

Central Banking in the Post Crisis Era: Experiences and Way Forward



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Central Banking beyond monetary management....

- ▶ The mandate of central banks has, over decades, been a subject matter of many a debate and question:
 - ▶ Should central banks be responsible only for monetary management
 - ▶ Are there conflicts of interest in a central bank balancing the objectives of
 - Price stability and financial stability
 - Microprudential supervision and systemic risk management
 - Sovereign debt management, monetary policy and financial stability
- ▶ even as the conduct of monetary policy is getting complicated, especially in EMEs...
 - ▶ Large volatility in commodity and food prices impacting price stability
 - ▶ Volatility in capital flows impacting domestic financial stability
 - ▶ Growing financial integration transmitting shocks more quickly

Evolving role of central banks

- ▶ The role of central banks have been evolving over the years with
 - ▶ The development of the economy and the financial sector
 - ▶ Internationalization of financial systems

Many central banks assuming new responsibilities such as

- ▶ Growth and /or reigning in unemployment objectives
- ▶ Regulation and supervision of financial institutions, financial markets and financial market infrastructure
- ▶ Sovereign Debt Management (SDM)
- ▶ Financial stability
- ▶ Financial inclusion and financial literacy
- ▶ Various socio-economic objectives (especially in developing economies)

Evolving role of central banks (cont'd..)

- ▶ The recent global financial crisis (GFC) has opened a series of questions about.....
 - ▶ The role of the central bank in the prevention, management and resolution of financial crisis and
 - ▶ The relationship of the central banks with other relevant bodies including the government
- ▶ ... leading to a reconsideration of the mandates of central banks....
- ▶ And raised issues about the central banks' governance, accountability and autonomy

Evolving role of the Reserve Bank of India

- ▶ The Reserve Bank's statute tasks it with the objective of
 - ▶ maintaining price and financial stability, while providing support to growth through adequate availability of credit.
- ▶ The Reserve Bank's policy objectives are multiple....
 - ▶ Price stability
 - ▶ Growth
 - ▶ Financial stability (explicitly since the early 2000s)
- ▶ ...And it is a full services central bank responsible for the regulation and supervision...
 - ▶ the banking and the non banking financial sector
 - ▶ key segments of financial markets, foreign exchange management and public debt management
 - ▶ Financial market infrastructure
- ▶ drawing tremendous synergies in policy making from these diverse roles...
- ▶ The Reserve Bank is also tasked with socio-economic responsibilities including financial inclusion and literacy

To sum up....

- ▶ The GFC has ...
 - ▶ Led to wide ranging re-orientation of central bank mandates and functions
 - ▶ **Price and Financial Stability**
 - ▶ **Systemic approach to policy and micro-prudential policy**
 - ▶ **Sovereign debt management, monetary policy and financial stability**
 - ▶ **Managing Capital Flows**
 - ▶ **Accumulation of reserves**
 - ▶ **Liquidity management**
 - ▶ **Payment and Settlement Systems**
- ▶ Raised issues about the regulatory infrastructure
 - ▶ Relationship of the central banks with the government and other agencies
 - ▶ The central banks' autonomy, accountability and governance

The evolving role of central banks

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Price and Financial Stability

- ▶ Monetary policy and policies for financial stability complement and supplement each other..
 - ▶ Measures aimed at strengthening financial system resilience....
 - ▶ Buttress monetary policy by potentially preventing sharp financial disruptions
 - ▶ Facilitate smoother transmission of monetary policy
 - ▶While Monetary policy
 - ▶ Ensures efficient allocation of resources – key to financial stability
 - ▶ Can play a role in restoration of stability in the midst of a crisis
- ▶But there could be trade offs as well...
 - ▶ Stable prices and low interest rates can incentivize under pricing of risks
 - ▶ Financial stability considerations involve a longer policy horizon than price stability
- ▶which will need to be carefully managed
- ▶ In any case, the central bank around the world are reconsidering their pure inflation targeting status

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Systemic approach to policy.....

