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Assigning Financial Stability Role to Central Banks: The Case of Bank of Sierra Leone

Mamoud Abdul Jalloh

Research and Statistics Department, Bank of Sierra Leone, Freetown, Sierra Leone

Email address:
abdulmoud99@gmail.com, mjalloh@bsl.gov.sl

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Abstract: After the great financial crisis of 2007/8 and its contagious effects on economies across the world, many countries including Sierra Leone began focusing more attention on their financial systems stability. The key question for policy makers was which institution could be best assigned the financial stability role, given the current institutional arrangement? This paper attempts to present a clear case on why the Bank of Sierra Leone was best suited for financial stability role as enshrined in the Bank of Sierra Leone Act 2019 and the level of framework necessary for the effective execution of this new objective. In addition, Calvo *et al* (2018) revealed that of the jurisdictions surveyed, 78 percent allocated financial stability responsibility solely to their central banks, and increasing number of jurisdictions have dedicated inter-agency committee in which the central bank plays an important role. Interestingly, for the case of the West African Monetary Zone (WAMZ) region, the central banks are solely responsible for financial stability and prudential guidelines. From the analysis, we also discovered that while the current institutional arrangement may not be sufficiently adequate for sound financial stability implementation, the process of developing a strong financial stability framework was at an advanced stage. The study thus concludes that assigning this role to the Bank of Sierra Leone was the right move as it was already charged with banks' prudential guidelines and no other institution in Sierra Leone was better placed for it. The study therefore recommends the need for more financial sector reforms to mitigate risks emanating from financial imbalances and destabilising interaction among various key markets, payment and financial institutions.

Keywords: Financial Stability, Macro Prudential, Framework, Monetary Policy, Financial Crisis

1. Introduction

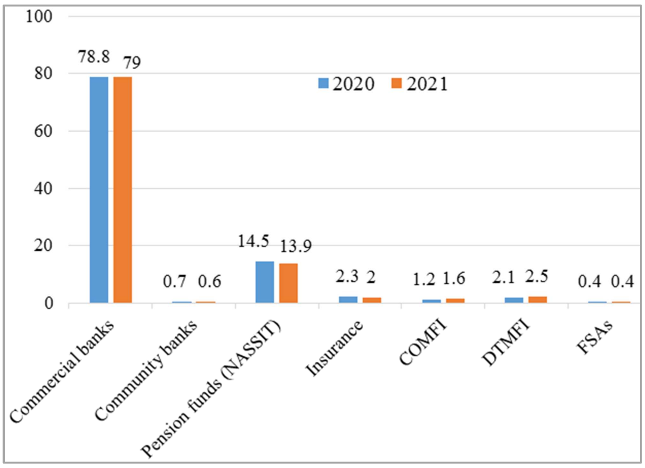
Before the 2007/08 Great Financial Crisis (GFC), the dominant orthodoxy was that central banks should be one-objective one instrument institutions (focus on price stability and with short-term interest as the only instrument) and financial system stability was best kept outside the central banks realm [1]. There was a call for a global financial stability framework, and a greater recognition of synergies between the central banks being entrusted with monetary policy as well as financial regulation. Accordingly, the central banks' institutional architecture was re-designed across the world.

However, financial stability as a key objective of Central banks in most countries including the US and UK predates price stability [2]. But upon the collapse of the gold standard, price stability became the dominant policy stance for most central banks. As a result, development of the framework for financial stability was neglected, remained vague and where some resemblance existed, it was not properly structured. Also, efforts to develop sound instruments to detect and mitigate its causes was relegated. In addition, the institutional design and arrangements for the financial sector oversight for policy makers was contentious [3].

Therefore, the key challenge faced by policy makers was which institution (s) was or should be responsible for the stability of the entire financial system. Consequently, there was a sharp call for the monitoring and supervision of the broader financial system and not just the banking sector as was traditionally done. More than ever, there was demand for the handling of this responsibility to a single agency or department so as to ensure coordinated and smooth macro-financial policies and linkages. But when a specific policy instrument can significantly influence more than one objective, the case of assigning each of those objectives to a different agency weakens [3]. In the case of Sierra Leone, section 5 of the Bank of Sierra Leone Act 2019 provides that the Bank of Sierra Leone (BSL or the bank) must, among other functions, contribute to fostering and maintaining a stable financial system [4].

Although the BSL Act did not define financial stability and its various tenets, financial stability could be a condition of optimal saving-investment plan of an economy deriving from perfections in the financial sector [2]. Accordingly, a sound financial stability framework has three (3) key components, namely individual financial institutions supervision; payments, settlement and other market infrastructure oversight and lastly proper monitoring of financial markets functioning [5].

