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Yes, we need a Central Bank

By Muhammad Nadim Hanif

The financial system of a country comprises entities engaged in transactions involving financial instruments in money, capital, and foreign exchange markets.

This sector has strong linkages with other sectors of the economy like external, fiscal and real sectors. The apex financial institution in every country is its Central Bank and the State Bank of Pakistan functions as our Central Bank.

The conduct of monetary policy and financial stability oversight are among the core functions of the central banks. Monetary policy's major task is to contribute to sustainable economic growth through maintaining low inflation, and financial stability oversight means reducing vulnerability to the financial fragility and preventing the financial crisis. Major concern of this article is to discuss the role of the Central Bank in enhancing and maintaining financial stability.

A financial system is called fragile if there are unsound asset structure of financial institutions (reflecting, for example, subsidised credit and insider loans); changes in relative prices, including interest rates and exchange rates, that are influenced by viability of borrowers; and weaknesses in structure of financial institutions, including weak prudential regulations and supervision, that facilitates unnecessary risk taking. Financial stability means the least possible fragility in the financial system of the country and its capability to avoid a financial crisis.

A financial crisis is a more modem term for describing what used to be called' banking panics', 'bank runs' and 'banking collapses'. The broader term financial is used because, with today's financial systems, the source of the crisis could be the capital market or a non-bank financial institution rather than a bank. However, in some circumstances, the failure of one or even a few financial institutions might be part of the normal market mechanism, in that it represents the exit of unprofitable firms that took on inappropriate risks while, in different circumstances, the failure of a single financial institution might create financial crisis.

The ultimate objective of financial system stability is the avoidance of financial crises that are likely to cause significant costs to other sectors of the economy. A well-functioning financial sector is critical to an economy's well being because it is so intimately connected to every other sector of the economy through its role of providing a host of financial services from facilitating the trading, lodging, diversifying, and pooling of risk; allocating resources; monitoring managers; mobilising savings; to facilitating the exchange of goods and services. Additionally, the financial sector is such a part of the economy that is most susceptible to crises of public confidence.

A problem that hits one part of the financial sector can quickly spread to the rest of the sector, and then to the economy more widely. Once it becomes widespread, it is termed a systemic financial crisis to distinguish it from one that is confined to a single institution or a very narrow part of the financial system.

There are very good reasons for a country to do what it can to avoid financial instability.

History shows that it does not happen very often, but when it does, its effects can be devastating. There is widespread recognition in the world that the normal growth path of an economy is not smooth. The world has faced a number of business cycles, and although we wish that the cycle could be abolished, most of us are resigned to the fact that expansions cannot go on forever, and they will be followed by a recession. Provided that these recessions are not very frequent and not very deep, public confidence in the legitimacy of the economic system remains intact.

The problem with a serious bout of financial instability or a systemic crisis is that it makes the recession much deeper and longer, and can even turn it into a depression. The best-known example of this is the Depression in the United States in the 1930s, the severity of which is now widely attributed by modem scholars to the collapse of the US banking system. During late 1990s, we witnessed the East Asian economic crisis, the depth of which is largely due to the collapse of financial systems in these countries. According to some estimates it cost 20-25 percent of GDP.

The idea that a Central Bank should have responsibility for financial stability has roots deep in the history of central banking. Indeed, in many countries, financial stability considerations were the original reason for the formation of the Central Bank. Perhaps the best example is the United States. The establishment of the Federal Reserve System in 1913 was a direct response to the bank runs and financial panic of 1907.

It was only later that an explicit monetary policy role was grafted onto the Federal Reserve's financial stability responsibility. Elsewhere too, financial stability issues played a significant role in central banking. In the 1850s and 1860s, following the bursting of speculative bubbles in the US and UK railroad sectors, Bank of England lent freely to institutions to prevent financial panic. In France, the unraveling of speculative positions in the stock market in 1882 led the Banque de France to provide secured loans to the Paris Bourse. In Italy, the collapse of a building boom in Rome and Naples in 1893, and the resulting failure of one of Italy's largest banks, prompted the creation of the central bank, the Banca d'Italia.

As mentioned earlier, the conduct of monetary policy and financial stability oversight are among the core functions of a Central Bank. The relationship between the twin goals of price stability, on the one hand, and the stability of the financial system, on the other, runs deeper than is often imagined. More specifically, the pursuit of price stability can sometimes allow financial imbalances to arise inadvertently, and can sow the seeds of subsequent instability. Conversely, the pursuit of prudential objectives, institution by institution, can take inadequate account of feedback mechanisms that can exacerbate macroeconomic cycles.

