Banking Sector of Bangladesh:

Performance, Reforms and Challenges

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Financial sector of Bangladesh, like most poor countries, is dominated by banking enterprises. Banks at early stages of history of Bangladesh were nationalized and there was mismatch between assets and liabilities. Central bank of the country had limited tools to manage monetary policy. Open mouth operation, so called moral suasion, was the main instrument supported by other direct tools namely determination of SLR/CRR and administered interest rate policy. Most banks pursued a policy of financial deepening through extending bank branches to the remote and rural areas without considering financial viability. In this situation, causality between economic growth and performance of the financial sector could not be established.

Open mouth operation, so called moral suasion, was the main instrument supported by other direct tools namely determination of SLR/CRR and administered interest rate policy.

There was a major policy shift in early 1980s when private sector banks were allowed in the economy. In addition to existing 19 public sector and foreign banks, 10 new private banks opened their business during early 1980s. Thereafter, another 7 and 13 banks started commercial functions in the country during mid-1990s and early 2000s respectively. The sector embarked upon a Financial Sector Reform Program in the 1990s which primarily aimed at entrusting additional powers to the central bank by strengthening efficacy of its instruments. Interest rates were liberalized; open market operation was activated by introducing new Bills. Attempts were made to improve governance in the financial sector. But the most effective policy stance was adopted beginning 2001.

Structure

Currently, the banking sector comprises of 4 nationalized commercial banks (NCBs), 5 government-owned specialized banks (SBs) dealing with development finance, 30 private commercial banks (PCBs) and 10 foreign commercial banks (FCBs). The structure of the banking sector as of December 2004 is shown in the following Table.

Structure of Banks

Type of Banks	Number of Branches	Total Assets (Tk.Billion)	Percent Distribution	Deposits (Tk. Billion)	Percent Distribution
NCBs	3388	684	40	568	43
SBs	1328	168	10	75	6
PCBs	1550	749	43	588	44
FCBs	37	125	7	95	7
Total	6303	1725	100	1326	100

The structure of the banking system has changed substantially over the last couple of years. NCBs' role has gone down. Their share in total assets went down from 54 percent in 1998 to 40 percent in 2004. On the other hand, PCBs' share went up from 27 percent in 1998 to 43 percent in 2004. The change reflects adoption and implementation of new policies for the banking sector.

Banking Sector Policies

A. Regulatory Reform

Corporate Governance

(a) Governance structure of banks has

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been strengthened; better disclosure and transparency standards have been introduced and dissemination to the public at large has been mandated. Banks are required to publish selected financial information in at least two major daily newspapers. Fit and proper tests have been prescribed for bank directors, chief executives and advisors. Some restrictions have been imposed on the composition and tenure of the membership of the Board of Directors. The roles and functions of the Board and management were clarified and redefined.

(b) Bangladesh Bank's capacity to supervise and regulate banks effectively, monitor non-performing loans, enforce actions against banks found violating regulations and laws has been strengthened. (So far 65 bank directors and chairmen lost their directorships for default of loans, insider lending practices and other violations). This process is ongoing.

(c) Audit Committees were mandated for all banks with clear guidelines and TORs. Banks have been asked to strengthen their internal control system.

(d) The Bangladesh Bank recently introduced Early Warning System (EWS). Banks which are exhibiting certain weaknesses, and deteriorating trends in selected indicators will be brought under EWS to ensure that appropriate steps are taken to address the issues before the situation deteriorates further. Monitoring of 'problem banks' has been strengthened through agreements on clear, quantifiable targets for improvement and monthly returns on performance.

(e) Government borrowing from the banking system is now market based

and the annual volume of borrowing is limited, allowing greater room for the private sector. Private sector credit grew at over 14 percent during the last fiscal year.

These measures may be seen as undue interference into business activities of a bank by the central bank. At the same time, it must be realized that banks are different from other businesses and are public companies whose most important function is to protect deposits of the public. The directors of a bank, therefore, have some degree of public responsibility beyond protecting their own and other shareholders' interests. Banks are amongst the most regulated industries in most countries and the regulatory authorities have wide ranging power in these countries.

upper limit on a bank's exposure to a particular customer or group was introduced. Strict measures have been laid and enforced on loan loss provisioning, and tier 1 and tier 2 capital adequacies. Loan write off guidelines were issued by the Bangladesh Bank, allowing the banks for the first time, to write off "bad" debts against which full provisioning has been made. The Bangladesh Bank has fixed the limit of the single borrower/single group-borrowers credit to a bank. Large loan limit has been linked to bank's NPL ratio. The BB is encouraging syndication of several banks for large loans and has issued guidelines for restructuring such loans.

Non-Performing Loan Ratio
In Percentage

Type of Banks	Gross Non-Performing Loan Ratio					Net Non-Performing Loan Ratio				
	2000	2001	2002	2003	2004	2000	2001	2002	2003	2004
NCBs	38.6	37.0	33.7	29.0	25.3	26.1	25.2	22.6	22.3	17.6
DFIs	62.6	61.8	56.2	47.4	42.9	29.2	33.8	26.9	25.0	23.0
PCBs	22.0	17.0	16.7	12.4	8.5	9.1	5.5	6.7	6.1	3.4
FCBs	3.4	3.3	2.6	2.7	1.5	-1.1	-1.7	-1.8	-1.0	-1.5
Total	**34.9**	**31.5**	**28.1**	**22.1**	**17.6**	**18.7**	**16.8**	**14.8**	**13.7**	**9.8**

Risk Management

Core Risk Management Guidelines on five major risks e.g. credit risk management, foreign exchange risk management, asset-liability risk management, internal control and compliance, and anti-money laundering have been issued by the Bangladesh Bank. These lay down policies, processes, procedures and structures that will lead to better governance and improved services. These are now under various stages of implementation in the banks. These measures will help the banking system to manage major i.e., credit, market and operational risks much better than before. Given the increasing importance, separate prudential guidelines have been issued for consumer credit and small business loans.

As a result of the policies adopted in recent years the NPL of the banking system as a whole went down to 17.6 percent in December 2004.

Loan Recovery

Stringent loan rescheduling conditions were introduced to stop ever greening of loans. An

The ratio of gross non-performing loans (NPLs) of the banking system stood as high as 41 percent in 1998, which came down to 31.5 percent in December 2001. As a result of the policies adopted in recent years the NPL of the banking system as a whole went down to 17.6 percent in December 2004. NCBs' gross NPL ratio has improved from 37 percent to 25.3 percent, and the net position has also improved from 25.2 percent to 17.6 percent during 2001-2004. PCBs' gross NPL position has improved from 17 percent to 8.5 percent, and net NPL of the PCBs has gone down from 5.5 percent to only 3.4 percent at the end of 2004. The improvement in the NPL of private banks has been remarkable.

Deepening of Money Market:

Financial instruments of varying tenure

such as repo and reverse repo, and five-year and ten-year Government Investment Bonds have been introduced. Efforts are continued to develop the government and corporate bond market and the functioning of the **primary dealership**. The BB and the Securities and Exchange Commission agreed to allow the government bonds to be traded in the stock exchange. BB, SEC and NBR have developed an enabling legal, regulatory framework for bonds/**securitization** of receivables. Securitization of receivables of private financial institutions has started. First ever securitization was completed. Work is ongoing on securitization of Jamuna Bridge revenue.

Exchange rate and Interest Rate

The interest rates have become flexible and now show a declining trend. Introduction of repurchase agreement and reverse repurchase agreement, strict limit on government borrowing from banks, reduction in SLR and reduction in yield on T-bills have contributed to this flexibility. The weighted average advance rate which stood at 13.75 percent in December 2001 went down to 10.8 percent

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in December 2004. The reduction in interest rates has resulted in higher investment by private sector. Strengthening of the regulatory measures and their enforcement by BB has improved the quality of financial intermediation by the banking system, leading to better allocation of resources.

As a part of the liberalization effort, floating exchange rate regime has been successfully introduced. Further reform in simplifying and streamlining foreign exchange operations and payments system is underway.

B. Legal Reforms

Beginning 2001-02, some Acts were either amended or enacted to revitalize the financial sector. Money Laundering Prevention Act, 2002 gave BB responsibility for prevention of money laundering offences. Banks Nationalization Order was amended in 2003. Among others, the amendment requires disclosure of financial statements to the Board and the BB and gives BB greater say in the appointment and removal of MDs. Bank Company (Amendment) Act 2003, helped the BB to raise capital requirement of the banks to Tk. 1 billion. Financial Loan Court Act 2003 provided the authority to set up special courts dealing exclusively with default loans. It has prescribed time limits for courts to give judgment on original and appeal suits; mandated banks to sell collaterized security before filing cases; and provided alternative dispute resolution mechanism.

C. Institutional Reforms:

Bangladesh Bank Strengthening

As a central bank, the Bangladesh Bank is mandated to promote the operation of a stable and sound financial system. Bangladesh Bank also is mandated to conduct the monetary policy to ensure price stability and support growth. We have initiated a capacity building program in the Bangladesh Bank. Service standards have been introduced for work in the different departments. Workflow analysis has been initiated to bring in greater speed and ensure quality. The Bangladesh Bank Strengthening Program includes

(a) computerization of the operations of the Bangladesh Bank, (b) human resource development through reforms of recruitment, promotion and compensation policies, (c) restructuring the different departments, (d) reengineering the business processes, (e) automation of the Clearing House, (f) capacity building in the core activities i.e. monetary policy, regulation of the financial sector, and research and policy analysis. The goal is to transform the decades-old traditional and manual system to a modern, automated system.

The improvement in capacity will enable the Bangladesh Bank to perform its roles effectively and assert its independence, while winning the respect of the stakeholders.

Impact of Reform

Following restructuring initiatives, financial sector further deepened as measured by M2/GDP ratio. The ratio, which stood at 28 percent in FY 1996, went up to 39 percent in FY 2004. Two other indicators namely, total credit to GDP ratio and private credit to GDP ratios show similar trend.

Financial Deepening (In percentage)

FY	M2/GDP	Total Credit/ GDP	Private Credit/ GDP
2000	31.5	23.1	21.0
2001	34.4	25.5	23.0
2002	36.1	26.8	24.9
2003	37.9	27.7	27.4
2004	39.0	30.7	28.2

The impact of the reform can also be realized by analyzing the developments in the CAMEL framework, which considers Capital adequacy, Asset quality, Management soundness, Earnings and Liquidity. These may be discussed in some details.

Capital Adequacy

The BB raised minimum capital requirement on risk-weighted basis, as per Basle standard, from 8% to 9% in 2002.

Capital Adequacy Ratio of Banks

Type of banks	2000	2001	2002	2003	2004
NCBs	4.4	4.2	4.1	4.3	4.1
DFIs	3.2	3.9	6.9	7.7	9.1
PCBs	10.9	9.9	9.7	10.5	10.3
FCBs	18.4	16.8	21.5	22.9	24.3
Total	6.7	6.7	7.4	8.4	8.8

Minimum capital requirement of banks was raised to Tk. 1000 million ($17 million) from Tk. 400 million in 2003. The minimum capital requirement of Non-Bank Financial Institutions (NBFIs) was also raised from Tk. 50 million to Tk. 100 million in 2001 and further to Tk. 250 million from June 2003.

Many banks have floated their shares in capital market to achieve the target of capital adequacy. Most banks, other than NCBs, are now well capitalized and the target for capital adequacy set out in the Bank Company Act 2003 has been achieved. PCBs' capital adequacy ratio has increased from 9.9 percent in December 2001 to 10.3 percent in December 2004. Private banks are now listed in the capital market which helped revive the capital market. In total market capitalization, the share of banks rose from 10% in June 1998 to 47% in December 2004.

The reasons for increasing the minimum capital requirement are not often clearly understood. Firstly, the higher is the net worth of a bank in relation to deposits, the more likely it is that it will be able to weather any shock, including bank collapse. Equally importantly, the size of the equity is a measure of what stakes the owner-directors have in seeing that the banks are run profitably. The higher the stakes, the less will be the temptation to do things to the detriment of the bank's interest.

Asset Quality

Asset quality remained poor all through the history of Bangladesh. There have been significant improvements in recent years. Much of the problem is a manifestation of corruption, politics of public ownership, weak banking management, poor staffing quality, inadequate regulation and weak supervision. Actions taken over the last 3 years described earlier have led to significant improvements, which includes improvement in NPL position.

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Management Soundness

Though it is difficult to measure management soundness, attempt may be made by using different ratios such as total expenditure to total income, operating expenses to total expenses, earnings and operating expenses per employee, and interest rate spread. In particular, a high and increasing expenditure to income ratio indicates the operating inefficiencies that could be due to weaknesses in management.

Expenditure to income ratio of the banking sector has improved from 99.9 percent in 2000 to 93.9 percent in 2003.

Earnings

Earning and profitability of the banking sector has also improved in recent years as measured by return on assets (ROA) and return on equity (ROE). ROA improved from 0.0 percent in 2000 to 0.7 percent in 2004 and ROE improved from 0.3 percent to 13.0 percent during the same period. Although the net interest income of the NCBs has been negative since 2000, the overall banking industry experienced a consistent upward trend. It is discernible that performances of private banks are significantly better than that of public ones. It is also notable, however, that some improvement of NCBs has happened only recently.

Liquidity

Presently, commercial banks are required to hold 16 percent of their total deposits as statutory liquidity requirement (SLR) which includes a 4.5 percent cash reserve requirement (CRR). Liquidity indicators measured as percentage of demand and time liabilities (excluding inter bank items) of the banks indicate that all the banks maintained excess liquidity over the minimum requirement. However, foreign private banks maintained higher levels of liquidity

Excess Liquidity Ratio

Type of Banks	2000	2001	2002	2003	2004
NCBs	6.5	5.7	7.3	8.4	6.8
DFIs	9.9	8.9	6.9	5.8	4.7
PCBs	6.8	6.2	8.5	9.8	8.8
FCBs	14.8	14.3	21.8	21.9	21.9
Total	**7.5**	**6.7**	**8.7**	**9.9**	**8.7**

Profitability Ratios

Type of Banks	Return on Assets (ROA)				Return on Equity (ROE)			
	2001	2002	2003	2004	2001	2002	2003	2004
NCBs	0.1	0.1	0.1	-0.1	2.4	4.2	3.0	-5.8
DFIs	0.7	0.3	-0.04	-0.1	12.3	5.8	-0.6	-2.1
PCBs	1.1	0.8	0.7	1.2	20.9	13.6	11.4	19.5
FCBs	2.8	2.4	2.6	3.2	32.4	21.5	20.4	22.5
Total	**0.7**	**0.5**	**0.5**	**0.7**	**15.9**	**11.6**	**9.8**	**13.0**

than domestic banks. In 2004 excess liquidity has gone down to 8.7 percent from the level of 9.9 percent last year.

Conclusion

From a poorly performing sector owing to public ownership, lack of competition, weak governance and inefficient management, the banking industry is, after the recent reform initiatives taken during 2001-2004, poised for rapid development. Good progress has been made in deregulating interest rate, functioning of the floating exchange system, strengthening prudential regulations, enhancing the capacity of the central bank, introducing new monetary instruments, strengthening legal environment and reforming nationalized commercial banks. Private commercial banks have now greater share in assets, credit and deposits.

While a lot has been achieved during the past three years, it is needed to continue to move forward with measures to widen and deepen reforms.

While a lot has been achieved during the past three years, it is needed to continue to move forward with measures to widen and deepen reforms. As the demand for loans in the traditional areas becomes more and more limited, the BB is encouraging banks to find new areas of lending; areas including agriculture and agro based industries, small enterprises, housing and consumers' credit. As regards loans to small business, Bangladesh Bank has established a Tk. 1 billion refinancing facility under which participating financial institutions can get refinancing at the bank rate i.e. five percent, for loans between Tk. 0.2 million and Tk. 5.0 million disbursed to enterprises anywhere in Bangladesh, as either term loan or working capital. The IDA has approved a contribution of $10 million and the ADB is finalizing a proposal to contribute $30 million to the Bangladesh Bank's Refinancing Facility. Bangladesh Bank has also a refinancing facility for agro-based industries of larger sizes located in rural areas.

The other important challenge that the banking sector is facing, is introduction of information technology in the banking system in an aggressive manner. This is required to improve management efficiency, reduce operational cost, improve customer services, and increase transparency.

The BB would continue the journey on the path it has chosen.

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An Introduction to the People's Bank of China

History, Functions and Relevant Experiences

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I. History

On December 1, 1948, not long before the founding of the People's Republic of China, the People's Bank of China (hereinafter referred to as the PBC) was established in the city of Shijiazhuang to issue new currencies known as the Renminbi. Since then, the PBC has been undergoing profound changes in terms of its institutional structure, functions and status as well as the roles it plays in the economy. Its development can be divided into five periods.

1. The establishment of the PBC and the national banking system (1948-1952)

In February 1949, The PBC's office was moved from Shijiazhuang to Peking (the former name of Beijing, now the capital of China). In September 1949, the *Organizational Law of the Central People's Government of the People's Republic of China* passed by the Chinese People's Political Consultative Conference legally designated the PBC as a national bank that assumed the responsibilities of issuing the nation's currency, managing the state treasury, administrating the financial market and supporting the economic recovery and reconstruction of the nation.

During the period of rebuilding the national economy, the PBC, under the leadership of the central government, started to establish a unified national banking system. By 1952 when the recovery and reconstruction was basically completed, the PBC had set up a vertical organizational structure to exercise unified administration on various financial institutions. By effectively resolving financial market disorder and hyperinflation, the PBC contributed importantly to the stability of the value of Renminbi and the recovery and development of the national economy.

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2. The PBC as a national bank in the planned economic system (1953-1978)

In the planned economic system, the mobilization and allocation of financial resources were mainly channeled through the vertical structure of the PBC. The PBC acted as both a government institution administrating the state's financial system and a bank conducting comprehensive banking business. In line with the highly concentrated banking system, a centralized credit planning system was established in 1993. Under this system, the PBC head office administered the sources and uses of credit resources on a unified basis, which constituted an importance means of macroeconomic management. The PBC also assumed the responsibilities for managing the circulation of currency and conducting various types of credit businesses. Its operation comprehensively reflected, from the monetary point of view, the implementation of the state's macroeconomic plans.

3. The transition from the national bank system to the central bank system (1979-1992)

In January 1979, the Agricultural Bank of China resumed operation to strengthen the support to the rural economy. In March 1979, as China further pursued the opening-up policy and the international financial business further developed, the Bank of China was reorganized to act as the designated foreign exchange bank. The State Administration of Foreign Exchange was also established. Since then, the financial institutions and financial businesses have become increasingly diversified, calling for unified management and comprehensive coordination of the financial industry.

In response to these new developments, the PBC began to act solely as the state's central bank since January 1, 1984.

In response to these new developments, the PBC began to act solely as the state's central bank since January 1, 1984. Its primary responsibilities included formulating and implementing the national financial policies as well as controlling credit aggregates and

The People's Bank of China

managing the funds of the financial institutions with the aim of maintaining the stability of the Renminbi. The Industrial and Commercial Bank of China was established to take over the savings and industrial and commercial credit business formerly conducted by the PBC. With the establishment of the required reserve system and central bank lending system, the basic framework for the central bank system was set up.

During the initial period of performing the central bank functions, the PBC took active steps to improve the means and methods of macro financial management. While improving the planning management system, it increasingly adopted such instruments as interest rate, required reserve ratio and central banking lending to control the supply of money and credit. Monetary policy began to play an effective role in China's macroeconomic management.

4. Improvement of the central bank system (1993-2003)

In 1993, in accordance with the State Council's *Decision on Reforming the Financial System*, the PBC strengthened its functions of macro financial management, financial regulation and financial services, and further transferring the policy financial business and commercial banking business to other relevant institutions. On March 18, 1995, the *Law of the People's Republic of China on the People's Bank of China* passed by the National People's Congress for the first time legally confirmed the central bank status of the PBC, marking a milestone for the development of the central bank system.

5. The central bank after functional re-adjustment (2003-present)

In 2003, according to the restructuring plan of the State Council approved by the First plenum of the Tenth National People's Congress, the supervisory responsibilities of the PBC over the commercial banks, asset management companies, trust and investment companies and other depository institutions were transferred to the newly established China Banking Regulatory Commission. It is clearly stipulated that "the People's Bank of China, as the central bank of the People's Republic of China, is a member of the State Council, which, under the leadership of the State Council, formulates and implements monetary policy, maintains financial stability and provides financial services."

II. Major functions and organizational structure of the PBC

After the functional re-adjustment, the PBC mainly performed the functions of formulating and implementing monetary policy, maintaining financial stability and providing financial services.

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In particular, its functions related to the formulation and implementation of monetary policy were strengthened, the approaches to macro financial management and the prevention and resolution of systemic financial risks were transformed, and anti-money laundering and management of the credit information system were added as new responsibilities to the PBC. With years of reform and development, the organizational structure of the PBC has undertaken evident improvement (see the attached organizational structure of the PBC head office).

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In addition, the PBC has also established a branch network comprising 9 regional branches and operations offices across the country.

With the development of the socialist market economy, the PBC's role as the central bank has become increasingly important in China's macroeconomic management. In face to the increased tasks and greater responsibilities, the PBC has forcefully strengthened its functions related to the formulation and implementation of monetary policy. In particular, regulation, surveillance and monitoring of financial markets like the money market, the foreign exchange market, and gold market have been enhanced while close attention has been paid to the performance and risk developments of other financial markets which bear significance for systemic financial stability. Besides, a mix of monetary policy instruments including the interest rate and exchange rate has been flexibly applied to exercise macro control over the financial industry, and important strategies concerning the reform, development and stability

of the overall financial sector have been brought under careful study and planning so as to ensure adequate protection of the national economic security and interests.

III. Relevant experiences

In a timeframe of over 50 years, the PBC has been playing a significant role in implementing monetary policy, maintaining currency value, safeguarding financial stability, boosting economic growth and facilitating economic restructuring. Many useful experiences and lessons have been attained in this process.

1. Currency stability constitutes the prerequisite for stable and rapid economic growth

Experiences over the past years have proved that there exists a strong and mutually re-enforcing correlation between currency stability and the steady economic growth. Economic instability, either in the form of inflation or deflation, could damage healthy economic growth.

2. Market rules must be observed to improve the effectiveness of monetary policy, consolidate market infrastructures and foster product innovation

With the advancement of market orientation of the Chinese economy, the PBC has shifted to take a more scientific, forward-looking and effective approach to macro control over the financial industry. In particular, various monetary policy instruments have been flexibly adopted to adjust the frequency and intensity of the macroeconomic control. Market instruments have been emphasized to strengthen both aggregate control and structural adjustment, with the market-based financial control mechanism further enhanced. Meanwhile, a series of measures have been taken to consolidate market infrastructures, aiming at fostering market development and product innovation.

3. Monetary policy must be coordinated with other macro economic policies to promote economic growth and restructuring

Monetary policy and fiscal policy are the two basic tools for the government to carry out macroeconomic management, and therefore both have a great bearing on economic growth and restructuring. In a market economic environment, how to most effectively coordinate the functions of monetary policy and other macroeconomic policies so that they could jointly produce concerted support to the development of the national economy has long remained a key subject for the authorities. In recent years, under the leadership of the State Council, monetary policy has been effectively implemented along with other macroeconomic policies to fine-tune the economic management and the policy mix has produced good results.

