The New Vision of Central Banks

by Juraj Sipko[1]

Central banks have played a critical role during the global financial crisis. Historically, it was the first time that central banks of the main developed economies adopted mutually harmonized and coordinated policies at the beginning of a crisis. Despite the deep global recession, central banks significantly contributed to stability of the global financial system. The present global financial crises have called for a new role of central banks in individual countries. Lesson learnt from the financial turmoil was the conclusion that a new approach of central banks is crucial in the process of financial gloablization. The main aim of this paper is to describe the past, present and future role of central banks in the process of strenghtening financial globalization.

The gold age of central banks

Monetary policy before the global financial crisis significantly contributed to economic growth and the stabilisation of prices. Historically, the majority of central banks of major developed economiesfocused on the monetary policy framework in their policies. This framework concentrated on monetary aggregates. Gradually central banks obtained their independence. In line with their independence, central banks started to concentrate on price stability in their policies[2]. Central banks, e.g., the European Central Bank, in a decision making process follow the tramsmission mechanism (see chart 1). Later on, some central banks have continued to undertake other changes in the monetary policy framework. Some central banks started to be more transparent in providing information of future monetary policy. Central banks‘ independence, transparency and accountability have improved macroeconomic performance. Although the monetary policy did not cause the crisis[3], central banks at the beginning of crisis have faced enormous pressure in order to stabilize the global financial system. One might note that the accommodative monetary policy[4] of the FED between 2002 and 2006 contributed to the mortgage crisis in the USA.

Central banks during the financial crisis

After the collapse of Lehman Brothers, central banks of major developed economies, including some emerging market economiesquickly adopted appropriate measures in order to stimulate global liquidity. Central banks of major developed economies, including the

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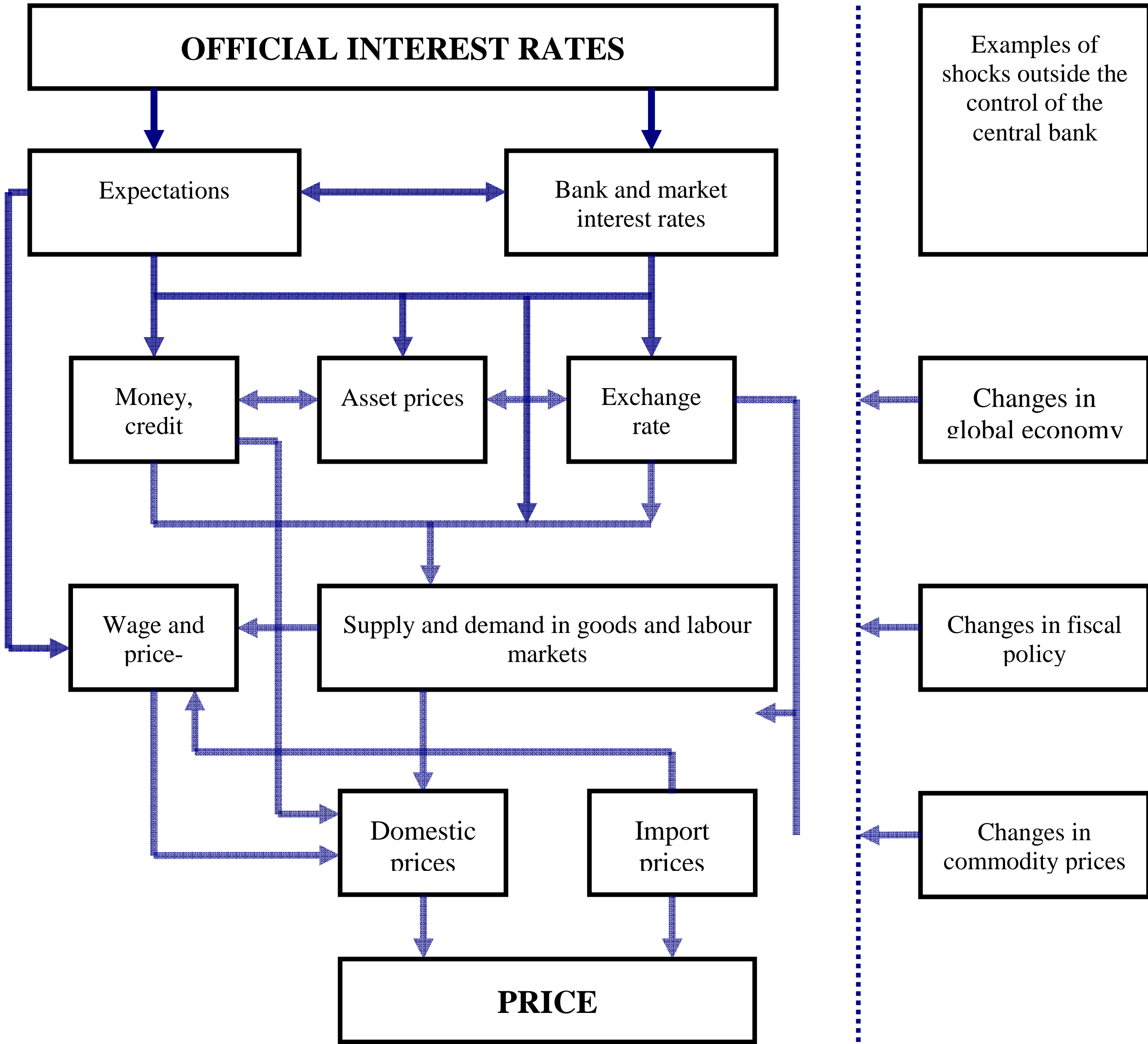
[2] At the beginning of 90’s, central banks adopted as a main objective monetary policy instrument price stability. New Zealand was the first country, which successfully introduced explicit inflation targeting framework. Later, Canada, Sweden, UK and others adopted full fledge inflation targeting framework. Those countries have involved an inflation target of around 2 percent for two/three years.

