A NEW PARADIGM IN CENTRAL BANKING

Shaping Central Banking Institutions in the New Paradigm

Sukhdave Singh
Central Bank of Malaysia
21 October 2013

A fine balancing act to maintain stability of inter-dependent variables in deceptively calm waters.

The views expressed are my own and do not necessarily reflect the official views of Bank Negara Malaysia.
Outline

The New Paradigm

Central Bank Mandates

Independence

Governance

Risk Management
Among the many ongoing debates...

1. Price stability is not enough
2. Better appreciation of macro-financial linkages
3. Greater acceptance of the need to manage capital flows
4. Monetary policy can do more than earlier thought, but how much more?
5. No one-size-fits-all central banking
6. Markets do not deliver optimal outcomes all the time
Price stability is not enough

- Managing inflation will remain a key objective of MP
- But it is now not the only one – in crisis, growth & employment have become key objectives
  - Fed, BOE – unemployment level is now the key determinant of MP
  - BOJ – Escaping deflation - inflation target for super QE
- Forward guidance – trying to directly influence expectations of future interest rates
- Alternative targets proposed: price level, nominal GDP
- In times of spillovers and reduced global demand, the exchange rate may have become a target of MP, even if not explicitly
Price stability is not enough

Selected Advanced Economies (G7) – Average Inflation and Policy Rate

Sample: G7 countries comprising United States, Germany, France, Italy (ECB policy rate from Q1 1999), Japan, United Kingdom, Canada
Source: Haver, Bloomberg, IFS

The Economist, 4 Oct. 1997
Price stability is not enough

High interest rates
- Credit rationing due to moral hazard & adverse selection (Stiglitz & Weiss 1981)

Low interest rates
- Increased risk taking across the economy
- Search for yield & excess leverage
- Increase in collateral values & over-optimistic assessment of risks
- “clean” stance of policy made central banks inadvertent cheerleaders and led to moral hazard

It is in times of macroeconomic stability (and low interest rates) that financial risks build-up in the economy

Price stability does not guarantee macroeconomic stability
• Slow-burning financial cycle developments may portend future financial and economic distress
• Recessions coinciding with financial crises are especially severe

Interest rate cuts in response to the business cycle may further accelerate the financial cycle.

Unfinished Recession: US Case

Source: Haver Analytics - Property price index, equity price index (S&P), Real GDP; Bloomberg – CPI, Federal Funds Rate, consumer credit outstanding. Property price and equity price have been deflated by the CPI.
Better appreciation of macro-financial linkages

- Risks to financial stability during unstable and stable macroeconomic conditions
- Stance of monetary policy has implications on financial conditions.
- Macro-prudential regulations and other regulatory measures can:
  - Influence the transmission of monetary policy
  - Can change the availability of loans and thereby impact on economic growth
- Monetary policy models failed to capture these relationships.
Policy spillovers and greater acceptances of need to manage capital flows

- QE period flows exceeded those in the pre-crisis period
- Prior to May 2013, inflows had contributed to the appreciation of regional exchange rates, sharp increases in regional equity markets and dampened bond yields

**Currency, equity and bond market performance between 1 Apr 2009 – 21 May 2013**

<table>
<thead>
<tr>
<th></th>
<th>Exchange rates (% change)</th>
<th>Equity markets (% change)</th>
<th>Bond yields (b.p. change)*</th>
</tr>
</thead>
<tbody>
<tr>
<td>KR</td>
<td>24.7</td>
<td>64.2</td>
<td>-265.5</td>
</tr>
<tr>
<td>SG</td>
<td>21.1</td>
<td>102.6</td>
<td>-39.1</td>
</tr>
<tr>
<td>MY</td>
<td>21.1</td>
<td>104.8</td>
<td>-181.3</td>
</tr>
<tr>
<td>TH</td>
<td>19.5</td>
<td>280.9</td>
<td>-129.5</td>
</tr>
<tr>
<td>ID</td>
<td>18.7</td>
<td>261.8</td>
<td>-496.7</td>
</tr>
<tr>
<td>PH</td>
<td>17.6</td>
<td>268.9</td>
<td>-295.5</td>
</tr>
</tbody>
</table>