The linkage between the two is that the monetary policy transmission is wholly based on the financial system. A stable financial system is essential for successful monetary policy because of its pivotal role in the transmission of monetary policy measures. On the other hand maintaining low and stable inflation is a necessary condition, though it does not guarantee, for financial stability. (If an absence of inflation is not, by itself, sufficient to ensure financial stability, and the authorities' reaction function does not prevent financial

imbalances, to what can we look to contain their build-up? The answer is, of course, prudential regulation).

Thus, monetary and financial stability cannot be put in separate compartments and separately pursued. What is needed to ensure is that arrangements for the pursuit of price stability do not inadvertently endanger the stability of the financial system; and that the financial system weaknesses do not impede the effective operation of monetary policy.

Against a background of price stability, financial stability is seen to be assured by rigorous prudential supervision, targeted at the risk management practices, and the solvency of individual institutions. However, there is a debate among economists over the issue of separating the supervisory function from Central Bank and to delegate it to another institution. There are some areas of agreement and disagreement and there are some arguments for and against. Here I am not going into this debate. However, I would like to mention that authority can be delegated but responsibility cannot be and this fact is evident from such countries that created a separate supervisory agency but the financial stability oversight responsibility is still upon central banks.

Section 9A. 1. of the State Bank of Pakistan Act 1956 shoulders the function of securing the soundness of the financial system explicitly upon the Central Board of Directors of the Bank. Traditionally, it has been considered ideal to place banking supervision under the umbrella of Central Bank because this function is key to the conduct of monetary policy and financial stability oversight.

But in Pakistan SBP's role, as a Central Bank, remained considerably weakened until early 1990s due to the presence of Pakistan Banking Council (PBC), which acted as a holding company of Nationalised Commercial Banks (NCBs) and also exercised supervisory control over them. Duplication of supervisory role diluted SBP' s enforcement of its regulations over NCBs. Not only the supervisory capabilities of SBP were less effective, it could not formulate and implement the monetary policy independently.

In addition to this, non-bank financial institutions (NBFIs) remained practically unsupervised because of lack of autonomy and multiplicity of supervisory agencies over them that included Corporate Law Authority, Monopoly Control Authority and Controller of Capital Issues, all attached directly with the Ministry of Finance.

Weaknesses in the supervisory system and lack of governance in state-owned institutions largely resulted in the concealment of the financial facts in opaque balance sheets of the banks and NBFIs. This with the lack of market mechanism for pricing rendered any meaningful analysis of the financial system stability a difficult job and to the best of my knowledge no such analysis existed for the period of financial repression. However, it was largely agreed that the policy measures of the pre-reform era resulted in a weakened the financial structure in the country.

Financial sector reforms and restructuring process started in the early 1990s. Objectives of reforms were to create a level playing field for financial institutions and markets for instilling competition, strengthening their governance and supervision, and adopting a market-based indirect system of monetary, exchange and credit management for better allocation of financial resources. Reforms covered seven important areas: financial

liberalisation, institutional strengthening, domestic debt management, monetary management, banking law, foreign exchange, and capital market.

Several steps were taken to enhance effectiveness of SBP as a central bank: a Credit Information Bureau (CIB) was established to keep credit records; an NBFIs department was established that subsequently issued 'Rules of Business' to supervise them; autonomy was granted to SBP in matters related to administration and conduct of business, that was later expanded to give SBP 'monetary policy operational independence'; regulatory function of SBP was consolidated through dissolution of Pakistan Banking Council; and supervisory role was further enhanced by placement of CAMELS and CAELS frameworks and extensive training of SBP officers on off-site surveillance and on-site inspection.

Various monetary management measures were initiated to dismantle the system of financial repression and establish a market based mechanism of monetary control. Bank by bank credit ceilings were abolished and replaced with credit deposit ratio that too, was subsequently removed. In addition to this, caps on lending rates of banks and NBFIs were eliminated to pave the way for implementation of monetary policy indirectly through signals of liquidity and short-term interest rate changes.

Banking laws also underwent significant changes during 1990s in order to provide a supportive legislative framework for the reform process, where necessary. Important amendments were made in all the relevant banking laws including SBP Act, 1956; Banking Companies Ordinance, 1962; Banks (Nationalisation) Act, 1974; and Banking Companies (Recovery of Loans, Advances, Credits and Finances) Act, 1997. More recently a new recovery ordinance has been promulgated.

Effectiveness of SBP supervision over banks has strengthened significantly after adoption of CAMELS framework, revision of disclosure requirements for banks and NBFIs in conformity with international standard, prescription of risk-weighted system of capital requirements and increasing compliance in adopting Core Principles of Effective Banking Supervision formulated by the Basel Committee. SBP is now fully or largely compliant in twenty-two out of twenty-five core principles and progress is under way to achieve full compliance.

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