William J. McDonough

Opening Remarks

I am pleased to welcome you today to the Federal Reserve Bank of New York and to this conference on financial innovation and monetary transmission. The transmission of monetary policy is a topic of fundamental and perennial interest for central banks. We decided to hold this conference because we realized that we were accumulating interesting questions about the transmission mechanism in our daily work. For us at the Federal Reserve Bank of New York, that work includes participating in the formulation of monetary policy, executing monetary policy, and monitoring financial markets and the economy.

Some of our questions involve the response of sectors to monetary easing and tightening. Changes in mortgage markets and household wealth, for example, may have given housing a new resilience in the face of rising interest rates. Other questions center on the impact of structural changes in markets that are central to monetary operations: the federal funds and government securities markets. These changes include the long-run decline in reserve balances of U.S. depository institutions and, more recently, declines in the stock of U.S. Treasury securities. Yet a third group of questions concerns how rapid changes in the structure of the global financial industry affect the sensitivity of credit flows and liquidity creation to changes in monetary policy.

These questions—and others like them—are the subject matter of this conference. Besides monetary transmission, these questions all involve aspects of financial change. In addition to our conduct of open market operations, the Federal Reserve Bank of New York has a particular interest in the impact of financial innovation on monetary transmission because of the central role of New York City in the global financial system, especially as a pacesetter in the financial innovation process.

The topics of this conference also illustrate the close links between monetary policy and several other roles of the Federal Reserve. The Federal Reserve sets broad policy for the payments system and operates key parts of that system; it also supervises major banking institutions and key institutions in the market infrastructure. Finally, the Federal Reserve monitors markets, liquidity, and credit in order to safeguard the stability of the financial system. Here in New York, we assign great value to the interaction within the Bank among market specialists, economists, bank supervisors, and payments system staff. The sharing of information and ideas across the Bank assists us in understanding the environment in which we operate and the linkages between the activities we engage in, and insights we can gain in one field often help us in our other responsibilities.

At this Bank, we have a special interest in the first session of this conference, involving the market environment in which we execute open market operations. Our objective in monetary operations on a day-to-day basis is to achieve a federal funds rate close to the target established by the Federal Open Market Committee. Deviations from that target interest rate generally

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have been small, despite major changes in the composition of the Federal Reserve balance sheet over time, with continuing declines in commercial banks' balances held at the Federal Reserve and rapid growth in currency outstanding. I note with interest that the papers in the first session deal with several aspects of change affecting the federal funds market—from the response to policy announcements in the interbank market to the management of vault cash. The session ends with what should be a very interesting roundtable on the challenges facing our Open Market Desk today.

In the second session of the conference, we turn to familiar channels of monetary transmission—the direct macroeconomic effects of monetary policy on consumption and investment demand. The economy's favorable performance in the 1990s has highlighted a set of issues concerning the role of asset holdings and their valuation in consumption, residential housing, and the cost of capital to businesses. The deepening and broadening of financial markets over the course of the 1980s and 1990s raise the intriguing question of whether mature financial markets dampen or exacerbate economic cycles. This session also explores the extent to which the increased stability of the U.S. economy in the past fifteen years is a consequence of structural changes or appropriate policy decisions.

Of special importance to central banks and financial supervisors is the transmission of monetary policy through credit channels. I believe many of the most important questions on the transmission of monetary policy involve the shift of financial activity from larger financial institutions, especially banks, to broader—and global—markets. One consequence of this shift in activity is that financial institutions will adapt to and exploit opportunities in markets. Even as we see banks turning more to markets, however, very large banks appear to internalize some transactions, decreasing their reliance on markets.

These shifts may have potentially important consequences for monetary transmission. For example, the increasing use of securitization as an approach to managing risk and balance-sheet leverage in commercial lending activities may alter the sensitivity of the bank credit channel to changes in monetary policy. In addition, financial sector consolidation may provide the opportunity for banks to internalize activities such as liquidity provision and securities settlement, reducing their transactions in markets. Our experience here at the New York Fed suggests that banks and other financial institutions continue to influence the full range of credit channels, even as their traditional channels of influence appear—from a quantitative standpoint—to be waning. Thus, how commercial credit standards affect the availability of credit may have broad applicability to the investment- and speculative-grade bond markets. And as the Basel Committee on Banking Supervision, which I currently chair, completes its work on new capital standards, we want to understand the ramifications that the new standards may have for the liquidity and depth of markets, as well as for the pricing and availability of bank credit.

This conference should help this Bank in several ways. First, in the near term, we expect that the substantial body of work carried out for these sessions will provide new insights into aspects of the transmission mechanism while corroborating our current understanding of others. We are seeking to stimulate research in this area, and I am pleased to see the large number of contributions from Federal Reserve and other central bank economists. I am especially pleased to see collaboration between central banks, and between academic economists and central bankers.

Second, as an institution engaged in policy implementation, we hope that the papers presented and their discussion will lead us to new approaches to monitoring the economy and the financial markets. We, and the Federal Reserve more broadly, have benefited from a variety of useful analytical tools and empirical measures that had their origins in the research efforts of economists. The Taylor rule for evaluating the stance of monetary policy, the derivation of recession probabilities from yield curves, and the estimation of potential growth rates all rely on techniques first developed in research by academic and nonacademic economists. The occasion of this conference provides us with the opportunity to review the techniques we use to monitor and interpret economic and financial developments, and to identify areas where new techniques are available and areas where new techniques are needed to enhance our work in the future.

A third goal of this conference has a longer horizon: to stimulate additional research on monetary transmission beyond the work presented here. Despite the very full agenda of this conference, we could not address every important topic. Let me mention two areas of particular interest to us as central bankers. The first is the international transmission of monetary policy. For many of us, we learned that the international transmission of monetary policy occurs through mechanisms meant to achieve interest rate parity or purchasing power parity across borders in the medium term. The developments of the 1990s, however, have highlighted the role of international credit channels, as we saw in Asia. The major redirection of capital flows in the aftermath of the Asian and Russian crises—much of the redirection ultimately into the United States—has made us wonder whether we underestimate the impact of capital flows on large economies like our own. The surge in global flows of portfolio equity and direct investments in the 1990s also suggests that differentials across borders in the rates of return on financial equity and real capital are probably drivers of international capital flows that are as important as interest rates.

The second area of interest is more prospective, but no less important. Even as the marketplace is developing a more sober assessment of the prospects for Internet and related technologies, there is no question about the transforming nature of these technological advances. We are already seeing dramatic changes in trading markets as a result of electronic brokerage as well as the growing use of electronic auctions and central limit-order books in segments of the financial markets.

Internet and related technologies are just beginning to have an impact on one of the most basic roles of money: as a medium of exchange. Changes in the payments arena include potential reductions in transactions costs and operational and counterparty risks through increased netting and straight-through processing of transactions. Among the most far-reaching ideas, some designers of electronic exchanges for goods and services are considering approaches to settling transactions that look more like securities settlement than today's invoice for goods and services and payment by check. Although the implications for monetary policy of such a transformation of "money" are far from clear, these developments require the Federal Reserve to be at the forefront of research on these issues. We are gratified to see that the academic community has already begun to turn its attention to these very important questions.

I welcome you again to New York, and I thank you for participating in what I know will be a highly productive conference.