Central banking between past and future: which way forward after the crisis?

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Ladies and Gentlemen,

It is a pleasure to be here for the South African Reserve Bank's 90th anniversary seminar. The theme of today's seminar is well chosen. Central banking is in a state of flux. The crisis pushed central banks into the front line and tested to the limit their ability to provide instant system-wide liquidity. At the same time, it highlighted a new set of challenges for monetary policymakers. The consequences for the role of central banks are likely to be far-reaching.

What are these challenges? I would suggest that they fall into three categories – economic, intellectual and institutional.

First, central banks must work within a difficult economic context. In many mature economies, the trajectory of fiscal policy is unsustainable, threatening to undermine economic and financial stability. Sovereign and banking risks continue to be tightly intertwined, increasing the fragility of economies and financial systems. Meanwhile, soaring commodity prices have lifted headline inflation rates to uncomfortable levels in many countries, suggesting that monetary policy may be globally too loose. Moreover, diminished slack raises the risk of second-round effects. At the same time, financial imbalances, similar to those that heralded the crisis in the advanced economies, show every sign of building up in a number of fast-growing emerging market economies.

Second, central banks must undergo an intellectual makeover. The crisis opened up a gap between the theory and practice of central banking. It exposed the limitations of the pre-crisis policy consensus and of the macroeconomic models that underpinned it.

Third, central banks face institutional challenges. Central banks are taking on an expanded role in financial regulation and supervision. They have a particularly important part to play in new macroprudential supervision frameworks. These responsibilities bring with them new powers, but also new institutional setups that remain to be worked out in detail.

In what follows, I will try to sketch out how central banks might meet these challenges. With that end in mind, I will also outline four main guidelines for post-crisis central bank policy frameworks. These consist in:

- containing the build-up of financial imbalances;
- paying greater attention to the risks of aggressive post-crisis monetary easing;

- going beyond the “own house in order” doctrine; and
- safeguarding central bank independence and clarity in the new macroprudential supervision role.

Let me address each point in turn.

Containing the build-up of financial imbalances

Policy frameworks should be adjusted so that central banks can contribute more effectively to containing the build-up of financial imbalances. Macroprudential frameworks will be part of the solution, with central banks playing a prominent role. But financial stability is too large a task for prudential or macroprudential frameworks alone. Monetary policy strategies also need to be modified, so that central banks can lean against the build-up of financial imbalances even if near-term inflation remains low and stable.

Policy rates in the pre-crisis years were persistently low – in fact, as low as they had ever been since the 1970s. To be sure, these rates matched the low inflation rates of the time. But, by keeping leverage cheap, they arguably fostered risk-taking and the build-up of vulnerabilities.

Yet, in theory, the build-up of financial imbalances was simply not supposed to happen against this background of low and stable inflation. According to the consensus of the time, macroeconomic stability and manageable financial cycles would naturally arise from self-adjusting financial markets and price stability secured over horizons of two years or so.

The crisis suggests that a more nuanced perspective is needed. Financial imbalances can build up gradually, over many years. And when financial distress eventually materialises, it can hurt the economy, cripple monetary policy and undermine price stability.

If central banks are to counteract such build-ups, they will need longer policy horizons than the two years or so typical of inflation targeting regimes. Longer policy horizons are more likely to reveal the risks to macroeconomic stability that emanate from factors that could destabilise the financial cycle. And they would give central banks more scope for leaning against financial booms even when near-term inflation remains low and stable.

Lengthening the time horizon is not a matter of simply extending the range of point forecasts. Rather, it encompasses a more systematic approach to assessing the balance of risks ahead. Tightening policy to lean against the build-up of financial imbalances is like buying insurance. It adds a risk management element to monetary policy.

