The Fourth L.K. Jha Memorial Lecture

*The Fourth L.K. Jha Memorial Lecture by **William J. McDonough,** President, Federal Reserve Bank of New York, Mumbai, India, on December 5, 1996*

Strengthening the Financial Marketplace

Mr. Governor, distinguished guests and ladies and gentlemen, I am honored to appear before you today to deliver the fourth L.K. Jha Memorial Lecture. It is a great pleasure for me to be visiting your country for the first time. I thank you for your warm and generous welcome.

In my remarks to you today, I would like to take the opportunity to stand back and take a look at the role of central banks and financial system, particularly within the context of the ongoing transformation of the financial services industry and recent regulatory reforms that have been implemented in numerous countries, including the United States. I am especially pleased to have the opportunity to discuss these issues in Mumbai, given the changes that are under way here.

In any market economy, the banking and financial system plays a key role in mobilizing a society's savings and in channelling these savings into productive uses and investments. In providing an efficient and rigorous process for intermediating the flow of a society's savings into productive uses, the banking and financial system is one of the core determinants of the pace of a country's economic development and increase in the standards of living of its citizens. Furthermore, the banking and financial system must facilitate transactions in an economy by ensuring that they can be effected safely and swiftly on an ongoing basis. Both buyers and sellers of goods and services must have confidence that instruments used to make payments in these transactions will be honored and accepted by all parties to that transaction and to subsequent transactions. Such confidence is of paramount importance, for without it, the system simply cannot work.

While these crucial economic functions of transforming savings into productive uses and making payments are often taken for granted, in fact, it can be difficult to ensure that the legal and institutional framework within which these functions are performed is consistent with the often conflicting goals of free choice, economic efficiency, and safety and market stability. As we have learned from history, no society has found it easy to forge its financial institutions in way such that these goals are appropriately balanced and remain so over time under a variety of economic conditions. Numerous countries, including the United States, are continually debating which paths should be followed in reforming and modernising their banking industries. The reason for the inherent difficulties in this area are an almost classic blend of political and economic considerations that have their roots in the crucial functions the banking system must perform in a market economy.

The importance of a well-functioning banking and financial system for a country's long-term economic prospects cannot be overstated. The system must provide a mechanism for inducing households to save some of their current income and to entrust these savings to institutions that are able to put these savings to work in productive investments. Households will generally desire to put some of their funds into savings vehicles that entail some degree of risk in exchange for rates of return that compensate them for this risk. Household's longer-term savings often fall into this category. However, virtually every household will also desire to maintain some proportion of its savings in the form of highly liquid, very safe assets to be used for more immediate transactions.

A household's willingness to entrust its savings to institutions for either short-term or longer-term purposes depends fundamentally on its having the utmost confidence in the financial integrity of those institutions. If that confidence does not exist, a society's ability to mobilise its savings will be compromised as will its ability to reap the benefits from the increased production and distribution of goods and services. As instances in history have shown, a loss of confidence in a country's financial intermediaries can induce households to redeploy their savings, possibly converting to cash and/or hard goods -- with all of the attendant implications of destabilizing runs on banks -- or indeed, possibly converting those savings to uses outside the country.

For a financial system to mobilize and allocate a society's savings successfully and facilitate day-to-day transactions, there must be a class of financial institutions and financial instruments that the public views as safe and convenient outlets for its savings. In virtually all countries , the single dominant class of institutions that has emerged to play this crucial role as both the repository of a large fraction of the society's liquid savings and the entity through which payments are made is the commercial bank. Indeed, even in countries with highly developed capital markets, the commercial banking system is still the most important single element of the financial system, especially when it is kept in mind that participants in the capital markets rely very heavily on the banking system for their financing facilities.

For banks to be able to perform their key role in this process of financial intermediation, it is obvious that households must have the utmost confidence in the banking system. This confidence is a key reason why banking institutions and banking instruments are crucial to a country's economic growth and development. The combination of functions typically provided by commercial banks, however, also carries with it the risk that a loss of confidence in an individual institution can spread to the system as a whole, the so-called systemic risk phenomenon.

Instances in which a country has experienced a loss of confidence in its financial institutions have in many cases caused major damage to the country's real economy. Given the indispensable role that financial institutions play in the success of a country's economy, all governments have found that financial institutions must be subject to at least some form of regulation or oversight, particularly given that risk to the system as a whole could potentially undermine the ability of these financial institutions to perform their crucial roles.

In most countries, the central bank plays a key role, either explicitly or tacitly, in preserving and enhancing the stability of the banking and financial system. Indeed, while the primary task of most contemporary central banks is viewed as the conduct of monetary policy, many central banks--certainly including the Federal Reserve--were established largely with a view toward preventing or at least containing financial shocks and disruptions.

In light of the importance of the efficiency and stability of the financial system, in my view, the necessary functions of the contemporary central bank are threefold. One of the primary functions of the central bank is, of course, monetary policy. In addition, however, the central bank must have some hand in the broad oversight of the financial system as well as in the oversight of--and direct participation in--the operation of the payments system. All three of these functions of a central bank are mutually dependent and all require a degree of stability in order to be carried out successfully.

