Redefining Central Banking

Central banks must distill lessons from the global crisis and make concrete reforms

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CENTRAL banks have been at the heart of the global financial crisis. They have been blamed for policies and actions that got the world into the crisis; they have been praised for leading the world out of it. Both are fair assessments. Central banks have been a part of the problem and a part of the solution.

As the crisis unwinds and recovery takes hold, central banks face a number of issues, of which I will address five.

Monetary policy in a globalizing environment

The crisis has demonstrated the difficulties of macroeconomic management in a globalizing world. Even as governments and central banks acted with an unusual show of policy force, they were unable to get the situation under control because of the interconnectedness of the financial system and the effects, positive and negative, of external developments on domestic policy actions. Most important, they found that sentiment and confidence were remarkably correlated across countries.

External developments interact with the domestic economy in complex, uncertain, and even capricious ways. Central banks have to deepen their understanding of these interactions. Some of the channels through which cross-border transmission occurs are quite familiar—global prices, including commodity price movements; synchronization of business cycles; capital flows; strong comovement of asset prices; exchange rates of key international currencies; and interest rate policies of major central banks. Some of the transmission channels are less familiar. For example, the crisis has shown that even differences in regulatory regimes can trigger arbitrage-based action and dilute the efficiency of domestic policies.

Take managing capital flows. Emerging market economies experienced a sudden stop in capital inflows during the crisis as well as capital outflows—the result of global deleveraging. Now the situation has reversed and many emerging market economies again have net inflows. Managing these flows, especially if they are volatile, will test the effectiveness of central bank policies in semi-open emerging market economies. A country whose central bank does not intervene in the foreign exchange market will incur the cost of currency appreciation unrelated to fundamentals. If central banks intervene to prevent appreciation, they will have to contend with additional liquidity and potential inflation pressures. If they sterilize (soak up) the resulting liquidity, they run the risk of driving up interest rates, which would hurt growth prospects.

Volatility in capital flows could also impair financial stability. How emerging market economies manage the impossible trinity of an open capital account, a fixed exchange rate, and an independent monetary policy will affect their prospects for growth and price and financial stability.

Redefining the mandate of central banks

The crisis has triggered vigorous and wide-ranging debate on the role and responsibilities of central banks and raises three big questions:

Should central banks persist with inflation targeting? In the years before the crisis there was a powerful intellectual consensus in favor of inflation targeting—that is, basing monetary policy on achieving a target inflation rate, usually consumer prices. Even where central banks did not target a precise inflation rate, their policy objectives were informed, if not dominated, by price stability. This approach seemed successful. There was an extended period of price stability accompanied by stable growth and low unemployment. In the world before the crisis, central bankers were a triumphant lot. The unraveling of the Great Moderation has diluted, if not dissolved, the consensus around solely targeting inflation. The mainstream view before the crisis was that price stability and financial stability reinforce each other. The crisis has proved that wrong: price stability does not necessarily ensure financial stability. The crisis has given fresh impetus to the "new environment hypothesis" that pure inflation targeting is inadvisable and that the mandate of central banks should extend beyond price stability to include bank regulation and supervision, financial stability, and preventing asset price bubbles.

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What is the role of central banks in preventing asset price bubbles? The emerging view is that preventing an asset price buildup should be within the purview of a central bank. Opinion is divided, however, on whether central banks should prevent asset bubbles through monetary policy action or through regulatory action. What is indisputable, though, is that central banks' efforts to check asset price bubbles demand not just analytical capability but mature judgment of the nature of the risk.

Should central banks also engage in bank regulation and supervision? In many regulatory models the central bank is purely a monetary authority, with bank regulation and supervision vested in another agency. The emerging view is that the crisis was caused, at least in part, by a lack of coordination and communication between central banks and supervisors and, in the interest of financial stability, it is optimal to entrust regulation and supervision of banks to central banks. Admittedly, this is not a settled issue. There is no one-size-fits-all answer, as is clear from the variety of regulatory models around. Each country and each central bank will have to resolve this issue according to its specific circumstances.

Central banks and financial stability

While there is broad agreement that financial stability is neither automatic nor inevitable, there is less agreement on whether it should be explicitly included in the mandate of central banks. One argument is that explicit inclusion would be redundant, because financial stability is a necessary—although not sufficient—condition for achieving the conventional central bank objectives relating to inflation, output, and employment. On the other hand, there is a growing view that unless financial stability is explicitly included in the mandate of central banks, it is likely to fall through the cracks.

Complicating matters, defining financial stability in a precise, comprehensive, and measurable manner is proving to be difficult. Nevertheless, we now know that there are two attributes of financial instability:

- excessive volatility of macro variables such as interest rates and exchange rates that have a direct impact on the real economy; and
- financial institutions and markets threatened by illiquidity to the extent of jeopardizing systemic stability.

Do central banks have the instruments to address the mandate of financial stability? One clear instrument for preserving financial stability is the lender-of-last-resort function. During the crisis, central banks pumped in enormous amounts of liquidity to unfreeze the system through the lender-of-last-resort window. While this made individual institutions liquid, the market remained illiquid, thereby revealing the limitation of the window instrument in combating illiquidity. A central bank can infuse liquidity, but it's hard to ensure that the available cheap and abundant money is used to purchase assets whose value is rapidly eroding. The only option may be for the central bank to buy the assets. This means that the central bank must be not only the lender but also the market maker of last resort. These issues have yet to be clearly defined, let alone resolved. But they must be resolved soon.

Managing the costs and benefits of regulation

To safeguard financial stability, the Reserve Bank of India used a variety of prudential measures, including specification of exposure norms and preemptive tightening of the risk weights attached to assets and the requirements for loss provisioning. But these measures often carry a cost. For instance, tightening risk weights arguably tempers the flow of credit to certain sectors, but excessive, premature, or unnecessary tightening can blunt growth. Similarly, exposure norms offer protection against concentration risks; however, such limits can restrict the availability of credit for important growth sectors. Thus, as in the case of price stability, central banks face the challenge of managing the trade-off between financial stability and growth.

After a crisis, with the benefit of hindsight, all conservative policies appear safe. But excessive conservatism can thwart growth and stifle innovation. The question is, what price are we willing to pay, or—conversely—what potential benefits are we willing to give up, to cope with the unexpected, a black swan event? Experience shows that balancing the costs and benefits of regulation is more a question of good judgment than analytical skill. Central banks, especially those of developing countries, such as India, need to hone their judgment skills as they pursue growth and financial stability.

Autonomy versus accountability

During the crisis, governments and central banks coordinated their efforts to launch unprecedented expansionary fiscal and monetary policies. As countries contemplate exiting these expansionary policies, the familiar tensions between monetary and fiscal policies are showing up again. And a possible return of fiscal dominance could undermine the independence of central banks.

Responsibility for financial stability must be shared by the government, the central bank, and other regulators. Although that shared responsibility is not in itself a problem, there are two related concerns. The first is that the rescue of financial institutions is an inherently political act, and involvement in such decisions may compromise central banks' technocratic credentials. The second concern is the risk that coordination with the government for the purpose of financial stability may spill over into other areas within central banks' purview, thereby undermining their independence.

The case for central bank independence is coming under increasing assault as a result of crisis-spawned developments. Central banks must advocate for independence not with weighty arguments but through more vigorous and voluntary efforts to be transparent, responsive, and accountable.

This list of issues addressed here is by no means exhaustive, nor have all the nuances been considered. But central banks must gain a better understanding of how to begin tackling these issues, and on that basis adapt and change the way they function. ■

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