Prof. H.A. de S. Gunasekara was Professor of Economics and Head of the Dept of Economics & Political Science of the then University of Ceylon. He succeeded Prof. Das Gupta to become the second occupant of the Chair (and the first Sri Lankan) in the Department in 1961.

He also served as the Dean of the Faculty of Arts at Peradeniya (1963-1969) and later on as Secretary, Ministry of Planning (1970-1977) under Prime Minister Sirimavo Bandaranaike. He was a much respected academic and public servant. A large number of his students have made outstanding contributions to both academic and public life in Sri Lanka and overseas.

Dr. Ranee Jayamaha has more than 45 years of experience in the banking and finance field, of which nearly 38 years were spent at the Central Bank of Sri Lanka. During her career at CBSL, she held numerous national and international positions. At the point of retirement from CBSL, in 2009, she served as the Deputy Governor in charge of Financial Systems Stability.

She currently serves as Lead Consultant on South Asia to the World Bank Group. She has more than 30 national and international publications to her credit. She holds a B.A. (Honours) in Economics (specializing in Money & Banking) from the University of Ceylon, Peradeniya (where she was a student of Prof. H.A. de S. Gunasekera), a M.Sc. in Economics from the University of Stirling, UK, and a Ph.D. in Monetary Economics from the University of Bradford, UK.

THE PROFESSOR H.A. DE S. GUNASEKERA MEMORIAL ORATION 2016

11th November 2016

At

4.00pm

Senate Room
University of Peradeniya

Department of Economics & Statistics
And the Prof. H. A. de S. Gunasekara Memorial Trust Fund

The Professor H.A. de S. Gunasekera Memorial Oration 2016

Program

4.00-4.05	**Opening Ceremony**
4.05-4.10	**Welcome and Introductory Remarks** Head, Department of Economics and Statistics
4.10-4.15	**Vice Chancellor's Address** Vice Chancellor, University of Peradeniya
4.15- 4.20	**Introducing the Speaker**
4.20-5.20	**Oration** Dr. Ranee Jayamaha Former Deputy Governor, Central Bank of Sri Lanka.
5.20-5.30	**Vote of Thanks** Secretary, Prof. H. A. DE. S. Gunasekera Memorial Trust Fund
5.30- 6.00	**Refreshments** Committee Room, Senate Building

World Financial Crises and Challenges to the Governance Structures of Central Banks

The Professor H.A. de S. Gunasekera Memorial Oration 2016

University of Peradeniya
11th November 2016

by

Dr. Ranee Jayamaha
Former Deputy Governor
Central Bank of Sri Lanka

Introduction

Following the emergence of the global financial crisis, close attention is now being paid to the responsibilities of monetary policy to support financial stability and, more generally, to interactions and possible conflicts between the two objectives of fostering price and financial stability. This sharpened focus on financial stability should come as no surprise, since it has historically been a dominant concern of central banks and, in many countries, a fundamental factor in their original establishment. The global financial crisis has dramatically demonstrated that price stability alone might not suffice to prevent the build-up of financial imbalances and systemic risks, even in conditions of steady economic growth. Governance structures of central banks across the world are threatened by the frequent occurrence of global as well as domestic crises. Moreover, 'non-standard' or 'unconventional' monetary policies that have been adopted by major central banks in advanced countries to offset unprecedented threats to the stability of their financial systems have influenced the policy thinking of central banks around the world and some central banks have become mere followers of advanced country central banks, ignoring the state of play of the nations' macroeconomic imbalances. Due to their resilience and traditional way of moving forward within the established governance structures, many central banks have been able to overcome some of the challenges, while a few were financially supported by governments through recapitalization to enable them to handle domestic and external crises with no reputational risks. These central banks have accepted the need for change and already introduced appropriate legislation or amended existing statutes. Central banks, which have been on alert during the crisis period, used their discretionary powers and softened the blows from external crises on their financial systems. They are now in hibernation perhaps waiting until the symptoms of the next crisis

appear. Some other central banks are struggling to convince their governments of the need to amend their governance structures. Ironically, there are some central banks which are either ignorant of, or indifferent to, potential risks and assume that their governance structures are resilient enough to handle future crises. What one clearly sees in this mix of reactions is that the recent financial crises have threatened the traditional governance structures of central banks thus compelling them to make necessary changes. The widely accepted view is that the central banks being public institutions should not march forward using their inherent discretionary powers, creating tension in the macro economy and losing public confidence in them.

This lecture is organized into four sections. Following a brief introduction, Section I sets out the key elements of traditional governance structures inherited by central banks and the difference between central bank governance and corporate governance applicable to banks and financial institutions (BFIs). Section II deals with the impacts of the global financial crises that necessitated the widening of the range of central bank objectives and mandates, and the main issues and challenges confronted by them. Section III highlights the restructuring process of governance frameworks and the main focus of post-crisis governance structures of central banks. Finally, Section IV presents concluding remarks and the main takeaways from this lecture.[1]

Section I: Historical Backdrop: the Currency Board System

Let me start with a brief description of the governance structure of the currency board system that prevailed in most of the British colonies and dependent territories. The currency board system is well articulated in

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[1] I am deeply indebted to Mr Dhammike Amerasinghe, Advisor to the Minister of Special Projects, for reviewing this lecture and providing valuable editorial comments. Incidentally, Mr Amerasinghe has also been a student of Professor H.A. de S. Gunasekera.

Professor H.A. de S. Gunasekera's exemplary research, "From Dependent Currency to Central Banking in Ceylon: An Analysis of Monetary Experience, 1825-1957". According to his analysis, currency boards had been a forerunner to most central banks in the developing and emerging countries and their operations were based on the "real bills doctrine' [2] that provided a unifying theoretical basis for both price stability (monetary policy) and financial stability. So long as discounts and lending were strongly directed to 'output based real bills', both price and financial stability would be simultaneously assured under the currency board system. The currency boards were constrained by the need for maintaining a 100 percent foreign reserve backing for the currency and they perform well in situations where the country continues to experience a balance of payments surplus. Even if the economy required a higher credit growth, the currency board will not provide additional funds without the backing of real output and corresponding foreign currency reserves. The currency board structure is supply driven and is unable to cater to market demands for liquidity or to facilitate clearing and settlements. In surplus balance of payment situations, a currency board structure will enable it to monetize the surplus but at the cost of building inflationary pressures. Unlike a central bank, currency boards lack instruments to contain inflationary pressures and its role is reduced to the status of a passive spectator[3]. They do not have instruments to control the growth of demand deposits, while a central bank could do so through statutory reserve requirements and assumes implicitly that the private sector is inherently self-stabilizing as long as the government does not make misguided interventions. The currency board systems that acted as a prelude to the establishment of central banks, had their definite boundaries and the authorities did not have discretionary powers compared to central

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[2] Goodhart, C E A , The Changing Role of Central Banks, Financial Markets Group, London School of Economics

[3] & [4] Wijewardena, W A, Central Banking Nearly Six Decades after John Exter.

banks. Currency boards are ‘fair-weather’ systems[4] and are not geared to handle serious domestic or global crises and their governance structure is rule-based. The dependency of the banking system in Ceylon at that time, further illustrates this point. The crash of the Oriental Bank in India in 1884 due to misfortune and mismanagement[5] impacted the banking system in Ceylon requiring an authority with supervisory powers to regulate and supervise BFIs and maintain the stability of the financial system.

