Keynote Speech by Dr. Yuba Raj Khatiwada, Governor, Nepal Rastra Bank

"Challenges in Effective Implementation of Central Bank's Monetary and Financial Stability Policy in Emerging Market Economies"

Delivered at 6th SEACEN-CCBS/BOE Advanced Course on Macroeconomic and Monetary Policy Management On 28 October 2013

Pokhara, Nepal

Mr. Hookyu Rhu, Executive Director of The SEACEN Centre

Ms. Gill Hammond, Centre for Central Banking Studies, Bank of England

Distinguished Speakers

Course Participants and Observers,

Ladies and Gentlemen!

1. Let me express my deep sense of appreciation to the SEACEN Centre for giving me this opportunity to speak on this important topic: Challenges in Effective Implementation of Central Bank's Monetary and Financial Stability Policy in Emerging Market Economies. At this moment, I feel greatly honored to share my views on the issues and challenges we central bankers face in implementing our monetary policies amid global financial integration, open capital account, and flexible exchange rate. Innovation of new financial products, also triggered by sophisticated information technology, have diluted the traditional channels of monetary transmission to real economy. This topic has been very important among the central bankers and macroeconomic policy analysts, particularly after the advent of the recent financial crisis. I will highlight some issues and challenges to monetary and financial stability policy implementation and also share some experiences of Nepal in the above regard.

Ladies and Gentlemen,

2. While there are different tools for stabilizing the macro economy, monetary policy is typically taken as the first line of defense. This is perhaps due to the relative ease in implementing this tool (versus fiscal policy). The use of monetary policy management is characterized by different transmission channels, namely the cost and availability of credit channels, wealth channel, exchange rate channel, and monetarist channel as reflected in the traditional monetary framework. Monetary policy is being implemented using both direct (such as reserve requirements) and indirect (such as open market operations) tools in the arsenal of the monetary authority. For implementation of monetary policy, it is implicitly assumed that the financial sector is working well and that there is efficient allocation of financial resources.

3. Until few years ago, the major concern of monetary policy authority around the world was to ensure monetary stability (i.e. price stability). Monetary authorities used the above-mentioned framework to have different targeting frameworks; however the popular mechanism was for inflation targeting. Even in inflation targeting the focus was on core inflation, which was taken a monetary phenomenon as opposed to headline inflation, which often captures non-monetary shocks as well. Once an inflation target is chosen, the prior mentioned tools are adjusted to attain this target. However, in focusing on monetary stability, the issue of maintaining financial stability was relegated to a secondary concern. The recent market turbulence suggests that implicitly assuming financial systems are healthy is wrong; and monetary authorities should focus on the health of the financial system and on the maintenance of financial stability.

4. Financial stability refers to the ability of the financial system, taken as the banking and non-banking sectors, to smoothly fulfill its key economic functions

at all times, including in stress situations and periods of structural upheaval. In particular, it refers to the efficient allocation of financial resources and risks along with the provision of a well functioning financial infrastructure. Financial stability is a precondition for the real economy to create jobs, promote economic activities and sustain economic growth and is a necessary condition for those linkages to operate effectively. A well functioning financial system is a necessary condition for monetary policy to be able to achieve its macroeconomic objectives. In this regard, central banks also opt for financial stability objective, which is achieved through macro-prudential regulation and supervision, along with prudent monetary policy.

5. Prior to the global crisis, central banks regarded monetary policy as the principal function of central banks and had overlooked their role in preserving financial stability. The task of maintaining financial stability was overshadowed by confidence on market mechanisms. The financial crisis has altered all that and the financial stability work has now gained a more prominent position after the crisis. Accordingly, policies to enhance financial stability and monetary policy are perceived as co-equal responsibilities of central banks. Evidence shows that asset price bubbles triggered by easy credit policy have often preceded financial crisis and banks' over leveraging was a root cause of financial instability. As such, implementation of cautious monetary policy can preserve financial stability and can enhance financial market developments; and effective regulatory framework supported by macro prudential measures can better govern the financial markets, which may trigger a positive response in respect to monetary policy implementation.

6. While there is not yet a consensus on the causal link between monetary policy and financial stability, there could be synergies between them. Experience suggests that both concepts are intertwined, since the absence of financial conditions and financial stability makes monetary policy less effective. Thus,

just a good monetary policy is not sufficient to ensure financial stability and there are no clear-cut monetary policy instruments for maintaining financial stability. But I feel that central bank activities for maintaining monetary and financial stability should go hand in hand.