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4. Financial stability provides basic insurance for national economic security

Due to some historic reasons, financial risks accumulated in the banking sector remain high

While strengthening risk disposal, the PBC has also been striving to put in place a long-lasting effective mechanism for preserving financial stability . . .

and much needs to be done to dissolve the risks. Under the leadership of the State Council, the PBC has been taking a series of creative measures in its capacity as the lender of last resort to safeguard financial stability, contributing to the gradual mitigation of the exposed risks in the financial industry. While strengthening risk disposal, the PBC has also been striving to put in place a long-lasting effective mechanism for preserving financial stability, cultivating risk awareness of the investors and safeguarding national economic security.

Organizational Structure of the People's Bank of China Head Office

- General Administration Department
- Legal Affairs Department
- Monetary Policy Department
- Financial Market Department
- Financial Stability Bureau
- Financial Survey and Statistics Department
- Accounting and Treasury Department
- Payment System Department
- Technology Department
- Currency, Gold and Silver Bureau
- State Treasury Bureau
- International Department
- Internal Auditing Department
- Personnel Department
- Research Bureau
- Credit Information System Bureau
- Anti-Money Laundering Bureau

Evolution and Role of the Reserve Bank of India

Evolution of the Functions

After the enactment of the Reserve Bank of India Act, 1934, the Reserve Bank commenced its operations on April 1, 1935. The changing role of the Reserve Bank can be reviewed in four broad phases, viz.,

I. Initial phase (1934-1948),
II. Maturing phase (1948 till bank nationalisation in 1969),
III. Phase of Government dominance (1969-1991), and
IV. Economic reform phase (1991-till date).

I. Initial phase (1934-1948)

The objective of the Bank, as set out in the Preamble to the Act is to focus on monetary stability and operations of currency and credit system in India. Even after the separation of Burma (now Myanmar) in April 1937, the Bank functioned as the currency authority of that country till June 5, 1942 and as banker to the Government of Burma till March 31, 1947. On partition of the country in August 1947, the Bank continued to render central banking services to the Dominion of Pakistan until June 30, 1948. In view of the need for close integration between policies of the RBI and those of the Government, the question of State ownership of the RBI was raised from time to time even during the pre-Independence days. With the cessation of the Bank's role as the central banker to India as well as Pakistan after September 30, 1948, the intention of State ownership of the RBI fructified in the form of the Reserve Bank of India (Transfer to Public Ownership) Act, 1948 which nationalised the RBI and it became a State-owned institution on January 1, 1949. During this initial phase (since inception of the RBI till its nationalisation in 1949), the RBI, even as a private institution, was functioning under the dictates of the Government.

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II. Maturing phase (1948 till bank nationalisation in 1969)

After the country's Independence from the British rule in 1947 and the nationalisation of the RBI in 1949, the RBI was required to perform, besides the traditional central banking role, a wide range of promotional functions to accelerate the pace of economic development with social justice through the process of economic planning. Thus, one of the major tasks of the RBI was building up of a modern, sound and adequate banking and credit infrastructure. The RBI was vigorously involved in promoting the institutionalisation of credit delivery to agriculture and industry, and promotion and mobilisation of overall savings in the economy. This required active involvement of the RBI in institution building and expansion of its activities, as observed up to the nationalisation of 14 major banks in 1969. Through necessary legal changes, the functions of debt management, banking regulation, deposit insurance, and exchange control were conferred on the RBI. Thus,

The Bank was empowered under the Banking Regulation Act, 1949, to curb undesirable banking practices and protect the interests of depositors.

under the provisions of the RBI Act, 1934, the Public Debt Act, 1944 and the Public Debt Rules, the RBI was conferred the power to manage and administer the public debt of the Central and State Governments. The Bank was empowered under the Banking Regulation Act, 1949, to curb undesirable banking practices and protect the interests of depositors. Deposit Insurance Corporation of India was set up in 1962 (renamed as Deposit Insurance and Credit Guarantee Corporation in 1978) as a wholly owned subsidiary of the RBI to provide insurance cover to the bank depositors. The co-operative banking system was partially brought within the statutory ambit of the Bank in 1966. The majority ownership of the country's largest commercial bank, namely the State Bank of India, set up in 1955 as the successor to the Imperial Bank of India, was vested with the RBI. The RBI also had a role in setting up of several specialised financial institutions at the national and regional levels, which, *inter alia,* include the erstwhile Industrial Finance Corporation of India, the erstwhile Industrial Development Bank of India, State Financial Corporations and the erstwhile Unit Trust of India. In the interest of making the most prudent use of the foreign exchange resources, the Foreign Exchange Regulation Act was enacted in 1947 and provided the statutory basis for placing the subject under the RBI's control. This Act remained in force for little over half-a-century though with substantial modifications in 1973. The RBI's responsibilities and functions were significantly redefined through various statutory amendments, to enable it to function as an important agency in building post-independent India.

III. Phase of Government Dominance (1969-1991)

The period during 1969 to 1991, i.e., up to the initiation of economic reforms, may be called the phase of Government dominance. With the nationalisation of 14 major banks in 1969 and another six banks in 1980, the RBI became an important instrument for planned development. During the period from the nationalisation of the RBI in 1949 until nationalisation of 14 major commercial banks in 1969, the RBI matured into a full-fledged professionally managed central bank, perhaps one of the foremost in the developing countries. However, it was during this phase of institution building and ascendancy of planned economic development that the system of *ad hoc* Treasury Bills and automatic monetisation of government deficit got institutionalised. It was

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agreed between the Government and the RBI that the latter would replenish the Government's cash balances by creation of *ad hoc* Treasury Bills in favour of the RBI. The *ad hoc* Treasury Bills, which were meant to be temporary, gained, over the years, a permanent as well as a cumulative character. Indeed, it became an attractive source of financing government expenditures since it was available at an interest rate pegged at 4.6 per cent per annum since 1974, i.e., actually at a negative real interest rate!

The nationalisation of major banks brought about a situation where the Government became the owner of a number of banks, but the supervision of these banks was, in turn, conducted by the RBI, which was also owned by the Government. The development financial institutions (DFIs), on the other hand, were not only under the control of the Government but were also not subjected to prudential regulation or supervision. Though the situation was not unique to India and was somewhat similar to that in some European countries, in India, persistence of high fiscal deficits posed serious problems for prudent monetary management. For cost-effective and easy access to market borrowings, the interest rates were administered and the Statutory Liquidity Ratio (SLR) requirements of the banking sector were periodically hiked. With the government ownership of banks, there was a captive market for Government securities. At the same time, recourse of the Government to RBI credit led to high levels of monetisation. To neutralise the effect of monetisation on the price level, the RBI had to intermittently increase the Cash Reserve Ratio (CRR) requirements for the scheduled commercial banks. Besides the above pre-emption of funds, banks were required to extend a large share of their credit to priority sectors at pre-determined interest rates. Thus, only a small proportion of banks' funds were left for credit to non-priority sectors at much higher rates of interest. There was, thus, a significant cross subsidisation of interest rates across sectors within the administered interest rate structure, wherein there was little scope for banks to assess or price the risks of borrowing entities.

. . . in India, persistence of high fiscal deficits posed serious problems for prudent monetary management.

IV. Economic reform phase (1991-till date)

The period since 1991 till date, which marks the phase of economic reforms, has seen ongoing efforts by the Government in designing and implementing various reform measures, especially in the external and the financial sectors. In the aftermath of the balance of payments crisis of 1991, the stabilisation programme was accompanied by measures of structural reforms to remove the structural rigidities afflicting the various sectors of the economy, of which the reforms of the financial and external sector were the important constituents. The reforms in the financial sector were guided by the Report of the Committee on Financial System (Narasimham Committee I, Government of India, 1991) and the Report of the Committee on the Banking Sector Reforms (Narasimham Committee II, Government of India, 1998) while that of reform in the external sector, accompanied by other changes, was guided by the Report of High Level Committee on Balance of Payments (Chairman: Dr. C. Rangarajan; RBI, 1993).

It is essential to recognise that reforms in the financial and external sectors are, in a large measure, part of the overall economic reforms and necessarily involve redefining the role of the public institutions as well as the market participants. Since financial sector reforms in

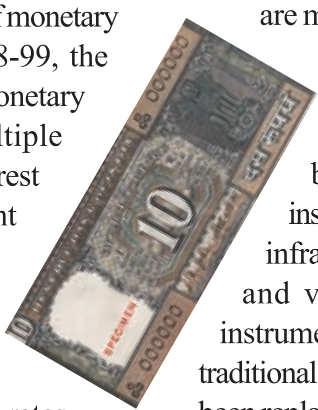
India were taken up in the early part of the reform cycle, the changing role of the RBI acquired prominence in the reform process as a whole. It is useful to trace the changing role of the RBI since 1990s in terms of the functional features.

Monetary and Credit Operations

Traditionally, the Reserve Bank has pursued the twin objectives of price stability and ensuring adequate credit to productive sectors of the economy. The relative

. . . after the opening up of the economy since the early 1990s, financial stability has emerged as a key consideration in the conduct of monetary policy.

emphasis between these two objectives depends on the underlying economic conditions and is spelt out from time to time. With the move towards a market-oriented regime consequent upon the introduction of structural reforms and the increasing episodes of financial instabilities after the opening up of the economy since the early 1990s, financial stability has emerged as a key consideration in the conduct of monetary policy. Accordingly, since 1998-99, the Reserve Bank switched from a monetary targeting framework to a multiple indicators approach wherein interest rates or rates of return in different financial markets, along with relevant macro, monetary and fiscal data are juxtaposed with output for drawing policy perspectives. Short-term interest rates have emerged as signals of monetary policy stance. A significant shift is the move towards market-based instruments away from direct instruments of monetary management. A key step has been the introduction of a liquidity management framework in which market liquidity is modulated through a mix of open market (including repo) operations including liquidity adjustment facility (LAF), Market Stabilisation Scheme (MSS) and Cash Reserve Ratio (CRR), and using the policy instruments at its disposal flexibly, as and when situation warrants.



Development and Regulation of Financial Markets

The development of financial markets in India has been pursued essentially for bringing about a transformation in the structure, efficiency, and stability of markets as also facilitating integration of markets. The emphasis has been put on strengthening price discovery, easing of restrictions on flows or transactions, lowering of transaction costs, and enhancing liquidity. During post-reform period, the structure of financial market has witnessed a remarkable change in terms of the types, the number and the spectrum of maturity of financial instruments traded in various segments of money, gilts and foreign exchange markets.

Money Market

The primary aim of Reserve Bank's operations in the money market is to ensure that the liquidity and short-term interest rates are maintained at levels consistent with monetary policy objectives. Accordingly, the strategy has focused on developing pure inter-bank call/notice money market, instituting full-fledged LAF, developing infrastructure, promoting transparency, and various measures pertaining to instruments for non-bank participants. The traditional refinance support on fixed terms has been replaced, while moving to a full-fledged LAF since 2000.

Government Securities Market

As a debt manager to the Government, the development of a deep and liquid market for Government securities is of critical importance to the Reserve Bank in facilitating price discovery and reducing the cost of Government debt. Such markets also provide an effective transmission mechanism for monetary policy, facilitate the introduction and pricing of hedging products and serve as benchmarks for other debt instruments. During the 1990s, the approach to development of Government securities market focussed on removal of structural bottlenecks, introduction of new players and instruments, free pricing of financial assets, relaxation of quantitative restrictions, and improvement in trading, clearing and settlement practices. Reforms also encompassed regulatory and legal changes, technological upgradation and refinement of the market microstructure. In order to facilitate these reforms, various measures have been taken to widen the repo market, stabilisation of the Negotiated Dealing System (NDS) and Clearing Corporation of India Ltd. (CCIL), introduction of trading on stock exchanges, and release of NDS trade data on RBI website.

Foreign Exchange Market

With the institution of the market determined exchange rate in March 1993 and large capital inflows during 1993-95, the Reserve Bank has undertaken several measures to widen and deepen the foreign exchange market. Over a period, considerable flexibility has been given to the corporates, banks, and non-residents to hedge their foreign exchange exposure in the market. Measures have been taken to gradually liberalise capital account transactions.

India's exchange rate policy, drawing on cross-country experiences, of focusing on managing volatility with no fixed rate target while allowing the underlying demand and supply conditions to determine the exchange rate movements over a period in an orderly way, has stood the test of time.

Exchange Rate and Reserve Management

The conduct of exchange rate policy in India is guided currently by three major purposes. First, to maintain orderly conditions in the foreign exchange market by providing foreign exchange as considered necessary from time to time, and to prevent the emergence of destabilising and self-fulfilling speculative activities. Second, to help maintain an

adequate level of foreign exchange reserves. Third, to help eliminate market constraints with a view to facilitating the development of a healthy foreign exchange market. India's exchange rate policy, drawing on cross-country experiences, of focusing on managing volatility with no fixed rate target while allowing the underlying demand and supply conditions to determine the exchange rate movements over a period in an orderly way, has stood the test of time. The Reserve Bank continues to follow the approach of watchfulness, caution and flexibility in regard to foreign exchange market. It co-ordinates its market operations carefully, particularly in regard to the foreign exchange market with appropriate monetary, regulatory and other measures as considered necessary from time to time.

The overall approach to management of foreign exchange reserves in India has mirrored the changing composition of balance of payments, and has endeavoured to reflect the 'liquidity risks' associated with different types of flows and other requirements. The policy for reserve management is thus judiciously built upon a host of identifiable factors and other contingencies. Operationally, the essential framework for reserve management in the Reserve Bank is provided by the legal enactments as regards currency, market and instruments for investment. The overall stance of the Reserve Bank's forex reserve management policy continues to be

Consolidated accounting for banks has been introduced along with a system of Risk-Based Supervision (RBS) for intensified monitoring of vulnerabilities.

a risk averse one aiming at stable returns. The Reserve Bank has instituted sound systems to identify, measure, monitor and control various risks. The reserve management strategies are continuously reviewed by the Reserve Bank in consultation with the Government. The foreign exchange reserves stood at US $ 135.6 billion as on February 27, 2005.

Financial Regulation and Supervision

The Reserve Bank is entrusted with the supervision of India's banking system under the provisions of the Banking Regulation Act, 1949 and the RBI Act, 1934. In order to provide focused supervision of financial entities, the Board for Financial Supervision (BFS) was constituted in November 1994, as a committee of the Central Board of Directors of the Reserve Bank with the objective of supervising commercial banks, select financial institutions, non-banking financial companies, cooperative banks and primary dealers.

A major element of financial sector reforms has been a set of prudential measures aimed at imparting strength to the banking system as well as ensuring safety and soundness through greater transparency, accountability and public credibility. Capital adequacy norms for banks on the lines of the Basel Committee have been effected in a gradual manner since March 1992 and from end-March 2000, and the prescribed ratio has been raised to 9 per cent.

As a result of improvements in the regulatory and supervisory framework, the degree of compliance with Basel Core Principles has generally been high, and observed areas of weaknesses have been addressed. Consolidated accounting for banks has been introduced along with a system of Risk-Based Supervision (RBS) for intensified monitoring of vulnerabilities. A scheme of Prompt Corrective Action (PCA) was introduced effective December 2002 to undertake 'structured' and 'discretionary' actions against banks exhibiting vulnerabilities in certain prudential/financial parameters. With liberalisation, financial conglomerates are emerging. Banks have accordingly been advised to prepare and disclose consolidated financial statements and prepare consolidated prudential reports. The inter-regulatory coordination has also been streamlined with the establishment of a monitoring system in respect of Systemically Important Financial Intermediaries (SIFIs), coupled with the establishment of three Standing Technical Committees constituted by the High Level Coordination Committee on Financial and Capital Markets (HLCCFCM) to provide a more focused inter-agency forum for sharing of information and intelligence. To identify the strengths and vulnerabilities of the financial system, a half yearly review on financial soundness indicators (also known as macro-prudential indicators MPI) is undertaken. The MPI review comprises both aggregated micro-prudential indicators (AMPIs) of the health of individual financial institutions and macroeconomic indicators (MEIs) associated with financial system soundness.

Public Debt Management

Till the early 1990s, the focus of debt management was on minimising the cost of borrowing to the Government. Thereafter, with the switch towards borrowing at market-related rates, the focus has broadened to minimising the cost of borrowing over the long run, subject to acceptable refinance/rollover risk, the maturity profile of debt, timing of issuances and types of instruments, depending on market conditions. The era of reforms during the 1990s has been marked by significant developments with respect to the evolving relationship between the Reserve Bank and the Government. In this respect, the historic agreement in 1997 between Government and the Reserve Bank on the termination of the system of automatic monetisation and introduction of a system of Ways and Means Advances constitutes a watershed in public policy governing their mutual relationship.

Currency Management

The Preamble to the RBI Act makes it obligatory for the Bank to carry out the function of note issue and currency management. Given the vast geographical spread of currency operations, prevalent marked preference for cash in payment transactions and the currency handling practices, the Reserve Bank endeavours to ensure the availability of adequate quantities and reasonably good quality of notes and coins in the country through its various offices and a wide network of currency chests and small coin depots. The Reserve Bank has embarked upon an ambitious project of mechanisation of currency processing and introduced various changes in the systems and procedures related to currency management for effective execution of the 'Clean Note Policy'. The steps included mechanisation of the currency processing activity by installation of Currency Verification and Processing Systems as also destruction of notes by modern Shredding and Briquetting machines, introduction of latest security features in the notes, *etc*.

Payment and Settlement System

The Reserve Bank has made concerted efforts at developing a safe, secure and efficient payment and settlement system to enhance financial stability. Recognising the need for providing a safe, sound and robust platform to facilitate the absorption of technology by banks, the Institute for Development and Research in Banking Technology (IDRBT) was established in 1996, which is an autonomous centre for providing essential core networking functions for banks. The IDRBT has set up the country's financial communication backbone called the INFINET (INdian FInancial NETwork) – which is a Wide Area Network based on Satellite communication (using VSATs) and terrestrial lines. To reduce risks in Deferred Net Settlement System (DNSS), the real time gross settlement (RTGS) has been operationalised by the Reserve Bank since 2004. RTGS is a large value funds transfer system whereby financial intermediaries can settle inter-bank transfers for their own account as well as for their client.

Human Resource Development

The focus of human resources (HR) development in the Reserve Bank has also altered in tune with the rapidly evolving dynamics of the operating environment. The goal of HR initiatives in the changed financial landscape has been to adopt/develop a robust HR management system that enhances efficiency and creates an enabling work environment, which encourages individual responsibility. Increased emphasis is being placed on facilitating performance improvement and personal growth within the overall institutional goals whereby personnel policies and practices are being increasingly integrated into the corporate strategy. Upgradation of the available human resource pool so as to keep it attuned to the challenges arising out of globalisation and advances in technology has been an important challenge facing the Reserve Bank. The efforts of the Reserve Bank have been aptly reflected in the number of recent initiatives undertaken towards enriching its human potential and right sizing the institution.

V. Concluding Remarks

The Reserve Bank, in close and continuous consultation with the Government, has played a major role in institution building since independence. Efforts in this direction encompass Reserve Bank's contribution in the form of development of commercial banking, development finance institutions for different segments of the economy, and specialised institutions for development of financial markets. Since the onset of economic reforms in the early 1990s, the role of Reserve Bank in the area of developing the various financial markets have come to the fore. Furthermore, in a global environment, with increasing integration of the international economy, the Reserve Bank's role as the regulator and supervisor of commercial banks and financial institutions has assumed a central place in promoting transparency and credibility of institutions and monetary and financial policies.

(This article is prepared by the Department of Economic Analysis and Policy of the RBI)

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Friendly Ties between the Nepal Rastra Bank and the Bank of Japan

Contribution commemorating the 50th anniversary of NRB establishment

Toshihiko Fukui
Governor
Bank of Japan

I wish to offer my sincere congratulations to the Nepal Rastra Bank (NRB) on the 50th anniversary of its foundation, and to Mr. Bijaya Nath Bhattarai for his recent appointment as NRB Governor. The Bank of Japan (BOJ) and the NRB have a long and cordial relationship, and it is a great honor to be invited to contribute an article to this publication marking 50 years of prosperity at the NRB. I would like to take this opportunity to recall the history of the relationship between our two central banks, so to look forward into a future in which our ties are strengthened further.

Japan established diplomatic ties with Nepal in 1956, when the NRB began operation. The relationship between the BOJ and the NRB began following the establishment of diplomatic ties. In June 1961, the NRB opened a yen deposit account with the BOJ. This was an event of particular note as the NRB was the first foreign central bank to open an account with the BOJ, which is not widely known. In other words, the NRB is the BOJ's oldest customer and has a longer history of transactions through its BOJ account than any other central bank.

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The two central banks also have a long history of personnel exchange. The BOJ, at the request of the NRB, sent Mr. Masaaki Muto (then Manager, BOJ Research and Statistics Department) to Nepal in 1971. He was stationed there as an adviser from 1971 through 1972. Although no written record is available today detailing either the events leading to Mr. Muto's visit or his mission at the NRB, the visit was noteworthy as a dispatch of BOJ staff in a personnel exchange.

The BOJ sent an adviser to the NRB during the 1980s as well, though it was for only a short period of time. At the request of Mr. Ganesh Bahadur Thapa (then NRB Governor) to Mr. Satoshi Sumita (then BOJ Governor), who met at the annual meeting of the World Bank and the International Monetary Fund in Seoul in 1985, the BOJ sent Mr. Takayoshi Shimamura (then Adviser to the Governor, BOJ Research and Statistics Department) to the NRB in 1986. He was assigned as an adviser to improve administrative operations of the NRB.

The short stay of less than one month from January to February 1986 was so memorable that Mr. Shimamura devoted a paragraph in his book to describe his experience. In matters related to his work, Mr. Shimamura engaged in frequent discussions with NRB directors and department staff, and visited job sites. Based on these interviews and visits, he made recommendations on organization, internal management, banknote issuance operations, and economic research and statistics activities, and submitted them directly to NRB Governor. Mr. Shimamura, also offering advice regarding the importance of savings to NRB officers, was asked to make a presentation on the topic

Bank of Japan

and gave a speech entitled "Towards a More Self-Reliant Economy", explaining the savings drive that had taken place in Japan after World War II. Backed by the warm support of NRB staff, Mr. Shimamura was able to complete his mission.

In personal terms, Mr. Shimamura notes in his book that he was treated with great respect. He received warm welcomes at reception parties hosted by NRB directors, and he was provided with an executive office, a personal secretary and a chauffeur. He was also moved by the beautiful temples near Kathmandu and the magnificent scenery of the Himalaya Mountains and lakes as seen from Pokhara. Although it took time for him to adjust to certain local customs, such as the two-meal day, working on Sundays, and taking Saturdays off, the short stay converted Mr. Shimamura into a fervent admirer of Nepal.

I should also mention how our relationship has been cultivated through international forums including those provided by the Asian Development Bank, The South East Asia, New Zealand and Australia (SEANZA) group, and the South East Asian Central Banks (SEACEN). Of these, SEANZA offers an opportunity to renew our ties through its governors' symposiums and training courses.

In 1983, Mr. Satoshi Sumita, then Deputy Governor and later appointed the 25th BOJ Governor in December 1984, participated in the SEANZA Governors' Symposium held in Kathmandu with his wife and several BOJ colleagues. The BOJ delegates spent their time in Nepal very comfortably thanks to the kind support and warm hospitality of NRB staff. The hospitality was clear as early as the delegation's arrival at Katmandu Airport, where immigration and custom clearance went smoothly and efficiently, thanks to generous assistance of NRB staff. The logistics overseen by the NRB were so efficient; in fact, the symposium ended one day ahead of schedule. The NRB staff promptly arranged an air tour of the Himalayas, a day earlier than originally scheduled. This greatly impressed

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all BOJ delegates, who reflected that in Japan rescheduling wouldn't go as smoothly as this. Needless to say, the glorious landscape of the Himalayas from the air impressed them as well.