The Exter Report (John Exter was the first Governor of the Central Bank of Ceylon (CBC)) provides specific reasons for abandoning the currency board and emphasized the need for moving towards establishing a central bank for Ceylon in 1949 [6] . The report also outlined the key elements of the governance structure for the CBC.

- **Stylized Governance Structures for Central Banks**

The concept of good governance at political level and corporate governance at commercial entity level is in common parlance in most countries, but not so the governance structures of central banks. The governance frameworks of a central bank comprises a number of key elements which are fitted together through legislation, ordinance, by-laws, rules of procedure etc. The central bank is a public policy institution with a specific mandate. Most central banks are owned, but not operated by governments. Central banks therefore, are seen to be independent and autonomous and the degree of independence and autonomy depends on the political structure, the macro economic, social

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[5] Gunasekera, H A de S, From Dependent Currency to Central Banking in Ceylon: An Analysis of Monetary Experience, 1825-1957.

[6] John Exter, Report on the Establishment of the Central Bank of Ceylon, 1949

and cultural factors of different economies, the governing law of the particular central bank and the respect for the Governor and the board. Generally, central bank boards are appointed for limited periods on a staggered basis and the government appoints at least one ex–officio member (often the Secretary to the Treasury/the Ministry of Finance) to central bank boards. Some central banks have government ministers and deputy ministers on their boards. Being independent institutions, central banks are possessed of significant discretionary powers compared to currency boards and they maintain their "public institution "character.

Central banks are the bankers to banks and the government but in lending or providing liquidity, central banks are careful of the quality of collateral offered by their clients. Central banks have a responsibility to provide liquidity to market participants to tide over their short term problems. This is known as "the lender of last resort (LOLR) function", and it entails numerous risks to central banks. The collateral requirements and rules have changed over time and in emergencies. In general, self-imposed rules should be applicable in liquidity management and central banks should be extra cautious in providing liquidity to the system in emergency situations. Central banks are demand driven institutions and their balance sheets are unique. Through money creation, central banks expand their balance sheets – which is tantamount to the creation of high powered money (monetary base or reserve money). In the money creation process, central banks generate seignorage profits[7]. Traditionally, central banks do not have the profit making objective unlike a corporate entity but loss making central banks are vulnerable to risks. As a risk mitigation measure, central banks can set financial buffers in their balance sheets, thereby limiting the exposure of LOLR. For example, the Central Bank of Switzerland has such buffers. Despite the wide array of instruments in

[7] the difference between the face value of currency notes and the expenditure incurred on note printing, and the face value of coin minting and the expenditure on coin minting

a central bank, usually one instrument is expected to be used to achieve one objective. In multi- regulatory systems, while preserving their reputation, the central banks interact with other domestic regulatory agencies, and build relationships with regional and global regulators. Central banks are expected to work within their governance structures and be transparent in their operations, and are accountable to the Parliament, the general public and to other authorities. The global crisis has made it necessary for central banks to review their governance structures primarily due to the failure of a number of systemically important financial institutions (SIFIs) and other BFIs and for bailing them out using public funds.

- **Corporate Governance for Corporate Entities and BFIs**

Before proceeding further on the governance structures of central banks, it would be fitting to explain to this audience the main differences between corporate governance applicable to commercial entities and those applicable to BFIs. Compared to the other corporates, certain special governance considerations apply to BFIs, because of the fiduciary responsibilities attached to them. The corporate governance frameworks for corporate entities have evolved following the recommendations made by a number of committees and international institutions[8] aiming at improving the overall responsibilities of the board and senior management of corporates in promoting corporate fairness, transparency, accountability, responsibility, credibility, integrity and trust[9] in their operations. That requires the boards to introduce risk management measures, internal controls, compensation

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[8] Cadbury Report (1992); King Report I &II (1994 and 2002); OECD Corporate Governance Principles (1999, 2004 and update in 2015); the Corporate Governance Guidelines for Banks and Financial Institutions, the Commonwealth Secretariat (2000) and the Basel Committee Reports on Corporate Governance in (2001, 2006 and 2015).

[9] Karasneh,I A & Bolbol, A (2008), Corporate Governance, Concentration, Growth in the GCC Banking Sector, Savings and Development, 51-75

systems and disclosure requirements. Corporate governance is the process by which businesses and affairs of a company are directed, managed and guided to ensure shareholder value through enhanced corporate performance and accountability. There are a number of reasons for the application of voluntary or mandatory corporate governance codes on BFIs: they play a major role in the provision of required liquidity for economic activities of a country; the disruption and systemic impacts of a failure of a BFI on the wider financial system can be costly; they play a critical role as transmitters of central banks' monetary policy to the rest of the economy and; they are involved in value transfer through the payment and settlement systems. Unlike central banks, BFIs are profit driven and use different instruments and products to achieve their sales/profit goals. The applicability of corporate governance to the BFI sector empowers the regulators to apply "fit and proper criteria" to the boards and senior management and shareholders to keep an eye on the performance of the BFIs. In 2003, CBSL announced a voluntary governance code for BFIs in Sri Lanka and mandated it in 2008 mainly due to the non-compliance by BFIs and to safeguard the country's banking and financial system from global financial crises.

Section II: Key Components of the Governance Structures of Modern Central Banks

- **The Mandate: Objectives and Role of Central Banks**

The term "mandate" or "policy mandate" refers to a combination of the responsibility and authority to wield powers in pursuit of public policy objectives. Generally, the governing laws of central banks set out their mandates/objectives, powers, functions/roles, instruments, regulatory and supervisory powers, appointment of the board, governor and senior officials, accountability, external audits etc. Constitutional provisions, statutory statements and judicial interpretations also influence the

mandate setting of central banks (Australia, Brazil). Mandates/objectives vary among central banks and they can be broadly categorized in to three sets:

i. Single objective, i.e. price stability, subject to the monetary regime in operation (New Zealand, Sweden, Canada, UK)
ii. Dual objectives: price stability and financial stability/foster financial sector development more broadly (UK, Malaysia, Sri Lanka)
iii. Multiple objectives (USA, Thailand, the Philippines)

On the basis of these objectives, most mandates have defined the role of central banks. Traditionally, central banks set the interest rates; provide and manage liquidity in the system through monetary or inflation targeting; serve as the banker to banks and government; regulate the financial systems; facilitate payments and settlements; promote financial sector development; and undertake agency functions etc. In performing these numerous roles, central banks are expected to be transparent and regularly communicate with all stakeholders explaining their policy stance.