Ladies and Gentlemen,

7. Let me now turn on the issues and challenges of implementing monetary and financial stability policy in emerging market economies. Emerging market economies are characterized as generally having relatively less external integration and also having embryonic financial sectors. However, recent times have seen rapid financial globalization, and deepening and broadening of the respective financial sectors. The former makes credit conditions more sensitive to external situation while the latter enriches the financial system on provision of financial resources and risk. This has resulted in new challenges to policy makers for ensuring monetary and financial stability. While the above trends have benefited the domestic financial system, they have also put a number of constraints on the effective formulation and implementation of monetary policy in emerging market economies.

8. Further emerging economies generally have shallow markets with the significant presence of informal markets - this often leads to a weak transmission of monetary policy. That is, emerging economies generally have an underdeveloped financial system, shallow markets with significant presence of informal market, less presence of financial innovation, and rudimentary allocation of financial resources and risk. Further, many emerging markets generally have presence of foreign currency in circulation, known as currency substitution. This makes the estimation of currency in circulation difficult. Further, the control of monetary policy is weakened when there is substitution between currencies. Thus the demand of money can potentially be unstable and then the management of monetary policy even complicated. Also, the

situation of the financial system makes it difficult for alternative sources of financing such as through capital markets. In this regard, empirical experience suggests that the credit channel is more common and thus use of it for achieving monetary stability can be effective. However the allocation of credit in emerging economies is often inefficient and the stance monetary and credit policy leads to the question of financial stability. In this regard and for example, a fragile banking system can make it hard for a central bank to aggressively utilize policy interest rates for attaining domestic objectives; as large changes in interest rates can have potentially devastating consequences on the balance sheets of weak banks.

9. The embryonic financial markets in emerging economies are generally unable to fully meet the credit demand; this credit gap has been met by informal markets, also in the form of 'shadow banking'. This can broadly be described as credit intermediation involving entities and activities outside the regular banking system. The shadow banking system can become a source of systemic risk, especially when it is structured to perform bank-like functions like mobilizing current or call deposits, undertaking off balance sheet activities, doing maturity transformation, and leveraging and when their interconnectedness with the regular banking system is strong. The interconnectedness implies that any shocks in the shadow banking will be transmitted to the proper banking system with a bearing to the real sector as well and lead to both monetary and financial instability.

10. Despite this risk to stability, the shadow banking system plays an important role in the economy by ensuring credit intermediation through extension of credit or through facilitating its intermediation. Two concerns arise with the use of shadow banking system: (i) systematic risk concerns; and (ii) regulatory arbitrage concerns. The prior predominantly deals with activities that generate maturity and/or liquidity transformation, that involves flawed risk transfer,

and that creates or facilitates leverage, much like banks however using non-deposit instruments without an "explicit official sector backstop and/or without being subject to the same prudential standards and supervision". Thus this implies that there may be a built up of leverage within shadow banking system. This has implication on pro-cyclicality within the economy (i.e. shadow banking system can facilitate high leverage when asset prices are high and vice versa). On the other hand the later concern of regulatory arbitrage deals with activities for circumventing and undermining bank regulation, which generally has more restriction and supervision. This is attributed to the interconnectedness with the banking system where credit can easily move to take advantage of different regulations regarding assessing risk – this will lead to an unnatural buildup of leverage and risk in the system.

11. There is also an important issue regarding fiscal spillovers and the issues of central bank independence. This is particular to emerging economies, as governments spend beyond their revenue generating capacity. This leads to increase in deficit, which is being financed by debt issuance. The nature of central bank independence affects the ability to resist purchasing government debt, since this has an impact on the balance sheet of the central bank and thus on the monetary base - this has an impact on the effectiveness and control of money supply. Irrespective to the degree of statutory independence, operational independence of the central bank is also constrained in some cases.

12. The issue of external financial integration has contributed to increased volatility of capital flows. The challenge is to manage large and persistent capital inflows to avoid the risk to financial stability and exchange rate appreciation in the perspective of small open emerging economies. There is potential for capital flows to be larger and more unpredictable, and its effective management will require constellation of policies, both economic

and financial. Monetary management has to contend with the vicissitudes of capital flows and the increased volatility in exchange rates; this also impacts on the magnitude of currency substitution in some economies. Moreover, the instruments and operating procedures of monetary policy have also to be constantly fine-tuned to meet the challenges that arise from unprecedented capital inflows, where credit is internationally mobile and affects financial stability. Also, external fiscal spillovers have an effect on the domestic economy. Again, given the uncertainty surrounding the nature of capital inflows, it would also be prudent for the central banks in small open economies to build up reserves as a cushion against a possible change in investor sentiment, leading to a sudden stop syndrome.

