View metadata, citation and similar papers at core.ac.uk
brought to you by CORE
provided by Research Papers in Economics

Occasional Paper No. 53

CENTRAL BANK GOVERNANCE AND CHALLENGES POSED BY THE CRISIS

Y.V. Reddy

The South East Asian Central Banks (SEACEN)
Research and Training Centre
(The SEACEN Centre)
Kuala Lumpur, Malaysia

Occasional Paper No. 53

CENTRAL BANK GOVERNANCE AND CHALLENGES POSED BY THE CRISIS

Y.V. Reddy[1]

[1] Dr. Y.V. Reddy was Governor, Reserve Bank of India, from 2003 to 2008. He is currently Professor Emeritus, University of Hyderabad. He is also Honorary Fellow of the London School of Economics and Political Science. Dr. Reddy is on the Advisory Board of Institute for New Economic Thinking (INET) and is also on the International Advisory Board of the Columbia Program on Indian Economic Policies, Columbia University, New York. He is a Member of an informal international group of prominent persons on International Monetary Reforms, and is also on the Advisory Group of eminent persons to advise the Finance Minister of India on G-20 issues. This Paper was delivered at the 46th SEACEN Governors' Conference, High Level Seminar and 30th Meeting of the SEACEN Board of Governors held in Sri Lanka on 24-26 February 2011. The views expressed in this Paper are those of the author and do not necessarily represent those of The SEACEN Centre.

Table of Contents

		Page
Summary		iv
1.	Role of Central Banks in Causing the Crisis	1
2.	Generalizations are Misleading	1
3.	Role Of Central Banks in Managing the Crisis	3
4.	Role of Central Banks in Exit Policies	4
5.	Reforms Underway and their Broader Relevance	5
6.	Governance Issues: Need to Revisit	6
7.	Emerging Governance Issues for Developing Economies	8

Summary

In the first section of this paper, it will be explained that though generalizations are misleading, some of the central banks, especially among the advanced and systemically important economies, may have to take some, though not entire responsibility, for causing the global financial crisis. The second section elaborates that central banks have acquitted themselves well in avoiding a financial collapse through support of respective governments, and coordination at global level enabled them to do so. The fiscal authorities were leading the coordinated actions towards managing the crisis and embanking on the stimulus on multiple fronts. It is likely that the transparency and accountability processes are also unconventional. The third section postulates that in regard to exit policies, central banks face pressures in terms of coordination among them and with fiscal authorities as well as other regulators within each country. The fourth section briefly mentions select issues arising out of reforms under contemplation in financial sector, as a consequence of the crisis. The fifth section lists the need to revisit governance issues in central banks in the light of experience with the crisis. The concluding part focuses on governance issues of special relevance to central banks in developing countries.

1. Role of Central Banks in Causing the Crisis

Central Banks have been held responsible for causing the crisis on several accounts:

a) The monetary authorities, particularly in Advanced Economies, permitted excess liquidity by adopting relatively loose monetary policy;
b) They focused excessively on inflation or price stability, and thus neglected credit booms and asset bubbles;
c) They did not assume responsibility for financial stability on the ground that financial stability was not part of their mandate, and that they had responsibility mainly for inflation and, to some extent, for employment or output objectives;
d) Some of them were aware of the risks that were building up in the financial system, but they felt that the markets should be allowed to correct themselves. In their view, they had no way of determining whether the markets had under-priced risks and, in any case, they could not have a better perception of risks than the market mechanisms;
e) Many of them felt that they do not have necessary policy tools and instruments to take actions to correct asset bubbles;
f) Some of them were uncomfortable with the build-up of excessive risks, but took the view that because of financial innovations, the risks were highly dispersed and hence there was no serious threat to the financial system;
g) Many of them felt that even if there was excessive risk-taking because investors were searching for yield, the banks were very well regulated and hence banking system was safe. The non-banks, particularly non-deposit taking institutions were, in their judgment, expected to assume the risks if they were to materialise, and they were capable of assuming such risks;
h) Most of them expected the large financial institutions to have sophisticated risk assessment models, and many of the central banks and regulators assumed that self-regulation by such individual institutions was adequate to ensure the stability of the system;
i) More generally, the central banks had neglected issues like sudden drying up of liquidity in the system and prolonged pro-cyclical biases in the functioning of markets. They assumed that if individual institutions were solvent, the system would be risk-free.

Several reasons are attributed for the failure of central banks in anticipating the crisis or preventing the crisis. These include to a belief in ideology of unfettered markets; dependence on unrealistic models; capture of the monetary authorities and regulators by political economy considerations and the regulatory institutions; a failure in governance in the central banks, and possibly in several institutions including central bank and finally a combination of these.

