The future of central banking: an emerging markets view

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POLICY PANEL DISCUSSION

BANK OF JAPAN CONFERENCE

THE FUTURE OF CENTRAL BANKING UNDER GLOBALIZATION

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Monetary policy: objectives

Legal mandates for monetary policy (%)

	Safeguard internal purchasing power	Safeguard external purchasing power	Safeguard purchasing power	Complex
25 CBs BIS survey	32	4	32	32
53 emerging economies	21	4	38	38
12 advanced economies	42	0	0	58
Total	27	3	31	39

Source: BCB, BIS.

Monetary policy: objectives

- **Legal mandates more focused on price stability in emerging economies (inflationary history & more recent laws)**

- **Recent changes in legislation have stressed price stability**

- **Complex objectives usually do *not* include financial stability (employment, growth)**

Monetary policy: lean or clean?

- **“No one in the industrial countries should now question the substantial economic benefits associated with reducing inflation from earlier, high levels. At the same time, history also teaches that the stability of consumer prices might not be sufficient to ensure macroeconomic stability. Past experience is replete with examples of major economic and financial crises that were not preceded by inflationary pressures.” – Bill White, 2006.**

- **“The monetary policy framework will most likely expand to consider asset prices – and perhaps the growth of monetary aggregates and credit, as well – in some way. The high cost of the current crisis has highlighted the importance of preventing crises, and this suggests that monetary policy will shift from a “clean up after the bubble” stance towards a more active “lean against the wind” stance to deter the formation of asset price bubbles. ” – Vittorio Corbo, 2009.**

Dealing with asset price surges: Brazilian equity prices (Ibovespa index in reais)

Source: Bloomberg.

Dealing with asset price surges: Brazilian 12m interest rates (% pa)

Source: Bloomberg.

Dealing with asset price surges: exchange rate (R$/USD spot)

Source: Bloomberg.

Monetary policy: reaction to the crisis in IT economies

- **“Inflation targeting is being put to the test – and it will almost certainly fail” – Joseph Stiglitz, 2008.**

- **“To sum-up the findings, IT has had a positive scorecard thus far. The monetary policy of IT countries appears to be more suited to dealing with the crisis. Relative to other countries, IT countries lowered nominal policy rates by more and this loosening translated into an even larger differential in real interest rates. With this monetary stimulus, IT countries on average seem to have dodged the deflation bullet better than other countries. With their flexible exchange rate regimes, IT countries also saw sharp real depreciations which were not associated with a greater perception of risk by markets. Perhaps as a result of that, there is some weak evidence that IT countries did better on unemployment rates and advanced IT countries have had relatively stronger industrial production performance.” – IMF WP 10/45, 2010.**

Monetary policy: the state of the debate

- IT better at crisis management than at prevention
- The case for using monetary policy to deal with asset prices & credit booms, to supplement prudential policies, has strengthened, but implementation is not straightforward:
  - Lack of professional consensus
  - Communication to the public (especially in countries that did not face asset-credit bubbles)
  - Need for better modeling of the transmission mechanism from policy changes to asset prices
  - Trade-offs: negatively correlated asset price movements (exchange rate vs. equities)

Monetary policy tools: conventional and unconventional

Conventional (changes in basic interest rate)

- **IT countries farther from zero lower bound than non-IT countries: "Concentrating first on nominal rates, from the beginning of 2008 to August 2008, on average there were nominal rate increases for both groups of countries, but slightly more so for IT countries. The tightening momentum in IT countries can be grasped by noticing that in September 2008, the month of Lehman's failure, 6 out of 22 IT countries tightened their policy rates (Brazil, Chile, Indonesia, Israel, Peru and Sweden). However, as the crisis deepened, IT countries cut their policy rates by 2 percentage points more and the difference in mean policy rates across the two groups has been statistically significant and persistent." – IMF WP 10/45, 2010.**

Unconventional (changes in CB balance sheet)

- **Unconventional policies extensively used in EM economies, even in quiet periods (incomplete markets, lack of institutions)**

Monetary policy tools: conventional and unconventional

BRL market strategy

- **There was no systemic loss of deposits, but a significant increase in concentration in the larger institutions (state-owned and private), hence measures directed at liquidity conditions in smaller banks**

- **Communication aimed at restoring market confidence, measures announced in a sequence over several weeks**

- **"Conventional" monetary policy focused on controlling inflationary fallout from BRL depreciation, easing only after inflation outlook improved and credit channel had been repaired**