The existence of a policy mandate is clearest when the law explicitly establishes the central bank’s responsibility for executing a policy function, states the objective(s), and provides the powers and authorities that may be needed. But some laws are not that comprehensive in that some of the above elements may be missing; objective(s) may not be clearly stated, powers may not be expressly provided, or the law itself may not be clear. As a result, with the passage of time, it may even change the way one interprets public policy. The Bank for International Settlements (BIS) surveys (2009 and 2011) on central bank governance and financial stability responsibilities in normal times indicate weaker forms of legal grounding, ranging from mandates that were only implied in law, to mandates specified in extra-statutory statements or based on tradition or similar procedures (e.g. in the UK, mandates are in the law

and in Australia, some mandates are in extra-statutory statements, which are derived from important announcements made by the government or ministers in charge of the subject).

- **Single, Dual and Multiple Objectives**

Prior to the recent crisis, no central bank had a clearly articulated financial stability objective as an explicit part of its formal monetary policy objective. The only clear mandate held by almost all central banks was the oversight of payment systems. Bank of Thailand (BOT) was one of the few central banks that had the mandate and powers ahead of the crisis to act as the macro-prudential regulator (taking financial stability as a whole rather than its individual components). Bank Negara Malaysia (BNM) acquired a similar mandate following the passage of the Bank Negara Malaysia Act in 2009. However, all central banks in the BIS 2009 Survey sample reported having used analytical frameworks that take financial market developments into account when formulating monetary policy. The European Central Bank (ECB)'s "two-pillar monetary policy strategy" is one example, the Bank of Japan (BOJ)'s "one objective, two perspectives" is another.

In the meantime, central banks with a heavy involvement in bank supervision consider themselves as having established means of addressing broader financial stability issues. Some central banks were mandated to achieve a mix of stability and growth objectives. For example, as per the Monetary Law Act (MLA) No. 58 of 1949, at the commencement of the then Central Bank of Ceylon, its objects were set out as [10] the stabilization of domestic monetary values; the preservation of the par value of the Ceylon Rupee and the free use of the Rupee for current international transactions; the promotion and the maintenance

[10] The Monetary Law Act No 58 of 1949, para 5

of a high level of production, employment and real income in Ceylon; and the encouragement and promotion of the full development of productive resources of Ceylon. During 1950 to 2002, no comprehensive review was done to assess whether Sri Lanka's central bank (named Central Bank of Ceylon up to 1984 and Central Bank of Sri Lanka since then) has achieved all, only some, or none of these objectives.

As a significant component of the CBSL modernization programme, its governance structure was reviewed in 2002 and it was mandated to achieve two core objectives, i.e. economic and price stability and financial system stability (MLA amendment in 2002). Like most central banks did in the 1960-1990 period, CBSL has been targeting monetary aggregates, the broad money target in particular, to achieve price stability but with no specified target point or range. CBSL has now enhanced its monetary policy framework aiming to achieve a combination of monetary and flexible inflation targeting[11]. In the meantime, using its discretionary powers and pre-emptive actions, CBSL managed to soften the impacts of external crises on the country's financial system although there had been no visible revision to the governance structure.

While the recently adopted unconventional policy prescriptions by global central banks to prop up their economies through money printing has ruffled the policy thinking of most central banks, the ever increasing domestic fiscal issues together with the collapse of a number of non-bank financial institutions (NBFIs) have forced many Asian central banks, including CBSL, to continue the use of their discretionary powers. In this context, it is opportune time for central banks which have not reviewed their governance structures in the recent past to start

[11]Annual Report -2015, box 10, Modifications to the Monetary Policy Framework in Sri Lanka, Page 204

the process by identifying gaps and risks and selecting appropriate risk controls to deal with emerging situations rather than continuing with "business as usual".

- **Defining and Measuring Financial Stability are Difficult**

Given the wide range of components, such as financial institutions, instruments, payment and settlement systems (financial infrastructure) and legal and regulatory systems, it is hard to define or clearly interpret the financial stability objective. There is a wide array of definitions for financial stability but none is precise enough to be pinned down in law. A sample of such definitions are mentioned to illustrate the gaps and incompleteness in them. Andrew Crocket (1997)[12] defined financial stability as a condition in which economic performance is not being impaired by asset price fluctuations or by an inability of financial institutions to meet obligations. Roger Ferguson (2002)[13], stated that the absence of instability is characterised by some combination of a number of diverging and distorting factors and opined that taking financial stability as an outcome is more practical than as an objective. Y V Reddy (2006) defined financial stability as the smooth functioning of financial markets and institutions, but not the complete absence or avoidance of crises. The Bank of Norway defines financial stability as the system's resilience that is capable of financing, carrying out payments, and redistributing risk in a satisfactory manner even under stress. The Deutsche Bundesbank describes it as a position in which the financial system efficiently performs its key economic functions, such as allocating resources and spreading risk as well as settling payments. The UK's new definition for financial stability (under the new Banking Act of 2000) comprises five elements (i.e. system stability, with

[12]Andrew Crocket(1997) , BIS , "The Theory and Practice of Financial Stability" in the GEI Newsletter, Issue No 6, July 1997

[13] Roger Ferguson, (2002), "Challenges to Central Banking from Globalised Financial Systems entitled "Should Financial Stability be an Explicit Central Bank Objective?"

particular reference to continuity of service; confidence; depositor protection; fiscal protection; and property rights protection).

Any one of the above mentioned components can disturb financial stability. One easily identifiable component in financial stability is the payment system pillar and that is why the facilitation of payments and settlements has been an essential role of central banks. In terms of reducing financial stability risks relating to payments and settlements, at one time, CBSL was ahead of all central banks in South Asia and was on par with many advanced central banks.

The Global Financial Survey (GFS)[14] - 2011 showed an interesting diversity of intermediate cases where the central bank was not the supervisor of all BFIs but had a number of supervisory tools at hand. One of these was the senior central bank representation on the boards of the other supervisory agencies, as an ex -officio member. The Financial Stability Executive Committee established by BNM in 2009 and the Financial Stability Committee of the Bank of England (BOE) in 2009 are examples.

During the pre-crisis period, while some central banks kept a close eye on market development and market corrections, some others left market corrections to markets themselves. These central banks, wittingly or unwittingly, created a regulatory anarchy and also did not act decisively on time. The former Chairman of the Federal Reserve Bank, Allen Greenspan once hailed the best central banker the world has ever had, was now blamed for the financial crisis that occurred during 2007-09. In his book on “The Man Who Knew: the Life and Times of Allen Greenspan, Mr. Sebastian Mallaby argues “The tragedy of Greenspan’s tenure is that he did not pursue his fear of finance far enough; he decided that targeting inflation was seductively easy, whereas targeting asset

[14] The Global Financial Survey-2009 (BIS data)

prices was hard; he did not like to confront the climate of opinion, which was willing to grant that central banks had a duty to fight inflation, but not that they should vaporize citizens' savings by forcing down asset prices. It was tragedy that grew out of the mix of qualities that had defined Greenspan throughout his public life – intellectual honesty on the one hand, a reluctance to act forcefully on the other" (Sebastian Mallaby, 2016).