Figure 1 shows that as of December 2021 the banking sector accounts for 79 percent of the entire financial system assets, and it implies that any banking crisis will have a ripple effect on the whole financial system. The closest contributor, pension funds accounted for 12 percent of total financial sector assets whilst the rest accounted for 7 percent. Out of the 14 commercial banks, only 4 are local owned (2 state-owned, 2 domestic privately-owned) and 10 are foreign-owned, mainly from Nigeria. As the banking sector continues to expand, there is need to increase the surveillance on financial systems vulnerabilities across the world, especially in Nigeria.



Source: BSL, NASSIT and SLICOM (2022)

Figure 1. *Share of Sierra Leone Financial System Assets by Sector (%).*

It is worth noting that while in other countries banking crisis may be a limited view or special case of financial instability, in the case of Sierra Leone a systemic banking crisis could be a severe disturbance to the intermediated saving-investment nexus. How effectively would the Bank of Sierra Leone play this role given its current institutional and legal environment and on how best the various tenets of financial stability framework can be implemented are also examined. The possible spillover (negative) effects of monetary policy instruments on the financial sector makes this decision well in place in Sierra Leone and ensures that well tested instruments implemented in the banking sector could be extended to other non-bank financial sectors. It is advised however that there is no one cap-fit-it-all solution as the various sectors are in varying life cycles; for example, whilst insurance and capital market need takeoff, banks are well developed.

While drawing lessons from across the world, we assess why the responsibility for financial stability has been formally added to the Bank of Sierra Leone (BSL) key objectives via BSL Act 2019. An effective framework for ensuring stability in the financial system should consider multiple factors, including the influence of business models, products, and operations, as well as the potential risks associated with a lack of transparency, credit expansion, high debt levels, trading in risky securities, low capital ratios, poor underwriting practices, and a shift towards the "originate and distribute" banking model. Additionally, some studies suggest that the overall regulatory framework if not properly structured may contribute to the instability of banks during financial crisis, particularly through deregulation, regulatory arbitrage, and an overreliance on credit rating agencies and self-regulation [6-8].

The rest of the paper is divided as follows. Section 2 discusses the changes in recent institutional arrangements for sound financial stability. We also show how the current set up in Bank of Sierra Leone maybe sufficient or deficient for the proper delivery of the financial stability mandate. Whether instruments of monetary policy are complimentary or conflicting to financial stability is presented in Section 3. Section 4 concludes with some policy recommendations.

2. Institutional Arrangements for Financial Stability

In this section, we examine the institutional arrangements for sound financial stability across the world, including the West African Monetary Zone (WAMZ) and as well as in Sierra Leone.

2.1. Development in Institutional Arrangements Across the World

With the collapse of Lehman Brothers in October 2008, the G-20 Leaders at their Washington Summit (November 15, 2008) agreed on a broader policy response based on closer macroeconomic cooperation to restore growth, avoid negative spillovers, and support emerging market economies and developing countries. Thereafter, four working groups were formed and tasked with objectives of enhancing sound regulation and transparency; reinforcing international financial cooperation and thus, promoting integrity in the financial markets; reforming the International Monetary Fund; and finally reforming the World Bank and other multilateral development banks.

These initiatives led to significant strengthening of financial sector regulations and the regulatory architecture, including the establishment of the Financial Stability Board (FSB) in April 2009. The FSB coordinates the work of national financial authorities and international standard setting bodies in order to develop and promote the implementation of effective regulatory, supervisory and other financial sector policies. In addition, at the Pittsburgh Summit (September 2009), the G-20 Leaders also pledged to work together to ensure a lasting recovery and strong and sustainable growth over the medium term.

On financial oversight, Table 1 reveals the evolution of primary prudential roles for banks in 82 jurisdictions [9]. Based on Table 1, central banks are the main supervisory authority in most countries. However, even after the GFC, there were only 7 institutional reforms in the transfer of this responsibility to the central banks. The purposes of the reforms were to mitigate risks emanating from financial imbalances and destabilizing interaction among markets and financial intermediaries, especially banks. Moreover, macro prudential guidelines may affect financial and economic factors thereby impacting financial systems resilience and general consumer prices.

Thus, a sound financial stability framework should incorporate political, economic, financial, and country risks that have negative and significant effects on bank stability, with a stronger emphasis on observed impacts among highly unstable banks. Drawing from data on over 500 banks across 21 developed and 18 emerging countries from 2009 to 2018, the study reveals that bank stability was surprisingly more pronounced in emerging countries compared to developed countries [10]. Overall, the findings suggest that country risk will remain an essential factor in explaining variations in bank stability, particularly in emerging economies.

