

Monetary and Financial Stability: Requirements for Regulatory Surveillance

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Dr. Meir Sokoler, IMF Advisor

The Topics

- **Monetary Policy Effects on Financial Stability**
 - *Duration Gap*
 - *FX Risk*
- **Effects of Financial Stability on Monetary Policy**
 - *Effectiveness of Monetary Policy*
 - *The Mode of CB Operation*
 - *Volatility of Commodity Prices*
 - *Foreign Owned Banks*
- **Some Implications of the Interaction for Regulatory & Surveillance Systems**
 - *CB Central Role in Financial Supervision*
 - *The Bi Polar Supervision Model*
 - *The Important Role of CB Capital*
- **The Importance of Data**

Monetary Policy Effects on Financial Stability

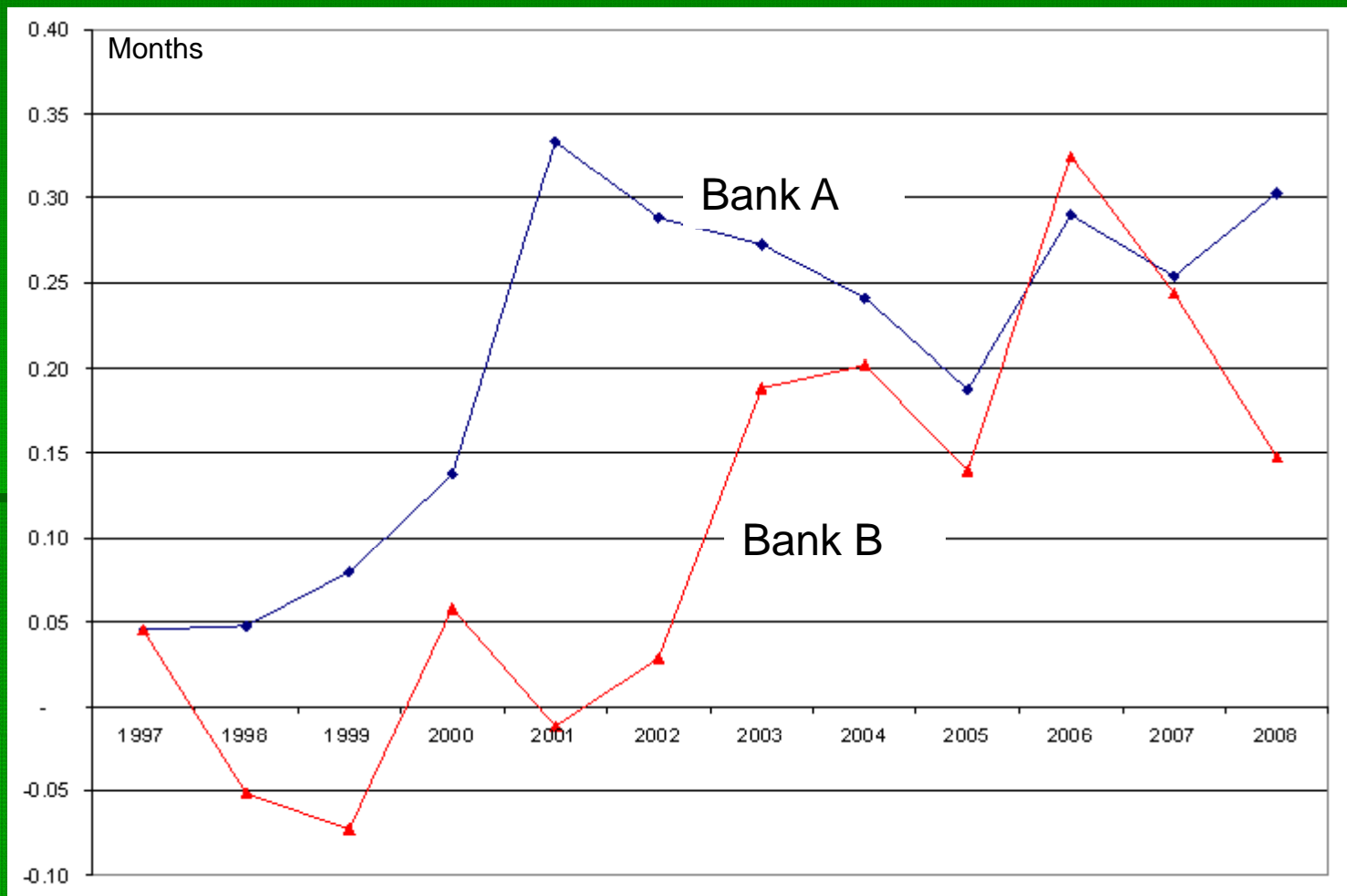
The Relationship Between Monetary and Financial Stability

