CONTEMPORARY ISSUES IN CENTRAL BANKING

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INTRODUCTION

- The rationale behind the establishment and the evolutionary process of Central Banks discussed earlier bear ample testimony to the desirability of having a Central Bank at the apex level of the financial System.
- However, some countries have provisions for alternative institutions/arrangements in case they (Central Banks) fail to carry out their responsibilities in the wake of a financial break down or in situation of a general economic crisis.

AUTONOMY AND INDEPENDENCE OF A CENTRAL BANK

- In the initial years of evolution, most Central Banks were established as private institutions and remained independent of Government control.
- This situation continued till the outbreak of the Second World War. Later the functional role of Central Banks has widened.
- The relationship between the Government and the Central Banks took a new turn; particularly in wake of war financing. Around the Second World War - Central Banks in a number of countries (for instance, Germany, France, England, Japan, Italy and Sweden) were made subordinate to their governments.
- It was also realized that it is possible to attain and sustain a low level of inflation if the Central Bank functions as an autonomous **institution**.
- For achieving the set goals, Central Banks should ideally enjoy both operational independence and legal independence.

- The rationale for this is the realization that Central Banks free from Government control and endowed with constitutional assurance towards autonomy could perform their responsibilities best in regard to monetary policy objectives.

The degree of independence enjoyed by the Central Bank is contingent on three major factors:

INDEPENDENCE IN PERSONNEL MATTERS

- Personnel independence refers to absence of government interference in matters such as appointments of senior officials, term of their office, and the dismissal procedures of top Central Bank officials and the Governing Board.
- Pre-specified and transparent appointment and dismissal procedures add to Central Bank independence.

INDEPENDENCE IN FINANCIAL ASPECTS

- Financial independence relates to the freedom of the Central Bank to decide the extent to which government expenditure is either directly or indirectly financed via central bank credits.
- Automatic monetization of deficit subordinates’ monetary policy to the fiscal policy. In this context, it is observed that if the Central Bank has a budget of its own, it is more independent.
- In that case, the Central Bank has sufficient financial resources to carry out its work without having to wait for sanctions from the government.

INDEPENDENCE IN THE CONDUCT OF POLICY

- Policy independence is related to the flexibility given to the Central Bank in formulation and execution of monetary policy.
- The operational independence is further examined as "goal independence' or 'instrument independence?

- **Goal independence** refers to a situation where the Central Bank itself can set its own objective/s from a broader set of policy objectives such as full employment and low inflation, at any point of time.
- **Instrument independence** refers to a situation where the Central Bank is free to choose instruments in order to achieve the pre-specified goals.
- Most Central Banks have legislative mandates and, therefore, do not have goal independence as the goals are set by the legislation.

It was argued that central bank independence is neither a necessary nor a sufficient reason for monetary stability. This is because independence imparts a fair degree of flexibility and leverage for the central bank in monetary policy formulation.

- An independent central bank may adopt policies that are conflicting with other policies followed by the government.
- Such inconsistencies in policy objectives may lead to economy-wide problems.
- This suggests the desirability of a coordinated policy approach as between the central bank and the Government.
- On the other hand, it can be argued that such conflicts are inevitable over the short-term, as long as Central Banks have the primary responsibility of controlling inflation.
- However, over the long-term, stable financial conditions ultimately lead to higher economic growth rates, more employment, and increased welfare.

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CREDIBILITY OF A CENTRAL BANK

- A credible track record of central banks in terms of maintaining low inflation or price stability gains paramount relevance in managing monetary policy.
- This in a sense shape and sets the move for adapting public perceptions towards inflation.
- Hence, central banks tend to establish reputation for pursuing price stability and financial stability consistently and persistently.

ACCOUNTABILITY OF A CENTRAL BANK

- Accountability implies bearing responsibility for monetary policy actions.
- Central Bank accountability coupled with autonomy and transparency facilitates price and financial sector stability, which is conducive to sustainable economic growth.
- It is sometimes argued that accountability of Central Banks is facilitated by setting up a single objective (typically price stability).
- Fixing a strict inflation target to the exclusion of all other equally important targets like output growth is not a desirable approach.
- It is also an issue that the economy is subject to a variety of shocks and flexibility can be a valuable asset in tackling the dynamic situations as they arise.
- Another source of accountability is the reappointment process for the central banker.
- If the terms are short, greater control can be exercised by the government through the appointment process.

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- Over the years, countries have adopted certain mechanisms to ensure accountability of the Central Bank. These include a review of a Central Bank's decisions, budget, expenditures and maintaining transparency in the operating procedures and the monetary policy-making process.
- The greater the independence of the Central Bank, the greater is the need for it to have its decisions and policies made available for scrutiny by the appropriate authority.
- Currently, Central Banks have become more open and they disclose the rationale behind their policies and decision making.
- The BIS and the IMF norms relating to data dissemination also contribute in increasing the accountability of the Central Banks.
- The publication of the Central Bank annual reports, inflation reports and publication of the proceedings or minutes of monetary policy committee meetings, are important methods to ensure accountability.

Three types of best practices that enhance transparency have been spelt out for achieving greater accountability.

