Macroeconomic Environment and Financial Sector Stability: Vulnerability and Managing Crises

Comments by Dr. Yuba Raj Khatiwada, Governor, Nepal Rastra Bank on key note speech delivered by Dr. Atiur Rahman, Governor of Bangladesh Bank, at the 29th SEANZA Governors' Symposium organized by Bangladesh Bank, Dhaka, 30 August 2014

1. Thanks for giving the opportunity to comment on Dr. Rahman's key note speech. There are not many specific comments to be made in the presentation. I would like to add a few complementary issues amongst the august gathering which could perhaps add value to further discussion on the theme.

2. The first point I want to raise is whether macroeoconomic stability necessarily ensures financial stability. I would argue that macroeconomic stability is a necessary, but not sufficient, condition for financial stability. One reason for this is that the achievement of price stability may have been associated with an increased risk of financial instability; as financial imbalances may build up even in an environment of stable prices. It is argued that low and stable inflation may even foster asset price bubbles, due mainly to increased incentives to take on more risk. And thus, price stability may not be a sufficient condition for financial stability. Similarly stable exchange rate or fiscal balance may not necessarily prevent bubles or over-leveraging in the financial system. So we can argue that macroeconomic stability is a necessary but not a sufficient condition for financial stability.

3. The second point I want to raise is the financial structure under which we are talking financial stability. In most Asian countries, public sector owns a large number of banks and financial institutions. As representative of the capital ownership, bureaucrats sit in the board of the business entities like banks and it entails a big challenge to efficient and effective business decisions. Also effective enforcement of regulations becomes a challenge in the presence of such public sector financial institutions.

4. The third point I want to raise is on the regulatory and supervisory regime. Fortunately, in most Asian countries, central banks have been working as both the monetary and supervisory authorities. This

has enabled the central bank to finetune monetary and macroprudential policies so that both monetary and financial stability could be achieved. In some countries where a separate bank regulatory and supervisory institution exists, there is a need for better coordination between monetary and supervisory authorities to bring in complementarities between monetary and financial policies which ensure stability. In the absence of such a cordination, if two authorities attempt to protect respective territory only, conflict between monetary and financial stability can not be ruled out.

5. The fourth point I want to mention is about central bank independence and governance challenges. If the central bank doesnot have free hands to formulate monetary and financial policies, issue regulations, and enforce them, and if central banks have to succumb to political pressure, then financial market would try to get political protection to misdeeds resulting in regulatory and supervisory forbearances. This may lead to weak governance and financial system fragility even in an environment of macroeconomic stability.

6. The fifth point I want to put forth is financial inclusion and financial stability. Financial inclusion requires some interventions which may not be market based. Also inclusion might have a trade off with efficiency. Despite this, financial inclusion has to be taken as a complement to financial stability as it enhances sustainability and widens the base of financial services. Most financial crises have taken place due to failure of big institutions rather than the micro finance institutions. As such microfinance institutions working towards financial inclusion have better survived during financial crisis. This implies that financial inclusion has to be taken not only as a corporate social and environmental responsibility, but also as an instrument to safeguard financial stability and protect the financial system from financial vulnerability.

7. As the global economy is in the process of recovering from the 2008 financial crisis, the lessons on maintaining financial stability are still being drawn by central bankers and policy makers. A lesson learned from the financial crisis is the need for a comprehensive program of regulatory reforms and supervisory actions. Central bankers and

policy makers have taken this to heart; and this is making the global financial system more resilient.

8. The recent financial crisis has highlighted the damaging impacts on living standards that can result from macroeconomic instability. Large swings in economic activity, high inflation, unsustainable debt levels and volatility in exchange rates and financial markets can all contribute to job losses and increasing poverty, endangering progress towards improving macroeconomic environment and financial stability. Maintaining macroeconomic stability therefore is a prerequisite for sustained and inclusive development while also promoting a stable financial system.

9. While exisitng financial stability frameworks need to be strengthened, central banks must have a major voice in financial stability policy – as this is closely linked with monetary policy management. Central banks are naturally the official institutions closest to financial markets. Nevertheless, responsibility for financial stability will have to be almost always shared with other entities. This is because the central banks generally focus on the monetary system, which does not include other stakeholders in the financial sector such as capital markets and insurance. Although how coordination is done among different entities differs from country to country; howsoever this is done, supervisors need the independence and the powers to act quickly and impartially.

10. Good progress has been made in addressing some of the issues related with financial stability, although the reforms are still insufficient. The challenge will be to complete the transition to a new regulatory structure effectively and to develop a solid foundation for the crisis management framework. An important pre-requisite for the success of the reforms is providing legal protection to financial sector regulators and supervisors as well as to public officials involved in crisis management and resolution.