- Until the 2008 Crisis many academics and practitioners stressed the complementarity of price stability and financial stability (one tool one target)
- However, the recent crisis demonstrated the potential conflict between the two

The Duration Gap Example

- At Present, because of the crisis, Central Banks (CB), world over, are still keeping their key policy rates (KPR) at historical low levels
- There is empirical evidence that prolonged periods of low interest rates lead banks to increase loan amounts and maturates as part of softening lending standards (one dimension of the risk taking channel).
- This, in turn , increases the duration gap exposure of the banks and the risks associated with it.
- The KPR in many countries will at some point in time need to be raised in order to guard against rising inflation. (this has already happened in Israel for example) and banks will find themselves with losses due to rising refunding costs.

The Duration Gap Example



The Duration Gap Example

- In order to counter balance the losses, banks may make increasingly risky loans to restore profitability (gambling for resurrection).
- This is one example where there is a clear trade-off between monetary and financial stability, since what is necessary from a monetary policy point of view may have adverse consequences on financial stability.
- The challenge is how to improve the terms of this trade off by:
 - a) developing domestic capital markets to provide stable long term sources of finance
 - b) coordinating timely and effectively between monetary policy and financial stability policies

FX Risk Example

- In countries which manage the Exchange Rate there is often a build-up of financial imbalances (,Argentina 1997-98, East Asia 2001-2002, Baltic countries 2008), through domestic borrowing in foreign currency, and when a large depreciation occurs it leads to a financial crisis.
- Inflation Targeting (IT) Regimes with Flexible Exchange Rates often face similar problems.
- In Many emerging countries the exchange is perhaps the most important monetary policy transmission channel.