Right now, these considerations are relevant for several emerging market economies – especially those where burgeoning credit expansion and asset prices call to mind the booms seen in other parts of the world before the crisis. Extraordinarily accommodative monetary conditions in mature economies have played a part here through their effect on global bond and equity markets, as well as by making foreign currency borrowing temptingly cheap.[1] Some of the attendant risks to financial stability can be countered by the macroprudential measures adopted by many emerging market economies. But these measures cannot

[1] See J Caruana, “Capital flows to the emerging market economies: a perspective on policy challenges”, speech at the 46th SEACEN Governors’ Conference, Colombo, Sri Lanka, 24–26 February 2011. On the growth of the US dollar debt of obligors outside the United States, see J Caruana, “Global liquidity: a view from Basel”, speech at the International Capital Markets Association Annual General Meeting and Annual Conference, Paris, 26 May 2011.

replace tighter monetary policy and greater exchange rate flexibility. As for capital controls, these should be regarded only as temporary safety valves for extraordinary circumstances – a last resort.

Fiscal policy also has an important role to play in financial stability. As the financial crisis showed, fiscal capacity is vitally important when it comes to supporting both the financial sector, through bank rescue packages, and the real economy, via additional government spending. In many economies, however, these very necessary measures have diverted fiscal policy onto an unsustainable path. The upshot is that fiscal policy has itself become a threat to financial stability. A number of countries are also struggling to fill the financial hole left by the collapse in revenues inflated by the boom. These are lessons that should be kept in mind for the future. If governments were to accumulate prudent budget surpluses in good times, they would provide themselves with ample capacity to address a financial crisis without jeopardising fiscal sustainability and, indeed, financial stability. Admittedly, this prudential approach to fiscal policy will make larger demands on fiscal policy in good times than would the rules of thumb derived from macroeconomic considerations alone.

Better appreciating the risks of aggressive post-crisis monetary easing

Side effects attend the monetary policy responses to the financial busts that follow the unwinding of imbalances. When a crisis erupts, central banks should certainly do everything in their power to prevent the system collapsing. But once the crisis management phase is over, the policy focus should shift towards promoting the necessary post-crisis adjustments in balance sheets and the economy.

Booms raise output growth beyond sustainable rates while masking sectoral distortions and growing vulnerabilities. After the bubble bursts, the necessary adjustments can be smoothed but should not be hindered. As financial imbalances correct, balance sheets need to be repaired and excesses in the financial sector corrected. But unusually and persistently low policy interest rates, together with ample funding provision, may delay the incentives to adjust – and this for a number of reasons:

First, they may allow loss recognition and debt repayment to be postponed. They may encourage renewed risk-taking by removing a source of external discipline. And they may foster an excessive search for yield, with repercussions beyond domestic borders.

Second, low policy rates may actually undermine profitability in some financial segments. Near zero short-term interest rates compress banks' interest margins by reducing the profits on retail deposits. And low long-term interest rates may put the insurance and pension fund sectors under stress.

Finally, over time, the inflation-fighting credibility of central banks is likely to suffer if they pursue this type of monetary policy in an environment of high public debt and rising commodity prices.

Over the past decades, central banks have tended to loosen monetary policy aggressively during a crisis, but to tighten only cautiously into the recovery. As a consequence, interest rates in many economies have gradually trended lower, remaining consistently below the average natural level that theory would predict for the cycle. This narrows policymakers' room for manoeuvre and, by entrenching distortions, complicates the task of normalising the policy stance. Instead, a more symmetrical approach is called for over the financial cycle, with monetary policy tightening more aggressively in the boom and easing less persistently during the bust. Macroprudential frameworks will also help, by strengthening the financial system against the bust.

Going beyond the "own house in order" doctrine

The externalities arising from monetary policy spillovers across currency areas need to be internalised. Put differently, in an interconnected world, it may not be enough to keep one's own house in order, important though that is as the first line of defence. Tightly integrated markets, production factors and financial instruments across the world mean that a country's economic and financial conditions are increasingly subject to global conditions. And those conditions, in turn, are influenced by the collective behaviour of nations, even though they might appear independent of any one country's actions.

One example is how accommodative monetary conditions spread in the run-up to the recent crisis and are now spreading again. Unusually low policy rates in the core industrial countries in the years preceding the crisis were transmitted to the rest of the world through a reluctance to allow exchange rates to appreciate. The outcome was an unusually accommodative global monetary policy stance despite record global growth. This arguably amplified the global credit and asset price boom, magnifying and extending the damage of the subsequent bust. Currently, some emerging market central banks appear hesitant to raise interest rates, this time against the background of rising inflation and signs of a renewed build-up of financial imbalances in the world's more vibrant economies.