11. The emerging and developing countries' financial systems have deepened and are integrating with the global economy. These markets have introduced new asset class segments, including local currency sovereign bonds, with increased direct participation of global investors. Corporate leverage has risen, accompanied by

increased exposure to foreign currency liabilities. In many financial markets, assets valuation could come under the pressure if interest rate rose more than expected and adversely affected the investors' sentiment. On the otherhand, there are uncertainties related to quantitative easing with the risk of sudden reversal of capital flow and subsequent effects on the reserves and exchange rates. Therefore, despite the progress so far achieved in the financial sector stability, some vulnerabilities and risks to financial stability of this region still persist.

12. The improvement in financial conditions can only be sustained through further policy actions that address underlying stability risks and promote macroeconomic environment for inclusive growth with greater financial access. Moreover, continued improvement will require further balance sheet repair and a smooth unwinding of public and private debt overhangs. Financial supervision should thus be tightened to limit the extent of vulnerabilities. Likewise, financial regulation will need to play a more proactive role at both the macro and micro prudential levels. Central bankers have therefore to remain alert with the risks stemming from increased cross-border capital flows and rising domestic financial vulnerabilities to avoid the financial instability.

13. Nepalese financial system is stabilizing after having corrected, over the last few years, major financial stresses including the assets quality, liquidity and capital adequacy ratios of banks and financial institutions (BFIs). Likewise, many proactive measures taken in recent years and enforced by the Nepal Rastra Bank have reinforced and supported the stability of the financial market. As a result, there is noticeable improvement in the capital base, liquidity position, credit quality, allocation of credit to the productive sectors, deposit mobilization and overall sector-wise credit exposure of the financial institutions.

14. Since the moratorium for bank licensing implemented and consolidation process adopted in 2011, the pace of numerical growth of BFIs in Nepal has receded. NRB has adopted merger and acquisition policy along with other corrective measures for maintaining financial stability and to limit the immediate banking sector risks. Likewise, many more prudent and stringent financial

sector polices such as risk based supervision mechanism, enforcement of Basel Core Principles, financial inclusion, consumer protection guidelines, problem banks resolution mechanism have been formulated and implemented in the past few years. This has contributed broadly to stabilize and mitigate the immediate vulnerabilities and risk of our financial system. Moreover, the renewed financial sector policies adopted by the NRB have helped to boost the confidence on the domestic financial system. As a result of such endeavors, upcoming initiatives such as formulation of Financial Sector Development Strategy, establishment of problem bank resolution division, and introduction of a new organization structure for the Payment and Settlement regulation is expected to contribute towards a stable financial sector development and economic growth in Nepal. Besides, proposed amendments in the central bank and banking institutions acts are also geared to prevent, mitigate and resolve the financial sector crisis.

15. NRB is recently using two policy tools - base rate and interest rate spread - to ensure interest rate stability. Base rate is the cost of funds that bank and financial institutions (BFIs) need to bear since the collection of saving to the disbursement of loan. Nepalese financial sector has entered into base rate regime from mid-Jan 2013. It is the minimum rate below which banks are suggested not to lend. This has prevented banks from entering into unhealthy underpricing of credit at the time of excess liquidity. Likewise since mid-July 2014, BFIs have also been directed to publish their spread rate on monthly basis and ensure that the interest rate spread is not more than 5.0 percent. This has also prevented undue cut in the deposit rates during the period of excess liquidity which might pose a risk of liquidity crunch with savers substituting their financial portfolio.

16. Prompt Corrective Action (PCA) based on capital adequacy has been adopted and enforced in the banking sector. Moreover, a study is underway to add liquidity as the extra cushion to the criteria for imposing PCA. Similarly, in order to make the liquidity forecasting more realistic, the Liquidity Monitoring and Forecasting Framework (LMFF) now covers development banks and finance companies along with the commercial banks. In order to optimally manage open market operations (OMO) for better liquidity management, a new

OMO by-law has been recently formulated and implemented. Basel III framework is also being drafted in preparation to move forward to a more advanced approach for strengthening the financial system and for maintaining financial stability.

17. For risk management purposes, risk based supervision has come to effect; a new guideline for limiting trading book activities has been enforced; credit information has been strengthened; implementation of stress testing framework is in place; targeted deposit and credit guarantee schemes are introduced; and amendment and enforcement of laws related with AML/CFT are in place. All these are expected to minimize the risk in the Nepalese financial sector.

18. Finally, let me take this opportunity to thank Bangladesh Bank for successfully hosting the SEANZA Governor' symposium and giving me the opportunity to comment on the key note speech delivered by Governor Dr. Rahman. I look forward to a highly stimulating dicussion on the theme.

Thank you.