Table 1. *Allocation of financial/prudential functions across the world.*

From \ To		Current		
		Central bank	**Separate supervisory agency**	**Total pre-GFC**
Pre-GFC	Central bank	48	1	49
	Separate supervisory agency	5	27	32
	Government department	1	0	1
	Total current	54	28	82
		Total Changes	7	

Note: changes are highighted/shaded
Source: Calvo et al. (2018)

2.2. Development in Institutional Arrangements in West African Monetary Zone (WAMZ)

In the West African Monetary Zone (WAMZ), the allocation of financial stability and prudential responsibilities are to their respective central banks. However, over 10 years ago the duty of maintaining financial systems stability was covertly performed by the central banks and it made enforcement of breach of the micro and macro prudential guidelines difficult. The GFC turned the tide of time and now all the central banks are legally mandated and are monitoring their financial systems at both local level and at regional level through college of Supervisors of the West African Monetary Zone (CSWAMZ). However, Table 2 also shows that all except Nigeria and Ghana have no operational capital markets or stock exchanges, and this may affect the raising of large capital by companies and governments.

Table 2. *Allocation of financial/prudential functions in WAMZ.*

Country	Financial Stability/Macroprudential Functions	Capital Market Functions
The Gambia	Central Bank	No
Ghana	Central Bank	Yes
Guinea	Central Bank	No
Liberia	Central Bank	No
Nigeria	Central Bank	Yes
Sierra Leone	Central Bank	No

Source: West African Monetary Institute (2021).

Like in most regions, the banking sector is the dominant force in the financial system across the WAMZ. The total number of operational banking institutions in the WAMZ rose from 104 in 2020 to 106 in 2021, which was attributed to the licensing of two domestic banks by the Central Bank of Nigeria. The number of banks increased to 32 in Nigeria and 18 in Guinea but remained unchanged in The Gambia (12), Ghana (23), Liberia (9), and Sierra Leone (14). The number of foreign-controlled banks operating in the Zone stood at 62 for three consecutive years. The foreign-controlled banks represented 75 percent, 60.9 percent, 88.9 percent, 15.62 percent, and 71.4 percent of the total number of banks in The Gambia, Ghana, Liberia, Nigeria, and Sierra Leone, respectively. All the banks operating in Guinea were foreign controlled. By size, measured by asset size, the assets of foreign banks in The Gambia, Ghana, Liberia, Nigeria, and Sierra Leone accounted for 72.29 percent, 59.70 percent, 85.51 percent, 13.00 percent, and 60.2 percent of the respective country's total banking assets.

At the end of December 2021, the banks in the WAMZ had a total of 6,227 branches and 19,815 ATMs, which represented an increase of 7.20% and 3.13% respectively from 2020. Nigeria accounted for the majority of branches and ATMs at 4,555 and 19,399, respectively. The number of bank branches increased by 2 in The Gambia, 41 in Ghana, 7 in Guinea, 2 in Liberia, and 398 in Nigeria, while Sierra Leone remained unchanged at 120 bank branches. The Gambia had 88 bank branches and 128 ATMs, Guinea had 191 branches and 199 ATMs, Liberia had 87 branches and 89 ATMs, and Ghana had 1,118 branches and 2,278 ATMs. Despite the positive developments in digital banking and payment systems, access to banking services remained relatively low in the Zone.

In terms of concentration, as shown in Table 3 banking sectors of WAMZ Member States were concentrated as the top-5 banks' average asset size constituted 64.6% of the total bank assets of the Zone. The Herfindahl-Hirschman Index (HHI), which shows the degree of concentration of banking assets, was 613 points in Ghana, 1,579 points in Liberia, 841 in Nigeria, and 1,022 in Sierra Leone as of the end of December 2021. Based on this index, the concentration of assets was relatively low in Ghana and Nigeria and moderate in Liberia and Sierra Leone.

As of December 31, 2021, the sector was generally safe and sound in 2021 due to the regulatory interventions undertaken by the Member States and the waning impact of the COVID-19 pandemic. Member States had begun resetting to their pre-pandemic regulatory regimes following full resumption of economic activities. Key financial soundness indicators such as capital adequacy ratio, assets quality ratio, liquidity ratio, and profitability indices were generally satisfactory and within regulatory benchmarks in the WAMZ. However, credit, operational, cyber, and global rising interest risks remained key supervisory concerns [11].

