

“Macro-Prudential Policies: Asian Perspectives”

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Roundtable: The Changing Role of the Central Bank¹

The recent global financial crisis represented the most profound challenge to central banks since the Great Depression. Faced with unprecedented financial stresses and sharp contractions in economic activity, many central banks responded with extraordinary measures. The focus has now shifted to recasting the mandates, instruments, and analytical frameworks of central banks to prevent future crises.

What are the key aspects of central banking that proved to be strengths during the crisis and how can these be maintained and protected?

The financial crisis confronted central banks around the world with severe disruption of financial markets, a rapid deterioration in economic activity and prospects, strong shifts in capital flows, and sharp declines in commodity prices. This disruption stemmed in large part from important macroeconomic circumstances, including a period of exceptionally low interest rates, rapid and unsustainable asset price and loan growth, and significant external payments imbalances.

To meet the immediate priority of shoring up financial markets, central banks provided large amounts of liquidity, including by modifying liquidity provision arrangements to better meet exceptional needs and/or establishing new facilities to alleviate liquidity shortfalls in specific markets. Such measures demonstrated the considerable flexibility of central banks and their legal frameworks in exceptional and exigent circumstances.

Central banks also took extraordinary measures to ease monetary policy. In most countries policy interest rates were cut rapidly to unprecedentedly low levels. And as interest rates were taken to their zero bound, many countries undertook unconventional monetary operations in order to avoid damaging declines in aggregate demand.

In several countries, including much of Asia, central banks also faced the challenge of coping with large capital flows. Central banks used a variety of tools to limit the impact on exchange

¹ This section draws extensively on IMF, 2010, *Central Banking Lessons from the Crisis* (<http://www.imf.org/external/np/pp/eng/2010/052710.pdf>), Erlend Nier, 2010, “Financial Stability Frameworks and the Role of Central Banks: Lessons from the Crisis,” *IMF Working Paper 09/70* (<http://www.imf.org/external/pubs/ft/wp/2009/wp0970.pdf>), and IMF, 2010, *Exiting from Monetary Crisis Intervention Measures* (link: <http://www.imf.org/external/np/pp/eng/2010/012510.pdf>).

rates and domestic financial systems, including large-scale foreign exchange market intervention, foreign exchange liquidity support, and regulatory measures.

Despite the massive easing of monetary policy stances and, in some cases, large movements in exchange rates, inflation expectations remained remarkably stable in most economies. This reflects the success of the extraordinary easing measures to leverage the expectations channel as well as the credibility of commitments to price stability that central banks have built over the past two decades. This credibility allowed central banks to respond forcefully to the near-term exigencies posed by the financial crisis and the slump in activity, without undermining public confidence in the commitment to longer-term inflation objectives.

Looking forward, central banks face a number of challenges:

- Monetary policy frameworks will need to be modified. The crisis revealed important shortcomings in the way in which central banks take financial developments and vulnerabilities into account in setting interest rate and other policies. Concomitantly, it has also become clear that there is more work needed in building an analytical framework to support a macro-financial focus for policy, including better bases for monitoring and analyzing the role of financial systems in the transmission mechanism.
- The crisis also underscored the challenges posed both for monetary policy and for financial stability of large capital flows and large external imbalances. Central banks, especially in countries that expect to continue to receive large capital inflows will need to consider how to manage or contain such flows, and the associated exchange rate movements and financial stability risks, in a manner consistent with their other policy objectives.
- In some countries, government deficits and debt have ballooned in the wake of the crisis. Fiscal consolidation in some countries will be a challenge for monetary policy given the limited room currently available for monetary policy to provide offsetting support for economic activity, and because unsustainable fiscal positions could put at risk the credibility of monetary policies.
- Many central banks also are now being asked to take a more explicit responsibility for systemic stability. Although many central banks had already established financial stability departments to monitor and evaluate financial system risks, there remains the need to define more clearly frameworks for financial stability and how these might be integrated into more conventional central banking responsibilities.
- Monetary operational frameworks will also need to be reconsidered in light of the crisis experience to put in place sounder frameworks, for normal operations as well as for exceptional or crisis situations, specifying more clearly the objectives of

operations, the range of instruments, as well as institutional and legal arrangements, taking account of both the lessons of the crisis and the rapid pace with financial market innovation, especially the growing systemic importance of the nonbank sector.