*Change in spread between 10-year government bond yield and policy rate
Source: *Bloomberg, BNM staff calculations*

**Cumulative net foreign portfolio inflows to selected emerging economies**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>KR</td>
<td></td>
<td></td>
</tr>
<tr>
<td>CN</td>
<td></td>
<td></td>
</tr>
<tr>
<td>IN</td>
<td></td>
<td></td>
</tr>
<tr>
<td>MY</td>
<td></td>
<td></td>
</tr>
<tr>
<td>ID</td>
<td></td>
<td></td>
</tr>
<tr>
<td>TH</td>
<td></td>
<td></td>
</tr>
<tr>
<td>TW</td>
<td></td>
<td></td>
</tr>
<tr>
<td>PH</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

IN – India, ID - Indonesia
Source: *Haver, national authorities*
Policy spillovers and greater acceptances of need to manage capital flows

- **Spillovers** make the “independent conduct of monetary policy” in small open economies rather difficult.

- **Diverse negative effects:**
  - exchange rate overshooting/volatility, loss of export competitiveness, asset price bubbles, etc.

- **Fear of great unwinding** (coming soon, maybe….)

- What could be ignored in normal times could no longer be ignored in the age of QE.

- **Greater acceptance of CFMs** because of realization that:
  - Global monetary system is broken & we do not know how to fix it.
  - QE countries are not going to do anything to manage the large externalities of their policies.
  - EMEs are on their own – will have to protect themselves.
Market failures has led to change in view of regulators

**Pre-Crisis**
- Markets know what they are doing better than regulators
- Light-touch regulation / regulatory capture

**Post-Crisis**
- Spectacular excesses in markets – right under the noses of regulators
- Greed, abuse of information asymmetries & conflict of interests
- Predatory behavior and mis-selling
- Focus on near-term profits/benefits and ignoring the longer term risks
Implications for regulators/central banks

- No more “light-touch” – more intrusive regulation
  - Higher capital, caps on bonus, European tax on financial transactions, etc.
- Role of policymakers in determining the development of the financial system
- Market conduct and consumer protection
- Financial inclusion
  - Financial sector must not only serve the real economy, it must also serve all sectors of society
IMPLICATION FOR CENTRAL BANK MANDATES
Implications for Central Bank Mandates

- Complex economic environment
- Complex policy environment – monetary stability and financial stability interactions
- MP needs to look at policy horizons beyond 2 years to consider possible effects on financial/credit cycles
- Central banks responsible for monetary and financial stability:
  - How to integrate the two functions?
- Central banks share responsibility for financial stability with other agencies:
  - What sort of collaborative mechanism and how to apportion accountability?
Examples of changes in central bank mandates

- **BOE:** Bank of England Act amended to include a financial stability objective: “An objective of the Bank shall be to protect and enhance the stability of the financial system of the United Kingdom.”

- **ECB:** To gain direct oversight over euro area banks and credit institutions through the *single supervisory mechanism*, which was approved by the European Council on 15 October 2013.

- **Riksbank:** Together with the Swedish financial authority created the *Council for Cooperation on Macroprudential Policy* to “mitigate risks to the financial system.”
Greater central bank involvement in financial stability

Explicit financial stability objective in laws as at December 2012

- 82% of central banks have some form of explicit financial stability objective
- A BIS survey in 2009 indicated that <50% of 47 central banks had objectives in statutes relating to financial stability

Source: "Financial stability objectives and arrangements – what’s new?" forthcoming as a BIS paper
Implications for Central Bank Mandates

- Many emerging market central banks already have responsibility over multiple mandates
- But there are still relevant lessons from the crisis
- Need to also relook at our monetary policy frameworks and how we do monetary policy
  - Many EME central banks use the same macro-models and policy frameworks that are used by the major central banks
- Need to pay more attention to the cross-effects of different policies
- Leveraging on the rich information set but yet maintaining clear accountability for each mandate
Implications for Central Bank Mandates

- Managing capital flows
  - Who will decide? Central Bank (MPC?)? Others?
  - Thresholds?
  - Operational framework?