As another example of the two central banks' contact through SEANZA, Mr. Ryoichi Shinagawa (then economist, BOJ Research and Statistics Department) took part in a SEANZA training course held in Nepal in the year after Mr. Sumita's visit.

With regard to BOJ technical assistance programs, the BOJ has invited NRB members to participate in its seminars for SEANZA central banks. Participants in recent seminars

have included Mr. Keshav Prasad Acharya (Executive Director) and Mr. Rewat Bahadur Karki (Chief Manager). The BOJ also sends lecturers to seminars and workshops organized by SEACEN, of which the NRB is a member.

A recent example of an exchange is the visit of Mr. Ganesh Kumar Shrestha (Executive Director, Policy Planning Department) to the BOJ in November 2003, for which the meetings were arranged with Mr. Eiji Hirano (BOJ Assistant Governor) and other officers of the BOJ International Department. This visit was at the request of Mr. Bijaya Nath Bhattarai (then NRB Deputy Governor) to Mr. Toshiro Muto (BOJ Deputy Governor), with the aim of studying payment, clearing, and settlement systems of Japan and promoting friendly relations between our two institutions. At the meeting, Mr. Shrestha and BOJ senior officials exchanged views on the economic conditions and on the payment and settlement systems in both countries. They also discussed technical issues, such as establishing reliable telegraphic dispatches between the NRB and the BOJ through the SWIFT network. I am grateful to the NRB, since these discussions gave the BOJ insight into the economic situation in Nepal as well as the activities of the NRB.

I have learned that the NRB is currently making efforts to reform its central banking operations and the nation's financial system under the new NRB Act. Needless to say, effective central banking and a sound financial system are essential for the development of a national economy. I would like to express my admiration for the NRB's dedicated efforts in tackling reform and my conviction in future NRB success.

Central banking and financial system reforms pose enormous challenges. This is because of the need to address the two reforms together amid ongoing, rapid and dramatic changes in the global economy.

Reform also takes time. In Japan, for example, the complete liberalization of interest rates, which began in the 1980s, took almost ten years. It would be a great pleasure if the relationship between the BOJ and the NRB helps to facilitate central banking and financial system reforms in Nepal.

Amid ongoing globalization, economic development in Asia is spurring economic growth around the world. In particular, since the 1980s, the Newly Industrialized Economies (NIEs), major countries of the Association of Southeast Asian Nations (ASEAN), China and India have registered high economic growth, propelling Asia to the center of world economic growth. Regional interdependency among Asian economies is increasing, particularly in trade. However, compared to trade, financial

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linkages are still weak. No major change has been seen in the flow of large amounts of Asian savings to the United States which then flow back to Asia as risk money. Therefore, it is important that central banks in the region cooperate to promote the development and stability of Asian financial markets.

Against the background of increasing economic linkages among Asia as a whole, however, I believe it is beneficial for both the BOJ and the NRB to exchange information and share views despite their differences.

The BOJ has been working on the development and stabilization of Asian financial markets through regional forums and its own technical assistance programs. It has played an active role in the establishment of the Asian Bond Fund under the aegis of the Executives' Meeting of East Asia-Pacific Central Banks. I hope that this wave of international financial cooperation, which began in East Asia, will expand across the entire Asian region.

There are many differences between Japan, a maritime state, and Nepal, a mountain country, in terms of their geographical endowments and institutional frameworks. Against the background of increasing economic linkages among Asia as a whole, however, I believe it is beneficial for both the BOJ and the NRB to exchange information and share views despite their differences. I hope such exchanges will further strengthen the ties between our two central banks, and I conclude

with my sincere wishes for the prosperity of the NRB and of Nepal.

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Korea's Experiences in Conducting Monetary Policy

Executive Summary

Since the Bank of Korea was founded as the country's central bank on June 12, 1950, it has continually evolved to deal effectively with changes in the financial and economic environment. Upon outbreak of the Korean War just after its foundation it provided effective support for the financing of the war effort. Following the war, it sought to assist in the rebuilding of the economy and to bring inflation under control. After the launch in the early 1960s of planned economic development to pull the country out of its absolute poverty, the Bank devoted its energies to ensuring smooth supply of the funds needed for investment and to raising the efficiency of their distribution. In the 1980s, the Bank focused its policy on building up a sound economic foundation to counter the inflation that had emerged following the long period of continued rapid economic growth. From the early 1990s, it put in place a market-oriented monetary policy while undertaking a programme of deregulation, including deregulation of interest-rates in line with the worldwide trend toward financial liberalisation and openness. After the foreign exchange crisis that broke out toward the end of 1997, in keeping with the drive for structural adjustment of the Korean economy, the Bank sought a redefinition of its functions and role as an advanced central bank through, for example, the launch of inflation targeting.

Dr. Seung Park
Governor
The Bank of Korea

In the future, the Bank of Korea will seek to build up its credibility with the general public by increasing its efforts to secure the foundation for price stability and by upgrading its capacity for economic analysis and policy formation.

Financing of the War Effort and Effective Support for Postwar Reconstruction

About 10 days after the Bank of Korea was founded, the Korean War broke out (June 25, 1950). The Bank therefore helped to finance the war effort, by putting in place a system of wartime financing and making up the budget deficits by loans to the government. In order to suppress wartime inflation, it undertook measures such as imposing restrictions on lending by financial institutions and raising banks' reserve requirement ratios. It also provided support for the government's implementation of emergency currency reforms on two occasions.

Upon outbreak of the Korean War just after its foundation it provided effective support for the financing of the war effort.

Following the armistice agreement in July 1953, the Bank focused its policy on rebuilding after the devastation of the war and on reining in the galloping inflation. Priority in support from the limited funds available was given to sectors essential for bringing about stable living conditions and to achieving an early restoration of production facilities.

In order to rein in the supply of funds to less urgent sectors, direct regulatory tools were employed including prioritisation of lending, imposition of ceilings on financial institutions' loans, and the requirement of prior consent to lending. Notably, from 1957 onwards a money

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supply target was established in line with the government's plan for the stabilisation of budget financing.

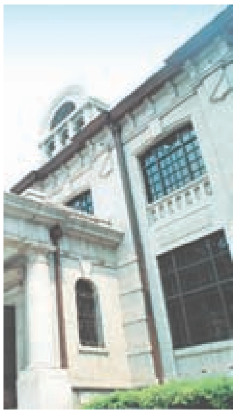
Thanks to such policy initiatives and the large-scale of foreign aid, the average level of economic growth (real GDP growth) rose to 5.7% during 1957~59, from 2.9% during 1954~56. The rate of inflation in terms of the producer price index also eased, to the 4% level from its average of 42% during 1953~56.

Support for Economic Development by Supplying Funds for Growth

Despite the postwar efforts to recover from wartime devastation, even in 1960 Korea remained among the poorest countries in the world with annual per capita income reaching no more than $80.

In order to lift the country out of this situation of absolute penury, from 1962 onwards the government pursued a series of five-year economic plans putting policy priority on economic growth and expansion of employment.

For its part, the Bank of Korea, in its conduct of monetary policy, placed emphasis upon seamless supply of the investment funds required for economic development and upon heightening the efficiency of their distribution. It undertook various methods of selective financing in order to prioritise funding support to growth-leading sectors of the economy. In the early stages of Korean economic development, top priority was given to the provision of funds for those industries with large import substitution effects. Because Korean light industries had international competitiveness, the support for export financing to them was expanded in the subsequent stage, so as to bring about their growths as export industries. Following on this, the allocation of funds was expanded to heavy and chemical industry sectors such as iron and steel, petrochemicals and shipbuilding from the early 1970s, when the Korean economy was considered to have moved out of the initial stages of industrialisation. Bank interest rates were set at lower-than-equilibrium levels to encourage firms' production and investment activities. Meanwhile, preferential rates were paid on deposits in order to mobilise savings. Notably, to encourage exports, various



Bank of Korea

In the early stages of Korean economic development, top priority was given to the provision of funds for those industries with large import substitution effects.

types of policy financing were put in place including export support funds on which interest rates lower than those on general loans were applied. The burden that this placed on banks' earnings was made up for by low interest rate rediscounts from the Bank of Korea.

The Bank of Korea contributed greatly toward the Korean economy's achievement of high average annual growth above the 8% level during the 1960s and 1970s, by underpinning the financial aspects of the government-led growth-first policy. In the process, however, chronic inflation lingered on and the adverse side effects of credit allocation at the direction of policy authorities gradually emerged as the scale of the economy expanded.

Construction of a Foundation for Economic Stability, and the Drive for Financial Liberalisation

From the beginning of the 1980s, policies were put into place to overcome the problems that had built up during the prolonged period of rapid economic growth, and to provide a foundation for economic stability. An attempt was made to change the way in which the economy was run, from government direction to private sector leadership in line with the market mechanism. The main priority of economic policy also shifted, from high growth to sustainable growth plus price stability.

Toward these ends, the government and the Bank of Korea put in place macroeconomic policies oriented toward reining in fiscal spending and money supply as far as possible. The Bank of Korea implemented full-fledged monetary targeting, adopting M2[1] as its chosen aggregate. It subsequently sought to minimise demand-pull pressures on prices through downward adjustment of the money supply target year

The main priority of economic policy also shifted, from high growth to sustainable growth plus price stability.

by year. Consequently, the rate of M2 growth, which had exceeded 30% on an annual average during the 1970s, dropped to the 10% level from 1983 onwards. The rate of increase in consumer prices, meanwhile, which had remained in double digits until the early 1980s, fell to the 2~3% range during the three years from 1983 to 1985.

The firming up of this foundation for economic stability enabled the Korean economy to make rapid progress, taking advantage of the improved external environment during the latter half of the 1980s. From 1986 onwards crude oil prices fell, the US dollar weakened internationally, and international interest rates eased, producing the episode termed "the triple lows". For three years running, the Korean economy achieved high growth of about 10%, while the current account shifted into large-scale surplus. The consumer price index, meanwhile, was held to a 4.3% average annual rise.

The shift of the current account into surplus greatly spurred the progress of internationalisation and liberalisation. There was a great easing of a broad range of regulations concerning foreign exchange and capital transactions, and a number of new financial institutions were established including banks, investment trust companies, insurance companies and leasing companies.

Large-scale monetary expansion, meanwhile, occurred through the overseas sector with the shift of the current account into surplus. To sterilise this inflow, the Bank of Korea adopted a multi-pronged monetary

1 M2, at that time, consisted of currency in circulation plus deposits at deposit money banks.

policy response: it expanded its issuance of Monetary Stabilisation Bonds, raised reserve requirement ratios and introduced a system of marginal reserve requirements. In tandem, it began a drive to reduce the various systems of policy financing that gave preferential treatment in terms of the fund allocation and application of interest rates. The Bank's intention in this was to create an environment conducive to monetary policy operation using indirect methods of adjustment.

. . . the Bank of Korea adopted a multi-pronged monetary policy response: it expanded its issuance of Monetary Stabilisation Bonds, raised reserve requirement ratios and introduced a system of marginal reserve requirements.

Globalisation of the Economy and the Acceleration of Financial Liberalisation and Openness

From the start of the 1990s, the government and the Bank of Korea stepped up their drive for the liberalisation of financial and foreign exchange transactions and opening of the capital markets. In the years from 1991 to 1995, three stages of the plan for interest rate deregulation were put in place, freeing up the majority of interest rates apart from those on some types of short-term deposits such as demand deposits[2]. The year 1994 saw abolition of the greater part of the Bank of Korea's policy financing, with some of it shifted over onto fiscal funds. At the same time, the rediscount system was completely reorganised, through simplification to comprise the Aggregate Credit Ceiling Facility. There was a bold drive to ease regulations on banking business: the mandatory ratio of lending to manufacturing was abolished, that for lending to small and medium-sized enterprises was lowered, and branching by financial institutions was liberalised. The government introduced a market average exchange rate regime, and greatly expanded the scope of foreign exchange liberalisation including relaxation of the foreign exchange concentration system. Similarly, regulations were continually lightened on foreign inward investment and on domestic residents' overseas investment.

Korea was admitted to the OECD in 1996, in view of its drive for financial and economic liberalisation and openness and the success of its economic development.

Outbreak of the Foreign Exchange Crisis and the Drive for Structural Reform

With the growing maturity of the Korean economy, its GDP growth rate retreated gradually into single digits from the early 1990s, while the current account slid back into deficit.

Strikingly, in 1994 and 1995, there was a rebound in domestic business activity with GDP growth rising to the 8% level, but the current account deficit widened. In 1996, subsequently, the current account moved even more deeply into the red despite the downturn in the trend of economic activity as exports slowed and investment slackened off.

. . . foreign funds for equity investment turned to a net outflow under the combined impact of a sharp rise in financial institutions' non-performing assets and the contagion effect from currency crises in Southeast Asia.

From early 1997, the Korean economy showed a pattern of accentuated instability exemplified by a series of bankruptcies involving large companies and the drying up of foreign capital inflows. Notably, from early July onwards, foreign funds for equity

2 With the abolition in February 2004 of regulations on demand deposit interest rates, all interest rates are now fully liberalised.

investment turned to a net outflow under the combined impact of a sharp rise in financial institutions' non-performing assets and the contagion effect from currency crises in Southeast Asia. In the international financial markets, Korean financial institutions found themselves in an awkward situation in which the rolling over of their maturing loans became difficult.

Eventually, in November 1997, the situation developed into a crisis when the exchange rate of the Korean won against the US dollar shot up precipitously amid concerns over foreign exchange settlement failure because of the steep decline of the nation's foreign exchange reserves. The exchange rate of the Korean won against the dollar, which stood below 1,000 won to the dollar until mid-November, climbed sharply to reach 1,900 won per dollar for a while in December. The country's foreign exchange reserves, meanwhile, shrank from 22 .3 billion dollars at the end of October to just 3.9 billion dollars on December 18.

The government accordingly requested support from the IMF on November 21. In consultation with the IMF, it was agreed that financial support amounting to 58.4 billion dollars[3] would be made available from the IMF and other international financial organisations.

Financial institutions deemed incapable of return to viability because of their bad loan overhangs were forced to exit the market, while the early rehabilitation of those deemed capable of turnaround was engineered through support for their recapitalisation and disposals of their bad loans.

The government pursued a rigorous structural adjustment of financial institutions and firms, in order to remedy the economic structural fragility at the root of the foreign exchange crisis. Financial institutions deemed incapable of return to viability because of their bad loan overhangs were forced to exit the market, while the early rehabilitation of those

deemed capable of turnaround was engineered through support for their recapitalisation and disposals of their bad loans. Terminally insolvent companies were forced to exit through merger, sale or liquidation. Those deemed capable of turnaround, meanwhile, were required to undertake work-out programs involving adjustments of their financial structures and receipts of support in the form of fresh financing. In order to promote the inducement of foreign investment funds in line with this, the bond market was opened in December 1997, and 1998 saw the full openings of the stock and money markets.

In keeping with these government initiatives, the Bank of Korea devoted wide-ranging efforts to support the restructuring of financial institutions and recovery of the real economy. After the outbreak of currency crisis, the Bank adhered to a high interest rate policy so as to secure foreign currency liquidity and stabilise the exchange rate. The overnight call rate reached the 30% mark at the end of December 1997, as against its level of 12~14% in November before the crisis erupted. Once some degree of stability had returned to the foreign exchange market, from the beginning of the second quarter of 1998, the Bank of Korea engineered a steady

3 The total of the funds actually made use of amounted to 30 .2 billion dollars. Of this, 19.5 billion dollars consisted of loans from the IMF and these were redeemed in full by August 23, 2001.

reduction of interest rates to prevent the real economy from sliding into overly deep depression. The overnight call rate responded by dropping back to the 9% level by the beginning of August 1998. In a move to support the restructuring of financial institutions, the Bank of Korea purchased bonds issued by the Deposit Insurance Fund and the Non-Performing Asset Resolution Fund. It also supplied additional liquidity to stabilise the financial markets. Financial support for small and medium-sized enterprises and exporters, many of which were experiencing problems in the course of restructuring, was strengthened by the expansion of the Aggregate Credit Ceiling Facility.

Thanks to these policy initiatives, the financial and foreign exchange markets regained their stability, and it proved possible to escape the deep business recession that had followed the currency crisis. The GDP growth rate, after registering -6.9% in 1998,

. . . there was a shift in the method of monetary policy operation from monetary targeting to inflation targeting.

rebounded sharply to reach 9.5% in 1999 and 8.5% in 2000.

Introduction and Operation of Interest Rate- Oriented Inflation Targeting

As part of the financial reform following the foreign exchange crisis, the Bank of Korea Act was revised with effect from April 1998. Under its revised provisions, there was a shift in the method of monetary policy operation from monetary targeting to inflation targeting. Entering the mid-1990s, monetary targeting in Korea had been seen to have various problems, in line with the unstable movements of the monetary aggregates amid the progress of financial reform and the realignment of various financial systems. Consequently, the Bank of Korea opted for inflation targeting, a system which had already spread to many countries during the 1990s, and shifted to a monetary policy focused on interest rates

The GDP growth rate, after registering -6.9% in 1998, rebounded sharply to reach 9.5% in 1999 and 8.5% in 2000.

employing the interbank overnight call rate as its operating target.

A constant process of improvement and refinement has taken place since the Bank of Korea adopted inflation targeting. Initially, during 1998 and 1999, the rate of increase in the consumer price index(CPI) was employed as the target index. From 2000 onwards, however, a shift was made to the core inflation rate[4], since this shows the underlying changes in price trends more clearly. From the initial introduction of inflation targeting until the year 2003, an annual inflation target was employed, but since 2004 there has been a change to a medium-term inflation targeting system, taking the annualised average rate over a three-year period as a inflation target, in view of the long transmission lags of monetary policy and other factors. Currently, the inflation target for the years 2004~2006 has been set as a range of 2.5~3.5% in terms of the annualised average rate of core inflation. The Monetary Policy Committee establishes the target level for the overnight call rate each month, and this is used as the operating target for attaining the inflation target.

So far, Korea's operation of inflation targeting is assessed as having been successful. In the six years from 1992 to 1997, the rate of core inflation averaged 4.9%, but in the five

4 Core inflation is calculated by stripping out non-grain farming products and oil fractions from the CPI. The weight of the excluded items makes up 11.65% of the consumer price index.

years from 2000 to 2004[5] with inflation targeting in place, its annual average rate fell to 2.9% while its volatility was also greatly reduced. The conduct of an interest rate-oriented monetary policy making use of the call rate as its operating target has also greatly furthered advancement of the Korean financial markets as a whole by, for example, encouraging development of the bond market and increasing the linkages between long-term and short-term market interest rates.

Future Tasks

In systematic terms, following two revisions of the Bank of Korea Act undertaken since the 1997 foreign exchange crisis, the Bank of Korea now in no way falls short of international standards in its degree of independence.

Nor is this all. In keeping with the spread of democracy throughout Korean society, there has come about a great improvement in the customs and practices associated with monetary policy, so that the Bank of Korea's autonomy has come to be effectively guaranteed in terms of practical policy operation as well.

From this new starting point, the Bank of Korea should from here on place utmost importance, along with development of the Korean economy, upon raising its credibility with the general public as an advanced central bank. For this, it must steadily build up its track record in maintaining price stability, its fundamental duty. It is also moving to strengthen its economic analysis and forecasting capabilities and its policy formation capacity.

History of the Bank of Korea from an Institutional Aspect

The Bank of Korea was established on June 12, 1950 under the Bank of Korea Act, as the country's central bank. For more than 50 years since its establishment, the Bank has gone through many adjustments in respect of its independence and functions, in accordance with changes in the financial and economic environment and government economic policies.

At the time of its foundation, the Korean economy was in turmoil suffering severe and chronic inflation with adequate monetary and financial systems not in place. There was, therefore, an urgent need for a modern central bank that had the authority to manage monetary policy in order to bring order to the Korean economy and secure international confidence in it. This situation of the times could explain the fact that the primary purposes of the Bank of Korea included, besides securing price stability as the central bank's traditional objective, preserving the soundness of the banking and credit systems and managing the country's foreign reserves.

. . . government intervention in its policy-making and implementation was not allowed.

For those purposes, the Bank of Korea

5 The years 1998 and 1999 are excluded because of the sharp variations in price increase rates brought about by the large swings in the exchange rate due to the foreign exchange crisis.

was empowered to perform not only the orthodox functions of a central bank, such as issuing banknotes and coins, playing the roles of the bankers' bank and the government's bank, and formulating and implementing monetary and credit policy through direct or indirect instruments, but also given the exclusive authority to carry out banking supervision and formulate foreign exchange policy. In order to ensure the independence of the Bank of Korea, its policy-making body (Monetary Board) was to be made up of experts with ample experience and extensive knowledge concerning finance, economy and industry (but chaired by the Minister of Finance). Moreover, government intervention in its policy-making and implementation was not allowed.

In 1962, 12 years after its establishment, the Bank had to face a significant change of institutional structure. The newly installed Government set out growth-oriented policies. Accordingly, it strengthened its influence over the central bank to support the government's economic program. In particular, authority for foreign exchange policy-making was transferred from the Bank to the Ministry of Finance, the proportion of members recommended by the Government within the Bank's policy-making body was increased, the Minister of Finance was authorized to request the reconsideration of decisions on monetary policy by the Bank, government approval was required for the Bank's budget, and the Minister of Finance acquired the authority to examine the Bank's management. As a result, the independence of the Bank in regard to its policy-making and internal management was significantly weakened.

During the 30 years after this transition, there were no significant changes in the Bank's institutional aspects. There were technical improvements including the supplementing of monetary and credit policy instruments (1968), an increase in the number of officers in charge of banking supervision (1977) and abolition of the government's prior approval for the Bank's budget (1982). During this period, there were several legislative attempts to enhance the independence of the Bank, but they failed to be passed.

The Bank of Korea underwent significant institutional change and financial reform initiated following the financial crisis at the end of 1997. With the amendment of the Bank of Korea Act in late 1997, on the one hand the Bank was granted more autonomy in its monetary policy, on the other hand the authority for banking supervision was stripped from the Bank and assigned to a new integrated financial supervisory body (the Financial Supervisory Service). Even though the purposes of the Bank were reduced to the single goal of securing price stability, the Bank's independence was clearly provided for in the Act, the Governor of the Bank of Korea replaced the Minister of Finance and Economy in the chairmanship of the policy-making body (Monetary Policy Committee), the Minister of Finance and Economy lost his seat on the policy-

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making body, and the proportion of members recommended by the Government within the body was reduced. In addition, the Minister of Finance and Economy's authority to examine the Bank's management was abolished. Inflation targeting was newly stipulated as the operating framework for monetary and credit policy. Meanwhile, the Bank had to report on its policy implementation to the National Assembly at least once a year, which heightened the Bank's accountability. There were substantial changes in the functions of the Bank of Korea. The transfer of its banking supervision authority to the integrated financial supervisory body was partially balanced by the maintenance of its right to request information from financial institutions for monetary policy implementation, to require the financial supervisory body to examine banking institutions and to participate on a joint basis in the examination of banking institutions.

Meanwhile, the Bank had to report on its policy implementation to the National Assembly at least once a year, which heightened the Bank's accountability.