Monetary policy tools: conventional and unconventional

Main measures targeted at BRL market

- **Releasing R$116bn (4% of GDP) of banks' reserve requirements**
- **RR releases conditional on use of funds to buy assets from smaller banks and to buy USD from the BCB (to offset the effects of intervention on local liquidity)**
- **Improvement in legal and operational framework of discount window operations**
- **Enabled Deposit Insurance Fund (a private sector fund supported by the banks) to offer guarantees to CDs issued by smaller institutions**
- **RRs have already returned to pre-crisis levels, restoring liquidity buffer**

Monetary policy tools: conventional and unconventional

Liquidity squeeze was important, but limited to smaller FIs and short-lived:

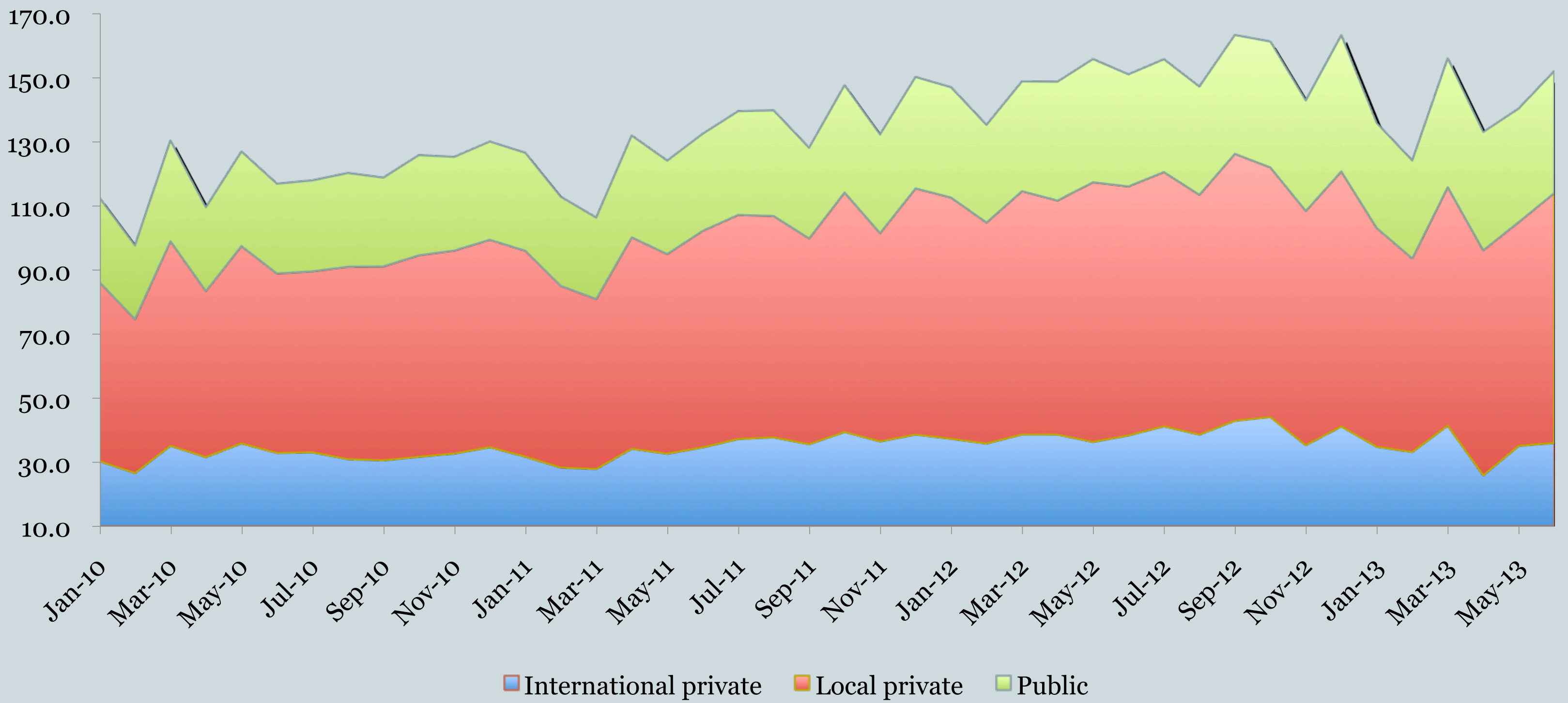
Liquidity availability utilization

Class	8 Sep 2008 - 12 Sep 2008		6 Oct - 10 Oct 2008		17 Nov 2008 - 21 Nov 2008	
	number of banks	share of the payments (%)	number of banks	share of the payments (%)	number of banks	share of the payments (%)
0 - 30%	83	90.8	29	75.5	88	94.8
30-70%	20	8.8	36	19.1	15	4.2
70-100%	3	0.4	41	5.3	3	1.0

Source: BCB.