- **Mandate and powers**

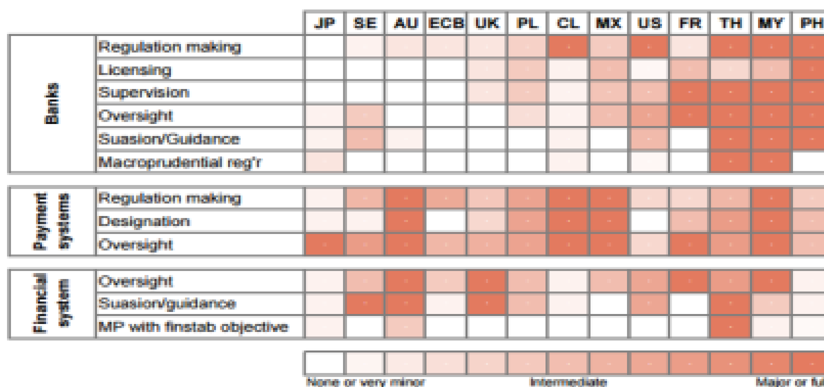
The great depression in the 1930s is said to be the largest negative external shock that the world has experienced. Although conditions were not similar, the more recent 2007-2009 global financial crises have left many more debris and blemishes that are equally negative to many financial markets. This situation has been aggravated by the frequent occurrence of mini crises, such as tensions in Russia, economic slowdown in China, the Syrian refugee crisis in Europe, the unexpected Brexit in June 2016, the fall of one of the oldest Italian banks, the historically low commodity prices and, more recently, the capital inadequacies in Wells Fargo Bank in the USA and Deutsche Bank in Germany have caused setbacks in the US and European recovery processes with headaches to world financial markets.

Similarly, the recent crises have undoubtedly raised a number of issues regarding mandates and powers of central banks. The present trends indicate that many central banks are moving away from a narrow focus on price stability to mandates that include financial stability, development of financial sector and the implementation of micro/macro-prudential policies (MMPPs). Price stability is measurable, easy to define and the public can monitor the performance of central banks. There is no precise definition or a measure to gauge financial stability nor can it be felt or enshrined in a law easily. A weak monetary policy could also endanger financial stability as a mandated

objective and even in the absence of such an explicit mandate, most central banks attempt to safeguard financial stability. The discussion therefore, focuses on whether the mandates of central banks should be expanded to make financial stability an explicit objective alongside price stability. This might be deemed controversial, but perhaps unnecessarily so, if one considers that financial stability is a precondition for price stability.

As seen in chart 1, some of the South East Asian central banks (Thailand, Myanmar, and the Philippines) appear to be using intense regulatory and supervisory powers over banks, while Myanmar, Mexico, Colombia and also the Philippines concentrate on the payment system aspect of financial stability.

Chart 1: **Financial stability related mandates of central banks in 2009** (The darker the shading the bigger the mandate).



Source: BIS Survey of participating Central banks, conducted in 2009

The severity of global financial crises and the economic contraction have also raised a number of fundamental issues about the role of monetary regimes (the fixed or flexible exchange rate systems), governance structures and financial systems. During the sub-prime

crisis, the balance sheet of the US Federal Reserve Bank was unprecedentedly inflated due to take overs of troubled BFIs as well as non BFIs. A growing consensus in the post crisis period is that the reform agenda should re-orientate regulatory frameworks to place stronger emphasis on mitigating the impacts of instability on the wider financial system. The regulatory failure and lack of transparency and accountability on the part of central banks/regulatory authorities were seen as the major reasons for the collapse of the financial institutions which in turn were attributed to the lack of clear mandates and power to regulate BFIs. This stance is also well illustrated in Sebastian Mallaby's book which I referenced earlier on. ''Mr Greenspan also held a fear and a hope. His fear was that participants in the financial game would always be too far ahead of the government's referees and that of the regulators would always fail. His hope was that when risk management did fail, the FED would clean up afterwards. Unfortunately, after the big crisis in 2007-08, this no longer proved true''. In other words, the absence of an appropriate governance structure with clear objectives, mandates and risk mitigating measures has been a major reason that contributed to the crisis.

The 2007-2009 world financial crisis has compelled some of the advanced country central banks to assist the collapsed systemically important financial institutions (SIFIs) adopt a near zero interest rate policy and continue quantitative easing (i.e. using central bank money to purchase monetary assets, such as government bonds in a phased manner), all of which have expanded the balance sheets of central banks beyond their normal operations. Notwithstanding this, more recently, the BOE, Bank of Japan, and the European Central Bank (ECB) have extended their asset purchase beyond government bonds to corporate bonds and equities of private firms. The emerging country central banks have not reduced their interest rates to near zero levels nor have they initiated large scale quantitative easing compared to the advanced central banks, although the former too have bailed out SIFIs and other

BFIs using their discretionary power and providing funds directly or indirectly through different sources. The major issue faced by the emerging country central banks is the ever increasing demand for monetization of fiscal deficits. In this regard, both advanced and emerging country central banks are forced to follow accommodative monetary policies. The difference is that the advanced country central banks have sought legal protection and amended their laws and statues, while most of the emerging country central banks have used their discretionary powers with little or no attention to revisiting their governance structures. Perhaps, due to domestic stresses such as fiscal indiscipline and the troubled NBFIs, emerging country central banks may not have an appetite for changing their governance structures although the complex global situations and potential risks cannot be ignored any further. Nowadays, most central banks are on a fire-fighting mode and live by the day.

Section III: Governance Structures of Central Banks Re-visited

- **Debate on Critical Issues and Readiness to Face Challenges**

Prior to revisiting their governance structures, central banks should internally discuss the appropriateness of their present mandates to face the next crises and debate on the wide range of pertinent issues, such as should price stability be mandated as the prime objective and financial stability the secondary objective? What degree of responsibility do central banks have for financial stability and do central banks have the instruments commensurate with that responsibility? What indicators and benchmarks must be used to measure financial stability? How best can MMPPs and financial infrastructure be taken as critical elements of financial stability? Should financial stability be a policy objective or a component of governance? Should financial stability be rule-based or principle-based or a combination of the two? Should a central bank – a non-elected agency be assigned the responsibility for price stability,

financial stability and the implementation of MMPPs? Should implementation or supervision of MMPPs be handled by another agency? What type of a coordinating mechanism should be established between a central bank and such agencies? How can wider central bank powers be reconciled with the need for greater control – without compromising the autonomy required for effective policy delivery? Why should a central bank bailout SIFIs and other BFIs? Should it not be the responsibility of the government or a separate agency set up for the purpose? If central banks are mandated to preserve financial stability, shouldn't they act pre-emptively and defuse risks to financial stability even when price stability is not at stake? Almost all matured central banks have widely debated these issues and changed their governance structures after taking into consideration the capabilities of central banks. It is therefore, prudent for emerging country central banks to debate these issues prior to introducing legal and institutional amendments necessary for new governance structures.

