Transcript of Interview with Dr. Guillermo Ortiz

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Interviewed by
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Garten: As I mentioned to you, we are doing a project at Yale on the future of the global financial system and I wanted to ask you a few questions, really mostly about central banking, but I will conclude with a question about regulation more generally and then about the G20 as a governing mechanism. But I’d like to start with central banks and we’re at the five-year anniversary of the collapse of Lehman Brothers; there’s been a lot of commentary. One of the themes has been that central banks did not do a very good job of anticipating what turned out to be a very big global crisis. And I wonder if you had any thoughts about why was that, because in fact the central banks tend to have the best talent and they had a terrific reputation for the past decade or so. So what do you think went wrong with regard to the ability of central banks to anticipate something that was so large and so destructive?

Ortiz: Well I think that the crisis now that you’re mentioning, the fifth anniversary of Lehman Brothers, maybe it was a massive institutional failure including the authority central banks, regulators, the banks themselves, rating agencies. I think that the whole framework collapsed. In the case of central banks, I guess the main reason why they did not anticipate it is that there was a preventing paradigm that lightly regulated financial markets…The
other side of the coin is that in the view of most central banks price stability was almost the equivalent to financial stability.

_Garten:_ Okay.

_Ortiz:_ So it was believed that as long as central banks did their job in their own country in the sense of providing a low inflation environment, and they trusted the models of commercial banks for risk management, light regulation, they thought that these would result in financial stability, no? And obviously this was not the case and I think that the main thing that they did not see was the huge build upon leverage and debt. The leverage of the financial system was huge when the crisis erupted. Leverage ratios in major financial institutions were 30, 40, 50 times, you name it. And this is something that I think was quite unprecedented.

_Garten:_ And do you feel that in these last five years, central banks now have the capacity to have a broader view of the global financial system, that the ideology may have changed and that the focus on leverage and the knowledge is greater? Or are we still in a very transitory period?
Ortiz: Well I think that the lessons are there but it’s very difficult to see whether the lessons have been fully absorbed. As you know the paradigm has changed and central banks are now very, very focused on financial stability. So the first reaction of central banks after the crisis was what it should have been. They acted as the lender of last resort to the financial system in the different jurisdictions. There was also an unusual level of cooperation among major central banks in facing the first stages of the crisis. I think that central banks in the aspect of financial stability, for example, in the U.S., they were very helpful together with the U.S. authorities in really addressing the question of vulnerabilities of the banks. That’s why the banking system in the U.S. healed much more rapidly than the banking system in the U.K. or in Europe. In Europe, you’re still at the stage where a banking union has been proposed that will supposedly start in 2014. They have two major, I would say, components before it becomes fully operational. One is the assets quality tests and the other one is the stress test. I think the U.S. is in the second year of a crisis and by forcing the bank to accept capital and by doing very much more stringent stress tests, they were able to make sure that the financial system reconstituted way ahead of the UK and Europe. So I think that the reaction of the Fed was much quicker than that of the ECB and the Bank of England at least in what concerns the banking systems. Then we
can talk of course about what happens when central banks have reached the zero bounds.

_Garten:_ Right, right.

_Ortiz:_ Interest rates –

_Garten:_ Let me come to that but I just want to stay on this subject of the central banks in terms of the crisis itself, and the challenge of crisis management. You’re saying that there was an unusual amount of cooperation among the central banks, and of course, it is a fact that the global banking system did not self-destruct, when a lot of people thought it was close to doing that. So you have to give the central banks a good deal of credit in terms of their firefighting and their crisis management. When you look back and you think about what was learned in the heat of that crisis from a central bank standpoint, what do you think will stand central banks in better stead when the next crisis happens?

_Ortiz:_ Well I think that what was learned of course is that you can have a banking system which is apparently healthy, and that the risk management models of commercial banks that were the basis for overall assessment of financial stability was wrong. And I think
that central banks have learned that. That’s why they have held together with all of the organizations to increase banks capital and to reduce leverage. I think this is the main lesson learned. The question is that this crisis is a balance sheet crisis. It was a crisis of over leveraging in a massive scale of both the banking systems and in some cases of households. They were supported by housing bubbles. So I think that the basic lesson that you learn is that you have to control leverage and you have the control the leverage of the major banks. That leads you to another point which is sort of too big to fail questions and frankly speaking, not much has been done on that specific question like living wills and this idea of breaking up major financial institutions, and so on. They’re still in the middle of the road there and as you know there are divergent views.

_Garten:_ Right.

_Ortiz:_ But I think that the focus on leverage is the correct one.

_Garten:_ And where do you personally come out with regard to huge banks that are quote, too big to fail? Do you subscribe, generally speaking, to the idea that no bank should be that big? Or conversely, that any bank should be capable of being wound up?
Ortiz: To be realistic, that’s a theoretical notion.

Garten: Okay.

Ortiz: I think in practice, not only because of the lobbying of our banks but the practical difficulties in really separating this massive and gigantic financial institutions are complex. I think, for example, in the U.S. it’s clear that with the new leverage ratios the banks themselves will shed some businesses that are unprofitable. For example, you see banks such as JP Morgan getting out of the commodities business.

