Living in interesting times: Navigating the new era for central banking

Participants from PwC’s Central Bank Forum 2013 talk about how to address the challenges ahead.
Responding to change

Welcome to the report on PwC’s Central Bank Forum: Living in interesting times, which was held in PwC’s More London offices in September 2013.

The title of the conference, ‘living in interesting times’, was chosen to reflect the challenges of a new era in which longstanding economic and policymaking certainties no longer apply and central bankers are taking on responsibilities and an associated public profile that few have encountered before.

While the worst of the fire-fighting may finally be coming to an end, the repercussions of the financial crisis will continue to be felt for many years to come. Central banks are grappling with how and when to unwind stimulus measures in the face of regulatory upheaval and continuing economic uncertainty. They also face the challenge of how to sustain financial stability – an expanded remit born out of the crisis, whose objectives are poorly defined, toolkit is largely untested and which risks raising unrealistic public expectations.

The two days’ of round table discussions were an opportunity for invited central bankers and PwC representatives from around the world to share experiences and debate these issues in an informal, but thoughtful environment. I had the honour of co-chairing the forum with Kenneth Sullivan, Senior Financial Sector Expert at the International Monetary Fund. The central bankers’ comments were non-attributable under the Chatham House rule to allow for full and free discussions, though some of the PwC participants have agreed to be quoted in this report.

One of the concerns that came through strongly from the forum was that the current caution over stimulus withdrawal may be storing up problems for the global economy and could undermine the credibility of central banks. The latter is especially critical at a time when reputation is seen as the most valuable asset central banks possess and its loss their biggest risk – even more than financial independence in the view of some forum participants. Confidence in monetary policy has already been severely shaken and central banks can’t allow it to be further dented by failure to check inflationary pressures and potential asset bubbles as the economies recover. The importance of reputation is further underlined by the media spotlight in which central bankers now operate and the necessity for greater collaboration in their operations, especially in relation to financial stability.

The independence central banks once enjoyed may be difficult to maintain in this new era – some forum participants went so far as to question whether it really existed in the first place. But none doubted the need to sustain a distinctive voice and room for manoeuvre, even when acting in concert with other policymakers and regulators.

The phrase ‘may you live in interesting times’ has sometimes been referred to as a ‘curse’, possibly due to its resemblance to the Chinese proverb: ‘It’s better to be a dog in a peaceful time than be a man in a chaotic period’. Many central bankers may indeed yearn for less ‘interesting times’ as the challenges they face continue to mount. But few would doubt that the decisions they make now are going to shape their organisations and determine the effectiveness of their activities for many years to come.

This summary paper is designed to provide a record of these and other issues debated, and a platform for ongoing discussions among the participants. If you would like to know more about the Central Bank Forum or would like to discuss any of the issues in more detail, please feel free to contact me.

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Living in interesting times: Navigating the new era for central banking
1. **Back to the new normal: Preparing for stimulus withdrawal and interest rate normalisation**

While the special measures were only ever intended to be temporary, there is a natural reluctance to withdraw too soon in case fragile recoveries are thrown off course. But several forum participants argued that central banks need to begin the tapering now. Stimulus is losing its impact on the one side and is having a distorting impact on the financial markets on the other. In turn, failure to address inflationary pressures or the emergence of asset bubbles could undermine the credibility of monetary policy.

All agreed that the stimulus should be unwound gradually to avoid economic shocks and market destabilisation. If central banks delay ‘normalisation’ for much longer they could be forced into a more sudden and potentially destabilising policy shift. Effective forward guidance is clearly a crucial element of this planned withdrawal. But, the forum discussions highlighted concerns over the efficacy of these communications. On the one side, messages don’t appear to be getting through as sceptical markets bet on earlier rises¹. On the other, central banks risk creating a strategic straightjacket by tying policy measures to economic indices that may not be aligned with monetary developments.

2. **Steering through uncharted waters: Developing the mindset, structures and tools to manage a new and expanded remit**

Central banks are now expected to play a key role in sustaining financial stability. But there is no clear definition of what ‘stability’ actually means in practice or firm mandate over how this can be achieved.

