

Challenges for Central Bankers in a Changing World

Bruno Gehrig *

* Miembro del Directorio del Banco Nacional de Suiza

Ladies and Gentlemen,

It is a great honour for me to address such a distinguished gathering. The Bank of Bolivia's 70th Anniversary is a fine occasion and the high La Paz plateau a perfect place to reflect about the "high school" of central banking. Unlike you, though, I am not an expert on Latin American economic affairs, which limits my contribution to this seminar. Hence, my remarks shall deal with more general concerns. However, I think that some of my experience can be usefully applied to the work of central banks everywhere, in small as well as large economies in all parts of the globe.

Stable monetary conditions are the key to economic efficiency and welfare. This is one of the few insights of economic theory that nobody can seriously challenge. In fact, it is clear that the opposite experience of numerous countries in the past accounts for a broad willingness to accept this very basic truth.

Unfortunately, the real world has many more facets than academics can ever handle at any one time. I fear this will never change, despite all the progress in the research profession, for which I have a very high regard.

The only constant is change. This also applies to central bankers. What are the key challenges we face? Let me start by highlighting some of the relevant trends and issues of interest to central banks. I will then take a closer look at some important aspects of the international financial scene, before drawing conclusions for central bank policy.

1. OVERRIDING ECONOMIC TRENDS

a) Market Integration

The past decades have brought unprecedented progress on a global scale in technology, trade and market integration. Goods, services and financial markets have profited from lower transaction costs and deregulation. Financial markets have taken the lead in the trend towards globalisation. Financial flows in and between countries have expanded enormously.

Increased competition has made the supply of goods and services more efficient. As a result, more and more consumers are paying less for goods

and services of a higher quality. On the other hand, production sites tend to move to places that offer them the most favourable resource-profile. Fortunately, these trends cover both the old industrialised *and* the emerging economies. Consequently, they promote a more efficient allocation of capital on a worldwide basis.

b) Disinflation

Rapidly growing market integration has made central banking more critical and demanding. Monetary frameworks and policy requirements have become more compatible; it is easier to compare policy performance nowadays. Monetary policy makers around the world are exposed to similar circumstances. And they have acted in a remarkably coherent manner; the global process of tackling inflation in the past decade is exemplary – and of lasting benefit to both industrialised and emerging economies. Last year, inflation in Latin America dropped to 14 % on average, with inflation rates in many countries, including Bolivia, below 10 %. Disciplined monetary policy, together with trade liberalisation, efforts to strengthen financial systems and growing international financial integration, has contributed to this success.

2. A CLOSER LOOK AT THE FINANCIAL SCENE

- The financial sector has changed dramatically in the last twenty years. New communication and information technology has lowered the cost of gathering and processing information. Deregulation has taken root partly because of the compelling advantages of free markets, but also due to the impossibility of keeping controls effective in the face of innovations.
- As a result of greater integration, financial markets have become more interdependent and interactive. Experience shows that such markets can be very powerful and fast moving, particularly in response to political events, changes in fundamentals or simply rumours. Modern markets tend to sanction and discipline economic policy almost immediately. Countries are more vulnerable to changes in market sentiment, even if these changes are an overreaction.
- Problems in one country or market spill over into others much faster and with greater effect than ever before. As a result, an increasing number of countries have the potential to influence financial and economic conditions almost anywhere in the world. Spillovers can be positive: there can be no doubt that industrial countries benefited from the

dynamic growth in developing countries in the early nineties. But spillovers can also do harm, as we have seen in the recent crisis in Asia.

- Economic problems in one country or region may change investors' attitudes towards risk in general. One possible result is waves of excessive pessimism or optimism. This has serious consequences for other, seemingly unrelated economies. As a result, overall financial conditions in other economies in similar circumstances may worsen or improve drastically, even if such change is not justified by economic fundamentals or economic policies.
- The fact that a limited number of big global players dominate the international financial arena increases the problem of systemic risk. No doubt, large firms do benefit from economies of scale in the production and distribution of their services, thereby improving the efficiency of the international economy as a whole. However, we cannot overlook the simple fact that the bigger a financial player is, the more damage it can potentially cause to financial systems.

