Pentti Hakkarainen: Threats to operational and policy effectiveness?

Key talking points by Mr Pentti Hakkarainen, Deputy Governor of the Bank of Finland, at the panel discussion “How real is a threat to policy capacity arising from financial outcomes? What are realistic options for threat management?”, Workshop on the Finances of Central Banks, organised by the Bank for International Settlements, Basel, 12 November 2013.

*   *   *

When considering potential threats to the policy effectiveness of the central banks, the key concept is credibility. Credibility of the central bank is almost synonymous with its ability to make its actions effective in the market. This is equally important for the effectiveness of policy commitments as for the effectiveness of actual monetary policy operations.

Credibility has at least the following components:

- The financial position of the central bank: Sound finances are important for the de facto independence of the central bank. The reason for this is clear. An independent central bank should be able to fund its operations independently and not become dependent on the government discretion for its financial resources.
- The institutional position of the central bank as a public institution, its prerogatives and its legal independence. Independence protects the bank from political influences and makes it possible for the bank to pursue its mandate in a consistent way. Only consistent policy can be fully effective.
- The quality of the bank’s operations and communications. To be able to influence the market, the central bank’s policy intentions must be transparent and the practical implementation of the policy must be perceived as professional. Otherwise the market reactions to policy may not be as desired.

So, a sound financial position is not the only condition for policy effectiveness. There seems to be a mutually reinforcing relationship between these three factors of credibility which I mentioned. They tend to support each other, and to a degree they can substitute for each other, too: for example, a central bank with a solid institutional position and an excellent professional record may remain effective even if its finances are relatively weak in the medium term.

The three factors of credibility are not independent either. For example, political tolerance for the central bank’s financial losses may be quite small and therefore a more immediate threat to policy effectiveness than the loss of capital itself.

Large financial losses if not well understood and justified might undermine the institutional position of the central bank and also endanger its professional reputation as a high-quality institution. My point is then that central bank finances must be considered in the context of political and market perceptions. The financial requirements for effective policy are conditional on our communications and the stability of our institutional position.

As stated in the paper, the central banks have considerable loss-absorbing capacity even over and above their book equity and provisions, if only the present value of future seigniorage income is sufficiently high.

So it is not only credit and market risks which are of consequence but the income stream as well. In this sense, a prolonged state of ultra-low interest rates might prove to be a challenge to central bank profitability in the long run, and reduce the risk bearing capacity of the central banks.

The Bank of Finland routinely uses the VaR (including expected shortfall) methodology and also stress scenarios to assess the soundness of its financial position, and publicly reports summary statistics from its VaR calculations. These calculations show that the bank is able to absorb considerable losses with its provisions and reserves without endangering its capital position.

Which alternative financial structures might be desirable and feasible?

The paper pinpoints the asymmetry of profit distribution as a major source of concern for central banks, especially if the volatility of profits (including capital gains and losses) is large compared to the average expected profit flow.

The Bank of Finland suffered heavy losses during the Finnish banking crisis of the early 1990s. In the ensuing two decades, the bank has been very successful in achieving a sound, well capitalized financial position which now after the international financial crisis is broadly appreciated in the Finnish society.

There have been both financial and political factors behind the favourable experience.

- ***Flexible rules on provisioning.*** We are able to book above-the-line provisions from unrealized capital gains which can then be used to cover future capital losses. Moreover, the law allows us to book above-the-line provisions also for maintaining the real value of equity capital.
- ***Sensible rules on profit distribution.*** The basic scheme according to law is that half of the accounting profit of the Bank be transferred to the reserve fund and the other half paid to the state. However, the law also says that exception can be made from this rule if the financial condition of the Bank warrants such exception. It is the Supervisory Council of the Bank, composed of parliamentarians, which makes the ultimate decision. After the Finnish Banking crisis of the early 1990s, it took until 2000 before any profits were transferred to the state.
- ***The governance structure.*** The Bank of Finland is institutionally not subordinate to the government, but instead to the parliament. The supervisory Council which wields the ultimate financial powers over the bank is a parliamentary body separate from the government ministries. It has proven to give a high priority to the financial soundness of the Bank of Finland, and has not reflected the occasional pressures arising from the Ministry of Finance for example.
- ***Institutional support by the ECB.*** The ECB's opinions give powerful support to the financial independence of the National Central Banks of the eurosystem. For instance, when there was political discussion in Finland in 2003 about extracting capital from the central bank, the institutional support from the ECB was important in avoiding that action.

Ultimately however, all of these pillars of central bank financial soundness are dependent on the general understanding of the tasks and responsibilities of the central bank, and on a broad trust and acceptance on its activities and operations. If these are undermined, the provisioning and distribution rules, governance structures and other safeguards of central bank soundness are not on a durable basis. The central bank must therefore strive to demonstrate by acts and words that it serves a public purpose.