After having gone through dramatic changes in the aftermath of the financial crises, the Bank of Korea saw the independence heightened and consolidated by a further revision of the Bank of Korea Act in 2003 (entry into effect in 2004). In particular, the Deputy Governor of the Bank became an ex-officio member of the policy-making body so that the independence of the Bank's monetary policy was enhanced and the link between policy-making and policy implementation was strengthened. In addition, the Bank took on a new responsibility for the oversight of the payment and settlement systems, an area which has recently attracted greater attention globally. Meanwhile, the Bank's accountability was also heightened as it now has to report on its conduct of monetary policy implementation to the National Assembly at least twice a year.

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Financial Sector Development in Malaysia

Introduction

In addition to the traditional role of central banks in promoting monetary and financial stability, a key objective of Bank Negara Malaysia (the Central Bank of Malaysia) has been to influence the credit situation[1] to the advantage of the nation. A well-functioning and efficient financial system is vital to achieve these objectives. Indeed, the development of an effective and efficient financial system that is sound and resilient is an essential pre-requisite to achieve balanced economic growth and social development. Over the course of the past several decades, since independence of the nation was achieved in 1957. Bank Negara Malaysia has consciously and systematically sought to develop a modern and sophisticated financial system. During this period the financial system has had an important role in effectively mobilising and allocating resources for productive use to contribute towards the rapid economic transformation and changing financing requirements of the Malaysian economy.

Indeed, the development of an effective and efficient financial system that is sound and resilient is an essential pre-requisite to achieve balanced economic growth and social development.

During the formative years (in the post-independence period of the 1960s), a key priority of the Central Bank was the creation of the basic financial infrastructure, including the development of domestic banks to complement the already strong foreign banking presence in the economy. The creation of the basic infrastructure of the financial system, notably the development of a wide network of domestic banks, was considered an important pre-requisite for ensuring access to banking services for all segments of society, regions and economic activities, thus the financing requirements for economic diversification.

With the basic banking infrastructure in place, the Central Bank directed its attention in the 1970s towards the development of other financial intermediaries, including merchant banks and development finance institutions, to provide other services that were not available from the commercial banks. The Bank's role in institution building also included an active involvement in the development of the capital market as an important source of long-term financing.

Bank Negara Malaysia

Indeed, public trading of stocks and shares was first undertaken in May 1960 by four stockbrokers, under the direction of, and with administrative support provided at the Central Bank. The Central Bank was also instrumental in establishing the Securities Commission in 1993, as the regulatory authority for the capital market.

The 1980s was a turbulent period, characterised by the global recession and international debt crisis. During this period, the Bank's attention was focused on further strengthening the regulatory and supervisory framework for the banking system to reduce the economy's vulnerability to external shocks. This involved a process of prudential re-regulation and significant structural changes to strengthen the banking system. These measures were instrumental in maintaining the soundness and resilience of the Malaysian banking system in weathering the difficulties which arose when Asian financial unfolded in 1997. The Asian crisis brought to the fore, the challenges confronting the Central Bank in meeting its objectives of promoting a dynamic and competitive banking system, while preserving financial stability. The crisis underscored the challenges of operating in an environment characterised increased globalisation and liberalisation, technological advances and financial innovation. In many respects, the 1990s was a watershed period, which tested the resilience of Malaysian financial system. The introduction of prompt remedial measures restored stability in the financial system and Malaysia has emerged from the crisis stronger and more resilient.

Indeed, the development of an effective and efficient financial system that is sound and resilient is an essential pre-requisite to achieve balanced economic growth and social development.

Financial Sector Master Plan

Following the regional financial crisis, the opportunity was taken to focus on medium- and longer-term issues that needed to be addressed to build a strong and resilient financial sector that responds effectively to the challenges of a changing economic and financial environment. It was in the context of achieving these objectives that the Central Bank launched the Financial Sector Master Plan in March 2001, which outlined the strategies for the development of the financial sector over a 10-year period to meet the challenges of a more competitive and globalised financial environment and assume a meaningful role in Malaysia's future economic development.

Philosophy of the Financial Sector Master Plan

The over-riding objective of the Financial Sector Master Plan was to develop a more competitive, resilient and dynamic financial system, benchmarked against international best practices and standards, which was able to meet the increasingly sophisticated and demanding requirements of the domestic economy. It was also envisaged that the system would be able to adapt and adjust to the technological advances and financial innovations. Central to this process, was the development of a core of strong and forward looking domestic financial institutions that were more technology-driven and able to face the challenges of globalisation and liberalisation. The system would also need to be positioned to weather changes in the economic cycle, and

The introduction of prompt remedial measures restored stability in the financial system and Malaysia has emerged from the crisis stronger and more resilient.

contribute to the overall economic growth process and stability.

In achieving the objective of creating an efficient, effective and stable financial sector, it was recognised that the respective building blocks of the various components in the financial system would need to be put in place to form a solid foundation upon which further progress could be made.

The different components of the financial system include the banking, insurance, specialised and development financial institutions. Also important is the development of a comprehensive Islamic financial system that operates in parallel with the conventional financial system.

In this regard, the Master Plan focused on enhancing the capacity and capability of domestic financial sector, before proceeding with the introduction of an increasingly competitive environment with greater integration with the international financial markets.

The different components of the financial system include the banking, insurance, specialised and development financial institutions. Also important is the development of a comprehensive Islamic financial system that operates in parallel with the conventional financial system. These components are reinforced by the development of the financial markets, in particular, the capital market for which a separate Master Plan has been prepared that outlines the blueprint for its development.

Project Approach

A consultative approach was adopted in the formulation of the Financial Sector Master Plan. Inputs were received from the key stakeholders, namely, the financial industry, Government agencies, private corporations and consultants. In developing the Master Plan, it was recognised that efforts to strengthen and develop the financial system required an assessment of the financial services required as Malaysia moved towards the new economy, as well as an assessment of the implications of the forces of change in the global and domestic environment. The future landscape of the Malaysian financial system was developed, against the backdrop of an increasingly globalised and integrated international economic and financial environment.

The process of developing the Master Plan was entrusted to a cross-functional team, with its members drawn from the key Departments in the Central Bank. A Bank-wide steering committee, was convened at regular intervals to oversee the progress of the team. Consultations with the financial sector were facilitated via the establishment of an Industry Advisory Group, comprising the chief executives of key financial institutions. Discussions were also held to obtain feedback from Government agencies, and other stakeholders on specific aspects of the Plan.

The aim was to determine the most viable options in achieving the strategic direction and objectives of the Financial Sector Master Plan, with an emphasis on a consultative and collaborative process.

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In preparing the Master Plan, it was envisaged that the Malaysian economy would continue to be transformed and expand significantly over the next decade and become more integrated with the global economic and financial system. A more dynamic economy would evolve, with rapid innovation and an increased importance of high-technology services and small- and medium-scale enterprises, leading to more differentiated and demanding consumers of financial services. To serve this more dynamic economy efficiently and effectively, and to ensure that domestic financial institutions would have a leading role within the financial sector, these institutions would need to be more focused, efficient and innovative. The regulatory framework within which the financial industry operated would be based on a supervised market approach. The regulations would allow product innovation and market activism, within a framework of strong supervisory standards and prudential requirements. It was envisaged that the financial landscape at the conclusion of the 10-year period would consist of a more diversified range of "brick-and-mortar" financial service providers, from large one-stop financial centres to niche providers of specialist services. In this new environment, the capital market would have a relatively more important role in the allocation of resources and risks.

A more dynamic economy would evolve, with rapid innovation and an increased importance of high-technology services and small- and medium-scale enterprises, leading to more differentiated and demanding consumers of financial services.

The challenges that the financial industry would face include the need for domestic institutions to improve their efficiency and competitiveness to be on par with international best practices. To ensure that performance gaps between domestic and foreign financial institutions do not widen, domestic institutions would need to invest in new technology, become more global and specialised, adopt new organisation structures, as well as rely more on strategic alliances.

To foster greater innovation, flexibility and dynamism in the Malaysian financial system, the Financial Sector Master Plan made a total of 119 recommendations to be implemented over the 10-year period. The recommendations sought to identify and remove impediments to progress, beginning with improvements in the financial infrastructure and increasing the intensity of domestic competition. To develop the domestic institutions, steps would be taken to build their capabilities and increase the incentives for driving performance. An important part of institutional development included the creation of a more market-driven consumer protection infrastructure. At the same time, attention would focus on maintaining stability in the financial system through the development of an efficient infrastructure, more resilient institutions as well as strong prudential regulatory and supervisory framework. A major priority was the need to meet the socio-economic objectives of Malaysia, that would result in the least possible distortion and minimise the burden on financial institutions.

Implementation approach

The development of the financial system envisaged in the Financial Sector Master Plan would be implemented over a 10-year period in three phases, subject to achieving specified milestones and safeguards. While the strategic direction had been set in the Plan, the implementation of the recommendations would be managed with flexibility, taking into account the potential for changes that might occur in both the domestic and global environment, and changes in technology. In moving forward, the implementation of the Financial Sector Master Plan would be the result of the combined efforts of all the relevant stakeholders in the financial system: the industry players, the regulators, the market participants and the Government. While the Plan would be motivated by the need to achieve the desired objectives, it would also be tempered with the realities of the environment. The Central Bank and the Government had and would continue to provide the supporting infrastructure and to implement policies for a positive economic and financial environment.

The first phase of the Financial Sector Master Plan would focus on building the capacity of domestic institutions. In the second phase, competition would be increased in the domestic financial system. During the third phase, the pace of integration of the Malaysian institutions with the international financial markets would be intensified. While measures on domestic capacity building would be implemented in the first phase, they would continue to be strengthened during the second and third phases to ensure orderly adjustment to an increasingly competitive and deregulated and liberalised financial market. Implementation of the recommendations of the Master Plan would be conducted in a practical manner such that the desired outcomes would be achieved without having destabilising implications on the Malaysian financial system.

The creation of robust financial institutions that were able to withstand any potential shock, and that possessed the agility and adaptability to embrace future challenges were key in ensuring their long-term sustainability in a more competitive environment, as well as in preserving financial stability.

Progress of Financial Sector Master Plan

Four years since its launch in March 2001 the implementation of the Financial Sector Master Plan is on schedule. A total of 45 recommendations have been successfully completed as of end-2004, representing nearly 50% of the recommendations with specific milestones. Another 28 recommendations are being implemented on a continuing basis, where initiatives were continuously being taken to achieve the desired outcomes.

The initiatives that had been implemented thus far had resulted in a financial sector that was stronger, more resilient and better placed to face greater competition. The ability of the domestic financial institutions to continue to register strong financial results despite the increasingly competitive environment reflects their enhanced strength and capabilities. At the same time, the regulatory framework had also been further strengthened commensurate with the challenges of the increasingly complex financial markets. Financial institutions had adopted better risk management practices in their business operations, which accorded them greater flexibility and capacity to respond to the increasing consumer demands and expectations. These achievements and the narrowing in the performance gaps between domestic and foreign-owned financial institutions provided the foundations for further liberalisation and deregulation as envisaged in Phase II of the Financial Sector Master Plan.

Moving Forward

The key emphasis of the Financial Sector Master Plan was to move toward a more diversified and balanced financial system with a strong institutional framework, comprehensive market infrastructure, world-

The creation of robust financial institutions that were able to withstand any potential shock, and that possessed the agility and adaptability to embrace future challenges were key in ensuring their long-term sustainability in a more competitive environment, as well as in preserving financial stability.

class best practices, and a conducive regulatory environment. As the financial system transitioned into Phase II of the Financial Sector Master Plan, the thrust of initiatives would be 2-pronged. The first area of focus would be to continue with efforts to strengthen the institutional development of domestic financial institutions so that they were well positioned to cope with a more competitive, liberalised and deregulated environment. The second would be to review existing policies and regulatory requirements in order to level the playing field among the various market players. Equally important, would be need for institutions to be able to adapt adjust and respond to changing economic and financial conditions, notably in supporting new growth sectors in the economy. The creation of robust financial institutions that were able to withstand any potential shock, and that possessed the agility and adaptability to embrace future challenges were key in ensuring their long-term sustainability in a more competitive environment, as well as in preserving financial stability. This was considered essential, in view of the strong inter-linkages between the financial sector and overall economic development. In particular, policy initiatives would continue to focus on improving access to financing to support economic growth. This would include specific attention to strengthening the infrastructure and access to financing for small and medium scale enterprises and new growth areas such the agriculture and agro-based industries.

(This article is sent by the Office of Governer, Bank Negara Malaysia)

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MONETARY POLICY ISSUE IN MONGOLIA

Ochirbat Chuluunbat
Governor
The Bank of Mongolia

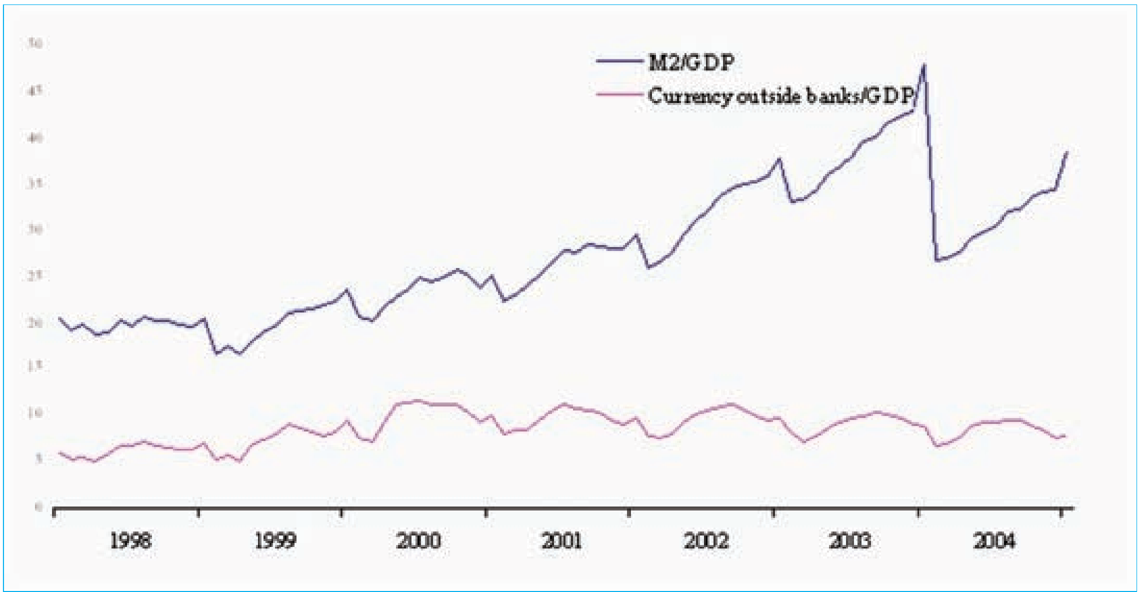
Mongolia is landlocked country in northern Asia situated between Russia and China with only two and half million populations that has a vast but sparsely populated territory. Until 1990, the economy was strictly based on the centrally planned model that had been adopted more than six decades earlier. Nearly all production and distribution activities were reserved for the state and concentrated in large monopolistic enterprises. Distribution outside state channels was closely controlled, and the development of informal markets for goods, foreign exchange rates played no role in allocating resources.

Under the former centrally planned economy, the financial sector operated under a mono-bank system. The State Bank carried out all banking activities such as central banking and commercial banking activities. As far as central banking activities are concerned, these activities consisted of the issuance of currency, the management of foreign exchange reserves and the provision of credit. However, the commercial banking activities were carried out by the State Bank branches. The regional units provided the usual banking activities. Access to credit was mainly a privilege for enterprises. The amount of credit they could rely on was centrally determined and based on the production and investment targets. The interest rates charged for the credits were maintained at a low level of 2-4 percent per annum, reflecting the virtual nonexistence of inflation. Individuals on the other hand, had no access to credit, nor were they allowed to have demand deposits. Their contact with the banking system consisted merely of depositing and withdrawing money from savings accounts.

At present, the Bank of Mongolia has focused on price and exchange rate stability, while ensuring an adequate money supply.

It's been more than ten years since Mongolia abandoned centrally planned model and stepped towards a market-oriented economy. In 1991, banking laws were passed and the two-tier banking system was established. The Bank of Mongolia was established as a central bank with substantial autonomy but subject to the oversight of Parliament; its main functions consist of implementing monetary policy, issuing currency into circulation, facilitating the payment system, reserve management, and supervision of commercial banks. Also in 1991 several new banks were licensed and started operating as commercial banks. During this relatively short time substantial work were done by the central bank. The Bank of Mongolia formulates and implements monetary policy by " regulating money supply through changes in reserve money" to achieve its main objective of currency stability. At present, the Bank of Mongolia has focused on price and exchange rate stability, while ensuring an adequate money supply. Its goal is to contain annual CPI inflation to around 5% in 2005. The second focus is financial market stability. The monetary policy guideline defines a broad range or framework of monetary policy and actions designed to ensure financial stability, but the Bank of Mongolia conducts policy independently from government and political factors-it has "operational independence". Monetary policy, despite some tightening, remains expansionary; substantial liquidity exists from money supply and bank credit growth. The recovery of normal financial intermediation has allowed Mongolia to boost the money in circulation without creating serious inflationary pressure. Monetary (M2) growth has is reserve money (banks' reserves plus money outside banks) and the main instruments used are open market operations in Central Bank Bills in primary and secondary markets, also reserve requirements are used. A rediscount financing facility operates, and "repo" arrangements were introduced in 2002. In the early 90's the Bank of Mongolia focused on creating monetary policy instruments and establishing an inter-bank settlement system. In the mid 90's, we shifted towards indirect instruments relying on the issuance of central bank bills. However, more recently monetary policy has focused more on support for the control of the real sector. The recent recovery of bank lending and financial intermediation has allowed the central bank to pay more attention to economic growth, and a favourable external environment has created a room for stimulation of economic activity. Thus the Bank of

Graph 1. M2/GDP and Currency Outside Banks/GDP, in percentage



accelerated from 17.5% in 2000 to 49.6% in 2003. This reflects healthy restoration in financial intermediation, growth of domestic and foreign currency deposits, partly reflecting greater confidence in the banking system; there is also substantial unofficial "dollarization" of the economy.[1] The primary monetary variable Mongolia is now in a position to support the broad economic objectives of the government.

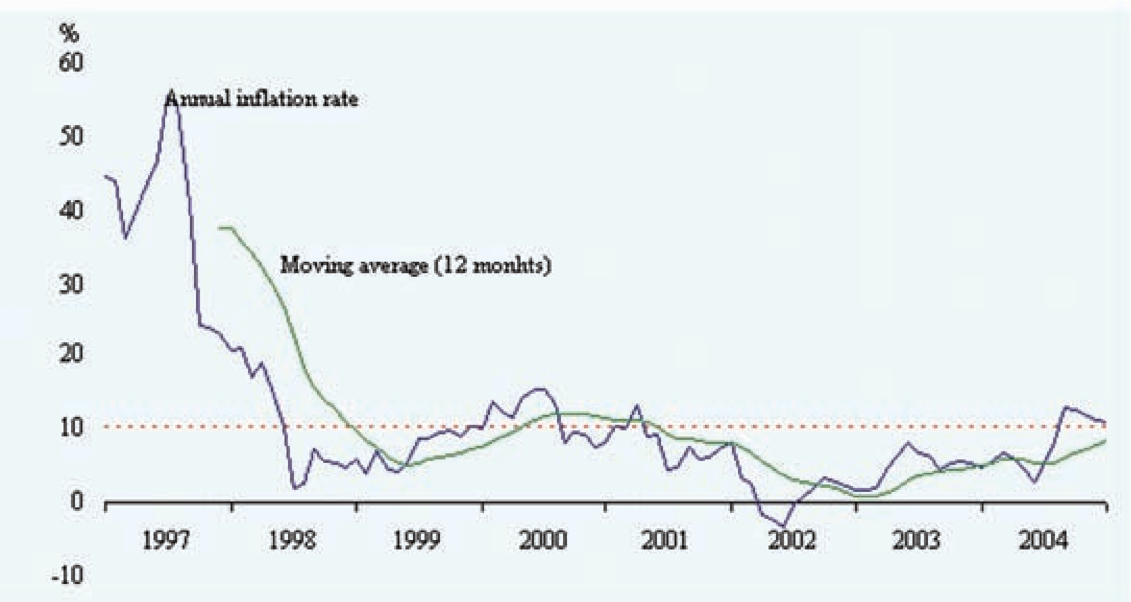
Since May 1993, Mongolia has operated a floating exchange rate system to allow the

[1] Mongolia is a "middle dollarized economy" (Bank of Mongolia, *Dollarization*, Research Bulletin 1).

Togrog's value to be set by the market. A flexible exchange rate is reflected in the Bank's annual state monetary policy guidelines and has been generally followed. The BOM is decreasing its presence in the interbank forex market, and now participates in the market only when requested by commercial banks. The inflation rate was reduced from 420 % in 1993 to a single digit rate.

Mongolia's efforts during the 1990s to restructure the banking sector had limited success, with two banking crises, culminating in bank closures and costly injections of public funds. Especially banking sector performance deteriorated sharply in 1998, as a result of the impact of the large external shocks and the adverse movement in Mongolia's terms of trade on the liquidity and profitability of major corporate clients. Several factors undermined the banking sector's performance in the 1990s. These included the legacy of directed lending and the limited consequences of loan default inherited from the pre-1991 situation, as well as excessive government borrowing and failure to honour payments. Poor accounting and banking standards and skills also contributed to the sector's woes. It has, however, expanded rapidly since 2000, with total bank assets rising from 22.1% of GDP to 61.3 % at end-2004. Since 2000, financial sector reform has progressed, especially bank restructuring and privatisation. In the past few years, the banking system has observed a high and increasing currency-to-deposit ratio, indicating an increasing lack of confidence in banking sector. Financial intermediation has deepened, and the sector's performance has improved, generating renewed confidence in banks and non-bank financial institutions (NBFIs).

Graph 2. Inflation rate, in percentage



The sector's share of non-performing loans (NPLs) of 10.0 % at end-2004 was well below previous high levels (such as above 50% in 1996 and 1999 for banks alone). The share of NPLs, while lower for NBFIs is also much higher for savings and credit cooperatives. The central bank is strengthening as a high priority the prudential and supervisory framework, including detection and compliance, for banks and NBFIs. It is implementing outstanding Basle Core principles. Minimum bank capital

Selected financial indicators

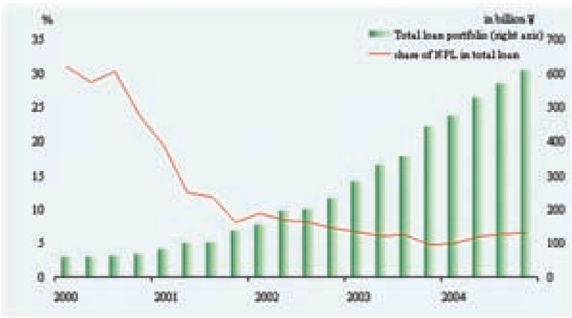
Indicators	1998	1999	2000	2001	2002	2003	2004
Real GDP growth	3.5	3.2	1.1	1.0	4.0	5.5	10.6
M2/GDP	20.5	23.8	25.4	29.7	37.9	51.6	46.9
Loan/GDP	10.5	8.4	6.6	12.1	18.7	32.5	33.6
Deposits/GDP	13.6	13.7	15.5	19.9	28.2	42.0	34.6
Assets/GDP	22.0	19.7	22.1	29.8	39.7	60.6	61.3
CPI growth	6.1	10.0	8.1	8.0	1.6	4.7	11.0
Annual growth of M2	-1.7	31.6	17.6	27.9	42.0	49.6	20.4

requirements were raised to MNT 4 billion, and Bank of Mongolia approved to rise up to MNT 8 billion in 2006 (exchange rate of Togrog against USD is 1209 by the end of 2004).

