

Macro-Prudential Policies: Asian Perspectives
Shanghai, China, October 18, 2010

Session IV: The Changing role of the central bank

The roundtable focused on the role of the central banks in the aftermath of the crisis. The issues that received particular attention included aspects of central banking that proved to be strengths during the crisis and the need for recasting of mandates and operational frameworks to better address systemic risks.

The participants noted that the provision of 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, demonstrated the flexibility of central banks and their legal frameworks in exceptional circumstances.

It was noted that despite the massive easing of monetary policy stances and, in some cases, large movements in exchange rates, inflation expectations remained stable in most advanced economies. The participants emphasized the credibility that the central banks have built over the past two decades allowed them to respond forcefully to the near-term challenges posed by the financial crisis and the slump in activity, without undermining public confidence in the commitment to longer-term inflation objectives (although this is seen as a limitation for some EM countries as they have not yet established the same degree of credibility). In this context, the participants noted the importance of preserving the independence of central banks, in particular in terms of conducting their price stability mandate. It was also noted that 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.

Participants agreed that dedicated governance arrangements are needed to ensure monetary policy independence. The key challenge will be to balance this with the macro-prudential mandate which cannot be conducted in an independent manner (due to potential implications of financial instability for public purse). Where monetary policy is institutionally separate from prudential regulation or supervision, more complex institutional arrangements will be needed 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. It was noted that 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. It was stressed that the central bank should have a lead role given its institutional strength, credibility, human capital and the continuity over political cycles.

Going forward, the participants agreed that monetary policy frameworks will need to be modified to take into account financial developments and vulnerabilities in setting interest rates and other policies. The lack of analytical frameworks to support a macro-financial focus for policy—including better bases for monitoring and analyzing the role of financial systems in the transmission mechanism, measurement of systemic risks and stress tests—was seen as an important impediment. However, it was stressed that shortcuts and rules of thumb need to be applied in the interim as models are developed.

Some participants raised concerns regarding an explicit financial stability objective in addition to the monetary policy mandate as this could undermine the central bank's credibility and independence, especially in the absence of additional macro-prudential instruments. They also indicated that central banks have in the past used monetary policy tools on specific occasions to maintain financial stability. In this context, they emphasized the need for strengthening the capacity of central banks to monitor and analyze macro-financial imbalances and risks, and possibly expanding the range of indicators that feed into policy decision making to include asset prices and loan growth.

The specific challenges for Asian countries were discussed. A distinctive feature of the Asian, and in particular, the Japanese financial system, is that bank lending plays a dominant role in financial intermediation. It was stressed that the real economy could be adversely affected if the risk-taking capacity of the banking sector is seriously damaged. In this context, during the recent crisis, the Japanese authorities reintroduced the stock purchasing program (first implemented in 2002) and adopted a facility to provide subordinated loans to banks as temporary counter-cyclical measures. The Bank of Japan has an explicit financial stability mandate.

It was also noted that although prudential supervision is conducted by the Japanese FSA, Bank of Japan continues to conduct on-site examination and off-site monitoring over a wide range of individual financial institutions, including securities firms. The off-site monitoring pays particular attention to liquidity risks, including daily assessment of the liquidity position of individual institutions. It was stressed that quarterly-disclosed balance sheet figures are not sufficient for effective monitoring and that the information obtained through the Bank of Japan's on-site examination and off-site monitoring has enabled the Bank to respond quickly to the liquidity drain in the recent crisis.

It was suggested that the policy horizon for achieving the inflation objective should be lengthened to facilitate taking financial stability concerns into account. However, several participants noted that persistent deviations of inflation should be avoided as this would dilute policy accountability and fuel uncertainty about the long-term commitment to price stability.

The discussion then focused on the aspects of liquidity provision by central banks to address problems in specific markets and institutions. The experiences of several countries to make liquidity management frameworks more flexible and broader to increase the crisis options were discussed. The measures used included 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.

The participants stressed the 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. In particular, there is a need to analyze transmission mechanisms and their effects on financial innovation, including the growth of the shadow banking sector.

Empirical analysis for Korea was presented showing the growth of non-core liabilities by the financial sector under an interest-rate oriented monetary policy framework. This induced massive interbank transactions raising financial stability issues. The policy conclusion was that the central bank needs to take into account the endogeneity of asset prices and credit cycles when formulating its monetary policy.

The challenges of low interest rates and unconventional monetary operations conducted by most of the advanced country central banks in terms of large capital inflows to many EM countries, especially in Asia, were also discussed. Central banks are using a variety of tools to limit the impact on exchange rates and domestic financial systems, including large-scale foreign exchange market intervention, foreign exchange liquidity support, and regulatory measures. The key concern in the medium term is the potential reversal of flows as expansionary policies are phased out. The long-term concern is the ability of EM countries to continue to attract capital flows due to potential crowding-out by MM countries with high public debt.

The Korean experience in mitigating capital flow volatility was presented—widening the inflation target band from 3% +/- 0.5% to 3% +/- 1%; strengthening foreign currency liquidity ratio requirement; increasing the eligible liquid asset requirement; limits on net fx derivatives positions of banks and caps on fx bank loans.

The need for greater international cooperation among central banks and governments was emphasized to address the challenges posed by global imbalances.

Finally, it was noted that the global regulatory framework should have sufficient flexibility to allow for regional and functional heterogeneity. There was a call for balancing rules versus discretion in financial regulation and making full use of the Pillar II of Basel Accord.

The use of prudential liquidity policy as a macro-prudential tool—liquid asset ratio and core funding ratio to raise bank cost of funds relative to money market rates at the same time as reducing the reliance of banks on volatile short term wholesale funding sources. It was noted that this can shift monetary policy pressure towards domestic demand, away from the traded goods sector, by reducing carry trade pressure on the exchange rate.