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# **The Role of Central Banks in Financial Stability**

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II CEMLA-SEACEN Conference on “The Role of Central  
Banks in Macroeconomic and Financial Stability”

Punta del Este, November 15, 2012

## The global recovery is fragile and uneven...

- Global growth is projected to remain sluggish for several years.
- Financial sector strains having receded somewhat, but markets remaining sensitive to sovereign and banking sector risks.
- Downside risks to economic recovery remain large.
  - Further strains in the U.S. housing market
  - Lack of credible medium-term fiscal consolidation plans
  - Risks of spillovers from turbulence in sovereign debt markets
  - Risks of overheating and asset price bubbles in emerging economies owing to large capital inflows
  - Fears of financial and trade protectionism and currency instability continue to weigh on economic recovery.

## **Recent change in emphasis at Central Banks with regard to financial stability**

- Prior to the recent financial crisis, there were significant differences across countries in how and to what extent financial stability was pursued by central banks.
- In some countries, the central bank had an explicit stability objective but did not always actively manage stability other than to ensure liquidity access.
- In other countries, the central bank prepared formal stability reports and/or pursued financial stability explicitly.
- Following the global financial crisis, reforms have been initiated in many countries to address financial stability more directly, frequently focusing on macroprudential policy frameworks in which Central Banks play a more active role.

# The roles of Central Banks have expanded since the crisis

- Conventional monetary policy roles (setting interest rates in the pursuit of macroeconomic stability and acting as lender of last resort to provide liquidity) have been transformed.
- Central Banks have added other financial stability responsibilities, including macro-prudential and micro-prudential regulation, to their conventional monetary policy roles.
- In advanced economies: official policy rates near or at the effective lower bound, size of the central bank's balance sheets have increased, composition of its assets and liabilities has changed.
  - The lender of last resort role has expanded to include solvency support for SIFIs and, in the euro area, the provision of liquidity support and solvency support for sovereigns also.

## Coordination with Finance authorities remains an issue

- Major central banks have used their balance sheets to engage in quasi-fiscal actions that have been essential to prevent even greater financial turmoil and possible disaster
  - The ECB was forced into this role by the fiscal vacuum in the euro area; the Fed by the fiscal difficulties of the US government.
  - The non-inflationary loss-absorption capacity major central banks is vast. For the ECB/Eurosystem it is estimated at no less than EUR3.2 trillion, for the Fed at over \$7 trillion. This is tax payers' money that is not under the effective control of the fiscal authorities.
- In emerging markets, coordination between Central Banks and Finance authorities have always been a condition for macro –and hence, financial- stability.

## Policy priorities to deal with the crisis

- Monetary policy must remain the first line of defense, although this line is becoming increasingly thin in most advanced economies.
- Given a fragile recovery, an accommodative monetary policy stance remains appropriate in advanced economies, and can counteract some of the contractionary effects of fiscal consolidation, but negative spillovers to other economies, in particular emerging economies, need to be closely watched and managed carefully.
- Policymakers should be mindful of the impact of such action on emerging economies, notably through large and volatile capital flows.
- Urgent need for multilateral policy coordination.

## The challenge of managing capital inflows

- Many emerging economies are faced with a difficult policy challenge of managing large capital inflows.
  - The task becomes more onerous in the context of limited exchange rate flexibility in some emerging economies.
- In cyclically-advanced emerging economies, where reserves are adequate and exchange rates have been flexible, fiscal tightening will help manage capital inflows. This would also help reduce the burden of adjustment on monetary policy and facilitate convergence towards lower real interest rates, thereby reducing the incentives for short-term capital inflows.
  - If these measures are insufficient, the policy response may also include some combination of further appreciation, accumulation of reserves, macro-prudential measures (such as limits on foreign-currency loans by banks), and carefully designed capital controls.

## Fiscal consolidation should not jeopardize growth

- **Fiscal policies must increasingly address medium-term requirements to enable debt sustainability.** Successful fiscal adjustment will require that medium-term consolidation plans are accompanied by structural reforms that raise the trend level of growth and thus support long-term fiscal solvency.
- **The type and speed of fiscal consolidation should reflect different circumstances in different countries,** especially in terms of the pace of recovery and risks to fiscal credibility. Country consolidation plans should strike an appropriate balance between strengthening public finances and continuing to support the recovery.
- If growth slows down appreciably more than expected, some of the planned consolidation could be slowed or postponed in countries with more fiscal room.



