CHALLENGES IN EFFECTIVE IMPLEMENTATION OF CENTRAL BANK'S MONETARY AND FINANCIAL STABILITY POLICY IN EMERGING MARKET ECONOMIES

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BACKGROUND

- Emerging market economies (EMEs) – key drivers of global growth and economic dynamism.
- Growingly integrated into the global economy through trade, investment & finance.
- Spill over effects, volatile capital flows, and turbulences in advanced economies posing difficult challenges in designing monetary and financial policies.
- Many EMEs still have less developed financial instruments, markets and institutions, lower central bank independence, shadow banking system, and weak coordination among regulators.
- Structural and institutional issues make conduct of monetary and financial policies in EMEs more challenging.

RETHINKING CENTRAL BANKING FUNCTIONS

- Weakening money- price relation, recurring financial crises, & new roles of central banks resetting objective(s) of monetary policy.
- General recognition - primary role of central bank is price stability; rationale - best way to promote growth & employment is by keeping inflation low.
- Current practice - financial stability a more prominent objective of central banks
- With no direct monetary mechanism to maintain financial stability - dilemma on adopting monetary policy for financial stability objective.
- Financial inclusion, financial safety net, output & employment emerging issues for central banks after financial crisis.

RETHINKING CENTRAL BANKING FUNCTIONS..

- Why financial stability the concern of central banks?
  - Occurrence of macroeconomic and financial crisis destabilizes the domestic economy.
  - Financial crisis breaks down channels of monetary transmission to real economy through the balance sheet (of HH, corporate, banks) effects.
  - With any crisis ,initial use of monetary policy has been for stabilization purposes
- Monetary Policy (MP) based on the four-stage monetary framework: instruments - operating targets - intermediate targets - ultimate targets impeded by bubbles in financial and real assets market.
- MP framework has an implicit assumption that financial system is working well; but it is not the case also because of lax in MP.

CONCERNS OVER FINANCIAL SYSTEM

- Until few years ago, major concern of MP authority around the world was to ensure monetary stability (i.e. price stability).
- Global crisis (with financial instability) resulted in adjustment of assumption regarding the financial system
- Now activities for having financial stability felt important & has to go hand in hand with the objective of monetary stability.
- Complex set of policy challenges which also have domestic cross border banking, financial, and economic implications.
- Relatively underdeveloped financial instruments, markets and institutions EMEs.
- Financial globalization multiplying transmission channels - external factors influence domestic policy environment; synchronization of business cycles & faster transmission of shocks (price, output, exchange rate, etc).

CHALLENGES TO MONETARY & FINANCIAL STABILITY POLICY IMPLEMENTATION

- **Strong & volatile capital flows pose unusual challenges to central banks…**
  - **Large shift of global economic activity towards EMEs together with easy monetary policy in advanced economies causing huge capital inflows; difficult to distinguish transitory from structural changes in such flows.**
- **More open capital account create difficulty to insulate monetary policy from external influences…**
  - **Despite de jure capital controls, financial flows finding their ways around those controls; open capital account making it harder to maintain independent monetary policy when central bank is also trying to manage exchange rate.**
- **Volatile food, energy & other commodity prices creating challenges to manage inflationary expectations…**
  - **A naive and simplistic way of targeting only core component of price index and letting prices of food & energy prices to adjust to market conditions is not creditworthy.**

CHALLENGES TO MONETARY & FINANCIAL STABILITY POLICY IMPLEMENTATION..

- **Targeting core inflation politically unacceptable...**
  - Expenditures on food a large proportion of consumption expenditures; so difficult for central banks to let food prices to market conditions.
- **Central banks also face a number of technical challenges in inflation targeting…**
  - Central banks need technical capacity to model economy, understand transmission mechanism and forecast inflation & output; structural changes in the economy make past a less reliable guide to the future.
- **Asset price booms along with currency appreciation have threatened financial stability…**
  - Dealing with asset price bubbles through monetary policy debated issue; central banks expected to control those prices but low consumer price do not prevent asset price bubble and financial instability.

CHALLENGES TO MONETARY & FINANCIAL STABILITY POLICY IMPLEMENTATION..

- Fiscal dominance is a challenge for the conduct of monetary policy…
  - In many EMEs, long term fiscal discipline lacking & monetary policy often adjunct to fiscal policy; an unsustainable fiscal policy acts as a severe constraint on monetary policy - as government debt management objective may conflict with price stability objective.
- Exchange rates are volatile and monetary policy is often in dilemma or trilemma…
  - Most EMEs enjoy export-led growth; so their worries on exchange rate appreciation justified; measures taken to sustain real exchange rate often conflict with price stability objective.
- Other institutional rigidities also impede functioning of monetary policy…
  - Inflexible labor markets can lead to substantial inflation persistence, which again makes it harder for monetary policy to reliably manage economic activity; wage indexation also create wage –price spiral.

CHALLENGES TO MONETARY & FINANCIAL STABILITY POLICY IMPLEMENTATION..

- The new trilemma: price stability, sovereign debt sustainability and financial stability
- Inflation targeting enabling to maintain low rate of inflation; but intensive focus on single objective lead to build-up space for financial instability due to emergence of a shadow banking.
- Sovereign debt threat a direct fallout of response of policy authorities - both monetary and fiscal - to infuse massive liquidity to prop up consumption and output.
- Banks holding of large share of sovereign debt contribute to increased vulnerability of banks.
- Constellation of outcomes - emergence of new trilemma of price stability, financial stability and sovereign debt sustainability.