[3] Despite the fact that more than 3 years have passed since the outbreak of the global financial crisis, there is not full agreement between policymakers, research and academia, who caused this crisis.

[4] FED, after the dotcom crisis, significantly reduced the interest rate from 5,25 to 1 percent within the above mentioned period. Since the US economy had all the symptons of a recession at the beginning of the last decade, the main goal of the FED was to support the economic growth in the USA. This was theright decision in the right direction. However, the FED maintained a very low level of interest rate longer than was necessary. Immediately, when construction industry in the USA began to boom, it was necessary to adopt a restrictive monetary policy. This was one of the big mistakes of the FED, which led to the mortgage crisis in the USA and later on the global fianncial crisis.

European Central Bank (ECB) have in a vigilant way implemented additional non-stardard or unconventional measures, including expansionary monetary policy[5].

Transmission mechanism of the ECB chart 1



Source: ECB

Historically, this was the first time that individual developed economies introduced common harmonized monetary policies. Since October 2008, different central banks significantly reduced their interest rates. FED moved its interest rates from 5,25 percent to 0,25 percent. ECB followed the FED by reducing interest rates from 3,75 basic points to 1 percent. Almost all other countries followed a similar expansionary monetary policy.

The question is whether the mutually harmonized policy was successful. To answer this question, it is necessary to note that in terms of harmononized and coordinated monetary policies this was done well. However, in reality, it was less effective. In this regard, there is another question: why? The lesson learned from the global financial crisis is that this crisis is

