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Second Session:

"Monetary Stability in the Function of Financial Stability"

Financial Challenges for the B10 Central Banks

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1. Introduction.

First of all, I would like to congratulate our hosts on the tenth anniversary of a very successful central bank. I am certain that if anyone during the labour pains at Dayton had been asked to describe a monetary framework for BiH for the ten years ahead, not even the biggest optimists would have dared to predict such a successful position for the CBBH. Stable inflation and increasing gross international reserves indicate the stability of the currency board and its growing credibility. So, congratulations to all the governors and their teams on this achievement.

Second, I am really honoured to be on this session. I hope I will be up to the challenge. If nothing else, I will do my best to stay within the time slot allocated to me. Therefore, I will go straight to the subject.

Third, the topic of this session is quite challenging. Its title:"Monetary Stability in the Function of Financial Stability" implies, if understood literally, the role of monetary policy (as an independent variable) in the stability of the financial system (as a dependent variable). This is challenging, especially in the framework of the CBBH and its currency board. So I decided to focus on the region, the B10 countries. The combinations of letters and numbers are quite fancy in the world of finance. The B10 is simply an acronym for ten Balkan countries, with Balkan being meant as a geographical term, not a socio-political adjective with the usual negative connotations attached to it, we are often concerned about in the region. Furthermore, Kosovo is not an independent country (UN Security Council Resolution 1244), but it has a monetary authority independent of Serbia, hence its separate treatment in the note. I will first focus on monetary stability, then on financial stability, and I will end up with some recommendations (advice is cheap) to the B10 central banks regarding maintaining financial stability in the context of rapid globalization, huge net capital inflows, financial innovations and shocks spreading almost instantly from one epicentre throughout the world.

Fourth, we should keep in mind that the financial system is very important for any economy. "*The financial system is a coordinating mechanism that allocates capital to productive investment opportunities. If capital goes to the wrong uses or does not flow at all, the economy will operate inefficiently and economic growth will be very low.*" (Mishkin, 2006, p. 1). Accordingly, there will be more focus on the financial system than on the monetary system.

2. Monetary stability

About ten years ago, when I started travelling regularly to the holiest site in central banking, the BIS in Basel, the usual introductory lesson on central banking was that the four main points a governor should always keep in mind were as follows:

- inflation is always too high,
- interest rates are always too low,
- if things go well in the economy, it is because of central bank's good policies; and
- if there are problems, blame it on the government.

And this was only partially meant as a joke.

This philosophy could further be distilled into the simple mantra for central banking at the end of the last century: price stability. As with spiritual development, the trick was to repeat that mantra often enough in order to achieve enlightenment in central banking.

Today it is widely accepted that price stability (low inflation) is a necessary precondition for sustained economic growth. All over the world inflation has gone down in the last two decades. What is even more important, low inflation is accepted as a normal state, a standard of good behaviour, not only in central banks, but in the academia, in politics and, most importantly, in the population at large. It seems as if central bankers can sit back and relax, look at inflation problems that made them sweat in the past and proudly say: "Mission accomplished".

However, monetary stability is not as well defined as low inflation is. For the sake of simplicity and due to limited time I will assume that monetary stability is achieved as long as there are no inflationary pressures, regardless of the usually high growth rates of money aggregates in the B10 countries. The long-term relationship between money growth and inflation, asset price bubbles etc. will not be discussed here.

The following table shows the type of monetary policy, inflation and money aggregates in the B10 countries for the period 2001-2006.

Table 1: Monetary stability in the B10 countries[2]

	B10 country central bank	Monetary policy type	Inflation*	M3 growth*	Δ M/GDP in % **
1	Albania	Independent	3.1%	12.9%	+8.1%
2	BiH	Currency board	2.6%	28.9%	+12.5%
3	Bulgaria – EU	Currency board	5.7%	21.8%	+23.6%
4	Croatia	Quasi independent	2.7%	17.1%	+8.8%
5	Kosovo	Unilaterally euroised	0.1%	N/A	N/A
6	Macedonia	Pegged to euro	2.0%	20.7%	+11.6%
7	Montenegro	Unilaterally euroised	8.7%	N/A	N/A
8	Romania – EU	Inflation targeting	16.6%	35.1%	+9.5%
9	Serbia	Independent	27.1%	47.5%	+13.8%
10	Slovenia – EU	Part of eurozone	5.1%	12.0%	-1.2%
11	Eurozone		2.2%	8.0%	+14.9%

Source: Own computation based on data from the IMF, Eurostat, national central banks and statistical offices.

