Gabriel Loza Tellería: The role of central banks in macroprudential regulation – the case of Bolivia

Opening remarks by Mr Gabriel Loza Tellería, Acting President of the Central Bank of Bolivia, at the Primera Jornada de Estabilidad Financiera, La Paz, 29 September 2010.

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Today I will speak about the experience of Bolivia, a small, open, partially dollarized and commodity export-oriented economy. Gathered here are representatives from the central banks of Argentina, Brazil, Chile and Colombia with whom we usually meet within the framework of Mercosur, CEMLA and FLAR to discuss not only monetary policy issues but also issues regarding the financial system. I would like to highlight the presence of the Bank for International Settlements' (BIS) Chief Representative for the Americas, because of the close relationship we have been building in recent years. As you know, the BIS is the leader in macroprudential regulation issues. I am also pleased to welcome the European Central Bank, as well as the Bank of Spain. From Argentina, the Center for Financial Stability will present us its private-sector point of view on the subject.

Macroprudential regulation is not an isolated issue, but is closely related to macroeconomic policy, specifically central banks' monetary policy and so-called macroprudential policy instruments, which are the general topic of this conference. We will be speaking about stress tests and reviewing the experiences of Argentina and Bolivia, the latter as part of our Financial Stability Report.

With regard to Bolivia, I would like to point out that our experience is perhaps not widely known, and that, furthermore, each country's experience is unique. I will briefly highlight some lessons from the international crisis and recent reforms in macroprudential regulation, particularly the role of central bank in macroprudential regulation, then describe the Bolivian experience, and finally draw some conclusions.

1. Lessons from the international crisis

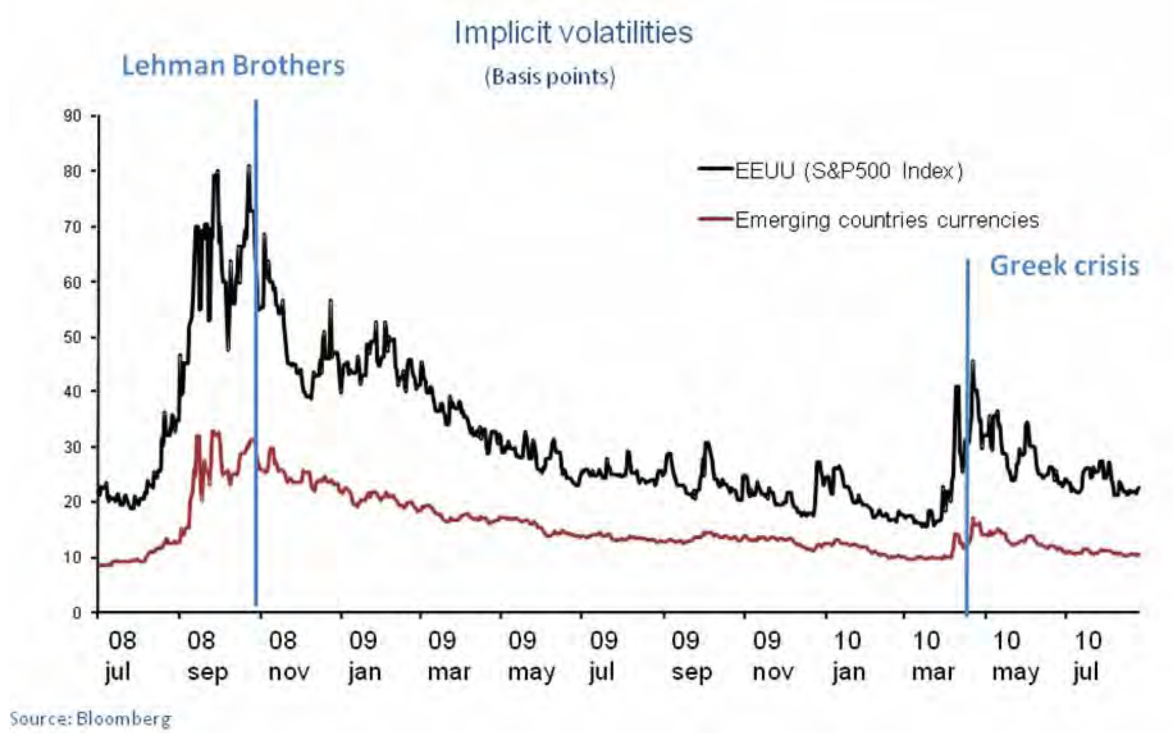
One of the main lessons from the crisis is that, after Lehman, financial markets will not return to their pre-crisis level. The most likely scenario is one of successive crises/shocks of different magnitudes and intensities. Some experts, for instance Roubini, foresee a number of big crises yet to come. Stock, bond and foreign exchange markets are currently characterized by higher levels of volatility than those observed during the Lehman period.

