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CENTRAL BANKS AND THE REGULATION OF THE FINANCIAL SYSTEM

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Abstract

The author reviews the process of the strengthening of the macro-prudential functions of central banks, placing it in the new monetary policy tendencies evolving after the 2007-2010 financial crisis. Central banks of advanced countries have been more active in redefining their roles than CBs in emerging and transition countries. In each country group, relations between the central bank and the other national monetary authority (e.g. ministry of finance) came under stress during crisis years.

The author, based on his practical experiences, cautions against overburdening the central banks with functions, even if there are good reasons for defining the mandates of the central banks more broadly, particularly in European periphery countries and in emerging economies.

Key words: central banks, monetary authorities, monetary policy, macro-prudential activity, transition countries, inflation targeting, institutional overload of central banks.

JEL: E42, E52, E61, G28

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On functional changes of monetary authorities

International financial turbulences appearing after 2007 first took the form of *liquidity crisis* in the financial system of various advanced countries, and they later evolved into *solvency problems*, and sometime they led to *systemic risks*. The latter provoked massive budgetary stimuli, like in the case of Island and Ireland but to certain degree in other West European countries as well. After 2010, the problems once again took a new shape: ballooning sovereign debts caused crisis in several countries, spreading eventually from some high debt member states to the entire euro zone. The European economic crisis, once thought to be over, became a key issue of the world economy again.

The financial turbulences have been linked to vast global imbalances (huge balances of payment deficits and surpluses) accumulating over a long period of time prior to 2008, aggravated by weaknesses in economic governance and by regulatory defects. Thus, in the light of these, the financial crisis should not have come as a big surprise. However, the general public and decision makers alike had got unused to financial crises in the advanced world and its adjacent regions during the preceding period. The fact is that Europe was taken by surprise in the fall of 2008; events did surprised many business players even after the burst of the American sub-prime crisis. Then came the surprises of 2010: explosion of perceived sovereign risks, despite all theoretical predictability, appeared abruptly that spring, starting with the case of Greece.

The rapid alternation of crisis cycles is also surprising: as a consequence of the collapse of credit, amounting to a *sudden stop*, several open economies of the world sank into recession, but only for a short while; the recession officially ended by the end of 2009 and early 2010 in most respective countries.

Quick alternations of business cycle stages were coupled with similarly rapid changes in economic policy directions; these have sometimes followed, sometimes led to, economic cyclicality. Similarly, quickly alternating stages in monetary policy directions have been noted recently. But what calls for attention is the diversity among various economies and country groups: the developed and wealthy world (the ‘core’ or ‘center’, practically the United States, Western Europe and Japan) has followed patterns very different from those of other nations that are far from the core in terms of development level and geographical distance.

Out of the latter countries, I will here focus on the practice and experience of European periphery countries that may be called emerging economies from another perspective (for short: PE-EM group). Note that 'core' and 'periphery' are relative concepts, and the classification of certain countries is always arguable. Spain or Ireland, from the view-point of genuine periphery nations, seem to belong to the center; yet the Spanish and the Irish situation are to be studied along with the case of new EU-member states in our present context.

Looking at recent changes in the practice of monetary policy making, it is important to recall an oft forgotten truism: a country's financial policy is shaped by *monetary authorities* - the plural refers to the fact that the responsibility and the scope of national authority is not restricted to one single institution, namely to the central bank; the ministry of finance (or Treasury, etc.) also acts as a authority in money matters. Functional division between the two institutions alters country by country, but there are some common patterns; for instance these two authorities jointly represent a given country in international organizations: it is typically the minister of finance who represents the country at the World Bank while the central banker acts as the country's governor for the International Monetary Fund; these two types of institutions are jointly responsible for deciding about the exchange rate regime, and – the most important issue relating to our present topic – managing the financial system's risks.

Therefore, one should not identify monetary policy making with the activity of the central bank. Still, there is a good excuse for making this common mistake in discourses on financial and economic policy. Actually, it was quite natural to compound these two institutions during the period of what was called the 'Great Moderation' that coincided with the undisturbed years of central banking independence. During this period the central banks (national banks on a national level, ECB in the eurozone, respectively) embodied financial policy to the public. You may say this was the *golden age of central banking* as for social prestige of the institution as well as for professional achievements measured by low interest rates and restrained inflation.

The other monetary authority, that is the given country's ministry of finance (Treasury), played a second fiddle only in financial policy management and particular in its external embodiment. However, governments have powerful effects on financial processes through their conduct of budgetary policy, especially by managing the national debt and shaping the budget balance. The government's monetary policy weight is of particular significance when it acts as *sovereign debtor* at home and abroad or, what is rarer in the developed world, it enters the financial markets as an owner of sovereign fund.

It has become a tendency since the 1970s for the governments to finance public sector debt directly, instead of financing it through the central bank. That is, the government acts both in domestic and international financial markets directly. Similarly, it is the financial ministry (or similar agency under another name) that acts on behalf of the state in operating deposit insurance schemes, alone or together with the respective financial institutions; in many countries, however, the central bank is also involved in this task. From time to time, the government becomes a protagonist in reorganizing and rescuing strategically important financial institutions (banks, insurance companies); central banks have not played the role of '*bank hospital*' for a long time. As for *banking supervision* is concerned, it is the government in some country cases, while in other cases it is the central bank that performs these activities, whereas sometime hybrid solutions also exist.