1. publication of official reports that analyse economic conditions;
2. publication of forecasts of key variables (e.g., inflation, output) and their central forecast as well as risks;
3. and explaining the reasons for Central Bank decisions and various contingencies under consideration.

TRANSPARENCY IN CENTRAL BANK OPERATIONS

- Transparency is the absence of asymmetric information between monetary policy makers and other economic agents with a view to reducing the uncertainty.
- The need for transparency has emanated from several developments in the recent years.

- The episodes of financial crises resulting from information asymmetries, growing integration of financial markets, the need for enhanced autonomy as well as accountability of Central Banks, and the emphasis on financial stability have necessitated increased transparency on the part of Central Banks and market participants.
- The growing global macroeconomic imbalances could create further uncertainty for market agents and policy makers.
- This calls for greater transparency and better communication by the Central Bank.
- Monetary policy has to be based robust information and diversified approach taking into account different views about the functioning of the economy and the international linkages.
- Transparency is, thus, a secondary, but an important, objective of the Central Bank. This is because the accountability of the Central Bank is centered on the bank fulfilling its primary objective relating to monetary policy.
  - The stability of financial system could be achieved only when institutions and market players take informed decisions.
  - Adequate disclosure acts as a deterrent to discretionary monetary policy, time inconsistency and excessive risk taking.

The importance of transparency emerges from the primary consideration that monetary and financial policies could be made more effective if the public knows and understands the goals and instruments of policy and if Central Banks and financial agencies make a credible commitment towards achieving them.

In order to put in place desirable transparency practices for Central Banks on stronger grounds. the International Monetary Fund in March 2000, has formulated a **Code of Good Practices on Transparency in Monetary and Financial Policies known as the ELRIC framework.** The acronym ELRIC stands for five areas, viz.,

1. External audit mechanism,
2. Legal structure and independence,
3. Financial reporting,
4. Internal audit mechanism and
5. A system of internal control.

- The ELRIC framework employs International Financial Reporting Standards, International Standards on Auditing, guidelines promulgated by the Institute of Internal Auditors.
- The safeguard assessment under the ELRIC framework attempts to generate a report so as to identify vulnerabilities in case of a Central Bank's operations and offer recommendations to mitigate them.
- The recommendations include a timeframe for implementation.

Key International Standards and Codes

- The advocacy for implementation of international standards and codes and transparency practices has become sharp in the context of the need for crisis prevention and for containment of financial stresses and vulnerabilities.
- Inappropriate macroeconomic policies, weaknesses in financial structure and institutions, institutional rigidities and distortions have been the main contributors to crises.
- The growing internationalization of financial markets and the application of computer networking systems have unleashed the dimension and intensity of crises.
- The expression 'standards and codes' is used to include transparency practices in macro policy-making, and core principles relating to regulatory and supervisory systems and market infrastructure.

- The Task Force on Implementation of standards with Mr. Andrew Sheng as Chairman, which was constituted by the Financial Stability Forum (FSF), favoured 12 as the key standards.
- The Reserve Bank of India was represented on the Task Force.
- The key standards would have to be implemented, as held by the Sheng's Task Force, with a measure of flexibility both by the industrialized economies and emerging market economies.

Subject Area	Key Standards Issuing	Body
Monetary and Financial Policy Transparency Fiscal Policy Transparency Data Dissemination Insolvency Corporate Governance Accounting	**Code of Good Practices on Transparency in Monetary and Financial Policies Code of Good practices on Fiscal Transparency Special Data Dissemination Standard/ General Data Dissemination Standard Principles and Guidelines on Effective Insolvency and Creditor Rights System Principles of Corporate Governance International Accounting Standards International Standards on Auditing Core Principles for Systemically Important Financial Institutions (SIFIs) Forty Recommendations of the Financial Action Task Force on Money Laundering Core Principles for Effective Banking Objectives and Principles of Securities Regulation Insurance Core Principles**	**IMF IMF IMF World Bank OECD IASB IFAC**

Auditing		**CPSS-BIS**
Payment and Settlement Market Integrity		**FATF-OECD**
Banking Supervision		**BCBS-BIS**
Securities Regulation		
Insurance Supervision		**IAIS**

IMF = International Monetary Fund;

OECD = Organization for Economic Co-operation and Development;

IASB = The International Accounting Standards Board;

IFAC= International Federation of Accountants;

CPSS = Commission on Payment and Settlement Systems in the Bank for International Settlements;

FATF = Financial Action Task Force;

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BCBS = Basel Committee on Banking Supervision;

IOSCO= International Organization of Securities Commission;

IAIS = International Association of Insurance Supervisors

CONFLICT WITH FISCAL POLICIES

- Monetary policy addresses interest rates and the supply of money in circulation, and **it is generally managed by a central bank**.
- Fiscal policy addresses taxation and government spending, and it is generally determined by government legislation.

Why do monetary and fiscal policies sometimes conflict?

- Conflict may arise between **fiscal goals for more investments and monetary goals for low inflation**.
- The optimal solution is fixation of threshold limit for inflation and if it crossed the threshold limit inflation has big negative impact on investments and growth.