* Average annual growth rate 2001-2006 (except: Kosovo-2004-2006, Montenegro-year-end).

** Change in the share of (broad) money in GDP.

It is interesting to look at different monetary policy regimes in the B10 countries. Most of them have opted for a fixed exchange rate (monetary) regime, rather than independent monetary policy. Six out of ten are now either firmly pegged to the euro, unilaterally euroised or in the eurozone. Even the three remaining independent ones cannot completely be considered as "free floaters", especially not Croatia, which, for the well-known reasons, has a “fear of floating”, being a small, open and highly euroised economy, which cannot allow excessive exchange rate fluctuations against the euro (in order to avoid potentially disastrous balance sheet effects and the triggering of inflation).

Average inflation is low in all of the countries, especially if one looks at the last numbers for Serbia and Romania. Romania's mid-year inflation was around 4% and Serbia's July number for CPI was 4.25% annual inflation (from the countries’ web sites). Money growth has been rapid in almost all of the countries, reflecting financial deepening and rapid credit growth (partly a catching up process), but at least so far without major consequences for inflationary pressures. Summing up, one can conclude that low inflation has been achieved

[2] The help from Ivana Jović and Ana Lokin in constructing this table is greatly appreciated. The responsibility is entirely mine.

in the region and that, so far, despite the rapid growth of money aggregates, there is monetary stability.

2. Financial stability

In this note, by financial stability I do not assume only the absence of a financial crisis, but also a well-functioning financial system (as defined in the introduction[3]). "The stability of the grave", as the profession sometimes refers to too tight regulation that minimizes all the risks, is not conducive to sustained high growth. Therefore, the challenge is to find an optimal balance between deregulation, which promotes market forces and financial innovations (thus increasing efficiency), and the negative consequences of possible market failures and financial crises.

With inflation conquered, a new challenge for the very beginning of the 21st century in central banking is simple: financial stability. And by this I mean the systemic stability of a country's financial system, not just the soundness of individual financial institutions, which is the task of prudential supervision. In retrospect we see that during the first decade of the transition (and all of our B10 countries are or were transition economies) systemic financial stability was occasionally mentioned, but it did not play a major role in central banks (Coats and Škreb, 2001). Afterwards, it was associated with exchange rate movements, primarily due to the Asian crisis, and it was only after this shock that systemic work on financial systems started (Blejer and Škreb, 2002). So, in the last couple of years central banks have been publishing more and more reports on the risk evaluation in the financial system, usually called Financial Stability Reports (see Cihak, 2006).

After the numerous financial crises in the last decade (Asia, Russia, Brazil and the last one involving sub-prime mortgages still going on both in the US and all over the world) it is clear that systemic financial stability (on the global and county levels) is not just a new seasonal fashion that is going to vanish with falling leaves this autumn, but something that will stay with us in the future. The large number of conferences, governor's speeches and academic papers that one can goggle on the subject, as well as the tremendous amount of work done in central banks and IFIs (International Financial Institutions) on the topics regarding systemic financial stability clearly demonstrates its relevance for the global economy as a whole.

[3] More on defining financial stability can be found in Goodhart (2004).

The question is whether central banks will be able to look back ten to fifteen years from now and say:"Mission accomplished" when referring to financial stability. Or will the next financial crises (plural) make us think of it as “Mission impossible”? Only the time will tell whether central bankers will in the future speak more like Tom Cruise or President Bush.

Financial stability is definitely a much more complex task than price stability: from its definition and measurement to operational implementation, financial stability is a multidimensional, multifaceted subject[4]. No doubt that maintaining systemic financial stability is a relatively new, but rapidly growing function of central banks worldwide, especially the advanced ones**.** In modern central banking systemic financial stability is considered a core mandate of a central bank, alongside the broadly accepted price stability. For example, the Bank of England defines its main mandate (besides price stability) as: “*One of the Bank's two core purposes is to maintain the stability of the financial system. The Bank has to make sure the overall system is safe and secure and that threats to financial stability are detected and reduced. By monitoring and analyzing the behaviour of participants in the financial system and the wider financial and economic environment, the Bank aims to identify potential vulnerabilities and risks, with a view to making the system stronger*.” (www.bankofengland.co.uk).