After Lehman, world economies had to deal with the Greek crisis and, more recently, the Irish one. Some financial stress has also been observed in emerging markets due to transmission effects, although not of the magnitude seen in previous crises.

A recent work by Blanchard *et al*. (2010)[1] questions the ability of policy makers to conduct macroeconomic policy, and, among other things, concludes that one of the lessons of the international crisis is that financial intermediation used to be considered – at least by most economists – as not relevant, despite its importance for the credit channel and for the role of central bank as lender of last resort. The financial system as such received little attention, whereas emphasis was given to inflation targeting, low inflation and the role of interest rates.

[1] Blanchard, O., Dell' Aricia, G. and Paulo, M. "Rethinking of macroeconomic policy". IMF Staff Position Note No. 10/03.

Lessons drawn from the crisis suggest that financial intermediation is important and that proper attention should be given to supervision and systemic regulation. On top of that, central banks should follow household prices and other asset prices – in addition to consumer prices – to prevent or take action during bubbles, like the one we have just seen in the real estate sector in several advanced economies.



The policy interest rate, as a traditional instrument, was not enough to prevent the recession and should be complemented with other instruments such as capital and leverage ratios. Central banks have also asked themselves if they should have regulatory capabilities in macroprudential issues. Recent experience points to using a variety of instruments for several objectives, and within this mix of objectives and available tools macroprudential regulation is a key issue. As I said before, the predominant opinion before the crisis was that macroprudential regulation was not part of macroeconomic policy; instead, regulation had mainly microeconomic objectives. In addition, since the 1990s there had been a trend towards deregulation.

Another lesson from the crisis is that macroregulation is not neutral: insufficient regulation led to the crisis, and it follows that it is necessary to combine monetary policy and regulation. In addition, central banks should not only be responsible for monetary policy, but also for macroprudential issues. In the end, we have learned that financial markets do not necessarily move to equilibrium. Government intervention is necessary to achieve stability. Macroeconomic policy alone was not sufficient to prevent the crisis, especially in advanced economies.

Regulation should be one element alongside macroeconomic policy instruments: before the crisis systemic risk was not trivial, it was latent, and it turned out to have been extremely costly to have neglected this variable. Price stability is not a sufficient condition to guarantee financial stability; the relationship between monetary and macroprudential policy should be taken into account. What is required is: proper risk management, awareness of procyclicality and of how risk is distributed, removing the notion of banks as “too big to fail”, surveillance and individual and systemic risk assessment, and awareness of credit growth.

2. Recent reforms and macroprudential regulation

I will only briefly summarize stylized facts, since throughout the conference we will dig deeper into these issues. The establishment of the Financial Stability Board within the G20 framework was an excellent initiative, as was taking into account macroprudential risks and the establishment of anticyclical capital buffers and a capital conservation buffer, among others.

Some additional work was also undertaken by the Obama administration, in particular updating the legal framework of the Federal Reserve and exit rules for big banks; enhancing consumer and depositor protection; strengthening deposit insurance; regulating derivatives markets; requiring a higher level of capital for banks; and improving control over credit rating agencies (which ahead of the crisis did not work properly and could not send early warnings to the markets).

There was, and still is, a debate about taxing banking activity, for instance in the U.S. and Europe. Germany is assessing how to handle the social cost of future financial crises and possible government intervention. We must decide who will face the burden of future crises. Hence the current debate on taxing banking activity – although it is important to keep in mind a global tax, since a mere national tax may lead to disequilibrium. The level of tax for each country may be dependent on risk and the size of the financial system. We must be very diligent in this, since imposing taxes does not in itself eliminate the possibility of future crises, and coordination among countries may be required.

