Learnings from the International Conference on "Challenges to Central Banking from Globalized Financial System" held at the IMF in Washington D.C. September 16-17, 2002.

1. THE ROLE OF THE CENTRAL BANK (C.B.) IN BANKING CRISES:

Main Causes of Banking Crises:

> Loss of Confidence

> Liquidity Crunch

> Solvency Problem arising from excessive volatilities

Sources of problem:

1. Domestic and external macroeconomic volatility
2. Credit Booms and Capital Inflows
3. Asset Prices bubbles and collapses
4. Excessive Public Sector Involvement & political pressure
5. Increasing currency and maturity mismatches
6. Legal and Prudential weaknesses

What can the C.B. do?

✍ Volatilities could be dealt with by:

- Reducing volatilities under domestic control.
  Implementation of steady monetary policies.
- Reducing exposure by diversification
  Foreign-owned banks
- Insurance – Protection against volatilities
  Derivative markets
- Financial Cushion
  Capital levels to compensate for volatilities

✍ <u>Credit Booms and Capital Inflows</u>

- Excessive credit creation and unsound financial expansion in the upswing.
- Surge of Short term and Unstable Capital Inflows

<u>What should the C.B. do</u>?

– Sterilization policies
– Controls on Capital flows
– Reserve requirements, Variable Capital requirements and other prudential instruments

✍ <u>Asset prices bubbles and collapses</u>

- Bust create a Collateral – induced Credit Crunch as the Value of securities held in banks is eroded
- bubbles could lead to output contraction
- bubbles distort financial decisions and credit risk management becomes difficult

<u>What should the C.B. do to restrain excessive rise in asset prices</u>?

– Difficult to identify a bubble.
– Not clear if monetary policy should be tightened

✍ <u>Excessive public sector involvement and political pressures</u>

- Loan decisions of public banks likely to be subject to Political considerations
- Government influence on Credit allocation of private banks

- Interest rate caps and high reserve requirements
- Govt forcing banks t1o finance the budget and to hold govt paper at below market rates

What should the C.B. do?

- Independence of Central Bank
- Legal limit on government and public sector entities
- Privatize public banks

✍ Increased Currency and maturity mismatches

- rapid transformation of currency composition of bank Deposits
- High domestic interest rate increases incentives to denominate debt in foreign currency
- Maturity mismatches to increase with the limitation of access to longer term financing
- limitations to hedging operations – spread risks on the asset side

What should the C.B. do?

- Implement prudential measures that limit the scale of foreign currency denominated borrowing
- Promote deeper longer term credit markets
- Higher FE reserves reduce vulnerabilities. Increasing reserves in time of crisis is conducive to increase confidence.

✍ Legal and Prudential weaknesses

- Inadequate bankruptcy and insolvency legal framework

- weak enforcement of contracts
- Prudential regulations (PRs) unresponsive to business needs

What should the C.B. do?

- Strengthen the legal framework and contract enforcement mechanisms
- Review the PRs and compliance mechanism

2. CHALLENGES OF INFLATION TARGETING (IT)

- Different objectives or single objective ?
- Coping with succession of shocks
- Pass through devaluation to inflation – low or high
- Use of escape clause: Credibility will be affected
- High interest rate response required for I.T. not appropriate for EM_s :

  will Strengthen exchange rate (XR) but stifle growth and capital flows can put Pressure on XR.

Empirical experience

- 42 IT countries
  - 24 without clear commitment
    - 19 low Credible IT i.e. IT lite
    - 5 highly Credible Industrial countries.
  - 18 full fledged IT (FFIT)

Characteristics of ITL Countries

- Smaller GDP
- Fatter upper tail for inflation
- Higher govt debt
- Shallower financial systems
- Capital controls
- Greater exposure to economic shocks

Monetary Policy (MP) in ITL Countries

- transmission mechanism not clear
- tough setting for MP
- conflict with financial stability
- less market oriented targets & instruments
- policy formulation relatively varies
- more active foreign exchange intervention

Role of Financial Stability (FS)

- more attention to FS objective
- inherent conflict of clarity in adherence to objectives
- constructive ambiguity

Life after ITL

Choices of monetary regimes (i) dollarisation (ii) currency bonds (iii) Pegged XR (iv) Veiled IT (v) ITL (vi) Full Fledged IT

- FFIT or currency boards – minimal degree of credibility
- Dollarisation very extreme
- Pegged XR requires capital controls
- VITs for industrial countries only