

‘Global Financial Stability: the Challenge for Central Bank Governance’

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Aim of the research:

The succession of global financial crises (Asiatic crises, Argentina crisis, Long Term Capital Management, sub-primes, Northern Rock, Fannie and Freddie) has put the issue of *global financial governance* on the international agenda (Underhill and Zhang, 2006); with in particular the role of central banks governance in the regulation of financial instability (Underhill, 2007a :3 ; 2007b :18,27 ; Underhill and Zhang, 2006 :23,28,37).

Indeed, a wide range of economic analysts do not believe any more in the hypothesis of efficient financial markets, in self-regulated markets and banks, and in the endless flexibility and resilience of free markets. It is widely believed that active regulation of financial liberalization is valuable. It is also claimed that financial markets developments generate interdependencies among countries, in particular with the increasing internationalization of financial crises. Thus, *it is because financial markets are global that their regulation should also be global*. The issue of the reform of the regulation of liquidity crises, especially in emerging market economies is thus central: should the IMF become a form of international lender of last resort? Or can regional monetary areas emerge and regulate liquidity crisis through a regional organisation or regional cooperation of central banks?

The current global financial architecture suffers from a lack of efficiency and legitimacy (Underhill and Zhang, 2006): the International Monetary Fund (IMF) is considered as a weak institution, and it is generally admitted that the Bank of International Settlement (BIS) failed to provide an efficient macroprudential policy. The IMF especially has demonstrated a large ‘regulation failure’, explaining why the Fed is *de facto* playing the role of international lender of last resort. But it is an informal, unsatisfactory and unilateral arrangement. Central banks have thus tried to reduce the impact of financial crises on the economy and are now emerging as key actors of the regulation of the global financial system. Moreover, the behaviour of Asiatic countries and of Latin American countries with the Bank of the South seems to give evidence of the relevance of the strategy of regional central banks cooperation.

This research focuses on the reform of the international financial architecture in relation with the regulation of financial stability, and more precisely on the reform of central banks to face the challenge of financial stability: *what role can central banks play in regulating financial stability? To what reforms does this new role lead?*

Central banks are at the forefront of the stabilisation of financial cycles, and are able to actively regulate systemic risks – due to their top position in the financial system, because they can be in charge of bank supervision, and due to their role of provider of liquidity for financial markets under crisis (lender of last resort).

But even if they become increasingly influent in regulating the global financial system, central banks also lack of public legitimacy (they are considered as too independent) and can't be fully efficient against financial distress (they are too small actors and insufficiently coordinated among themselves). There is a major asymmetry: financial crises are global when central banks coordination at international level is weak. It is thus claimed for a reform of the international financial architecture in order to organise a strong regulation of financial markets instability.

This question of central bank governance needs to be asked at the operational level (Meade and Crow, 2007): How in practice central banks can regulate financial markets? How central bank can integrate this problem of financial stability?

In practice and in theory, those questions are framed by the new mainstream in monetary policy regime: *inflation targeting*. The latter is now regarded as a new global model of monetary governance for central banks, a new '*stable international monetary system*' (Rose, 2006). Today, we assist to the spread of the inflation targeting regime all over the world. It has been implemented by at least 24 countries and has been introduced in the policy recommendations of the International monetary (IMF, 2006). Central banks on inflation targeting regime will thus be the analytical frame of our research.

In order to answer to our main research questions, we will address three main points:

The first question that needs to be tackled relates to the modalities of integration of financial stability into central banks' objectives: *how the inflation targeting regime can integrate the financial stability objective?* This would require an enlargement of the final objectives of central banks: their objectives of price stability would be completed by financial stability. This raises the issue of the relevance to consider financial stability as a final objective of the central bank. According to Aglietta (2008), this is not a good idea because there is a risk that financial markets would be leading the way, while central bankers would just follow them. It could reduce the independence of central banks vis-à-vis of financial markets. But at the same time financial stability has become a form of *public good* (Kaul, Grunberg and Stern, 1999), there is thus a need for the central bank to intervene in financial distress. Could an enlarged inflation targeting regime consider financial stability as an indicator? Or could it allow more flexibility in inflation targeting, through a larger target band, or a longer time horizon?

If we consider that central banks are taking financial stability into account, the second question is related to the modalities of central bank's action. Due to interdependencies among countries produced by /resulting from the globalization of financial markets, the intervention of a national central bank in financial regulation has an impact on other countries. It could even lead to negative externalities: financial instability could be relocated or even exacerbated. So the central question is: *in an environment of financial interdependencies, can a central bank regulate a financial crisis on its own?* It seems to be very difficult. As financial stability is a 'global public good' and financial crisis are global problems, there is a co-responsibility of central banks over financial stability. This 'global risk management' calls for international cooperation. There is a need for global institutions of financial and monetary governance that could consist in 'clubs', networks, of central banks working together to produce a common financial policy.

In light of recent experience, it looks like if central banks are just beginning to realise this need for coordination. But, according to the famous word of Goodhart, it is '*too little, too late*'. Does it mean that states have to intervene and impose global coordination to central banks? Such intervention would lead to a reduction of a central characteristic of inflation

targeting: central bank independence. Since this concept has a high value in the financial community in the name of ‘credibility’, there is a risk that it hurts central banks’ interests, generating resistances.

The third main question focuses on the legitimacy of central banks: *even if central banks had the will to regulate financial markets, do they have the legitimacy to do it?* Central banks suffer from a lack of legitimacy that comes primarily from their insistence on independence from political pressure, which is considered by the public as lack of democratic accountability. Can central bank positive response to political pressure for central bank global or regional coordination contribute to reduce this legitimacy deficit? Could central banks regulation of financial instability generate both *input* and *output* legitimacy (Underhill and Zhang, 2006 :15 ; Underhill, 2007a :4)? Does financial regulation benefits from an input legitimacy because people regard financial stability as a global public good? Can central banks coordination really prevent from and/or resolve financial crises? These questions suggest that global financial liberalization drives to a global financial and economic integration, that in turn calls for a global regulation integration. It invites to an evolution of central bank governance from a national to a global level. Legitimacy and accountability are key notions in the reform of central bank governance (Underhill and Zhang, 2006:53).

To summarize, in this research project, we address several questions and problems that we intend to tackle during the mobility programme:

- What is the way to reform the regulation of liquidity crises, especially in emerging market economies?
- *What role can central banks play in regulating financial stability? To what reforms does this new role lead?* How in practice central banks can regulate financial markets? How can central bank integrate this problem of financial stability?
- How the inflation targeting regime can integrate the financial stability objective?
- In an environment of financial interdependencies, can a central bank regulate a financial crisis on its own? Can central banks coordination really regulate financial crises?
- Do central banks have the legitimacy to tackle this issue? Can central bank positive response to political pressure for central bank coordination contribute to reduce this legitimacy deficit?