Monetary policy tools: conventional and unconventional

New lending (R$bn/month) by local FIs soon revived:



Source: BCB.

Monetary policy tools: conventional and unconventional

Outcomes (CB policies + fiscal stimulus + state-owned banks' credit expansion)

- **Credit growth restored after 1Q09**
- **Economic activity reached bottom in January 2009, recovering since then. Market consensus is that growth will reach 6.3% this year, after a mild (0.2%) GDP contraction in 2009. The unemployment rate is near all time lows, and capacity utilization in manufacturing is above the medium-term norm**
- **Disinflation was limited, from 6.2% in August 2008 to a low of 4.2% in October 2009, rising to 5.3% by March 2010 (compared with a target of 4.5%). Hence BCB is back in tightening mode**

Foreign exchange policy: crisis management

Brazilian experience

- **"…the foreign exchange easing measures undertaken by the BCB during 2008-09 seemed to have alleviated the various market stresses arising from local dollar liquidity shortage, at least on impact. The announcements and to a lesser extent the interventions themselves reduced the relative cost of onshore dollar financing. The varied foreign exchange operations also appeared to have stabilized market expectations of exchange rate volatility. The positive effects of the announcements of the currency swap facility between the Fed and BCB across the three regressions strongly suggest that this arrangement helped boost confidence." IMF WP 09/259, 2009.**

Foreign exchange policy: crisis management

USD market strategy

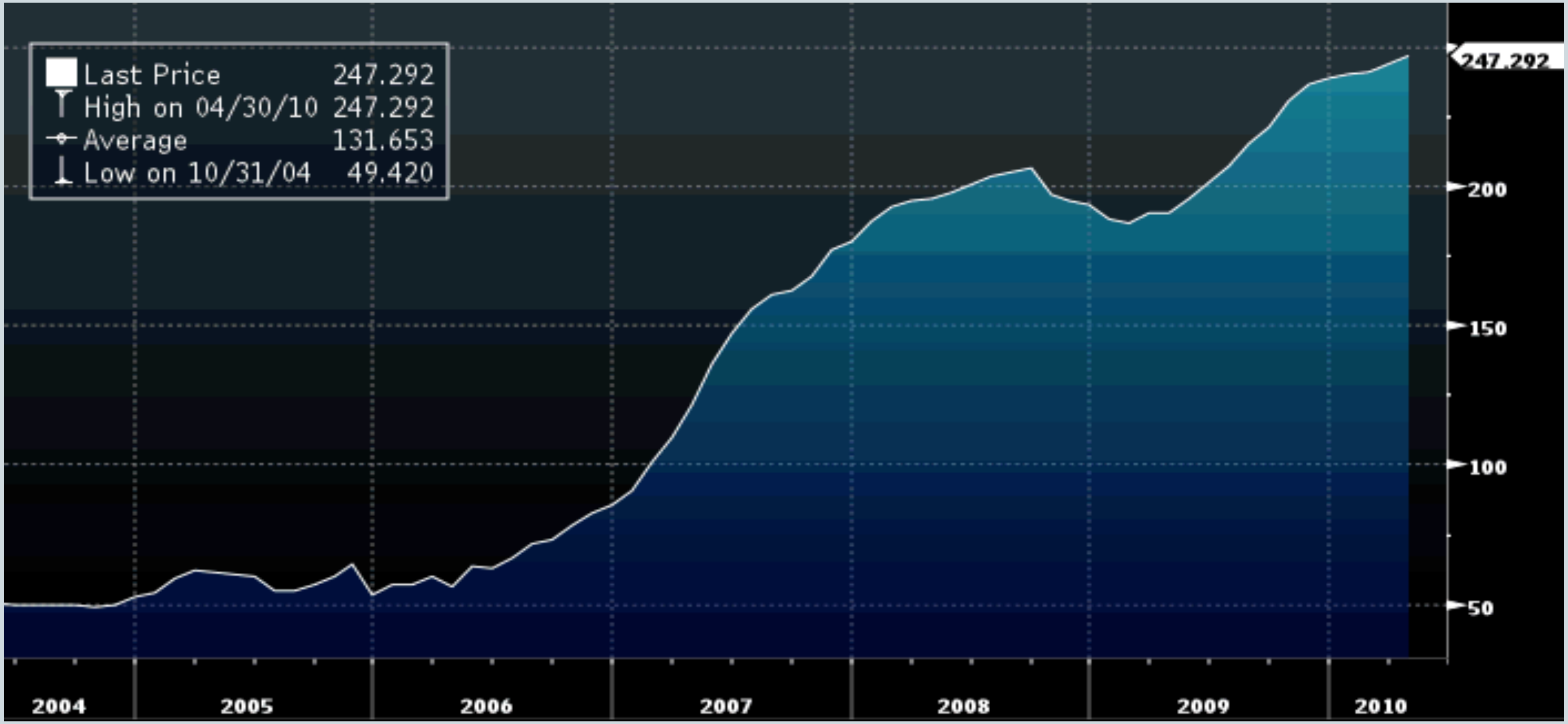
- **Allow the exchange rate to act as the primary shock absorber (62% BRL depreciation from August to December 2008)**
- **Provide liquidity where it was most needed & could have more impact on economy (e.g. trade finance)**
- **Refrain from rewarding private sector mistakes (corporate fx derivative exposure)**
- **Prepare for prolonged period of global market disruption (1930s scenario)**

