Zeti Akhtar Aziz: Role of central banks in emerging economies

Speech by Dr Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia, at the Svein Gjedrem Colloquium, Oslo, 18 November 2010.

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Introduction

Central banks continue to be challenged with changing demands as the environment before us is rapidly being transformed. These fundamental and pronounced changes have prompted calls for a review of the role of central banks in the financial system and in the economy. Frequently, such calls have been precipitated during a financial crisis, as was the case during the Asian financial crisis and more recently during this current global financial crisis. However, such institutional reforms undertaken in periods of exceptional conditions risks influencing the nature and direction of the reforms. While the reforms following a crisis may address the immediate term demands, of equal importance is the medium and the longer term implications of the reforms. Perhaps, an important lesson for central banks is that such reinvention and modernisation should be undertaken during the good times so that we will not be subjected to such changes during the worst of times. In essence, in such a dynamic environment, central banks need to continue to adjust and evolve to remain relevant and, thus, useful.

It is my great honour to be invited to speak at the Norges Bank Colloquium held in honour of Governor Svein Gjedrem. Let me take this opportunity to congratulate Governor Gjedrem for the achievements of the Bank under this leadership during his twelve year terms in office. My remarks today will focus on the role of central banks from the perspective of emerging economies and more specifically in the context of central banking in Asia as we confront the challenges in this rapidly changing global economic and financial environment.

Central bank mandates

While there is no unique blueprint for the design of the institutional arrangements for a central bank, of importance is that it needs to be relevant to our own circumstances. But of importance is that there is clarity on the mandate, the governance framework and the areas of accountability of the central bank. And that needs to be supported by the empowering legislation to ensure that the central bank has at its disposal the capabilities to deliver the mandate.

Central banks in emerging economies generally have a broader mandate beyond the traditional mandates of monetary and financial stability. Even within these traditional mandates, the role of central banks have varied considerably. In the mandate of monetary stability, it has ranged from having the narrow mandate of price stability to the mandate where price stability is the primary role of the central bank while due consideration is also given to economic and employment objectives. While for some the mandates are clearly hierarchical, for others, the multiple mandates involve assessments of the trade-offs.

The central bank mandate of financial stability is less clearly defined particularly in circumstances in which the supervisory function does not reside in the central bank. The majority of central banks in emerging economies in Asia, however, has the responsibility of the supervisory function although for three of the region's major economies – Japan, China and Korea, this function resides in a separate agency. Even for central banks that has the responsibility of the supervisory function, the specific outcomes to be achieved are less clearly defined compared to the mandate for price stability. In Malaysia, our new Central Bank Act of 2009 has defined this mandate in terms of the risks to financial stability – that is, the risk of the disruption to financial intermediation, the risk of disruption to the orderly functioning of financial markets and the risk of loss of confidence in the financial system.

Common to most central banks in emerging economies is the mandate to develop the financial system. Given the stage of development of financial systems in emerging economies, this is an important mandate not only to enhance the financial intermediation process in the economy but also for the purposes of facilitating the mandate of monetary and financial stability. This mandate has involved institutional building, financial market development and the strengthening of the financial infrastructure including that of the payment systems and the legislative framework.

The decade of financial reforms and financial sector development that followed the Asia financial crisis have resulted in more developed and resilient financial systems that is now better able to intermediate the more volatile financial flows and to withstand shocks to the system. During the recent global financial crisis, most emerging economies in Asia did not experience any disruptions to the financial intermediation process and credit flows continued uninterrupted providing important support to economic activity. It also allowed the financial markets to facilitate the transmission of policies to support the economic recovery.

This developmental role is also significant in contributing towards preserving financial stability. The development of the domestic financial markets and the development of a more diversified financial system has reduced the risk of over concentration on the banking system, a feature that was prevalent during the Asian financial crisis. The introduction of new institutional arrangements has also been aimed at keeping abreast with innovation, the advancement in technology and the intensification of globalisation. It has also allowed for the adoption of a more balanced approach towards regulation in which it is complemented by the newly developed mechanisms for surveillance including across borders, strengthened supervisory oversight and institutional arrangements for resolution.