Another example is the role of commodity prices in the formulation of monetary policy. Although commodity prices have been affected by supply factors, their price movements also reflect some endogenous components such as rising global demand. It is quite common for countries to treat commodity price increases as "imported", and hence independent of their policies. This may be so from the perspective of an individual economy. But it cannot be true globally. Commodity prices are very sensitive to global demand conditions. In turn, these conditions are naturally shaped by central banks' collective decisions, that is, global monetary conditions. In an uneven recovery, this raises a number of policy challenges.

These considerations do not require a global coordination of monetary policies, but they do call for central banks to take better account of the global side effects and feedbacks that arise from their individual monetary policies. The first step towards doing so is to recognise such effects. This will require a shift to a more global analytical approach towards monetary policy, one that seeks to factor in interactions and feedback effects. Such a shift would resemble the move that has already occurred in regulation and supervision, from a micro- to a macroprudential perspective. A frank exchange of views on the international dimension of domestic policies is a first step towards better domestic policymaking.

Strengthening central bank independence

There is a need to ensure operational independence of central banks in the pursuit of new tasks in financial stability. As already mentioned, central banks play a leading role in emerging macroprudential frameworks. The South African Reserve Bank is a case in point. As announced by the South African Minister of Finance, the Reserve Bank now has a revised mandate that includes responsibility for financial stability. This mandate will be institutionalised by the creation of a Financial Stability Oversight Committee to be co-chaired by the Reserve Bank Governor and the Minister of Finance. One key function of this new Committee will be to oversee financial stability from a systemic perspective.

The well known arguments for central bank independence in the context of price stability apply with even greater force in the context of financial stability. We are all familiar with the political pressure not to take away the punchbowl when the party gets going during inflationary economic phases. But these pressures are surely even stronger when financial booms get going. While there are constituencies against inflation, only brave souls will raise their voices against the illusion that everybody's getting richer. In addition, independence is needed not only from political cycles but also from financial markets. Decisions will be difficult and controversial, The call will never be easy; when uncertainty is high, it is all the more important to clearly understand and explain the trade-offs so that reasonable expectations can be set.

An argument for assigning financial stability responsibilities to the central bank is that it already enjoys and has demonstrated independence in the conduct of monetary policy. To be effective in fulfilling the new macroprudential role, the central bank's exercise of the new powers needs to be underpinned by arrangements that safeguard its operational independence.

Clarity about roles, responsibilities and powers is the precondition for accountability, for effective and rapid policymaking and for the sound management of difficult trade-offs. Authorities and safeguards are needed, as well as tools such as access to micro-supervisory data. At the same time, frameworks need to be flexible enough to adapt with experience.

Accountability is the quid pro quo for independence. True, financial stability objectives are difficult to quantify or define precisely, making accountability harder to achieve than for central banks' traditional price stability objectives. This increases the importance of transparent communication, so that policy intentions can be clearly set out as the basis for accountability.

Before I conclude, let me say that, whether or not they are in charge of supervision, central banks will need to think about a number of additional issues that range from internal organisation to attracting and retaining talent. These may look minor in relation to the conceptual and institutional issues we have discussed here but, in my view, they will be no less critical in addressing the challenges that all central banks face.

Conclusions

Let me conclude. I have suggested four guidelines that may help central banks to face the post-crisis era. In summary, post-crisis policy frameworks should seek to contain more effectively the build-up of financial imbalances; they should pay greater attention to the risks of aggressive and protracted easing in the wake of financial busts; they should more systematically take into account global monetary policy spillovers; and they should safeguard the operational independence of central banks as they take on new macroprudential tasks. The end result will be a stronger medium- and long-term orientation and a more symmetrical policy approach through the cycle.

My considerations also have implications for the present. Depending on local conditions, central banks in both mature and emerging market economies should not unduly delay their exit from the current very accommodative monetary policy stance. A timely normalisation of policy rates and an exit from unconventional policies should help contain rising inflationary pressures and prevent a renewed build-up of financial imbalances. In the longer run, it would also help to safeguard central banks' hard-won credibility.

Thank you very much.