As for the details of functional division of the nation's monetary policy institutions, there are a lot of national specificities, stemming from the political system and the former practice, as well as from institutional and personal relations. At the same time, there exits a 'best practice' - or if you wish: a fashion - transmitted in this matter by international financial institutions (IFIs). The separation of the monetary policy tasks within a country is never definite and never devoid of conflicts. The conflicts and clashes between the two main monetary institutions tended to be moderate during the period of 'Great Moderation', and the unavoidable conflicts between these institutions remained mostly invisible for the general public.

The rapid spread of the inflation targeting (IT) monetary policy regime has also enhanced the culture of consonance among institutions, since the government and the central bank must be in tune with each other concerning the inflation path: IT rests critically on the "management of expectations". When and where, however, the operability of the financial system, rather than the inflation, becomes the paramount problem, the previous (apparent or factual) harmonic relations disappear. The central bank may insist, following the mainstream, to concentrate on its supreme goal: preservation of the value of the currency - but inflation is generally not the real problem in crisis. As for the government: it becomes active in this period and might grow from a silent monetary companion to a powerful operator. Under such circumstances, of course, identifying financial policy with central banking becomes untenable, and conflicts between the mentioned institutions intensify.

In the following section we are going to peruse the central banking functions concerning the management of systemic risk, to which we explicitly address the issues of collaboration between different monetary authorities, as well as issues of separation of functions and possible conflict situations and relevant experiences.

Recent developments in monetary policy making

Signs of crisis led to un-orthodox or non-conventional economy policy responses in some countries. However, as we will see, certain "new" solutions are but long known but rarely used measures discovered anew. Monetary policy makers also had to face often long-forgotten problems, very different from the ones they had got used to during the peaceful period before the crisis; they, understandably, considered solutions of earlier times.

The adjective 'non-conventional' is therefore a misnomer because economic policy makers of the advanced world, faced with the financial disturbances, often applied very conventional textbook methods (that is, taken from Keynesian or neo-Keynesian textbooks): *budgetary stimulus* (tax cuts, expenditure rise), and central banks responding to the freezing of the credit markets with *reduction of their reference interest rates*. Whenever the measures to cure the 'credit crunch' proved to be inefficient and the general instruments of easing the monetary conditions became ineffective as central bank policy rates were approaching zero, non-conventional solutions were adopted involving substantial increase in CB's balance sheet during the liquidity shortfall arising in the fall of 2008.

Such solution includes, for instance, acceptance of formerly rejected collaterals for discounting, and granting credit directly to economic agents. However, you may notice that acceptance of corporate bonds as collateral or direct funding of the state institutions' borrowing requirements are not new phenomena. They are new only in a sense that in the two decades preceding the crisis such measures had not usually been applied by central banks of the developed world or by central banks following the practice of the former.

The main issue here is that the central bank of an advanced country whether followed a mainstream solution or adopted unconventional measures, its efforts were aimed, in any event, at restoring at least the abundance of liquidity in order to remedy the problems resulting from the sudden shortage of credit (credit crunch) if restoring trust directly between the players of the financial intermediary system was impossible.

However, the monetary policy reaction diverged from the above in most countries outside the euro zone (European periphery nations) and the countries considered emerging relative to the European core (together: PE-EM). As observers noticed with certain surprise, the majority of the previously vulnerable emerging and transition countries got over the first, very intense, stage of the crisis relatively well partly because of the high level of their international currency reserves serving as a buffer. In these countries the balance sheets of central banks did not increase as fast as in the case of the FED or the Bank of England since the former did not much adopt the techniques of 'quantitative easing' in order to increase money supply.

Since until the crisis asset prices had not increased in most EM-PM countries to such an extent as in the case of the U.S.A, Spain or Ireland, and the ratio of budgetary deficit (deficit measured against the GDP) was not so high either, these countries could have possibly applied fiscal and monetary policy measures to increase aggregate demand, like China did at the end of 2008. Still, the majority of EM-PM country group found it unnecessary, due to the relatively good state of the real economy and adequate fiscal positions, to adopt massively conventional policy instruments or resort to non-conventional monetary instruments. Some countries did resort to renewal of corporate bond discounting, direct purchase of state securities, decrease of the commercial banking reserve ratio, even market interventions to protect the exchange rate by using international currency reserves; but one still can claim that the intensity of non-conventional measures remained secondary to those of the advanced countries.

Central banks of the countries outside the advanced regions had good reasons for abstaining from the selective financing of sectors and corporations, leaving such remedial and microeconomic crisis management measures for the governments. Central bankers, for one thing, felt that they might not rely on such *institutional credibility* as could the older, acknowledged central banks of the developed world: the latter could afford, with their acquired authority, to apply less transparent monetary policy instruments without compromising credibility. Second, central banks of the periphery did not want to risk their *hard gained independence* by voluntarily giving up from their professional separation from politics; mind you: unconventional economic policy measures only work effectively when there is a close cooperation between the government and the central bank.

