

## ECONOMIC NEWS UPDATE

Irwin Stelzer

14 April 2008

### **Central Bankers Need Not Grin, But They Must Bear It**

“Infamy, infamy, they’ve all got it in for me!” That wail from a British comedy spoof of the last days of Julius Caesar might now be heard in the private offices of most of the world’s key central bankers. Former Federal Reserve Board chairman Alan Greenspan is being blamed for America’s house-price bubble. It seems he kept interest rates too low, too long, and failed to target asset prices. Never mind that similar bubbles foamed up in Spain, Ireland and Britain, to name just a few countries in which house prices soared and which are far beyond Greenspan’s jurisdiction.

Greenspan’s successor, Ben Bernanke, is being criticized both for being too slow to cut interest rates, and for cutting them so

much that he will trigger inflation. His charge sheet also includes an entry alleging that he was too slow to understand the gravity of the liquidity squeeze and too quick to bail out investment banks caught in that seizing up of credit markets. Worse still, former chairman Paul Volcker, Greenspan’s predecessor, told the Economics Club of New York that Bernanke has gone to “the very edge” of the Bank’s legal authority, and that “Out of perceived necessity, sweeping powers have been exercised in a manner that is neither natural nor comfortable for a central bank.” Volcker is one of Barack Obama’s advisors, so should the senator from Illinois end up in the White

House, Bernanke cannot bank on reappointment.

In Britain, Governor of the Bank of England Mervyn King's infamy stems from his continued insistence that moral hazard is so great a problem that he has to go slow in lowering interest rates lest he encourage foolish borrowers and lenders to repeat their folly, and also trigger inflation. Critics want him to lower rates to give a boost to a flagging economy. Never mind that unlike his US counterpart, King has no remit to maintain growth, and is mandated by law to focus solely on containing inflation, which is already at least 50% above the government's 2% target.

In the European Union, the head of the European Central Bank, Jean-Claude Trichet, is under fire for having allowed the housing booms and inflation to get out of hand in Ireland by not raising interest rates, and from Nikolas Sarkozy for not lowering rates so as to bring down the value of the high-flying euro and stimulate the sagging French economy.

So the life of central bankers is not an easy one these days. But they can take solace from an important fact: when they have piloted their respective economies through the current rough waters, and with skill and luck avoided the shoals, they will leave the

capitalist market system in better shape than it was when they inherited it.

The most important changes will stem from the realization that it makes no sense to distinguish between ordinary commercial banks and investment banks. Many of the former are too big to fail, and many of the latter too interconnected to be allowed to fail. Which is why the generally anti-interventionist Bush administration approved the use of taxpayer money to make it possible for J.P. Morgan to take over Bear Stearns just before Bear would have gone bankrupt. And why the Fed has opened its discount window to investment banks so that they can trade in their often less-than-safe paper for cash.

So from now on these once-lightly regulated institutions will have to meet capital requirements and other constraints on their operations that the Fed will deem appropriate for firms able to tap Fed cash. In essence, we are witnessing a retreat from the age of deregulation that culminated in the 1999 repeal of the 1933 Glass-Steagall Act, ending tight government control of investment banks' operations. That was largely the work of former Texas senator Phil Gramm, now John McCain's top economic advisor.

We are also about to see the end, or at least major changes in the model that has come to predominate in some markets for debt, and most particularly in the mortgage market: the originate-to-distribute chain. Firms that originated loans -- vetted borrowers and approved mortgages -- often had an incentive never to say "no". For one thing, their commissions depended on the volume of loans they originated, rather than the quality of those loans. For another, having sold the loan off to others, they risked no loss should a borrower default.

The protection against these perverse incentives was to be the rating agencies. Their job was to look at the quality of the loans underlying the securities in which they were bundled, and provide investors with a rating of the safety of those securities. Problem: like originators, rating agencies get paid only if a deal is consummated. And that takes a high rating, AAA being the best. Say, "Yes, these are lovely AAA-rated bits of paper," or no fee. The saintly can be trusted to overlook such an incentive, mere work-a-day mortals cannot.

So look for legislation that leaves some risk with originators, and more closely regulates rating agencies. Bernanke is of the view that "with adequate repairs" the

originate-to-distribute model can remain an important tool in making loans available to consumers and small businesses. Perhaps, but there comes a point at which repairs are so extensive as to make the original unrecognizable.

Finally, the age of go-it-alone central banking is over, in two senses. First, it is now clear that so-called independent central banks cannot cope with major upheavals without close coordination with politicians. Bernanke spends more time than many critics feel he should meeting with congressmen -- and being photographed so they can send pictures home proving they are working with the Fed to solve the economy's problems.

Second, international cooperation will become more structured and intense, although it is unlikely to reach the degree of formalized coordination that some of the finance ministers, departing Washington after their weekend confab, are proposing in an effort to find some role for largely outdated international institutions. The Financial Stability Forum (FSF), consisting of central bankers, finance ministers and regulators from all the important (and some not-so-important) countries, will become more active. Individual national interests will always predominate, but those

interests are now seen to include controlling events in other countries.

None of these changes will do much to reduce criticism of central bankers for doing too much too soon, or too little too late when crises occur. Nothing much they can do in the face of such criticism except to hope that the good they have done will not be interred with their bones.

A version of this Update appeared in  
The Sunday Times (London)