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# Financial Stability and the Role of Central Banks

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# Questions Posed by Mark Schieritz (Die Ziet)

1. What macro-prudential measures are needed to safeguard financial stability?

2. What are the consequences of the role of central banks?

3. How do monetary, financial stability and fiscal policies interact and what are the institutional and policy implications for central banks?

4. What are the consequences of a broader role mandate for central bank independence and democratic accountability?

5. Does a monetary union without a strong fiscal authority need to be treated differently?

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# Which Macro-prudential Measures?

- Right objective: <u>System-wide</u> (or macro-prudential) perspective

- Tool: Capital requirements / Leverage controls

  <u>Risk that risk will change</u>:

  Stress tests, sectoral risk-weight revisions, multiple ratios

- Robustness to regulatory arbitrage / shadow banking:

  <u>Counter-cyclical</u> monetary policy: Leaning against liquidity

  <u>Regulation by function rather than form</u>:

  CCPs, market-wide leverage restrictions (LTV, DTI, …)

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# Consequences for Central Banks

- Regression of function back to <u>Financial Stability</u>
- Lesser focus for the time being on <u>Inflation Stability</u>
- Nonetheless, the two functions are intimately tied

  <u>Healthy financial sector key for transmission</u>

  Under-capitalized banks in a low interest-rate environment perhaps the worst state of the world for prudent risk-taking

  - Carry trades on southern periphery debt

  Zombie banks after a downturn misallocate resources

  - Lack of SME lending in Italy

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# Unintended Policy Consequences

- Under macro-prudential view, <u>ALL</u> policies interact

- Expansionary policy: Jobs – may be, but asset-price inflation?
  Greenspan “put”
- Financial (in)stability: Stimulus – may be, but fiscal capacity?
  Ireland
- Fiscal policy: Populist spending – may be, but inflation?
  India

- The incentive problems at each deeply influence the other
  <u>Monetary policy (rules versus discretion)</u>
  <u>Financial sector (under-capitalization)</u>
  <u>Fiscal policy (government myopia)</u>

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# Broader Mandate for Central Banks

- Mopping up by central banks involves quasi-fiscal (LOLR) actions
- Quasi-fiscal actions push the boundary of central-bank mandate
- They risk political-economy influences in central-bank operation
- Focusing on financial stability in good times can exonerate the central banks from independence and accountability issues
- Operational independence different from effective one:
  fiscal policy <-> monetary policy <-> financial stability
  Paul Volcker versus Ronald Reagan

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# Monetary Union w/o Fiscal Authority

- Ability to tender collateral to the Central Bank affects the price of collateral and its funding liquidity

- Financial sector will own all collateral that has this liquidity put
  - Home bias in government bond holdings
- Entanglement of the financial sector with a given collateral builds the implicit guarantee that this collateral is guaranteed
  - Issuers of this collateral receive a funding advantage

- The liquidity put of central banks should be conferred judiciously
  - Only the very best collateral should be accepted
  - If lower-quality collateral is accepted, only at steep haircuts