Domestic-owned, especially state, banks no longer dominate the banking system. The largest bank, Trade and Development Bank (TDBM), was fully privatised in May 2002, followed by the Agricultural Bank in March 2003, to foreign interests. This reduced state equity in the banking system from 60% in 2001 to currently around 4 %. There remains one fully (Savings Bank) and two partially state-owned banks Capital Bank (state equity 9 %) and Ulaanbaatar City bank (state equity 20 %). Foreign-owned banks, primarily TDMB and the Agricultural Bank, now have a substantial share (30.8%) of total bank assets.

In the last four years, the Bank of Mongolia has been working towards further bank restructuring, improving the banks' financial conditions and raising the level of bank supervision. The growth of political and economic stability in recent years has been accompanied by measures to discontinue

Graph: Total loan portfolio and share of non-performing loan (in mln Togrog and %).



imprudent government intervention in banks' business, to improve the ability of banks to withstand different risks by gradually boosting minimum capital requirement and ensuring that bank accounting is consistent with international standards. Amendments have been introduced to the banking law and other related laws, which contributed greatly to the recovery of the banking system.

The key objectives of the Bank of Mongolia in the future are to establish a more secure foundation for stable growth in the long run, to provide necessary banking services for the economy and to improve the results and quality of the bank's regulatory actions.

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Historical Developments and Financial Sector Reforms

Dr. Ishrat Hussain
Governor
State Bank of Pakistan

Introduction

The State Bank of Pakistan (SBP) is the central bank of Pakistan. The founders of SBP set a multi-dimensional target before it that included not only regulation of the monetary and credit system but also the growth of this system. The vision of its founders was a stable monetary system in Pakistan with fuller utilization of the country's productive resources (SBP Act, 1956).

The SBP's main objectives as defined in the strategic direction it set for itself in the year 2000 include:

1. Ensuring the soundness of the Financial Sector.
2. Maintaining price stability with growth.
3. Prudent management of the Exchange Rate.
4. Strengthening of the Payment System.

In addition to these primary functions, the SBP is also engaged in various non-traditional or promotional roles, which include development of financial framework, provision of training facilities to bankers, and provision of credit to priority sectors. The SBP has also been playing an active part in the process of Islamization of the banking system.

Historical Developments

At the time of independence in 1947, Pakistan was faced with the prospects of imminent breakdown in the banking and financial sector operations triggered by the migration of non-Muslims who owned and managed most of the banks in this part of British India. The massive closure of bank branches led to a decline from 631 to 195 branches by June 1948. Pakistan's banking system at that time consisted of nineteen foreign banks (non-Indian) and two Pakistani institutions – Habib Bank and Australasia Bank. Muslim Commercial Bank moved its headquarters from Calcutta to Dhaka in 1948.

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The Government of Pakistan, therefore, decided to establish the State Bank of Pakistan (SBP) to take over the central banking functions from the Reserve Bank of India. The SBP was inaugurated by the Quaid-e-Azam on July 1, 1948 and the State Bank of Pakistan Order 1948 was promulgated by the Governor General of Pakistan to provide the legal framework for SBP operations. In 1956, the State Bank of Pakistan Order 1948 was replaced with the State Bank of Pakistan Act

1956. The Act required the SBP to "regulate the monetary and credit system of Pakistan and to foster its growth in the best national interest with a view to securing monetary stability and fuller utilization of the country's productive resources".

In the period immediately after its establishment, the main challenge was to rehabilitate and reorganize the existing banks, ensure the integrity of the payment system and set up new financial institutions to meet the credit needs of the country.

Over the years, the SBP helped develop many financial institutions by providing both financial resources and technical assistance, including training personnel to meet the shortage of professional staff. During the 1960s the financial system in Pakistan made rapid progress. Several new banks were added to the list of scheduled banks. The total number of scheduled bank branches by June 1970 had expanded to 3133.

After the nationalization of industries in 1972, the Bhutto Government also decided to nationalize commercial banks, insurance companies, etc. This was a big set back to industry and economic growth of Pakistan and its adverse consequences were felt over the next two decades. A Pakistan Banking Council (PBC) was set up to supervise the nationalized commercial banks (NCBs) and the role of the SBP was curtailed. During the 1970s, the banking sector had a number of weak banks that were riddled with many problems, mostly due to mismanagement and misuse of powers by directors to their personal advantage.

The nationalization of banks brought with it the reorganization of the banking system, entailing regrouping of all nationalized banks, numbering eleven at that time, into five major banking companies {viz. NBP, Habib Bank Ltd. (HBL), United Bank Ltd. (UBL), Muslim Commercial Bank Ltd (MCB), and Allied Bank of Pakistan Ltd. (ABL)} through a process of merger of weaker banks with stronger ones. The merger plan came into force on June 30, 1974 resulting in nine Pakistani and fourteen foreign banks.

From 1972 to 1988, no license was issued for new domestic banks except for the Federal Bank for Cooperatives (FBC). The FBC was the apex body created in 1976, to meet the credit needs of cooperative banks and societies. It was a development bank and served as a tool for the SBP to regulate the Provincial Cooperative Banks.

At the beginning of the 1990's, the financial structure of Pakistan continued to reflect the policy initiatives taken in the early 1970s, which drastically enlarged the role of government in the process of deposit mobilization and credit allocation. Despite the opening of non-bank financial sector for

In September 1997, public sector banks and DFIs went through a restructuring process and branch rationalization, which resulted in reduction of the work force of these institutions from 99,954 to 81,079, while 815 loss-making branches were closed.

private investment in the mid-1980s, public sector financial institutions held the bulk of assets, deposits, advances and investments of the entire financial sector at the end of the 1980s. The First Women Bank Limited was established in the public sector during the 1989-90 periods.

State Bank of Pakistan

In 1990, the Bank Nationalization Act 1972 was amended to pave the way for privatization of the NCBs. Between 1991 and 1993, 75 percent shares of MCB and 51 percent of ABL were divested to the private sector. In September 1997, public sector banks and DFIs went through a restructuring process and branch rationalization, which resulted in reduction of the work force of these institutions from 99,954 to 81,079, while 815 loss-making branches were closed. The 1997 reforms also resulted in abolition of the Pakistan Banking Council and the strengthening of the SBP. Greater autonomy was granted to the SBP and the unified supervision and control of the banking system was reinstated.

Major Policy Initiatives and Financial Sector Reforms

Liberalization of the financial sector has been the major policy agenda of all Governments since the late 1980s. Since then, various reforms have been undertaken to enhance efficiency of the financial system to keep pace with global developments. These reforms were aimed at reducing segmentation of financial markets, introducing competition in the financial sector, encouraging product development and innovation, and switching over to indirect, market-based and relatively more efficient monetary and credit policy.

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Financial sector has made significant progress in the last five years by transforming itself into a market oriented, predominantly privately owned sector performing efficient intermediation. The reforms implemented in the banking sector consist of the following components:

1. *Privatization of Nationalized Commercial Banks (NCBs)*

All the nationalized commercial banks, except one, have been privatized. As a consequence, their domination of the banking sector has been reduced from almost 100 percent in 1991 to about 20 percent by December 2004. Even in the case of National Bank of Pakistan, the only remaining NCB, 23.5 percent shares have been floated through Stock Market mainly aimed at small retail investors.

2. *Corporate Governance and Enhanced Disclosure*

Strong corporate governance is absolutely essential if the banks have to operate in a transparent manner and protect the depositors' interests. The SBP has taken several measures in the last five years to put in place and enforce good governance practices to improve internal controls and bring about a change in the organizational culture.

To facilitate the depositors to make informed judgments about placing their savings with the banks, it has been made mandatory for all banks to get themselves evaluated by credit rating agencies. These ratings are then disclosed to the general public by the SBP and also disseminated to the Chambers of Commerce and Trade bodies.

3. *Capital Strengthening*

Capital requirements of the banking sector have to be adequate to ensure a strong base, ability to compete and withstand unanticipated shocks. The minimum paid- up capital requirements of the banks have been raised from Rs500 million to Rs1 billion and have again been raised to Rs2 billion, which is to be achieved by December 31, 2005. This has already resulted in mergers and consolidation of many financial institutions and weeding out of several weaker banks from the financial system.

4. *Improving Asset Quality*

The quantum of non-performing loans (NPLs) by the end of December 2004 amounted to Rs211.2 billion, a decline of nearly Rs10 billion from Rs221 billion at end December 1999 As a ratio of gross advances, these NPLs now stand at 12.1 percent compared to 25.9 percent in 1999. The positive development is that the quality of new loans disbursed since 1997 has improved and recovery rate is 95 percent.

5. *Supervision and Regulatory Capacity*

The banking supervision and regulatory capacity of the Central Bank has been strengthened. Merit – based recruitment, competency – enhancing training, performance – linked promotion, technology – driven process, induction of skilled human resources and greater emphasis on values such as integrity, trust, team work have brought about a structural transformation in the character of the institution. The responsibility for supervision of non-bank finance companies has been separated and transferred to Securities and Exchange Commission of Pakistan. The SBP itself has been divided into two parts – one looking after central banking and the other after retail banking functions.

The prudential regulations in force were mainly aimed at corporate and business financing. The SBP in consultation with the Pakistan Banking Association and other stakeholders has developed a new set of regulations which cater to the specific separate needs of corporate, consumer and SME financing. The new prudential regulations will enable the banks to expand their scope of lending and customer outreach.

6. *Liberalization of Foreign Exchange Regime*

Pakistan has further liberalized its foreign exchange regime and set up foreign exchange companies to meet the demands of Pakistani citizens. Pakistani Corporate sector companies have also been allowed to acquire equity

Foreign registered investors can bring in and take back their capital, profits, dividends, remittances, royalties, etc. freely without any restrictions.

abroad. Foreign registered investors can bring in and take back their capital, profits, dividends, remittances, royalties, etc. freely without any restrictions.

7. Legal Reforms

Legal difficulties and time delays in recovery of defaulted loans have been removed through a new ordinance i.e. The Financial Institutions (Recovery of Finances) Ordinance, 2001. The new recovery laws ensures the right of foreclosure and sale of mortgaged property with or without intervention of court and automatic transfer of case to execution proceeding. A Banking Laws Reforms Commission is reviewing, revising and consolidating the banking laws and drafting new laws such as bankruptcy law.

8. Payment Systems

There is a big surge among the banks including NCBs to upgrade their technology and on-line banking services. During the last three years there has been a large expansion in the ATMs and at present about 700 ATMs are working throughout the country. The decision mandating the banks to join one of either two ATM switches available in the country has provided a further boost. Progress in creating automated or on-line branches of banks has been quite significant so far and it is expected that by 2005 almost all the bank branches will be on-line or automated. Utility bills payment and remittances would be handled through ATMs, Kiosks or Personal Computers reducing both time and cost.

Finally, the country's payment system infrastructure is being strengthened to provide convenience in transfer of payments to the customers. The Real-Time Gross Settlement (RTGS) system will process large value and critical transactions on real time while electronic clearing systems will be established in all cities.

9. Broadening of Access to Credit of Middle and Lower Income Groups

Financial sector development can lead to broad based growth and improved distribution only when the less privileged segments of society are able to get access to credit. The financial sector reforms that were initiated in the late 90s were intended to lead to financial deepening and better access to credit for previously marginalized borrowers and savers. In the context of poverty alleviation, several sectors were identified where a need was felt for the financial sector to channel higher amount of credit, in order to generate employment opportunities. These sectors include:

(i) Agriculture Credit

A complete revamping of Agriculture Credit Scheme has been done recently with the help

In the context of poverty alleviation, several sectors were identified where a need was felt for the financial sector to channel higher amount of credit, in order to generate employment opportunities.

of commercial banks. The scope of the Scheme which was limited to production loans for inputs has been broadened to the whole value chain of agriculture sector. The broadening of the scope as well the removal of other restrictions have enabled the commercial banks to substantially increase their lending for agriculture by a multiple of four times compared to FY

1999-00 thus mainstreaming agriculture lending as part of their corporate business.

(ii) SME Financing

The access of small and medium entrepreneurs to credit has been a major constraint to expansion of their business and up gradation of their technology. A Small and Medium Enterprise (SME) Bank has been established to provide leadership in developing new products such as program loans, new credit appraisal and documentation techniques, and nurturing new skills in SME lending which can then be replicated and transferred to other banks in the country. Program lending is the most appropriate method to assist the SME financing needs. The new prudential regulations for SMEs do not require collateral but asset conversion cycle and cash flow generation as the basis for loan approval.

(iii) Micro Financing

To provide widespread access to small borrowers particularly in the rural areas the licensing and regulatory environment for Micro Credit and Rural financial institutions have been relaxed and unlike the commercial banks these can be set up at district, provincial and national levels with varying capital requirements. There is less stringency and more facilitative thrust embedded in the prudential regulations designed for this type of institutions. Khushhali Bank and the First Microfinance Bank in the private sector have already started working under this new regulatory environment. Khushhali Bank has already reached a customer base of 125,000 mainly in poorer districts of the country and its recovery rate is above 95 percent.

(iv) Consumer Financing

By removing restrictions imposed on nationalized commercial banks for consumer financing, the SBP has given a big boost to consumer financing. Middle class employees can now afford to purchase cars, TVs, air-conditioners, VCRs, etc. on installment basis. This, in turn, has given a large stimulus to the domestic manufacturing of these products.

(v) Islamic Banking

Pakistan has introduced Islamic banking system to operate in parallel with the conventional banking providing a choice to the consumers. A large number of Pakistanis have remained withdrawn from commercial banking because of their strong belief against riba-based banking. These individuals and firms – mainly middle and low class – will have the opportunity to invest in trade and businesses by availing of loans from Islamic banks and thus expand economic activity and employment. A full-fledged Islamic bank has already opened the doors for business and several banks have branches exclusively dedicated to Islamic banking products and services.

The State Bank of Pakistan has set up a full-fledged Islamic Banking Department and a Shariah Advisory Board to help it in the promotion of Islamic banking in the country.

Central Banking in the Philippines
(1949-2004)

Rafael B. Buenaventura
Governor
The Bangko Sentral ng Philipinas

After the Philippines regained its independence in 1946, a joint Philippine-American Finance Commission was created to study the Philippine financial and budgetary difficulties. The Commission recommended the reform of the currency system, which required the formation of a central bank. In 1947, a Central Bank Council was formed to review the Commission's report and prepare the necessary legislation and, in 1949, the Central Bank of the Philippines (CBP) was inaugurated and formally opened. Under the original charter, the general objectives of the CBP consisted of the maintenance of monetary stability, the preservation of the international value and convertibility of the Peso and the promotion of a rising level of production, employment and real income. To make the CBP more responsive to changing economic conditions, the CBP's authority included not only the supervision of the banking system of the Philippines, but also the regulation of the Philippine financial system as a whole.

In carrying out its mandated tasks, the CBP incurred substantial deficits in its operations prior to 1993, which were incurred in connection with: (i) certain quasi-fiscal activities conducted by the CBP consistent with policies of the Government at the time, including foreign exchange forward cover contracts and swaps entered by the CBP with certain banks and government-owned and -controlled corporations (GOCCs) and the CBP's assumption of foreign exchange liabilities of certain GOCCs and private sector companies during the Philippines' foreign exchange crisis in the 1980s; (ii) development banking and financing by the CBP; and (iii) the CBP's conduct of open market operations and incurrence of high interest expenses on the CBP's domestic securities issued in connection with such operations. The Bangko Sentral no longer undertakes the quasi-fiscal activities described above.

In 1991, the CBP began to consider solutions to its increasing deficits, which were impairing the CBP's ability to maintain domestic price stability. As an interim solution to reduce the CBP's losses, major credit programs under the CBP's administration were transferred to other Government institutions, forward contracts for oil and other imports were phased out, CBP's swap contracts with banks and

GOCCs were unwound, debt buy-back operations and other debt reduction schemes were undertaken, and the CBP's organization and operations were streamlined. In 1993, the Bangko Sentral ng Pilipinas (BSP) was established under the New Central Bank Act as the successor to the CBP.

The structure and operations of the BSP, as provided in the New Central Bank Act, differ in a number of ways from the structure and operations of the CBP. Such changes are intended to prevent any recurrence of the circumstances that gave rise to the CBP's financial problems and include the following:

(i) the BSP and the Monetary Board are substantially independent from the Government. A majority of the members of the Monetary Board come from the private sector;

(ii) the BSP has divested itself of its fiscal agency functions. As of July 1998, all fiscal agency functions of the BSP have been transferred to the DOF-Bureau of the Treasury (BTr) including: (a) over-the-counter (OTC) sales of Government securities, particularly OTC sales for tax exempt institutions (such as retirement and pension funds and provident funds of companies) and GOCCs; and (b) operation of the book-entry system;

the BSP is permitted to issue its own securities as instruments for open market operations only as it deems necessary in cases of extraordinary movements in general price levels.

(iii) the BSP conducts its open market operations primarily with Government securities that have been issued by the Government to the BSP for that purpose or that have been purchased by the BSP in the secondary market;

(iv) the BSP is permitted to issue its own securities as instruments for open market operations only as it deems necessary in cases of extraordinary movements in general price levels; and

the BSP and the Monetary Board are substantially independent from the Government. A majority of the members of the Monetary Board come from the private sector.

(v) the BSP is not permitted to engage in development banking or financing and may lend funds to the Government only on a short-term basis to finance expenditures authorized in the Government's annual appropriation. Under the New Central Bank Act, the BSP acts as banker and financial advisor of the Government. The BSP is empowered to represent the Government in all dealings, negotiations and transactions with the IMF and to carry such accounts as may result from Philippine membership in, or operations with, the IMF. Republic Act No. 2052 dated 21 May 1958 as amended mandated the BSP to make advances to the Government for purposes of funding the Republic's membership or subscription fees for the IMF on a short-term, medium-term or long-term basis. As financial advisor, the BSP provides financial advice to the Government on any of its official credit operations abroad. Likewise, whenever the Government contemplates borrowing within the Philippines, the opinion of the Monetary Board is requested on the probable effects of the proposed operation on monetary aggregates, the price level and the balance of payments.

Functions of the BSP

Under the New Central Bank Act, the BSP

performs the functions described below, all of which relate to its status as the country's central monetary authority.

1. Monetary Policy

Reserve requirements, rediscount window and open market operations

The BSP formulates and implements monetary policy in pursuit of its primary objective to maintain price stability consistent with balanced and sustainable economic growth. In line with this objective, the BSP influences the level of money supply through

A minimum of 25% of all such reserves is required to be in the form of cash and deposited with the BSP. Interest is paid on up to 40% of such reserves at the rate of 4% per annum.

open market operations, imposition of reserve requirements and rediscounting operations.

The BSP buys and sells, for its own account in the open market, debt securities issued by the Government, by its political subdivisions or by Government instrumentalities that are fully guaranteed by the Government. Such purchases and sales may be made outright or used as the underlying collateral for transactions under the reverse repurchase and repurchase agreements. The BSP may also issue, place, buy and sell its own negotiable instruments in cases of extraordinary movements in price levels.

The BSP requires all banks and quasi-banks operating in the Philippines to maintain reserves on their deposit and deposit-substitute liabilities, in order to manage the volume of money and credit in the financial system. All banks and quasi-banks are also required to maintain reserves against funds held in trust. A minimum of 25% of all such reserves is required to be in the form of cash and deposited with the BSP. Interest is paid on up to 40% of such reserves at the rate of 4% per annum. The remainder of such reserves may be maintained at the relevant bank or quasi-bank in the form of cash or eligible government securities. Effective 6 February 2004, the reserve requirement for Peso deposits and deposit liabilities of commercial banks stood at 19%, consisting of 9% regular reserves and 10% liquidity reserves to be held in the form of government securities purchased directly from the BSP.

Rediscounting transactions generally involve the refinancing by the BSP of credits extended by banks using eligible instruments as collateral. When the prevailing economic conditions call for a reduction in domestic liquidity, the BSP may limit credits extended

under this facility. Conversely, in an expansionary monetary environment, the BSP may increase the volume of rediscount credits. The rediscount rate is adjusted monthly.

In addition to the major instruments of monetary policy, the BSP also coordinates closely with the fiscal authorities in order to maintain the level of National Government (NG) deposits with the BSP that is consistent with the internally-set monetary program.

Issuing Currency

The BSP has the exclusive power to issue the national currency. All notes and coins issued by the BSP are fully guaranteed by the Government and are considered legal tender for all private and public debts.

Lending to other Banks and the Government

The BSP is authorized to extend discounts, loans and advances to banking institutions for the purpose of influencing the volume of credit consistent with the BSP's objective of maintaining price stability. The BSP is also authorized to extend commercial credits, advances against specified collateral, special credits or loans for liquidity purposes and emergency loans and advances (consistent with its function as the lender of last resort), which are subject to interest and appropriate charges.

The aggregate amount of advances granted by the BSP to the Government may not exceed 20% of the average annual income of the Government during its most recent three fiscal years.

In general, the BSP does not regularly extend credit to the Government, although it purchases Government Securities in the secondary market in connection with its open market operations. In certain circumstances, the BSP may make direct provisional advances to the Government to finance expenditures authorized in the Government's annual appropriation, provided that these advances are repaid within three months. The aggregate amount of advances granted by the BSP to the Government may not exceed 20% of the average annual income of the Government during its most recent three fiscal years.

Managing Foreign Currency Reserves

The BSP aims to hold its foreign exchange resources in freely convertible currencies. The BSP gives particular consideration to the prospects of continued strength and convertibility of the currencies in which the reserve is maintained, as well as to the anticipated demands for such currencies. The Monetary Board issues regulations determining the other qualifications which foreign exchange assets must meet in order to be included in the international reserves of the BSP.

Determination of Exchange Rate Policy

The BSP determines the exchange rate policy of the Philippines. Currently, the Philippines' exchange rate policy supports a freely floating exchange rate system whereby the BSP leaves to market forces the determination of the exchange rate, with some scope for occasional BSP action to dampen sharp fluctuations in the exchange rate. Thus, consistent with the inflation targeting framework for monetary policy, the BSP closely monitors developments in the foreign exchange market and, when necessary, uses intervention or adjustments in policy instruments (e.g., policy interest rates, reserve requirements) in cases where extreme movements in the peso threaten the inflation target.

Setting of Interest Rates

The BSP sets its key policy interest rates taking into account primarily the outlook for inflation and macro economic factors, including financial developments, and other indicators that affect inflationary expectations.

2. Banking Stability

Supervision and Regulation of Financial Institutions

The BSP supervises and regulates banks and quasi-banks in the Philippines. In that capacity, the BSP conducts periodic or special examinations of banking institutions and quasi-banks, including their subsidiaries and affiliates engaged in allied activities. The BSP's supervisory responsibilities include not only the issuance of rules, but also overseeing that banks and quasi-banks comply with applicable regulations and conduct their business on a sound financial basis.

The BSP has completed the transfer of its regulatory powers over the operations of finance companies without quasi-banking functions and other similar non-bank financial institutions (other than those which are subsidiaries and affiliates of banks and quasi-banks; those authorized to engage in trust and investment management; and those required by law to be under BSP supervision such as pawnshops) to the Philippines Securities and Exchange Commission (SEC) as provided for in the New Central Bank Act, in line with its adoption of the consolidated approach to regulation.