Regarding the reforms to the capital adequacy framework, known as Basel III, one lesson drawn from the crisis was that financial institutions' capital was not enough to protect them from losses. Currently, banks have to keep a Tier 1 (primary capital) of 4%. From 2013, this proportion will be raised to 4.5% and to 6% in 2019. By the end of the decade, quality reserves of banks should be around 8.5%.

In parallel, the European Union has made progress on transparency and safety of derivatives trading, on regulating swaps and hedge funds and on improving a new framework for banking supervision.

3. Prudential regulation and the role of central banks

In the end, the key issue is: what is the role of central banks in prudential regulation? If the traditional approach has revealed itself to be narrow, then we need a systemic approach that incorporates economic cycles and macroprudential regulation. In times of crisis, central banks tend to react quickly, either because they have a mandate or because they are lenders of last resort: central banks are usually the first to try to extinguish the fire. The reason that underlies the former should be clear: central banks oversee monetary stability, financial stability, macroeconomic policies (in our case, monetary and exchange rate policy) and macroprudential regulation.

Several reasons point to the need for central banks to be involved in prudential regulation (in Bolivia there is currently an institutional separation between the central bank and the Financial Supervision Authority (ASFI)). Central banks have daily flows of information coming not only from the financial system but also from the economy as a whole. Therefore, monetary policy decisions should be made in coordination with those decisions related to the macroprudential area in order to smooth the economic cycles. We should take preventive measures before illness appears. The central bank's reputation plays a key role in systemic regulation, as does its role of lender of last resort.

Nevertheless, there are some pending issues[2]:

- What financial stability mandate should central banks have? Is there a need for a new mandate in terms of macroprudential policy?
- Close coordination with government agencies plays a fundamental role. In Bolivia, we thought hard about the true meaning of central bank independence. Central banks had to act immediately, pushed by governments. How do these relationships impact on institutions and their management? Obviously, policy decisions regarding financial stability have some political aspects: whether Lehman should be bailed out or not, or whether any other corporation should be. There is still some debate about this. We can discuss such issues for a long time after a given event, but taking decisions at the right moment is harder to do.

Macroprudential policy is not a substitute for sound macroeconomic policies; macroprudential policies alone do not fix everything, so there has to be close coordination. Who decides the timing and the design of these policies? What is the relationship between the macro- and microprudential issues?

4. The Bolivian experience

The consensus within the Bolivian financial system is that the international financial crisis did not have a direct impact on our economy.

The Central Bank of Bolivia implicitly recognizes that financial stability is a public policy objective, but not an end in itself. Financial stability has to contribute to the economic development of the country. Our approach, therefore, includes close coordination between the Ministry of Economy and Public Finance (Ministerio de Economía y Finanzas Públicas, MEFP) and ASFI.

One of the factors that contributed to the small impact of the international crisis in Bolivia is our low vulnerability – not only in the financial system, but also low fiscal and external vulnerability. We were ready to face exogenous shocks a result of prudential and sound macroeconomic management in the years before, during and after the crisis. The following table shows some relevant data in this regard.

Ratios (%)	Dec-08	Dec-09	Aug-10
Capital			
Regulatory capital to risk-weighted assets	13,7	13,3	12,5
Nonperforming loans net of provisions to capital	-7,7	-7,0	-8,5
Assets quality			
Nonperforming loans to total loans	4,3	3,5	2,7
Provisions to nonperforming loans	132,3	135,5	147,5
Management			
Administrative expenses to total assets	4,2	3,9	4,9
Administrative expenses to financial income	56,4	59,4	71,3
Earnings			
Return on equity	18,7	19,6	20,2
Return on assets	1,7	1,7	1,7
Liquidity risk			
Liquid assets to total assets	43,3	48,0	41,2
Liquid assets to short-term liabilities	91,2	96,8	82,2
Foreing investments to financial investments	10,3	17,9	18,0
Bolivianización			
Loans in domestic currency to total loans	32,1	38,4	50,5
Deposits in domestic currency to total deposits	46,8	47,7	49,6
Foreign liabilities to total liabilities	**3,8**	**2,8**	**2,2**

[2] Heinrich, G. (2010). "El papel de los bancos centrales en la supervisión macroprudencial". CEMLA-LXXXIX Meeting of Central Bank Governors of Latin America and Spain. 13–14 May 2010. Buenos Aires. Argentina.

