Central Banking and Financial Sector Development

2nd Organization of Islamic Cooperation (OIC) Experts' Group Workshop

Kuala Lumpur, Malaysia, 13-14 November, 2011

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Outline

I. **The role of central banks:** *a narrow definiton (price stability only) versus a broad mandate (price stability plus financial stability)?*

II. **If yes to a broader mandate:** *what instruments to be used?*

1980s till mid 2000s

- Price stability as the (primary) mandate
- Inflation targeting as the popular framework
- Single goal – single instrument
- Financial stability:
  - Orthogonal to price stability
  - Responsibility of others
  - Use micro prudential policies

Results

- From Great Moderation to Great Turmoil
- Examples: the United States, Ireland, Spain

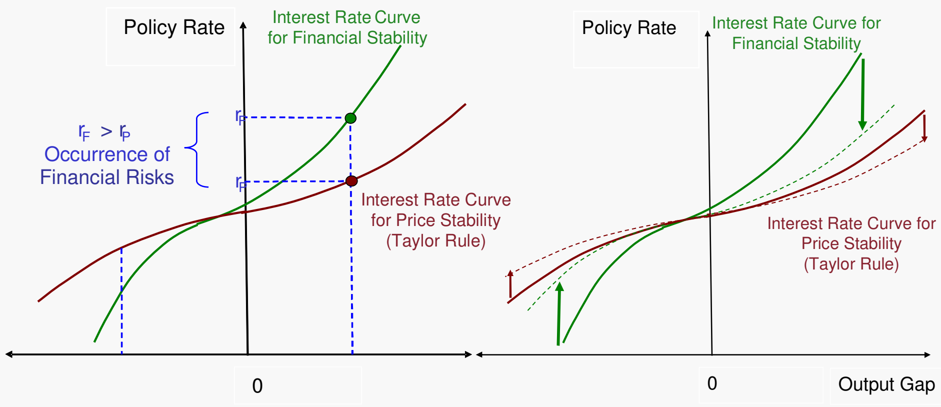
Central Banks and Financial Stability

- The origins of central banking
- "Bank of banks", "Lender of last resort"
- Late 1970s: High and persistent inflation, paradigm shift, Volcker, Inflation Targeting

Need for Macro-prudential Tools

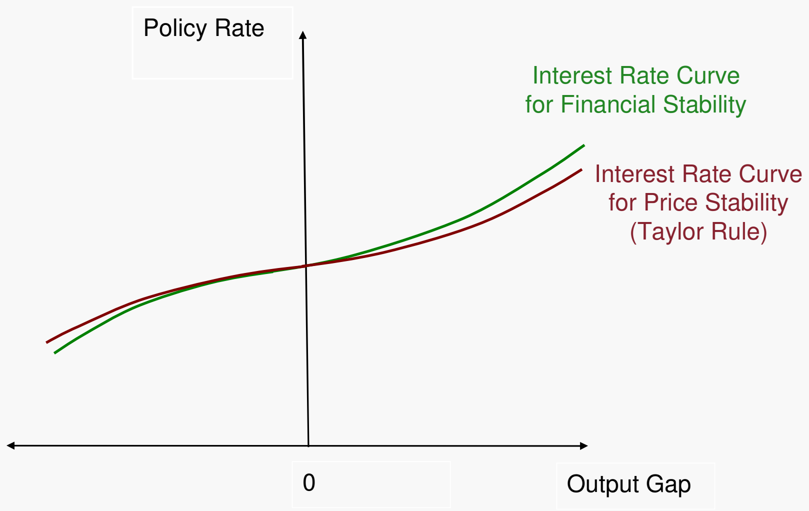
When the Macroprudential Tools are not Used

When the Macroprudential Tools are used



Need for Macro-prudential Tools

When the Macroprudential Tools are Fully Used ?



Case Study: Turkey

Challenges in the post (?) crisis period

- Strong, rapid, domestic-demand driven recovery
- Divergence between domestic and external demand
- Strong credit growth, weak exports, widening CAD
- Strong, speculative capital flows, undue appreciation pressure
- Core inflation subdued, output gap closing but still negative

What to do?

One challenge, two approaches

- **Challenge:** Quantitative easing in major economies, dramatic increases in central banks' balance sheets, huge influx of capital, undue currency appreciation.
- **Approach 1:** *Use capital account measures to restrict inflows while tightening via interest rates (Brazil, South Korea)*
- **Approach 2:** *Use macroprudential measures to restrict domestic credit and domestic demand while keeping the short term interest rate differentials as low as possible (Turkey)*

Central Bank of Turkey

- Primary mandate: price stability
- Duty: contributing to financial stability
- Policy response:

from a single policy instrument to policy mix

What is policy mix?

Policy rate
(1-week repo rate)

+

Required reserves
Liquidity management
FX Reserve management

(1) Required Reserves Policy

- ***Average ratio raised/lowered***: to control credit growth
- ***Differentiated across deposits***: to lengthen maturity
- ***Option to meet TRY reserve requirements with FX and gold***: to facilitate better liquidity management and raise FX reserves
- ***Non-remuneration of required reserves***: to increase the effectiveness of RR policy

(2) Interest Rate Corridor Policy

IR Corridor: The difference between the lending rate and borrowing rate of the central bank

IR Corridor widened:

- To raise/reduce uncertainty in MM
- To discourage speculative capital flows
- To lengthen the maturity of capital flows
- To prevent undue appreciation in currency

(3) Reserve Management Policy

Policy tool: daily, preannounced, competitive auctions

- Be opportunistic (accumulate reserves in good times)
- Provide FX liquidity in bad times
- Fully sterilized (target FX volatility, not FX level)

Policy mix

Policy rate
(1-week repo rate) + **Required reserves**
Liquidity management
FX Reserve management

- The framework we adopt in spirit is not significantly different from the conventional inflation targeting framework.
- The only difference is that, previously our policy instrument was the one week repo rate, but now our instrument is a “policy mix”
- We seek to use these instruments in the right combination in order to cope with both inflation and macro-financial risks.
- The monetary policy stance in this framework is not only determined by the path of policy rates, but as a combination of all the policy instruments.

Policy Flexibility

Risk-on environment

- Lower policy rate
- Widen interest rate corridor
- Raise reserve requirements
- Accumulate FX reserves

Risk-off environment

- Lower policy rate
- Narrow interest rate corridor
- Lower reserve requirements
- Start FX sale auctions

Extreme uncertainty

- Widen interest rate corridor, raise upper band of the band, tighten TRY liquidity

Results

- Credit growth slowed down (from 40% pa to 20% pa)
- Domestic demand moderated
- Export growth accelerated
- Current account deficit started to decrease
- Misalignment in local currency prevented
- Quaility of capital flows improved

Conclusion

- Perfect dichotomy between price stability and financial stability not possible:

  need for a comprehensive framework

- Volatility in global conditions likely to stay for a while:

  need for policy flexibility and more policy tools

- Every country has unique features:

  need for creative, pro-active central banking

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