BANK FOR INTERNATIONAL SETTLEMENTS

Redesigning the central bank for financial stability responsibilities

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On the occasion of the 135th Anniversary Conference of the Bulgarian National Bank

Sofia, 6 June 2014

Introduction

I would like to thank Governor Iskrov for the kind invitation to join you on this historic occasion. I am very pleased to be here to celebrate 135 years of the National Bank.

These 135 years indeed make for a remarkable story – few central banks have seen as many fundamental changes as this one. Part of the reason may simply be that it is one of the older central banks, being one of just 17 in existence at the end of the 19th century. Now the number is almost 180, with most having comparatively short histories.

Two features of your history serve as important reminders to any student of central banking. The first is that institutions evolve. The needs of society change; ideas about the regulation of economic activity change; and so too must the institutions that do the regulating. The second is that central banking does not have a homogenous, uniform character. The range of functions performed by today's central banks is as broad as the range of functions that they have served over history.

Central banking continues to evolve. The global financial crisis has reminded us of the complexities of attaining monetary and financial stability in a globalised world. Of particular interest to the BIS, especially following the crisis, is the adaptation of thinking about the regulation of financial activity. Central banks are at the centre of this adaptation.

Whereas we had come to think of monetary and financial stability as two separate things, we are now realising how damaging it can be to keep them separate. This is for many a new realisation. And it is what I want to talk about today. The main points I want to make are the following:

- Price stability and financial stability are part of the same public good.
- A perfectly neat assignment of policy instruments – the short-term interest rate to monetary stability (via exchange rate stability or otherwise), prudential tools to financial stability – is not always feasible or sensible.
- Financial cycles, which feature a build-up of leverage and risk-taking on the upswing, last longer than the standard business cycle. Financial cycles interact strongly with the real economy and require a symmetric policy of leaning against it as well as cleaning up after it.
- Since much of the responsibility for financial stability is shared, integrating financial stability considerations into monetary policy, and vice versa, presents tough institutional challenges. Independence of action against the build-up of financial imbalances is as important as independence of action against the threat of inflation or deflation.

Financial and price stability: two dimensions of the same public good

I am convinced that it is useful to think about price stability and financial stability as two dimensions of the same public good, as opposed to two separate public goods. I have four reasons to offer:

1. Both are about money and credit.
2. If one is unstable, it is more difficult to keep the other stable; but price stability is not sufficient to guarantee financial stability.
3. Interest rate settings determine the universal price of leverage in a given currency and influence the price of risk. Interest rates influence everyone's decisions on spending now or later, in this currency or that currency, and on gearing up or down.
4. At the same time, changing capital and leverage rules also affect the price of risk and of leverage, and, via both, the business cycle.

To a significant degree, monetary and financial stability policies are inseparable. This makes it difficult to neatly assign each instrument to its own unique objective.

Moreover, from time to time monetary and financial stability policies may well need support from each other. On their own, regulatory and prudential policies – including macroprudential policies – are not sufficient to rein in excesses in the upswing of financial cycles. History suggests that macroprudential policy tools can build resilience and be effective in treating specific sectors, but much less so in constraining widely based financial booms. For instance, macroprudential tools can help limit the quantity of bank-provided mortgages and thus banks' exposure to the housing market, but they cannot reach all forms of financing of house purchases or directly dampen the volatility in house prices. In such circumstances, changes in interest rates – and thus the price of risk and leverage – can "get in all the cracks", as Federal Reserve Governor Jeremy Stein put it in a speech last year.[1] To be sure, the size of any plausible changes in interest rates may appear small. But if applied persistently to reduce the underpricing of risk, even small changes can influence the incentive to use leverage, both inside and outside the regulated perimeter.

It is also true that interest rate policy sometimes needs a friend. There may be situations where the bluntness of the interest rate tool – the counterpart to its broad reach – means that the brunt of policy action is taken by the wrong sectors. Some countries, amongst them many emerging market economies, have therefore found that capital outflows that are driven by others' economic developments, rather than their own, are best managed by targeted regulatory measures that lessen the need for wide-reaching interest rate hikes.

Of course, using monetary policy in support of financial stability, or regulatory policies in support of macroeconomic stability, will never be easy to get right, or always fully effective. Our understanding and capacity to control systemic risk is incomplete. We will still struggle to identify the problem in time. We will still struggle to understand the best mix of instruments, and to avoid the temptation to use the least politically sensitive mix as opposed to the most effective one.

And there remains the risk of overburdening both elements of policy. When monetary policy is asked to do too much, its credibility (and that of the central bank) is put at risk. If monetary policy actions are not credible, they don't work. And when regulatory policy is asked to do too much, all manner of unintended consequences and distortions are bound to follow. Moreover, we run the risk of

[1] J Stein, "Overheating in credit markets: origins, measurement, and policy responses", speech at research symposium sponsored by the Federal Reserve Bank of St Louis, February 2013.

abusing the term macroprudential by using it to lend credibility to all kinds of administrative controls, which may be right or wrong policies, but which are not macroprudential policies.