13. The existence of shallow financial market and availability of a few financial market instruments to sterilize the monetary impact of large capital flows makes it difficult for the central banks to put monetary aggregates or interest rate under desired level. In a pegged exchange rate regime, the task is even more difficult because of the full transmission of the impact on the monetary aggregates than in the level of the exchange rate. The global crisis has forced the emerging market economies to rethink on monetary policy. While monetary policy must accord top priority on maintaining low and stable inflation environment, which is indispensable for sustainable growth, it is clear from the current crisis that low and stable inflation alone is not adequate for ensuring financial stability. This is because the risk to financial stability can emanate from many sources other than simply from domestic inflation. Therefore, to maintain financial stability, priority must be accorded to all the key sources of risk and imbalance, other than price stability, that can have systemic implications for the economy's growth and stability. In this perspective, the emerging market economies have to manage the challenge posed by the new globalization in the pursuit of price stability. More

importantly, they should focus on the monetary policy financial stability framework that addresses the challenge to price and financial stability.

14. It is important for monetary authorities when pursuing monetary and financial stability that they should not lose track of macroeconomic welfare. This is because the sole pursuit, while heightening efficiency, could generally be at the cost of equity. In this regard, a key challenge is achieving the right balance between making the financial system more efficient and also more equitable. That is, we have to balance the need for an efficient financial system with an inclusive financial system; the latter, of course, also contributes to its sustainability.

Ladies and Gentlemen,

15. The challenges during the implementation of monetary and financial stability policies can be generated with the emergence of increasing new financial products and cross-border capital flows. The former blurs the definition of components of the financial market, as well as the stability of money demand is difficult with the rapid development of complicated financial derivatives. This also brings new challenges to financial stability and monetary policy transmission. The latter poses a challenge not only to monetary control, but also to exchange rate stability, and to the financial system.

16. In this financially integrated world, central banks face many complex challenges during the implementation of the macroeconomic policies; and to mitigate with such challenges, central banks cannot draw a choice for single objective of price stability or financial stability as both are equally important. For the effective implementation of both the policies, central banks in emerging market economies should focus on the justifiable macro prudential tools hand in hand with prudent monetary policy to achieve their respective policy objectives. Furthermore, there is a need to effectively integrate monetary and macro prudential policies into coherent frameworks. Central

banks in emerging market economies should always be mindful that financial stability is not always associated with price stability. So, separate sets of macro prudential and monetary policy instruments to achieve both targets at the same time will be essential. Similarly, central banks will have to play a key role in the development and use of macro prudential policies, and financial stability considerations need to be clearly incorporated into the monetary policy decision-making process.

Ladies and Gentlemen,

17. There would, however, be limitations to setting more than one objective to monetary policy when it comes to measurability of central bank performance and its accountability. Still, while having more than one objective of the monetary policy, the central bank should be cognizant of the complementarities and trade-offs between objectives and work out for an optimal solution if trade-offs are there. But let me mention that most objective complement each other also.

18. Let me also take this opportunity to share some experiences from Nepal, a low- income economy having a pegged exchange rate regime, regarding implementation of monetary and financial stability policy. Monetary stability is being maintained using broad money targets. However, there are issues with currency substitution and shadow banking. There is lesser issue with domestic fiscal spillover since the NRB Act limits it. For instance, government outstanding debt holding by NRB is utmost 10 percent of the previous year's total revenue of the government; and, one fiscal year borrowing from NRB is limited to 5 percent of the previous year's revenue of the government. However, monetary autonomy is constrained due to external shocks and exchange rate arrangement. External shocks are transmitted to the domestic economy through India due to pegged exchange rate regime with Indian currency.

19. For ensuring financial stability, the NRB has made some major policy arrangements, while others are in the process of being introduced. Macro-prudential regulation is focused on ensuring stable financial markets while risk-based supervision practices are being applied to the banks to prevent financial crisis. A risk management guideline has been issued in order to make banks identify measure monitors and manage various risks inherent in the banking sector.

20. In the above regards, NRB is aware that actions for monetary stability have an impact on financial conditions and on financial stability. In this regard, a High Level Committee for Financial Sector Coordination has been set up under the chairmanship of the Finance Minister and comprises of all the regulators of the financial system, namely the NRB Governor, Chief of Insurance Board, Chief of Securities Board, and Finance Secretary as members. The Deputy Governor of NRB in charge of bank regulation is a permanent invitee of the Committee. Further, the NRB as a regulator of banking sector is a major participant in domestic financial system, and working for government initiated Financial Sector Development Strategy. This has cognizance of the involvement of all actors in the financial sector as well as it will be giving guidance to the trajectory of financial sector development.

21. Finally, I look forward to your active participation during the course and hope you all will enrich your understanding of the issues relating to macroeconomic and monetary policy management. I suggest the participants also to benefit from the policy experience of talented training fellows gathered here. I am confident that it will help you to formulate, implement and communicate monetary and financial stability policies in your respective economies.

Thank you!

***