- Leaning against the wind
  - "When asset prices are getting way out of line it should be cause for alarm. The monetary authorities should lean against extreme asset price movements." Robert Shiller (2013 Nobel laureate)
  - Know now that cleaning up can be very expensive.
  - How will the surveillance framework be set up?
  - Decision making: central bank alone or also include other agencies?
Implications for Central Bank Mandates

- Financial sector development
  - Lesson from crisis: financial markets left on their own may not necessarily deliver optimal outcomes for sustainable growth and economic welfare enhancement.

- Financial inclusion
  - More developed financial systems do not automatically make them more inclusive
  - US sub-prime lending – financial inclusion gone wrong?
  - Without intervention of policymakers, sizeable portion of population may have no access to financial services

- Market conduct and consumer protection
Implications for Independence, Governance & Risk Management
Implications for Independence
Implications for Independence

3 Sources of Central Bank Independence

- Legislation
- Balance Sheet
- Reputation
Democratic deficit?

Independent Central banks needed to conduct MP
  • Politicians have strong incentives to exploit short-term benefits even if long term cost is higher inflation

What about financial stability?
  • Politicians may choose not to reign in financial imbalances because of:
    • Unpopularity of decision
    • Positive effects of financial booms on government revenue
    • Buoyant financial conditions seen as reflecting market confidence in govt’s economic policies

Therefore, an independent central bank may be good for both monetary and financial stability.
Nevertheless, multiple mandates do have their challenges:

- How to hold the central bank accountable against **less well defined financial stability outcomes**?
- **Communications and transparency** is more challenging – confidentiality of information, balancing between talking about risks and not creating unwanted expectations, etc.
- In a crisis, rescuing banks when the public is suffering from a loss of welfare may breed **public resentment** towards the central bank.
- Resolution of insolvent banks would require **assistance of other agencies** including the ministry of finance.
- Cross-policy **contagion**
- Organisational **culture**
Implications for Independence

• Measures to strengthen independence:
  • **Legislation** to institutionalize the boundaries of accountability and powers
  • Strengthen **internal governance structures and processes**
  • Establish **clear policies, roles and accountabilities** with respect to crisis prevention, management and resolution
  • Establishing **essential infrastructure to reduce risks** within the financial system – robust risk management and strong governance standards for regulated entities
  • Take a more proactive role in determining the **development** of the financial system
Implications for Governance
Implications for Governance

Elements of a Holistic Governance Framework

- Clear mandates and policy objectives backed by strong legislative framework
- Strong institutional arrangements, governance and coordination
- International collaboration and coordination
- Business planning for focus and effective use of resources
- Effective communication framework
- Effective talent management
Strong legislative framework
Bank Negara Malaysia’s Legal Framework for financial stability

Financial Stability

- Deterrence of financial crime
- Fair, responsible and professional business conduct
- Shariah compliance
- Prudential regulation and supervision
- Orderly financial markets and payment systems
- Tools for crisis management and prevention
- Financial safety nets

CBA Central Bank of Malaysia Act 2009
IFSIA Islamic Financial Services Act 2013
FSA Financial Services Act 2013
DFIA Development Financial Institutions Act 2002
AMLATFA Anti-Money Laundering and Anti-Terrorism Financing Act 2001
MSBA Money Services Business Act 2011
MDICA Malaysia Deposit Insurance Corporation Act 2011
Institutional arrangements, governance and coordination
What we have at Bank Negara Malaysia

Specific proposals by BNM to avert or reduce systemic risk

Financial Stability Executive Committee

- High level committee established under CBA:
  - For entities outside of BNM’s regulatory perimeter:
    - Macroprudential measures
    - Orders for financial stability
    - Liquidity assistance
  - Use of public funds

Monetary Policy Committee (MPC)

- Monetary policy formulation
- Decide on key risks to the economy
- What form of non-monetary policies may be needed?