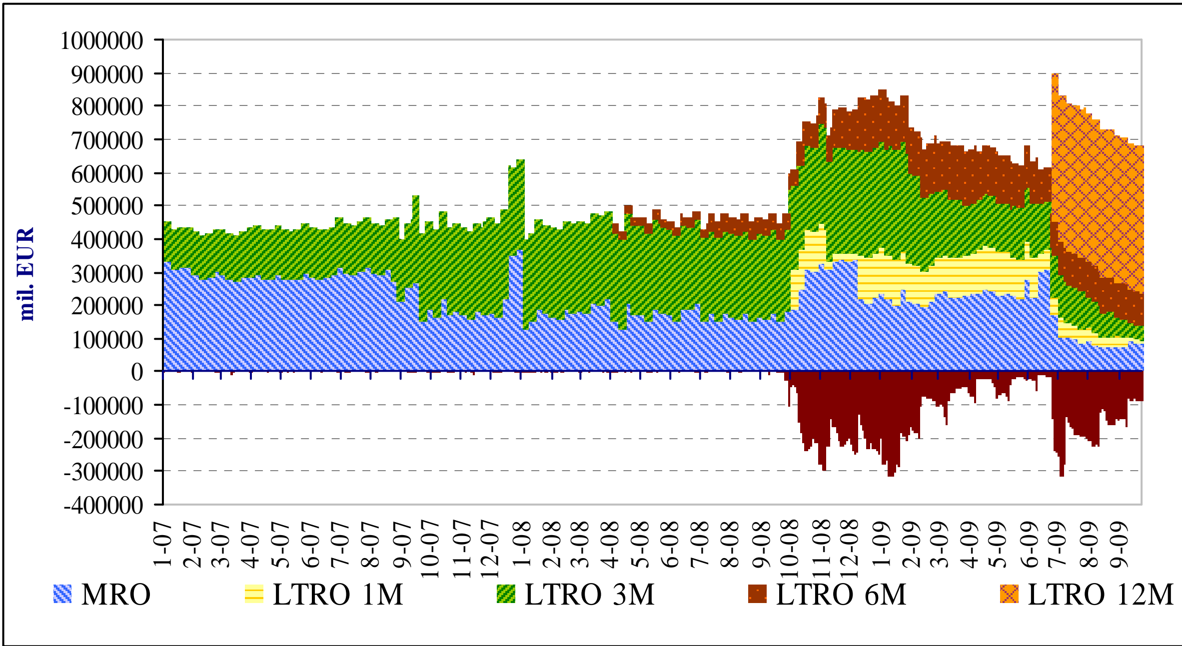
[5] Federal Reserve System (FED), ECB, Bank of Canada, Bank of Japan, Bank of England, Risks Bank, Swiss National Bank adopted mutually coordinated and harmonized monetary policy in supporting economic growth.

more complex. In order to support economic growth, expansionary monetary policy is appropriate, but the crisis itself needs to solve also other factors which significantly contributed to the present global financial turmoil.[6]

Central banks as lender of last resort

Although the expansionary monetary policy of the FED was not the main factor which caused the global financial crisis, the central banks have significatly contributed in stabilizing the global financial system. Since July 2007, central banks of major developed economies were providing the necessary bulk of liquidity to the financial sector. Even after the collapse of the Lehman Brothers, the FED and ECB remarkably increased liquidity in the financial market. The increase of additional liquidity to the financial sector altogether with the expansionary monetary policy was essential to stabilize the global financial system. In addition, ECB in supporting the financial system, changed its operation policy. Therefore, there is a consensus that central banks have played a critical role in supporting economic growth and supporing liquidity to the financial sector as lender of last resort.

ECB operation policy during the global financial crisis chart 2
Source:ECB



ECB before the global financial crisis mostly concentrate on the main refinancing operation (MRO) (see chart 2). As the problem started with the global illiquidity, the ECB moved from the MRO to long-term refinancing operation (LRO). When the global financial system reached its peak, the ECB moved from LRO previously used for 3 months to 6 and 12 months, which were dominate at the end of 2009.

In addition, central banks around the globe, but mainly in developed economies introduced the so-called non-standard or unconvetional measures[7]. Historically, central banks

[6] In order to put the world economy on a strong, sustainable path and to balance economic growth, restructuring of the financial sector is essential. In addition, there are other imperatives, which should be solved, e.g., global imbalances, currency wars, protectionism, the unfinished agenda of regulation of the financial sector, etc.

changed their strategy. Deregulation of the financial markets and the process of financial globalization, capital movement liberalization, including the rapid growth of financial engineering[8], called for a new role of central banks in a new global environment.