2. Generalizations are Misleading

The above presentation should be treated as broad generalizations, but it should be subjected to several caveats. Firstly, the crisis in financial sector did not happen in all countries, and particularly most of the developing economies , were

spared of serious financial crisis. In fact, many of the advanced economies such as Canada, had their financial sector, by and large, resilient.

Secondly, the failure of government was not confined to central banks or regulators because the regulated institutions had several layers of governance prescribed, such as Board of Directors, Audit committees, Risk Management Institutions, etc. Similarly, the accounting and auditing bodies, credit rating agencies and self-regulatory organizations have all contributed to the enormous leverage and risk taking.

Thirdly, among those countries which were seriously affected, the regulatory structures had differed. In other words, there was no particular regulatory structure or governance arrangement that could be identified as common to all the countries where the financial crisis occurred. The crisis had happened in a country like the USA with multiple regulators and U.K. with a single regulator. A study of those countries which were not affected by serious financial crisis also shows diversity in regulatory structures, and consequential governance arrangements.

Fourthly, the most affected countries are, however, found to be those where the growth of financial sector was significantly ahead of the growth of 'real' sector.

Fifthly, countries where the retail banking dominated the financial sector and where less sophisticated financial instruments were used, were less affected compared to those economies in which large scale financial innovations dominated.

Sixthly, in many of the developing economies, the financial crisis did not occur domestically, but severe problems arose as a result of the contagion from advanced economies. The extent, to which the financial sector of developing economies was affected, depended on the extent of integration of their financial markets with markets of advanced economies. Further, those countries which had heavy dependence on commodity exports were also affected through the secondary impact of financial crisis in advanced economies on real economic activity, resulting in recession or fear of recession.

Seventhly, those developing economies which had maintained significant forex reserves, and those which did not have high current account deficits, faced lesser intensity of the contagion from advanced economies to their financial markets and financial institutions.

In brief, the structures relating to monetary and regulatory authorities seem to have played a lesser role than the policies adopted, especially those which related to growth and regulation of financial sector, and to some extent monetary policies. The policies adopted could be explained in terms of either ideological commitments or political economy considerations, both at national and global level. In a way, therefore, the lessons that central banks have to learn have to be more in terms of governance very broadly defined, rather than institutional structures and their inter-relationships narrowly defined to be relevant to analysis of governance.

3. Role Of Central Banks in Managing the Crisis

There is a general consensus that in times of financial crisis, the central banks are at the forefront in managing the crisis and are often described as the first line of defense. In a narrow sense, they are lenders of the last resort to vulnerable institutions, and in a broader sense, they are finally in charge of liquidity in the system, as a whole. In brief, to the extent central banks are critical to liquidity in the system as well as in individual institutions, they would have to be the first line of defense in times of stress. The central banks of select relevant advanced economies responded promptly to the onset of the crisis, and there was significant coordination among them. Initially, as soon as crisis erupted, coordinated monetary actions were taken by systemically important countries. However, in view of the nature, spread and intensity of the financial crisis, the lines between solvency and liquidity of individual institutions, as also the requirement of liquidity in the financial markets, became blurred and uncertain. There was virtual collapse of the normal functioning of the markets in the sense that there were no transactions to guide either the market or the authorities on the right price (since process of price discovery collapsed in the light of absence of transactions), and this occurred almost across the board in many systemically important financial markets.

The central banks, which were in the forefront of managing the crisis, had to take a call in determining whether they were taking serious risks of supporting insolvent institutions, or non marketable market instruments. The large scale operations involving provision of liquidity to markets and institutions required significant assumption of risky assets on the balance sheets of the central banks with attendant quasi-fiscal implications. Hence, while the central banks were first line of defense, as soon as it became clear that it is a large scale financial crisis requiring massive liquidity injections through open market operations, central banks had no choice except to obtain assurances of firm support from the fiscal authorities about their operations with huge potential for quasi-fiscal implications. Moreover, there are many financial institutions whose solvency was questioned by the financial markets themselves. Hence, it was not possible to ensure their normal functioning without prompt injection of capital. Since financial markets were almost collapsing, many of the affected institutions were not in a position to raise capital. It was, therefore, necessary to undertake either nationalization as in U.K. or bail-out operations as in USA, and both these operations possibly proposed by the central banks, required firm fiscal actions or backing.