Orthodox monetary instruments failed to address credit booms and the accepted single focus on price stability meant central banks did not use micro-prudential measures to counteract accumulating bubbles. As a result, potential problems built up. Participants believe that macro-prudential tools could prove useful in helping to curb excessive credit growth and helping to direct capital to sectors that benefit the real economy, while sustaining a healthy banking system. But the development and implementation of these tools is still at a very early stage, with policymakers still grappling with a range of conceptual and practical issues. It’s also far from clear what metrics should be used to gauge ‘stability’. The contrast with the clearly definable and quantifiable inflation targets and the accepted mechanisms for realising them couldn’t be starker.

Forum participants underlined the crucial importance of a clear exposition of what is achievable by central banks under this dual mandate, and the policy trade-offs this may demand to avoid raising false expectations. They also highlighted the importance of a clear demarcation of responsibilities, definition of trigger events and timings for involvement between regulators, governments and central banks. Quality data is needed for clarity and currently this is lacking. More progress on developing analytical models and more international co-operation between authorities are also needed to ensure that qualitative assessments can complement quantitative analysis.

New approaches are emerging. For example, rather than simply using the ‘blunt instrument’ of interest rates, central banks could work with regulators to apply extra capital controls to particular overheating sectors. Some forum participants also warned against overly cautious approaches that could do more harm than good by driving all institutions to a common concentration of risk exposures. One went so far as to argue for greater diversity and allowance for failure in the financial system to avoid such a dangerous uniformity and concentrations of risk.

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¹ Markets bet on rate rise two years early’, Financial Times, 6 September 2013.
3. **The art of the possible: Managing expectations over what central banks could, should and cannot do**

Alongside other policymakers, central banks in the countries most severely affected by the financial crisis face the challenge of how to restore market and public confidence. Credibility is also critical to their ability to influence other policymakers within a collaborative macro-prudential management framework, especially if government and central banks were to come to conflict – the timetable for withdrawing special measures is an area where there may be disagreement.

The importance of reputation is further heightened by the media spotlight in which central banks now operate. Forum participants highlighted the extent to which communication has become as important as financial monitoring and management to effective central bank operations – the column inches now devoted to central bank chiefs and the emergence of forward guidance as a material element in monetary policy attest to this. Noting the different approaches to forward guidance and their relative success, several participants argued that such communications should be as much about shaping the market mood as setting and pursuing quantifiable targets.

4. **Making the most of ‘soft power’: New twists to independence need not erode influence**

The need for collaboration with other agencies in managing financial stability, be they other policymakers or other central banks, is reshaping concepts of central bank independence. The need to call on governments for the funds to underwrite stimulus measures or rescue stricken financial institutions – few central banks have the necessary resources – means central banks must share authority in these areas. But a distinctive voice for central banks and clear demarcation of roles and responsibilities are still crucial for sound central bank strategies and operations. This is creating an ongoing debate regarding functional and institutional independence for central banks.

Forum participants made the distinction between exercisable ‘de facto’ independence and legal ‘de jure’ independence. The latter can easily be overridden by governments unless it’s backed up by the former. Finding new ways to bolster income streams can help to strengthen de facto financial independence and the freedom of manoeuvre that comes with it. De facto independence also stems from confidence in the central bank, which if in place allows it to exert its influence over markets, regulators and other policymakers, but if lost can very quickly erode its authority and compromise its ability to discharge its functions.

5. **On top of the risks: Managing the upsurge in financial, reputational and strategic risks**

The financial crisis and its fallout have exposed central banks to unprecedented levels of financial, strategic and reputational risk. The challenge is how to bring these risks together into a coherent and effective enterprise-wide approach to risk management. Many participants felt that the development of such frameworks is being hampered by deficiencies in the risk appetite assessment, management information and organisational co-ordination, which in turn often stem from underlying shortcomings in IT, communication and the allocation of resources and responsibilities.

In addressing these gaps, the forum discussions highlighted the importance of making the risk appetite as tangible as possible – for example moving from a vague statement of intent over asset management to determining how much the central bank would actually be prepared to lose. They also stressed the importance of understanding the interactions between the risks – for example, managing the impact of losses from the eventual sale of assets on their public credibility. Underpinning this are clear lines of governance and accountability, in which risk takers rather than risk management are responsible for the risks being assumed.
Fundamental questions

Drawing on the debates at the forum and our continuing work with central banks around the world, we believe that there are six fundamental questions they will need to address if they’re to steer a successful course through this new era:

1. How is new regulation and strategic re-orientation going to affect the markets central banks oversee?

2. How can central banks maintain independence for monetary policy when needing to share it with government for financial system stability?

