

The trouble with financial bubbles

Howard Davies

It is said central banks should not try to head off a bubble, just clean up the mess. Now the cost is so high, and the cleanup so long, maybe we should change tactics

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Very soon after the magnitude of the 2008 financial crisis became clear, a lively debate began about whether central banks and regulators could - and should - have done more to head it off. The traditional view, notably shared by the former US Federal Reserve chairman, Alan Greenspan, is that any attempt to prick financial bubbles in advance is doomed to failure. The most central banks can do is clean up the mess.

Bubble pricking may indeed choke off growth unnecessarily - and at high social cost. But there is a counter-argument. Economists at the Bank for International Settlements (BIS) have maintained that the costs of the crisis were so large, and the cleanup so long, that we should surely now look for ways to act pre-emptively when we again see a dangerous buildup of liquidity and credit.

Hence the fierce (albeit arcane and polite) dispute between the two sides at the International Monetary Fund's recent meeting in Lima, Peru. For the literary minded, it was reminiscent of Jonathan Swift's *Gulliver's Travels*. Gulliver finds himself caught in a war between two tribes, one of which believes that a boiled egg should always be opened at the narrow end, while the other is fervent in its view that a spoon fits better into the bigger, rounded end.

It is fair to say that the debate has moved on a little since 2008. Most important, macroprudential regulation has been added to policymakers' toolkit: simply put, it makes sense to vary banks' capital requirements according to the financial cycle. When credit expansion is rapid, it may be appropriate to increase banks' capital requirements as a hedge against the heightened risk of a subsequent contraction. This increase would be above what microprudential supervision - assessing the risks to individual institutions - might dictate. In this way, the new Basel rules allow for requiring banks to maintain a so-called countercyclical buffer of extra capital.

But if the idea of the countercyclical buffer is now generally accepted, what of the "nuclear option" to prick a bubble: is it justifiable to increase interest rates in response to a credit boom, even though the inflation rate might still be below target? And should central banks be given a specific financial-stability objective, separate from an inflation target?

Jaime Caruana, the general manager of the BIS and a former governor of the Bank of Spain, answers yes to both questions. In Lima, he argued that the so-called “separation principle”, whereby monetary and financial stability are addressed differently and tasked to separate agencies, no longer makes sense.

The two sets of policies are, of course, bound to interact; but Caruana argues that it is wrong to say that we know too little about financial instability to be able to act in a pre-emptive way. We know as much about bubbles as we do about inflation, Caruana argues, and the need of central banks to move interest rates for reasons other than the short-term control of consumer-price trends should be explicitly recognised.

At the Lima meeting, the traditionalist counterview came from Benoît Cœuré of the European Central Bank. A central bank, he argued, needs a very simple mandate that allows it to explain its actions clearly and be held accountable for them. So let central banks stick to the separation principle, “which makes our life simple. We do not want a complicated set of objectives.”

For Cœuré, trying to maintain financial stability is in the “too difficult” box. Even macroprudential regulation is of dubious value: supervisors should confine themselves to overseeing individual institutions, leaving macro-level policy to the grownups.

Nemat Shafik, a deputy governor of the Bank of England, tried to position herself between these opposing positions. She proposed relying on three lines of defence against financial instability.

Microprudential regulation, she argued, is the first line of defence: if all banks are lending prudently, the chances of collective excesses are lower. But the second line of defence is macroprudential manipulation of capital requirements, to be applied across the board or to selected market segments, such as mortgages. And, if all else fails to achieve financial stability, central banks could change interest rates. Because British law assigns capital regulation and interest-rate policy to two separate committees - with different members - within the Bank of England, the Shafik strategy would require some clever political and bureaucratic manoeuvring.

Industrial quantities of research, analysis and debate have been devoted to the causes of the 2008 crisis and its consequences; so it seems odd that senior central bankers are still so sharply divided on the central issue of financial stability. All those days spent in secret conclave in Basel, drinking through the BIS’s legendary wine cellar, have apparently led to no consensus.

My view is that Caruana had the best of the arguments in Lima, and Cœuré the worst. Sticking to a simple objective in the interests of a quiet life, even if you know it to be imperfect, is an inelegant posture at best. We need our central bankers to make complex decisions and to be able to balance potentially conflicting objectives. We accept that they will not always be right. However, it is surely incumbent on them to learn from the biggest financial meltdown of the last 80 years, rather than to press on, regardless, with policy approaches that so signally failed.

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