The role of central banks in globalized financial markets

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In recent years, considerable changes have taken place in domestic and international capital markets: deregulation, the creation of new financial instruments, the use of futures markets, a blurring of frontiers between financial intermediaries, computer based instant communication closely linking markets and currencies.

In many respects these changes were advantageous and represent a positive trend. Individuals, enterprises and countries were enabled to find at any time financial instruments tailored to their own requirements. The large-scale internationalization of capital markets and banking activities has brought about benefits in terms of access, transaction costs, and an efficient and market-based allocation of resources.

Yet these changes have also caused new problems both domestically and internationally, exemplified by defaults and failures in the inter-bank currency markets and in other markets rendered more fragile by the rapid development of new financial instruments.

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More fundamentally, the growing interconnection between markets may mean that crises in one market will lead to cumulative and mutually reinforcing downward adjustments on a world-wide basis, as in the case of the 1987 market crash.

As a consequence, shifts by major countries may have disproportionately large effects on emerging markets, banks, and the development strategies of developing countries. These fledgling entities may see their domestic stabilization efforts impaired and their currencies overwhelmed by excessive capital flows. Already, central banks and other regulators have taken measures to enhance their capacity to deal with such crises in the new financial environment, such as the allocation of supervisory responsibilities, new relationships between bank and market regulators, and coordinated responses to international liquidity crises.

Some of these measures have themselves raised new concerns, notably the risk of an oversupply of liquidity fueling inflation, overcautious lending by banks, or a credit crunch. At the same time the requirements of Eastern European and developing countries, Gulf reconstruction, and securing market access to countries emerging from debt rescheduling, all pose new and equally urgent challenges.

On the 19th and 20th of April, 1991, the Inter-Action Council convened in Paris a High-Level Expert Group on "The Role of Central Banks in Globalized Financial Markets," chaired by Mr. Valery Giscard d'Estaing. The meeting was attended by four other members of the Inter-Action Council -María de Lourdes Pintasilgo (Portugal), Malcolm Fraser (Australia), Manuel Ulloa (Peru), and Olusegun Obasanjo (Nigeria)- and fourteen experts.

As the world globalizes it is moving toward a tri-polar system of three large blocs centered around the dollar, the European currency (ECU) and the yen. This itself may ultimately prove to be an interim stage toward an even broader or more closely linked global system. Meanwhile, the considerable capacity of each of the three blocs to influence one another highlights the need for closer policy coordination in the interest of a stable world economy.

The case for a ten point strategy

The High Level Expert Group has formulated a ten point strategy which aims at greater transparency, stability and efficiency in financial markets through changes in the role of central banks and other supervisors.

"Reinforcement of the independence of national central banks, and strengthening and unifying supervisory activities at the national level"

1. **Ensuring the independence of central banks.** The best way to encourage market stability is to maintain price stability. This is best accomplished through independent central banks with a clear mandate to that effect. Accordingly, it has been agreed that the new European System of Central Banks (ESCB) should take on these characteristics, but the individual European national central banks have yet to begin to reform.

   An important economic policy lesson learned in the last two decades is that price stability is the ultimate objective of monetary policy, and it is best conducted by independent central banks immune from the day to day fluctuations of the market. Another lesson is that a short-run trade-off exists between lower inflation and securing employment, but that the central banks should not attempt to address conflicting goals.

   Hence the efforts of the central banks must be complemented by governmental fiscal policies and by structural policies which aim to minimize the social cost of disinflation. A medium-term objective of low interest rates in the United States, the European Community and Japan, and the perception of monetary policies which aim to achieve this will by itself encourage financial stability.

   Crucial to this program is the independence of the central banks. However, it is important to remember that independent national central banks would not necessarily ensure greater coordination in a deregulated market. But if the ESCB, the Bank of Japan, and the U.S. Federal Reserve were to pursue identical policies, their coordinated action would be much more likely to achieve the desired effect.

2. **Adapting money policies to the new financial environment.** The pursuit of price stability in a deregulated world financial environment is complicated by the uncertainty over what objectives should be targeted. World-wide financial innovations make monetary bases less reliable in their definitions and more loosely related to their economic aggregates. With this in mind, in the new financial environment most central banks should aim to stabilize their exchange rates against a stable major currency. Target zones for exchange rates should be established and maintained through intervention and policy adjustments, taking into account domestic conditions.

3. **Taking advantage of a single European currency to strengthen the international monetary system.** The move toward a single European currency establishes the third leg in a three polar internation order made up of the dollar, the yen, and the ECU. To offset any possible destabilizing effects measures would have to be taken to broaden the ECU-denominated and the yen-denominated financial instruments markets in order to create the same transparency, depth and liquidity that exist in the dollar-denominated markets. Also, target zones for tri-polar currency exchange would foster the convergence of domestic price stability objectives.

   Other currencies might then choose individually between a link with one of the three leading currencies or with a basket of the three, either standardized or adjusted to individual national requirements.

   Moving from the current G-7 to a G-3, particular responsibility ought to be given to a small group of countries which would agree on a general approach to exchange rate evolution, and would coordinate a stabilizing fiscal policy. Assuming these responsibilities would mean assuming world leadership in the aim of making international economic policy and interest rates convergent, and

would require close cooperation with the IMF and Central, Eastern European, and developing countries.

In this connection the role of the IMF should be reevaluated and reinforced with a view to ensuring adequate surveillance over the economic policies of the richer countries. The role of a strengthened IMF would be to ensure that the international financial system functions efficiently and provides relative stability in exchange rates and lower interest rates for countries engaged in adjustment processes.