3. Other Functions

The BSP functions as the banker, financial advisor and official depository of the Government, its political subdivisions and instrumentalities and GOCCs. As the official depository of the NG and its political subdivisions and instrumentalities, as well as of GOCCs, cash balances of such entities are deposited with the BSP, with only minimum working balances held by Government-owned banks or other banks designated by the Monetary Board. Regular current accounts of the NG and GOCCs earn interest at a rate of 4% per annum while their fixed term deposits bear market rates that vary depending on the applicable tenor thereof.

The BSP also represents the Government in international financial institutions, such as the IMF and the World Bank.

The BSP also approves the NG's foreign borrowings and provides opinion on the monetary implications of its foreign and domestic borrowing operations. In addition, the BSP approves the foreign borrowing operations of the NG. The BSP also represents the Government in international financial institutions, such as the IMF and the World Bank.

Major Policy Reforms

1. Monetary Policy Reforms

A. Shift to inflation targeting as the framework for monetary policy

- The BSP's primary objective of maintaining price stability conducive to a balanced and sustainable economic growth

. . . the BSP shifted formally to inflation targeting on January 2002.

is accomplished through the conduct of appropriate monetary policy. In the past, the BSP conducted monetary policy through monetary aggregate targeting. Under this approach, its policy actions were aimed at influencing the behavior of monetary aggregates. Behind the use of these indicators is the presumption that monetary aggregates are meaningful indicators of economic activity, implying that there are stable and predictable relationships between high-powered money (or the monetary aggregate that the central bank is able to control) and money supply, as well as between money on the one hand, and output and inflation on the other hand.

- However, financial liberalization through the years has led to changes in financial structures and the evolution of new financial products and services. These changes have weakened the traditional relationship linking money supply to income and prices.

- The BSP modified its focus on monetary aggregates starting the second semester of 1995 to put greater emphasis on price stability. Under this approach, monetary targets were monitored closely along with a broader set of economic variables but the emphasis was on keeping inflation within program levels. However, this framework lacks the forward-looking feature needed in an effective monetary policy framework inasmuch as it was reacting basically to contemporaneous inflation.

- On 24 January 2000, the BSP's policy-making body, the Monetary Board, approved the adoption of inflation targeting as the framework for the conduct of monetary policy by the BSP. After two years of preparation, the BSP shifted formally to inflation targeting on January 2002.

- The BSP has shifted to inflation targeting for the following reasons:

  - It is a relatively simple framework and can, therefore, be easily understood by the public.
  - It allows greater focus on the goal of price stability, which is the primary mandate of the BSP.
  - It is forward-looking and recognizes that monetary policy actions affect inflation with a lag.
  - It reflects a comprehensive approach to policy by taking into consideration the widest set of available information about the economy.
  - It promotes transparency in the conduct of monetary policy through the announcement of targets and the reporting of measures that the BSP will adopt to attain these targets, as well as the outcomes of its policy decisions.
  - It increases the accountability of monetary authorities to the inflation objective since the announced inflation target serves as a yardstick for the performance of the BSP, and thus helps build its credibility.
  - It does not depend on the assumption of a stable relationship between money, output and prices, and can still be implemented even when there are shocks that could weaken the relationship.

B. Liberalization of the BSP rediscounting policy

- The BSP rediscount window was liberalized in September 2002 to allow access by all sectors of the economy. The move was among several changes aimed at refocusing the use of the rediscounting window from a selective credit policy instrument to a monetary policy instrument that complements the BSP's open-market operations in managing liquidity in the financial system.

- The removal of the selective credit nature of rediscounting is consistent with the BSP's adoption of price stability as the dominant objective of monetary policy. The approved amendments to the BSP rediscounting policy are as follows:

  - expansion of the rediscounting facility to a more general type of facility that will be available to all

The mandatory ratio for peso deposit liabilities and deposit substitutes (both regular and liquidity reserves) was lowered from 24 percent on 29 January 1993 to 15 percent on 4 July 1997, prior to the Asian financial crisis.

sectors, but excluding certain types of loans such as interbank loans, DOSRI, extended/restructured loans, past due loans, unsecured loans (other than microfinance loans), personal consumption loans, and loans for capital asset acquisition;

- ➢ standardization of eligibility requirements and rediscounting ceilings across all types of banks; and
- ➢ adjustment of the rediscounting rate to reflect actual market rates on comparable maturities.

C. Phased reduction in reserve requirements

- ♦ Reserve requirements (RR) are a useful monetary policy tool in countries like the Philippines where the financial system is relatively underdeveloped and dominated by banks. Changes in RR ratios have a significant effect on the level of liquidity in the banking system, making them an immediate and powerful means of changing the stance of monetary policy. However, RR also constitute an implicit tax on bank intermediation. High RR add to banks' intermediation costs and act as a tax on intermediation. High RR ratios have also encouraged banks to engage in off-balance sheet transactions and other schemes conceived to go around the RR. Such transactions thus, have not been reported and are not accurately reflected in the monetary statistics. They also pose market and liquidity risks to the non-bank public, which at present, are not easily captured by either on-site or off-site bank examination.

- ♦ Such consideration prompted the BSP to reduce the regular RR several times during the period 1993-97. The mandatory ratio for peso deposit liabilities and deposit substitutes (both regular and liquidity reserves) was lowered from 24 percent on 29 January 1993 to 15 percent on 4 July 1997, prior to the Asian financial crisis. However, further reductions were hampered by recurring episodes of exchange market pressure, which necessitated increases in RR (particularly the liquidity RR) in order to siphon off liquidity from the financial system that would otherwise be used for speculative activity.

- ♦ Recent efforts to further reduce RR have proceeded with caution because of the possibility that the increased liquidity from a reduction in RR could lead to higher inflation. This has been particularly important over the last few years in the context of inflation targeting. In particular, the observed risks to inflation and the inflation outlook over the past year or so have necessitated a cautious monetary policy stance and argued against monetary loosening. Efforts to reduce RR were also limited by the extent of the BSP's liquidity assistance to troubled banks, which, when combined with a reduction in RR, could further increase domestic liquidity and lead to higher inflation.

The BSP's initiatives in reforming the banking sector have continuously focused on developing a stable, sound and globally competitive banking system.

2. Financial Reforms

The Philippine financial system has had a long history of continued policy reforms, enabling it to serve as an efficient channel for the transmission of monetary policy and to perform its roles of intermediating funds and managing risks appropriately. The BSP's initiatives in reforming the banking sector have continuously focused on developing a stable, sound and globally competitive banking system. Major banking reforms were implemented with the following objectives:

A. To strengthen the banking system

Encouraging mergers and consolidations

- The Bangko Sentral has implemented incentives to encourage bank mergers and consolidations. The regulations on mergers and consolidations for banks and other financial institutions were modified and improved in April 2000 for participating institutions and included, among others, the removal of the 3-year limit on the incentive package introduced in 31 August 1998 and the addition of incentives which include, among others:

The Bangko Sentral has implemented incentives to encourage bank mergers and consolidations.

  - temporary relief from full compliance from the prescribed net worth to risk asset ratio, at the discretion of the Monetary Board and subject to certain conditions which may be prescribed by the Monetary Board;
  - rediscounting of up to 150% of adjusted capital accounts for a period of one year, from the date of merger or consolidation, provided the bank being merged meets the net worth to risk asset ratio and rediscounting requirements; and
  - possible grant to commercial banks whose outstanding real estate loans exceed 20% of their total loan portfolio a one-year grace period, from the date of merger or consolidation, to comply with the prescribed 20% ratio.

Implementing the General Banking Law of 2000

- The Philippines has made substantial progress in strengthening and modernizing the basic legal framework for the banking system when the General Banking Law (GBL) of 2000 was signed into law on 23 May 2000, amending the country's 52-year old General Banking Act.

- The GBL 2000 was crafted to address the need for a new law that will both meet the challenges and provide additional safeguards for new risks attendant to globalization. The passage of the GBL 2000 is expected to foster greater investor and public confidence in the banking system as it enhances the supervisory capability and enforcement powers of the BSP, improves prudential and regulatory standards, and fosters greater competition in the industry.

- Some of the more important features of the new law include:

  - granting authority to the Monetary Board to require banks to adopt internationally accepted standards relating to risk-based capital adequacy;

. . . the adoption of this framework encourages banks to strengthen their capital bases relative to their risk exposure and thus enables them to better withstand adverse shocks.

  - providing for stricter rules governing bank exposure to directors, officers, stockholders and related interests (DOSRI);

- strengthening current regulations with respect to transparency practices;
- adopting fit-and- proper rule test in the appointment of senior bank officials; and,
- liberalizing further the ownership participation of foreign banks in the local banking system to 100 percent within seven years after effectivity of the Act.

Addressing the non-performing assets (NPAs) of banks

♦ In a move to address the problem of rising level of non-performing loans of the banking system which was triggered by the 1997 financial crisis, the Philippine Congress passed the SPV Act of 2002 (R.A. No. 9182) which was signed into law by the President on 23 December 2002 and took effect on 16 January 2003. On 19 March 2003, the Congressional Oversight Committee approved the Implementing Rules and Regulations ("IRR") of the SPV Act which took effect on 9 April 2003.

B. *To improve banks' risk management*

♦ The BSP adopted a risk-based approach to bank supervision to effectively manage risks inherent in today's highly complex financial environment (as a result of increased globalization, advances in information technology, increased volumes of transactions, volatility of markets and the emergence of new financial products and services) and avoid potential bank as well as systemic problems.

♦ Risk-based supervision looks not only at the financial performance of banks but also at the way banks identify, evaluate and manage risks. An assessment of risk is done from both the current and prospective view of a bank's risk profile. This is more forward-looking and a more pro-active supervisory approach compared to the checklist-type supervisory approach used before.

♦ In line with the upgrading of bank risk management practices, the BSP has also formally introduced a risk-based capital adequacy framework consistent with international best practice.[1] This framework links the required level of capital with the risk profile of a bank. In this way, the adoption of this framework encourages banks to strengthen their capital bases relative to their risk exposure and thus enables them to better withstand adverse shocks. Initially, the new capital requirement covers only credit risk and prescribes a 10 percent risk-based capital ratio on a solo and consolidated basis.[2]

Risk-based supervision looks not only at the financial performance of banks but also at the way banks identify, evaluate and manage risks.

♦ The BSP also implemented a consolidated approach to supervision in an effort to strengthen its regulatory oversight by having a more comprehensive assessment of the risks involved in the activities of financial groups.[3] Financial conglomerates

1 The legal basis for risk-based capital requirement is embodied in Section 34 of the General Banking Law of 2000.

2 Circular No. 280 dated 29 March 2001 contained the guidelines on the risk-based capital adequacy framework which initially covered only capital requirements for credit risks. Circular No. 360 dated 3 December 2002 specified the guidelines to incorporate market risk in the risk capital adequacy framework for universal and commercial banks.

3 In fact the BSP reorganized its departments under the Supervision and Examination Sector (SES) and a regrouping of the banks assigned to the various bank examination departments whereby parent banks are grouped with their subsidiaries and affiliates in line with consolidated supervision.

operate as integrated entities involved in different business lines and even across countries. For such institutions, supervision must focus on the determination of the adequacy of the risk management system and internal control processes of the bank as a whole and on how well these systems are working to protect the safety and soundness of the bank.

C. To strengthen the prudential supervisory and regulatory framework in accordance with international standards

- The BSP has also continuously strengthened and aligned its prudential standards with international norms for better corporate governance, greater transparency and reduced moral hazard. Some of the specific initiatives toward this end include:

  - Adopting fit and proper standards for directors and officers of banks and non-banks;
  - Expanding the duties and responsibilities of the board of directors for a more prudent and efficient administration of banks;
  - Requiring directors to attend special seminar on corporate governance;
  - Requiring the election of independent directors as members of the board of directors of banks;
  - Selecting external auditors with high level of competence and integrity;
  - Adopting sound accounting rules in the compilation of financial statements, including those relating to classification of loan account, loan loss provisioning and loan restructuring; and
  - Requiring banks to report information on non-performing loans and other risk assets; loan loss reserves; return on equity and insider loans in the banks' financial statements and annual reports.

D. To enhance anti-money laundering efforts

- In order to implement its continued commitment and support of the global fight against money laundering, the Bangko Sentral has issued a number of measures to bring the Philippines' regulatory regime on money laundering closer to international standards. In September 2001, the Anti-Money Laundering Act of 2001 was passed, which, among others, define money laundering as a criminal offense, prescribes penalties for such crimes committed and has formed the foundation of a central monitoring and implementing council called the Anti-Money Laundering Council.

The government has also been working on the removal of the Philippines from the Financial Action Task Force (FATF) list of uncooperative countries in the fight against anti-money laundering.

- The government has also been working on the removal of the Philippines from the Financial Action Task Force (FATF) list of uncooperative countries in the fight against anti-money laundering. On 8 March 2003, President Gloria Macapagal-Arroyo signed the amendments of the Anti-Money Laundering Act of 2001. These amendments address the concerns raised by the FATF when they reviewed the Anti-Money Laundering Act.

3. Capital Market Reforms

Developing the capital market is necessary to increase the menu of financial services and financial assets in a country. The capital market complements, not competes, with the banking industry. Several measures have already been undertaken to develop the Philippine capital market. These include:

A. Improving the payment and settlement system

One of the reasons put forward explaining the lack of development in the financial market is the lack of information on the credit worthiness of corporate entities.

- ♦ In December 2002, the Philippine RTGS or PhilPASS has been launched, covering wholesale interbank loan transactions among banks and non-banks, the purchase/sale of government securities under repurchase agreements between and among banks and the BSP, customer electronic fund transfer transactions and net check clearing results processed by the Philippine Clearing House Corporation. The system has improved the efficiency of the existing Multi-transaction Inter-bank Payment System (MIPS 2 Plus)[4] by allowing the banks to interface directly to the automated accounting and settlement system of the BSP. The processing and final settlement of electronic fund transfer instructions take place continuously and individually, thereby achieving real time, final and irrevocable gross settlement of high value electronic fund transfers of banks and participating non-banks. The system is intended to eventually cover all transactions in the equities, fixed income, and money and foreign exchange markets.

- ♦ In July 2003, the request of Megalink, Inc. to do intra-network settlements through PhilPASS was approved by the Monetary Board.

- ♦ In November 2003, the real-time gross settlement for peso-dollar foreign exchange transactions was launched. The BSP, the BAP, Citigroup Manila, and the Philippine Depository and Trust Corporation (PDTC) have formally launched a *Payment-versus-Payment* (PvP) electronic system for the local inter-bank spot and forward foreign exchange market. Under the PvP, final transfer in one currency takes place only if a final transfer in the other currency occurs[5]. Thus, the mechanism is expected to eliminate settlement risks inherent to peso-dollar foreign exchange transactions, spur trading activities and enhance market liquidity, leading to stronger growth of the financial sector. The PvP links two real-time gross settlement systems- the BSP's PhilPASS for peso transactions of commercial banks and Citigroup's Philippine Domestic Dollar Transfer System for dollar transactions of commercial banks- with PDTC as designated clearing entity for peso-dollar transactions of commercial banks under the BAP.

- ♦ The system is now on its 3rd phase with the live implementation of DvP for transactions on secondary trading of government securities beginning 23 August 2004. Under Phase 3, the BSP is allowed to handle custodianship of government securities. The BSP is awaiting the direction of the BAP and the PDS regarding the rules and regulations of this project. The PSE is also expected to be connected to PhilPaSS under Phase 3.

4 MIPS is an electronic multilateral net clearing system that handles large amount inter-bank call loans and bank transfers. This has been partially replaced in July 2001 by the RTGS-based MIPS2 for payments of inter-bank call loans between banks and non-bank financial intermediaries performing quasi-banking functions. In November 2001, the RTGS-based MIPS2 Plus has been installed for payments of foreign exchange transactions and other bank operations.

5 Before, banks place pesos first before receiving equivalent dollars later in the day. If the amount requested is insufficient, however, buying dollars from a new source expose banks to the risk of transacting under a different foreign exchange rate.

B. *Establishing a fixed income exchange*

- The BSP has strongly supported efforts of the BAP to establish a fixed income exchange (FIE) in the country. The trading platform (Philippine Dealing and Exchange Corp.) will cater initially to an interbank market. It is expected to expand its reach to include other institutional players and the broader public/retail market within a year after it opens. It will adopt Model 1 of the delivery-versus-payment (DvP) system using the demand deposit accounts of banks thru the Philippine Payments System (PhilPASS) and the BSP as nominee holder for securities. The settlement unit will likewise operationalize at about the same time as the trading platform.

  - In October 2004, the BSP granted the Philippine Depository and Trust Corporation (PDTC) a permit to operate as a non-bank financial institution with authority to perform quasi-banking functions, trust and other fiduciary business and investment management activities. The issuance of the permit, which carried with it an automatic accreditation as a securities custodian and securities registry, is aimed at paving the way for the PDTC to serve as the depository and custody unit of the FIE, which is expected to begin operations in early 2005.

C. *Developing the credit ratings industry*

- One of the reasons put forward explaining the lack of development in the financial market is the lack of information on the credit worthiness of corporate entities. This lack of information discourages investors from investing in financial assets, particularly corporate bonds, since it casts a shadow of doubt on the price discovery process for these assets.

- Developing the credit ratings industry can solve this problem, since ratings are perceived to be a major variable that factors into the pricing function.

- Regulators can play an important role in promoting a favorable environment for rating agencies by promoting high standards of practices through (1) the accreditation process, (2) the development of standards, and (3) capacity building program for the industry. For example, regulators may require recognized rating agencies to comply with specified performance and training standards for their ratings output and rating analysts, respectively, and regularly monitor compliance with those standards. In addition, regulators may help in sponsoring programs for training rating analysts, especially in terms of aligning their skills and practices with international standards.

- The BSP has recently issued Circular No. 404 containing the guidelines for the recognition and derecognition process of rating agencies.

D. *Developing hedging and financing instruments for dealers*

- The Monetary Board has approved on 1 August 2003 the revised Memorandum of Agreement (MOA) for Cash Settled Securities Swap Transactions (CSSST) among the BSP, the Bureau of the Treasury (BTr), the Bankers Association of the Philippines (BAP), the Money Market Association of the Philippines (MART), and the Investment Houses

Association of the Philippines (IHAP). CSSST is an agreement between financial institutions to simultaneously buy or sell government securities spot, and sell or buy comparable securities at a predetermined future date and price with the same counterparty. The CSSST takes advantage of the established settlement procedures of the Registry of Scripless Securities (RoSS) of the BTr. The CSSST effectively paves the way for the introduction of domestic securities lending in the Philippine market. In more developed financial markets, securities lending type activities are essential to the proper functioning and deepening of secondary market for securities.

♦ In addition to developing hedging and financing instruments, the BSP has recently approved the application of a preferential reserve requirement of 2 percent on repo transactions of banks. This move will help reduce transaction costs and is expected to spur activity in the secondary market for government securities. On the other hand, the BSP has also allowed banks to engage in repos involving foreign currency denominated government securities booked as Trading Account Securities as the underlying security.

. . . the BSP has recently approved the application of a preferential reserve requirement of 2 percent on repo transactions of banks.

3. Tax reform

Rationalization of the Documentary Stamp Tax (DST)

♦ On 17 February 2004, R.A. 9243, entitled "An act rationalizing the provisions of the documentary stamp tax of the National Internal Revenue Code of 1997, as amended," was signed into law. Among the measures approved under the statute include the following: (1) waived the DST on secondary trading of debt and equity issues for a 5-year period; (2) raised DST on primary government or private debt issuances to ₱1 for every ₱100 worth of security from 30 centavos under the present system; (3) reduced DST on equity issues to ₱1 from the current ₱2; (4) shifted the basis for computing taxes from the amount of the policy to premium payments in the case of pre-need and insurance products. The law seeks to eliminate DST on secondary trading of financial instruments and lowering transactions cost, consequently increasing the volume of financial transactions in the secondary market.

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CENTRAL BANKING IN SINGAPORE

Introduction

The Monetary Authority of Singapore (MAS) was established on January 1, 1971 as a statutory board to conduct monetary policy, manage the nation's foreign reserves and regulate its fledgling financial sector. In its formative years, MAS concentrated on putting the domestic financial sector on a firm footing. Throughout the years, MAS has played an important role in ensuring the sustained non-inflationary growth of the Singapore economy and stability of its financial system.

Along the way, MAS' powers were further broadened as it took on additional functions to become a fully integrated supervisor of the financial sector, overseeing all aspects of banking, insurance and securities activities. It was also entrusted with the development of Singapore as an international financial centre and the issuance of currency.

The concentration of functions within MAS runs contrary to the global trend toward separating the supervision function from central banks. While we are mindful of the arguments that call for a separation of functions, our own experience has shown that there are many synergies to maintaining the present structure of housing central banking and integrated supervision under the same roof. For instance, this structure has enabled us to adopt an overall systemic risk perspective. Furthermore, the central banking function means that MAS is self-funding. This ensures that we are free of conflicts of interests from both the government and the financial institutions under our supervision. Our preference for such an integrated approach is to a certain extent driven by pragmatism. Singapore being a small country has limited human capital. By combining the various functions into MAS, we are able to tap on cross industry knowledge and maximize our expertise in the different policy areas.

In the following paragraphs, we shall describe the major stages of MAS' development over time.

The Early Years

In the 1970s, the world went through a series of crises, starting with the lifting of the Gold Standard and then two oil shocks. MAS' initial responsibility was to defend the Singapore dollar in those turbulent times and maintain price stability.

The concentration of functions within MAS runs contrary to the global trend toward separating the supervision function from central banks. While we are mindful of the arguments that call for a separation of functions, our own experience has shown that there are many synergies to maintaining the present structure of housing central banking and integrated supervision under the same roof.

On the developmental front, MAS put in place other important building blocks of a regional financial centre. The Stock Exchange of Singapore and the Securities Industry Council – which regulated takeovers and other corporate activities in Singapore – were both set up in 1973 to establish some order in the securities market. To cater to the demand for foreign currency from multi-national corporations that were operating in Singapore, an Asian Dollar Market was

The Government of Singapore Investment Corporation (GIC) was set up and the function of reserve management was divided between MAS and GIC.

quickly set up and offshore banking licences were given out to foreign banks. Subsequently in 1978, MAS proceeded to lift exchange controls.

Organizational Restructuring

The next milestone for MAS was in 1980. The Government of Singapore Investment Corporation (GIC) was set up and the function of reserve management was divided between MAS and GIC. This represented the new approach towards the management of our reserves with a view to preserving their value from a long-term perspective.

The other major change was to conduct monetary policy by managing the exchange rate, and with an inflation objective. Since then, MAS' policy objective has been to maintain the purchasing power of the Singapore dollar - its monetary policy centres on the management of a trade-weighted basket of exchange rates of Singapore's major export competitors and sources of import.

Following the instability of the 1970s, one of MAS' key objectives was to strengthen the financial system in Singapore. The focus was to put in place regulations and prudential requirements to carry out proper supervision of the banks. Thus began an era of close supervision of the financial institutions in Singapore, and prudential oversight of the system. During a time when other financial centres were plagued by a number of successive scandals in the financial sector, Singapore stood out because MAS was very prudent in its selection of institutions that could come to Singapore to do business.