Garten: Right.

Ortiz: If regulations continue to progress and you see leverage rations increase to five or six, which is the idea in the U.S., other businesses will become unprofitable, and banks will shift. But for the regulator to actually break them up, I think it’s a daunting task and that a precondition for that is that banks have to be very well capitalized and you have to arrive at a concept of what is the adequate level of capital that is necessary and I don’t think that we’re there yet.
Okay. So now let me ask you about the phase of the recovery since the tourniquet was put on the banking system and the bleeding stopped and the central banks stepped in with various plans but really pumping in a huge amount of liquidity into the global economy. One of the big issues is, do you feel that this is a kind of permanent change in the way central banks are going to operate or is this just a temporary detour from the more conservative focus that central banks have had? How much are we actually seeing a transformation of central banking?

I think this a key question, and one that is not clear going forward. In fact, in the G30, we’re starting a project on the future of central banking, which is asking precisely that question. So my own reaction is that central banks will be much more focused on the issue of financial stability. To the extent that they succeed in maintaining financial stability, these extraordinary, unorthodox measures – quantitative easing and so on – that were put forth by central banks will become unnecessary. I think this is the hope of central bankers that this was just a one reaction that was amended by circumstances and that the tool kit of central banks would always have that alternative, but the hope of central banks that these will not be used. I am convinced that when central banks
reached the zero bound limit, the ensuing unorthodox measures to try to act not only on the short end of the curve but along the yield curve was a correct one. Now all these actions have unintended consequences. One of the unintended consequences of course, was that risk premium and risk spreads were unduly compressed after so many years of easy money. You have emerging markets that were flooded with money looking for yields and, as you recall, when the Fed announced in May [2013] that they were going to start rolling back some of the extraordinary measures that they had instituted, there was a violent reaction.

Garten: Right.

Ortiz: Many emerging markets, which are more vulnerable in the sense that they have higher external finance needs, either capital account deficits, or financing needs coming from abroad, are the most exposed. When you look back at episodes of Fed tightening, they have always been somewhat dramatic or even very dramatic like in ’94, but the scale of the extension of balance sheets in central banks underneath and the eventual need for retrenchment is of precedent scale. So I think that we’re just beginning to see what its consequences are.
**Garten:** If you looked at this form the standpoint, not so much what is conventional and unconventional but what are the objective economic conditions and objective financial conditions that central banks are going to face? Very high debt levels in the U.S., very high debt levels in Europe and possibly -- I’m just saying “possibly” -- an inability of the fiscal authorities to deal with it, creates a different sort of objective situation that the central banks at least in the industrial economies are going to face than they faced in the past. Am I right? In other words –

**Ortiz:** Yeah. Of course that’s already happening. You see what the Fed is doing. The U.S. economy I think by far is the economy which has mended the fastest among the developed economies. As we mentioned before, the banking system in the U.S. has already healed. There has also been quite a lot of deleveraging in the household sector. This was a result of course by the very low levels of interest rates which helped the deleveraging process. The so called financial repression -- negative interest rates and real interest rates, and so forth. So I think that in the case of the U.S., despite the fact that the economy is performing better than in other places, the Fed has been taking pains to communicate that low interest rates will be present for a long time. I think that this is in a way the correct view from the U.S. standpoint. Now the
consequences of prolonging this process will be to encourage the action of risk taking in other markets and the possible creation of other bubbles, including emerging markets. And the adjustment process will be even more dramatic. It is difficult to win them all, you know?

_Garten:_ So let me ask you this. Maybe it’s slightly theoretical but I think it deals very much with what you’re talking about. If you were to look ahead, far enough ahead so that you don’t have to be constrained by today’s policies, decisions, or even 2014. Let’s say we’re talking five years or ten years. And if you yourself were asked to design a system, do you think it would be possible for central banks, especially the U.S. central bank, to operate on the basis that they take into account external effects much more than today? Because what you were just talking about is that the U.S. can do something which seems exactly right for America’s economy, but create bubbles elsewhere which ultimately come back to hurt us anyway given the interlinkages. Do you think there is a scenario where there is a level of international perspective on part of the major central banks, or do you think that the political reality will always be such that we will be living with the constraints that we have now?
Ortiz: Yeah. I think that the question can be answered on two levels. At the political level the Fed, given its mandate and given its legal framework, cannot say and will not say that it takes into account spillovers —

Garten: Right.

Ortiz: in its monetary policy decisions. The Fed’s actions, if you see all the communiques and everything, it’s always with the U.S. economy in mind. Now in the international forums for example, in Basel where all central banks meet, obviously central banks talk about spillovers all the time. There are discussions and I think that in practice in their deliberations -- maybe it’s not really reflected in the minutes -- although the spillover discussion sometimes comes out in the minutes of the Fed. They do take that into consideration. For example, if you look at what happened in May [2013] when they announced that tapering could begin in the next few meetings, and the reaction was violent. In the few days the long term rates went up in the U.S., close to 100 basis points and the rest of the world the same thing happened, particularly in the emerging markets, I think that the Fed was first surprised at the very violent reaction. And second, they tried to modify it in a way that, if you remember, several Fed governors, even the more hawkish ones,
went out of their way explaining that tapering or cutting tapering
was not the same as tightening monetary policies, that they were
two separate decisions.