- ▶ Pre-crisis regulation focused more on stability of individual institutions
- ▶ Crisis under-scored the importance of focusing on systemic stability...
 - ▶ Time dimension of systemic risks or pro-cyclicality
 - ▶ Cross sectional dimensions of systemic risks or the build up common exposures and risk concentrations and of interconnectedness between key financial sector entities
- ▶A leap from bottoms up to a systemic approach!
- ▶ Strong complementarities between macro and micro prudential policy frameworks
 - ▶ Tools are broadly the same
 - ▶ Significant elements of the emerging macro prudential framework, post crisis, use prudential tools to address systemic risks
 - ▶ Core capital prescriptions
 - ▶ Leverage ratio
 - ▶ Expected loss provisioning
 - ▶ “through the cycle” methodologies, etc.

..and potential trade offs

- ▶ Notwithstanding the synergies, the policies
 - ▶ Serve two different purposes
 - ▶ Potential for conflict arise during a crisis
 - Macro-prudential policy – warrants release of countercyclical buffers
 - Micro-prudential policy – warrants that banks remain as well capitalized as possible
 - ▶ Are used by different authorities in different jurisdictions
 - ▶ Continuous interaction and exchange of information mandatory if the policies rest in different institutions....
 - ▶ ...But conflict resolution easier if both policies rest in the same institutions – as is being increasingly realized internationally

The Indian experience

▶ Pursuit of Financial Stability

- ▶ Not an explicitly stated objective under the Reserve Bank statute but an explicit policy objective (since 2004)

▶ The broad compulsions of financial stability

- ▶ Have, however, driven all major policy initiatives since the balance of payment crisis in the 1990s and have guided the pace and intensity of financial liberalization in the economy in, *inter alia*,
 - ▶ Banking Sector and Non-banking financial sector
 - ▶ Management of the capital account
 - ▶ Development of financial markets and infrastructure
- ▶ Are evident in the Reserve Bank's regulatory approach and orientation



Increasing the resilience of Financial Institutions

- ▶ All leveraged entities (banks and non-banks) within the Reserve Bank's regulatory framework
 - ▶ A gradual process of introduction of reforms in the banking sector – a case study in increasing resilience in a non-disruptive manner
 - ▶ The sequence followed:
 - ▶ A prudential framework
 - ▶ Interest rate deregulation and lowering of statutory preemptions
 - ▶ Accounting reforms
 - ▶ Good governance through “fit and proper” owners, directors and senior managers
 - ▶ The non-banking financial sector brought within regulatory ambit through statutory amendments in the late 1990s
 - ▶ Initial focus on depositor protection
 - ▶ Later, a prudential regulatory framework put in place for systemically important non-deposit taking entities as well
 - ▶ A framework for monitoring of financial conglomerates is in place since 2004

Addressing systemic risks

- ▶ A macroprudential hue to the Reserve Bank's policy framework has been evident though not christened as such
- ▶ Time dimensions of systemic risks sought to be addressed since 2004 through a series of macroprudential measures including time varying risk weights and provisions
- ▶ Possible risks arising from inter-connectedness taken on board
 - ▶ Prudential limits on aggregate inter-bank liabilities
 - ▶ Higher risk weights on investments by banks in subordinated debts of other banks
 - ▶ Restricted access to overnight un-collateralized funds
 - ▶ Exposure limits between banks and non-banking financial companies

Systemic risk identification.. (1)

- ▶ Continuous assessment of the financial system to identify and assess burgeoning risks in the financial sector is build into the operating framework of the Reserve Bank
- ▶ In 2010, a dedicated Financial Stability Unit was set up to, *inter alia*, conduct macroprudential supervision of the economy on a continuing basis
- ▶ The Bank has also started publishing half yearly Financial Stability Reports in an effort to communicate its assessment of risks to financial stability to all stakeholders
 - ▶ More frequent assessments are prepared internally

Systemic risk identification.. (2)

