Central Bank Governance and Emerging Issues for Developing Economies

Dr. Yuba Raj Khatiwada
Governor, Nepal Rastra Bank

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Background

- Central bank an apex institution of the financial system with multiple responsibilities: macroeconomic stability, financial stability, exchange rate and foreign exchange management, etc.
- Additional role in developing economies: supporting economic growth, promoting financial development, increasing access to finance.
- Has to function in the interconnected world full of volatility and uncertainty.
- Demands visionary, efficient and dynamic central bank leadership to navigate the financial markets and the economy in the right direction.

Key Components of Central Bank Governance

- **Legal & regulatory regime and political governance structure**
- **Strategically defined visions, missions and objectives**
- **Governor's appointment, Board composition & stability**
- **Internal control system & procedures; risk management system**
- **Accounting, auditing, and financial reporting standards**
- **Disclosure norms and communication strategy**
- **Institutional capacity- human resource, IT, basic physical infrastructure, logistic support system, etc**
- **Leadership - stability, quality and accountability**

All these encompass the three pillars of central bank governance: independence, accountability and transparency

Independence and Conduct of Monetary Policy

- Conduct of monetary policy the primary task of a central bank; institutional arrangements ensuring good governance must first and foremost relate to this function.
- Central bank requires power to formulate monetary policy independent of political interference; must serve its mandate (stability) first followed by that of government (growth).
- Central bank roles changing with the emergence of financial crises; significant reworking of governance arrangements in many countries; countries re-examining appropriate role of central bank in financial stability.
- Central banks also insulating themselves from fiscal spill-over channeled through deficit financing and public debt management.

Accountability and Credibility of Central Bank Roles (1)

- Growing consensus: while central banks should be made independent, they should be made more accountable to defined institutions or general public through legislation.
- Institutional accountability to be set by law - reporting to the government (ministry or cabinet), parliament, head of government or head of state to be defined.
- Accountability to general public implies protecting financial service consumers, promoting green financial services, and undertaking other corporate social responsibilities.
- Designing suitable accountability mechanism requires clear, measurable and non-conflicting targets in both policy and resource use areas.

Accountability and Credibility of Central Bank Roles (2)

- Democratic accountability of central banks to ensure that, with the delegation of powers to independent unelected officials, they are accountable to democratically elected institutions.
- Accountability a form of 'checks and balances' within central bank independence, which legitimizes the position of central bank within a country's constitutional system.
- Accountability ensures central bank functioning in a complementary and responsible way to deliver national development goals.
- Accountability also includes bearing responsibility for monetary policy actions and possible correction when a policy appears deficient.

Transparency and Communication for Policy Clarity (1)

- Transparency (i) relates to central bank's openness in explaining the rationale behind its specific policy decisions; (ii) describes the extent to which central bank's actions are observable to outsiders.
- Central bank is transparent when it provides at all times sufficient information for the public to understand policy regime, to check whether bank's actions match the regime, and to pass judgment on its performance.
- Transparency functions as a precondition for accountability, credibility, and predictability of central bank functions.
- Information disclosure, clarity, and accuracy, as some components of transparency, are means to monitor progress made by central banks in attaining their policy objectives.

Transparency and Communication for Policy Clarity (2)

- Main reasons to promote transparency of central banks:

  (i) effectiveness of monetary and financial policies strengthen if goals & instruments of central bank policy are known to public.

  (ii) transparency in central bank's mandate and clear rules of procedure for its operations ensure good governance and facilitate policy consistency.

- Information asymmetry between central bank and public problematic: need to address this for policy effectiveness.
- Transparency increases credibility, reduces uncertainty, enables the public to understand & anticipate central bank's decisions leading to more effective monetary policy by facilitating better decision-making by the public.

Emerging Governance Issues for Developing Economies (1)

- Emerging market economies (EMEs) - most dynamic & economically important groups.
- Becoming larger & more integrated into international trade & finance, facing more complex settings and difficult challenges in designing monetary and financial policies.
- Financial globalization leading to growing exposure of EMEs to financial turbulences; spill-over effects.
- Less developed financial markets and institutions, less central bank independence, low level of monetization and large population in poverty.
- Structural and institutional issues make the conduct of monetary and financial policies more challenging.
- Increasing frequency of financial crisis & fragility of financial system - challenges to selecting right objective(s) of monetary policy.

Emerging Governance Issues for Developing Economies (2)

- **Maintaining price stability through monetary policy:**

  maintaining price stability a challenging task; as inflation is not solely a monetary phenomenon; structural as well as external factors affect prices in developing economies.

- **Maintaining Financial Stability**

  much work remains to be done in designing effective central bank structures for making financial stability operational; a narrow focus on price stability might sometimes create or exacerbate financial imbalances.

- **Trade off between monetary stability and financial stability ? There is room for complementarities if monetary and macro-prudential policies are designed in coordinated way.**

Emerging Governance Issues for Developing Economies (3)

- **Increasing financial access and financial inclusion**

  developing economies having low financial access and low financial inclusion, central banks becoming proactive to promote microfinance; this obviously drains central banks' human and financial resources out of core business.

- **Addressing financial barriers to economic growth**

  when monetary expansion has little impact on inflation and when supply side is crucial, central banks have to address supply side and structural issues within their reach.

- **Financialization of the economy and financial deepening for monetary policy effectiveness**

  ***shallow financial markets often deter policy effectiveness*.**

Emerging Governance Issues for Developing Economies (4)

- Corporate governance problems in EMEs associated with the prevailing financial market structure, ownership structure, political economy, and the role of the state.
- Financially illiterate population and lack of proper information and communication system; poor financial journalism.
- shadow banking system.
- Weak regulating institutions, lower quality of governments, lack of transparency and market failures.
- Spill over effects: need for considering externally imposed obligations or constraints on national policies; conflict between domestic interest and global compulsions.

Emerging Governance Issues for Developing Economies (5)

- Strong & volatile capital flows - unusual challenges to central banks - large shift of global economic activity towards EMEs.
- Increasing openness of capital account - difficult to isolate monetary policy from external influences; open capital account a challenge to maintain an independent monetary policy when also trying to manage exchange rate.
- Institutional rigidities impede functioning of central bank - inflexible labor markets, wage indexation, multiple objectives and trade-offs, fiscal spill over, debt management role, etc.
- Public expectation from the central bank - beyond its mandate and instruments at its disposal.
- Coordination with other regulators, government agencies, etc.

Concluding Remarks

- Extended mandate of a central bank from monetary stability to financial stability requires appropriate legal & governance structure.
- Governance structure of central banks in EMEs may differ from that of in advanced countries given the stage of economic and financial development.
- Effective governance arrangements for central banks can be quite complex; evolving over time, depending on economic challenges and country's social-political developments.
- To discharge multiple roles, sometimes mutually exclusive, compared to that of advanced countries, central banks in EMEs should be equipped with credible leadership quality.

Thank You Very Much