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Monetary Policy, Sovereign Debt and Financial Stability: The New Trilemma

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Background:

The world economy has been observing a series of crises in recent decades such as the Latin American debt crisis of the 1980s, the Mexican crisis of 1994, the East Asian crisis of 1997-98, the Argentinean crisis of 1999-2002, the US financial crisis of 2007-09 and the recent European financial crisis of 2010. The recent US and European crisis are the most serious financial crises at least since the 1930s. As such, the mainstream free market economic system has this inherent characteristic of booms and busts and the crises ever since 1930s are linked to the traits of market economy. Nevertheless, state policies have also often led to such crises.

The weak economic growth since the US financial crisis has exposed the unsustainable fiscal policies of countries in Europe and around the globe, making high budget deficit unsustainable. The unprecedented monetary easing and fiscal stimulus have resulted in the swelling of sovereign debts in many countries. Greece has been one of the first to feel the pinch of weaker growth. In response, investors demanded higher yields on Greece's bonds, thereby raising the country's debt burden and necessitated a series of bailouts. The markets also began driving up bond yields in the other heavily indebted countries in the region, anticipating similar problems as in Greece.

Unsustainable debt built-up, in both private sector and public sector, can create an unstable financial situation leading to a financial crisis. Experience till now showed that any mismatch in the balance sheets of any sector of the economy could pose a great threat to financial stability because of growing inter-linkage among the different sectors of the economy. This has created a serious challenge to monetary policy. In addition, the globalization and liberalization have made

monetary policy more vulnerable to external developments. Situations and policies adopted by any important country or region could spill over to others through the channels of trade and finance.

After the Latin American public debt crisis, the current European debt crisis has increased the renowned interest on the sovereign debt crisis. Subsequently, after the US financial crisis, which was triggered by the meltdown of housing market bubble amidst the widespread shadow banking, the sovereign debt crisis emerged in the European Union, particularly in Greece. Other EU countries such as Italy, Spain, Portugal and Ireland have also very high level of public debt. These countries are in immediate danger of a possible default, which could result in far-reaching consequences beyond their borders to the world as a whole.

It is true that there has been massive financial globalization in almost all countries of the world since 1990s. An unintended consequence of financial globalization is the growing exposure of developing countries to financial turbulences associated with cross-border capital flows.

Monetary Policy and Financial Stability

There is no consensus view on monetary policy and stability -- trade-offs or synergies between them. Some argue that monetary policy should be regarded as a legitimate tool in the financial stability toolbox while others argue that monetary policy and financial stability policy are distinct and should not be confused with one another. Since most of the times credit booms precede the financial crisis, monetary policy should not ignore the concern of financial stability. Hence, many central banks have started to give due attention to financial stability while conducting monetary policy. Financial stability is a vital condition for economic growth as most transactions in the economy are settled through financial system.

Monetary stability and financial stability have two-way linkage between them. Macroeconomic stability and financial market stability are inter-related; and the transmission of monetary policy depends on the healthy banking sector; and implementation of monetary policy depends on the payment systems and institutional as well as regulatory framework. Hence, financial stability is a

precondition for monetary stability. Equally, bad monetary policy certainly causes financial crisis such as over tight monetary policy would weaken the banks' solvency and over expansionary monetary policy could inflame bubbles and increase risks to the financial system. However, just good monetary policy is not sufficient to ensure financial stability.

Sovereign Debt and Financial Crisis

Financial institutions usually hold government bonds, which are believed to carry low risks with high degree of liquidity. Such investments are used to meet the regulatory liquidity buffers. It is obvious that the presence of well functioning government debt markets is essential for efficient financial markets, which act as an effective transmission mechanism of monetary policy and provide the benchmark for private sector funding. However, when the stock of public debt is high and unsustainable, it itself can trigger a financial crisis, posing serious challenge for monetary policy.

Through several channels, the public debt stock can endanger financial stability such as a high public debt affects the government's balance sheet adversely by raising the future fiscal costs and thereby lower the credibility of the government. In addition, a higher stock of public debts affects the prices of financial assets, which ultimately affect the soundness of the financial sector's balance sheets.