Stability and Growth

From the early 1980s to the mid-1990s, Singapore's financial sector did extremely well, posting solid double-digit yearly growth in most years. By 1996, the Asian Dollar Market was more than 10 times its size in 1980 and Singapore became the fourth-largest foreign exchange trading centre in the world.

The formation of the Singapore International Monetary Exchange (SIMEX) in 1984 was another major step forward. SIMEX was the first exchange in the world to have a mutual offset trading arrangement with another exchange – the Chicago Mercantile Exchange.

Singapore's local banks grew strongly, partly as a result of being insulated from foreign competitors. The priority then was to strengthen the financial system, particularly the

The priority then was to strengthen the financial system, particularly the domestic institutions, in order to increase confidence in Singapore as a financial centre . . . .

domestic institutions, in order to increase confidence in Singapore as a financial centre. Regulations were imposed to limit foreign banks' penetration into the domestic banking business. This was to allow local banks sufficient time to strengthen their operations so that they would be in a better position to withstand further economic upheavals.

Winds of Change

In mid-1997, a high-level Financial Sector Review Group embarked on a study to chart a new course for Singapore's financial sector in the midst of a rapidly changing environment. That led to significant changes across the whole financial industry, requiring a new approach to regulation and supervision and greater tolerance of risk.

From 1999, MAS gradually liberalised foreign banks' access to Singapore's domestic banking industry and removed the 40% foreign shareholding limit on local banks.

As MAS liberalized the Singapore financial sector, it had to put in place a more robust framework for supervising financial institutions while allowing greater risk taking and financial innovation. MAS also had to reinvent itself as it took on new challenges. New ideas and new staff entered the institution's ranks, while management adopted an open-minded approach to ensure that the core of existing talent was not alienated and morale remained high.

Liberalising the Banking Industry

Another area of liberalization has been that of the domestic banking sector. From 1999, MAS gradually liberalised foreign banks' access to Singapore's domestic banking industry and removed the 40% foreign shareholding limit on local banks. Offshore banks were given greater leeway to do Singapore Dollar business.

Liberalising the Stockbroking Industry

The stockbroking industry too underwent reforms that allowed for progressive liberalization of brokerage commissions and the opening up of trading access to the Exchange. As a result, the industry has consolidated with fewer players. The bigger local players have expanded their product range and overseas operations. More foreign players have entered the market. Overall, investors have benefited from lower trading costs.

Another significant milestone was the merger of SIMEX and Singapore Stock Exchange (SES) to form the first integrated stock and derivatives exchange in Asia-Pacific, known as Singapore Exchange (SGX). With the increasing convergence of cash and derivative products, the Securities Industry Act and Futures Trading Act was amalgamated into a single Securities and Futures Act.

Liberalising the Insurance Industry

In 2000, MAS liberalized entry into the direct insurance industry and abolished the 49% limit on foreign shareholdings of locally owned direct insurers. MAS also implemented several measures to enhance disclosure standards and efficiency in the distribution of life insurance.

Risk-focused and Integrated Supervision

One of the key changes in MAS has been the fundamental shift from prescriptive one-size-fits-all regulation to risk-focused supervision. As the new approach relies heavily on the quality of a financial institution's own risk management process, MAS put greater emphasis on the quality of management and the processes that an institution uses to monitor and control its risks. Risk profiles of individual financial institutions are generated to tailor MAS' supervisory plans. In addition, more supervisory resources are assigned to the systematically more important institutions. It was also necessary for MAS to acquire specialist knowledge and expertise in assessing the key risks, including credit, market, liquidity and technology risks, as well as corporate governance.

. . . MAS put greater emphasis on the quality of management and the processes that an institution uses to monitor and control its risks.

In view of the blurring of boundaries among the various financial activities, it has become imperative for MAS to reduce the opportunity for regulatory arbitrage and identify possible gaps in the coverage of our supervisory radar. MAS is in the process of harmonising rules across similar financial activities, aligning supervisory approaches for banking, insurance and capital market intermediaries, and supervising diversified financial groups on an integrated basis.

To achieve its objective of integrated supervision, MAS created a new Complex Institutions Supervision Department (CI). CI has the responsibility of supervising such systemically important financial groups on a whole-of-group basis across their banking, insurance and securities activities. Furthermore, MAS has set up a Supervisory Methodologies Unit to develop a common supervisory approach for the financial supervisory departments and enhance the practice of consolidated and integrated supervision. These changes are encapsulated in the monograph that MAS published in 2004, setting out its objectives of supervision and the principles that guide its supervisory approach.

To achieve its objective of integrated supervision, MAS created a new Complex Institutions Supervision Department (CI).

Higher Standards of Corporate Governance

Another pillar of MAS' new supervisory regime was to raise the standards of corporate governance. Among other things, the board of directors had to assume overall responsibility for the risks undertaken by a company or a financial institution and to manage such risks. Besides the fit and proper test for individuals who are appointed to the Board and key management positions of locally incorporated banks, there was a new requirement for these banks to appoint new external auditors every 5 years. To minimize the risk of contagion from non-financial businesses, MAS also required the local banking groups to separate their financial and non-financial activities and to unwind any cross-shareholdings.

Greater Emphasis on Market Discipline

Another major paradigm shift for MAS has been the move away from a merit-based regime, under which we judged the appropriateness of securities being made available to the public, toward a market-driven, disclosure based regime of regulation. This approach is aimed at allowing market participants greater choice and free play to take calculated risks. To this end, our new Financial Advisors Act sets out the sales and advisory process for financial advisors dealing with the retail public, irrespective of whether they are banks, securities firms or insurance companies.

Apart from supporting initiatives for greater disclosure standards, MAS has also put in place legislation that encourage companies to adopt high standards of corporate governance and disclosure while taking legal action against those who manipulate the market. The new Securities & Futures Act embodies this approach.

Raising the Financial Literacy of the Public

MAS has sought to raise the financial literacy of the public. In 2003, MAS worked with industry associations, community organizations and consumer bodies to launch a national financial education programme entitled "MoneySENSE". MoneySENSE covers basic money management, financial planning and investment know-how. The underlying rationale is to let Singaporeans become more self-reliant in their financial affairs and be equipped to exercise their rights as consumers so that they will be treated fairly by financial institutions.

The international inter-linkages of capital flows have meant that financial shocks are spread both quickly and widely worldwide.

Enhancing Transparency

To assist MAS to realize one of its objectives of achieving intended regulatory outcomes while minimizing the additional cost to the industry, MAS has instituted a consultation process to seek feedback and views from the financial industry and the general public before introducing significant policy changes or new regulations. This helps MAS better understand the practical implications of such changes so that the proposed regulations can be adjusted where necessary.

Lending of Singapore Dollar to Non-Residents

MAS recognized that while the blanket restriction on the lending of Singapore dollar to non-residents was useful in protecting the currency against wilful speculation, it had also stifled the growth of Singapore's capital markets. From 1998, MAS took steps to gradually loosen the restrictions on the lending of the Singapore dollar to non-residents, paving the way for greater participation by international investors in Singapore's capital markets. These changes have helped to develop its debt market, providing a cost-effective alternative funding source to a diverse group of local and foreign borrowers. The Singapore Government Securities yield curve has been extended from 7 to 15 years, which resulted in some statutory boards issuing long-term bonds of up to 20 years.

Concluding Remarks

Going forward, the challenge ahead will be for MAS to keep pace with the continuous evolution and revolution in the financial landscape. This is a challenge not unique to MAS. The international inter-linkages of capital flows have meant that financial shocks are spread both quickly and widely worldwide. Central banks must remain vigilant and stand ready to deal with these situations swiftly and decisively.

(This article is sent by the Office of Managing Director, Monetary Authority of Singapore)

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Thailand: Post-1997
Rising to the Global Challenges

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The Asian financial crisis of 1997 has significantly changed the agenda and policy priorities of policymakers in a number of Asian economies towards building domestic and financial infrastructure conducive to sustainable economic growth as well as macroeconomic and financial stability.

Today, Thailand has come a long way since it was faced with the most serious economic crisis in recent history in 1997. The country has had to implement a wide range of reforms during the recovery period to restore growth and strengthen economic fundamentals, as well as to revitalize the financial sector. These reforms have since created a robust and resilient economy with a strengthened financial sector.

Meanwhile, the years following the crisis have also witnessed dramatic changes in the global economy, some of which are direct responses to the Asian crisis. The move by international financial institutions to –set international standards and codes of practices governing the activities of corporates, financial institutions and regulatory authorities, the emergence of China as a regional powerhouse and the strengthening of intra-regional cooperation in financing and trade are but a few transformations in the wake of globalisation. Thailand, as a small open economy, has therefore had to rise and face these global changes in tandem with implementing her domestic agenda of economic and structural adjustments to achieve solid recovery and sustainable growth.

The following article will highlight the various reform efforts Thailand has undertaken since 1997 alongside the changing environment brought about by new global challenges.

Restoring growth and strengthening economic fundamentals

Course for Reforms

Thailand went through an economic and financial crisis in 1997 when the country had to enter a 34-month Stand-by Arrangement

The country has had to implement a wide range of reforms during the recovery period to restore growth and strengthen economic fundamentals, as well as to revitalize the financial sector.

Programme (SBA) from the International Monetary Fund (IMF) in August 1997. The IMF, and other institutions namely the World Bank and the ADB, along with a number of other central banks and governments contributed to Thailand's financing package of USD 17.2 billion. Of these, $ 14.3 billion were actually disbursed. Principal reform measures which Thailand had to undertake in monetary and fiscal policies are illustrated as follows:

A. Monetary Policy

The events of 1997 started with a crisis of confidence in the value of the currency and the country experienced continued capital outflows and a run down in her international reserves. The first priority of the Thai authorities was to stabilise the currency. Under the IMF programme, the authorities adopted tight monetary policy and very tight fiscal policy to restore confidence in the exchange rate, rebuild international reserves, and rein in inflation. The very tight fiscal policy of a one-percent fiscal surplus for FY 1997/98 was adopted as part of the policy mix along with the high interest rates to address the country's large current account deficits. Short-term interest rates rose to unprecedented levels of over 20 percent to restore the stability of the baht which had depreciated by over 100% in January 1998.

As a result of these drastic measures, the trade and current account balances, which had previously been in deficit, began to turn surplus in November 1997, owing to the sharp economic contraction. With international reserves gradually rebuilt, the exchange rate stabilizing, and inflation declining, the Bank of Thailand gradually lowered interest rates in late 1998.

Following the completion of the three-year SBA programme which ended in 2000, the authorities began to take a longer term approach to macroeconomic policies and development. It was recognised that Thailand, as a small, open economy that would have to live with the risks of volatile international capital flows, a monetary and exchange rate regime involving a managed floating exchange rate within an inflation targeting monetary framework would be the most suitable policy anchor.

In 2000, therefore, the inflation targeting framework was introduced, whereby a target range for core inflation was set at 0-3.5 percent, the ceiling being derived from the average inflation of Thailand's trading partners. A Monetary Policy Board, later changed to Monetary Policy Committee with the power authorized by the Bank of Thailand Governor, was set up to set the direction of monetary policy. In so doing, the Committee assesses the current economic conditions and determines the course of monetary policy together with implications on exchange rate and capital movements to ensure that the core inflation rate remains within the target range. The 14-day repurchase rate is the instrument of monetary policy.

Since its implementation, the inflation targeting framework has provided greater transparency, efficiency, and predictability in the conduct of Thailand's monetary policy. The framework is working well, with inflation well within the target range, and any inflationary pressure, even those stemming from recent rises in oil prices, has been successfully managed.

Short-term interest rates rose to unprecedented levels of over 20 percent to restore the stability of the baht which had depreciated by over 100% in January 1998.

B. Fiscal Policy

It should be noted that Thailand's fiscal position has always been a key anchor of macroeconomic policy discipline, given the nine consecutive years of budget surpluses experienced prior to the crisis. Indeed, Thailand's currency and financial crisis did not originate from a lack of fiscal discipline as may have been the cases of other

... Thailand's currency and financial crisis did not originate from a lack of fiscal discipline as may have been the cases of other countries.

countries. Nonetheless, when recourse has been made to all the macroeconomic policy tools to revive the economy and ensure the soundness of the economic and financial system, the burden of adjustment ultimately fell on fiscal policy in terms of the cost of financial sector restructuring, as well as the social safety net.

In the initial period of the IMF programme, the Thai Government had to adopt a very tight fiscal stance—the first Letter of Intent to the IMF even targeted a surplus in the balance of consolidated public sector (from a deficit in the previous year).

As soon as recovery took hold and measures were implemented to resolve the financial sector, the tight rein on fiscal policy was gradually relaxed with a steer towards fiscal stimulus for a broad-based recovery. Again, fiscal policy was crucial in these years of recovery because two main reasons: First, at that time commercial banks were preoccupied with the recapitalisation programmes and restoring their balance sheet. There was severe credit crunch, as banks could not perform their intermediation functions at a time when firms most needed financing. Second, fiscal policy turned out to be an important driver of domestic demand, because decreased personal income as well as the rise in unemployment could not help shore up private consumption; also pre-crisis over-investment did not allow for significant increases in investment demand.

Areas of fiscal priority included a strong social safety net to alleviate the burden on those most affected by the crisis and building up reserve funds for contingency cases. Once Thailand exited the programme in June 2000, fiscal policy was actively used to stimulate domestic demand. In 2001, the Government initiated the so-called "dual track" policy of strengthening the economy at the grass-root level. This was implemented through projects such as the village revolving fund, the debt suspension scheme for farmers, and the universal health insurance, which all shared similar goals of alleviating the most vulnerable members of society from the direct effects of the crisis and thus creating a strong foundation at the grassroots. Meanwhile, global links

have also been maintained through structural reforms to raise the country's competitiveness and strengthen the export sector.

Results of the Reforms

Following the implementation of macroeconomic policy and reform efforts growth rebounded, with economic fundamentals strengthened underpinned by an invigorated domestic demand and strong export performance. Meanwhile, private consumption has picked up primarily due to strengthened consumer confidence and increased farm income, which has risen since 2001. The low interest rate environment also provided impetus for housing demand which can be well considered as a turning point in Thailand's recovery process.

Exports, the other main driver of growth, have gradually been diversified both in terms of product and market destination. Intra-regional trade has also played an important catalytic role, which is presently being fostered by bilateral and regional Free Trade Arrangements. In 2003-4, private investment also picked up, which complemented exports and domestic consumption.

Significant increases in exports resulted in a current account surplus, averaging some 5 percent of GDP in the past four years, and reductions in external debts from $ 109 billion in 1997 to $ 51 billion in 2004.

Significant increases in exports resulted in a current account surplus, averaging some 5 percent of GDP in the past four years, and reductions in external debts from $ 109 billion in 1997 to $ 51 billion in 2004. Reserves have gradually been built up to record levels, and enabled Thailand in mid-2003 to make an early repayment of remaining financial obligations to the IMF and other bilateral creditors, two years well ahead of schedule. Following the repayment, Thailand joined the ranks of other creditor-country members of the IMF through its participation in the Financial Transaction Plan since late 2003.

Signs of recovery have also resulted in the continuous upgrades of Thailand's sovereign ratings by credit rating agencies over the years. Since the crisis, credit ratings of Thai sovereigns have been upgraded 2 notches by Standard & Poor's (from BBB- to BBB+) and 3 notches by Moody's (from Ba1 to Baa1), with continued positive outlook.

Financial sector reform and restructuring

Course for Reforms

The financial crisis exposed significant vulnerabilities in Thailand's financial sector. Revitalising the banking sector to health so that it could resume its financial intermediation function was an important policy priority to support investment and growth. The first step in financial sector restructuring was to segregate unviable financial institutions and strengthen the financial system as a whole. Ailing finance companies were closed down in 1997, and the Financial Sector Restructuring Authority was established to oversee the rehabilitation or liquidation process of assets of the closed financial institutions. For the remaining financial institutions, the supervisory framework was tightened to regain investor confidence. Other measures implemented included the following:

(i) a recapitalisation scheme using public funds under clear safeguards;
(ii) the use of incentives for accelerating corporate debt restructuring and new lending to private sector;
(iii) the establishment of private Asset Management Companies (AMCs) to encourage swift resolution of distressed assets.

Furthermore, in 2001, a centralised AMC was established, called the Thai Asset Management Corporation (TAMC) to provide additional impetus for debt restructuring multiple creditors debts which had exposed them to complications in the debt restructuring process.

To ensure sustainable recovery, a new strategy was adopted for the financial sector in 2001 to ensure that the sector is first profitable before it can play a significant role in the intermediation process. In this regard,

. . . unrealistic and impractical regulations imposed on the banking sector had been eased such as the classification of NPL by accounts rather than by name.

unrealistic and impractical regulations imposed on the banking sector had been eased such as the classification of NPL by accounts rather than by name. This enabled certain accounts

The Bank of Thailand has secured the commitment from the Government to fiscalise the estimated 1.4 trillion baht (around USD 33 billion) of losses from financial sector restructuring.

of the same customer to continue servicing its obligations and be classified as current, while others could be classified as NPL accordingly.

Another important progress included the resolution of outstanding debt of the Financial Institutions Development Fund (FIDF), which incurred huge liabilities from the provision of liquidity support to ailing financial institutions. The Bank of Thailand has secured the commitment from the Government to fiscalise the estimated 1.4 trillion baht (around USD 33 billion) of losses from financial sector restructuring. Following the first phase of fiscalisation in 1998 and 2000, the Government came to the resolution on the remaining losses in 2002 amounting to 780 billion baht (or around USD 18 billion) by fiscalising them through the issuance of bonds, with interests to be paid from the government budget, and the principal from the profits remitted by the Bank of Thailand.

Results of the Reforms

Massive recapitalisation of banks to the tune of USD 22 billion or 18 % of GDP has considerably improved the financial standings of commercial banks. As a result of the reforms and a reorientation of financial sector strategy towards a more immediate goal of profitability, banks have returned to profitability in 2003. Returns-on–asset of commercial banks, which were negative between 1997 and 2001, began to turn positive in 2002, reaching a healthy level of 1.33 percent in 2004. Banks have resumed their financial intermediation function, credit growth reached 8 percent year-on-year in 2004 and is continually growing.

Credit rating agencies have also been continuously upgrading the ratings of Thai commercial banks. In February 2005, six commercial banks' ratings have been upgraded by Fitch, with positive sector outlook, due to stronger loan growth, further declines in costs of funds and smaller provisioning. Commercial banks' shares rose along with the SET Index and during a certain period, actually outperformed the market index.

The resolution of the debt of the FIDF through the fiscalisation has further helped bring about confidence in the transparency of the Thai financial system, where foreign investors previously could not assess the fullest impact of the cost of financial sector restructuring on the Thai economy. The issuance the bonds helped to absorb excess liquidity in the system during that time and has also provided a savings alternative for the public.

Preparations to Cope with Future Challenges

Maintaining Momentum of Growth with Economic Stability

With the post-crisis period, a reorientation in policies is expected from that of demand management toward supply management,

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which will work to ensure that the growth momentum is maintained. The Government has had noteworthy achievements in fiscal consolidation, and has presented a balanced budget for FY 2005, the first time since the crisis. Emphasis has been shifted to projects involving the strengthening of large-scale infrastructure, which includes, for instance, a network of mass rapid transit system for Bangkok and its environs. Such projects will raise growth prospects of the Thai economy by ensuring that the economic productivity and growth will not be offset by constraints in the existing infrastructure.

The current domestic challenge that Thailand is dealing with concerns the growing asset prices and household credit, both of which have risen significantly since 2003, albeit at levels considerably lower than those of other countries in the region. This may not pose an immediate financial risk to the system, but may signal vulnerabilities due to overheating and potential financial imbalances in some pockets of the economy. The Bank of Thailand has been monitoring the situation very closely and has sought to pre-empt these through various prudential regulations. These included tighter limits on mortgage loan-to-value ratios for high-end residential property or stricter eligibility requirements for credit card holders.

Thailand is at presently making strides in preparing for participation in the IMF/WB's FSAP programme by 2007,

Concurrently, the Thai economy has also been challenged by external developments, particularly growing global imbalances, higher oil prices, and more volatile international financial markets. Here again, the monetary policy tightening together with managed-float exchange rate, both of which are not inconsistent under the inflation targeting framework, will serve to anchor financial stability for the macroeconomy going forward.

Challenges for the financial sector

Thailand's financial sector have not only faced the challenge of adjustments and reforms resulting from the crisis, but it also has had to keep abreast of the challenges and move in line with the global trends. Over eight years following the crisis, an additional challenge for Thailand's financial sector has therefore been to strengthen the system towards international standards. As a crisis-prevention mechanism, international financial institutions such as the BIS, IMF and the World Bank have proposed standards and codes, including the Financial Sector Assessment Programme (FSAP), for countries to be assessed by and evaluated against these standards. Thailand is at presently making strides in preparing for participation in the IMF/WB's FSAP programme by 2007, which will benchmark current practices against that of international standards, thus bringing about a more mature process of operation.

On banking supervision, the Bank of Thailand intends to implement the Basel II Accord by end-2008, the aim being to encourage sound risk management practices and fostering risk-based supervision. We have gradually moved from transactions-based supervision to risk-based supervision as a regulatory framework

Efforts have also been made to strengthen the governance structure of financial institutions, and upgrade the quality of banks' board and senior management through more stringent regulatory requirements. This has been an issue of great concern for a number of government agencies in addition to the Bank of Thailand, in particular the Securities and Exchange Commission and the Stock

Exchange of Thailand.

To further consolidate the financial sector, the Bank of Thailand launched the Financial Sector Master Plan in January 2004, which aims to further strengthening and re-orienting the financial sector to provide financial services for all viable users, foster efficient, competitive and financial sector, and customer protection.

Going forward, Thailand recognizes that the development of a financial system that is more balanced between the credit, the equity and the debt markets would help reduce reliance on the banking sector and improve the intermediation process. Thailand has made great strides in deepening and broadening both the equity and debt markets through promoting development in demand, supply and infrastructure. The combined capitalization of both markets at almost equal to that of the outstanding loans of the banking system has thus lessened the corporates' dependency on the banking sector.

It should be noted that an important lesson that Thailand has learned in this process was that the financial system needs to adjust to the tougher regulatory framework and strengthened governance standards.

It should be noted that an important lesson that Thailand has learned in this process was that the financial system needs to adjust to the tougher regulatory framework and strengthened governance standards. Such regulatory framework and good governance are elements that would ensure that banks are able to enjoy sustained operating results. They will also be resilient against shocks and create an environment of confidence and trust among all stakeholders.

Conclusion

In retrospect, Thailand's most recent experiences in dealing with and managing the crisis stands out not only because the country had to endure difficult periods of adjustments, but because the recovery period took place at the same time when global changes compelled Thailand to make additional adjustments or even longer-term reforms on top of the immediate challenge of the crisis. Undertaking a wide array of policy reforms prescribed under the IMF programme was not an easy task. Undertaking such reforms alongside the challenge of having to upgrade its systems and practices to be on par with international standards, at the same time as managing the global challenges has proven to be even more ambitious programme for the country. Yet, all the stakeholders, be they government, financial institutions and the general public, have risen to the challenges to create a solid economic foundation, paving the way to sustained, quality growth and a resilient financial system.

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The IMF has had A Long and Cherished Relationship with the NRB...

Sukhwinder Singh
IMF Resident Representative, 2002-present

First of all, I would like to offer my congratulations to the Board, Management, staff, and retirees of the Nepal Rastra Bank (NRB) on the auspicious occasion of the 50th anniversary of the Bank. This is indeed an important milestone and the Bank can be proud of its service to the nation and to the financial system. In fact we are almost peers, the IMF recently having celebrated the sixtieth anniversary of the Bretton Woods Conference.

