



Indranarain Ramlall

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# Central Bank Ratings

## A New Methodology for Global Excellence

*Second Edition*

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*Dedicated to my parents (Leelawtee and Bijayeparsad) and GOD*

## PREFACE

At the time of writing the second edition on central bank ratings, many key changes were noted in the landscape of central banking in the world. First and foremost, once again, central banks around the world were compelled to act as shock absorbers through their balance sheets following the detrimental effects of COVID-19 on the economic activities of various economies in the world. Second, central banks now consider the objective of price stability as being practically on the same footing as that of financial stability, corroborated by the presence of financial stability reports in nearly all economies in the world. Third, and perhaps the most significant change pertains to the aggressive efforts by central banks to come up with their own digital currencies in view of fighting back against private digital currencies such as bitcoins, among others. It is no wonder that the sphere of central banking represents a highly dynamic area with challenges being the normal norm.

In view of converging towards the population number of central banks, more central banks were incorporated for the second edition of the book. It is strongly believed that over time, the full number of central banks will finally be captured in our ratings, as currently, our sample size employed for the ratings is almost close to the total number of central banks in the world.

On a final note, whether it is formally agreed or not, no one can deny the blatant truth that the quality of a central bank does entail significant repercussions on the way economic activities are conducted in an

economy, congruous with the notion that central bank quality can be regarded as a corollary to country risk level. Backtesting exercises carried out do confirm such state of affairs, whether for sovereign ratings or Ease of Doing Business. From that perspective, central bank ratings can be used to assess country risk.

Moka, Mauritius  
January 2022

Indranarain Ramlall  
Associate Professor (Dr.)

# CONTENTS

<b>1</b>	<b>Introduction</b>	<b>1</b>
<b>2</b>	<b>An Overview of Central Banking in the World</b>	<b>11</b>
<b>3</b>	<b>Some Stylized Facts About Central Banks</b>	<b>37</b>
<b>4</b>	<b>Ratings Methodology for Central Banks Worldwide</b>	<b>49</b>
<b>5</b>	<b>Second and Third Division Rated Central Banks</b>	<b>89</b>
<b>6</b>	<b>Results and Discussions</b>	<b>93</b>
<b>7</b>	<b>Backtesting</b>	<b>115</b>
<b>8</b>	<b>Conclusion</b>	<b>123</b>
	<b>Index</b>	<b>129</b>

## LIST OF FIGURES

Fig. 2.1	Monetary policy transmission channels ( <i>Source</i> Author's illustration)	16
Fig. 3.1	End of year reporting of financial statements	39
Fig. 3.2	Continental composition of central banks	40
Fig. 3.3	Risk management reporting of central banks	41
Fig. 3.4	Age composition of central banks—Lower batch	42
Fig. 3.5	Age composition of central banks—Middle batch	43
Fig. 3.6	Age composition of central banks—Higher batch	44
Fig. 3.7	Accounting body for central banks	45
Fig. 6.1	Marks—Upper batch	95
Fig. 6.2	Marks—Middle batch	96
Fig. 6.3	Marks—Lower batch	97
Fig. 7.1	Backtesting based on Ease of Doing Business 2019	117
Fig. 7.2	Backtesting based on Human Development Index 2018	118
Fig. 7.3	Backtesting based on Corruption Perception Index 2018	118
Fig. 7.4	Backtesting based on Sovereign ratings	120

# LIST OF TABLES

Table 2.1	Marks assigned to credit ratings notch	30
Table 4.1	Rating methodologies for banks	51
Table 4.2	Description of credit rating under Morningstar Corporate Credit Rating	54
Table 4.3	Differences between the ECB and the Federal Reserve	55
Table 4.4	Components of pillars under Thomson Reuters	80
Table 4.5	Markings of metrics under ratings methodology	82
Table 5.1	Second division rated central banks (Category B)	90
Table 5.2	Third division rated central banks (Category C)	91
Table 7.1	Ease of Doing Business and CBR	120
Table 7.2	Sovereign ratings and CBR	121
Table 7.3	10-year CDS spreads and CBR	121



# Introduction

## 1.1 INTRODUCTION

The objective of this chapter is to provide the readers with a general historical and functional overview of central banking worldwide. First, the historical background of central banking is discussed. Then, the multi-dimensional tasks of central banks are considered which is then followed by the theoretical underpinnings of monetary policy. The challenges that buffet central banks' activities are also addressed. Finally, the chapter ends by laying out the motivations behind a proper ratings methodology to set the pace for excellence in central banking worldwide.