The moment the magnitude of the crisis was recognized as large, a close involvement of fiscal authorities particularly in regard to judgment on the range and magnitudes of actions mentioned above became inevitable. More generally, the magnitudes of financial crisis were such that it quickly transformed into an economic crisis. Fiscal stimulus thus became inevitable, and thus very close coordination between fiscal and monetary authorities also became inevitable. The extent and nature of coordination between central banks and governments in countries depended on the requirements of liquidity and solvency in financial sector and dampening of economic activity.

Soon after the onset of the financial crisis, it was realised that coordination between systemically important countries comprising of both advanced economies

and developing economies was essential. It was also realised that the crisis required action not only on the part of finance ministers and governors of central banks, but on a broader scale. Hence, the heads of states had to take the initiative for international coordination through the convening of meeting of heads of governments of G20 countries. In these arrangements, it becomes necessary for central banks to reconcile the national interests with global obligations. It is not necessary that the national and global demands for action always converge, though at the time of the crisis management, there has been considerable convergence in terms of direction. The compulsions of coordination at global level on broader economic issues necessarily involve initiatives at the level of sovereign. These considerations further reinforce the need for central banks to align their policies with that of governments.

The governance arrangements in most of the central banks are predicated on the assumption of operational autonomy to the central banks in terms of discharge of their functions while simultaneously insisting on transparency and accountability. These governance arrangements are meant for normal circumstances and designed essentially to respond to domestic issues. It is quite possible that extra-ordinary measures required to meet a crisis would normally involve an understanding of unconventional accountability procedures. The balance sheet of a central bank in dealing with the crisis generally expands significantly, and given the nature of the problems will be inherently less transparent. Further, it is virtually impossible to assess the value of assets and liabilities on a mark to market basis when the markets have collapsed. At the best, there can be only what may be termed as retrospective transparency and expected accountability. At the same time, there are serious reputational risks for central banks in regard to these operations. These may be revealed as time passes and not necessarily when the crisis is at its worst.

It is necessary to note that most of these issues are essentially applicable to select advanced economies. In most others, including developing economies, there have been pressures on the financial markets, and in response, some unconventional measures were undertaken, but these related essentially to liquidity with insignificant implications for solvency. Where financial markets were affected and external sector was under serious pressure with a consequent serious impact on real economy, the actions by central banks were considerably influenced by the programmes under IMF and World Bank, especially for developing economies. Hence, for most developing economies, the governance arrangements in central banks in the context of the crisis may not be a contentious issue in terms of managing the crisis.

There is a general consensus that, by and large, the central banks have succeeded in avoiding a collapse of the financial markets. However, in doing so, central banks in systemically important advanced economies had undertaken extra-ordinary measures involving significant fiscal costs. In brief, the debates in regard to the governance arrangements in central banks may be predominantly in select advanced economies.

4. Role of Central Banks in Exit Policies

Central banks have acted in response to the crisis on an emergency basis, addressing both liquidity and solvency issues. In terms of general direction, the crisis was common to all economies and hence both central banks and fiscal authorities in

all countries moved in the same direction. The measures were unconventional in many cases. They were coordinated because the crisis happened about the same time on a global scale. The immediate impact of the crisis and the stimulus on the individual national economies has been uneven across countries in terms of slowing down of growth and loss of confidence while financial markets resumed functioning globally in a fairly normal manner. Hence, the compulsions to exit from the unconventional measures and stimulus are also uneven among the countries.

However, two sets of issues are to be addressed by central banks in all countries. First, exit policies are to be coordinated and sequenced between central banks and fiscal authorities. While the central banks consider medium to long term horizons in the post-crisis period, the fiscal authorities, and possibly financial markets, may lay greater emphasis on avoiding shorter term risks. Secondly, coordination is required between central banks of different countries, which becomes extremely complex when the response of economies to the stimulus varies. The initial conditions of different countries were vastly different, and correspondingly the policies towards stimulus and the response of the financial markets and economies had necessarily to be different. While inherent preference to delay initiation of exit or prolong the process of exit by fiscal authorities may be common between advanced economies and developing economies, the objective conditions in many advanced economies warrant priority to avoiding deflation or double depression while for many developing economies fighting inflation is the over-riding priority.

In view of divergence in economic cycles among countries, divergence in policies particularly monetary policies become inevitable. The monetary authorities particularly of systemically important countries (issuing reserve currencies) have a challenge before them, viz., to take risks that appear reasonable to stimulate their domestic economy, but at the same time, they cannot ignore the risks that may arise to the rest of the global economy due to their actions. It is in this context that the quantitative issuing in United States has become a subject matter of both domestic and global debate.