- ▶ Several initiatives in the Reserve Bank are aimed at continuously assessing the financial system so that any emerging risks can be identified and dealt with at an early stage.
 - ▶ A **Financial Stress Indicator** - a contemporaneous indicator of conditions in financial markets and in the banking sector.
 - ▶ **Systemic Liquidity Indicator** for assessing systemic liquidity
 - ▶ A **Fiscal Stress Indicator** for assessing fiscal risks
 - ▶ A **network model** of the bilateral exposures in the financial system – for assessing the inter-connectedness in the system
 - ▶ A **Banking Stability Indicator** for assessing risk factors having a bearing on the stability of the banking sector
 - ▶ A series of Banking Stability Measures for assessing the systemic importance of individual banks.

The evolving role of central banks

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Sovereign debt management, monetary policy and financial stability

- ▶ The GFC has
 - ▶ brought to the fore synergies and potential conflicts on interest between central banks' role as monetary authority and systemic regulator and its role as manager of public debt.....
 - ▶ Triggering academic rethinking in favour of debt management by central banks
- ▶ It is being increasingly realized that
 - ▶ Debt management is much more than a mere resource raising exercise, especially in an EME context
 - ▶ Independent debt management could jeopardize monetary and financial stability
 - ▶ Independent Debt Management Offices are not necessarily a panacea and also raise issues of coordination.

The Indian experience

- ▶ SDM with the Reserve Bank of India – A confluence of interest
 - ▶ The perceived conflict between SDM and policies for price and financial stability found to be hugely overstated in the Indian context....
 - ▶ On the contrary,
 - balancing the objectives of growth with price and financial stability with SDM enabled the Reserve Bank to fulfil a huge government borrowing programme in a non-disruptive manner;
 - To increase the maturity profile of government debt and to elongate sovereign yield curve while ensuring that the
 - Has facilitated capital account management
 - The Market Stabilization Scheme
- ▶ Resolving conflicts with policies for price and financial stability
 - ▶ The FRBM Act
- ▶ *“Central bank should take over or at least be involved/consulted for SDM even in the developed world” (Goodhart (2010)/Fischer (2010))*

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Capital flows – a double edged sword

- ▶ Resource constrained Emerging Economies value capital flows
- ▶ There remains risks from such flows in a closely interconnected world as strongly demonstrated by the financial crisis
 - ▶ Sudden reversals / volatility in flows especially if the composition of flows is skewed towards portfolio flows
 - ▶ Risks of inflows concentrated in “sensitive” sectors like real estate leading to asset price bubbles
- ▶ Challenges have been accentuated by recent policies in some advanced economies - Quantitative easing and stimulus policies to support ailing economies,
 - ▶ Leading to increased flows to EMEs

A menu of policy options

- ▶ EMEs are resource constrained and value capital flows
- ▶ How to benefit from the flows without stress of reversals?
- ▶ EMEs manage capital flows by one or more of many policy tools
 - ▶ Floating exchange rates
 - ▶ Accumulating reserves – sterilized and unsterilized interventions
 - ▶ Adjusting interest rates
 - ▶ Fiscal policy measures
 - ▶ Reinforcing prudential regulations
 - ▶ Liberalizing capital outflows
 - ▶ Capital controls
- ▶ Challenges in selection of optimal policy response
- ▶ *‘Circumstances in which capital controls can be a legitimate component of the policy response to surges in capital flows’*. IMF (February 2010)

Managing Capital Flows in India

- ▶ Governed by broader objective of maintaining financial and macro-economic stability
 - ▶ Active capital account management
 - ▶ Driven by various concomitants such as fiscal consolidation, monetary policy objectives, banking system stability
 - ▶ Encourage long term debt creation and long term capital
 - ▶ Discourage debt flows - short term debt permitted for trade transactions only
 - ▶ Calibration of inward and outward flows – overseas investments/ECBs/Portfolio flows

Forex intervention to smooth excess volatility needs to be combined with a policy orientation that allows currency flexibility along with continuous development and strengthening of domestic financial sector.