4. **Streamlining bank regulation and supervision.** Raging diversity prevails in the supervision of banks, even among the richer countries. While respecting national choices we must look in the future to streamline bank regulation -one single national regulator- and the autonomy of bank supervision -either an independent central bank or a specific agency. In all cases, central banks, either alone or working with other agencies, should monitor the financial soundness of the banking system as a whole. The same goes for developing countries in order to give their banks credibility in the international capital markets.

5. **Strengthening the supervision of other major intermediaries in capital markets.** Coordination of the supervision of non-bank financial intermediaries remains extremely loose. To date there are gaps in supervisory coverage, and a complete absence of an agreed division of supervisory responsibilities. Such measures need to be developed in coming years.

   At the same time the interrelationships between different functional supervisors -particularly between banking, securities and insurance regulators- will have to be brought within a coherent overall framework of supervision and control. Something analogous to the Basle Committee on Bank Supervision might be appropriate.

6. **Adopting a set of standards for regulation.** Working from the efforts of regulators governments themselves should agree on a set of standards to be applied to the regulation of financial markets and intermediaries. They might keep in mind six principles:

   a. *Transparency*. The regulations governing a particular market should be fully apparent to all participants, active and potential. The mechanisms through which regulations evolve should permit open dialogue between international industry, officials, and legislators.

   b. *Neutrality*. *De facto* and *de jure* firms should be treated in the same way as domestic firms, both in entry and in operation.

   c. *Inclusiveness*. The entire financial system should be regulated. Gaps allow firms or their clients to conduct business at a lower cost to themselves but at a greater risk to the system.

   d. *Regulatory independence*. The value of a central bank free from political pressure is increasingly acknowledged, but the value of independence for other financial regulators, though equally important, remains less widely acknowledged.

   e. *Mutual recognition*. Financial services should be able to conduct business in other countries in the same way they are permitted to do so in their home country, contributing, through competition, to reduced regulatory costs.

   f. *Harmonized standards*.

> *"Cooperation among the most important central banks with respect to the supervision of private commercial banks and the establishment of an international authority"*

7. **Avoiding systemic risks.** Supervising the prudent behavior of individual banks would not, however, bring stability to the markets if other systemic risks are not at the same time addressed. As always, central banks should be prepared to act as lenders of last resort in crises within their own systems, and also take action in foreign exchange markets when necessary. The traditional stance of constructive ambiguity allows banks to maintain their freedom of action and minimizes the moral hazards of misleading intermediaries who might wrongly count on being bailed out, but it should not be used as an excuse for inaction between crises.

   In order to reduce the chances of having to intervene in a crisis, central banks should promote a comprehensive program for the strengthening of payment and settlement systems. They must also pursue the implementation of fully reliable systems aimed at strict registration of orders and quotations, and the development of early warning indicators.

8. **Ensuring a better integration between the financial world and the real economy.** The stability of financial markets is not an end in itself but an instrument to enhance stability and growth in the real economy. To ensure a better integration between these two worlds, two main concerns would have to be addressed:

a) Financial regulation should not take precedent over overall efficiency. This implies flexibility in domestic labor markets and renewed efforts to dismantle international trade barriers.

b) Adequate signals must be given by financial markets to the real economy, with particular emphasis on the open promotion and dissemination of information, and the adoption of adequate rules allocating domestic jurisdiction over mergers, acquisitions and concentrations.

"That central banks pursue a single objective consistent within the new global financial environment"

9. **Adapting present policies.**
this long-term strategy toward stability we must pay due regard to current circumstances. In particular, three immediate concerns must be addressed:

a) Concern over a U.S. domestic credit crunch should not warrant a loosening of regulatory requirements.

b) There is a risk of world-wide shortages of savings as a result of recent capital requirements in the Gulf, Eastern Europe, the developing nations, and for the environment.

c) The continued risks of the ever-postponed access to the market of countries emerging from debt crisis.

10. **Addressing the specific concerns of non-OECD countries.** Our concern for non-OECD countries must go beyond present circumstances and must be tailored to those countries' individual needs. In the Union of Sovereign States this implies a coordinated effort to maintain the convertibility of the ruble to insure the coherence of domestic development and the insertion of the former Soviet markets into global financial markets.

Central and Eastern European countries are developing financial markets and introducing internationally accepted supervision standards. The progress already made should be consolidated and extended to all of the countries in the area.

The developing countries are extremely diverse, with newly industrialized Asia moving toward the OECD, Latin America emerging from the debt crisis, Africa striving to meet the basic needs of its population, and oil producers, the Middle East, China, India, and Pakistan all having specific characteristics. In the face of this complexity additional allocations of SDRs, with a pattern of distribution different from the quota system, has been suggested.

Long term strategies, foreign aid and investment, and the emergence of a new entrepreneurship are the key answers to the problems of the developing world. Thus, the traditional role of the regional development banks and the World Bank needs to be strengthened, and attention would have to be paid to an extension of the supervisory standards in the OECD countries to banks and markets throughout the world. Groupings centered around a regional financial market, such as Singapore for the ASEAN countries, might prove advisable.

Compensatory mechanisms, or some measures of support should be created within each of the three currency blocs to soften the effects of short term disturbances. For instance, Europe might encourage flows of capital to Africa while African countries strengthen their banking systems and develop frameworks for attracting foreign capital. Obviously, for political reasons, capital markets cannot meet all the capital requirements of the non-OECD countries, and there needs to be a renewed emphasis on the role of official capital flows from multilateral and private institutions.

In the end, financial markets should serve as the cause of development itself in ensuring a proper allocation of resources and sufficient liquidity to attract foreign investors, thus ensuring the healthy development of financial systems