- **Perspectives of LOLR, Emergency Lending and Financial Stability**

Even if central banks can live with a practical mix and match of definitions, lending in emergencies to safeguard or to bail out a BFI is particularly difficult due to maintaining the boundary between secured lending (LOLR) and lending at risk. The availability of information and knowledge necessary to assess credit risk, the reluctance on the part of the central banks to back out or withdraw assistance from the institution/s fearing that the institution will collapse and the non-availability of high grade collateral are serious challenges. The boundary of regulation needed to offset any moral hazard that arises with the availability of imperfectly priced public sector liquidity assurance may pose yet another issue.

In most countries, decisions on the LOLR are fully within the remit of the central bank, while most central banks consult or even let governments take decisions on emergency lending. In the UK, the provision of LOLR loans is determined by the Chancellor of the Exchequer. As providers of LOLR, central banks may find themselves at the sharp end of public policy actions in the face of financial instability. As money markets need to operate smoothly in order for central banks to effectively implement monetary policy, central banks are also morally obliged to provide emergency lending to markets. To what extent the central banks should stretch themselves cannot be legislated that easily but if there is a well-knit governance structure that may help in prudent decision making.

- **Use of Macro and Micro Prudential Measures to Attain Financial Stability**

The financial stability mandate, whether formal or informal, explicit or implicit, has until recently been thought of by many as a policy function, discharged mostly through: the regulation and supervision of financial institutions; by ensuring the safe functioning of financial infrastructure; adhering to standardised contract arrangements; and reporting to credit bureaus and rating agencies etc. When things go wrong, they assumed that the extended LOLR would be the answer. In the wake of the 2007-2009 financial crises, there has been burgeoning interest in macro-prudential policy as an overarching framework to address financial stability as a whole rather than only its individual components.[15] The array of macro prudential measures includes, caps on the loan-to value ratio (LTV), caps on the debt-to-income ratio, ceilings on credit or credit growth, reserve requirements, countercyclical capital requirements and time-varying/dynamic provisioning, net open currency positions/

[15] C. Lim, F. Columba, A. Costa, P. Kongsamut,A. Otani, M. Saiyid, T. Wezel, and X. Wu, IMF working papers, October 2011,Macro prudential Policy: What Instruments and How to Use Them? Lessons from Country Experiences

currency mismatch and limits on maturity mismatch etc. Countries often use these instruments in combination rather than singly, to complement other macroeconomic policies, and adjust them counter-cyclically so that they act in much the same way as "automatic stabilizers." The CGFS[16]- 2009 indicated that 10 of the 17 emerging market central banks had significant micro prudential responsibilities, compared with just three of the 18 advanced economies. Figure 1 summarizes the propensity to use macro prudential instruments in advanced and emerging countries. The survey classified them according to the financial stability mandate assigned to central banks, i.e. Extensive, Constrained and Minor/None.

Figure 1: Propensity to Use Macro-prudential Instruments

Nature of financial stability mandate:	Extensive	Constrained	Minor/None
Average number of categories of macroprudential instrument deployed, per country in the CGFS sample			
Advanced economies	–	0.6	0.5
Emerging Market Economies	2.3	2.0	1.4
Average number of categories of macroprudential instrument deployed, per country where the central bank has a major role in microprudential supervision			
Advanced economies	–	1.0	0.5
Emerging Market Economies	2.0	2.0	1.8

Source: Committee for the Global Financial System Survey, 2009; BIS data

Notes: Financial stability mandates are classified as: (1) Extensive if relevant statutes give the central bank an unqualified objective for the stability of the financial system as a whole; (2) Constrained if the stability objective is expressed in directional terms (eg to promote, to reinforce, on a best endeavours basis), or is related only to a specific central bank function (eg bank supervision, bank licensing, payments system oversight), or is only for a part of the financial system (eg banks, deposit-takers, payment system providers); and (3) Minor/None if there is no such stability objective in the law. The categories of macroprudential instruments referred to are the four presented in Table 3 of the CGFS report cited in footnote 1. No number appears for advanced economies with extensive financial stability mandates because there were no such countries in the CGFS sample.

Source: Committee for the Global Financial System Survey, 2009; BIS data

In practice, this 'macro-prudential' orientation would be implemented by conducting monetary policy in a more systematic and symmetrical way (i.e. through the cycle); not only the normal easing of monetary conditions in downturns, but also a preventive tightening in upturns that

[16] the Committee on the Global Financial System (CGFS) Macro prudential instruments and frameworks: a stocktaking of issues and experiences

feature rapidly growing credit volumes and asset prices, even when price stability is not immediately threatened.[6,] The Basel Committee on Banking Supervision has introduced the use of the countercyclical capital buffer (Basle III) as one of the new macro-prudential tools. Moreover, like the policy rate itself, macro-prudential measures too may suffer from a 'dosage' issue; that is, magnitude appears to be crucial to effectiveness[9] of the interactions, complementarities and potential conflicts among them. The development of a macro-prudential framework is still at an early stage, and several aspects of these policies, most notably how they will work in practice, require further analysis. Micro-prudential information about individual financial institutions is also clearly relevant and such information can be obtained from a variety of sources. While "no one size fits all", some approaches may have advantages in different country situations.

In the legislation adopted in September 2010, the European Parliament opined that the new governance arrangements should have both the micro and macro-prudential spheres. However, ECB's clearly expressed view was that monetary policy should continue to be directed to a price stability objective, not a wider financial stability objective. In the US, the Dodd-Frank Act (2010) created a new centralised macro-prudential body, known as the Financial Services Oversight Council (FSOC). Both jurisdictions emphasise regulatory instruments in the accompanying (implicit) macro-prudential policy frameworks. In the Philippines, Bangko Sentral Philipinas (BSP) is already responsible for supervision of the banking system and oversight of payment systems takes a broad, systemic view of that responsibility. For the sake of clarity, an amendment specifying financial stability as an explicit objective of BSP is presented to the legislature, while leaving price stability as the prime objective. In mid-2010 and early 2011, the UK Government adopted a radically different approach to financial stability policy. The former Financial Services Authority(FSA)'s responsibilities for micro-prudential supervision of banks and insurers have been

absorbed into a new operationally-independent subsidiary of BOE called, the Prudential Regulatory Authority (PRA) which is responsible for the oversight of the safety and soundness of all prudentially significant financial firms (including non-banks). A new Financial Policy Committee (FPC) was established as a formal committee of the Bank's Court of Directors (the Court), with responsibility for delivering systemic stability through macro-prudential regulation and oversight of the micro-prudential function. The Bank's existing financial stability objective – introduced by the Banking Act in 2009 – was reaffirmed but amended to emphasise the need for coordination with other relevant bodies[17].