Reworking the governance of macroprudential management

A clear lesson from the crisis is that financial stability has a macroprudential or systemic dimension that cannot be ignored. Treating the financial system as merely the sum of its parts leads one to overlook the system's historical tendency to swing from boom to bust. Interestingly, it was in the more advanced economies where the macroprudential dimension was most ignored in the run-up to the crisis. Emerging market economies have generally been more aware of the importance of thinking about the financial system as a whole, and more willing to intervene when a build-up of imbalances and risks seemed to be inconsistent with economic fundamentals.

Along with greater awareness and a more proactive attitude towards systemic risks, many countries have now given their central banks explicit mandates for financial stability, or created new institutional arrangements for macroprudential policy that involve the central bank. Before the crisis, around two thirds of central banks had some form of explicit mandate for financial stability written into their law. Now, that share is up to four fifths and growing. And in recognition that financial stability is usually a shared responsibility across state agencies and the government, since 2009 we have seen the creation of more than 30 inter-agency councils for macroprudential policy.

In many cases, giving the central bank a mandate for financial stability has been making explicit what was implicit all along. When we surveyed BIS member central banks in 2008, nine out of 10 of them indicated that they had a major responsibility for financial stability policy and oversight of the financial system. That is much more than the two thirds that had such a responsibility in law. But when such responsibilities are made explicit, something quite important happens. Parliaments put beyond doubt that financial stability is a core responsibility of the central bank – and often explicitly add a macroprudential dimension.

Before the crisis, this responsibility was probably not being discharged as actively, or with as much awareness of the systemic dimension, as it should have been. Making the responsibility explicit is one way in which legislatures send a message to central banks – that this is a vitally important function that should be treated as seriously as maintaining price stability. With the responsibility explicit, there is no excuse – central banks will be held to account for their performance on that front too.

And in terms of adding a macroprudential focus, up to 2008 many central banks with some type of financial stability objective had it connected to a microprudential task, such as banking supervision, or related to oversight of payment and settlement systems. Let me give you an example. Up until the end of 2012, the Czech National Bank had supervision of financial entities and contributing to the stability of the financial system as a whole among its listed tasks, but financial stability was not clearly stated as an objective. Now there is a clear financial stability objective, one that is linked with new tasks that clearly indicate a macroprudential character.[2]

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[2] Article 2(2) says, "In accordance with its primary objective [to maintain price stability] the Czech National Bank shall: … (d) supervise the activities of entities operating on the financial market, analyse the evolution of the financial system, see to the sound operation and development of the financial market in the Czech Republic, and contribute to the stability of the financial system as a whole …".

Article 2(1) now includes, as an objective, "In addition, the Czech National Bank shall work to ensure financial stability and the safe and sound operation of the financial system in the Czech Republic" and Article 2(2) includes, as a task, "(e) set

Another example is the Central Bank of Malaysia's law, which provides the central bank with extensive powers to intervene in the financial system, including with respect to entities that it does not directly supervise.[3] Since 2009 the law has explicitly stated that its regulatory powers are expressly for the purpose of promoting financial stability, which is in turn defined as a risk of disruption to the functioning of, or confidence in, the financial system as a whole.[4] With this new law, it is clear that the central bank's extensive powers are to be used to prevent disruptions to the financial system and the intermediation process. Use of these powers is not restricted to the protection of creditors of an individual institution, or to dealing with problems arising specifically in the regulated entity. A focus on the whole system is apparent.

I mentioned earlier that at least 30 macroprudential councils have been created in the last five years or so. It is also the case that many central banks have acquired new and explicit responsibilities for financial stability, with macroprudential considerations at their heart, through their membership in these councils. As formal members, central banks share the objectives of the council, to the extent that there is no conflict with their primary law.

The US Federal Reserve System provides an interesting example of a central bank acquiring an explicit macroprudential mandate in this indirect way. Although the Fed was created to limit financial crises, and despite provisions that gave it wide lender of last resort duties, until the passage of the Dodd-Frank Act in 2011 it arguably did not have an explicit financial stability objective. Now presumably it shares the Financial Stability Oversight Council's objectives of identifying risks and responding to emerging threats to the stability of the US financial system.

All in all, the action by parliaments to add and to clarify financial stability mandates for central banks is rather impressive. We have identified more than 60 changes in central banks' laws relating specifically to their financial stability objectives since 2009. And that does not count the many instances of central banks acquiring explicit financial stability objectives through the formation of macroprudential policy councils.

In terms of legislation relating to central banks, this is a whirlwind of change. In few periods in history have such a large number of central bank laws have been changed in important ways.[5]

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macroprudential policy by identifying, monitoring and assessing risks jeopardising the stability of the financial system and, in order to prevent or mitigate these risks, contribute by means of its powers to the resilience of the financial system and the maintenance of financial stability …".

3 The intended use of the central bank's powers to regulate activity in areas not under its direct supervision requires ex ante review by a special committee that includes the formal regulators of those areas.

4 "28. The powers conferred upon the Bank under this Act and the written laws set out in the Second Schedule are for the purposes of promoting financial stability."

