parts of the world, the “usual” causes of threats to financial stability are to be found in wider, more deep-rooted, problems. Major

⁴ Literature on this point includes ed. J Taylor & M Woodford “*The financial accelerator in the quantitative business cycle framework*” Bernanke, Gertler & Gilchrist in *Handbook of Macroeconomics* 1999

⁵ International Monetary Fund “*World Economic Outlook April 2003, Chapter 2*” April 2003

⁶ *Ibid* page 64.

miscalculations of monetary, fiscal and/or exchange rate policy; natural disasters, war or terrorism, major changes in key terms of trade have all caused serious but “localised” instability; and the list could no doubt be extended considerably.

25. And, of course, with modern communications, we all get to hear a good deal about these events in our so-called global village– usually very quickly. Fortunately, that “financial village” has shown itself in recent years also to be an immensely large and complex place, with so far very effective firewalls in place to limit the repercussions and shocks. We have seen and “felt” these crises but, unless they have been on our street in the village, they have not shaken *our* house!
26. Thus, at almost any time in recent years, it has been possible to identify some fairly obvious manifestation of financial *instability* around the world, even if the more spectacular (such as Argentina’s in 2001-02) are still mercifully rare.
27. Most of these events have been in the emerging markets; but developed countries are far from immune. Thus, between 1984 and 1991 we had the US thrifts crisis which “cost” perhaps 3% of US GDP, the Swedish bank crisis of 1991 (cost 4% of GDP), while the costs of the unfinished saga of the Japanese banking crisis have been put already at over 8% of GDP.⁷
28. Such a range of financial crisis is hardly new, but you would be right in thinking that there was a “good deal of it around” in the last quarter of the 20th Century. In the book I mentioned earlier, Eichengreen provides a historical perspective on the incidence of financial crises in a consistent set of 21 countries over the periods 1880-1913, 1919-39, 1945-71 and 1973-97⁸. [These periods broadly coincide respectively with the international gold standard, the interwar years, the Bretton Woods era and the first 25 years of the post- Bretton Woods period.]
29. This perspective shows (Annex 1A) that, the probability of there being a crisis between 1973 and 1997 in at least one country in the sample in any one year (either from banking failure, currency crisis or a mixture of both) ran at nearly 10% a year over the period. This was only modestly below the traumas of the inter-war period and well above either the gold standard or the immediate post-war eras.
30. The study goes on to show that, as soon as you broaden the number of countries to include a wider set of emerging markets (Annex 1B), the post-Bretton Woods era looks rockier still. When you think of several rounds of crisis in Latin America, the Asian crisis of the late 1990s and so on, it’s not difficult to see how this could have been. Pointing in the same direction is the now commonplace observation that, globally, more banks failed around the world in the 1990s, than was the case in the 1930s.
31. Many of these disturbing events of recent years of course had financial implications for firms operating in the UK. But, from the early 1990 until now (or

⁷ All estimates taken from Glenn Hoggarth & Victoria Saporta “*Costs of banking system instability*” *Bank of England Financial Stability Review* June 2001.

⁸ Data drawn from a 2001 study by Bordo, Eichengreen, Klingebiel and Soledad Martinez-Peria, “*Is the crisis problem growing more severe?*”

at least until very recently) their impact on the UK real economy (and thus whether or not they threatened financial stability here) was very limited.

32. The early 1990s certainly saw a number of bank failures in the UK, albeit of mostly small banks. They also saw a fairly clear portent of an incipient or actual financial crisis – lending of last resort by the Bank of England.⁹ Unemployment also rose well above its natural rate.
33. However, it's important not to overdramatise what happened. No major banks failed. There wasn't even a repeat of the sort of public disclaimer that National Westminster was forced into in 1974 that they were not in receipt of Bank of England support.
34. Nor, while employment and the prices of some key assets undoubtedly fell sharply in real terms in the early 1990s (Annex 3), does it seem that these followed from the banking failures. Rather, they were concurrent with it and did not, in turn, seem to precipitate further real economy weakness.
35. So far as the UK is concerned, the period since the last recession has been one of considerable evident financial stability. From its peak in 1993Q1, unemployment fell almost continuously until the middle of 2002 and, even since then, has been stable at historically low levels. There was indeed very considerable volatility in TMT share prices between late 1999 and late 2000 (Annex 2). There was also a substantial rise in real house prices from early 1999 until very recently (Annex 3). It's also true that mainstream equity prices have, as elsewhere in the G10, fallen sharply since early 2000. And, yes, this does have significant knock-on effects, most noticeably on the UK life insurance industry.
36. But, to date none of this has fed through in any serious degree to employment levels or the rate of price inflation. And central mainstream economic forecasts do not suggest that they will. If you want to be more pessimistic than that, you have to argue that actually there is a large and so far generally unexpected shock to come from the fall in equity prices.
37. This is not to say that the ride has always felt an easy one. Indeed, short-term volatility in the equity markets appears to have risen in recent years (Annex 4); and, while this hasn't been true for fx, trading in these markets in recent years has not been for the faint-hearted (Annex 5).
38. But there have been next to no bank failures since 1993; even Barings lost no depositors' money and made no call on the deposit protection scheme. Indeed, over its last five years (1996-2001), the banks' Deposit Protection Fund (which transitioned into a new scheme when the *Financial Services & Markets Act* came into force in December 2001) actually received more money from recoveries than it paid out on new failures.¹⁰
39. Other financial compensation schemes in the UK over the same period (save only for the general insurance scheme – and the case of general insurance would take

