1. THE ROLE OF THE CENTRAL BANK (C.B.) IN BANKING CRISES:

Main Causes of Banking Crises:  
> Loss of Confidence  
> Liquidity Crunch  
> Solvency Problem arising from excessive volatilities

Sources of problem:  
1. Domestic and external macroeconomic volatility  
2. Credit Booms and Capital Inflows  
3. Asset Prices bubbles and collapses  
4. Excessive Public Sector Involvement & political pressure  
5. Increasing currency and maturity mismatches  
6. Legal and Prudential weaknesses

What can the C.B. do? Volatilities could be dealt with by:

- Reducing volatilities under domestic control.  
  Implementation of steady monetary policies.  
- Reducing exposure by diversification  
  Foreign-owned banks  
- Insurance – Protection against volatilities  
  Derivative markets  
- Financial Cushion  
  Capital levels to compensate for volatilities
Credit Booms and Capital Inflows

- Excessive credit creation and unsound financial expansion in the upswing.
- Surge of Short term and Unstable Capital Inflows

What should the C.B. do? – Sterilization policies
– Controls on Capital flows
– Reserve requirements, Variable Capital requirements and other prudential instruments

Asset prices bubbles and collapses

- Bust create a Collateral – induced Credit Crunch as the Value of securities held in banks is eroded
- bubbles could lead to output contraction
- bubbles distort financial decisions and credit risk management becomes difficult

What should the C.B. do to restrain excessive rise in asset prices?
– Difficult to identify a bubble.
– Not clear if monetary policy should be tightened

Excessive public sector involvement and political pressures

- Loan decisions of public banks likely to be subject to Political considerations
- Government influence on Credit allocation of private banks
• Interest rate caps and high reserve requirements
• Govt forcing banks to finance the budget and to hold
govt paper at below market rates

What should the C.B. do?
– Independence of Central Bank
– Legal limit on government and public sector entities
– Privatize public banks

Increased Currency and maturity mismatches
• rapid transformation of currency composition of bank
  Deposits
• High domestic interest rate increases incentives to
denominate debt in foreign currency
• Maturity mismatches to increase with the limitation of
  access to longer term financing
• limitations to hedging operations – spread risks on the
  asset side

What should the C.B. do?
– Implement prudential measures that limit the scale of
  foreign currency denominated borrowing
– Promote deeper longer term credit markets
– Higher FE reserves reduce vulnerabilities. Increasing
  reserves in time of crisis is conducive to increase
  confidence.

Legal and Prudential weaknesses
• Inadequate bankruptcy and insolvency legal framework
• weak enforcement of contracts
• Prudential regulations (PRs) unresponsive to business needs

What should the C.B. do?

– Strengthen the legal framework and contract enforcement mechanisms
– Review the PRs and compliance mechanism
2. **CHALLENGES OF INFLATION TARGETING (IT)**

- Different objectives or single objective?
- Coping with succession of shocks
- Pass through devaluation to inflation – low or high
- Use of escape clause: Credibility will be affected
- High interest rate response required for I.T. not appropriate for EMs: will Strengthen exchange rate (XR) but stifle growth and capital flows can put Pressure on XR.

**Empirical experience**

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42 IT countries
  /------------------
  |                  |
24 without clear commitment 18 full fledged IT (FFIT)
  /      
19 low 5 highly
  /      
Credible IT Credible Industrial i.e. IT lite countries.
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**Characteristics of ITL Countries**

- Smaller GDP
- Fatter upper tail for inflation
- Higher govt debt
- Shallower financial systems
- Capital controls
- Greater exposure to economic shocks
Monetary Policy (MP) in ITL Countries

- transmission mechanism not clear
- tough setting for MP
- conflict with financial stability
- less market oriented targets & instruments
- policy formulation relatively varies
- more active foreign exchange intervention

Role of Financial Stability (FS)

- more attention to FS objective
- inherent conflict of clarity in adherence to objectives
- constructive ambiguity

Life after ITL

Choices of monetary regimes
(i) dollarisation (ii) currency bonds (iii) Pegged XR (iv) Veiled IT (v) ITL (vi) Full Fledged IT

- FFIT or currency boards – minimal degree of credibility
- Dollarisation very extreme
- Pegged XR requires capital controls
- VITs for industrial countries only