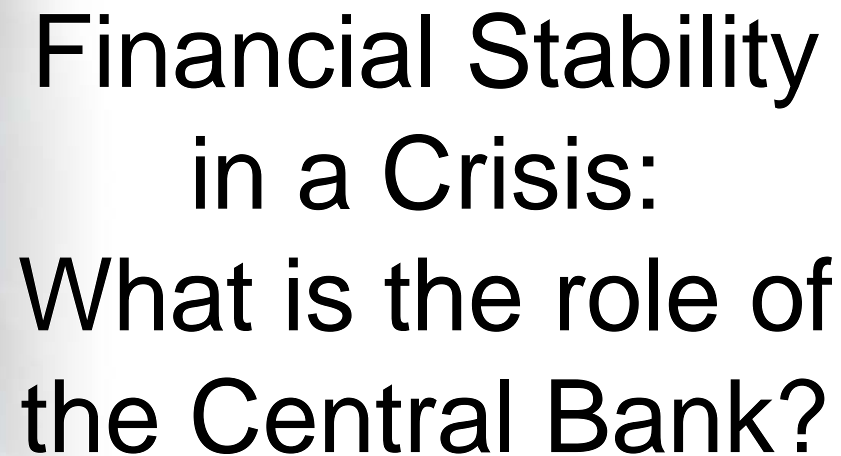

Financial Stability in a Crisis: What is the role of the Central Bank?

Vittorio Corbo

Centro de Estudios Públicos

Santiago, Chile

Prepared for presentation in a roundtable organized by the BIS in the LACEA/LAMES Meetings in Buenos Aires, Argentina, Oct.1-3, 2009

Crisis Prevention

- Central Banks have focused on treating financial crises, but they also have an important role in helping to prevent them:
  - Macro prudential tools are flexible and can deal with fragilities and distortions in the financial system better than the monetary policy rate and can have a countercyclical role.
    - Capital requirement, loan loss provision and lending-to-asset ratios.
  - Reducing systemic risk through improvements in the payment and security settlements systems and providing incentives for certain derivatives transactions to be settled in central counterparty institutions.
  - Designing procedures in advance to deal with the failure of systemically important institutions would contain damage and uncertainty during a crisis.
  - Design procedures to avoid large misalignments in the real exchange rate whose reversal could be to costly and affect the financial stability.

1. Financial Stability Objectives

- The main objective of central bank policy during a financial crisis is to contain the financial crisis to limit its impact on the real economy:
  - Stop market panics.
  - Ensure that short term credit markets function properly.
  - Prevent financial institutions from collapsing due to liquidity restrictions, and prevent systemically important institutions from collapsing even if insolvent.

2. Financial Stability Tools

- Policy actions called for:
  - First line of action is to offer extensive liquidity support—to banks that operate with the central bank—against good collateral at a penalty rate (Bagehot guide).
  - When non-bank intermediaries are also important then the lending of last resort support should include also these institutions.
  - Reduce policy rates aggressively to move the neutral level of the observed real policy rate closer to its new equilibrium value resulting from the forecasted reduction in aggregate demand.

2. Financial Stability Tools

- When the policy rate is close to the minimum, central banks should consider also non-conventional measures:
  - Make a commitment to keep the rate low for an extended period of time;
  - Offer unlimited financing to the banking system (with appropriate collateral) at the policy rate at longer maturity than usual;
  - Consider also outright purchase of assets to affect the yield curve or to restore the functioning of a systemically important credit market.
- Lend against wider types of collateral when necessary.
- When the crisis affects local foreign currency debt markets liquidity should be provided in foreign currency (swap arrangements).
- Cooperate with fiscal authorities when crisis requires additional tools in the form of government insurance or capital infusion.

3. Implications for Monetary Policy

- Monetary policy framework will probably expand to consider asset prices, and perhaps the growth of monetary aggregates and credit, for crisis prevention.
- Cost of the current crisis suggests that monetary policy will adopt more actively leaning-against-the-wind stance to deter the formation of asset price bubbles.
- Leaning-against-the-wind stance faces a trade-off:
  - Responding too aggressively against potential bubbles can cause instability and political tension;
  - Responding too weakly against potential bubbles may allow a real bubble to grow and provoke a financial crisis.

3. Implications for Monetary Policy

- Discussion has focused on how to include new elements into the monetary policy framework:
  - Separate arguments on the Taylor rule.
  - Price index that is broader than the CPI.
- Central bank objectives should remain focus on price stability and financial stability only.
- However, assets prices should be considered by central banks on a more judgmental basis.
- But one should be aware that monetary policy is too blunt a weapon to control an asset price bubble.

3. Implications for Monetary Policy

- Central Banks will need more instruments to deal with expanded responsibilities. A second objective requires a second policy instrument.
- Macroprudential regulation is the best-suited tool to maintain financial stability and prevent crises.
- Central Banks will likely take an active role in macroprudential policy. This will require important, explicit collaboration between all the regulatory authorities of the financial system and the Central Bank.
- There may be occasions in which the interests of inflation targeting (reducing output gaps and leading inflation to target rate) and macroprudential regulation (quantitative restrictions on the financial system) are at odds.

3. Implications for Monetary Policy

- Macroprudential regulation should aim to reduce the incentives for the banks to leverage up in a boom, as well as making the financial system more robust in a bust.
- Macroprudential regulation includes:
  - Pro-cyclical capital requirements;
  - Require large, systemically important institutions to carry larger capital requirements;
  - Dynamic provisions;
  - Increasing the risks weights that are attached to riskier lending during a boom (margin requirements adjusted by the cycle): housing, stocks.

3. Implications for Monetary Policy

- But one has to be aware that deeper intervention in the financial system will increase pressure on central banks.
  - Institutional framework must be strengthened to ensure the autonomy of the central bank and the credibilty of monetary policy.
  - Transparency and disclosure must be improved to satisfy public desire for accountability.

3. Implications for Monetary Policy

- Has the crisis cast a doubt on the use of flexible inflation targeting as a monetary policy framework?
  - Countries have been affected regardless of whether they used flexible inflation targeting or not. The epicenter of the crisis was the U.S., which does not use IT.
  - The IT policy framework has performed well and states that the monetary authority should act when there is a steep decline in forecast inflation that puts the objective of achieving the target in jeopardy.
  - Given the monetary policy's problematic ineffectiveness when the policy rate is near zero, this may require higher targets in the future.
- Inflation targeting should be complemented by a policy oriented towards reducing the risk posed by asset price bubbles.

3. Implications for Monetary Policy

- Central Banks will also have to work on:
  - Preparing emergency response guidelines for crisis periods, to reduce moral hazard and diminish the influence of special interest groups.
    - This should lead to greater transparency in their role as lender of last resort.
  - Broadening their portfolio of policy instruments, and the channels through which they inject liquidity into markets during crisis periods.
  - Cooperating with other supervisory agencies within the country, to ensure that an adequate leadership is in place to deal with emergency problems.
  - Cooperating more closely, on an international level, with their counterparts in other countries.
  - Avoid creating free, implicit insurance for systemic institutions.
  - Strengthening pre-financed deposit insurance.