Moreover …

"29. For the purposes of this Chapter, "risk to financial stability" means a risk which in the opinion of the Bank disrupts, or is likely to disrupt, the financial intermediation process … or affects, or is likely to affect, public confidence in the financial system or the stability of the financial system."

5 The unusual coincidence of the breakup of the Soviet Union, the formation of the European Monetary System and the move towards inflation targeting implemented by increasingly independent central banks was another such period.

New challenges

So it is apparent that all around the world, parliaments are willing to change the law to address the problems revealed by financial crises. At the same time, many different prescriptions are being tried out. And there are some formidable challenges that these new institutional designs have to overcome.

It is not a surprise that we see a range of approaches being tried. We could learn from the experience of those countries that have always had a more systemic approach to financial regulation, and that have not placed financial and price stability into separate silos. Countries often seem to regard their own circumstances as unique, requiring home-grown solutions. With a diversity of approaches, we will better be able to learn which cope best with the range of shocks confronted, within a variety of economic, political and cultural settings.

As mentioned earlier, central banks play significant roles in macroprudential policy. But the formal institutional arrangement varies. Sometimes the responsibility is directly assigned to the central bank; on other occasions it is assigned to an inter-agency council, of which the central bank is a member or sometimes the chair. Examples of the first kind of assignment include Malaysia, Singapore and Thailand, where the central bank is the main agency responsible for macroprudential policy. On the opposite side is Sweden, where the Financial Services Authority (the main bank regulator) has that responsibility.[6] Among examples of inter-agency councils, the European Systemic Risk Board is chaired by the ECB, and the Bank of England's Financial Policy Committee is chaired by its Governor. The Central Bank of Brazil has a two-committee arrangement similar to that of the Bank of England. For the majority of inter-agency councils – around eight out of 10 cases – the minister of finance or a similar figure is the chair, but the central bank is often a member with key responsibilities.

This varied pattern reflects a number of factors:

- financial regulation, which is the main tool for macroprudential policy, is often distributed across several agencies;
- financial regulation is politically sensitive, in part because its winners and losers are fairly obvious, often concentrated and rarely shy;
- financial instability can have serious fiscal consequences; and
- assignment to the central bank would concentrate power and operational risk too far from electoral checks and balances for the liking of many.

This pattern also highlights some of the deeper challenges that need to be confronted. First and perhaps most fundamental: the higher the institutional separation of price and financial stability policy, the more indispensable and more complicated the required coordination.

Second, and also quite fundamental: financial stability can require prompt and politically sensitive actions, in situations of great uncertainty. These are the same reasons why price stability policy was assigned to central banks, at arms' length from the political cycle. Yet they probably apply more compellingly for financial stability policy. Why? Because uncertainty is likely to be even more of a problem for financial stability policy. While under way, booms that involve a build-up of systemic risk seem benign – if not wholly beneficial – and their dangers cannot easily be estimated, let alone demonstrated with certainty.

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[6] In several EU countries, including Bulgaria, the central bank is the dominant macroprudential agency at home, but at the European level it operates within the context of the inter-agency European Systemic Risk Board. Other countries in this position include Belgium, the Czech Republic, Hungary, Ireland, Portugal, Slovakia and the United Kingdom.

This uncertainty could result in a bias towards inaction. The dangers of building in a bias towards inaction have been pointed out many times by Stefan Ingves, Chair of the Basel Committee on Banking Supervision. And I think he is right. Part of the problem is the mindset, but another part is that taking tough action would have been too difficult in too many countries.

Giving some agencies clear responsibility for financial stability – along with the necessary accountability – will help guard against repeating the inattention to instability risks that was almost built into the previous structure of policymaking. Distancing the agencies from the constraints of political cycles would help attention translate into action, when so needed. And to reduce the inaction bias, it is just as important to provide powers to go along with responsibilities.

Concluding remarks

To summarise, I take heart from the cases of Hong Kong SAR, Malaysia, Singapore and Thailand, among others. These are examples of central banks in charge of both monetary and financial stability policies, within transparent regimes. They are alert to risks of financial instability and are willing to take pre-emptive measures even when dangers are not certain, having carefully considered the side effects. And they seem able to explain those measures to the public.

I take heart from the fact that so many parliaments have been seeking to fill the policy gaps revealed by global financial crisis, even where their countries were not directly involved.

I accept that this is difficult territory. Important powers of state are involved, with important consequences for citizens' lives should policy failures due to inaction or misdirected action occur.

And I accept that dealing more effectively with financial stability concerns, and their intersection with prices stability ones, is going to be an evolutionary process. Evolution does not always progress smoothly, but rather in fits and starts.

Making progress will require a deeper understanding of the nature of financial instability, and its connections to monetary policy, such that we can set clearer objectives and make the reasons for action more transparent. And making progress will require the recognition that both price and financial stability are essential ingredients of the monetary systems of well functioning economies, and that they are in fact two aspects of the same public good.

In closing, I would like to again thank the Bulgarian National Bank for giving me the opportunity to join in this well deserved celebration, and to allow me to make these remarks. What better place to discuss the future roles and arrangements of central banking than in Bulgaria, with so many different approaches packed into 135 years of experience?