More and more central banks around the world have been introducing special financial stability departments/units within their organization, regardless of whether they conduct banking supervision. In addition to the well-developed central banks in the world, the regional central banks (B10) have also been following this trend and paying additional attention to systemic stability questions. As financial stability is much more difficult to measure than price stability, Table 2 will help in illustrating my point on rapid recent developments in the institutional attention to financial stability as one of the main central bank functions. It is important to note that none of those central banks had a separate financial stability unit five to six years ago[5].

[4] For an excellent overview of the issues regarding financial stability see Goodhart (2004).

[5] It is interesting to note that the joint WB-IMF exercise, FSAP (Financial Sector Assessment Program) had, in my view, a very important role in raising the awareness of systemic stability issues. See for example www.imf.org

Table 2: Organization of financial stability units in the B10 central banks

	B 10 country central bank	Supervision organization	CB Fin Stab. Unit	FSU mandate
1	Albania	Within	Separate unit	Financial system stability
2	Bosnia and Herzegovina	Outside	Separate unit within research and statistics	Recent change no formal details
3	Bulgaria	Within	No separate department (?)	(?)
4	Croatia	Within	Macro prudential	Analyze risks in financial markets
5	Kosovo	Within	FSU initiated, part of research now	FSI compilation, produce FSR and stress testing (plans)
6	Macedonia	Within	Financial Stability Analysis	Stability of the banking and the overall system,
7	Montenegro	Within	No separate unit in CB	No clear mandate as yet
8	Romania	Within	Separate unit which has 4 divisions	Promote stability of the Romanian financial system
9	Serbia	Within	Not a separate unit yet	Mandate to strive for financial stability (Law) same as price stability
10	Slovenia	Within	Separate unit	Analyze risks in the system

Source: Direct contacts with central banks. For Bulgaria and Macedonia, the countries' web sites.

The number of staff in the departments varies from three in the Central Bank of Bosnia and Herzegovina to thirty-five in the Romanian National Bank. So does the output of the departments and their interaction within and outside the central banks (with other regulatory and supervisory institutions). But the most important point is that all of them do focus on systemic stability issues and have plans to increase the focus in the future.

4. Challenges and recommendations

While we can probably agree that monetary stability (low inflation) is a necessary precondition for financial stability (and *vice versa*, causality works in both ways), the big question is what central banks in the region can do to maintain long-term financial stability of their systems, especially the ones that do not have an independent monetary policy?

First of all, it is important to note that the central banks that do not have an independent monetary policy are still central banks with many important functions to perform. More on this can be found in Škreb (2005). Second, central banks without a monetary policy are usually in charge of systemic financial stability and they need to be even better prepared for possible emergencies than those with an independent monetary policy. They have one degree of freedom less; however, they are far from helpless. Third, due to the complexity of financial stability, rapid globalization (especially with the high and growing share of foreign-owned, some of them true pan-European banks) and financial innovation, risks in the system might not be well understood, identified and located. Therefore, additional effort is required from all of them to be extremely vigilant regarding future financial stability issues. In view of this, below are some of the recommendations for the B10 central banks:

a) Continue to pay an increasing attention to systemic financial stability issues. This means more resources and more focus from the top management of the central bank. It is indeed very positive that special units have been or will soon be created in all B10. They are, in my view, a necessary precondition for the further development of this central banking function. However, from my own experience, it is essential that the top management of each central bank understands the importance of this (new) function and devotes the necessary resources to it (especially human resources, but capital as well).[6] Financial stability issues are here to stay with the B10 central banks in the foreseeable future. Even if for some of the B10 countries the prospect of entering the eurozone in the next five years is relatively high, financial stability issues will remain with them for longer than that (on those issues see Veron, 2007).
b) Be aware of the lack of quantitative data on financial stability. Measuring financial stability is a tricky issue. On the international level there are huge initiatives, like the FSI (Financial Soundness Indicators), but there are still open issues related to comparisons and"benchmarking". More investment is needed in gathering, standardizing, analyzing and using data with techniques like stress testing. For example, data on the quality of loans of commercial banks are usually less accurate than data on retail prices. Measuring risks is a risky business. Therefore, central banks must continue investing in statistical data on financial stability.

