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The Future of Central Banking under Post-Crisis Mandates
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I. Introduction

Most central Banks have as its main objective the preservation of monetary or price stability and the promotion of financial stability. However, the crisis has raised many questions on the role of central banks in the latter; that is, in the prevention or mitigation of financial crisis – and also its role in crisis resolutions.

The scale of the current crisis -probably the gravest financial crisis of all times, have obliged many central banks in the developed world to engage in a wide variety of actions aiming at restoring the confidence in the financial system and normalizing the functions of financial markets. These leading central banks have used an unprecedented amount of resources and tools that would have been considered unthinkable before the crisis erupted.

The outbreak of the crisis itself, the role that some central banks may have played in the generation of the crisis – by action or omission – and the measures taken have been the subject of enormous controversy. This controversy is unlikely to be resolved any time soon. It is already the subject of academic research and public discussion and it will remain so for some time.

As it is normally the case during financial crisis, the political and legislative bodies of the countries involved in the disaster actively participate in the public debate. These discussions usually end up having powerful implications for the formulation of economic policies. This is particularly true in the area of financial regulation and the role of central banks which is being shaped as we speak.

The controversy surrounding the past and the future role of Central Banks in emerging markets is far less heated and polemical. This is understandable since the epicenter of the crisis took place in the core of the financial system. Emerging markets (except for the Balkans and some countries in Central Europe) were not dislocated by the global crisis. This fact is in itself remarkable, since financial instability has been associated mostly with Emerging Markets during the last two decades (Rainhard and Rogoff).

Domestic financial systems in EM proved to be quite resilient to the global turmoil. The reasons behind this resiliency are – in my view - relevant for the more general discussion of the future role of central banks in crisis prevention and resolution, and more specifically, to the issue of establishing macro prudential frameworks. It is also relevant for the discussion on financial regulation, cross border issues and international cooperation.

In what follows, I will make some brief remarks on the following three points:

- The Evolving Role of Central Banks;
- Central Banks and the Crisis. The Experience of Emerging Markets:
- Some issues on Financial Regulation.

II. The Evolving Role of Central Banks

The role of central banks has changed significantly during the last decades. These changes have often been the response to severe crises or persistent policy problems.

Key changes in central banks include: the diffusion of different forms of independence and the narrowing of their objectives. Credibility needs independence. There are well known advantages of providing autonomy to central banks. The most important one is the greater capacity of autonomous central banks to achieve its objectives when they are free from political pressures.

Before the 20th century, central banks followed several objectives. Many central banks were founded in efforts to restore monetary stability and the credibility of the banknotes after periods of over issuance usually to finance wars and the collapse of convertibility to gold.

In Mexico one of the first tasks assigned to the central bank after its creation in 1925 was to restore the use of a single currency after the Mexican Revolution. Other functions that central banks

adopted with time were those of lender of last resort, banking supervisor and promoter of economic development. In order to aid economic development, some central banks began to subsidize the financing of economic sectors deemed strategic for a rapid industrialization (e.g.: Banco de México).

In recent decades, the direction of central banking contrasts with the experience of the early years. For monetary policy objectives, the trend has generally been narrowing towards a single or dominant goal: price stability. The other goals of preserving a well-functioning payment system or a healthy financial system have been implicitly considered by many central banks.

The consensus was that central banks did not have to play a major role regarding issues related to the financial sector. Their role was to keep inflation under control. The current crisis challenged this view.

Financial stability is a basic requirement for the right functioning of the transmission mechanism through which monetary policy accomplishes its objectives. In the same way, macroeconomic stability is a prerequisite for financial stability.

The remarkable period of low and stable inflation and the apparent strength of the financial system, that characterized the global economy over the last few years made monetary authorities complacent about the possibility of a financial turmoil like the one experienced since 2007.

Monetary authorities were unable to stop or even acknowledge the development of the house price bubble, supported by heavy leverage and loosely supervised and complex environment. This suggests that central banks should pay closer attention to financial assets in the design of their monetary policies. It also suggest that they should reinforce the institutional framework to prevent crisis or mitigate their effects on financial stability.

There is a growing consensus that price stability alone does not imply financial stability. Therefore, it is crucial to rethink the role of central banks as guardians of financial stability. In the two countries where substantial financial activities have developed (England and the US) we are already seeing how new responsibilities are been given to central banks: microprudential and macroprudential regulation.

Assigning new tasks to central banks is a complicated issue. Apart from the lender of last resort function and some regulatory powers, there are no central bank policy instruments that are uniquely suited to ensuring systemic financial stability. Using such instruments for an end other than their primary purpose inevitably involves trade-offs. For instance, the potential conflicts between the financial and price stability mandates have become clearer in the wake of the recent crisis.

III. Central Banks and the Crisis: The experience of Emerging Markets

I think it is fair to say that with the passage of time, the extraordinary actions taken by major central banks to prevent a financial collapse, particularly after September of 1998, have been seen in a better light. This does not mean, of course, that critics and skeptics have disappeared, but many of the concerns that were loudly expressed have proven to be unfounded. One example is the fear that the expansion of central banks balance sheets was going

to fuel an inflationary process. Today, deflation seems like a greater risk.

