

# **Challenges to Central Banking from Globalized Financial Systems**

**Conference at the IMF in Washington, D.C., September 16–17, 2002**

## **Opening Remarks by Mr. Eduardo Aninat, Deputy Managing Director, IMF**

It is a pleasure to welcome you all to this conference. This distinguished gathering of central bank governors and senior officials from over 45 countries provides a unique opportunity to address the challenges that central banks face from globalization. We hope that this conference will enable a sharing of experiences between those of you facing similar challenges, provide some analytical and practical insights into understanding these issues, and, ultimately, contribute to strengthening policy implementation.

The unprecedented integration of domestic and international financial markets in recent years has brought about sharply increased market-driven flows of capital across national borders. In my view, it is difficult to avoid the conclusion that these flows have boosted economic growth and prosperity. However, at the same time, financial globalization has also complicated the role of central banks in two broad areas:

One set of challenges relates to the choice of the exchange rate and monetary regime. When floating the exchange rate, implementing an alternative monetary policy framework might not be straightforward for many countries, especially when they are not yet ready to move to full-fledged inflation targeting. Partial dollarization of the economy can make the conduct of monetary policy even more difficult. Monetary unions could therefore gain popularity but can pose their own set of practical difficulties.

Financial globalization also carries a higher risk of financial instability as seen from the increase in the frequency and severity of financial crises. This raises a second set of policy challenges for central banks. While maintaining price stability as the primary objective of monetary policy, central bankers must increasingly pay due regard to both financial stability considerations as well as interaction with international developments in pursuing their monetary policy objectives.

We at the IMF have been working with national authorities and through various international fora to promote appropriate monetary policy and financial stability policy frameworks that will effectively meet the challenges of globalization. Let me highlight some of the specific challenges.

The increased incidence of financial crises in the era of financial globalization leads naturally to the question of whether financial stability should be an explicit central bank objective. Financial stability may loom large in policy formulation not just during a crisis, but also in

normal circumstances owing to balance sheet sensitivities. A key problem is how the central bank can conduct policy in support of financial stability without impairing price stability. A very practical institutional question is the choice between bank supervision by a specialized agency or by the central bank and the role of the central bank in maintaining systemic financial stability in addition to achieving monetary stability. This raises a knotty question on the degree of clarity of the financial stability considerations in the context of a highly transparent commitment to a nominal anchor.

The increased incidence of crises prompted by financial globalization has led central banks to regularly utilize financial soundness indicators to assess financial stability. The Fund and the World Bank have been working on the development and dissemination of indicators of financial vulnerability including through the Financial Sector Assessment Program. Some central banks have taken this a step further by publishing regular financial stability reports based on innovative in-depth analysis of financial vulnerability. With this experience in hand, now is a good time to ask which financial soundness indicators are the most useful. How should financial soundness indicators be used and analyzed in coordination with other surveillance tools such as stress testing and standards assessments? Then there is the issue of what the central bank should do when indicators signal potential problems.

However, historical experience shows that financial crises will stay with us and, as many of you well know, dealing with crises as they unfold in real time poses perhaps the most demanding and certainly the most stressful challenge to a central banker. The complication for monetary policy is caused by the instability in various behavioral relationships during crisis, and by conflicts that may arise between price and financial stability objectives. Price stability might require monetary tightening. But, at the same time, higher interest rates may severely affect the soundness of the financial system and corporations. Central banks must take a view on this policy dilemma. Central banks must also decide under what circumstances they should take a leading role in crises and what their role should be. In particular, should possible crisis measures be formalized ahead of time in a contingency plan? Another issue is to what extent should policy in times of a crisis be transparent.

The surge in the volume of external financing prompted by financial globalization has ratcheted up the importance of effective public debt and reserve management. Experience has shown that public debt and reserve management can not only enhance monetary policy, but also improve financial stability. The Fund and the World Bank have developed guidelines to assist policymakers in considering reforms to strengthen the quality of their public debt management and reduce their country's vulnerability to international financial shocks. Public debt is best managed by a single agency, which requires choosing either the central bank, ministry of finance or a separate agency to take the lead in managing government debt. Experience has also demonstrated that monetary policy and debt and reserve management need to be carefully coordinated, which can pose political and operational challenges. If the central bank does take the lead in debt and reserve management, it may face potential conflicts between its debt/reserve management role and monetary policy.

Financial globalization also greatly complicates monetary policy for many emerging market by helping preclude their full commitment to a single nominal anchor. Many emerging market countries with open capital accounts choose not to adopt a fixed exchange rate owing to its vulnerability to a speculative attack. Monetary targeting has in many cases ceased to be a viable policy framework due to unstable money demand. At the same time they cannot commit to full-fledged inflation targeting because of relatively weak fiscal positions and insufficiently developed financial systems. Therefore, they resort to a form of discretionary monetary policy, that varies in degrees of public commitment to announced inflation objectives. This type of monetary policy framework, which does not fit into the standard classifications, deserves to be analyzed and understood. The challenge for the central bank facing these realities is how to conduct an effective monetary policy without a single anchor, and with limited options for monetary targets and instruments. To what degree should the central bank be transparent in its objectives and operations? Should a central bank with sufficient credibility announce ahead of time its intention to adopt either an inflation target or an exchange rate target

Financial globalization is leading to increased interest in regional monetary arrangements among industrial and developing countries. A monetary union is an attractive option because it can reduce the vulnerability of member countries to worldwide economic shocks. However, the convergence criteria in the creation of a regional arrangement present important challenges. Further, central banks face some very practical difficulties in the integration of institutional arrangements across countries.

Financial and macroeconomic instability has led to the partial dollarization of many national financial systems. Central banks must deal with the problems posed by dollarization, even after the entrenchment of macroeconomic stability, because dollarization has proven to be extremely difficult to reverse. In particular, how can the central bank conduct an effective monetary policy when the domestic currency is not used for many (or even most) transactions? How does dollarization alter systemic financial risks?

I hope you will enjoy listening to the views and perspectives of experts and central bankers on some of these challenges. And I hope this helps all of you to derive the benefits of globalization while containing and managing the associated costs. In the meantime, I would like to thank you all for participating in this conference, and hope that you will enjoy yourselves and contribute to a lively exchange of views over the next two days.