Gill Marcus: Monetary policy and financial stability in the post-crisis era

Welcoming remarks by Ms Gill Marcus, Governor of the South African Reserve Bank, at the biennial conference of the South African Reserve Bank, Pretoria, 4 November 2010.

*   *   *

Introduction

It gives me great pleasure to welcome you to the third biennial policy conference of the South African Reserve Bank. The aim of this conference series is to stimulate debate on current topical issues and to add value to these discussions. In order to ensure this, we have invited economists from the policy arena, the private sector and academia. Having a wide cross-section of economists with different perspectives in our midst should enrich a lively debate. We are particularly fortunate to have a number of well-respected local and international economists present, and we are grateful for the opportunity to interact with them. Allow me to also welcome participants from some of our neighbouring countries, including Governor Shiimi of Namibia, Governor Senaoana of Lesotho, and Deputy Governor Mdluli from the Central Bank of Swaziland accompanied by senior officials from their Central Banks.

The previous conference, held in late October 2008, took place a few weeks after the outbreak of the global economic crisis. At the time, the full implications were unclear. Two years later, the world has emerged from the recession, but is not out of the crisis, and the global outlook remains uncertain. Some advanced countries are still struggling to stimulate their economies: quantitative easing continues in the United States and Japan, and monetary policy remains accommodative in the United Kingdom, and in the euro area. The banking sectors in Europe and the US remain under pressure.

Against the backdrop of fiscal austerity measures, monetary policy is likely to remain loose for longer, which has implications for emerging-market economies in particular, where significant capital inflows have put pressure on their currencies. Unfortunately, the global imbalances that were at the heart of the crisis in the first place are still with us, with few prospects for an imminent resolution of the problems.

Nevertheless, it is an opportune time to assess some of the implications of the crisis. Many questions are being asked: for instance, is there a changed role of Central Banks regarding Monetary Policy, Financial Stability and Regulation? This year the theme of the conference is: “Monetary Policy and Financial Stability in the Post-crisis Era”. Within this broad theme we will be focusing on three important areas, namely the implications for banking sector regulation, for emerging markets and for monetary policy. Three plenary sessions will address these themes and I will make a few introductory comments on each of them.

The regulatory response to the financial crisis

The global financial crisis has spurred a review of banking regulations. Much of the discussions in international forums, such as the International Monetary Fund and the Bank for International Settlements, have centred round the appropriate regulatory responses to prevent a recurrence of unfettered lending by banks in future. Achieving global consensus on these issues has not been easy, and while progress has been made, significant differences still remain.

There is the risk that the crisis will result in excessive politicisation of regulatory issues in a quest to ensure that someone is seen to be responsible for the crisis. This has the potential to create a new moral hazard by giving the impression that with the agreement on Basel III, the system is safe. But the regulators do not run the institutions and there are no absolute guarantees of safety. Nevertheless, if things do implode, it would be the regulator that would be deemed to be responsible.

The possibility also exists that there has been too much of a focus on banks, rather than on the broader financial system. Over-regulation of banks could not only reduce lending, but it could result in more disintermediation, thus preparing the ground for the next crisis. What the recent crisis has shown is the inventiveness of financial markets to come up with products or institutions that circumvent existing regulations. Furthermore, there is the danger that the pendulum could swing too much in the direction of an excessively tight regulatory regime which could, in turn, stifle the recovery of the banks and their ability to lend, with adverse consequences for the broader economic recovery.

South Africa did not have a banking crisis, thanks to prudent management and appropriate regulation and supervision. Nevertheless, the country has not been spared the fall-out of the crisis, nor is its regulatory environment immune to the changes that are being implemented at the global level.

Experience and implications of Europe's economic policy challenges: lessons for emerging-market economies

The crisis was characterised by a sharp and relatively synchronised global downturn. The recovery, however, has been varied across countries and regions. The euro area has been particularly hard hit. Its banking sector is still in recovery mode, and while there appears to be some stability currently, the sovereign debt issue that threatened the existence of the euro zone as a single currency area earlier in 2010 remains unresolved. The fiscal austerity measures that have been adopted in response to the sovereign debt overhang are likely to result in a low growth scenario in the region, especially in southern Europe, for some time.

These developments and policy challenges have implications for emerging-market economies, including South Africa. About one third of SA's manufactured exports go to the euro area, so there are obvious implications for South Africa from a slow-growing region. The IMF has revised down its projections for euro area growth in 2011 to 1,5 per cent, a figure that is positively affected by the 2,0 per cent growth expected in Germany.

There are also important lessons to be learnt from the euro area for future economic and monetary integration in Africa, where the euro was previously held up as the model to follow. The crisis, however, exposed two particular problems that were more easily hidden during periods of economic growth.