## Financial sector remains the Achilles's heel of recovery

- In many advanced economies, insufficient progress with repair and reform is weighing on credit growth, and slowing the normalization of monetary and fiscal policies, with adverse spillovers on emerging economies, through large and volatile capital flows.
- **Accelerated financial sector restructuring and reform should thus be top priorities.** Moving expeditiously to address the legacies of the crisis (including bank funding concerns, the resolution of weak banks, and the restructuring of balance sheets for distressed households) as well as to alleviate regulatory uncertainty will strengthen financial systems and help catalyze private-demand-led growth.

## Advances toward financial sector reform

- Since the onset of this crisis, national authorities and international bodies have advanced a major program of financial reforms, based on clear principles and timetables for implementation.
- A key piece of the global reform agenda has been addressed with agreement on strengthened bank capital and liquidity standards by the Basel Committee on Banking Supervision (BCBS).
  - Hopefully, the new standards will significantly improve the quality and quantity of bank capital and enhance the resilience of the banking system.
- Good progress has been made in defining a policy framework to address the moral hazard risks posed by systemically important financial institutions (SIFIs).

# Building high quality capital and liquidity standards

- Strengthening of bank capital and liquidity standards remains a cornerstone of the financial sector reform objectives.
- The design of the new global regulatory framework (“Basel III”) fundamentally strengthens the resilience of the banking system through several prudential measures:
  - **Considerable enhancement in the quality of capital** (there is much greater focus on common equity, the highest-quality component of bank capital in absorbing losses);
  - **Significant increase in the level of capital**: minimum level of common equity increased from 2% to 4.5%; minimum level of Tier 1 capital increased from 4% to 6%.
  - Promotion of the **build-up of capital buffers to mitigate procyclicality**: banks will be required to hold a capital conservation buffer of 2.5% in the form of common equity to withstand future periods of stress.

# Building high quality capital and liquidity standards

- **Improvement in the risk coverage of the capital framework:** capital requirements for trading book exposures, complex securitisations, and exposures to off-balance sheet vehicles are substantially strengthened;
- **Introduction of a leverage ratio as a supplementary measure to the risk-based capital requirements:** In order to help contain the build-up of excessive leverage in the financial system, serve as the backstop to the risk-based capital requirements and help address model risk, a leverage ratio will be introduced with a view to migrating to a Pillar 1 treatment, subject to appropriate review and calibration;
- **Introduction of global minimum liquidity standards:** New global minimum liquidity standards based on the Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR) introduced. The LCR will make banks more resilient to potential short-term disruptions in their access to funding.

## Other relevant financial reform issues

- **Addressing the moral hazard posed by systemically important financial institutions (SIFIs)**, whose disorderly failure, because of their size, complexity and systemic interconnectedness, would cause significant disruption to the wider financial system and economic activity.
- **Improving the OTC derivatives markets:** standardised OTC derivatives contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties. Commitment to accelerate the implementation of strong measures to improve transparency and regulatory oversight of OTC derivatives in an internationally consistent and non-discriminatory way.

## Other relevant financial reform issues

- **Expanding and refining the regulatory perimeter:** key issues arising from the differentiated nature of financial regulation in the international banking, insurance and securities sectors. It is also needed to address gaps arising from the financial regulation in order to help ensure that the scope and the nature of financial regulation are appropriate and as consistent as possible.
- **Strengthening the regulation and oversight of ‘the shadow banking system’:** This sector continues to play an important role in credit intermediation and liquidity transformation outside the rigorous capital and liquidity regulatory framework that applies to banks. Addressing the issues that this raises, and putting in place the needed safeguards, should be one of the priorities of the agenda.

# Conclusions

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- The international monetary system has proven resilient, but vulnerabilities remain.
- Central Banks have a fundamental role to improve it in order to ensure systemic stability, promote orderly adjustment, and avoid disorderly movements in exchange rates and persistent misalignment of exchange rates.
- This role includes conventional policies to deal with potentially destabilizing capital flows and management of global liquidity; and also less conventional macro-prudential measures.
- Central banks have become increasingly concerned about financial stability issues, even if they do not have regulatory powers.

# Conclusions

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- Central Banks are committed to pursuing the reform of the financial sector. Their contribution is fundamental to fully implement the Basel III new standards for banks within the agreed timelines.
- Despite significant progress to date on global policy reform, there is much to be done before a more resilient financial system has been secured.
- The policies that have been agreed need to be implemented consistently across jurisdictions. Regulations need to be nationally appropriate but also internationally consistent.
  - As experience shows, in a financially globalised world, uneven regulations across borders will inevitably lead to regulatory arbitrage and defeat of common regulatory objectives.