Macroprudential policy

The reasonable lesson from the global financial crisis has show that central banks should be oriented broader not only on monetary policy, but also on systemic financial stability, liquidity and crisis management, including macroprudential regulations and supervision. For the main feature of macroprudential policy, see chart 3.[9]

New European institutional framework for managing systemic risk chart 3

Macro-prudential oversight
European System of Central Banks
ECB
National Central Banks
Advisory Technical Committee
European Systemic Risk Board
Steering Committee
Board
+
Observers
ECOFIN (EU Ministers of Finance)
Early risk warning and recommendations
Micro prudential information
Micro-prudential supervision
European System of Financial Supervisors
Steering Committee
European Banking Authority (EBA)
European Insurance and Occupational Pensions Authority (EIOPA)
European Securities and Markets Authority (ESMA)
National Banking Supervisors
National Insurance and Pension Supervisors
National Securities Regulators

Source: European Commission

The future role of central banks

The global financial crisis called for revision of the policy framework for central banks. The policymakers, researchers and academia recognized that in order to avoid a future

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[7] FED and ECB, both monetary institutions during the global financial crisis have provided to the financial sector so called non-standard or unconventional measures.
[8] Financial deregulation and financial globalization connected with ? created new financial products which are very important for monitoring financial risk.
[9] Macroprudential policy seeks to develop, oversee, and deliver appropriate policy response to the financial system. In addtion, macroprudential policy aims to enhance the resilience of the financial system and to dampen systemic risks that spread through the financial system via interconnectedness of institutions, their common exposure to shocks and the tendency of financial institutions to act in procyclical ways that magnify the volatility of the financial cycle. Macroprudential policy should use varible and fixed tools and apply them with the goal of reducing systemic risk and increasing the resilience of the financial system to absorb such risk.

financial crisis, a comprehensive financial stability framework should be adopted. This framework has to focus changes on both monetary as well as liquidity management, including on deepening interaction between monetary policy, macroprudential and liquidity and crisis management.

The future role of central banks should be supported globally. In line with this, closer cooperation of central banks with the international institutions will be needed. Therefore, the International Monetary Fund (IMF)[10] with has brad? based valuable global experience might be very helpful for seting up the standards. In addition, the Financial Stability Board[11], including the Bank of International Settlements are very important to serve central banks.

Macroprudential policies will the essential for maintaining systemic financial stability. Although still there are some open questions regarding macroprudential regulation, it is clear that monetary policy should be consistent with price stability. However, the monetary policy should be formulated also to address systemic financial risks. This new framework has to set up the main goal, which is price stability. Part of this strategy should also include how to integrate analysis of development of the global financial system as well as monitoring of the risks. Nevertheless, broadly based analysis of the financial sector development, including the main risks will be crucial for policy formulation and implementation for individual central banks.

Despite the certain progress, which has been made in developing macro-financial linkages, still much remains to be done. In this regard, developing macroprudential indicators and which institutions will be responsible for collected data would be essential.

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[10] The International Monetary Fund (IMF) has for many years provided the Financial Sector Assessment Programs (FSAPs). In line with the FSAPs, the IMF has offered a unique experience in providing technical assistance for its member countries. The FSAPs, with a high quality of technical assistance, will create the important element for financial stability. In addition, the IMF could provide additional relevant data, which will better explain the main linkages between the financial sector and macroeconomic models, which are used by the central banks. Finally, the IMF can also provide appropriate training for the staff of the central banks for analysis of systemic risks and for monitoring the risks of the financial sectors.

[11] The Financial Stability Board (FSB) was established to address vulnerabilities and to develop and implement strong regulatory, supervisory and other policies in the interest of financial stability.

Abstract

The paer discribes the past, present and future role of the central banks. Historically, central banks focused on the monetary policy. At the beginning of 90,s central banks a major industrial countries moved from monetary aggregate to inflation targeting. During the last two decades central banks with their prudent policy significantly contributed to the economic growth. The global financial crisis called for a new approach of the central banks. despite the fact that will concetrate on price stavility, they will monitor also financial stability. In line with this has been adopted aproach of macroprudential policy framework. Broad based macroprudential policy will focus also on supervision and regulation, including monitoring the risk and crisis management.

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Finally, in order to follow the macroprudential policies framework for central banks, to maintain transparency, accountability and a high level of their independence would be nedeed. Since policymakers, researchers and academia have learned a lot from the present financial crisis.tak co? However, they came to the conclusion that given the present pace of financial globalization, including creating new financial enginnering, the development of a broadly based constructive dialogue between all participants of the financial market and central banks' decision-makers, a high level of cooperation would be critical.

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