Table 3. *Banking Sector Concentration indices in WAMZ.*

Countries	Top-5 Banks	HHI
The Gambia	71.73	-
Ghana	44.26	613.56
Guinea	63.41	-
Liberia	85.13	1579.00
Nigeria	57.31	841.12
Sierra Leone	65.46	1052.84
WAMZ	64.55	1021.63

Source: West African Monetary Institute (2021).

2.3. Development in Institutional Arrangements in Sierra Leone

In the case of Sierra Leone, macro and micro prudential responsibilities have always been the BSL mandate and taking on additional but complementary function of overall financial stability was no less a difficult task. The financial system in Sierra Leone operates under a liberalized framework, where market forces determine interest rates and exchange rates. Selective credit controls are absent, and although the largest commercial bank is state-owned, the government does not dominate the banking system's operations.

Following the enactment of the BSL Act 2019, the Bank reorganized its structure and operations to better achieve it new added objective of financial system stability. As a first step, His Excellency the President, Julius Maada Bio on 3rd August 2020 appointed a second Deputy Governor in charge of Financial Stability. Section 14 (2c) of the BSL 2019 Act established a Financial Policy Committee which advises on all policy issues relating to financial stability, micro and macro prudential supervision and resolution and financial market infrastructures. In retrospect the Bank in 2018 also established the Financial Stability Department to handle all financial system stability responsibilities. As part of its core mandate, the department supervises key financial sector indicators and annually produces the Financial Stability Reports which show thorough assessment of the financial system with greater emphasis on the banking sector.

In addition, the Bank in December 2021, restructured its Research Department into Monetary Policy Department (MPD) and Research and Statistics Department (RSD) and thereafter completely re-organised the entire policy and operational activities into Monetary Stability and Financial Stability spectrums to enhance proper supervision and monitoring by the two (2) Deputy Governors. In the RSD, a new section in charge of financial stability research to undertake sound and quality research on financial stability was also created in January 2022.

The Bank also issues prudential guidelines regularly to ensure that the financial system is well position to absorb any shocks and spills over from the international financial system. The latest Revised Prudential Guidelines for Commercial Banks 2022 is elaborate and exhaustive as it touches on all key elements of financial stability such as capital, assets and loss provisioning, liquidity and interest rate risks, lending, foreign exchange, publication of financial statements to enhanced corporate governance and transparency. Among its key highlights are banks are encouraged to always hold statutory reserve funds of not less than 50% of their paid-up capital. Consequently, no bank shall be allowed to appropriate any amount from its statutory reserve fund to any other source if such amount is less than 50% of its paid-up capital. Banks are also required to increase their capital base over the next three (3) years starting 2020 to 85 million New Leones. Also, the guideline requires complete implementation of International Financial Reporting Standard 9 (IFRS9) on income recognition, asset classification and provisioning.

Furthermore, the bank is in the process of adopting the Basel III accord by the Basel Committee on Banking Supervision. The challenges, however, remain as pointed out by [12]. First, there is a need for intensive training on Basel III for Banks' risk management and compliance staff and Board of Directors. Second, meeting all the minimum capital levels as well as capital quality to boost their resilience and by extension safeguard financial system stability will be a challenge. Third, the Government is yet to enact new laws or regulations to establish new institutions as deemed expedient by the bank to support the banking system in Basel III era. More so, a crisis management plan and emergency liquidity crisis measures should be put in place to rescue the financial system. Final and most importantly, the bank needs to develop a new national macro-prudential policy framework, thereby adapting it to specificities of Sierra Leone banking system.

Another challenge as highlighted by [13] is inactive stock exchange as countries with larger banks and active stock markets tend to experience faster economic growth in the long term, even after accounting for other factors that contribute to economic growth. Industries and businesses that rely on external financing tend to grow more quickly in countries with well-established banks and securities markets compared to those with underdeveloped financial systems [14]. Developing a sound financial stability framework should therefore incorporate among other things the structural problems of the financial system such as underdeveloped and inefficient short-term credit, medium and long-term credit, foreign exchange; the low innovation system, human capital, financial literacy of the population, infrastructure, public services, and other factors such as microeconomic incentives for enterprises (such as openness, taxation, administrative barriers, and the legal environment) as well as overall governance (including macroeconomic policies and socio-economic indicators).

3. Complementarities Between Monetary Stability and Financial Stability

The debate on whether central banks should take on financial stability responsibility, in addition to price stability functions, revolved around their conflicting or complementarities relationships and distribution of power between different agencies and government [3]. Although not explicitly stated before, central banks mandate of price stability has always embodied financial stability. For example, up to the 2000s sufficient assurance had to be provided to deposit taking institutions to avoid exchange rates differential among banks and preserve monetary system stability. In addition, as commercial banks became central banks counterparts and traded a large money stock, the need arose for central banks to monitor their solvency [3]. In fact, the Federal Reserve Act 1913 establishing the Federal Reserve System (FRS) as the central bank of the United States provides that FRS should ensure a safer, more flexible, and more stable monetary and financial system.