- **Complexity, Conflicts and Practical Difficulties in Achieving Multiple Objectives**

Central banks often face confrontations between price stability and financial stability objectives and also among financial stability and other objectives. Having an interest in financial stability does not by itself imply having a public policy mandate to pursue an independent financial stability goal. For example, central banks are concerned about the impacts of fiscal policy and deficit financing, but that does not mean central banks should have fiscal policy as a mandate in their governance structures. As these require different policy actions, it helps those charged with the execution of policy to know which actions are desired and which are articulated[18] in the law, but this may not be sufficient to establish a mandate for financial stability. In any case, it is desirable to spell out the mandates of each agency to understand how they overlap and deal with the potential inconsistencies and conflicts at the

[17] BIS: Central bank governance and financial stability. A Report by a Study Group Chair: Stefan Ingves, Governor, Sveriges Riksbank May 2011

[18] S Cecchetti, M Mohanty and F Zampolli (2010), "The future of public debt: prospects and implications", BIS Working Paper no 300, March.

boundaries. A powerful way of spelling out the mandate is to establish an explicit objective for the responsible agency. Over the recent decades, central banks' objectives for monetary stability have become considerably more explicit. Financial stability objectives are often vague compared to monetary policy objectives. "Maintain financial stability" is less easily interpreted than "maintain price stability" since price stability can be numerically approximated in terms of a generally agreed index, whereas financial stability cannot be pinned down to an index. Further, financial stability objectives are often expressed in directional, rather than absolute terms. For example, "to promote" or "to support" or "to endeavour to achieve", but there is no measurement to understand how much promoting, supporting or endeavouring is intended. For example, the BSP has responsibility for payment system oversight as an explicit objective and it is a critical component of financial stability. The more explicit the objective is, the easier it would be to decide on risk taking on financial stability.

Multiplicity leads to complexity. In addition to the number of issues mentioned earlier, using MMPPs to support the achievement of financial stability has raised another set of practical issues. If preserving financial stability is to be achieved through addressing a wide range of MMPPs, the concentration of central banks will be spread among a wide range of intermediate targets. For example, if this means bailing out SIFIs in crisis times, central banks will have to assess their capabilities of handling bloated balance sheets of some of the SIFIs and the degree of risks. What then is the order of priority in the achievement of multiple objectives? Should price stability prevail over and above others or should it be assumed or legislated for? Similarly adding growth objectives will add to the conundrum. Are there effective tools for central banks to manage economic development and growth objectives? Are central banks expected to fund the promotion of growth objectives and do they have the skills and capacity to deliver developmental objectives? From hindsight, it is worthy to note that it would be difficult

for central banks to focus on multiple objectives due to overlaps, numerous risks, lack of instruments and financial and human resource constraints.

- **Post-Crisis New Mandates and Powers: Preventive Action, Emergency Response and Crisis Management**

With regard to special resolution regimes for failing BFIs, authorities in the UK and the USA found that their ability to resolve large, complex BFIs whose failure posed a threat to the stability of the financial system was severely hampered by the lack of necessary resolution powers. Special resolution regimes or powers for dealing with failing banks are in place in a few countries (Australia and Japan). The absence of such powers means that destructive financial failures are more likely to threaten the financial system resulting in both fiscal and monetary risks and moral hazard problems. Following the experience with Northern Rock and the need to resort to emergency legislation in early 2008, the UK Parliament passed the Banking Act in early 2009, implementing a standing special resolution regime (SRR). That regime allows the authorities to intervene, before insolvency, to transfer all or part of a failing bank to another bank, to a bridge bank or bring it into temporary public ownership, to administer any residual business not transferred, or to close the bank, liquidate its assets and either pay out or transfer its insured depositors' accounts.

In designing governance structures or frameworks for central banks, the developments regarding emergency arrangements are worth noting in two areas of significance: the provision of emergency lending and the arrangements for managing the failure of SIFIS (bank resolution). In the provision of emergency lending, there are substantial differences across jurisdictions on the specific powers and authorities provided to the central banks. In some countries, a central bank's independent authority to lend to the private sector is tightly constrained by explicit

requirements about the nature of the security cover required, the pricing of the transactions, and the range of counterparties. In other countries, these elements are not set out explicitly and require judgment. Yet in others, the government becomes involved in decision-making when non-standard operations are being considered. According to Section 13(3) of the Federal Reserve Act, such emergency credit extension can only be made under the umbrella of a broad-based eligibility programme or facility, and only with the approval of the Secretary to the US Treasury. Similarly, the Federal Reserve Bank has to ensure that loans are not provided to any borrower in any form of insolvency proceedings, and that collateral taken in such loans is of sufficient quality to provide protection. There were no serious bank failures in recent times in Sri Lanka, although there have been a number of finance company failures. CBSL managed finance company crises using the provisions in the law and its discretionary powers but it is difficult to gauge the readiness of CBSL to handle a potential failure of a SIFI and risks to central bank balance sheet in the future. In trying to safeguard financial system stability, central banks may have to bail out SIFIs which are under its supervision or even a number of smaller BFIs. The issue is if central banks make losses in this process, will governments reimburse such losses?

- **Transparency and Accountability of Central Banking and Compliance**

Most of the new governance structures established or modified in the post-crisis period encompass improved accountability and transparency arrangements for all policy functions of central banks. Accordingly, new high-level coordination or decision-making bodies have been or are being formed with explicit mandates to focus on systemic risk identification and management. Developments in the area of accountability and transparency arrangements for financial stability and

new disclosure requirements are prominent parts of the reforms in major central banks (BOE and the Federal Reserve).

Financial stability related activities of the central bank, legal requirements or formal commitments to extensive disclosure have been rare compared to monetary policymaking. Publication of decisions is typically discretionary and often bounded by requirements (or powers) to keep information on individual financial institutions confidential (secrecy provisions). In this scenario, can the decision to publicise a particular financial stability action trigger a destabilising market reaction? Or can this be done through effective communication via central bank publications? The Sveriges Riksbank (RiksBank) in Sweden and the BOE in particular have included in their regular financial stability publications the messages they have wanted to communicate actively to market participants and the government. The latest financial stability reports from the BOE present the analysis leading to actual policy decisions while the Fed Board's semi-annual Monetary Policy Report contains a section on financial stability.[19] In contrast, the financial stability reports published by some central banks in the Asian region do not have the same characteristics and quality.

The governance framework of central banks should provide for both internal and external audit reviews. Although there is no best practice, central banks should consider the audit function as a critical component in their governance structures. The compliance culture will be reflected in the audit reviews. Central banks should publish their annual accounts and related financial reports on due dates and be ready to provide any information that are required by auditors, the Parliament and the general public. More importantly, central banks should volunteer to conduct periodic reviews to assess whether they have been working within or

[19] & 20 BIS: Central bank governance and financial stability. A Report by a Study Group Chair: Stefan Ingves, Governor, Sveriges Riksbank May 2011

outside the governance framework. A self- assessment by the Board itself would give them a better idea of the extent of their compliance with rules and regulations, the extent of the achievement of the prime objective/s and the areas where they have failed in achieving much. For example, Israel publishes two self-evaluation reports each month. Transparency of policy decisions and effective communication to the public remain essential complement of the interactions, complementarities and potential conflicts among them.