The evolving role of central banks

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- ▶ Managing Capital Flows
- ▶ **Accumulation of reserves**
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Accumulation of reserves

- ▶ **Need to distinguish policies behind the build up of reserves**
 - ▶ Current account deficit countries vs. current account surplus countries
 - ▶ With current account deficits, reserves are for self insurance purpose
- **Alternatives to reserves**
 - ▶ Increasing dependence on IMF and other multi-lateral institutions
 - ▶ Dependence on regional co-operations
 - ▶ Dependence on swap lines with countries having reserve currency

 - ▶ But are these alternatives feasible during GFCs?
 - ▶ Cost of holding reserves to be reckoned
- ▶ **Reserve accumulation in countries like India are not causes but effects of global imbalances**

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Liquidity management

- ▶ The global financial crisis
 - ▶ under-scored the criticality of liquidity for financial stability
 - ▶ Brought central banks to the forefront in liquidity management
- ▶ A series of conventional and un-conventional policy measures were adopted by central banks.....
 - ▶ In the wake of unprecedented funding market dislocations
 - ▶ Even as many questions were raised both about the resilience of global funding markets and about the management of such liquidity
- ▶Albeit at a significant cost in terms of
 - ▶ Expanded central bank balance sheets
 - ▶ Diluted quality of collateral

Indian experience

- ▶ Liquidity management – a core function of the Reserve Bank of India
- ▶ A plethora of tools to equilibrate demand and supply conditions on a continuous basis, both conventional....
 - ▶ Liquidity Adjustment Facility
 - ▶ Sterilized Intervention
 - ▶ Market Stabilization Scheme
 - ▶ Open market operations
 - ▶ Reserve Requirements
- ▶ ... And unconventional (during the crisis)... to provide ample liquidity – domestic and foreign – and maintain flow of credit to the productive sectors
 - ▶ Forex swap facilities
 - ▶ Lines of credit to the banking system for mutual funds and non banking financial companies
- ▶ Liquidity extended without expansion of balance sheets or dilution of collateral and counterparty standards

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Ensuring safety and security of PSS

- ▶ Post crisis - renewed focus on payment and settlement infrastructure
 - ▶ New standards- Principles of Financial Market Infrastructures
 - ▶ G-20 commitments to standardization, central clearing and trade reporting
- ▶ Role of central banks in payment and settlement systems (including FMIs)
 - ▶ Operational, oversight and catalyst role
- ▶ The FMI largely functioned without disruption during the crisis.... The crisis, nevertheless, brought into focus the importance of the smooth functioning of such infrastructure

Indian experience

- ▶ Payment and settlement systems in India within the regulatory perimeter of the central bank
 - ▶ Vide the Payment and Settlement Systems Act, 2007
- ▶ Many of the post crisis reforms being contemplated already envisaged
 - ▶ Settlement of all inter bank transactions in central bank money
 - ▶ Introduction of CCP settlement for foreign exchange, government securities, interest rate markets, equity and commodity
 - ▶ Trade reporting requirements for OTC derivative trades already introduced and being strengthened
 - ▶ Credit derivatives on the anvil albeit with safeguards

The emerging regulatory infrastructure

- ▶ Relationship of the central banks with the government and other agencies
- ▶ The central banks' autonomy, accountability and governance

Regulatory infrastructure for financial stability

- ▶ Sweeping changes to the regulatory infrastructure for financial stability since the financial crisis have
 - ▶ Designated the central bank as the systemic regulator with accountability;
 - ▶ Placed central banks in charge of micro-prudential regulation, where not already so responsible, in addition to macro-prudential regulation; and
 - ▶ Set up financial stability councils/commissions to provide high level focus on financial stability.
- ▶ Irrespective of the emerging regulatory contours, central banks are expected to occupy a pivotal role in the pursuit of financial stability

