The role of central banks in macroeconomic and financial stability

Jaime Caruana

Introduction

Central banks in Africa are changing as the continent becomes increasingly integrated with the global financial system. Four important challenges were analysed at this meeting.

1. The recent surge in ***pan-African banking*** is driving a new wave of financial integration. This has many benefits for the region, but confronts central banks and supervisors with new challenges in monitoring and managing risks.

2. Central banks have a key role in ***developing local debt markets***. The development of local currency bond markets is critical to Africa's financial development and resilience to shocks. Government fiscal and debt management policies should not undermine effective monetary policy. Good macroeconomic policy requires mechanisms that ensure appropriate coordination but avoid potential conflicts of interest.

3. ***Financial stability frameworks*** need to be strengthened. Central banks must have a major voice in financial stability policy which is closely linked with monetary policy. Central banks are naturally the official institution closest to financial markets. Nevertheless, responsibility for financial stability will almost always be shared with other bodies. How this is done will differ from country to country. But, however done, supervisors need the independence and the powers to act quickly and impartially.

4. The prolonged period of higher-than-average commodity prices, often attracting heavy capital inflows, has boosted growth but may also have created its own financial stability risks. In this context, a ***macroprudential perspective*** to policymaking – one that attempts to "look through" these long swings of commodity prices – can help to address systemic threats.

This meeting allowed central banks from different continents to compare notes on their experiences in dealing with such challenges. Nevertheless, each country has its own special context. Paul Collier urged policymakers to focus on Africa's distinct problems and to take account of their own situation. They need, he said, to modernise Africa's financial system to enhance investment and growth opportunities, and to develop robust institutions and rules for managing Africa's natural resources to their best advantage.

1. Financial integration in Africa: implications for monetary policy and financial stability

Over the past five years, cross-border capital flows into Africa have been driven up both by easy global monetary conditions and by the continent's own improved macroeconomic performance. As banks in advanced economies shed assets and risks, a greater share of cross-border bank flows into Africa has come from banks domiciled in major EMEs such as Brazil, China and India. Another new development, discussed in the paper by Benedicte Christensen in this volume, is the spread of pan-African banking groups (those domiciled in Africa with subsidiaries in several African countries). Pan-African banks typically bring expertise and competition to the host country, improving the functioning of interbank and foreign exchange markets and broadening access to banking services. At the same time, host country supervisors are well aware of the new financial stability risks that could arise from the global operations of these banks. To deal with such risks and monitor them, improvements in the regulatory and supervisory framework are required. They need more timely information about the health of foreign banks. Host supervisors also face the challenge of devising appropriate cross-border contingency plans for winding down unviable or failed banks. Moral hazard issues need to be carefully taken into account when designing the lender-of-last-resort assistance to pan-African banks.

The paper by Sarah Alade, Deputy Governor of the Central Bank of Nigeria, notes the challenges from the home country perspective. The rapid growth in the operations of Nigerian banks in the rest of Africa has prompted the central bank to introduce a new regulatory and supervisory system. Deputy Governor Alade highlights two basic aspects of supervision: first, all foreign banks should be subject to supervision and, second, supervision should be consistent with international standards. In addition, all foreign operations of domestic banks must be brought under consolidated supervision. She notes that in Nigeria all banks – whether domestic and foreign – are treated equally and supervised under a uniform framework. In the event of a liquidity crisis, the central bank is the lender of last resort to all banks operating in Nigeria.

In evaluating the importance of intra-regional financial integration, the discussions highlighted a cautious view that, while greater financial integration is beneficial to Africa, it should not be pursued with the goal of establishing a single currency or monetary union. The experience of the existing monetary unions in Africa suggested that strong fiscal discipline and a banking union is required to sustain them. These are the elements that differentiate the Central and Western African monetary unions, for instance, from the euro area.

The supervisory challenges posed by international banks were mentioned by many African central banks. Active information-sharing among supervisors is critical. In many cases, home and host countries have signed Memoranda of Understanding for consolidated supervision. However, the effectiveness of such agreements during times of stress is yet to be tested. Some argued for the establishment of cross-border crisis resolution frameworks. Others warned that major pan-African banks could become a threat to financial stability on account of their scale and equity cross-holdings. In crisis situations, the host central bank may have little choice but to act as the lender of last resort.

2. Government debt issuance and central banks

Domestic bond markets underpin the economy and the financial system in several ways. Sovereign bonds set the benchmark yield curve, and provide high-quality collateral for financial transactions. Indeed, deeper domestic bond markets in many emerging market economies, including in Africa, tend to be associated with more efficient and stable financial systems.

The paper by Stephen Vajs in this volume shows that some of Africa's new and fast-growing domestic bond markets are supporting the issuance of long-maturity bonds and greater foreign participation. Improved macroeconomic stability has helped. Low and stable inflation has whetted investors' appetite for fixed-income assets. Market fragmentation has been reduced as interest rates become more market-determined. And many central banks have played an important role in developing the necessary market infrastructure.

Kenya's experience, summarised in the paper by Governor Njuguna Ndung'u in this volume, is an excellent example. Kenya has developed a Medium-Term Debt Strategy (MTDS) programme that formally links debt management with government's medium-term fiscal framework. MTDS helps to increase public awareness about fiscal sustainability, improve investor relations and develop a dynamic debt market. As a complementary strategy, the central bank has established a Market Leader Forum that acts as a catalyst for the debt market's development.