Defining the role of the central bank by these three functions makes clear that the structure and workings of the banking system are integral to a country's financial stability and economic growth. The reforms that many countries are seeking in their banking industries thus take on a particular importance. Moreover, instituting reforms in a country's banking system is made all the more challenging by the fact that these reforms can be viewed neither in isolation from those in the central bank nor independently of those--and other emerging developments--in the capital markets. In fact, the greatest challenge may lie in forging these individual pieces in such a way that they fit together in a cohesive whole that will serve the dictates of stability, growth, and confidence.

From this perspective, it seems clear that the first priority is the mobilization of savings. This is where the importance of the liability side of banks' balance sheets--particularly deposits--becomes highlighted. Indeed, the design of the transactions and savings liability instruments of banks may be just as important, at least in the short run, as the design of the overall structure of the banking system. Of course, the design and workings of the infrastructure that go with these instruments are equally critical. For example, for transactions-type accounts and especially for interbank moivements of funds, efficient, safe, and swift collection and payments systems are crucial if confidence is to be built and maintained so that these instruments continue to be used.

In attracting deposits and thus mobilizing savings, a crucial role is played by the other side of banks' balance sheets--the asset side. Banks' ability to take deposits and put them to good use will, in turn, affect their ability not only to retain these deposits but also to attract additional savings. If a bank is not careful in the credit it extends, it will incur losses and will risk not being able to honor its obligations. If a bank's ability to honor its deposit obligations comes into question, the bank will risk losing depositors. Thus, the banking system has built into it incentives for individual banks to extend credit wisely and judiciously.

Part of the infrastructure that facilitates rigorous credit decisions on the part of banks is a sound and internationally accepted accounting system. Accounting systems serve a variety of purposes, but they are indispensable in helping creditors decide which enterprises meet the market test of efficiency, competitiveness and profitability that will permit both borrowers and creditors to meet their obligations in a timely fashion.

Another key ingredient in facilitating banks' ability to attract deposits and channel these funds into the most productive uses is the size and composition of a bank's capital account. The capital account, representing the ownership interests in the bank, serves as both a permanent source of funding and a cushion for absorbing losses. In addition, the group of individuals or institutions that constitute a bank's capital base have a direct interest in the profitability of the bank which, in turn, should strongly reinforce the soundness of the credit decision-making process. Private ownership of banks thus tends to provide some of the incentives conducive to an efficient and successful banking sector.

While private ownership of banks offers clear advantages, it is also true that in virtually all countries--the United States included--special purpose banking organizations involving degrees of government ownership, guarantees or sponsorship are not uncommon. Thus, understandably, even where there is a commitment to promote private ownership of banks, this commitment may be tempered by some realism as to what kinds of arrangements are workable.

Although the precise legal and organizational structure of individual countries' commercial banking systems may vary, the basic functions performed by these systems are common to all countries. To perform its role in a country's economy successfully, a commercial banking system requires a delicate balance between risk-taking and the need to maintain public confidence. Because of the importance of maintaining this balance, banking systems in all countries are subject to a higher degree of official oversight and regulation than is the case for most other forms of private enterprise. As part of their approach to overseeing the safety and soundness of their banking and financial systems, all countries have put in place some form of a so-called safety net.

While its specific form can differ appreciably across countries, the safety net is usually constructed to perform several basic functions. It generally includes, for example, oversight of the affairs of banking institutions. Such oversight usually entails the inspection and examination of banks for compliance with a broad set of safety and soundness standards. The safety net also frequently provides some form of protection against losses for small depositors and investors. Furthermore, some form of emergency liquidity facility is also typically provided for banking institutions and, in some cases, other types of financial institutions. Finally, the payments system, a crucial link in any financial system, generally includes some form of official regulation of or participation in its operations.

These central features of a safety net often feed into one or more of the functions performed by central banks. For this reason, in virtually all countries, the central bank plays a direct or indirect role in the operation of one or more of these features of the safety net. For example, the emergency liquidity facility is almost always the discount window of the central bank. In many countries--including the United States--the central bank also plays an important role both in the supervision of banking institutions and in the regulation and operation of the payments system.

The important role played by the central bank in helping to build and maintain confidence in the underlying stability of the banking and financial system in turn implies that there must be a high degree of public confidence in the central bank itself. Achieving and maintaining that public confidence depends first and foremost on the success of the central bank in discharging its monetary policy responsibilities. A sound economy and sound money are virtually synonymous, which is why monetary policy stands at the center of central bank functions. The importance of monetary policy is also the reason why central banks need special status with the governments they serve. For example, the central bank should not be directly responsible for financing government budget deficits; such a responsibility can, over time, compromise the financial integrity of the central bank, and thereby, public confidence in it.