Financial stability – a shared objective

- ▶ The importance of inter regulatory and inter agency coordination in a financial stability framework is critical
- ▶ The crisis threw up scores of illustrations of the need for better coordination between different agencies with a stake in financial stability – central banks, prudential regulators, supervisors, securities and other financial sector regulators, the government...
- ▶ Post crisis infrastructural reforms (e.g. financial stability councils) are aimed at addressing this need... but continuing interaction and information exchange at both the policy and operational levels will be critical if we are to avert another financial crisis

The Role of the Fiscal in Financial Stability and Central Bank Autonomy

- ▶ The crisis has underscored the role of the fiscal in financial stability in conjunction with central banks...
 - ▶ Fiscal policy plays a supporting role in a financial stability framework, especially for crisis management and resolution.
 - ▶ Automatic fiscal stabilisers can facilitate financial stability
- ▶ ... though the fiscal can also work at cross purposes with the financial stability framework
 - ▶ Unsustainable deficit levels – the Sovereign Debt Crisis
 - ▶ Aspects of fiscal policy e.g. the taxation policy and subsidy structures, could inadvertently facilitate or incentivise build up of excesses.
- ▶ ... This has
 - ▶ Raised issues of central banks governance and accountability
 - ▶ Especially with the setting up of financial stability councils involving the Government/Treasury

The Role of the Fiscal in Financial Stability and Central Bank Autonomy

- ▶ The case for autonomy of the monetary authority is well established
- ▶ It is less accepted but equally compelling for central banks with a mandate for financial stability
 - A macroprudentialist's mandate – to take away the “punch bowl” – especially if systemic fault lines appear in “good times”
 - Opens the gates for greater political interventions
- ▶ The need for central banks' accountability is unquestioned – But there are issues with designing a quantifiable accountability framework for financial stability

Indian experience

- ▶ A High Level Coordination Committee on Financial Markets (HLCCFM) chaired by Governor
 - ▶ Operational since 1992
 - ▶ Includes financial sector regulators and key government departments
- ▶ A Financial Stability and Development Council (2010)
 - ▶ Focused attention on financial stability, macroprudential supervision of the economy, inter regulatory coordination
 - ▶ Finance Minister in the Chair
 - ▶ Governor, Reserve Bank, in the chair of the Council's Sub Committee – its main operating arm
 - ▶ The Sub-Committee has since replaced the HLCCFM

Challenges and Way Ahead

Challenges and Way Ahead..

- ▶ Several challenges have emerged during and in the aftermath of the global financial crisis and many more will emerge as the global reforms agenda unfolds and is implemented ...
 - ▶ Implementation of a macroprudential policy framework
 - ▶ Challenges in calibrating the countercyclical buffers especially in EMEs where the credit to GDP ratio (advocated by the Basel Committee) may not be a reliable indicator for the purpose
 - ▶ Plugging data gaps and shortcomings in existing information systems
 - ▶ Greater international co-operation and co-ordination
 - ▶ For promoting open, flexible and resilient international financial system
 - ▶ Recognizing spill-over between economies
 - ▶ Co-ordinating the implementation of the global reforms agenda
 - ▶ Greater transparency in communication and fostering credibility of policy actions and strengthening the confidence channel

Challenges and Way Ahead

- ▶ The period leading up to the crisis saw central banks at the peak of their credibility and reputation
 - ▶ An elongated period of the Great Moderation meant that the central banks thought they had discovered the holy grail and declared victory
- ▶ The credibility and the reputation of central banks have been a little tarnished during the crisis
 - ▶ With central banks being, as they were, blamed for getting the world into the crisis
- ▶ Notwithstanding, the critical role of central banks in fostering financial stability was recognised and, world over,
 - ▶ The mandates of central banks are being strengthened to give them a greater role in the emerging framework for financial stability
- ▶ For central bankers like us ... the way forward is both a challenge and an opportunity
 - ▶ A challenge to rise up to & deliver on greater responsibilities being entrusted to us
 - ▶ An opportunity to retrieve, to its fullest extent and beyond, our credibility and reputation as an institutional body, *par excellence*



Thank you