Foreword

The unprecedented integration of domestic and international financial markets in recent years has brought about sharply increased market-driven flows of capital across national borders. In my view, it is difficult to escape the conclusion that these flows have boosted economic growth and prosperity. Yet at the same time, financial globalization has complicated the role of central banks and created new challenges in two broad areas.

The first set of challenges has to do with the choice of the exchange rate and monetary regime. When floating the exchange rate, an alternative monetary policy framework might not be so straightforward, especially for countries not yet ready to move to full-fledged inflation targeting. Partial dollarization can make the conduct of monetary policy even more difficult. Monetary unions could gain in popularity, yet they pose their own set of practical difficulties.

Financial globalization also carries a higher risk of financial instability, as can be seen from the increased frequency and severity of recent crises. This raises a second set of policy challenges. While price stability remains the primary objective of monetary policy, central bankers must increasingly pay due regard to both financial stability considerations as well as interaction with international developments in pursuing their monetary policy objectives.

We at the IMF have been working with national authorities and through various international forums. We promote appropriate monetary policy and financial stability policy frameworks that will effectively meet the challenges of globalization. Let me highlight some specific challenges.

The increased incidence of crises in the era of financial globalization forces us to ask ourselves: Should financial stability be an explicit central bank objective? Financial stability looms large in policy formulation—not just during a crisis, but also under normal circumstances owing to balance sheet sensitivities. A key problem is how the central bank should conduct policy in support of financial stability without impairing price stability. A very practical institutional question follows. Should banks be supervised by a specialized agency or by the central bank, and what is the role of the central bank in maintaining systemic financial stability in addition to achieving monetary stability? This raises a knotty question on the degree of clarity of financial stability considerations in the context of a highly transparent commitment to a nominal anchor.

The increase in crises prompted by financial globalization has led central banks to regularly utilize Financial Soundness Indicators (FSIs) to assess financial stability. The IMF and the World Bank have been working to develop and disseminate indicators of financial vulnerability, including through the Financial Sector Assessment Program. Some central banks have taken this a step further: they publish regular financial stability reports based on innovative in-depth analysis of financial vulnerability. Benefiting from this experience, now is a good time to ask which FSIs are the most useful. How should they be used and analyzed in coordination with other surveillance tools, such as stress testing and standards assessments? And ultimately, what should the central bank do when indicators signal potential problems?

Historical experience shows that financial crises are here to stay; and as many of you know only too well, dealing with unfolding crises in real time poses perhaps the most demanding—and certainly the most stressful—challenge to any central banker. The complication for monetary policy is that various behavioral relationships are unstable during crisis; moreover, price and financial stability objectives may conflict with each other. Price stability might require monetary tightening, but, at the same time, higher interest rates may severely affect the soundness of the financial system and corporations. Central banks cannot avoid this policy dilemma. They must decide under what circumstances to take the lead during a crisis, and what their role should be. In particular, should possible crisis measures be formalized ahead of time in a contingency plan? Also, to what extent should policy be transparent in times of crisis?

The surge in the volume of external financing prompted by financial globalization has ratcheted up the importance of effective public debt and reserve management. Experience has shown that public debt and reserve management not only enhances monetary policy but improves financial stability. The IMF and the World Bank have developed guidelines to assist policymakers in considering reforms to strengthen the quality of their public debt management and to reduce their countries' vulnerability to international financial shocks. Public debt is best managed by a single agency, which requires choosing the central bank, the ministry of finance, or a separate agency to take the lead in managing government debt. Experience has also demonstrated that monetary policy and debt and reserve management need to be carefully coordinated. This poses political and operational challenges. When the central bank takes the lead, potential conflicts may arise between its debt/reserve management role and monetary policy.

Financial globalization can also greatly complicate monetary policy for emerging market countries by helping preclude their full commitment to a single nominal anchor. Many emerging market countries with open capital accounts choose not to adopt a fixed exchange rate owing to its vulnerability to speculative attack. Monetary targeting as a policy framework has in many cases ceased to be viable due to unstable money demand. At the same time, they cannot commit to full-fledged inflation targeting because of relatively weak fiscal positions and insufficiently developed financial systems. Therefore, they resort to a form of discretionary monetary policy, which varies in degrees of public commitment to announced inflation objectives. This type of monetary policy framework, which does not fit into the standard classifications, deserves to be analyzed and understood. The challenge for the central bank facing these realities is how to conduct an effective monetary policy without a single anchor and with limited options for monetary targets and instruments. To what degree should the central bank be transparent in its objectives and operations? Should a central bank with sufficient credibility announce ahead of time its intention to adopt either an inflation target or an exchange rate target?