## 1.2 BRIEF HISTORY OF CENTRAL BANKING

In spite of the fact that central banking constitutes a rather new phenomenon in human history with some four centuries of experience, yet central banks are now deemed as important instruments of stability, spanning from monetary to financial, all-inclusive. Prior to the creation of money, man resorted towards metals such as gold as a means of transaction. Gold exhibited some very nice features such as medium of exchange and store of value. Eventually, these metals were standardized to take the form of coins. With time, paper money was created and central banks played prominent roles in ensuring price stability.

Many different monetary systems came to birth. Under the gold standard, central banks were able to issue money as per the value of gold they held in stock so that less focus was laid on the amount of money required to really boost the economic activities. Emphasis was laid to keep the value of money fixed to gold. Post the end of World War I, many central banks were subject to a dearth in gold stocks leading to a drift towards the gold exchange standard. Under the latter, countries simply pegged their currencies' values to gold. Much to the credit of the famous Economist in the 1950s, John Maynard Keynes, many central banks became aware of their inherent monetary policy power in influencing economic activities. This led towards the adoption of the Bretton Woods system and the collapse of the gold standard. Under the Bretton Woods system, the United States would simply peg the US dollar to gold per ounce and all other countries would then fix the value of their currencies to the US dollar. However, the Bretton Woods system became problematic as countries were not able to support their pegged currencies, all paving the way towards the floating exchange rate regime.

With time, central banks realized that money printing generated more detrimental effects than positive impacts so the rule-based approach (see Taylor, 1993) and (Clarida et al., 1998) in lieu of discretionary-based approach became the new monetary policy development. Monetary policy underwent a new era of development in 1989 when the Reserve Bank of New Zealand pioneered the inflation targeting framework in its monetary policy implementation strategy. The crux of such an approach is that it best helps to anchor inflationary expectations so that credibility is being induced along with transparency and accountability. As new risks spurted out, central banks adjusted their monetary strategies. During the US subprime crisis, some central banks resorted towards non-conventional monetary policies in the form of quantitative easing in view of scaling down the level of financial casualties. Today, modern central banking requires adherence to both monetary and financial stability, as vital ingredients, to spur economic growth.

### 1.3 MULTI-TASKING CENTRAL BANKS

Considered as the forefront actors in financial systems, central banks play preponderant roles when it comes to safeguarding the price stability function. However, with the impacts of globalization, central banks have been subject to constant pressures in view of being more flexible in terms of

multi-tasking or multi-dimensional tasks. Financial systems tend to be either bank-based or market-based (see Demirgüç-Kunt & Levine, 1999). As financial systems became more integrated and sophisticated, central banks were called upon to play more critical roles such as safeguarding the health of the financial system based on their vested powers of monopoly over the issuance of currencies, reserves management and close links with the governments. The most prominent of these tasks relates to the maintenance of financial stability with proper containment of systemic risks. Unfortunately, price stability or financial stability merely constitutes one of the other attributes that characterize a sound and properly functioning central banks. For instance, a central bank may be very successful in these functions but fares badly when it comes to timely and detailed reporting of its financial statements. These financial statements are particularly vital to gauge the transparency and sound corporate governance status of a central bank (see Ingves, 2011). The objective of this book is to construct a complete set of metrics to assess all the intricate activities of central banks in the world. In essence, a unique and innovative global central banking ratings system is developed. The ratings system can be used by international authorities to leverage the quality of central bank activities in the world and thereby establish a benchmark for comparative analyses.

#### 1.4 THEORETICAL UNDERPINNINGS OF MONETARY POLICY

The most basic foundation of monetary policy relates to the quantity theory of money as captured by Fisher's (1911) equation of exchange where the product of the quantity of money and velocity in circulation is tantamount to the product of price level and the level of output generated. It is assumed that the level of output and the velocity of circulation are constants so that any rise in the quantity of money translates into an increasing price level in the long run. However, in the short run, monetary policy can be used to stimulate economic activities and scale down unemployment but at the expense of inciting higher inflation. Such a phenomenon became captured by the Phillips curve which essentially depicts an inverse relationship that subsists between unemployment and inflation. The basic intuition behind the Phillips curve relates to the ability of central banks to decide about the inflation level and then let the corresponding level of unemployment prevail. In the long run, such an inverse relationship evaporates as unemployment is stuck at