3. FOUR RECOMMENDATIONS FOR CENTRAL BANK POLICY

What does this mean for central bank policy? I should like to summarise my recommendations under four headings: stability, market orientation, deregulation of capital markets, and international cooperation.

a) Strengthening Stability

I am convinced that the crucial concern of any central banker - always and everywhere - must be stability. This involves two aspects: macroeconomic stability and the stability of the financial system.

Macroeconomic stability refers primarily to price stability. Experience and theory suggest that the exploitable trade-off between inflation and output exists only in the very short run. However, the long-term cost of inflation usually far exceeds any short-term gain. Or, as economists might prefer to say: in the long run, the Phillips Curve is approximately vertical. In addition, there is evidence that as financial markets have become more flexible the chances of achieving real effects through monetary accelerations have deteriorated. Deviations from a pattern of policy consistent with a high degree of price stability will more rapidly be reflected in long-term interest rates, which will reduce the envisaged real short-term effects. It has, indeed,

become more difficult than ever to cheat market participants by promising A and delivering B.

Monetary policy has actually been remarkably successful in bringing down inflation. This is true not only in OECD countries, but also in most emerging economies. A crucial challenge for all of us is to continue to strengthen or preserve what has been achieved. The chances of succeeding seem significantly better if central banks can operate with a high degree of statutory independence from day-to-day politics. Not because politicians, parliaments and governments are less interested in price stability, but because they have strong incentives to optimize within much shorter time frames. However, the independence of central bankers has to be combined with a clear mandate to deliver price stability, and they have to be made politically accountable for their performance.

The second aspect of stability relates to the soundness of the financial system. Financial institutions, in particular banks, have to be regulated because of the nature of their business. The negative external effects of bank failures on other financial and non-financial institutions are inherently destabilising and potentially reinforcing. Without question, regulation is a very difficult task. Financial stability must not lead to rigidity. The rules have to assure a high degree of flexibility and competitiveness. Otherwise they will encourage inefficiency and moral hazard. Fortunately, there is an accepted set of minimum standards for banking supervision as well as useful best-practice experience, developed mainly by the Bank for International Settlements.

b) Working with, Rather than Against, Market Forces

My second recommendation for central bankers is to work with, rather than against, market forces.

It is a fact of life that modern financial markets have the power to influence policy operations more strongly than in the past. The market response to policy measures has grown significantly with international integration and the development of new financial instruments.

As a consequence, markets are able to support prudent economic policies, which makes it easier to realise their objectives. On the other hand, bad policy will be disciplined. As markets are fast-moving, this happens very

quickly, and, on account of the huge amounts of capital involved, possibly overshooting.

The effectiveness of some administrative instruments of central bank policy is being eroded by innovations in market practices and the blurring of national borders. Central banks must be aware that it is in their basic interest to make the market system work as efficiently as possible. This means working with, rather than against, market forces.

Likely reactions of markets to political decisions must be taken into account. Accordingly, it is essential that policy makers have a profound knowledge of markets. Four aspects appear to be of particular importance:

- Central banks using market prices or aggregates as indicator variables must be able to interpret changes. New instruments may influence prices and trading volumes across markets. A thorough understanding of the functioning of new instruments helps to draw clearer conclusions from movements in indicator variables.
- Central banks must reconsider their policy instruments. Market dynamics have changed the effectiveness of some traditional non-market instruments, eg interest rate ceilings or credit controls. Choosing the appropriate instruments will make it easier to achieve policy goals.
- Regulation should be based on market incentives wherever possible. This reduces attempts by financial institutions to get around the regulations.
- And, my fourth aspect, it is preferable for central banks to be explicit and credible about their intentions. In a world of highly flexible market responses where expectations drive market changes, it is crucial that authorities are committed to delivering what they promise. In other words: credibility has become a core condition for the efficient achievement of policy targets.

c) Deregulation of Capital Markets

In many countries, financial markets are still heavily regulated. They remain on the sidelines of international capital flows. And after the recent experience of a number of Asian countries, it has to be asked whether opening up capital markets is indeed such a good idea.