FX Risk Example

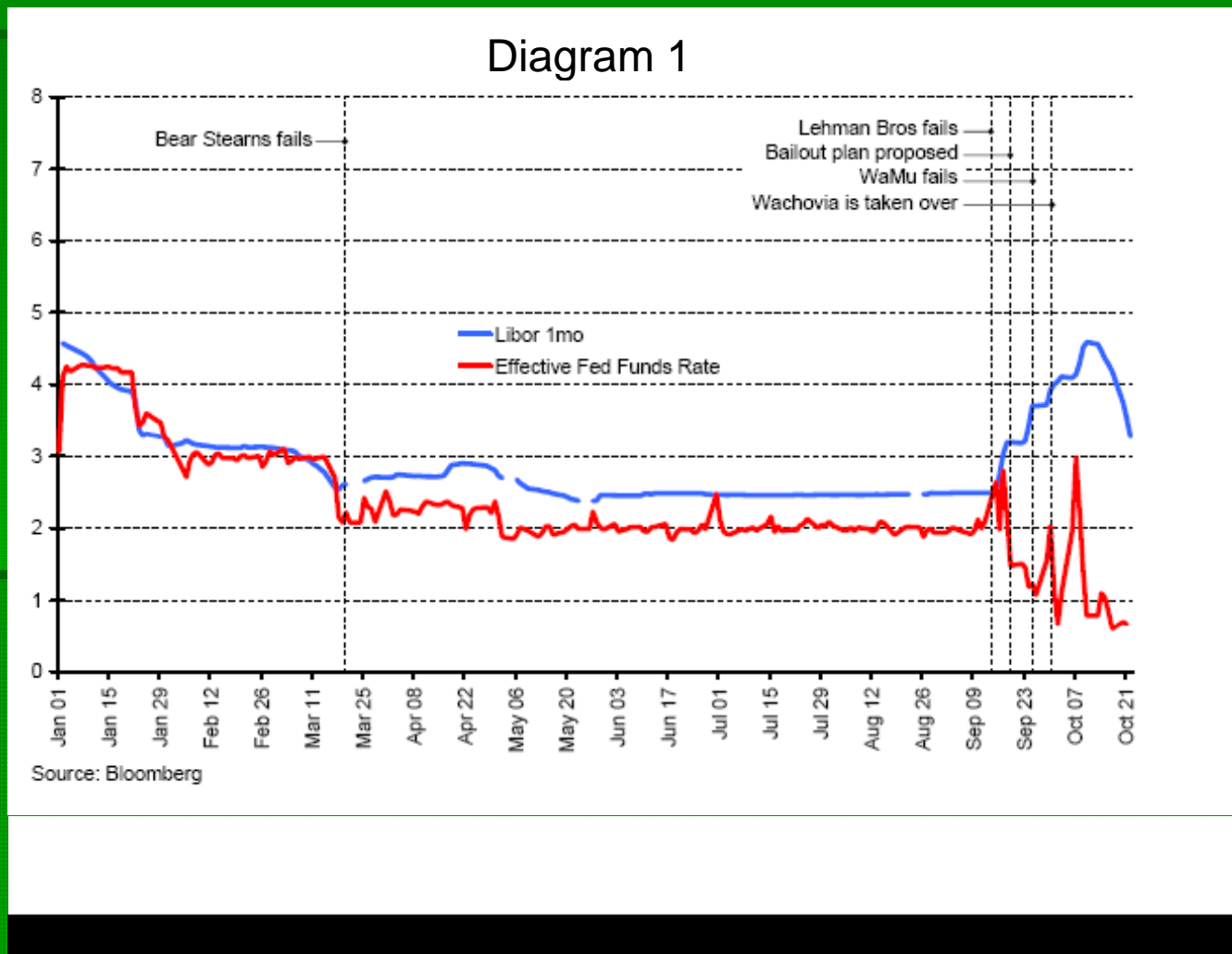
- The greater the exchange rate flexibility, the more effective monetary policy is.
- But here too there often is a trade-off with financial stability. If a CB has to raise the KPR to stem inflationary pressures, it induces an appreciation of domestic the currency and incentivizes domestic agents (with no of FX risk hedge) to substitute foreign for domestic loans
- But when the exchange rate depreciates in response to cut in the KPR or due to other factors, banks suffer from increased credit risk induced by adverse outcome of the FX risk of their customers.
- Here too surveillance, supervision, and governance structures are important elements in mitigating the possible trade-off between monetary and financial stability.

The Effect of Financial Stability on Monetary Policy

Effectiveness of Monetary Policy

- Modern monetary policy relies on the CB using the KPR to affect other rates in the economy-short and long rates, creditry and debitory rates-,and other asset prices in the economy (e.g., the exchange rate) and through them nominal spending (inflation and real activity).
- The effectiveness with which changes in the KPR are propagated into other rates and the rest of the economy depends on how well functioning (well oiled) the transmission mechanism is.
- The first link in the chain of the transmission process is the pass thorough from the KPR to very short run interest rates .
- As is shown in figure 1, the recent crisis has clearly demonstrates the damage to this link caused by financial instability.

Effectiveness of Monetary Policy



The Mode of CB Operation

Changes in CB Operations Since 2007

	Lending Operations				Outright Purchases				Bail-Outs Capital Injections
	More Counter Parties	More Liberal Collat eral	Longer Term	FX Swaps	FX	Equities	Private Debt	Government Debt	
Australia		<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>					
Britain		<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>			<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
Canada	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>			Possible	Possible	
Euro Area		<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>			Possible	Possible	
Japan		<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>		<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	Possible
Sweden	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>					
Switzerla nd		<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>				<input checked="" type="checkbox"/>
USA	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>			<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>

The Mode of CB Operation

- Expanding the counterparties to CB loans, and including more risky assets as collateral is problematic
- It may create political pressure which in turn may result in less CB independence and credibility.