Rethinking the central bank as institution

It is an important practical aspect – which is hardly discussed in academic literature – to gauge the volume of functions that a central bank can assume to carry out its duties well, at a proper professional standard, without causing what is known as '*institutional overload'*. The dilemma is simple: if an institution (the central bank in our case) takes on too many economic functions, it can run into management and human resources constraints. At the same time, it is the distance of the central bank from the government, a prerequisite of CB's monetary independence that can provide an institutional prestige making the central bank more capable of carrying out an array of important tasks than any other organization in the country concerned.

Let us take *banking supervisory function* as an example. This important supervisory (micro-prudential) function can be deployed to a governmental body (as in the case of Germany) but may also belong to a central bank as in the case of Italy or an array of emerging markets. Traditions of the past decades are in favor of banking supervision provided by the central bank; yet since the 1980s, mostly governmental agencies have been made responsible for the supervision of banks (as well as insurance companies, brokerage firms, other financial institutions and financial undertakings) under the international trends of strengthening the central banks' independence and narrowing the mandate of the CBs. Theoretical and practical considerations support the conclusion that government institutions may become successful in performing supervisory tasks in countries where professional and ethical level of the civil service is high, public sector salaries are sufficiently high for retaining financial professionals, and the supervisory activity is not pervaded by political interferences. In several developing countries and former planned economies, but also in some advanced countries, it has proved to be easier to create the necessary professional, skill-related and remuneration precondition at the central bank enjoying higher prestige than the ministry of finance or other governmental body, more influenced by daily politics.

Foreign exchange regulation (as long as current and capital account transactions are controlled) will also have a better place at the central bank, on similar grounds - as it was the case with several states in Europe and elsewhere. There are similar arguments for the involvement of the central bank regarding the management and control of *payment transfer*, although there are considerations in favour of placing the control of the payment system within the Treasury. *Managing the accounts* of banks and state institutions is again a similar area: there exist strong professional arguments for involving the central bank. As far as *collection and procession of financial statistics* as well as *macroeconomic research and analysis* is concerned, a central bank may be the ideal place because it has plenty of data, it is deeply embedded in international relations, it is distanced from party politics, and not the least, can offer attractive salaries.

As the above examples demonstrate, there are several significant social functions that may be performed efficiently at a central bank rather than in public administration or in the business sector. Putting all mentioned tasks together, however, may turn out to be too much; hence the intentions of the central banks, and similar efforts by governments, to reduce the scope of CB activities.

The increase in political uncertainties and the financial tensions of numerous states may bring about the appreciation of the central bank status. The central bank and its top management may assume, if temporarily, political roles even in full-fledged democracies, but particularly in former planned economies (transition countries), as well as in new democracies, and any place where less than stable political conditions persist. In countries where the (party-) political elite does not enjoy a stable social support, or where internal political dynamics leads to political deadlock, the society may prompt the president and the senior management of the national bank to step forward. Being a central bank president or senior staff has been a good reference for entry into high politics in Italy, and elsewhere in Europe; there were cases in the Czech Republic, Romania, and Estonia in the 1990s for the central banks' former or president-in-office to assume caretaker or permanent prime ministerial job.

The central banker as a high-level politician: it is certainly an exceptional phenomenon, depending on individual circumstances; still its relative frequency is due to the fact that CB is a national institution closely related to governmental processes without, if certain minimum of the central bank's independence is fulfilled, submerging in the often obscure affairs the daily politics. Economic and financial knowledge is particularly valued during the times of financial crisis.

It is obvious from to the above status and the institutional relations of the central bank that it has to take part somehow in performing *macro-prudential* functions. The European practice preceding the crisis basically covered these CB functions under the concept of *financial stability*; responsibility for the financial stability appears in the central banks' statutes, and such activities of the central bank are reflected by the periodic publication of "Financial Stability Reports". However, it might give rise to conflicts of interest, since the central bank, which in case of turmoil should act to defend the financial system, may face a hard choice: as regards its macro-prudential function it has to create so much liquidity that contradicts its primary function regarding the maintenance of price stability. Should one or more commercial banks' illiquidity, or particularly insolvency, lead to systemic risk, the state may intervene (on behalf of the society, having a mandate from the society and an obligation to be financially liable to it), passing the costs of the intervention to the taxpayers or/and to the next generation; such a decision cannot be made by the central bank in its own legal status. This example demonstrates the limits of CB's macro-prudential activities.

Since the central bank cannot be left out from the decision making process regarding financial system risk, neither - as explained above - can it assume the costs and responsibilities of public intervention, there remains but the constructive co-operative role as practiced on European level as well as in member states, even if under diverse institutional forms. *Consequently, one of the big practical financial policy issues of the years to come will be: how can a sustainable and clear balance be created between the central bank's prime professional function (namely, price stability) and its secondary (co-responsibility) macro-prudential function.* The international recommendations indicate the new norm; however, recent decades of monetary policy practice have shown that creating institutional order and obtaining the necessary reputation takes a long time.

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