3. Is it possible for central banks to carry sufficient resources to manage market crises, or is taking action without government funding no longer viable?

4. How can central banks best foster international collaboration and maximise influence over the decisions that affect national and international markets?

5. What is the most effective way to anticipate future threats in a fast changing and increasingly interdependent financial sector?

6. How will organisation, governance, communications and deployment of resources need to change to reflect the changing strategy and remit?
Comments from the chair

New paradigms for the new normal

One positive that has survived the crisis to date is the recognition that an independent central bank remains the best means of delivering price stability. Central banks remain largely free to continue to discharge their price stability function. What has changed is that the focus is now at the bottom end of their inflation bounds with the emphasis on avoiding deflation. This is still consistent with the price stability mandate as all mandates have lower bounds that were never lower than zero. This mandate still enjoys widespread support despite some calls for inflation to ease fiscal and household debt burdens, a tribute to the stability it provided the world economy in the ‘golden era’.

The crisis offered two major realisations a) that financial system stability is an integral element of price stability and b) central banks need a wider variety of tools to manage price stability at either end of its band. Currently, central banks are looking to flood the market with liquidity to prompt a recovery of banking activity, demonstrating how systemic liquidity has become a valid monetary policy tool. The other side of this is the provision of cheap liquidity to government, an outcome which raises questions regarding the bounds between monetary and fiscal policy.

Besides quantitative easing (QE), central banks have tried flattening the yield curve (‘operation twist’) and adopted the concept of ‘forward guidance’. This has heightened the importance of the quality of central bank communication, not just to its broader constituency but also to specific sectors such as market traders.

Financial markets provide the transmission mechanism for monetary policy. In stressed markets, not only may the central bank be unable to implement its monetary policy, but also the market may be working against the central bank’s policy objective. Hence market stability is a precondition to effective monetary policy implementation. Central bank mandates are expanding to a more proactive stance on market stability and the provision of liquidity.

As central banks cannot carry the resources to ensure the system’s financial stability in a crisis, the stability mandate raises interesting challenges about when the central bank needs to call on government resources. Any call on government resources presumes that the central bank will share responsibility with the ministry of finance for decisions relating to the parameters surrounding this provision of systemic liquidity. As the transition from entity specific liquidity support can transition to systemic liquidity issues very quickly, it is appropriate that the central bank and ministry of finance have agreed and documented the protocols covering government involvement. This decision raises new questions regarding functional and institutional questions for the central bank that central bank laws should reflect.

The combination of new toolkits and an expanding mandate means the discussion of the new normal and the paradigm it will operate under is still in flux but the old paradigm has gone.

Diversity of central bank experience of the crisis

Discussion of central bankers’ response to the crisis has focused on those major central banks that have undertaken QE as a monetary policy response to the crisis, namely the US, UK, European Central Bank (ECB) and latterly Japan. QE policies generate high income for the central banks with positive financial statements and large distributions to the stakeholders. The model considered the costs of exiting as tomorrow’s problems.

The crisis has confirmed just how global the world has become. While not all financial markets crashed, all felt the effects to some degree and the consequential effects of the monetary policy initiatives to restore stressed markets have had universal impacts.

The non-QE central banks have experienced a range of other outcomes. Some mature economies with a combination of efficient financial sectors, prudent regulation, and a natural resource base have survived the crisis with minimal stress. Other, smaller, open, economies have experienced the combined effects of a material decline in the earnings on their reserve currency FX holdings, an appreciation of their exchange rates from capital inflows and rising sterilisation costs. The outcome has been reported operating losses and deterioration of capital positions through realised and unrealised charges on capital buffers. The sustained situation over a number of years has weakened many banks financial independence.

In an interconnected world the effects of booms and bust have a truly global impact. Central banking conversations should consider the connections within world markets and how to manage the transmission mechanisms of bubbles and shocks.