⁹ For a description see EAJ George "The second Bank of England/LSE Lecture! 18/11/93

¹⁰ Deposit Protection Board *Annual Reports & Accounts* 1996-2001

me a lecture in its own right to cover) were also either totally dormant or made net payments of only modest size. And even where modest payments were made, the origin of the problem was nearly always the failure of small firms to guard client money properly, or these firms' inability to meet compensation claims from past mis-selling. In other words, they were localised "micro" problems, and neither reflected or threatened more widespread disruption.

Protecting financial stability in the UK.

40. Though the authorities can't claim all the credit for this, I want to argue that they deserve *some* and not just for the monetary policies pursued over the period. Let me now talk briefly about the efforts in respect of *financial* stability, with particular reference to the post-1997 period. [1997 was, of course, the year that the FSA was conceived and a new formal financial stability structure was agreed.]
41. The clear aim of this new structure was to ensure clear and proactive management of the relevant responsibilities of the 3 key domestic players – HMT, the Bank of England and the FSA. Its main features were set out in a Memorandum of Understanding published in October 1997 which, despite (or perhaps because of) the labours that went into producing it has so far stood the test of time very well.
42. The responsibilities of each of the 3 institutions involved are based on 4 key principles:
 - Clear accountability for each institution
 - Transparency (so that stakeholders know who is responsible for what)
 - No duplication of effort
 - Regular exchange of information (as each institution is plugged into somewhat different information circuits)
43. At the heart of the process is a Standing Committee of representatives of the 3 organisations. This Committee has now met over 60 times. Its role is to discuss possible threats to the UK's financial stability, to share ideas and to exchange information on what each of us propose to do in our own spheres of competence.
44. This is where threats to financial stability can be dealt with proactively. And, while you would not expect me to talk in detail about the subjects covered, I can attest that the range of subjects has been huge and the approach seems to work well. This is true whether we are discussing:
 - An event risk such as Y2K or a terrorist attack on London
 - A geographical or geopolitical problem such as the Asian or Argentine debt crisis
 - Major developments such as the knock-on effects of sharp falls in equity prices
 - Or firm-specific problems such as those that might have been caused by LTCM.
45. The FSA's contribution to this group is one that has drawn strength from the breadth of its regulatory remit. Before 1998, it would have been a major challenge to get the separate securities, banking and insurance regulators to work closely together. But such an integrated response is exactly what is needed from the UK regulator, given the complexity and diversity of the UK and global financial scenes and the growing diversity of different forms of non-bank intermediation in the UK.

46. This doesn't alter the fact that, to my mind, banks still remain the single most likely institutional conduit for the onward transmission of shocks. This is because a loss of confidence in wholesale markets is still one of the fastest acting threats to the stability of any developed financial system. But each case is taken on its merits and no-one involved in the Committee would, I think argue that banking was the only financial conduit by which financial stability could be threatened.

The FSA's objectives

47. Another strength of the new system, I would argue, is that at least one of the FSA's new statutory objectives "nests" very clearly within this wider framework.