A much more controversial and difficult subject is whether the policy framework of major central banks were actually responsible for the financial crisis. In a recent BIS paper, Philip Turner conveniently groups the many schools of thought on this subject under three headings: microeconomic, macroeconomic and macroprudential.

The first school of thought, the microeconomic, emphasizes failures of regulation and supervision. The arguments are familiar: The opacity and complexity of financial instruments facilitated the development of important information asymmetries between counterparties in these operations. The lack of understanding of the risks involved by users of these complex financial products and the irresponsible search of fees by some others lead to an enormous increase in leverage. In turn, the growth of a lightly regulated parallel banking system and institutions too interconnected and too big to fail increased moral hazard. The conclusion is straightforward: more effective regulatory oversight is needed.

The macroeconomic line of thought is also familiar. The expansionary policy of the Fed after 2001 increased risk appetite which lowered risk premia, compressed market vulnerability and led to the housing bubble that was the root cause of the current crisis.

Many others have emphasized on the lack of a macro prudential framework for the failure to detect the dangers of excessive leverage, the nature of the linkages among financial institutions, liquidity and the pricing of risks, and how all these elements interact with the wider macroeconomy.

There is a broad agreement among policymakers that the purpose of macroprudential policy is to reduce systemic risk, strengthen the resilience of the financial system against shocks. This implies limiting the buildup of financial risks and thus reducing the probability or the intensity of a financial crisis. The issue of how to define and construct the macroprudential element of financial stability, and the role that central banks in this process is at the center of discussions on financial reforms in the major financial centers.

The proposals by the UK to send back to the Bank of England the responsibilities of prudential regulation and the establishment of

a Financial Policy Committee with full responsibility for macroprudential oversight is the most recent example of how the debate is shaping concrete policy initiatives.

In the Emerging Markets, macroprudential issues are not at the center of policy debates. This follows from the fact that this crisis originated at the core of the financial system and not in the periphery. In fact, emerging markets' financial systems proved to be quite resilient to the global financial crisis. Indeed, none of the emerging markets in Asia or Latin America that experienced a financial crisis in the 1990's or in the first years of this century suffered a severe dislocation as a consequence of the global crisis.

Emerging Markets learned the hard lessons of their financial crises, and the extraordinary high costs imposed on society as a consequence of these crises. The response was to strengthen considerably the overall economic policy framework, accumulate sizable international reserves and implement deep reforms of the financial systems. In a way, a sort of macroprudential policy framework was formulated in many emerging markets, although it was not referred to as such. Some elements of this framework are:

- Since banks are the most important financial intermediaries in Emerging Markets, a first step was to recapitalize the banking system and to maintain high capital ratios. For example, average bank capital to assets in the major Latin American economies¹ between 2004 and 2008 was 10.34% that is 3.8 percentage points above the average capital ratio of developed country² banks.³
- Currency mismatches were a crucial element in the generation or amplification of financial crises in several Asian and Latin American countries. Strict regulation to prevent the recurrence of imbalances was implemented. Attention was also paid to liquidity requirements, particularly in foreign currency. Funding of long term positions in foreign currency with short term loans was also limited.
- In emerging markets, central bankers and regulators didn't rely so much on the concept of market discipline, in relation to their

¹ The Western Hemisphere according to the IMF: Antigua and Barbuda, Argentina, The Bahamas, Barbados, Belize, Bolivia, Brazil, Chile, Colombia, Costa Rica, Dominica, Dominican Republic, Ecuador, El Salvador, Grenada, Guatemala, Guyana, Haiti, Honduras, Jamaica, Mexico, Nicaragua, Panama, Paraguay, Peru, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, Suriname, Trinidad de Tobago, Uruguay and Venezuela.

² The Advanced Economies according to the IMF are: Australia, Austria, Belgium, Canada, Czech Republic, Denmark, Finland, France, Germany, Greece, Hong Kong SAR, Iceland, Israel, Italy, Japan, Korea, Luxembourg, Malta, Netherlands, Norway, Portugal, Singapore, Slovak Republic, Slovenia, Spain, Sweden, Switzerland, United Kingdom and United States.

³ International Monetary Fund, Global Stability Report Database, April 2010.

developed country counterparties. Much more emphasis was placed in the concept of bank supervision. In many countries, important efforts were made to upgrade the institutional and technical capacity of supervisory bodies. Practically all of the EM countries that experienced a crisis in the financial system undertook FSAP's under the aegis of the IMF.

- Banks in the EM did not engage in the development or purchase of complex financial products, nor a parallel banking system was developed. This is partly due to the fact that bank profitability in general is higher in emerging markets, so banks were not pressured to seek the extra yield. On the other hand, the subsidiaries of foreign banks that did engage in the business of origination and distribution of complex financial products were prevented from doing so.

Is the experience of Emergent Markets relevant for the more general discussion on financial stability and the role of central banks?