I am convinced the answer is "yes, but". Yes, because access to the international market allocation of capital can improve a country's economic

prospects fundamentally and permanently. But, experience has taught us that the success of such liberalisation depends on other conditions, too. I should like to name four.

First, deregulation should be a sequential process. Initially, it should apply to long-term capital, in particular foreign direct investment. Longer-term commitments of this nature often involve a valuable transfer of know-how. They are far less sensitive to passing volatility than short-term loans. Some countries have chosen, for political reasons, to do things in the opposite order, and have paid a high price.

Second, the domestic financial system, especially banking, has to be strengthened, before the economy can be opened to international capital flows. Financial institutions need to be strong and flexible enough to absorb some financial stress.

Third, the country must be prepared to accept and fulfil the internationally applied requirements of transparency. This applies particularly to information about the finances of the central bank, the government and private financial institutions. Experience teaches us that the less transparency there is, the greater the volatility and the bigger the risk of possibly damaging waves of overreaction.

Fourth, the opening up the capital account must be accompanied by an appropriate exchange rate policy. It is a basic truth that enjoying the fruits of a fixed exchange rate regime in the long-run implies the willingness and discipline to pursue a pattern of monetary and financial policies which is consistent with the fixed currency value. If a country participates to a significant extent in the process of international private capital allocation it seems indispensable to allow for a reasonable degree of exchange rate flexibility, thereby imposing on cross-border borrowers and lenders some exchange rate risk. This is - for systemic reasons - especially important in the area of foreign currency borrowing by banks. Even in a regime of managed exchange rates foreign currency liabilities have to be kept at levels and within a maturity profile which assures that a devaluation does not put the system into a serious crisis. Bankers and their supervisors should act with reflected prudence, taking care of some recent lessons of experience.

d) International Cooperation is a Necessity

My fourth recommendation is international cooperation. Because of the pronounced external effects of financial shocks, international cooperation is becoming indispensable in the face of global financial integration. It should focus primarily on prevention. In my opinion, the crucial element in this respect is adequate banking supervision. All our experience points to the fact that if, as a result of a financial shock, banks are unable to fulfil their obligations, countries soon find themselves in a system crisis. In reality, there is often no alternative to a bail-out using public money. This raises the acute problem of moral hazard – both for banks and for international lenders. Sure, international cooperation must go beyond prevention to include crisis management. The crucial institution at this level is the International Monetary Fund.

Its financial resources, however, are limited, certainly more limited than we could have imagined a few years ago. This further underlines that there is no alternative to making substantial progress in the preventive efforts. The IMF will always have to be able to extend credits, but it should in the future pay more attention to its role as a catalyst and coordinator, bringing creditors and debtors together in order to restore a country's access to private capital. The moral hazard problem is a critical issue. It can only be overcome if private creditors have to participate in any effort to solve a critical situation. And if they have to take the possibility of such a bail - in into account when they decide on credit proposals.

CONCLUDING REMARKS

Let me come to a conclusion. As central bankers we can learn a lot from one another. Because we speak the same language and – irrespective of country – deal with similar problems, networking and exchanging experiences can be extremely rewarding. Regular dialogue will enable us to do a better job in a world of integrated financial markets.

Regardless of the country in which each of us works, we have to take decisions on the basis of uncertainty that have consequences for large numbers of people. This is something we all share. When we draw up our policies, we know far less than we should know and would like to know. This encourages a sense of proportion, a willingness to question our assumptions and an openness to enhanced concepts.

But what we also have in common is an obligation to fulfil a fascinating task that is crucial to our countries' economic prosperity. On this note I offer our colleagues at the Central Bank of Bolivia our congratulations on the occasion of this anniversary today. I wish them, and us, their guests, a successful future in the service of our countries.