The Conflict with Fiscal Policies: The Case of Developing and Emerging Economies

1. Central Banks in developing and emerging economies have to take active interest in the fiscal position because the size of the deficit and the mode of financing will influence interest rates and prices, the **two most important key variables** that all Central Banks performs:
1. Monopoly of note issue function
2. Ensure price stability

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- Central Banks also seek to influence employment/ output position. They can influence money, credit and interest rates.
- A low rate of interest encourages bank credit and promotes investment.
- Similarly, reducing the reserve ratio could encourage banks credit expansion.
- At the same time, Central Banks may have to ensure that such a policy stance should not result in excessive credit creation, as the latter could generate inflationary pressures.

EMERGING MARKETING ECONOMY

In EMEs the dominant financing of **Public Debt takes place through domestic financing** of fiscal deficits. The foreign financing of public debt is very limited in EMEs possibly because the government papers issued by them are not much traded or their rating in international markets is low.

3. An alternative option for the Government to finance its deficit would be to access financial markets. Such market borrowing could occur through the issuance and sale of treasury bills and bonds of a wide variety of maturities in the financial markets.

Modes of Absorption of Government Borrowing by Central Banks

- The Government announce its targeted level of borrowing at the beginning of every year in its budget.
- The central bank, by virtue of its role as manager of public debt implements the **market borrowing programme**.
- The participants in the MBP are

1. RBI
2. commercial banks
3. Other financial institutions and
4. individuals.

- In case the other market participants are unable to absorb the offered securities/bonds even at the announced rates, the Central Bank itself would then be absorbing the balance of securities by virtue of the fact that it is a debt manager.
- Thus, the central bank completes the target set by the Government.
- The value of securities absorbed by the central bank represents central bank credit to Government.
- This process of absorption of Government securities by the central bank are usually termed as devolvement.

Ad hoc Treasury Bills

The origins of ad hoc Treasury Bills to finance Government deficit can be traced to the First Five Year Plan, although their volume was to be limited to the extent that it was noninflationary.

Transition from Automatic Monetization to Ways and Means Advances

- Ways and means advances are **special features of the Indian economy**.
- WMA are temporary advances given by the RBI to the centre and state governments to control over any mismatch in receipts and payments.
- It was introduced in 1997 and comes under Section 17(5) of the RBI Act of 1934.
- Under the WMA system the Reserve Bank has been extending short-term advances only up to the pre-announced half-yearly limits, at a

mutually agreed rate of interest and fully payable within three months.

- The Government of India was also allowed to incur overdraft but at an interest rate higher than that of the WMA

Private placement of govt. Securities

- A private placement is a sale of stock shares or bonds to pre-selected investors and institutions rather than on the open market. It is an alternative to an initial public offering (IPO) for a company seeking to raise capital for expansion.
- Investors invited to participate in private placement programs include wealthy individual investors, banks and other financial institutions, mutual funds, insurance companies, and pension funds.
- RBI Retail Direct scheme' allows retail investors to buy and sell government bonds online both in primary and secondary market.

Monetary Policy and Debt Management

The large size of the Government borrowings often posed problems for the monetary authority in effecting changes in the interest rates as the Government was averse to higher interest rates.

Separation of Debt Management from Monetary Management

For the purpose of removing the conflict of interest between **Debt Management and Monetary Management** the government would fully fund its deficit by borrowing from the public at market rates of interest and completely free the Central Bank from debt management responsibility.

The government would in the process:

(a) Enable the Central Bank to pursue its price stability objective without getting diverted into issues of debt management. This implies that the Government would have to take decisions on

I. the size of the issue,
II. the proportions of the issue in terms of bonds, treasury bills, bonds.
III. the proportions of the issue in terms of home currency and in terms of denominated foreign currencies where foreign currency borrowing is permitted,
IV. the timing of the issues, as well as the maturity patterns of issues, and the number of coupons that may have to be issued in case of Government bonds.

(b) **Why debt management and monetary management needs to be separated?**

if both the functions are located in a single body, it is likely that monetary policy may be so managed as to benefit debt management operations. This is akin to an insider information problem.

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QUESTION AND ANSWER

Q1. Central Banks can fulfil their set goals under the conditions of financial independence, operational independence and ________.

Ans: Policy independence

Q2. Central Bank accountability implies holding central banks responsible for__________?

Ans: Monetary policy actions

Q3. Around the Second World War, most of the Central Banks emerged as __________.

Ans: Subordinate to their governments

Q4. Credibility of Central Bank refers to Central Bank's ability in establishing a track record of maintaining _______or _________.

Ans: price stability, low level of inflation

Q5. ________addresses taxation and government spending, and it is generally determined by government legislation.

Ans: Fiscal policy

Q6. EMEs stands for ____________.

Ans: Emerging market economy

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Q7. The name of the programme implemented by the central bank, to perform the role as manager of public debt is known as the____________.

Ans: market borrowing programme

Q8. WMA are temporary advances given by the ____________to the centre and state governments to control over any mismatch in receipts and payments.

Ans: RBI