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Promoting Financial Stability: The Role of Central Banks

Age Bakker

Promoting financial stability is not just another mission of central banks. Indeed, while central banks have had increasing success in safeguarding monetary stability, their concerns about financial stability have risen together with the growing systemic dimensions of financial crises.

I will discuss the nexus between two main central bank missions, price stability and financial stability. Targeting both stability goals at the same time can be challenging to policymakers. I will focus my remarks on the role central banks have to play in this respect, the policy instruments available to them and the new challenges that the increasingly systemic dimensions of crises pose.

The Nexus Between Price Stability and Financial Stability

Mr. Greenspan has defined price stability as inflationary expectations that do not significantly influence economic behaviour. Some concepts of price stability are more precise, like the definition of the European Central Bank, that stipulates price stability as an annual rise of the consumer price index of less than 2 percent in the medium term. A host of emerging countries have also adopted a well-defined policy objective by switching to an inflation targeting strategy (like Brazil, Chile, Czech Republic, Indonesia, Israel, Mexico, the Philippines and South-Korea).

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In a broad sense, financial stability may be considered as a situation in which the financial sector is able to mobilise savings and allocate funds efficiently and to absorb shocks without major damage to the real economy or other parts of the financial system. Financial stability can be distinguished in the concepts of micro stability, which involves the health of individual financial institutions, and macro stability, which focuses on the health of the financial system as a whole, including the interrelationship between financial institutions, payment and settlement systems and financial markets. The costs of financial instability can be high, especially in emerging markets, where financial buffers to absorb shocks are much smaller.

So how do these objectives of price stability and financial stability fit together? Traditionally, it has been assumed that price stability contributes to financial stability and vice versa. However, the issue is more complex. Indeed, the 1990s taught us that price stability is necessary, but not sufficient to safeguard financial stability. The 1997/98 financial crisis in Asia is illustrative here. In the run-up to the Asian crisis, large imbalances were built up in the real estate and other asset markets, although inflation was relatively low.

The Role of Central Banks

Can central banks deliver both stable prices and financial stability simultaneously? In my view, there are three ways in which the central bank should be involved in financial stability. These include the identification of vulnerabilities in the financial system (by monitoring risks), the analysis of the transmission of shocks in the financial system (analysing transmission channels, financial market behaviour) and the implementation of policies to make the financial system shock resistant. Such policies will include public disclosure rules, transparency standards, supervisory rules and the like. Let me briefly mention the main other instruments central banks have available to foster the separate objective of financial stability.

The central bank by its nature is involved in policies to mitigate the negative impact in the unhoped-for event of a financial crisis. Besides the use of the interest rate, financial stability can be supported in a number of other ways. One of these, of course, is the lender of last resort instrument. Traditionally, this instrument is available to support individual institutions. Besides, liquidity injections may be given to the financial system in general. This function has become more important, because of the increasingly systemic dimensions of financial tensions.

The organisation of a deposit insurance system is important to safeguard confidence in the financial system. By (partially) guaranteeing bank accounts, the risk of bank runs is reduced. Oversight of payment and settlement systems is also a key element in the financial stability policy of central banks. Mutual credit and liquidity risks have been reduced significantly by the implementation of real time gross payment systems, like Target in the euro area.

The aftermath of 11 September provides a recent example of the use of central bank instruments in relationship to the maintenance of financial stability. The Eurosystem provided no less than 110 billion to support the liquidity of banks. Moreover, the Fed and the ECB cut interest rates with 50 basis points. This was a display of complementary interaction between monetary and financial stability instruments as well as good international cooperation between financial stability authorities. This could avoid a systemic crisis.

Challenges

Although central banks are not always responsible for supervision, they are often involved in designing or advising on the regulation. Safeguarding financial stability requires a changing focus of supervision. Traditionally, prudential supervision is designed to work bottom-up, focusing on individual financial institutions. However, to serve the stability of the financial system, supervision should also have a top-down point of view. Such a design focuses supervision on systemic risks of failing institutions and the macroeconomic costs of these outcomes.

In emerging markets in particular, supervision issues rapidly take on systemic dimensions since a few financial institutions are dominant. In such a situation, it may be advisable to concentrate the guardianship of both financial stability and price stability within one institution, the central bank. Such a model has another advantage, since it combines financial expertise that might be sparsely available in emerging markets.

Central banks are continuously being challenged to deliver both price stability and financial stability. The increasingly systemic dimensions of financial activities pose new challenges for financial stability authorities. With the ongoing process of financial deepening and increasing cross-border financial synchronicity, systemic aspects are raising the stakes. Fortunately, central banks have an extensive toolkit at their disposal. Indeed, the swift reaction after the 11September 2001 events shows that policymakers are up to the job.