

Financial Stability: Policy Choices for Small Economies

*Mohammed Al-Jafari
Director General
Jordan Deposit Insurance Corporation*

Strengthening Financial Stability- Deposit Insurance Contributions (Rome- Italy 30 Sept. – 1 Oct. 2010)

Financial Stability

Policy Choices for Small Economies: Outline

- The Conventional Framework for Financial Stability

 - Self Regulation and Risk Management

 - Prudential Regulation and Supervision

 - Monetary Policy

 - Deposit Insurance

 - Fiscal Policy

- Consistency of Policy Objectives

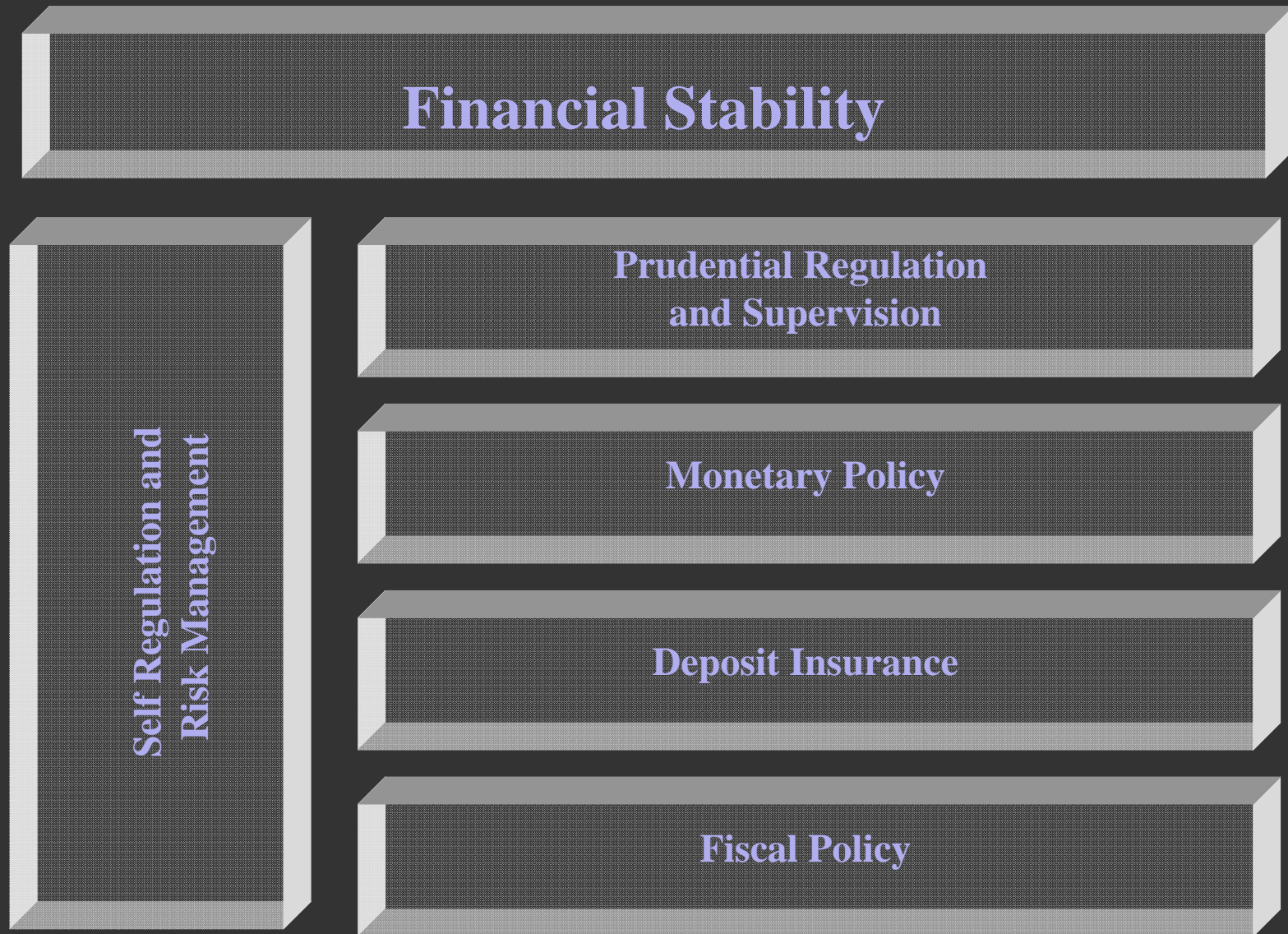
- Policy Choices for Policy Objectives

- Main Features for Small Economies

- Possible Policy Choices

- Conclusion

The Conventional Framework for Financial Stability



Consistency of Policy Objectives

Policy	Primary Policy Objective	Ultimate Objective
Self Regulation and Risk Management	Achieve Sustainable Returns to Shareholders	Financial Stability that Promotes Economic Growth
Prudential Regulation and Supervision	Prevent Distress of Financial Institutions	
Monetary Policy	Maintain Price Stability	
Deposit Insurance	Protect Less Financially Sophisticated Depositors	
Fiscal Policy	Manage Aggregate Demand	

Policy Choices for Policy Objectives

- Each Authority has Several Policy Tools to Achieve its Primary Objective;
- Primary Objective for One Policy could be a Secondary Objective for Other Policy;
- No One Policy Does the Job;
- No One Tool for Single Policy Objective;
- No One Size Fits All;
- Coordination and Harmonization Improve Policy Effectiveness.