As can be noted, the Bolivian financial system has sound capital, adequate asset quality and profitability ratios, as well as good ratios of deposits and loans in local currency relative to foreign currency – which is something I would like to highlight. The Bolivian case is still the one of a highly dollarized economy. Financial dollarization, i.e., deposits and loans in foreign currency, used to be around 90% of total deposits and loans. As a result of close coordination among the central bank, MEFP and ASFI, the ratios of loans and deposits in domestic currency over total loans and deposits are, for the first time in several decades, a little higher than 50% for loans and close to 50% for deposits. Banks' foreign currency liabilities are less than 3% of total liabilities due to low involvement in international financial markets, as explained before.

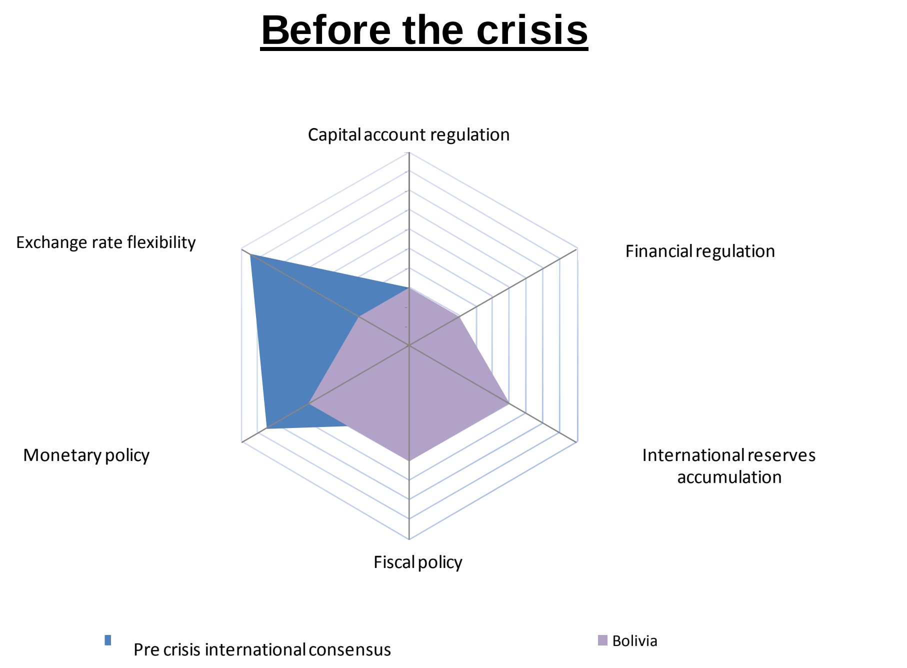
In Bolivia we view financial regulation as important. The prudential regulation measures taken by the Central Bank of Bolivia have improved in recent years and have been closely coordinated internally (monetary and exchange rate policies) and with the MEFP and ASFI. The challenge ahead is to give this coordination a more formal framework. What are the decisions we should make to arrive at coordinated results and decisions?