The exit policies are understandably more contentious than coordinated stimulus to avoid collapse of markets and depression in economy. The experience with what may be termed as successful cooperation in avoiding collapse and complexities in executing exit from stimulus should provide important lessons for the future governance arrangements for central banks. In brief, the experience with management of crisis and exit will have significant influence on several aspects of functioning of central banks in future.

5. Reforms Underway and their Broader Relevance

It is worth noting that reforms relating to the institutional arrangements that affect central banks have so far been undertaken mainly in U.S.A., U.K. and Euro areas where the financial crisis originated. Secondly, the guidelines in regard to the regulation of the financial sector have been designed under the aegis of the Bank for International Settlement in order to avoid threats to financial stability in future.

The three important issues that arise in this regard for discussion and debate are:

1) Should there be a review of the governance arrangements in central banks in developing economies also, though the crisis by itself had no link with their institutional arrangements?
2) Whether the financial sector regulations which are being designed in response to the crisis in select countries should be equally applicable to the developing economies also, despite the fact that there were no serious regulatory shortcomings in most of them. There may be problems that need to be addressed among developing economies, but how are they related to the causes and management of the crisis? Should there be attention to issues of contagion which was the main cause of crisis in developing economies?
3) Should the changes in the regulatory regimes that emphasis the importance of financial stability be equally applicable to developing economies?

Alternatively, it can be argued that broader lessons from the crisis should be taken by the developing economies in devising their own systems. These lessons are two fold: (a) admittedly, regulatory framework must be an instrument for stability, and equally therefore, it can be an instrument for promoting development; and (b) institutional structures and policies for central banks that were once considered to be ideal, towards which the developing economies were working, proved to be less than adequate. Hence, some of the changes that were considered appropriate by developing economies as part of financial sector reform or development in the pre-crisis period may not be warranted now. In brief, slow change in several areas in regard to the institutions and practices of central banking in developing economies or changes only in select areas where short-comings are experienced in developing economies concerned, may also be one of the appropriate lessons for developing economies.

6. Governance Issues: Need to Revisit

It is generally recognized that effective governance arrangements for central banks can be quite complex, involving several trade-offs and compromises, and they differ from country to country. However, it is possible to identify some common features in general terms. Broadly speaking, the common features relating to governance arrangements for central banks could be analysed in terms of the objectives or the mandate, the political framework and legal studies, the decision making structures, relations with government and financial resources. It is also recognized that these arrangements evolve over a period of time, depending on the evolving economic challenges, and social-political developments. The global financial crisis in terms of magnitudes, intensity and complexity and its management, are likely to evoke a revisit on several aspects of the governance arrangements in many, if not all, countries.

Firstly, it is clear that the mandate of a central bank is extending beyond inflation targets and output or employment. The mandate will certainly include, explicitly or implicitly, financial stability, and in some cases, development of financial markets. An extended mandate involves complex trade offs between

competing considerations. Further, an enlarged mandate often requires considerable element of judgment relative to rules.

Secondly, coordination issues will have to come to the fore in view of the change in the policy framework for management of financial sector which recognizes the need for intervention in the market mechanisms in a countercyclical manner. Such intervention may have to be coordinated between fiscal, monetary and financial regulatory authorities. In any such arrangement of coordination, the central bank as custodian of liquidity and a lender of last resort will have to play critical part though, in many cases, it could play a leading part in non-crisis circumstances.

Thirdly, the issue of accountability for the suffering that has been caused by the crisis is being raised. It was not focused in public debates as long as the emphasis was on preventing a financial collapse, but a detailed examination of the crisis and the consequences would inevitably point to the issue of accountability. As the future burdens get crystalised, the issue of accountability would come to the fore, particularly in countries where there have been heavy interventions by central banks due to the crisis in financial sector. Consequently, the strengthening of accountability arrangements in central banks should be anticipated, whether through law or by other means.

Fourthly, as part of the issue of accountability, the responsibility for decision making would also be considered, that is, whether it should be individual oriented or committee oriented. If it were committee oriented, whether the individuals will be held responsible for the position taken. Moreover, the composition of the committee itself could be a matter of discussion. In other words, it may be argued that the conduct of business in central banks should be governed by a Board which is not dominated by economists and financial experts, though they should find a prominent place. Representation for other stake holders in the decision making process in the central bank may be advocated. Possibility of a two tier boards, with a supervisory and executive levels should not be ruled out for central banks.