Kenneth Sullivan
Senior Financial Sector Expert
International Monetary Fund
Back to the new normal: Preparing for stimulus withdrawal and interest rate normalisation

Indecision and delay over the scaling back of quantitative easing and other emergency measures could be storing up trouble for the future. So how can central banks unwind the stimulus without putting the recovery in jeopardy?

The sovereign debt and wider global financial crisis have abated and there are tentative signs of recovery in Western economies. Forum participants acknowledged the risks associated with the expansionary monetary policy of the past six years, but on balance most felt that the expedient was justified. Several cited the reductions in government bond yields in Ireland and other countries caught up in the worst of the sovereign debt crisis concerns. Others argued that the emergency measures represented ‘sound monetary policy’ by averting the risk of deflation.

But what happens now that we’ve reached what a participant described as the ‘end of the emergency’? The special measures can’t last indefinitely – a participant described them as ‘a painkiller but not a cure’. But even talk of withdrawal has sent ripples through the financial markets, with share prices falling and rising depending on how long they believe it will be before tightening finally begins. The recoveries in developed markets are also still tentative, with debts still high and output struggling to return to pre-crisis levels. Like a country emerging from conflict, it would thus appear that winning the peace can sometimes be harder than winning the war.

So why do most participants believe that now is the time to begin unwinding the special measures? Several highlighted the diminishing impact of each new round of stimulus, likening quantitative easing to an addiction in which ‘ever greater hits are needed to have the same effect’. Indeed, some felt that we’ve reached the stage where stimulus is actually counterproductive. The forum discussions highlighted the potential for excessive risk taking and asset price bubbles in countries where quantitative easing is in place, with the dangers growing as dependence on loose monetary policy takes ever more permanent hold. Several participants argued that if central banks turn a blind eye to this potential overheating they risk undermining the credibility of their monetary policy.

In the emerging markets that have continued to sustain strong growth, there is the ‘billow effect’ of liquidity chasing yield and the resulting exchange rate volatility and high cost of sterilising inflows. This could quickly turn to a destabilising flight of capital once monetary policy is tightened in Western markets.

In a presentation to the forum, Andrew Sentance, a former member of the Bank of England’s Monetary Policy Committee and now Senior Economic Advisor at PwC, argued that the crutch of stimulus and cheap money risks impeding the necessary restructuring on the supply side of the economy. This includes holding up much-needed improvements in productivity and the weeding out of uncompetitive enterprises. In respect of interest rates, he pointed to how the prolonged fall in returns for savers has led to cuts in their expenditure.

Looking to central banks themselves, the ‘bomb damage’ from the special measures of the past six years includes bloated balance sheets (Figure 1-4 shows the sharp rise in asset and liability levels for the US Federal Reserve and European Central Bank).
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So when should withdrawal begin? Most participants accept that there is never going to be a good time and acknowledged concerns over moving too quickly for fear of stifling fragile recoveries. But there was a general consensus that it would be better to begin now rather than wait any longer, not least as further delay might mean that the shift in policy has to be carried out in a destabilising rush rather than a more gradual and manageable transition. Warning about the dangers of acting too late and too quickly, Andrew Sentance cited the 17 consecutive rate rises in the US between 2004 and 2006. He believes that if the Federal Reserve had begun to adjust rates earlier it might have been able to phase in the increases over a longer period and avoid the spike in defaults that some believe helped trigger the financial crisis. Similar dangers could arise if the stimulus withdrawal and eventual raising of interest rates follow a similarly rushed path.

Careful management of this transition is clearly critical. Participants noted that selling large quantities of bonds in one go could have a destabilising impact on the markets. It would be better to withdraw in phased steps, reinforcing the argument for a gradual approach.

Clear signposting is also important, though referring to recent rounds of forward guidance, a keynote speaker highlighted the need to balance market certainty with strategic flexibility. In particular, giving unemployment benchmarks for movements in interest rates will only be enacted when the economy is ready. But making this direct link may curtail the central bank’s room for manoeuvre, especially as there is limited correlation between falls in unemployment and upward pressure on inflation and credit supply. In contrast, the ECB has simply committed to maintaining interest rates at current levels for an ‘an extended period of time’.