- **Legal Protection, Financial Autonomy and Risk Management by Central Banks**

The recent financial crises have forced central banks to support growth and make available required settlement funds to facilitate global payment and settlements. At the start of crises, during 2007-2009, to avoid disruption to global payments, central banks (such as BOE, the FED, ECB, BOJ) joined forces in making available settlement funds and also resorted to non-conventional "quantitative easing" (QEs) in their respective countries. The Fed has stopped QE, but some others are still continuing with it. Do advanced country central banks have a choice during financial crises periods? A number of practical issues are raised with respect to risk management by central banks. Should central banks be assisting governments in crisis times? In what ways and to what extent? Can central banks preserve their independence while supporting growth objectives? As mentioned earlier, BOJ and BOE are still continuing with near zero interest rate policies (Fed at 0.25-5.0% but hinted of a possible rate increase in December 2016) while BOJ indicated that it will continue to buy bonds to the tune of USD 800 Bn a year at zero interest rates and will target an annual inflation of 2 percent. This shows that mandated or not central banks have no choice other than providing emergency funds to BFIs in the interest of financial stability and support governments in the national interest. In these instances, autonomy is needed to ensure that central banks are shielded

from political pressures and undue influence from business and industry. At the same time, close collaboration and effective cooperation will be necessary among the different agencies to successfully deal with the situation. A clear delineation of responsibilities helps achieve a suitable balance between autonomy and cooperation.[20]

Among all governance issues, it is the non-financial risk management of central banks that has been examined the least. Functions such as internal audit and compliance, the structure of the board and its decision-making processes have been well-charted in central banks. These issues require more attention, as non-financial risks carry potentially large adverse (financial) effects for central banks[21]. The Board is responsible for maintaining sound risk management and internal control systems.

- **Financial Capabilities: Funding Model for Operating Costs**

According to the definition used for the BIS survey, conventional LOLR support is fully collateralised and conditional on solvency (tested or presumed). Ex ante therefore, it is not expected to result in financial costs to the central bank beyond its risk tolerance for conventional LOLR actions. During crises, most central banks would bear any realised losses that result from such limited risks with their own financial resources, at least initially. Over time, any such losses would typically be passed on to the government, via a corresponding reduction in the surplus transferred by the central bank to the government. Notably, in Poland, a temporary law (passed during the recent crisis and was in force until the end of 2010) provided for the central bank to be

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[21] Ashraf Khan, Central Bank Governance and the role of non-financial risk management, IMF working Paper

reimbursed for 50% of any losses caused by LOLR loans that could not be repaid as a result of worsening financial conditions. The Reserve Bank of Australia (RBA) was at one end of the spectrum, as its balance sheet is not available intentionally to support insolvent institutions. If the government still decided to provide support to an insolvent institution, the RBA could facilitate the transaction or take other actions, so long as its balance sheet was not at risk (e. g. using a government indemnity).

Can a central bank work with a negative net worth for a long time? Traditionally, central banks are under-capitalized but they are confident of getting government capital in case they have to be recapitalized. The UK and Canada are under-capitalized by any standard or measurement as they have inflated their balance sheets during crises times. This is not a matter to be complacent about, as central banks should "not rest on laurels". They should endeavor to put pressure on governments and increase their capital as and when possible. More recently, as per section 6 of the Monetary Law Act (amendment) No 15 of 2014, the capital of the CBSL has been increased from Rs 15 mn in 1949 to Rs 50 bn thus providing a comfortable capital cushion. Although this is not commensurate with the growth in the CBSL balance sheet, it was a prudent measure taken by the CBSL in consultation with the Government.

The ability of a central bank to print money and take the seignorage profits is another comfort for central banks. During the recent crises period, BOE and BOC have taken seignorage profits into books and have also invested such profits in government paper. The consequences of this radical departure from traditional central banking, the dangers of the enormous discretionary powers of central banks and the loss of autonomy of the present day central banks in supporting the government during crisis periods have provoked public debates. The governing laws have prevented some central banks from the passing of seignorage

profits to governments. For example the MLA in Sri Lanka has no provision for direct monetization of seignorage profits the CBSL had earned. Like all other central banks, CBSL also makes seignorage profits on its currency issues and such profits are dispersed across all the assets of the Bank and it is not identified as a surplus to be paid to the government. Instead, the books of the CBSL would record the interest income which the Bank earns on the assets it has created. In arriving at the net surplus, all costs relating to the currency printing and minting as well as investment expenditure are deducted from the interest income. The net surplus however, cannot be automatically transferred to the consolidated fund as the CBSL has to follow the practice stated in the MLA in appropriating central bank profits. Clearly, the legal provisions in the MLA have provided safeguards to CBSL.

- **Decision Making and Effective Co-ordination with Other Agencies**

In multi-regulatory or agency systems, decision-making with respect to the provision of financial support to banks appears to be remarkably diverse, both in terms of the committee structure used by the central banks and the involvement (or not) of government or government agencies. Chart II below indicates a wide spectrum of decision making by central banks in bailing out SIFIs or a troubled bank (financial stability objective) and or supporting governments at crisis periods. As shown in Chart II, the decision-making framework at the BOE has made major threats to the Bank's capital less likely, while at the BOJ's capital is not necessarily protected ex ante. The quality of collateral offered by BFIs during crises periods may or may not be up to standard or even realizable. In these circumstances, legal risks to the central bank can be considerable, particularly when it is involved in bank resolution.

Chart II: Decision Making Processes of Central Banks at Crises Times

Central Bank	Internally -by Executive Board	Dedicated financial crisis management team	Internal policy board and decision making by government	Balance sheet support decision by Minister of finance or equivalent and for the Court of Directors to decide	Governing board in consultation with the ministry of finance	Use government indemnity and support but not through central bank balance sheet
Sveriges Riks bank-Sweden	✓					
Bank of England				✓		
Bank of Japan						
National Bank of Poland		✓				
Central Bank of Sri Lanka					✓	
The Fed reserve Bank					✓	
Reserve bank of Australia						✓
Bank of Mexico		✓				

Source: BIS Survey 2009

- **Independence, Interdependence and Trade-offs**

The effective conduct of monetary policy presupposes a stable financial system and vice versa. Stability in both dimensions help promote the efficient allocation of resources and sustainable economic development over time. However, the short-term interests of monetary policy and financial stability may occasionally diverge and in such situations, having explicit policy objectives will help authorities set the desired priorities. The trade-off dilemma should not be exaggerated, though, its management will be easier if the authorities have a wide range of tools, consistent with their mandate, for dealing with financial stability matters. The crisis has surfaced the assumption that over longer horizons there is no trade-off between the objectives of price stability

and financial stability – rather, there are synergies. As a result, even in the absence of a formal mandate for financial stability, central banks have long factored in developments in the financial sector – most notably in the money, credit and asset markets – into the conduct of monetary policy. A major issue that should be highlighted is the potential for conflicts and 'trade-offs' – between monetary policy and MMPPs.