Volatility of Commodity Prices

- An additional source of impairment of monetary policy effectiveness, caused by the financial crisis, is through its effects on the collapse of commodity prices
- The sharp decline in revenues from oil no doubt affected adversely the fiscal positions of countries such as Nigeria for example.
- The induced increases in fiscal deficits, the need to rely more on domestic sources to finance them, increased the danger of monetary policy being threatened by fiscal dominance.

Volatility of Commodity Prices

- An International Effort to Improve Capacity of Dealing with Volatility of Commodity Prices
 - How to improve the functioning of the commodity future and derivatives markets to improve the hedging capacity (e.g. lengthening future and option oil contracts)
 - What, if any, should be the role of international organizations in this endeavor (build on the idea of the IMF new FCL line)

Foreign Owned Banks

- Another potential problem for monetary policy effectiveness may be caused by foreign owned banks operating in the domestic economy.
- If their lending and borrowing activities, their policies, etc. are affected less by the conditions in the domestic economy, and more by conditions in the home country, the monetary transmission process will operate less effectively.
- The legal frameworks, governance structures, how they are supervised (including cooperation with the authorities in the mother countries) are obviously important in this regard.

Foreign Owned Banks

- Reconsidering the Policy towards Foreign Ownership of Domestic Banks (including governance issues) in order to enhance both Financial Stability and Monetary Policy Effectiveness

“Charles Goodhart raises the important point of cross-border operations. I am afraid that one outcome from this crisis may be that national authorities will insist that foreign banks conduct local operations through a separately incorporated local subsidiary. While this will impede efficiency, it could enhance stability and make closure easier. More generally, any bankruptcy plan will have to address knotty issues such as who has closure authority, what the loss-sharing arrangements between countries for closed banks will be, and how foreign operations of domestic banks will be treated. This is something that regulators have to pay far more attention to.”

Some Implications of the Interaction for Regulatory & Surveillance Systems

CB Central Role in Financial Supervision

- Central Banks should play a center role (much greater than before the crisis) in financial regulation because:
- The interaction of monetary and financial stability implies a need to coordinate between the two sets of policy tools.
- Coordination within one organization is better than across organizations, as proved by the experience of the BOE and NAS with Northern Rock. Distinguishing between a liquidity and solvency problems are often difficult to make in real time.
- The need CB's to extend the Lender of Last Resort Facility to other than banks financial institution (Bear Stern, AIG) also structuring supervision along functional lines rather than along sectoral ones.

The Bi Polar Supervision Model

- This means adopting the bi-polar approach to supervision (the Dutch model) ,where the prudential supervision of the entire financial system is at the CB and the conduct of business regulation is at the local SEC

The Important Role of CB Capital

- Adopting the bi-polar model of regulation and supervision requires political backing and sufficient resources, enabling CBs to act timely and on a necessary scale.
- This, in turn, would require paying much closer attention to the topic of CB capital
- CB capital is also important because recent enormous changes in the size and structure of several very important CB's raise the risk of political interference and less CB independence.
- Viewing the CB Capital (mostly seniorage -income accumulation) as cushion to be used in time of economy-wide systemic financial crisis should gain importance.
- Reconsider rules and procedures of transferring CB profits to the Government.

The Importance of Data

- The Importance of a Good Data Infrastructure
 - Stress Testing
 - The Importance of collecting and analyzing data with Macro prudential “glasses”.(a supervisor might press a particular bank to lend less during a slump,where as from a macro prudential point of view this could make matters worse.)
 - Importance of Data from non Financial Sectors and from the various relevant sectors of the real economy(both stock and flows data).
 - “Successful innovation will always run ahead of building the structures designed to support them” (Andrew Crocket)

But the Challenge of Policy Makers is to Reduce this Time Lag

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- THANK YOU