Foreign exchange policy: crisis management

Main measures targeted at USD market

- **USD sales ($14.5bn, 7% of total fx reserves as of end-August 2008)**
- **USD repos ($11.8bn)**
- **USD loans ($12.6bn, of which $9bn directed at trade finance)**
- **Currency swap with US Federal Reserve (up to $30bn, untapped)**
- **BRL-USD swaps (equivalent to $35bn) in derivatives market**
- **Repos, loan and swap operations have been unwound, fx currency swap lapsed**

Foreign exchange reserves at the BCB ($bn)



Source: Bloomberg

Foreign exchange policy: lessons from the crisis

Lessons from the crisis I: fx reserves pay

- **Fx reserves helped CBs alleviate sudden stop, mitigating effects on corporate sector**
- **Fx reserves helped CBs support trade finance**
- **Fx reserves enabled some EM central banks, including the BCB, to have access to US Federal Reserve swap lines (powerful signaling device)**
- **Fed swap lines (even after Greece) should not be taken for granted**

Lessons from the crisis II: fx flexibility also pays

- **Fx flexibility enabled CBs with credibility to ease policy aggressively, even after substantial depreciation**

Supervision: within the CB?

	CB	Shared	Agency (ies)
Brazil	X		
Czech Republic	X		
India	X		
Indonesia	X		
Israel	X		
New Zealand	X		
Romania	X		
Russia	X		
Slovak Republic	X		
South Africa	X		
Thailand	X		
China		X	
Japan		X	
US		X	
Australia			X
Canada			X
Chile			X
Colombia			X
Euro-zone 1/			X
United Kingdom			X
Sweden			X
Switzerland			X

1/ with national CBs.

Source: CB websites.

Supervision: within the CB?

International experience

- **No dominant arrangement.**
- **There are success stories of supervision both within and outside CBs**
- **CBs in emerging economies have historically been more involved with supervision**
- **Focus of supervision activity has trended to widen, including non-banks under regulatory umbrella**
- **Trend towards spinning supervision off (e.g. British FSA) that existed before the crisis may be checked**

Supervision: within the CB?

Cons

- **Conflict of interests between monetary policy and prudential responsibilities**
- **Risk of regulatory capture of the CB**
- **Specialization (CB & stand-alone regulatory agency) favors more efficient use of public funds**
- **Too much power at CB**

Supervision: within the CB?

Pros

- **The L-O-L-R role requires timely and comprehensive information on the state of the banks, such as that provided by supervisory activities**
- **Proper monetary policy design and implementation requires proper knowledge about the state of the financial system**
- **Synergies and information flows helpful in crisis situations**
- **Important in cases where the government controls important financial institutions (e.g. in Brazil), for prudential reasons and also to ensure monetary policy is not circumvented**

The way ahead: an emerging markets view

- **IT likely to remain in place where it has been adopted**
  - **Include asset prices, monetary and credit aggregates fully in information set (Pillar II)**
  - **Price Level Targeting ?**

- **Self-insurance policies likely to persist (probably with focus on USD assets)**

- **EM central banks to resort to macro-prudential policies:**
  - **Discretionary changes in LTV ratios**
  - **Discretionary changes in liquidity ratios**
  - **Cyclically adjusted capital adequacy requirements**
  - **Capital controls?**

- **CBs in EM economies likely to become more rather than less involved in regulation and supervision**

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