Therefore, the argument that allocating monetary and financial stability to the same agency or central banks shows lack of historical obliviousness by many policy commentators. [15] stressed that financial stability and price stability do not conflict with each other and on the contrary, they actually complement each other. However, this does not mean that they could never conflict with each other. For example, maintaining a very high financial stability could often affect credit expansion and thereby impacting price stability through low employment. Similarly, during the Great Moderation before the GFC, consumer prices remained broadly stable, but asset valuations were over-stretched or excessive credit growth loom thereby threatening financial stability [5]. In this situation, central banks may raise rates to mainly ensure price stability. Consequently, at prevailing high inflation rates in the world due to Russia invasion of Ukraine and Post Covid 19 pandemic, central banks including BSL have been gradually raising interest rates to calibrate inflation back to its target level and have led to slow credit growth.

However, even if central banks are required to adhere to a narrowly defined price stability mandate and delegate financial stability responsibilities to a separate authority, there is no guarantee of achieving a better social outcome. According to Cao, J and L Cholletec [16], the non-cooperative equilibrium is likely to be socially sub-optimal in more game-theoretical terms. Drawing from the policy responses to Covid-19, there appears to be a strong case for assigning the financial stability objective to the BSL. Moreover, the BSL has already successfully administered both macro and micro prudential guidelines, and any deviation could result in duplicative policy implementations.

Moreover, conventional monetary policy tools have a direct impact on credit dynamics, asset valuations, and bank profitability, thereby influencing the potential for financial stability. Similarly, macro-prudential tools such as credit or capital constraints have a direct effect on financial conditions, which can then influence investment and consumption decisions, hence affecting the possibility for macroeconomic stability. Lastly, the recent policy responses adopted globally suggest that price stability can be achieved without negatively affecting financial stability. As in the case of other central banks, the BSL employed measures like the Special Credit Facility to bolster the agricultural sector and the direct sale of foreign currency to Oil Marketing Companies and importers of essential commodities.

While we may argue that the current institutional arrangement may not be sufficiently suited for sound financial stability, the bank is in the advanced stage of the implementation of Basel II and enactment of other enabling legal and structural frameworks such as Deposit Protection Scheme, Sierra Leone Collateral Registry, and development in the IFRS Implementation (IFRS 9 and 16), among others. Furthermore, to mitigate risks in the payments, clearing and settlement systems, a national switch system is expected to be implemented in early 2023. When completed and fully operationalized, it ensures efficient migration from the traditional cash to digital mode of payments. In the region, the West African Monetary Zone (WAMZ) Payments System and the Pan African Payments and Settlements System (PAPSS) are expected to drive cross border payments and settlements in the WAMZ through national currencies. As well, the Unique Bank Identity (UBI) Project and cyber security guideline will lead to more stable financial system by protecting customers of banks, enhancing credit expansion and promote social welfare benefits to Sierra Leoneans. Finally, there is urgent need for banks to transition to Basel three Capital Framework which is forward looking and shore up the stability of the banking sector and makes provisions for risks that will emanate in the banking realms of Sierra Leone [17].

4. Conclusion

This paper presents reasonable evidence for assigning the financial stability function to the BSL. It also expresses the view that allocating monetary and financial stability objectives to one agency is socially optimal and political economic considerations are well in place. Although financial stability predates price stability as a key objective of Central banks in most countries it was not until the GFC that many countries in the world including Sierra Leone considered it a pivotal objective. In many jurisdictions including Sierra Leone, this responsibility was assigned to their central banks. In the case of BSL, development of the necessary frameworks is at an advanced stage, but there is a call for broader surveillance of the financial sector, not just the banking sector as it is traditionally done.

Financial stability framework should incorporate three key components, namely: supervision of individual financial institutions, oversight of payment and settlement systems and other key market infrastructures and monitoring of the functioning of financial markets. The Bank should also increase the financial system's corporate governance and transparency and strengthened consumer protection and take a more comprehensive view of financial stability. It is worth noting that whether overtly or covertly, central banks have a major voice in financial stability policy which is closely linked with monetary policy, and they are naturally the official institutions closest to financial markets. Nevertheless, responsibility for financial stability will almost always be shared with other bodies [18].

Declarations

The views expressed here are solely that of the Author and do not represent the institution he works. No funding was received for this research work.

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