The IMF has had a long and cherished relationship with the NRB ever since Nepal's membership of the Fund in 1961. We have had an office in the NRB since 1977, this being the sixth oldest IMF office anywhere in the world. I have had the privilege of being among the twelve resident representatives that have served in Nepal.

My two and a half years in Nepal have been eventful indeed. Only three days after my arrival the government was dismissed. A few months later, in January 2003, a ceasefire was announced and we all hoped that we would see a permanent return to peace. Unfortunately this was not to be and Governments changed again in June 2003 and after the Nepal Development Forum in mid 2004. A month later Prime Minister Deuba was reappointed. Things seemed to have come full circle by February of this year when Mr. Deuba's government changed once again. Although this has translated into four different Finance Ministers, things at the central bank have been more stable. I was warmly welcomed by Governor Rawal and Deputy Governor's Pant and Bhattarai. And it was good to see Governor Bhattarai's distinguished service to the Bank being recognized in his appointment as the new Governor a few months ago. In fact I and my colleagues from IMF headquarters have been extremely well treated by all the senior staff of the NRB for which we are deeply grateful. For instance, my office here at Baluwatar may not be the largest in Kathmandu but it sits in a beautiful Palace with a splendid view that is the envy of many donor colleagues.

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I cannot write on my experiences in Nepal without also mentioning the many other friends and colleagues at the NRB. Throughout my time here, I have had an excellent collaboration with departments throughout the bank. Although the Research Department has a special relationship with the Fund, the IMF has worked closely with many other departments, from Banking Regulation to

Internal Audit, and in the course of this we have learned a great deal. Even though much remains to be done to modernize the institution, I have often been impressed by the talented and dedicated individuals that are to be found across the bank, which I hope bodes well for the years ahead.

Excessive government ownership, high non-performing assets, weak regulation and supervision, inadequately developed financial markets, weak corporate governance in financial institutions, lack of a competitive environment resulting from fragmentation of the system, a dearth of reliable financial information and transparency, and of course ineffective banking services for the rural sector are some of problems that require urgent redress.

I would also like to take this opportunity to thank the NRB for providing a succession of highly dedicated and professional staff to the IMF's resident office. Although I am not familiar with all those who have contributed to building the strong bonds between our institutions, I would draw attention to Deepa Bhattarai who has served tirelessly since 1988 and Alok Pokharel who returned to the Research Department last year after almost a decade with the resident office.

The last two years have also been notable in deepening the reform relationship between the IMF and Nepal. After over a decade since the last reform program was agreed, an arrangement under the Poverty Reduction and Growth Facility (PRGF) was approved by the IMF Board in November 2003. This supports HMGN's implementation of its 10^{th} Plan/ PRSP which provides a comprehensive effort to address the country's low growth, inadequate social sector investment, and limited income opportunities for the poor. HMGN's program with the Fund aims at improving the conditions for sustained growth and poverty reduction, based on sound macroeconomic policies, better prioritization and enhanced efficiency in government expenditure, structural reforms in major sectors of the economy, and improved governance.

Reform implementation under the program has been mixed so far mainly due to the political instability that the country has faced over the past two years.

Let me now say a little about the challenges that face the financial sector in Nepal and its custodian, the Nepal Rastra Bank. There is a daunting agenda before us that has to be addressed if the financial sector is to support sustained growth. Excessive government ownership, high non-performing assets, weak regulation and supervision, inadequately developed financial markets, weak corporate governance in financial institutions, lack of a competitive environment resulting from fragmentation of the system, a dearth of reliable financial information and transparency, and of course ineffective banking services for the rural sector are some of problems that require urgent redress. This is made all the more urgent by the competition in financial services that will come from Nepal's membership of the WTO. Moreover, it is being implemented at a very difficult time for the country where the insurgency is imposing an enormous toll on economic activity, which of course has affected banking performance. But a crisis also offers opportunities and I am encouraged by some of the financial sector reforms that are underway in Nepal. Moreover, as we move into this millennium the NRB is fortunate to

But a crisis also offers opportunities and I am encouraged by some of the financial sector reforms that are underway in Nepal.

find itself operating under a new central bank act which provides it with the legal authority and autonomy to achieve its objectives.

But we still have a long way to go. The political leadership of Nepal must really believe in reforms and accelerate them or a poorly functioning financial system will be a major drag on growth and prosperity. The IMF will continue to help Nepal with technical advice and financial resources but Nepal must above all be ready to help itself. Let me highlight three key challenges facing the NRB as it enters its six decade.

First and above all the NRB must modernize itself quickly. The aim must be to engineer a central bank that can develop and implement sound monetary and supervisory policies, and command the complete confidence of the banking system. This respect cannot be ordered or demanded by its power, but must be earned by its capability. Its staff must be highly professional and competent officials familiar with modern banking practices, led by management who have a clear vision of how to develop the financial sector as an engine of growth. The bank must be a transparent, independent but accountable, institution that applies its mandate in an even handed way. And it should concentrate on core central banking functions. For an effective partnership to develop, the central bank must listen carefully to, and learn from, the banking community. At the same time, Nepal's banks should facilitate healthy competition, raise standards among peers, and ensure the timely provision of information required for the NRB to do its job.

While the management teams in RBB and NBL have been able to improve the situation, further support from the government and judicial system is required otherwise the general public of this country will pay the price for the excesses and corruption of a minority and scarce resources will be diverted.

A critical area must be the development of a professional staff. After all, the NRB is only what its staff make it. Its reputation depends on the performance of its officials. In this regard, when I came to the NRB over two years ago I found it heavily overstaffed with inadequate delegation of responsibilities and weak incentives for strong performance among the bank's officers. Two years on, staffing levels have come down, but much remains to be done to instill a merit based performance, recruitment and training system that builds the capacity of the NRB to function effectively in a globalised economy where financial transactions are becoming more sophisticated. Specialized career streams in critical areas such as bank supervision, auditing and accounting need to be established. I'm pleased that this issue is being given serious attention by the NRB's management.

A second crucial issue in front of the NRB is to deal with non-performing assets and privatization of public banks. NPAs of at least 7-8 percent of GDP or $450 million – the same as the country's entire development spending - are clearly unsustainable and present a major risk to the banking system and to the budget. Most of course are with the public banks - RBB and Nepal Bank Limited (NBL) – which have been raided by unscrupulous elements and are technically insolvent. But the problem extends to other banks in the system which poses a threat to banking stability even beyond restructuring of the big two. While the management teams in RBB and NBL have been able to improve the situation, further support from the government and judicial system is required otherwise the general public of this country will pay the price for the excesses and corruption of a minority and scarce resources will be diverted. The NRB should also oversee the quick privatization of these public banks where this is feasible to "fit and proper" owners. Improvement in these banks' performance should not be seen as reason to delay the process, but to accelerate it.

Third, we need to improve the regulatory system and bank supervision to avoid these problems arising in the future. The onus here falls squarely on the NRB. The central bank must prioritize the further strengthening of new banking legislation – the Banking and Financial Institutions Ordinance - that embodies the Basle Core Principles and ensure compliance with these principles. In this regard, the NRB has to move expeditiously to improve the quality of its on and off site supervision, the timeliness of its feedback to financial institutions, and be determined to act where there are violations of the regulations. As per the Basle principles, the NRB must urgently step up its evaluation of banks' lending and investment policies, practices and procedures and those on the management of the loan and investment portfolios. It can only do this if it has a cohort of trained, experienced supervisors and regulators who have incentives to perform to high standards and if adequate resources are devoted to this core central banking function.

NRB should continue to pay attention to the outsourcing of a range of administrative functions and non core activities which can bring further efficiency gains.

There are of course other important issues facing the NRB such as preparing Nepal for greater competition arising from its commitments in the financial services to the WTO, and improving access to banking services for the rural poor. An important consideration going forward is that the Bank should not overextend itself into areas which are beyond its mandate or where it does not have competence. Careful consideration needs to be given to the gradual phasing out of non core central bank functions such as development finance and the management of development funds. And the NRB should continue to pay attention to the outsourcing of a range of administrative functions and non core activities which can bring further efficiency gains.

Going forward, the NRB faces a radically different domestic and global environment than it has over most of its history. Given its apex role, it has no alternative but to adapt rapidly to the conditions it faces. This is no different for the IMF or any institution. While the NRB still has work to do if it is to become an effective central bank in a modern market-based financial system, it now finds itself more independent and autonomous than ever before. This provides enormous opportunities for it to modernize itself and to meet its core objectives. But autonomy also brings with it the need for accountability and transparency. The NRB must be able to show that its increased powers are being used responsibly and are producing better performance. This will enhance its public credibility and ensure the Bank serves the nation effectively over the next fifty years. You can be assured that the IMF will continue to stand by the Nepal Rastra Bank as a friend an advisor in the years ahead. Happy Golden Jubilee Nepal Rastra Bank.

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So, My Daughter is Laxmi

Roger Nord
Economic Advisor,
African Department
IMF
(Resident Representative to Nepal, 1988-1990)

My arrival in Nepal in 1988 coincided with the festival of Holi and you can imagine my surprise when I was pelted with bags of colored water the first time I walked down the streets of Kathmandu. But I learned to love the Nepali festivals, including the week-long Dasain and, of course, Laxmi Puja, after whom I named my daughter who was born while we lived in Nepal.

I remember being quickly introduced to life in and outside the Nepal Rastra Bank. My office was down the hall from the Research Department, headed by PK Kafle, and I spent many useful hours discussing the latest economic issues with PK and his colleagues. Governor GB Thapa was very welcoming, both at the NRB and outside. I witnessed my first Nepali wedding when his daughter married shortly after my arrival. Deputy Governors Tripathi and Bajracharya also helped me a lot in understanding how the NRB and the Nepali economy worked. And, of course, I enjoyed the able assistance of Deepa Bhattarai who first started working in the IMF office during my tenure.

We could reasonably conclude that the overall economic impact of the trade dispute would be manageable!

There were many economic challenges while I lived in Nepal but none remains more clearly in my mind than the trade and transit dispute that arose between Nepal and India in March 1989. India closed 19 of 21 border crossings, imposed tariffs on Nepali imports and banned the export of several commodities, including petroleum products. Industry operated at a fraction of its capacity, Kathmandu was often without electricity, and soon petrol shortages began to emerge. Fortunately, I lived quite close to the NRB and drawing on my Dutch heritage in began coming to the office on the bicycle. One day, my World Bank colleague Nigel Roberts and I decided to go down to the Terai and take stock ourselves of the impact of the trade dispute on border trade in Birgunj. It quickly became clear that while trucks were indeed held up at the border – hence the fuel shortages – most of the daily trade between Nepal and Northern India remained unimpeded. On that basis, we could reasonably conclude that the overall economic impact of the trade dispute would be manageable! The dispute ended in October 1989 and economic relations with India have improved markedly since then, boosted by the economic reforms that India embarked on in the early 1990s.

Overall, my stay in Nepal was memorable and I owe tremendous gratitude to the Nepal Rastra Bank for its hospitality. Happy 50th birthday NRB!

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Nepal Rastra Bank:
A Journey of Fifty Years

Bijaya Nath Bhattarai
Governor, Nepal Rastra Bank

Nepal Rastra Bank (NRB), the Central Bank of the Kingdom of Nepal, was established in 1956 under the Nepal Rastra Bank Act, 1955, to discharge the central banking responsibilities including guiding the development of the embryonic domestic financial sector. Since inception, there has been a significant growth of the domestic financial sector. The number of financial institutions has gone up from a single financial institution to presently having one hundred and ninety eight, consisting of seventeen commercial banks; twenty nine development banks; fifty nine finance companies; twenty financial cooperatives; forty seven Non-Governmental Organizations (NGOs) carrying micro-financial transactions; nineteen insurance companies; an Employees Provident Fund and a Citizen's Investment Trust. The structure of the Nepalese economy has also undergone a significant change. Today, Nepal is more integrated with the global economy as evidenced by higher levels of trade as a percentage of Gross Domestic Product (GDP) and increasing membership in international trading organizations such as Nepal's membership in the World Trade Organization (WTO) in 2004. As a reflection of this change, the new Nepal Rastra Bank Act was brought out in 2002. The Act has provided operational autonomy and independence to the Bank for addressing these new challenges, such as a definitive procedure for the appointment and dismissal of the Governor and limits on the borrowing from His Majesty's Government of Nepal. The Act has also focused on evolving

challenges with a focus on domestic financial stability.

The Nepal Rastra Bank Act, 1955 and the new Nepal Rastra Bank Act, 2002 however, reflect snapshots at the extreme ends of the Bank's present journey with no reflection of its dynamic and evolving quality. This shortcoming is addressed with details of the fifty-year journey of the Bank being provided.

By the end of the first decade, the Bank had succeeded in ending the wide circulation of Indian currency in the Kingdom of Nepal.

The basis for establishment of Nepal Rastra Bank was rooted in rudimentary financial and monetary system of Nepal in the 1950s which was characterized by an environment of dual currency - both Nepalese currency and Indian currency circulating side by side. The exchange rate between both currencies was also highly unstable. There was only one commercial bank present in the formal domestic financial sector at that time reflecting the lack of monetization and the low level of development of the Nepalese financial sector. Further, there was insignificant interaction with the outside world other than India and China (Tibet). Keeping this situation in view, the objectives of the Bank as provided by the Nepal Rastra Bank Act, 1955, were to: widen the circulation of domestic currency; stabilize the exchange rate of the Nepalese currency vis-à-vis the Indian currency; expand the banking network in the country; and evolve policy instruments for monetary management.

The journey of fifty years started with the establishment of the Bank on April 26, 1956. This journey can be broken down into five distinct decades. The **first** decade of establishment (1956 – 66) saw the Bank occupied with those aforementioned challenges. The efforts of Nepal Rastra Bank were then primarily focused on increasing the circulation of the Nepalese currency throughout the Kingdom of Nepal by expanding the branches of the Bank. Similarly Nepalese currency was also made available through the establishment of the currency chest in the commercial banks. Further, the Bank had also initiated efforts to stabilize the exchange rate between the Nepalese vis-à-vis Indian currency. For the latter, the Foreign Exchange Regulation Act 1963 was enacted which empowered the Nepal Rastra Bank as the custodian of the Kingdom's foreign exchange reserves. By the end of the first decade, the Bank had succeeded in ending the wide circulation of Indian currency in the Kingdom of Nepal. Likewise, during this decade the foundation for relationship with international organizations was set through commencing relations with

such institutions as International Monetary Fund (IMF) and the World Bank (WB), from 1961.

During the ensuring decades the Bank has noted a period of expansion and consolidation in the domestic financial sector. The evolution of monetary instruments and guidelines of the Nepal Rastra Bank related with credit control; fixation of interest rates; margin rates; refinance rates; cash reserve requirement; liquidity requirements; credit limit; and directed credit programmes was noted during the second decade (1966-76). Further, Nepal at that time followed an inward-looking, import-substituting industrialization policy. In order to diversify and promote exports, both commodities wise as well as country-wise, the trade regime was based in an incentive system named as bonus voucher, which entitled exporters additional incentives. Further, international relations had been also established with Asian Development Bank (ADB); South East Asia, New Zealand and Australia Central Banker's Forum (SEANZA) and Asian Clearing Union (ACU), in 1966, 1968 and 1975 respectively.

The evolution of monetary instruments and guidelines of the Nepal Rastra Bank related with credit control; fixation of interest rates; margin rates; refinance rates; cash reserve requirement; liquidity requirements; credit limit; and directed credit programmes was noted during the second decade (1966-76).

Likewise, the **third** decade of Nepal Rastra Bank (1976-86) saw a massive banking expansion and more active role of the Bank in development financing, along with growing emphasis on domestic and foreign joint venture private sector investment in the financial sector. Policy measures taken during this decade ranged from downward revision in the interest rate structure to credit ceilings and directed credit programmes. The focus at this period was on widening institutional set up for monetary deepening and formulating directed credit programmes to provide institutional facilities to targeted sectors, regions and groups of the society. Additionally, there had been a continuation of the previous trade policy by His Majesty's Government of Nepal with Nepal Rastra Bank having provided a dual exchange rate system and an auction system in regard to foreign exchange allocation. Likewise, international relations had also been established with Asia Pacific Rural and Agricultural Credit Association (APRACA), South East Asian Central Banks Research and Training Center (SEACEN) and the South Asian Association for Regional Cooperation (SAARC) in 1977, 1982 and 1985 respectively.

The focus at this period was on widening institutional set up for monetary deepening and formulating directed credit programmes to provide institutional facilities to targeted sectors, regions and groups of the society.

The **fourth** decade of Nepal Rastra Bank (1986-96) witnessed further financial liberalization; restructuring and economic stabilization along with the liberalization policy of His Majesty's Government of Nepal. Liberal economic policies were initiated in the wake of balance of payments (BOP) crisis in the early 1980s. These reforms were undertaken under the aegis

This decade also saw major changes in the policy measures such as: deregulation of interest rate in 1989; moving from direct to indirect methods of monetary control, emphasizing open market operations as the main policy tool; abolishing the provision of statutory liquidity ratio in 1993; and permitting market-determined exchange rate of the Nepalese currency against convertible currencies and full convertibility of the Nepalese currency in the current account.

of the Structural Adjustment Program (SAP) with the financial support of the International Monetary Fund in 1987. This decade also saw major changes in the policy measures such as: deregulation of interest rate in 1989; moving from direct to indirect methods of monetary control, emphasizing open market operations as the main policy tool; abolishing the provision of statutory liquidity ratio in 1993; and permitting market-determined exchange rate of the Nepalese currency against convertible currencies and full convertibility of the Nepalese currency in the current account. The latter is reflected by the acceptance of the Article VIII of the Articles of Association of the International Monetary Fund on 30th May 1994. Thus, during the second, third and fourth decades of its establishment, Nepal Rastra Bank was able to steer the deepening of financial sector with a changing role from provision of financial services to regulation and supervision of financial institutions in a more open and liberalized system.

Presently Nepal Rastra Bank is on the verge of completing the **fifth** decade (1996-now) of its establishment. The first part of the decade was characterized by greater financial sector deregulation and liberalization along with emerging challenges namely: growing financial sector fragility; increased non-performing assets in the two large commercial banks of Nepal viz. Rastriya Banijya Bank (RBB) and Nepal Bank Limited (NBL); and increasing depth and sophistication of the financial system through integration in the global economy. The latter part of this decade was thus characterized by financial sector reform aimed at improving the efficiency and effectiveness of the domestic financial sector to face challenges encountered by the ongoing global transformation. The domestic financial sector reform had three major components namely: (1) re-engineering of Nepal Rastra Bank; (2) restructuring of Rastriya Banijya Bank and Nepal Bank Limited; and (3) capacity building in the financial sector. These components are aimed at accomplishing all the programs as mentioned in the Financial Sector Strategy Paper of His Majesty's Government of Nepal, which was publicly announced on November 22, 2000. The financial sector

The latter part of this decade was thus characterized by financial sector reform aimed at improving the efficiency and effectiveness of the domestic financial sector to face challenges encountered by the ongoing global transformation.

reforms in the latter part of the fifth decade were initiated under the aegis of the International Monetary Fund supported Poverty Reduction Growth Facility (PRGF). In addition, there have been a number of initiatives to meet the increasing challenge of regulation and supervision of the domestic financial institutions through the Bank and Financial Institutions

In addition, there have been a number of initiatives to meet the increasing challenge of regulation and supervision of the domestic financial institutions through the Bank and Financial Institutions Ordinance and the Debt Recovery Act, along with establishment of a Debt Recovery Tribunal and amending the Public Debt Act and the Foreign Exchange Regulation Act.

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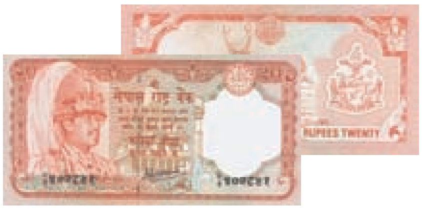

The most salient achievement of financial reform is the enactment of the Nepal Rastra Bank Act 2002, which addresses the challenges brought by the evolving financial sector and also focuses the role of the Bank on effective monetary management for domestic financial sector stability. These are explicitly laid down by the Act as the Bank's primary functions which are: to formulate necessary monetary and foreign exchange policies in order to maintain the stability in price and consolidate the balance of payments for sustainable development of the economy of the Kingdom of Nepal; to develop a secure, healthy and efficient system of payments; to make appropriate supervision of the banking and financial system in order to maintain its stability and foster its healthy development; and to further enhance the public confidence in Nepal's entire banking and financial system. As the Nepal Rastra Bank Act, 2002 mandates, the Bank has been bringing out the annual monetary policy of the Bank which provides the policies, strategies and actions and had first come out in 2002. For example, the Bank is pursuing a policy of prudential regulation of the domestic financial sector consistent with international standards exemplified by the Basle Accords. Further, the Act has recognized the importance of growing integration with the global economy and also provided for the Bank to represent the Kingdom of Nepal in international organizations and associations within its jurisdiction of working areas.

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To enhance the process of financial sector reform, Nepal Rastra Bank had commenced the process of the Bank re-engineering in 2002 under the Financial Sector Technical Assistance (FSTA) credit with the financial assistance from the International Development Association (IDA) of the World Bank Group, and has a vision to become "A modern, dynamic, credible and effective Central Bank". In this regard, the Bank has streamlined its organizational structure into four groups namely the bank management group; the general services group; the monetary and foreign exchange policy group; and the regulation and inspection group. Further the capabilities of different departments in the Bank related to bank regulation and supervision, foreign exchange management and research are being enhanced

Nepal Rastra Bank. . . . has a vision to become "A modern, dynamic, credible and effective Central Bank".

along with capacity building at the Bankers' Training Center. Further, Human Resource (HR) reform has been identified as one of the key reforms under the re-engineering process. In this regard, the Human Resource Department has been made responsible for provision of human resource services across a full range of disciplines dealing with staff policy and administration.

The Nepal Rastra Bank Act, 2002, determines the present organizational structure of the Bank. At the top level, the Bank is governed by a Board of Directors consisting of seven members: the Governor of Nepal Rastra Bank (as Chairman); the Secretary to the Ministry of Finance of His Majesty's Government of Nepal; both Deputy Governors; and three other appointees of His Majesty's Government of Nepal. The Board of Directors is responsible for necessary formulation of bank related rules, regulation, legislation and the overall management of the Bank. Directly under the Board there exists an Audit Committee which is headed by a non-executive Board member. The Internal Audit Department reports to the Board through the Audit Committee. The Act has also a provision for Management Committee which will be presided by the Governor. For the execution and, implementation of necessary decisions taken by the Board of Directors and the top management of the NRB, the information is disseminated by the Governor's Office. The two-deputy governors execute the regular affairs of the Bank.

This stage of the Bank's continuous journey is coming to an end, while another stage is in the beginning. During the last fifty years since its establishment, Nepal Rastra Bank has taken a dynamic and proactive approach in regard to the domestic financial system. This is noteworthy especially with the increasing openness and competitive process in the context of the emerging global financial scenario. This approach by the Bank shall ensure that under the guidance and leadership of Nepal Rastra Bank, there will be continued progress and stability of the domestic financial system, for an enduring journey where the domestic financial sector will provide a substantial contribution to the sustained development of the economy of the Kingdom of Nepal.

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