Vulnerability of public debt increases if there is foreign –currency dominated and short-term debt in total debts. The former is subject to exchange rate risk, while the latter is subject to rollover and refinancing risks. It has been a well-established fact that inappropriate debt structure and poor debt management can ignite the financial instability by increasing country's risk perception and deteriorating the balance sheets of economic agents. Average maturities of outstanding debt have fallen in many cases.

New Trilemma

The task of maintaining financial stability was overshadowed in the last decades despite having a series of crises. The financial stability work has, however, gained

a more prominent position recently after the US financial crisis all over the world. Hence, traditional policy trilemma – exchange rate stability, capital flows and independent monetary policy, also known as impossible trinity, has changed into new dimensions. The monetary policy trilemma was built on the Mundell-Fleming model of an open economy under capital mobility.

The current crisis situation in the advanced countries, that is, the US and Europe, has created a dilemma to monetary policy on whether to follow price stability or financial stability as an objective. Experience shows that maintaining price stability does not ensure financial stability, which is also the important matter of concern for monetary policy. Normally, against the background of price stability, financial fragility builds up through Minsky's hypothesis – the financial status of economic agents changes from hedge to speculative and then to Ponzi. Price stability plus financial liberalization leads to credit flows and credit boom, which fuels asset price bubbles in the economy.

In response to economic downfall and financial distress after the US financial crisis, many countries eased their monetary policy and introduced the fiscal stimulus which has resulted in huge debt built-up in the government sector. Now, the economy and financial sectors have been slightly recovering, the stance of monetary policy seems to have changed gradually, which will increase the interest rate, impacting adversely the sovereign debts. Any debt defaults by the government will again translate into a financial crisis.

Looking at the European financial crisis, some even argue that trilemma emerges as financial integration, financial stability and national sovereignty' which is named as financial stability trilemma. If we want to prevent cross-border crises and at the same time maintain national sovereignty, we must accept the reduced financial integration. On the other hand, it is also argued that if one wants to retain financial integration and low risks of crisis spreading across national borders, one must consider letting go of national sovereignty.

Adding financial stability to Impossible Trinity, one can also come up with policy of quadrilemma. Hoarding international reserves seems to be taken as a solution

to hold quadrilemma, which may help to keep partial monetary autonomy, exchange rate stability, and financial stability amidst financial integration. As a short-term solution, many emerging countries have been hoarding unprecedented level of international reserves to maintain financial stability with the growing financial integration.

Structural Issues

Financial crises have political-economic dimensions also. The political economic dimensions like the warfare costs and welfare costs of some of the industrial countries have raised sovereign debt which was also encouraged by the easy money policy adopted by the central banks in the wake of low inflation. Easy money policy also triggered excess consumption in the private sector and demand for assets which only created bubbles in the financial markets.

The next important aspect is the overly trust on the market forces, without taking into account the fact that markets do not always behave rationally. In fact market has pro-cyclic tendency and result in boom and bust in a routine way. In several cases, institutional vacuums also exist – as the presence of both the state and the market is not very effective for many countries.

The growth strategy of the EMEs is also faulty as they expect the advanced economies to consume more in order to create market for their exports. This strategy worked well so far as easy monetary and fiscal policies along with appreciated exchange rates of the industrial countries could be sustained. Once this started becoming unsustainable, the question of rebalancing growth has emerged and EMEs are now looking for higher domestic and regional demand to propel the growth process.

Confining the role of central bank to price stability and inflation targeting as the anchor of monetary policy also complicated the world economy. As regulatory and supervisory roles of the central banks were handed over to separate institutions, the link between monetary policy and regulatory policies was broken.

Evidence shows that debt financed consumption and then consumption led growth has sustainability problems. As debt overhang in government, corporate and household sectors has created a financial crisis, one should be beware of allowing debts to grow too much in any sector of the economy. Financial stability, along with macroeconomic stability, particularly hinges on prudent debt management by all sectors, most importantly by public sector. Moreover, in case of currency union, fiscal policy should be prudent enough since the member countries lack monetary policy to use. This could be an important lesson for SAARC member countries which are thinking to move towards currency union.

