

Defining the Role of a Central Bank

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While the dust from the current global financial crisis has yet to settle, many have begun to draw lessons to prevent a repetition of such crises in the future. One of the main questions to arise has been whether or not central banks should explicitly take on the additional mandate of financial stability.

While the traditional central-bank goal of price stability is usually well defined, current understanding of what a financial-stability mandate covers is much less clear. At a minimum it involves promoting stability of the banking system and standing ready to provide emergency liquidity assistance when needed. But it can also involve ensuring stability of the payments system, development of prudential policies and regulation and supervision of institutions and markets in general. It is worth pointing out that this responsibility over the financial system as a whole is distinct from the typical role of central banks in the oversight and supervision of specific institutions or markets, as currently specified in the case of the Bank of Thailand and in many other central banks across the globe.

Moreover, the additional responsibility of the central bank in times of crisis is less well defined. The crises in the UK and the US have demonstrated that central banks can be called upon to provide exceptional amounts of liquidity to the financial system when the system at a whole is at risk. The line between the provision of emergency loans to avert insolvency of illiquid institutions and the bailing out of financial institutions can be a fine one in such a situation.

A concern arises as to whether central banks are equipped to deal with such a mandate, given the limits on their policy instruments, powers and available information. This shortcoming was highlighted in the UK, where the separation of supervision and lender-of-last-resort functions led to a delayed response in the provision of emergency financing to Northern Rock. This served as a harsh reminder for UK financial authorities of the need to coordinate closely between the Financial Services Authority, the Treasury and the Bank of England.

As a result, a revision to the UK Banking Act earlier this year has mandated a statutory financial-stability objective upon the BOE.

This was complemented by increased roles and powers for the BOE, including the creation of a new Special Resolution Regime for dealing with distressed banks and a tripartite Financial Stability Committee to advise on financial-system matters in order to resolve a distressed bank in an orderly way, reducing the impact of a bank failure on financial stability and the public.

How these new mandates and powers will work out in practice, however, remains to be seen.

It is unclear whether or not this trend towards an explicit financial-stability mandate for central banks will catch on across the globe.

In the meantime, however, the public will continue to rely on the central bank as the guardian of the financial system, whether that role is explicit or otherwise.

(The views expressed are the author's own.)

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