How to ensure that monetary policy fosters both price stability and financial stability in the long-term?

The crisis has not overturned the widely accepted view that monetary policy should continue to focus on price stability as its primary responsibility. Moreover, some fear that adding an explicit financial stability objective to the monetary policy mandate could undermine the central bank's credibility and accountability, especially in the absence of additional macro-prudential instruments. Nonetheless, there is a recognition that monetary policy needs to pay greater attention to financial developments and risks, especially in cases where the effectiveness of macro-prudential policies has reached their limit. It is also clear that central banks have in the past used monetary policy tools on specific occasions to maintain financial stability, and this is likely to happen again in the future.

This will require strengthening the capacity of central banks to monitor and analyze macro-prudential imbalances and risks, and possibly expanding the range of indicators that feed into policy decision making to include asset prices, loan growth, etc. There have been suggestions that the policy horizon for achieving the inflation objective could be lengthened to facilitate taking financial stability concerns into account. However, in adopting this approach care would be needed to avoid persistent deviations of inflation that would dilute policy accountability and fuel uncertainty about the long-term commitment to price stability.

What is an adequate framework for independence and accountability?

Arrangements need to take into account of the existing institutional setup. If both monetary policy and prudential policies are conducted by the central bank, dedicated governance arrangements are needed to ensure monetary policy independence. Where monetary policy is institutionally separate from prudential regulation or supervision, more complex institutional arrangements will be needed need to ensure that the central bank works with and has an appropriate degree of influence over policies conducted by other agencies, to ensure that the agencies involved avoid conflicting policy actions and that systemic stability is appropriately accounted for. In some countries, this has led to the establishment of financial stability oversight committees that bring together relevant agencies, and the challenge will be to ensure these are equipped to take timely action in response to emerging vulnerabilities.

Is the crisis is likely to change the way that central banks manage market liquidity?

Although the core elements of pre-crisis operational frameworks should be preserved, during the crisis, some aspects of liquidity provision proved to be too rigid to address problems in specific markets and institutions. Liquidity management frameworks can be made more

flexible and broadened to increase the crisis options available to central banks. These could include higher reserve requirements, a broader range of counterparties, modifications to collateral requirements, measures to reduce the stigma attached to borrowing, and additional liquidity absorbing tools.

What are the implications for the transmission mechanism and the role of the central bank?

Central banks need to better understand macro-financial interactions, and build the key features of these interactions into their standard analytical and forecasting frameworks for monetary policy. For example, it will be important to understand better how transmission mechanisms are affected by financial innovation—the growth of the shadow banking sector—and how they can be disrupted in the face of tail or near-tail events. Similarly, it will be important to understand how macro-prudential tools and changes in regulation will affect financial market behavior.

What do central banks need to do to prepare themselves for the role of systemic risk overseers?

Central banks will need to play a leading role in the development of macro-prudential policy frameworks to help address different types of systemic risks. This will involve developing: appropriate institutional frameworks; communications strategies; monitoring systems; and policy tools.

Issues for discussion:

- *Macro-prudential analysis.* How should central banks modify their organizational and decision-making structures, information gathering, research, and analysis to more effectively monitor and assess systemic financial risks? What tools are needed to enhancing the understanding and measurement of systemic risk, detecting its build-up at aggregate and disaggregated levels? What obstacles are in the way of developing indicators that could be used for the application of macro-prudential tools?
- *Monetary policy.* Should monetary policy respond routinely to indicators of financial imbalances such as excessive growth money or credit growth or rapid increases in house prices over and above the implications for inflation and growth? If so, should responses be rules-based (i.e., based on well-defined targets and triggers) or simply taken on a discretionary basis? Should monetary policy horizons be lengthened to enable taking financial stability needs into account? How can the risk of overburdening monetary policy with too many objectives be minimized?
- *Institutional arrangements.* What are the main elements required to effectively coordinate monetary and macro-prudential policy analysis and decision-making?

Would it be better to house macro-prudential supervision within the central bank or establish a separate entity? What legal and accountability arrangements are needed for effective macro-prudential policymaking?

- *Monetary operations.* What have we learned from the crisis about the need to broaden monetary instruments and operations to handle crises? How should lender of last resort and resolution mechanisms be modified? To what extent will mechanisms and instrument for cross-border cooperation need to be improved?