I would say that there are three points to be made:

First, the emphasis on a well capitalized banking system with adequate regulation regarding liquidity and currency mismatches. This has been a central concern on the part of policymakers in the emerging world.

Second, less reliance on market discipline and much more emphasis on supervision. The assumption being that financial institutions have incentives to circumvent regulation. Maybe they will not cross the line, but the natural tendency is to increase leverage and thus profits.

Third, a careful approach to financial innovation. Some could argue that the experience of Emerging Markets may be of limited value to the current discussion of financial reforms, since in the group of countries financial systems are less sophisticated than in the developed world. Sophistication on financial systems is closely

associated with financial innovation. I would argue that financial innovation that is geared mainly to increase profits of the financial industry, and is more and more removed from the main function of finance—the channeling of savings to productive activities- is not adding value to society. On the contrary, the type of financial innovation that resulted in a very rapid growth of the financial sector over the decade prior to the crisis, which was based mostly on increasing leverage and propitiating the emergence of a parallel banking system is outright dangerous, as the events of the past few years have demonstrated.

IV. Financial Regulation

The experience of emerging markets during the crisis is also useful to shed some light on the current discussion on financial regulation. As is well known, this discussion is being held at few levels:

- Multilateral settings such as the Basel Committee (BC) and the Financial Stability Board (FSB); and,
- National Jurisdictions.

In theory, the work of multilateral organizations and national initiatives was supposed to converge at the G-20. This is not happening. On the contrary, increasingly each country is pursuing its own regulatory agenda, often responding to its own domestic pressures.

The basic problem is that we have a global financial system comprised by global financial entities and global financial markets that do not recognize sovereign legal jurisdictions. However, laws, regulations, jurisdictions, legal courts, lenders of last resort and tax payers do not have a global reach. They are framework fragmented in national jurisdictions. Hence in the absence of a world supranational authority, each national authority is the ultimate responsible of its own financial intermediaries and depositors.

This reality calls for increasing coordination. However, developed economies are increasingly pursuing their own domestic agendas. For example, the UK, Germany and France are imposing banks levies and USA is limiting the scope of banks. These domestic agendas are being shaped by the need to raise revenues (to compensate for the costs of the crisis), from the pressures of their domestic constituencies to take decisive actions and from the

practical impossibility of strengthening financial regulations when their banks are still very weak.

The different proposals regarding levies or taxes on the financial sector, limitations on the scope of activities (Volker Plan), etc... are unlikely to be agreed internationally.

So it would be up to national jurisdictions to design and implement legislation, including resolution regimes. Cross-border issues that arise from resolution regimes are extremely complicated. The experience of emerging markets that have a large presence of foreign subsidiaries may help to shed some light on possible courses of action. It is remarkable that, for example, in Latin America, the subsidiaries of foreign banks that experienced serious difficulties were largely isolated from the difficulties of the parent bank. Paradoxically, in some cases, the subsidiaries helped and supported parent banks with funding problems. In the cross-border parent/subsidiary discussions, perhaps the most viable outcome is to continue with the present model.

Spillover effects of parent banks on subsidiaries of levies or capital surcharges imposed for systemically important institutions

need a careful discussion at the multilateral level, particularly since these surcharges are likely to have a negative impact on subsidiaries that continued operating normally during the crisis.

Plans for a global bank levy took a major step forward last Tuesday as the UK announced the imposition of a levy of 0.04 percent on large banks balance sheets. Germany and France announced similar measures.

On Tuesday, Merkel and Sarkozy released a joint letter ahead of this weekend's G20 meeting calling for "international agreement to introduce a levy or tax on financial institutions to ensure fair burden-sharing and create incentives designed to contain systemic risks." The three governments also raised the possibility of additional taxes on banks, although their approaches varied.

Canada, the host of the summit, and Japan are strongly opposed. The UK bank levies will be imposed on the consolidated banks' balance sheets. These means that the costs will be bear by UK banks' borrowers as well as by the borrowers of all the countries where UK systemic banks operate.

Developed countries should be more careful designing these policies. If these policies end up increasing financial intermediation costs in EM with a large presence of foreign banks, an important political backlash against globalization could surge.

V. Conclusions

These have been extraordinary times for central banks. Major central banks have been under a great deal of pressure both from markets and from critics from the academic world, the financial market participants and the general public. My impression, however, is that the extraordinary variety of unprecedented actions aimed at averting a collapse of the financial system and of the real economy which are now better understood and, in general, seen in a more favorable light. However, the role of central banks in crisis prevention is much more polemical. On the positive side, it has given a new impetus for financial authorities to revalue existing financial stability frameworks.

Even if monetary authorities were unable to prevent the financial crisis, and even if central banks have not always been successful in promoting systemically robust procedures for the ever changing financial markets there are a set of benefits of a more formal role of central banks in financial stability and financial regulation. An expanded role in financial regulation can allow synergies, knowledge and expertise to be exploited. It is true that potential conflicts between prudential and monetary policy can arise.

However, it is in my view that complementarities between financial regulation and monetary policy may become stronger as both policies (monetary and prudential) need to mitigate system risk.