While central banks should not be responsible for the long-term, direct financing of government budget deficits, they can play an important role in facilitating the development of a market for government debt. Indeed, the development of a well-functioning government securities market--including a viable secondary market--can provide benefits beyond those emanating from a market approach to financing a government budget deficit. For example, a well-developed government securities market can provide the central bank with an effective avenue for conducting monetary policy. Any holdings of government debt that the central bank might acquire in connection with its efforts to supply liquidity to the economy as a whole through open market operations will generally serve to strengthen the balance sheet of the central bank.

Furthermore, a well-developed government securities market can deepen financial markets and provide the foundation for the creation of an array of sophisticated, additional financial market instruments that can enhance the process of channelling a country's savings into productive uses. As with all markets, however, a smoothly functioning government securities market depends critically on an infrastructure for clearing and settling transactions and on sufficient liquidity, so that these securities can be readily bought and sold by the central bank and other market participants.

Reforms in the banking and financial system thus take on great importance, given that a well-developed and smoothly functioning banking and financial system is a critical foundation for an economy to develop and prosper. Reforms also tend to be difficult, however, for technical economic, and political reasons. Perhaps most important, reforms tend to be difficult because the foundation of a successful banking and financial system rests so heavily on that great intangible--public confidence.

The central bank plays a crucial role in this area as it carries out its functions, instilling confidence in an economy through the conduct of its monetary policy and through its efforts in creating and maintaining a stable, efficient, and well-functioning banking and financial system. The rewards from this process are many, the most important of which includes economic growth that produces a rising standard of living for all of a society's citizens.

In this connection, let me add a few words about the role of central banks in the conduct of monetary policy and the importance of price stability in contributing to sound economic growth. Why do I believe price stability is so important and so desirable? In my view, a key principle for monetary policy is that price stability is a means to an end--to promote sustainable economic growth. Price stability is both important and desirable because a rising price level--inflation--even at moderate rates, imposes substantial economic costs on society. All countries incur these costs. They are familiar and entail, for example:

increased uncertainty about the outcome of business decisions and profitability; negative effects on the costs of capital resulting from the interaction of inflation with the tax system; reduced effectiveness of the price and market systems; and distortions that create perverse incentives to engage in non-productive activities.

Rapid moves toward price stability from high inflation, however, also have their costs. The overdevelopment of a sector for no reason other than the inflation rate is precisely one possibility. What can happen is that the removal of the distortionary incentive leads to a rapid transfer of resources out of that sector, causing unemployment and business failures to follow: what was boom, goes bust. In countries where, for example, we have seen the overexpansion of the financial sector, we have also seen the sharp contraction of that sector when inflation was finally brought down. This implies an additional argument for a rigorous policy of continuous price stability. Namely, in a low-inflation environment, these boom-bust cycles created by distortionary incentives are less likely to emerge and can be more easily contained when they arise.

The avoidance of such unnecessary boom-bust cycles also limits the serious social costs that inflation can impose. For one, inflation may strain a country's social fabric, pitting different groups in a society against each other as each group seeks to make certain its wages keep up with the rising level of prices. Moreover, as we all know, inflation also tends to fall particularly hard on the less fortunate in society, often the last to get employment and the first to lose it. They do not possess the economic clout to keep their income streams steady, or even buy necessities, when a bout of inflation leads to a boom-bust scenario for the economy. When the bust comes, they also suffer disproportionately.

While some would argue that establishing price stability as the primary goal of monetary policy means that central banks will no longer be concerned about output or growth, I believe this view is simply wrong. A stable price and financial environment almost certainly will enhance the capacity of monetary policy to fight occasions of cyclical weakness in the economy. Over the long run, price stability is the one sustainable contribution monetary policy can make to growth. This applies to all countries.

Over the past twenty years, there has been an emerging consensus among policymakers and economists that an activist monetary policy to stimulate output and reduce unemployment beyond its sustainable level, leads to higher inflation, but not to lower unemployment or higher output. Moreover, although some countries have experienced rapid growth in the presence of high inflation rates, often with the help of extensive indexation, none has been able to do so without encountering severe difficulties at a later stage. It is thus widely recognized today that there is no long-run trade-off between inflation and unemployment. As a result, we have witnessed a growing commitment among central banks throughout the world to price stability as the primary goal of monetary policy.

I believe that there is broad support within the United States today for a rigorous and consistent anti-inflation policy. Moreover, I am pleased by the credibility the Federal Reserve appears to have earned in controlling inflation over the past several years, while encouraging both growth of the real economy and financial system stability.

In short, what is most important to bear in mind is that by ensuring a stable price environment, monetary policy helps foster economic growth. This is a key point--and is often overlooked. Therefore, while its one explicit goal must be price stability, monetary policy can and must also maintain the broad environment for sustainable economic growth.

In my view, no central bank can maintain price stability over the longer term without public support for the necessary policies. Moreover, today's globalized markets leave central banks with no margin for complacency. Only with the confidence of the public in their policies and their own vigilance in implementing these policies can central banks in democracies ultimately succeed in achieving a goal of price stability. This is a goal worthy of the efforts of central banks throughout the world.