Garten: Right.

Ortiz: The Feds had the view that what mattered were the stocks and not
the flows so as long as the balance sheet of the Fed was not
contracting this could not be construed as any form of tightening
but the market had a totally different view. So I think that this, in
practice, the Fed does take it into account but that it will never say
it in a communiqué and I think that the central banks much prefer
to discuss things among themselves than in other forums like the
G20. The degree of policy coordination during the crisis that I
talked about was decided in Basel. For example, the Fed opened a
window for European banks that had a dollar shortage. But for the
first time they opened this window to some emerging markets
including Mexico, Korea and if I recall correctly, Singapore the
other central banks. So that kind of cooperation was, I think, very
important and also unusual because the times were very critical.

Garten: So I’m trying to figure out whether it is your view that these
discussions that take place in Basel -- and I know that you were the
chairman of the BIS for a awhile so you certainly saw those discussions and participated in them from many angles -- but is there something of a trend here? If you were to look ahead a decade or so from now, do you see the cooperation among central banks getting tighter and tighter? Are we going to see a tighter relationship among central banks? As you say, regardless of what is said in the minutes, regardless of what the legal mandates are, but in fact, de facto, are we from the standpoint of central bank governance or central bank coordination, are we incrementally moving to a different and higher plane?

Ortiz: I think so, I think so. I think that there was always a G-something forum…

Garten: Right.

Ortiz: ...that operated during particular crisis times like the Louvre Accord or the Plaza Accord. Those instances of cooperation were when we were facing a crisis in a critical situation. I think what’s happening now is that the central banks have much more lines of communication open.

Garten: Okay.
Ortiz: And two, that given the growing importance of emerging markets, the dialog and cooperation with emerging markets with central banks is at an unprecedented level. It used to be the case that central banks of emerging market countries were not even invited to the table for the discussions. Now they are active participants. So I do not think that this will translate into a formal structure of cooperation. But I think that keeping open these lines of communication open and keeping the dialog open and the analysis, I think they are a very important input into this whole process. It’s trying to understand precisely what happened. Where did the central banks go right, where did they go wrong, how could they have managed better both a crisis and sort of recovery and I think that this is very important this understanding of things and the continuous dialog among central banks. So yes, I will see a path towards more communication, more cooperation, not necessarily in meetings. I think probably lead to an informed structure of cooperation.

Garten: Right. But would you say that informal structure, the consultation, the sharing on insights, the pooling of information that they see on the world economy, Basel is the center of that, right? If that’s where all this is going to happen, it’s not in some new forum, it’s
not heads of state getting together, it’s really in the Basel framework that we will see this defacto deepening of interaction. Is that what you’re saying?

*Ortiz:* Yeah, yeah, that’s exactly what I’m saying.

*Garten:* So let me ask you a final question. It has to do with what gives you looking ahead at the next decade, what makes you the most optimistic, on the one hand, about the ability of the financial system, not just to heal but to reach a higher level of skill in terms of managing stability and managing growth, and what worries you the most?

*Ortiz:* Well what makes me more optimistic I think is contrary to what appears, I think that central banks and monetary authorities in general can actually learn from their mistakes. Look for example at the emerging market world.

*Garten:* Yep.

*Ortiz:* It’s very interesting that none of the emerging markets that had a financial crisis in the ‘90’s, starting with Mexico in ’95 and then the Asian crisis in ’97, Thailand, Indonesia, Russia, Brazil, Turkey
and so, none of these countries actually suffered a domestic financial dislocation as a consequence of the global crisis. None of the emerging market banking systems got engaged in exotic products or anything so in the emerging market space, I think that central banks without naming it as such, they worried after their own domestic crisis on the issue of financial stability. For example in Mexico, we put in place a number of measures to insure, for example, that there were no currency mismatches, that there was adequate liquidity in the banking system, that there was sufficient capital -- and this was before the crisis. That’s why the financial system of emerging markets were able to withstand the crisis. Now, after what central banks have learned, the major central banks of the world, there are terrible consequences of this crisis, not only for the tax payer, for the destruction of economic activity, employment and so on and so forth, they will be much more focused on the issues of financial stability. This is why this discussion about the too big to fail, the capital ratios is going to be happening for a long, long time. I don’t think that we will conclude in any fashion. I think that the major banks have lobbied very, very intensely to reduce the capital burdens and so on, but I think that the authorities have decided to really plunge and make a much safer financial system. So in that reason I am optimistic. What worries me that the next crisis will not be the same one as the
one we had before. The authorities may be doing the right thing in regulations on the formal banking system, capital ratios and so on, but there’s a shadow banking system that is out there that the authorities know a lot less about. It is much less regulated. Take the case in China for example, the growth of the so called shadow banking system has been huge in the past few years. I worry about the non-regulated part of the banking system.

Garten: Well Dr. Ortiz, thank you so much. That was extremely interesting and I just want to say again what a privilege it is to have the chance to talk to you.

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