48. The Financial Services & Markets Act that gives FSA its powers sets out 4 statutory objectives:

- Maintaining market confidence
- Promoting public awareness
- Protecting consumers
- Reducing financial crime

49. The FSA has from the outset accepted that maintenance of *market confidence* is fundamental to the successful operation of that market and, across the system as a whole, to the smooth operation of the whole economy. We have also accepted that maintaining this confidence "involves preserving both actual stability in the financial system and the reasonable expectation that it will remain stable".¹¹

50. Ways of achieving this include preventing material damage to the soundness of the UK financial system caused by the conduct of or collapse of firms, markets or financial infrastructure. We also need to explain to consumers and firms the basis on which confidence in the UK financial structure is justified. And in the process, we have the tricky task of explaining in the process explicitly what the regulator can and – more importantly cannot – achieve.

51. In this last endeavour, we have tried to make clear from the outset that the FSA cannot and should not aim to prevent all collapses in the financial system. But that still leaves hard judgements as to when a disruption in one part of the system could snowball (and therefore perhaps merit active intervention by the regulator or by another part of the public sector) and when market forces should be left to work unaided.

52. It also leaves unsettled the question raised long ago by Charles Goodhart and others as to "exactly what frequency of event should the regulators be trying to guard against.

53. Finally, it also says nothing about the fact that a complex economy such as the UK is made up of a large number of markets, many of which are international and not domestic in nature. So, how far does a failure of market confidence have to go?

¹¹ Clive Briault "Revisiting the rationale for a single national financial services regulator" FSA Occasional Paper No.16 February 2002.

How many markets have to be impacted? What total damage to market confidence is needed before this statutory objective can be said “not to have been met”?

54. My own answer would be that failure of market confidence in just one of these markets *might* but certainly *would not necessarily* generate a wider loss of confidence (and thus threaten to undermine financial stability). Indeed, I would go further and argue that – as in the global village I talked about earlier – the “walls” that support market confidence are stronger than is sometimes argued. (One recent example I would cite of this has been the remarkable resilience of energy trading markets in the US and UK to Enron and its aftermath. It is not often that you get, as in the UK in the autumn of 2001, the short-term failure of the trader that previously accounted for some 30% of your market.)
55. I accept, of course (after all, I was a central banker for nearly 30 years) that there will be times when the authorities need to “lend a hand” to support such a market. And, in the heat of a crisis, it can be a difficult judgement indeed as to whether a problem can be allowed to blow itself out or not.
56. The challenge for the authorities in any country is to decide – often early in a developing “crisis” and on the basis of inevitably limited information – whether some form of official action is justified on financial stability grounds. The US Federal Reserve has acted after making this judgement call a number of times in the last 20 years and when facing threats from a number of quarters¹².
57. In the UK over the same period, the Lender of Last Resort intervention by the Bank of England in 1991-2 has been the most noteworthy intervention of recent years; while in a number of other cases (BCCI and Barings being two) matters have been largely allowed to take their course. Frequently, markets have shown their ability to right themselves. In other cases, as with temporary Government-organised airline insurance cover, the markets have needed a little time to “regroup” and official “help” (but not in such cases from the central bank).
58. There are times when such help can and should be provided by the regulator. Early this year, for example, the FSA changed its solvency rules for life assurance firms, to remove any risk that financially sound firms would need to sell equities for “mechanical”, rule-based reasons. Such an action does not involve public money though it almost inevitably does involve a judgement call by the regulator, balancing the risks to policyholders, depositors or investors of action against the risks of inaction.
59. It is clear to me that, over a long period, the UK authorities have set a fairly high hurdle to be jumped, before official intervention in any form can be justified. That is, I think, how it should be. Markets can very often sort the problem out and in the process make a better job of doing it than would the official sector. Most problems in fact remain localised and do not go on to threaten financial stability as I’ve tried to define it. Market mechanisms are more likely to work (and the key private sector “actors” more likely to shoulder their responsibilities) if a feeling

¹² See, for example, Steve Solomon “*The confidence game*” page 526 for a summary.

does not grow up that, at the first sign of trouble, the authorities will always send the cavalry in.

- 60.** A further protection against precipitate public sector action in the UK is the public accountability that goes with the territory. Each partner in the Tripartite arrangements knows that, maybe not immediately but inevitably in time, they will be called to account individually in public for their action. And, thanks to the 1997 MOU, there is clarity now that was lacking before as to what exactly is the role and responsibility of each member of the arrangements.
- 61.** All that said, the “cavalry” does need to be there and to be ready for deployment if action by the authorities *is* required. As with its monetary cousin, financial stability is not easily gained. Like its monetary cousin, it can quickly be lost and - once lost –can be difficult to recover. And, while the private sector’s own firewalls have much to commend them, I’m most definitely not averse to having public sector firewalls available too, for the rare occasions when the private sector can’t cope on its own.