IMPLEMENTATION ISSUES

- **Implementing monetary and financial stability in emerging markets is complex.**
  - **Emerging markets are generally characterized as having (i) relatively less external integration and (ii) embryonic financial sector**
- **Emerging economies are relatively less open to flows of capital.**
  - **Still indirect capital flows occur from different channels**
- **Emerging economies have shallow markets and are characterized by underdeveloped financial sectors with a gap in meeting credit demand.**
  - **Informal credit markets interface with formal markets.**
  - **Shadow banking activities spill over to formal financial system if there is high financial transaction between the two.**

IMPLEMENTATION ISSUES..

- ‘Shadow banking’ broadly described as credit intermediation involving entities outside regular banking system..
  - potential source of systemic risk, especially when it is structured to perform bank-like functions and risk to financial and monetary stability.
- Interconnectedness of formal financial system and shadow banking exacerbate pro-cyclicality
  - Also has a bi-directional feedback to the financial sector – which affects financial stability.
- Emerging economies are also characterized by presence of currency substitution.
  - This threats stability of money demand, prudent monetary management and financial stability.

IMPLEMENTATION ISSUES..

- Key issues: (i) does monetary policy continue to impact real economy directly or through the financial system? (ii) is single monetary policy objective still valid amid complex fin. system.
- Cost of capital determined by monetary policy stance a key to demand for investment & real output; but less effective amid extensive non-banking services.
- Strong financial market infrastructure with prudential regulatory framework critical to strengthen monetary transmission through credit channel.
- Credit conditions a conduit through which financial conditions affect real output; and, only stable financial market condition can ensure uninterrupted credit flows to achieve targeted economic growth.

IMPLEMENTATION ISSUES..

- Independence of central bank key to effective implementation of MP…
  - Irrespective of statutory independence, operational independence often circumscribed by constraints such as exchange rate objective - limits central bank's use of policy instruments such as interest rate to pursue independent domestic monetary policy aimed at managing domestic activity and inflation.
- MP often hampered by weak transmission mechanism due to under-development of financial system…
  - Fragile banking system delimits aggressive use of policy rates to achieve domestic objectives, large changes in interest rates potentially devastate balance sheets of weak banks; underdeveloped financial markets means less effective interest rate channel of MP transmission.
- Monetary impulses also transmitted through asset (real estate and stocks) price channel
  - Fluctuations in asset prices prompted by monetary policy impulses impacts real economy

IMPLEMENTATION ISSUES..

- Capital flows threat monetary targets when space for sterilization of the flow is limited …
  - need to use all macroeconomic policies - including monetary, fiscal and exchange policies together to ensure domestic monetary stability; macro-prudential measures as 2nd line of defense; capital controls as last resort & as short-term palliatives.
- Open capital account makes much harder to carry an independent monetary policy when central bank is also trying to manage exchange rate..
  - MP falls in dilema when open capital account and target level of exchange rate have to go together with inflation targets

IMPLEMENTATION ISSUES..

- Lack of full integration of financial markets within emerging markets has led to asymmetrical responses to MP leading more long and variable lags in effects of MP on economic activity.
- Increased cross-border financial flow has weakened influence of domestic MP over domestic interest rates leading to weak transmission mechanism.
- Increasing trend on transactions of derivative products not only for hedging but also for speculation and financial innovations also weaken the traditional monetary transmission mechanism.
- Volatility in fuel prices in international market & resulting adjustment in domestic fuel prices create difficulties in policy objective of price stability.

IMPLEMENTATION ISSUES..

- Unsustainable fiscal policy - central banks have to meet debt management objectives in setting interest rates, than focusing exclusively on price stability.
- Complementing with macro prudential policies - as many EMEs are adopting macro prudential measures, coordination of monetary and macro prudential policies has become increasingly important.
- Communication strategy - central banks must properly communicate what their role is, what they are doing, why they are doing so, and how it complements to broader policy framework.

CONCLUDING OBSERVATIONS

- At present context, understanding monetary transmission mechanism & its linkage to both real & financial sectors very crucial - critical for central bankers to assess the nature of linkages & speed of transmission.
- Recent financial crisis showing linkages between financial & real economic variables; central bankers facing policy challenges when financial development seemingly matters monetary policy targets.
- Growing financial sophistication, cross border financial integration, and existence of shadow banking, particularly in low income economies, magnifying complexities in analyzing the extent of macro-financial linkages.
- We central bankers, therefore, need to calibrate our policy responses to macroeconomic developments.

CONCLUDING OBSERVATIONS

- Monetary policy does not operate in a vacuum, its environment is important.
- No single approach to monetary framework – conditioned by country context.
- Sovereign debt a set back to monetary policy credibility; prudent debt management is an essential complement to sound macroeconomic policies.
- Macro-prudential policies emerging as complement to monetary policy but a logical and rule based approach yet to develop.
- Central Banks should not ignore financial stability, despite focus on price stability.
- Global inter-linkages warrant coordinated efforts to maintain financial stability

Thank you very much