Central banks and financial markets

A more recently much discussed mandate is the role of the central bank in ensuring the orderly functioning of financial markets. Orderly functioning financial markets are vital not only for the efficient allocation of financial resources in the economy but it is also essential for the transmission of the monetary policy and for preserving financial stability. While competitive forces are expected to result in efficient and optimal outcomes, central banks in emerging economies have had the important role of balancing between the market forces and intervention with the objective of ensuring the orderly functioning of the financial markets. It needs to be recognised that several important preconditions need to be in place to generate equilibrium prices that reflect the underlying fundamentals. This includes the institutional and market infrastructure, the incentive structure, the rules of the game and the level of financial literacy that recognise and understand the market signals. When these elements are still yet to be fully developed in many emerging economies, it increases the risk to instability. Thus, as a result of the stage of development of such markets, or its size or prevailing market imperfections, emerging economies have tended to be more vulnerable to greater volatility and circumstances in which markets do not self-equilibrate. The recent global financial crisis has shown that such dislocations have occurred even in developed financial systems. Institutional structures and rules that become deficient and less relevant heighten the risk for such unstable market conditions. Experience has also shown that such market dislocations have severe and far reaching adverse implications on the overall economy.

For the effectiveness of such interventions, however, there needs to be clarity in the objectives to be achieved by such central bank presence and the results that are expected to be delivered. Of importance, there needs to be the recognition of the temporary nature of such interventions and the challenge of efficiently unwinding such presence when the objectives are achieved. There is also the need to manage the risks of unintended consequences of such direct central bank interventions. Such risks could include the potential for circumvention, or the gravitation to other markets not protected by such intervention. There could also be potential costs associated with such interventions, not only the current costs, but also the cost to future generations.

While the pace of deregulation and liberalisation may differ across emerging economies, there is a discernable distinct shift to greater market orientation in this recent decade. These reform efforts have been reinforced by efforts to develop the financial markets and financial infrastructure. Within this framework, the nature of intervention has been in the form of direct presence in the financial markets, the setting of rules and regulation, and in the resolution of problem financial institutions. Such interventions were evident during the Asian financial crisis in the late 1990s to restore stability in the financial markets. This in turn created conditions for the resumption of the financial intermediation process. While the efficient functioning of the financial system was vital for the economic recovery in Asia, more important was the comprehensive set of policies that produced the recovery. Within a year of the introduction of the pro-growth measures, most of the crisis affected economies experienced a strong recovery.

More recently, the global financial crisis has seen several rounds of wide ranging direct market interventions to restore the smooth functioning of these markets. Described as actions taken in the most extraordinary and exceptional circumstances, it demonstrates that this phenomenon of severe market dislocations has the potential to occur even in the most developed of the financial systems. As these massive interventions continue, primarily in the public and private securities markets, the concern is on its potential consequences on other parts of the world, in particular, to the emerging world. In the now more interconnected and interdependent world, these actions are already creating significant shifts in capital flows. Important for the emerging world is the ability to intermediate such surges in capital flows and to manage the risks associated with such liquidity inflows and its potential to undermine the current recovery.

A further element that has frequently been underestimated is the role of behaviour which has had a major influence on the dynamics of the financial markets. Extreme forms of such behaviour are evident in asset and foreign exchange markets. While the former is prone to boom and bust, the latter is prone to overshooting. While several emerging economies have successfully relied on macro prudential measures to contain the formation of such asset bubbles, the foreign exchange market is not like any other market. With a daily transaction amounting to USD4 trillion, it is the most liquid and dynamic market in the world. The role of sentiment and expectations has resulted in a market that is frequently prone to excessive movements and overshooting. As highly open economies, disruptions and disequilibrium in the foreign exchange market have far reaching consequences in the real economy. Intervention operations to maintain orderly market conditions reinforced by sterilisation operations have aimed at ensuring liquidity in the market and at ensuring that the market conditions reflect the underlying economic fundamentals. Similar to the presence in other financial markets, this is to ensure the sustainability of the efficient functioning of the market.