Main Features for Small Economies

- Stronger Cyclicality
- Greater Variation in the Length of the Business Cycle
- Higher Variation in Budgetary Revenues
- Venerable Current and Capital Accounts
- Clearer Need for Anchor Currency to Support Exchange Rate Stability
- Greater Role for Cost-Push Inflation

Possible Policy Choices: Self Regulation and Risk Management

Pursuant of High Returns (Unsustainable)



Distorted Incentive Structure



Excessive Leverage and Increased Risk

Credit Risk
Higher Credit to TA Ratio;
Higher Concentrations;
Higher Sensitivity to Business Cycle

Market Risk
Limited Exposure
Less Advanced Risk Management Techniques

Operational Risk
Stringent Internal Control System



Liquidity Risk

Insolvency Risk

Possible Policy Choices: Prudential Regulation and Supervision

Off-site Supervision

Compliance with Banking Regulations and Directives

OR

- Comprehensive Appraisal of Risks
 - Monitoring and Evaluating Safety and Soundness
 - Providing Early Warning of Potential Problems
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On-site Supervision

Compliance with Banking Regulations and Directives

OR

- Risk Assessment
- Assisting Banks in Managing their Risk
- Evaluate Potential Problems Identified by Off-site Examination
- Assessment of the Quality of Assets, Management, Earnings, Capital, and Funds Management, as well as the Bank's Internal Control, Audit, Management Information...etc.

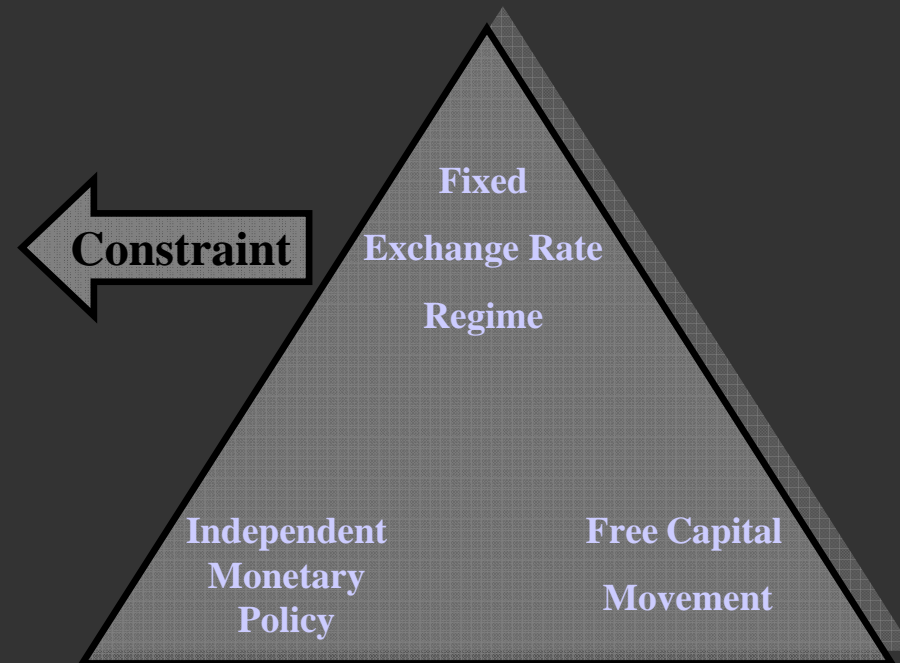
Possible Policy Choices: Monetary Policy

Conventional Role to Play

- Reserve Management;
- Lender of Last Resort;
- Exchange Rate Management;
- Provision and Management of Financial System Infrastructure (e.g.. Payment and Settlement Systems).

Exceptional Policy Tools For Crisis Management

- New Lending Programs
- Open Bank assistance
- Liquidity Support
- Asset Purchase
- Capital Injection
- Troubled Asset Relief
- Supporting Inter-bank Lending



Possible Policy Choices: Deposit Insurance



Possible Policy Choices: Deposit Insurance



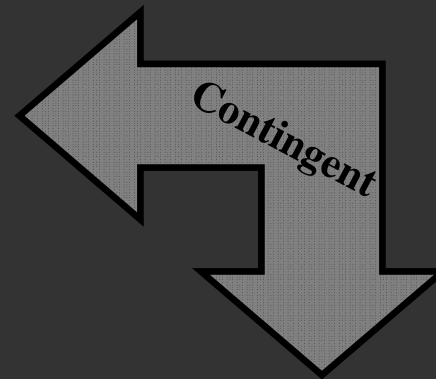
Possible Policy Choices: Fiscal Policy

Basic Function in Promoting Stability for Sustainable Growth

Countercyclical Management of
Aggregate Demand

Essential Role in
Dealing with
Global
Crisis
Economic
Spillover

Critical Role in Supporting
Financial System Stability



Exceptional Fiscal Policy Tools For Crisis Management

- Capital Injection
- Debt Guarantee;
- Asset Purchase;
- Recapitalization Using Public Funds

To Conclude

- Financial Stability is an Essential Prerequisite for Sustainable Growth;
- Risk Management, by Itself, Can't Do It All;
- Regulators Should Ensure the Harmonization among Primary Policy Objective (s) With the Objective of Financial Stability;
- Effectiveness of Policy Tools is Time Sensitive and Country Specific;
- The Achievement of Financial Stability Requires Effective Coordination among All Policy Makers in Charge with: Prudential Regulation and Supervision, Monetary Policy, Deposit Insurance, and Fiscal Policy;
- Prudential Regulation and Supervision Along with Deposit Insurance Must Play Wider Roles in Small Economies, Given the Limitation of Monetary and Fiscal Policies.