Financial globalization is leading to increased interest in regional monetary arrangements among industrial and developing countries. A monetary union can be attractive if it reduces member countries' vulnerability to worldwide economic shocks. However, the convergence criteria in the creation of a regional arrangement present important challenges. Further, central banks face very real limitations in their ability to integrate institutional arrangements across countries.

Financial and macroeconomic instability has led to the partial dollarization of many national financial systems. Central banks must deal with the problems posed by dollarization, even after macroeconomic stability is entrenched, because dollarization has proven to be extremely difficult to reverse. In particular, how can the central bank conduct an effective monetary policy when the domestic currency is not used for many (or even most) transactions? How does dollarization alter systemic financial risks?

Central bank governors and senior officials from over 45 countries attended the IMF's ninth conference on central banking in September 2002. Over two lively days, this distinguished group exchanged insights and perspectives. This collection of papers from that conference extends the sharing of experiences and provides new grist for analysis and debate. We are strongly indebted to these authors for sharing their expertise and experiences and, ultimately, for helping us learn how to benefit from globalization while managing and containing its costs.

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Preface

This volume is a collection of papers from the IMF's ninth central banking conference. Since 1983, these conferences have provided a forum for wide-ranging discussions among speakers, participants, and IMF staff on the evolving role of central banks. The conferences tackle emerging policy priorities for central bank practitioners. The objective is not necessarily to reach definitive conclusions or arrive at a consensus view, but to identify and improve our understanding of the topics of current debate and, ultimately, to improve policy effectiveness.

The focus of these conferences has shifted over time. In 1990, the conference took place during a period of unprecedented change in the world economic and political order. Attention was focused on central banks' roles as countries moved to market-based economic systems. Practical examples and guidance were provided on issues such as central bank legislation and central bank independence, measures to move from direct to market-based monetary policy instruments, and supporting the development of financial markets.

With many countries laying the groundwork for institutional changes in central banking, our 1994 conference focused on monetary policy frameworks to achieve monetary stability. The relevance of that topic arose not only from inflation rates in the three-digit range for many transition economies in the early 1990s but, more generally, the less-favorable inflation record in emerging and developing countries compared with industrial countries. The conference stressed the importance of a nominal anchor for monetary policy. It discussed the role that exchange rate pegs and currency boards could play in monetary stabilization. It also reiterated the importance of de facto central bank independence to protect its decision-making process from being dominated by fiscal concerns.

In light of rising globalization and increased incidences of financial crises, our conferences in 1997 and 2000 were devoted to the importance of strong, well-regulated financial sectors to cope with capital flows. Mexico and Sweden provided valuable case studies in how to deal with banking crises, many of which were unfortunately still to come. Since I attended the 1997 conference in my capacity as the deputy governor of the Bank of Sweden, I remember well the widespread interest among central bankers and the IMF on how Sweden dealt with its banking crisis.

Since then, many countries have considerably strengthened their regulatory and supervisory frameworks, and international best practices are increasingly being observed. Yet financial crises have hardly disappeared. The second day of the 2002 conference was thus devoted to the complex role of central banks in monitoring the stability of the financial systems, taking financial stability considerations into account when making monetary policy decisions, and responding in a time of crisis. In his foreword, Mr. Aninat has already provided a flavor of the many challenges and questions that central banks face in that respect.

Like many countries, the Monetary and Financial Systems Department in the IMF is grappling with the policy challenges posed by financial globalization. We have been asked to take on a new role of helping countries weather financial crises through the joint World Bank–IMF Financial Sector Assessment Program (FSAP). Our intensive work on FSAPs is moving us even closer to the cutting edge of policy on financial globalization.

At the same time, our traditional role of technical assistance to central banking is as prominent as ever. We find that financial globalization is leading to requests for assistance on new policy issues, such as the adoption of inflation targeting by emerging market countries. The challenges posed by partial dollarization are another area in which we are receiving new requests for assistance. A third example is strengthening frameworks for public debt management, for which the IMF and World Bank recently developed joint guidelines. The first day of the conference addressed these issues, sharing country experiences and perspectives.

This volume could not have been possible without the contributions of many people. I would like to express my greatest appreciation to Piero Ugolini, Mark Stone, and Andrea Schaechter for organizing this conference with excellent support from Zaynab Shatila, Graciela Argerich, Olga Penova, and Margaret Saliba from the IMF Institute. Sheldon Annis of the External Relations Department edited this volume and oversaw its production. Research assistance was provided by Sandra Marcelino. Secretarial assistance was ably provided by Patricia Mendoza. Above all, I wish to thank the contributors and distinguished experts whose experience, ideas, and comments brought this volume to life.

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