Central banks and crisis containment and management

The world going forward is likely to continue to be affected by financial crisis. History has shown that there have been more than a hundred distinct banking crises in this recent two decades. The prospect of surviving such a crisis is not only about building resilience but also having the capacity to manage it. Central banks have a critical role in crisis containment and management, in particular, to provide liquidity, to restore the efficient functioning of financial markets, to lead resolution programmes and to restore confidence to the financial system.

Given that the central bank is the lender of the last resort, the central bank is in the front line of actions to restore stability. Regardless of the institutional arrangements for the supervision function, – of whether it is based on an integrated model or a model that is organised along sectoral lines, effective coordination is vital to effectively safeguard financial stability. Established arrangement for coordination avoids a piecemeal approach by any individual agency in the system and ensures a comprehensive response to the crisis. Greater coordination across agencies also allows for prompt actions to be taken.

Elements for crisis management have largely been put in place in several of the emerging economies in Asia. This has included a framework for rigorous surveillance for the early detection of risks and vulnerabilities, the range of policy instruments to address the build-up of risks, the governance and accountability framework as well as the coordination framework. Regardless of whether the supervisory responsibility resides at the central bank, the role of the central bank in surveillance for macro-economic management, and its direct contact with the financial markets in its money market and reserve management operations can be leveraged upon to support the financial stability mandate. This allows for a more comprehensive response in containing and managing the crisis.

In Asia, as regional financial integration intensifies, there has been greater regional cooperation and collaboration. During the Asian financial crisis, the management of the crisis was by the individual economies. As the challenges become more complex, standalone actions may not achieve the desired outcomes. Moreover, the perceived best solution for one country may have unintended consequences for collective stability. Asia has, thus, come together collectively to conduct regional surveillance with concrete steps to establish financial support networks, to develop regional financial markets and payment systems. Such collaboration also provides a collective voice and representation and the potential to be heard in the sphere of global policy formulation.

Modernisation of the central bank

As central banks advance forward into the future of great uncertainty, the challenge of the new environment demands new institutional capability for the central banks to remain effective in delivering our mandates. Central banks also need to undertake its own transformation and modernization. Such institutional capability enhancement may involve changes in the institutional arrangements, organizational and governance structures and practices, the empowering legislation and the talent required. Such organisational development would thus require continual reinvention to adjust to the new realities of the changing environment.

In most emerging economies, the largest concentration of talent resides in the central bank. In this new environment, this talent needs to have new capabilities to deal with complex issues from different perspectives that are no longer based on functional boundaries. While this involves horizontal collaboration across the organization, it also requires management of relationships including with the government while retaining the independence of the organization. This would require institutionalizing the channels for information flows, governance structures and clarity of accountabilities as well as the mechanisms for dealing with disputes. Cumulatively, this would provide for a constructive relationship while preserving the independence of the central bank.

An essential element in central banking that is paramount in an environment of great uncertainty is having a well-developed communication strategy. Unlike the mature evolution of communication strategy in the conduct of monetary policy, central banks' communication with respect to financial stability is still very much in its early stage of development. Indeed, the recent crisis has clearly surfaced the need for central banks and policy makers to design communication strategy that balances the objective of providing information to the market and the public, while achieving an optimal outcome of enhanced financial stability.

Conclusion

Allow me to conclude. The rapidly changing global economic and financial environment will continue to exert much demands on the central banks. While extensive modernization and transformation of central banks can be implemented at the national level, the increasingly interconnected and interdependent world demands a greater emphasis on global perspectives and considerations. The greater interface at the international level has involved enhanced engagement to concrete collaborative actions. The common objective is surely for an inclusive participation in the international financial system that will facilitate the common agenda for a self-sustaining global growth and development. Thank you for your attention.