Some might see the ECB approach as vague. But the keynote speaker believes that this may strike the right balance between certainty and flexibility as the public and markets have been sufficiently assured that no movements in rates are imminent, while the ECB’s options are still very much open.

From a balance sheet perspective, many of the acquired assets may have to be sold at a loss. This needs to be carefully explained to avoid any erosion of confidence in the central bank. The impact on fiscal deficits will also have to be managed as the losses will most likely have to be covered by national exchequers.

Source: European Central Bank 2013

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ECB media release, 1 August 2013.
Navigating uncharted waters: Developing the mindset, structures and tools to manage a new and expanded remit

The extra responsibilities being taken on by central banks are forcing them to deal with far greater ambiguity than before, demanding fresh thinking and new modes of operation.

Central banks are in a state of flux as they take on a new and expanded financial stability remit – or at least what Malcolm Edey, Deputy Governor of the Reserve Bank of Australia, has described as a ‘renewed appreciation’ of this role. Some, notably the Bank of England and ECB, have assumed or are about to take on responsibility for regulatory oversight.

The scale of the new demands is evident in the physical expansion of many central banks. For example, the ECB is reported to be hiring some 800 new supervisors and will next year move into new headquarters able to house 2,900 people, nearly double its current headcount.

But these organisational considerations aside, the biggest challenge is determining how to meet what are at present often vague and uncertain financial stability objectives. Most central bank definitions point to sustaining the resilience of the financial system and ensuring its basic functions, though the Swedish Riksbank encapsulates the difficulties of setting clear and agreed objectives when it says that ‘there is no unambiguous measure of financial stability, and it is not easy to give a brief and precise definition of the concept of financial stability’.

Selected definitions of financial stability

‘A financial system is ‘stable’ when it continues performing its functions – e.g. maturity transformation, allocation of savings, etc. – across a time dimension (e.g. growing in a sustainable way across the financial cycle) without building-up systemic risk’.

Central Bank of Brazil

‘Financial system stability refers to a state in which the financial system functions properly, and participants, such as firms and individuals, have confidence in the system’.

Bank of Japan

‘Financial stability can be defined as a condition in which the financial system – comprising of financial intermediaries, markets and market infrastructures – is capable of withstanding shocks, thereby reducing the likelihood of disruptions in the financial intermediation process which are severe enough to significantly impair the allocation of savings to profitable investment opportunities’.

ECB

‘Financial stability can be described as the absence of the macro-economic costs of disturbances in the system of financial exchange between households, businesses and financial service firms’.

Reserve Bank of South Africa

‘A stable financial system can be defined as a system whose individual components – financial intermediaries and the financial market infrastructure – fulfil their respective functions and prove resistant to potential shocks’.

Swiss National Bank

The forum discussions highlighted the marked contrast between the vague financial stability objectives and more familiar and measurable monetary targets. This lack of clarity can create unrealistic expectations. For example, several participants pointed to the widespread, but almost certainly mistaken, belief that the new macro-prudential frameworks mean that public money would no longer be needed to bail out a troubled bank.

However you define it, sustaining financial stability is a complex process. Policymakers are at odds...
about what macro-prudential tools they should use to dampen the build-up of financial risks; under what conditions tools should be introduced to address common exposures, risk concentrations, contagion and linkages; and what impact this intervention will have on individual banks, the financial system and the wider economy. Research is at an early stage and lacks the necessary theoretical and empirical underpinnings to answer these questions. The participants suggested that macro-prudential tools need to be tried and tested in robust quantitative models before they’re implemented so that performance can be evaluated against expectations. The results would enable the tools to be modified or scrapped if they fail to achieve the desired outcomes.

However, there is little applied research to support or reject the value of these tools in mitigating the formation of credit bubbles and/or promoting long-term stability in the financial system. This could be an obstacle preventing authorities implementing macro-prudential reforms in the face of mounting opposition. Potential opposition is being fuelled by concerns about whether central banks have sufficient resources and specialist knowledge to manage macro-prudential regulation. Within the markets, there are concerns among banks about the additional costs (especially in raising high quality capital); concerns among investors about the potential impact on returns and concerns among businesses about the potential impact on the availability of credit. Further doubts centre on the potential for arbitrage as countries interpret international rules in different ways.