Although global inter-linkages among countries warrant a coordinated efforts to maintain financial stability in the world, materialization of such an effort in practice is quite difficult and challenging because over concerns on domestic situation, resulting in a state of Prisoner's Dilemma. Moreover, in this context, one cannot and should not forget the geo-political situation, which overshadows and shapes the economic policies of the country.

Prudent debt management is an essential complement to sound macroeconomic policies, an appropriate political environment and judicious choice of exchange rate policy regimes in achieving financial stability. Since monetary and debt management policies coexist in the same market, it is essential to ensure good coordination mechanism to signal the government intention and increase transparency. A lack of policy coordination can result in confusing signals for monetary policy.

There are institutional issues also related to recent financial crisis. Recent crises have unfolded the sheer deficiency of oversight institutions including the IMF. The Independent Evaluation Office of the IMF mentions that prior to the recent crisis, the IMF did not warn of the vulnerabilities and risks that eventually brought about the crisis. Also IMF gave too title consideration to deteriorating financial sector balance sheets, financial regulatory issues, possible links between monetary policy and global imbalances, and the credit boom and emerging asset bubbles. Central bankers are also charged for their preoccupation with orthodox policies and priorities and neglect of their role in financial stability.

Nepalese case

Despite a decade long internal conflict, Nepal has been following the prudent fiscal policy, maintaining the budget deficit below 5 percent. As a result, total government debt as a percent of GDP has been about 32 percent in 2010/11 – domestic debt of 13 percent and external debt of 19 percent of GDP. Normally, public debt level of 40 percent of GDP is considered as an optimal level for debt sustainability. Hence, Nepal does not face the trilemma at the moment but has the challenge of maintaining financial stability against a structurally weak financial system and the role of monetary policy being subdued on account of pegged exchange rate regime with a non convertible currency.

The rapid expansion of financial institutions in Nepal in the recent years, encouraged by the financial liberalization policy, has created several regulatory and supervisory challenges to maintain financial stability. An eased monetary policy, poor investment climate, and slower real sector growth led to the over concentration of bank lending to the real estate sector. This of course led to deterioration in the balance of payments and rise in prices. Tightening of monetary policy in the recent past in order to control the high inflationary situation and unfavorable balance of payments along with the adoption of macro-prudential measures to limit real estate exposure of the financial institutions caused a bust in real estate sector, which has put adverse pressure on the balance sheets of financial institutions.

In this way, Nepal has been observing its own trilemma -- monetary policy, financial stability and macroeconomic stability-- different from Mundell-Fleming's Trilemma because of the tremendous expansion of financial institutions, but low investment opportunities caused by sluggish economic growth. Hence, obtaining three goals together has been a serious challenge for Nepal Rastra Bank, although NRB has been maintaining some degree of monetary independency simultaneously having the pegged exchange rate with Indian currency by not opening up capital account so far.

The focus of the monetary policy, while working as a first line of defense against inflation, is to achieve financial stability and create an environment for higher growth. Nepal Rastra Bank has the view that without the growth of the real sector, the expansion of the financial sector will be constrained. So productive use of bank credit to the promotion of the real sector would be essential and this requires the adoption of judicious credit and macro-prudential policies.

Concluding Remarks

Given the volatility and growing integration of the world economy, time has now come to put crisis management mechanism in place in the armory of the central bank. Policy makers have to be ready with crisis management mechanism having contingency plans to maintain public confidentiality in the financial sector, in addition to prudent fiscal policy, and dynamic and conscious monetary policy.

As central banks do not operate in a vacuum; they have to work in tandem with broader political economic framework and policies of the state. As narrow focus on the role of central bank like setting single objective, single instrument and single indicator has posed a question on the credible role of the central bank, time has come to review the single objective and see where central bank fits in the development paradigm without compromising its core objectives.

We live in a world with highly vulnerable financial markets. This requires stronger regulatory and supervisory institutions at the national, regional and international levels. As such, liberalization of the financial markets calls for further strengthening of regulatory and supervisory institutions. Also a greater coordination of central banks with other regulatory authorities in the areas of pension funds, insurance, cooperatives, and securities is very crucial.

Thank you.