Fifthly, fiscalisation of central banking is, to some extent, inevitable. The quasi fiscal implications of crisis management are apparent. Once serious consideration is given to taxation of financial sector and bank tax, the overlap between the regulation of financial sector and the fiscal regime becomes apparent.

Sixthly, mounting public debt, particularly in advanced economies would require an active management of public debt. It is inevitable that management of large public debt would be facilitated by a broader public policy view on the level of inflation, the regulatory prescriptions on holding of government debt, etc. which often overlap with monetary policies.

Seventhly, the mandate for central banks is essentially to serve the interests of domestic economy. However, increasingly coordination of monetary policies including management of capital account and regulation of financial sector, do point to the need for considering externally imposed obligations or constraints on national policies. At one level, this raises the issue of the importance of clarity in the mandate, and at the other level, the issues of conflict between the domestic and global compulsions that would have to be addressed particularly by systemically important

countries. There are proposals for imposition of sanctions on those countries which do not carry out their global obligations in financial sector. The responses to these suggestions would require a view beyond national sovereignty vis-à-vis the global pressures and such a view cannot be taken by central bank without active involvement of the government.

Eighthly, there is often a discussion as to whether governance arrangements for meeting emergencies should be specifically designed since the normal arrangements do not suffice to meet emergencies. In view of difficulties in anticipating the crisis, and more important, the nature of the crisis as well as the possible policy responses, it may be difficult to have tailor-made governance arrangements for meeting the crisis. It is clear that during times of serious crisis, the government would virtually takeover the function of coordination among the regulators and monetary authorities. In the normal times, the central bank will have to play a central role in managing stability issues due to its expertise and being lender of last resort. In other words, as experience with recent crisis has demonstrated, the sovereign will assume the central role when conditions of instability turn into crisis-situations.

Ninthly, there is a view that arrangements for public governance over central banks (as distinct from the well known standards of corporate governance) should be strengthened in view of the experience gained. This approach would mean emphasis on personal integrity, security of employment or long term careers, and maintaining basic values and elements of public sector culture. There are some who argue that this would be at the cost of efficiency.

Finally, there are proposals from academics, to have a new institution working as a "public sentry", independent of both political and market influences, and comprising of eminent persons commanding high respect. Such an institution would continuously assess and comment on policies in financial sector, delivering a formal report to both legislative and executives branches, and thus to public at large.

7. Emerging Governance Issues for Developing Economies

Firstly, there appears to be greater legitimacy for a broader mandate which is often prevalent in many developing economies. In many of them, banking supervision is part of central bank's mandate. Even among those countries where banking supervision is separated, particularly in Asia, there is a close relationship between the two with defacto dominance of monetary authority. In some countries, central banks are closely involved in public debt management, though there have been recommendations for a separate debt office. Recent experience in Euro area and the possible developments in regard to public debt management may enhance the case for close coordination between management of public debt and central banks.

Secondly, in terms of micro structures, including technology, payment and clearing systems, and even rating agencies, the importance of public policy has been realised. Development of such infrastructure along with regulation would be a priority in developing economies.

Thirdly, there are several issues in regard to the functioning of financial markets, and a careful balance has to be struck between development of financial markets, regulation of financial markets and avoidance of excessive financialisation. Further, there is a greater need for understanding the links between the real sector and the financial sector, especially in economies undergoing rapid structural transformation. The development and regulation of financial sector that is expected to facilitate economic growth while maintaining stability could pose greater challenges to the policies of managing financial sector, particularly in terms of coordination.

Fourthly, intervention in the financial markets by central banks may be less of an exception and more of a rule, in future. Such interventions especially in the forex markets would require sound mechanisms for risk mitigation as well as accountability.

Fifthly, attracting and retention of skills in the central banks of developing economies has become a serious problem. Achieving a balance between high salaries of the private sector globally and relatively higher security in the public sector while retaining the incentives for performance within the central bank is a complex task.

Finally, the importance of precautionary steps in the management of the economy to avoid serious instability may have to be given priority. For example, it may be argued that monetary actions to facilitate successful conduct of government debt may distort the markets and involve moral hazards in terms of incentives to pursue prudent macro policies. On the other hand, taking precautionary steps, as it was done in the case of India, would protect the economies from threat of instability.

In brief, in developing economies, the central banks may have to become more central than they have been before, with an enlarged mandate and perhaps more accountable than they have been before. Many of their actions, including differentiating between structural and cyclical factors for their actions and other associated fiscal and regulatory policies, may warrant greater recourse to judgment than rules. The governance arrangements that served some of the developing economies well should be the role models for the future.