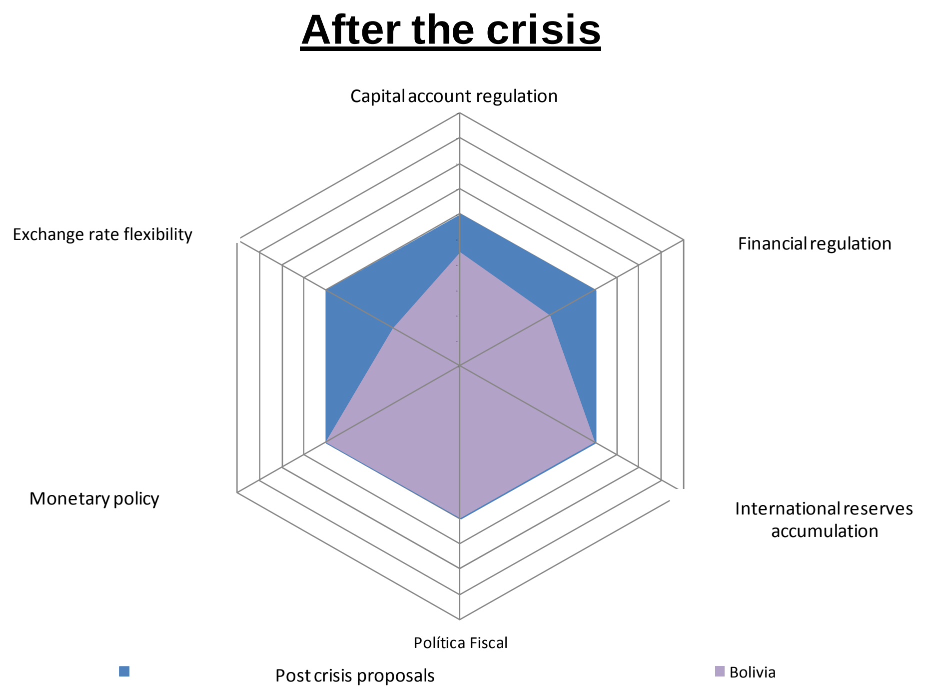
On the one hand, our experience is based upon a sound macroeconomic policy: current account and fiscal surplus, price and foreign exchange stability. On the other, microprudential analysis is performed with emphasis on individual entities, while we also perform macroprudential analysis, for example, our Financial Stability Report, which includes an analysis of stress tests.

The following chart uses an approach presented by the governor of the central bank of Argentina at the conference "Jornadas financieras y bancarias 2010". It is based upon the following variables: current account, financial regulation, exchange rate flexibility, monetary policy, fiscal policy and net foreign asset accumulation. As can be seen, before the crisis, emphasis was on monetary policy and exchange rate flexibility. The exchange rate was endogenous and little progress was made in capital account and financial regulation; net foreign asset accumulation and fiscal policy were not that important before the crisis. Bolivia, before the crisis, had a broader scope on these issues.

Exchange rate stability and net foreign asset accumulation policy were very important for us. This policy has led us to reach the current level of $9 billion in international reserves (45% of GDP). Some of the central banks represented here will be telling us their experiences in this area. Colombia and Mexico would be cases worth hearing about.

Adequate fiscal policy led to consecutive fiscal surpluses. In order to manage capital flows, the Central Bank of Bolivia imposes fees of 1% for outflows and 0.6% for inflows. These measures have been carefully analyzed, and the Bank continues to monitor them closely. In the wake of the crisis, recommendations have pointed to an equilibrated approach, and we have followed this line.





5. Conclusion

The financial crisis is not over; we are not going back to pre-crisis levels, and the financial environment will continue to be one of uncertainty. The challenge for central banks is to make monetary and macroprudential policies in times of stress. The current lack of macrofinancial regulation is part of the problem, but it is not the only one. There are market failures, but it is not possible to assess their intensity: there was not an automatic adjustment or a smooth transition back to equilibrium; there were also drawbacks derived from dominant macroeconomic policy thinking. Financial stability should be a public policy goal and a means to stimulate economic growth. In this context, that the role of the central bank is important: monetary stability is not enough, and sound macroeconomic and macroprudential policies to promote financial stability are needed. Integrated market regulation and supervision should include all agents and instruments as well as oversee leverage, liquidity and provisions. Macroprudential regulation is still in the process of being defined, and it is a pertinent issue. It is necessary to define and identify its tools and aims. As usual, these definitions should be done case by case, with a pragmatic approach.

I would like to thank you all for your presence at this conference, and I would like to extend a particular welcome to the university students in the audience, because ultimately you will be able to apply the information disseminated today, since you are, in the last analysis, the final users of the information. We have a very large audience today, and may I now invite all our speakers to share their experiences. Thank you very much.