Where the central bank has policy responsibility for both monetary and financial stability, some ranking of objectives would be desirable (though it may not be possible in all circumstances). In the case of the ECB, CBSL and BOE for example, such a ranking exists with the primary objective being price stability. Such a ranking would also be useful where decision-making on financial stability policy actions is shared with other authorities. Central banks are known to be independent. Where trade-offs exist and another party participates in decisions, without clear rules, the decision making would be difficult. Another example would be a central bank that defends a fixed exchange rate by raising short-term interest rates to stem capital outflows. The higher interest rates may support the nominal monetary policy anchor, but at the cost of creating strains in the financial system (inter alia, Sweden in 1992). Explicit policy objectives may be needed to manage policy trade-offs. Policy effectiveness may also be hampered if, at moments where decisiveness is required, lawyers need to be engaged to assess whether the law provides the necessary authority to act. What emerges is that there is a strong case for making the financial stability mandate explicit and clear in a central bank governance structure. Doing so, reduces the risk of boundary disputes and turf fights between different agencies and the risk of defensive responses by a central bank. Some central banks have set up Inter- Institutions Regulatory Committees to effectively coordinate regulatory and supervisory aspects among multi regulatory authorities.

Section IV: Concluding Remarks and the Way Forward for Central Banks

During the recent crises and post crises period, the advanced country central banks like The Fed, BOJ, and BOE have been keeping the short term interest rates at zero or near zero levels, while engaging in "quantitative easing" with the express aim of driving down long term interest rates. In doing so, these central banks have also taken steps to pass necessary statutes, amend existing governing laws and secure legal interpretations to cover them from legal and reputational risks. Yet, the unconventional moves by the advanced country central banks have raised a number of issues in the art of central banking and also changed the policy thinking of developing and emerging country central banks. While all central banks are keen to preserve the health of the transmission mechanism through a stable financial system, most central banks are confronted with the issue of how to undertake financial stability responsibility without an explicit mandate. Until central banks start reviewing the existing governance structures, they may not be able to gauge the complexity of the exercise and gather experience. The advanced countries have reviewed their governance structures, introduced relevant changes and have realized how painful and challenging the task was. Some central banks in South East Asia like Malaysia, the Philippines and Thailand have started the process. Some central banks have ignored reality, while others keep postponing revisits due to fear of challenges. The postponement of reviewing governance structures, would result in the central banks seeking clarity and legal interpretations or frequently referring potential cases to the legal authorities or the judiciary. Given the frequent global financial turmoil, it is imprudent for central banks not to pay attention to their governance structures and examine the relevance of the objectives and mandates.

In a crisis, it is safer for central banks to be the "first at the scene" with clear mandates and powers. Given the recent financial crises, central

banks may define what they wish to achieve and what they are capable of achieving through the financial stability objective.

Resuscitating Troubled BFIs

"STAND BACK,
I AM A CENTRAL
BANKER"

Source: Economist 13th -19th August 2011

No central bank is capable of achieving a whole range of objectives underpinning financial stability and managing to meticulously monitor the behavior of each such component covered by the term financial stability. Various options might be considered. One is to include the most important and prime objectives in statute, and then amplifying and interpreting the evolving understanding of what they imply for policy through high-level strategy statements. Another option would be to

define financial stability in terms of preconditions (rather than outcomes) and attempt to achieve such outcomes. A third, would be to decide on the more crucial and systemically important components of financial stability and mandate them in the governance structures.

As regards the role of central banks in assisting growth objectives, some economists will vigorously argue that central banks are capable of supporting economic growth. Those who have price stability as the prime objective will be dreaming of printing more money to buy any amount of assets, including stocks, like what the US FED did and what BOE, ECB and BOJ are still continuing to do. They can even edge interest rates to the negative range and raise their inflation targets thus propelling monetary policy driven growth. Does this mean that the concept of using fiscal policy in economic growth and fine tuning the economy is out of fashion? In the process of reviewing the governance structures, shouldn't governments and central banks rethink the mix up of their mandates, roles and responsibilities? Each agency should decide on the role they are capable of playing and more effectively than others rather than mixing up each one's responsibilities.

It is not practical to construct the building blocks for a "one size fits all governance structure" for central banks across the world. However, if a standard template can be used for the purpose, central banks can modify its components to suit their economies and the political environment. That would provide an opportunity for central banks to act pre-emptively using different components of the governance structure to achieve the desired objectives. The important point is not to wait till the next crisis hits central banks but to start a stock taking of their governance structures. The postponement of reviewing a governance framework, would result in the central banks seeking clarity and legal interpretations or judicial decisions. The debate on the appropriate governance structure for central banks is likely to continue into the future and also be renewed from time to time due to the influence of

global crises and actions by major central banks. Governing laws of central banks are neither sacrosanct nor inflexible. According to Professor H.A. de S. Gunasekera, 'flexibility is the hallmark of good central banking policy. Anything that hinders that flexibility or encourages a rule of thumb attitude to essentially dynamic problems, for that reason is undesirable.''[22] The enormous economic and social costs of the crisis have greatly reinforced the alternative view, that in some circumstances central banks need to act pre-emptively, even when price stability is not at stake. Many central banks have to walk a fine line between maintaining accommodative monetary conditions as long as necessary to support recovery and avoid disinflation, and preventing excessive risk-taking that could subsequently generate macro-financial imbalances. This makes the review of the governance structures of central banks even more imperative.

The evolution of central banking records both happiness and grief. Happiness because central banks have autonomy and a wide array of discretionary powers. Grief, because they have been made subservient to governments, dictating terms to central banks in numerous ways. Amidst frustrations and enormous external and internal challenges, central banks all over the world are struggling to do the right thing. When things are not right, central banks think of other options. One such option is to revert to the currency board system. Some central banks have reverted to currency boards due to the risks central banks are exposed to and the protection they have under the currency board system. However, due to the apparent limitations in the currency board system to adjust to the present complex macroeconomic and political environment, reverting to it may make things much harder for central banks which have enjoyed flexibility and autonomy for many decades. It must also be noted that the well-researched literature on the working

[22] H A de S Gunasekera (1961), Chapter xi, The Beginning of Central Banking, page 264,

of the currency boards systems is limited. The exemplary analysis done by Professor Gunasekera thus stands out as a much sought after piece of research to this date. The wisdom contained therein will continue to alert modern day central bankers. In that sense, Professor Gunasekera still lives in the hearts of professional central bankers throughout the world today and it will be so, in the foreseeable future as well.

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Abbreviations

1. BFIs: Banks and Financial Institutions
2. BIS: Bank for International Settlements
3. BOE: Bank of England
4. BOJ: Bank of Japan
5. BNM: Bank Negara Malaysia
6. BOT: Bank of Thailand
7. BSP: Bangko Sentral Philipinas
8. CBC: Central Bank of Ceylon
9. CBSL: Central Bank of Sri Lanka
10. ECB: European Central Bank
11. LOLR: lender of Last Resort
12. MLA: Monetary Law Act
13. MMPPs: Micro and Macro Prudential Policies
14. NBFIs: Non –Bank Financial Institutions
15. QE: Quantitative Easing
16. RBA: Reserve Bank of Australia
17. The FED: The Federal Reserve Bank