Central banks could also come into conflict with their political partners – possible instances cited by participants included the difficulties of tightening credit supply in the run up to an election. Such conflicts between monetary and broader macro-prudential objectives could emerge within the central bank itself, but the same senior personnel could be presiding over both.

So how can central banks carve out the right role and realise their objectives? The forum discussions highlighted the critical importance of clear mandates. While macro-prudential management is a collaborative process, there also needs to be a clear understanding of who does what and when between regulators, governments and central banks. This would include triggers for when central banks need to call upon governments for financial support. The discussions also highlighted the need for appropriate performance measures. ‘There is no single needle to gauge stability. Central banks need a range of indicators and experience in understanding what they mean and the levers that influence them,’ said a participant. This calls for fresh talent to make judgements and advise in these areas, along with the infrastructure of monitoring and reporting to support this.

While the financial crisis has thrown up new challenges, it has also expanded the range of available tools. Rather than simply using the ‘blunt instrument’ of interest rates, for example, a participant suggested that central banks could work with regulators to apply extra capital controls to particular overheating sectors. This underlines the importance of both flexibility and collaboration in managing financial stability.

More broadly, there was recognition that stability does not mean the elimination of risk. Neither can regulation be the only lever to ensure stability. Indeed they may even conflict. In a presentation to the forum, Eduardo Viegas, Head of Quantitative Analytics and Business Solutions at PwC, challenged whether central banks and wider supervisory agencies are being too cautious in seeking to drive out risk and avoid even the smallest failures. He argued that some risk and uncertainty are necessary for the effective operation and value creation of financial markets. He also believes that ‘diversity is the best form of stability’ and that the greatest systemic risk lies in uniformity and concentration (‘clustering’), whether emanating from a herd instinct or regulatory pressure. Eduardo Viegas focused in particular on the dangers of very different institutions choosing to follow similar return expectations. This can create an ‘unhealthy ecosystem’ in which when one falls everyone does. He therefore believes that promoting diversity should be an explicit objective of central banks.

Looking ahead, the forces shaping financial markets and the wider economy are evolving at an accelerating pace. Participants pointed to the danger of ‘fighting the last war’, rather than giving sufficient attention to new and emerging risks such as cyber security or shadow banking. They also highlighted the trends that will shape their objectives in the coming years. These trends include the shift in investment and growth to emerging markets. As these economies grow in sophistication, their regulators and central banks may not be able to maintain the conservative policies that helped them to avoid the crisis. Demographic change is also transforming the trajectory of growth and financial services demand. As a participant noted, one of the consequences of an ageing population is that governments aren’t going to be able to solve deficits through growth alone. In turn, digitisation is changing both the way and the speed in which financial services are delivered and central banks will need to find ways to track developments and remain relevant as markets evolve.

5 ‘ECB workload unsustainable, says union’, Financial Times, 3 July 2013.
Central banks now operate in a glare of publicity and may be subject to expectations that challenge their capacity to achieve. Sustaining the credibility needed to function in this unfamiliar landscape is a delicate task.

Central banking was once a quiet and inconspicuous profession, attracting little media scrutiny. This has all changed. The financial crisis has intensified the spotlight on what central banks do and how effectively they do it, a focus accentuated by the absence of aggressive fiscal responses in most countries. Their direct influence over the financial markets and wider economy has also grown, partly through their control of the supply of stimulus spending and partly because of their key role in strengthened macro-prudential management frameworks.

Some central bankers might appreciate their greater ability to influence events. They’re no longer what former Governor of the Bank of England, Mervyn King once described as clerics delivering sermons to a disinterested congregation, whose warnings are unlikely to be effective when people are being asked to change behaviour which seems to them highly profitable. But as we described earlier, politicians, the public, and the media may over-estimate the capabilities of central banks to shape events and safeguard the system. It’s telling that the most significant delivery risk cited in the Bank of England’s latest annual report is the ‘reputational consequences of inflated public expectations of what monetary policy can and should achieve within an inflation-targeting framework in the face of a continuing adverse economic environment’.