First, there was a lack of an effective mechanism to ensure uniformity in fiscal policy. The Stability and Growth Pact was not able to constrain fiscal deficits and in 2010 widely divergent fiscal deficits were apparent, which ultimately led to the sovereign debt crisis. According to the OECD, fiscal deficits in 2009 ranged from 3,1 per cent of GDP in Germany, to 13,6 per cent and 14,6 per cent in Greece and Ireland respectively. The associated debt build-up led to the sovereign debt crisis earlier in 2010 and the spreads on this debt indicate that the markets are not convinced that these issues have been fully resolved. This suggests that in order to have viable economic and financial integration, there may be a case for a single fiscal authority, in the same way that there is for a single central bank. Such a move, however, is likely to be far more politically sensitive than reaching agreement on a common monetary authority.

Second, the crisis in the euro area has shown that having a fixed exchange rate mechanism does not imply that a country's international competitiveness is automatically maintained. Fixing a nominal exchange rate does not imply real exchange rate stability. This is a well-known fact, but generally forgotten by the proponents of a fixed exchange rate, including those in South Africa who view it as the silver bullet to solve to country's problem of competitiveness.

If exchange rates are pegged, or if countries adopt a common currency, differences in wage settlements, productivity changes and fiscal stances can cause real exchange rates to diverge between different regions. In the euro area, for example, Greece's unit labour cost competitiveness declined by around 30 per cent in the course of the 2000s. Adjusting to this without the exchange rate as an equilibrating mechanism requires standard expenditure reduction policies. A number of euro area countries are now experiencing such pain. Professor Desmond Lachman's analysis of the Eurozone outlook provides a thought-provoking perspective on the challenges that lie ahead.

Monetary policy and financial stability in the post-crisis era

The crisis also had implications for how monetary policy is viewed. In particular, the role of monetary policy and its relationship with financial stability has come under intense scrutiny. During the 2000s, economists at the BIS were at the forefront of warnings against a singular focus on price stability at the expense of financial stability. The previous Economic Adviser and Head of the Monetary and Economic Department at the BIS, Bill White, argued that such a focus, in the presence of low inflation, was likely to lead to the emergence of asset price bubbles. While many of his predictions proved to be correct, there is still much debate about the interaction of monetary policy and price stability, the practical implementation of these policies, and appropriate policy instruments.

It is clear that the core focus of central banks has changed. It is no longer the case that monetary policy can be conducted in a vacuum, and there has to be a focus on financial stability issues. The challenge is to determine how best this is done. One has to determine what central bank measures are and what are not, and ensure that the core responsibilities and independence of the central banks are not overwhelmed or compromised.

Things will have to be done differently: central banks need to create better levels of knowledge and skill− perhaps also collect different data − or change the way in which they look at data.

There is still no general agreement on what the role of the central bank should be with respect to financial stability or, indeed, what financial stability actually means. However, the discussions raise some important questions about the changes in the design of central banks, and possible changes in the relationship between a central bank and government. There needs to be an understanding of who is responsible for financial stability and how it should be executed. Clear parameters need to be set and formalised arrangements made.

There can be little doubt that the central bank plays a key role in financial stability. In fact, most central banks already have an explicit or implicit responsibility in this regard. The question is, however, should this be the sole prerogative of the central bank? During times of crisis, it is usually the case that the first port of call of banks that are in trouble is the central bank. This is the case even if the bank supervision function is not located inside the central bank. The central bank has a role of lender of last resort: it generally oversees the payment system, it has the ability to inject liquidity into the markets in general or into specific dysfunctional sectors of the markets and, in many instances, it is responsible for the micro supervision of banks. But it does not necessarily follow from this that the macro prudential oversight or the financial stability mandate should be located solely within the central bank.

Financial stability requires a national response influenced by political priorities. During the crisis, the fiscal authorities in a number of countries made large capital injections into ailing banks and also provided government guarantees. Furthermore, any lender-of-last-resort activities have fiscal implications, even if they are initiated by the central bank.

The bottom line is that it would be difficult to define a financial stability objective for the central bank alone, and it would be difficult for the central bank to carry out the financial stability functions on its own. This points to a shared responsibility for financial stability, within clearly defined parameters.

Therefore, a way needs to be found to co-ordinate with government as many of the policy options and their funding requirements blur the boundaries between the central bank and the fiscal authorities. Financial stability decisions are generally more political and require more interaction with government.

It is finding a balance of engagement with government with regard to financial stability, and maintaining the independence that is an imperative in conducting monetary policy, that will be important going forward.

Both Professor Charles Goodheart's paper, and that of Dr Stephen Cecchetti, provides a very challenging and thoughtful contribution to these deliberations.

Conclusion

These broad topics will broadly cover the theme of the conference, and we are honoured to have such a distinguished line-up of world authorities to present their perspectives on these issues. In particular, I wish to thank and extend a warm welcome to our presenters, Charles Goodhart, Desmond Lachman and Stephen Cecchetti for their participation. I also wish to thank the discussants and panel members who I am sure will encourage vigorous dialogue. And to all participants, please do not hold back on your thoughts and views. Although we will not solve the problems of the world, hopefully our interactions over the next two days will contribute to a better understanding of the issues involved.