The discussion highlighted a number of challenges in developing liquid bond markets. Many participants noted that Africa's underdeveloped banking systems meant that the domestic market's capacity to absorb new issues is quite limited. In some cases the central bank has had to act as a market-maker. In addition, the lack of adequate competition in the banking system (and the danger of collusion between just a few banks) compromises price discovery in the bond market, reducing the usefulness of the yield curve in the monetary policy transmission mechanism. Finally, government bond issuance can crowd out much-needed credit for the private sector as banks typically prefer to hold lower-risk government bonds to maturity.

Another important issue was the coordination of debt management with monetary policy. Debt managers are primarily responsible for keeping the government's interest costs and funding risks to a minimum. But their decisions on the volume and the maturity of debt have major implications for the yield curve and monetary conditions. Coordination between the central bank and the government is therefore essential if monetary policy is to be effectively transmitted and financial stability preserved. Stephen Vajs argues that central banks should take a keen interest in ensuring that no additional financial vulnerabilities are created for the economy by the structure of government debt (currency and maturity composition). And the government's cash management should be consistent with the central bank's overall management of liquidity.

The discussions revealed that many African countries are working hard to coordinate with the government in terms of the amounts, maturity and methods of issuance as well as on cost allocation. Sustainable domestic bond markets require a credible monetary policy framework. Governments should assist by removing institutional and infrastructural impediments to market development.

3. Financial stability objectives and arrangements – what's new?

The financial crisis has added impetus to policies to strengthen financial stability in most African countries. Thanks to their strong governance and credibility, central banks have often been tasked with this work: how should central banks fulfil this role? Africa's central banks are still at an early stage of integrating microprudential and macroprudential regulation with monetary policy. Coordinating these new financial stability activities raises some institutional challenges. Serge Jeanneau's paper summarises recent work on this important question. One issue is the difference between the analytical frameworks for traditional central bank activities (such as monetary policy or payments systems) and those needed for financial stability work. Such differences are further accentuated by the differing types of talent that these two fields attract. However, it will be vital to harmonise these cultures and build an interface between macroeconomists and financial stability experts: as one participant from an advanced economy explained, a more efficient exchange of information before the financial crisis could have allowed the growing financial strains to be identified much earlier.

Many central banks have created financial stability committees that involve all major stakeholders. These committees seem to be useful in accessing the decentralised information necessary for financial stability work. In addition, most participants found the participation of the finance ministry to be crucial in such financial stability-related committees, given the potential fiscal costs of any resolution mechanism.

Yet the involvement of the finance ministry does raise several issues. Some participants warned that the involvement of politicians in financial stability work can give rise to "inaction bias": politicians could in principle respond forcefully to an actual crisis but they might fail to get agreement on pre-emptive measures to be taken before a crisis. Central banks might be better placed to run countercyclical policies. One participant said that one solution would be for central banks to take a more prominent role before the crisis (to limit the build-up of vulnerabilities) while the finance ministry shows its hand decisively during the crisis (in dealing with the fiscal costs of the resolution).

Several central banks have also started to issue financial stability reports. Organising this work and acquiring the necessary human capital and confidential data, while embedding these activities within the central bank structure, took some time and effort for most African central banks. Furthermore, whereas inflation targeting has created a clear benchmark for measuring central bank effectiveness, financial stability goals are harder to define and performance against them is more difficult to track.

The increased responsibilities of central banks are not without risks. The additional financial stability remit of central banks reflects their improved credibility with the public, and can improve their monetary policy. But too many or too unrealistic objectives may eventually hurt their hard-won credibility.

Participants agreed that there is no "one size fits all" approach to financial stability. The decision on whether banking supervision should be inside or outside the central bank was, in part, a political decision. But many participants argued that, notwithstanding the variety of formal arrangements, public perceptions tend to make central banks responsible for financial stability, whatever the official mandate may say.

4. Macroprudential policies, commodity prices and capital inflows

The final session considered how to frame macroprudential perspectives to policies in Africa. Many countries in Africa face large swings in commodity prices and capital flows (which often follow commodity price swings). The usual countercyclical fiscal and monetary policies may not be enough to deal with the system-wide consequences for the financial system. Paul Masson's paper argues that macroprudential policies aimed at moderating excessive swings in credit growth can play a useful stabilising role.

There was a discussion about intervention in the foreign exchange market. Many central banks have found that the exchange rates can move well beyond the bounds that fundamentals would appear to justify. Sometimes over-depreciation creates an inflation shock. At other times, over-appreciation threatens to strangle the tradable sectors, which do not depend on raw materials. A seriously mis-aligned currency that suddenly corrects is a danger to financial stability. At the same time, prolonged intervention, particularly a long period of high commodity prices and strong capital inflows, has large costs for the central bank. First, buying foreign currency for years in order to resist appreciation involves substantial carrying costs (because local debt paper has a higher interest rate than the reserves) and runs the risk of capital losses. This can expose the central bank to political criticism. Second, the swollen central bank balance sheets that result from such interventions can undermine the central bank's control of domestic monetary conditions.

In conclusion, Africa's central banks have done much over the past decade to modernise their monetary and financial systems, making them more resilient. As the integration of the African economies into the global economy proceeds, new challenges will arise. I hope the BIS's roundtable meeting of governors illuminated some of these new challenges in monitoring and regulating the financial system and in defending hard-won reductions in inflation.