The forum discussions highlighted the extent to which communication has become as important as financial monitoring and management to effective central bank operations in this new environment. As interest rates have approached their lower bounds, central banks have adopted forward guidance in the form of communication to deliver what are often complex and nuanced messages to a variety of public and professional audiences. Recent experience suggests this hasn’t always been a success. For example, Western central banks have sought to assure businesses and the public that interest rates won’t be raised until the recovery is on a firmer footing. But the yields on government bonds suggest that many investors doubt that central banks will be able to hold rates down as long as their forward guidance implies. In the UK, for example, investors have bet on a rise in 2014, two years earlier than the Bank of England’s labour market projections would suggest. Comparable difficulties are evident in central banks’ attempts to delineate the anticipated timetable for stimulus withdrawal and interest rate rises, which despite central banks’ best efforts are seen by many within both business and the financial markets as running in tandem. The market’s reaction to the Federal Open Market Committee’s announcement regarding the timing of tapering in May 2013 demonstrates the difficulties in managing the message to obtain the desired outcome.

So how can central banks adapt to this new environment and shape expectations in a more effective way? Central bank chiefs now have to be media savvy as well as sharp economists and shrewd political operators. Central banks also ‘live or die by their reputation’, a forum participant said. The fact that most money in its current form is ‘flat’ and therefore has no intrinsic value apart from the government and central bank’s ‘word’ highlights just how much of the financial system is underscored by this reputation. But this credibility can no longer be taken for granted and several participants argued that it could be undermined by any indecision or backtracking in stimulus withdrawal and other pressing policy questions. It’s therefore better to make fewer commitments and stick by them, even if this risks creating uncertainty in the areas where the central bank’s intentions are less clear. As such effective forward guidance is as much about shaping the mood as setting and pursuing quantifiable targets.

In creating realistic expectations, it’s also important to explain that many central bank actions don’t have an immediate impact, even if this doesn’t sit well with the political timetables or the world of rolling 24-hour news. Moreover, quite a bit of the most important rescue work will remain sensitive and the capacity to act behind closed doors if necessary therefore remains paramount.


7 ‘Markets bet on rate rise two years early’, Financial Times, 6 September 2013 and ‘Carney cautions on UK economy as he defends guidance policy’, Financial Times, 12 September 2013.
Making the most of ‘soft power’: Losing independence need not  
weaken influence

Financial independence will be more nuanced in the new era, but a sure touch will enable central banks to continue to operate with autonomy in achieving monetary policy and play a strong role in guiding financial system stability policy.

The level of independence enjoyed by central banks in the lead up to the financial crisis – an apparent ‘golden age’, as a participant described it – is under scrutiny as the sums needed to enact financial system stability policy have grown and central banks are called upon to work closely with other agencies to manage financial stability.

Some participants questioned whether this era of operational and financial independence is likely to prove to be a historical aberration or may in hindsight have been no more than an illusion. For most of their history, central banks have been an arm of government, through operations such as printing money and managing a countries foreign exchange reserves. A real positive is that, so far, the respective parties continue to respect the central bank’s independence in the area of monetary policy, though the general focus on loosening tends to align the interests of all parties. The challenge will arise at the tightening. At present, politicians continue to recognise that monetary policy is best operated independently as it takes longer to bear fruit than political ‘cycles’. Andrew Hawkins, a director at PwC, argued that while many central banks have a de jure independence written into their constitution, this is often ambiguous and may not have the real power of de facto financial and reputational independence. Indeed, if independence is defined as the tools, finances and political capital to act without recourse to government, then few if any central banks have ever enjoyed true independence, he argued. If the ‘arm’s length’ independence rules of accounting are applied, including the right to appoint their own boards, then most central banks would fail and be classed as subsidiaries. It’s not just the shadow of government that is curtailing independence, but the extent to which financial markets are globalised and therefore the need for central banks to act in concert. Examples include the co-ordinated action taken in 2011 by the Bank of Canada, Swiss National Bank, Bank of England, the Bank of Japan, the Federal Reserve and ECB to ‘ease the strains in financial markets and thereby mitigate the effects of such strains on the supply of credit’.

The power of a central bank is thus defined by its ability to act in collaboration with governments or its peers to achieve its delegated objectives. Over the past few years, there has been a community of interest between Western governments and central banks, individually and collectively, over the need for reflation. However, potential conflicts could now begin to emerge, notably when stimulus policies are unwound. As the forum discussions highlighted, the tough choices ahead call for central banks with a distinctive voice and the ability to fight their corner.