Joint Policy Committee (JPC)

- Deliberate and decide on macroprudential policy responses that may have broader implications on the economy

Financial Stability Committee (FSC)

- Macro- and micro prudential responses
- Supervisory interventions
- Recommend / monitor implementation of approved actions by Financial Stability Executive Committee
Communications and stakeholder engagement

- Multi-mandates – communication becomes more complex
- Financial stability – no equivalent of the MPS after meetings
  - Capital and liquidity ratios may not be meaningful to the public
- Exchange rate – high public interest but delicate topic
- Macroprudential – need to carefully manage affected stakeholder
- Financial inclusion + market conduct and consumer protection
  - Communications often have to be educational
  - Making consumers aware of what is available
  - Dealing with public complaints
International collaboration and coordination

Scope
- Development of common standards
- Crisis prevention and management

Purpose
- To manage cross-border transmission of financial risks

Approaches
- Regional information sharing forums
- College of Supervisors
- Regional cooperation arrangements for crisis management
- Regional financial integration and deepening

International Collaboration and Coordination

EMEAP
- Financial Stability Board Regional consultative Group for Asia

Chiang Mai Initiative

ASEAN Financial Integration Framework
Holistic Governance Framework

Talent diversity and cultural change

- Albert Einstein: “We cannot solve our problems with the same level of thinking that created them”

- Financial institutions are obviously in need of a cultural change
  - FT (17/10/13): “As banks try to change their culture following the financial crisis, how do they retrain their staff”[?]

- Also true for central banks, even if mandates do not change; but more so if they do:
  - Diversity of skills and competencies
  - Collaborative work culture
  - Value system, promotion and remuneration practices, recruitment – may need to change

- Leadership
Implications for Risk Management
Implications for Risk Management

Do central banks want to be REACTIVE or PROACTIVE to risks in their policy areas?
Potential sources of risk

- Failure to properly sequence policy actions
- Not anticipating reaction of stakeholder
- Failure to prioritize outcomes (and allocate resources accordingly)
- Failure to anticipate/react to significant changes in operating environment

- Unwinding QE
- Intervention and sterilization
- Loses on Fx reserves
- Rescue of insolvent financial institutions

- Incorrect policies
- Failure to undertake policies
- Not being pre-emptive
- Not anticipating unintended consequence of policies
- Dominant policymaker & groupthink
- Intellectual & organizational inertia

- Failure of internal processes, people and systems
- Monetary operations, currency issuance, data & info systems, payment system
Managing these risks

- Creating a strong risk awareness culture
  - Aligning work practices
  - Rewards and remuneration

- Organisational risk management framework
  - Dedicated and competent resources
  - Integrated with business planning
  - Contingency and crisis planning
  - Business continuity planning

- Governance framework
  - Role of the Board
Managing these risks

<table>
<thead>
<tr>
<th>Consequences</th>
<th>High</th>
<th>Medium</th>
<th>Low</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Risk B</td>
<td>Risk A</td>
<td>Risk D</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Probability</th>
<th>Low</th>
<th>Medium</th>
<th>High</th>
</tr>
</thead>
</table>

- New emerging risk
- Risk level increasing
- Risk level improving
- No change in risk level

Concluding Observations

- Post-Crisis: More complex economic and policy environment + policy lessons from crisis
- Central bank mandates will change or, the way they carry out their mandate(s) will have to change
- This would be challenging
- However, the additional responsibilities do not have to mean a loss of independence
- Independence will depend on legislation, but also on the central bank’s performance
- Having strong and robust frameworks for governance and risk management will ensure that enough resources, focus and accountability is provided for each mandate