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[6] There is ample literature on financial stability. A good starting guide on what to take into account when analyzing the financial system could be the IMF Handbook: *Financial Sector Assessment: A Handbook*, 2005, at: http://www.internationalmonetaryfund.com/external/pubs/ft/fsa/eng/index.htm.

c) Be aware of time lags. One should be aware of the possibility of long time lags between the moments when a problem occurs in the economy, when the central bank becomes aware of it and when its measures produce an impact on the economy (more on such lags can be found in Škreb and Šonje, 2001). For example, let us assume a company is in trouble and starts to default on a loan to the bank. About 90 days will pass for the bank to put it into category B, or even 120 days the loan is past due for category C. Assuming the bank reports correctly on its portfolio quality to the central bank, it can take up to three more months for the central bank to receive this info (the upper limit – quarterly reports to the central bank). So, the central bank will see the data more than half a year after the problem occurred. Will they react immediately? Probably, as they might not want to wait for another three months to get the confirmation. Then, if they send a team to the commercial bank, wait for the report, etc., we are more than a year down the time line since the problem surfaced. Preparing an adequate reaction (if the system as a whole is in problems) and obtaining the necessary approvals from the central bank decision-making bodies might take additional two to three months at best. Even if the measures taken are the adequate ones, we might need some more time for them to take effect (there is always inertia in the system). Regardless of the probability of the above scenario, perception, reaction and impact never happen instantly, thus time lags have to be factored in.

d) Have a forward looking approach to issues. When you look at your statistics, you are looking at the past and there is not much you can do about it. You cannot expect things to go better on their own. Remember that the old adage in central banking is: *Always take good news as transitory and bad as permanent*. To react on time you need to be forward looking. Like with inflation targeting, what you do now will affect your economy (and financial system) in the future, maybe a year or more from now.

e) Have ready contingency plans. True, crises never develop in line with contingency plans. But one is infinitely better off if there is a contingency plan for what to do than if there is not. Once the crisis breaks out (which means crisis prevention was not successful), one needs to manage it. Crisis management requires special skills. So does crisis resolution. When the crisis happens, be sure that costs will be incurred and that you will need to distribute them (and to some degree avoid spillovers and overshooting – crisis management). And cost distribution in a society is a political economy game. Furthermore, there are special risks in the B10 due to predominantly foreign ownership of banks (though the EU is also not immune to such problems, see

Veron, 2007). Don't forget that various MOU are non-binding. Be ready to be flexible. Liquidity assistance, possibly to individual banks and to the market, needs to be addressed. But do not undermine long-term stability goals. The main message here is that fire drill must be done *ex ante* to be effective. For example, do you have an answer to the situation of the reversal of net capital inflows which have financed large current account deficits in almost all B10 countries in the last decade?

f) Never forget sound fundamentals. With an inadequate fiscal policy, lack of structural reforms or some other crucial element of sound economic management, the financial system cannot be sound and perform adequately its main function. In particular, external imbalances (large current account deficits) should be carefully observed and analyzed (the build-up of imbalances and risks).

g) Follow very closely recent developments in the region and in the world. Globalization has benefits, but it has risks as well, so learn how to deal with them. An excellent overview of financial globalization can be found in Mishkin (2006). We live in a dynamic and constantly changing world. The very recent liquidity crunches on the money market in the US and in Europe are basically a problem of confidence among banks, lack of information and a spillover from credit problems in the US. A bad loan is a bad loan. New financial instruments do not make it less bad. The total costs of sub-prime mortgage problems in the US are probably not that large, but with new financial instruments (like "conduits" or SIVs) it is not quite clear where the risks are or where they may end up. Financial innovation will and must continue. So, central banks must be up to speed and understand the dynamic systems of today's and tomorrow's ever growing and changing world of finance.

h) Optimize financial regulation. There are a lot of reasons why financial sector needs regulation (see Llewellyn 1999). Stability is a public good and will not be provided by the market alone. However, regulators can easily fall into the trap of overregulation (with its excessive costs), which results in higher than optimal intermediary costs, or even be captured. Regulators tend to over-supply. Optimal regulation is not an easy equilibrium to be found and it must be constantly examined.

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