So what level of independence is sustainable and how can central banks maximise their influence? Forum discussions highlighted the need for clear ring-fencing between financial stability roles, where collaboration is essential, and monetary roles, where autonomy is still possible and useful. This discussion on institutional and functional independence will be critical in ensuring central bank effectiveness in its expanded range of responsibilities.

A strong capital underpinning can provide a certain level of de facto independence by avoiding too much recourse to government funds, which as a participant noted, ‘will always come with strings attached’. Making the most of independent funding demands effective budgetary control by the central bank. There may also be opportunities to generate revenue beyond seigniorage such as charging for government banking or banking supervision levies.

But participants believe that confidence in the central bank is the key determinant of its ability to influence core decisions. Indeed some central banks have remained effective despite what is in effect negative equity as their reputation is solid. This reinforces the importance of transparency over finances, objectives and their realisation, as it is much easier to gain and sustain public support when the purpose is clear and can be tracked.

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*Bank of England media release, 30 November 2011.*
Central banks have undergone a fundamental transformation in their risk profile. How can they develop the information, governance and decision making capabilities needed to respond?

Compared to a conventional bank, central banks’ exposures used to be relatively limited, apart from foreign exchange exposures arising from their responsibility for reserves management. Conservative investment strategies contained the financial risks. Strategic risks were there, but they were managed as part of the job, the corollary of decisions made. Reputational risks were held in check by the lower profile of central banks, a low ‘risk appetite’ and confidence in the policy regime.

Now, they face the heightened credit and market risk of investments acquired through asset purchasing schemes, along with decreasing earnings on their reserve assets and income volatility from exchange rate fluctuations in the face of material capital movements. Strategic risks have in turn been heightened by the evolving role within financial stability management. As described earlier, reputations are both harder to maintain and more vulnerable to the vagaries of media scrutiny and public perception.

The developments underline the need for a more integrated and accountable enterprise-wide approach to risk management. Jeremy Foster, a partner at PwC, believes that this more informed and systematic approach would strengthen governance and enhance decision making by providing greater insight into the nature of risks, their possible impacts and new or emerging risks. It would also allow for the development of cost-effective strategies to mitigate and manage risks, which links to the annual priority-setting and budget processes. But he believes that there is still insufficient integration across central bank risk management, with the differences between how strategic, operational and financial risks are measured and managed heightened by their separation into silos.

So why is risk management proving so difficult to bring up to speed? Recent experience has highlighted resource gaps and poor allocation of responsibilities. Many central banks also lack the necessary skills, IT systems and organisational collaboration, in a market that suffers the same shortages. The problem is often not the intention but the ability to find appropriate risk management expert resources.

The forum discussions highlighted the need for a clear risk appetite as the starting point for developing the necessary organisation-wide integration, understanding and accountability. To make it applicable, there needs to be tangible yardsticks in areas such as how much the central bank is prepared to lose in its asset portfolio or whether any banks should be allowed to fail and if so in what circumstances. This framework requires a clear understanding between the central bank and government as to where and how losses fall to ensure the maintenance of central bank financial strength and monetary policy independence.

The forum discussions also highlighted the importance of integrated scorecards in giving senior management the ‘big picture’ of the risks being taken and their interactions, and the tools/plans to mitigate and manage them. This is ideally supported by a common business language to describe and rate the different risks.

While dedicated risk teams and chief risk officers are now common, the forum highlighted the importance of risk takers retaining responsibility for the risks they take. The risk function’s job is to define standards and design monitoring and management tools, not manage the risks per se. Clear allocation of responsibilities between risk, compliance and internal audit teams is vital in avoiding gaps and overlaps.

Participants also stressed the importance of the integrity of data inputs and reporting in sustaining credibility and reputation. The recent LIBOR scandal highlights that incoming data needs proper vetting and controls.

These are major changes and therefore they can’t be achieved overnight. A participant stressed that as ‘risk frameworks evolve, the journey can be as important as the destination’.

On top of the risks: Managing the upsurge in financial, reputational and strategic risks
Central Bank Advisory Group
Regional Contacts

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