ok

بِسْمِ اللهِ الرَّحْمٰنِ الرَّحِيْمِ

Distinguished Guests from SAARC Member Countries,
Esteemed Speakers,
Ladies and Gentlemen,

Assalam-o-Alaikum and Good Morning,

It gives me great pleasure to welcome you all to the SAARCFINANCE Seminar on Financial Stability at Islamabad. I hope you would enjoy your stay here in Pakistan.

Events, such as these, provide us opportunities to exchange information, share ideas and learn from each other's experiences in tackling demanding issues such as smooth functioning of the financial system and effective implementation of various policies and regulatory and supervisory frameworks. I am sure you would find the presentations and discussions in the seminar highly useful and thought provoking.

Although speakers of the seminar will dig deep into the issues concerning financial stability, today I would like to share my thoughts with you about the challenges of implementing a financial stability framework in emerging markets economies and developing countries (EMEDCs), like Pakistan and, at the same time, ensuring complementarity between other policies such as monetary policy and financial stability.

Financial institutions – by their very nature – would always be prone to vulnerabilities emanating from uncertainties associated with maturity transformation and risk taking. The key point is that risks should remain within tolerable levels so that arrival of any potential shocks may not disrupt the smooth functioning of the intermediation process. This critically depends on the continuous assessment of the financial system under a proper framework.

Financial Stability Framework, also known as the Macroprudential Policy Framework (MPPF), though still under evolution, provides the foundations to establish and implement such a setup to keep risks of instability at prudent levels. There are five key elements of this framework that include (1) institutional arrangements (such as, legal mandate, powers, accountability) (2) methods for identifying and assessing key systemic vulnerabilities, (3) available toolkit to address various risks, (4) post implementation assessment and (5) international coordination.[1]

Macroprudential policy aims to identify the buildup of systemic risks both over time and across structures. Systemic risk overtime is normally referred to as rise in asset prices and excessive credit expansion, generally, exceeding their historical trends. Cross structure risks arise due to high scale inter-connectedness among financial institutions (such as Global Systematically Important Financial Institutions and/or Domestic Systematically Important Banks) and markets where failure of one or few institution(s) could potentially disrupt the entire financial system. In addressing these vulnerabilities, macroprudential policy complements microprudential policy on safety and soundness of the financial

[1] IMF-FSB-BIS (2016), "Elements of Effective Macroprudential Policies-Lessons from International Experience". https://www.imf.org/en/News/Articles/2016/08/30/PR16386-IMF-FSB-BIS-publish-Elements-of-Effective-Macroprudential-Policies

institutions. The macroprudential measures are designed to act as buffers to reduce the plausibility, frequency and severity of financial crises, if it occurs.

As in the policy world there is no one-size-fits-all framework, we, at SBP, are endeavoring to design our financial stability framework as per broad international standards but are also calibrating it to our peculiar needs. This recalibration of MPPF is essential for EMEDCs, like Pakistan, given the state of macroeconomic and financial development.

Emerging and developing economies, generally, lack financial depth. While in advance economies, excessive credit growth could raise financial stability concerns, in emerging economies, however, decent credit growth is needed to speed up the pace of economic development. Slow pace of credit off-take, therefore, is an issue and raising Credit to GDP ratio is always on the minds of the policy makers. So we need to be mindful of this fact while selecting the tools and their threshold levels for any macroprudential intervention.

Integration with global economy, though beneficial, poses some serious challenges for the EMEDCs because of their incapacities to manage capital flows. The East Asian financial crises in the nineties aptly demonstrated the power of unhindered capital flows. Many EMEDCs have, since, put in place some sort of capital controls and exchange rates, while floating, are being closely monitored. Consequently, financial markets, though not completely immune, are now less prone to vulnerabilities from external spillovers.

However, at the same time, it has been observed that external spillover still play a key role in the financial markets of EMEDCs. For example, the rate rise by the US

Federal Reserve's and investors' unsatiated "search for yield" resulted in high levels of volatility in the financial markets of EMEDCs during 2015

The above discussion implies that the implementation of macro prudential policy, in letter and spirit, is not easy in emerging and developing economies. Although most of the EMEDCs stayed safe during the recent Global Financial Crises of 2008 due to their specific characteristics which distinguish them from advance economies, they have started to face challenges, nevertheless. As such, I would like to mention the following few key challenges[2]:

- Financial systems in EMEDCs are, generally, characterized by small size, banks centric, and with less developed capital markets. Further, greater dependence on foreign capital, relatively weaker institutional framework and market infrastructure put limits on their capacities to efficiently deal with crises. Public dominance in the financial system is also prevalent. So, the key structural features of EMEDCs financial system, themselves, pose obstacles to the implementation of macro prudential policies.
- The EMEDCs have, generally, strengthened their supervisory and regulatory frameworks in banking, capital markets and insurance following international best practices. More needs to be done, however, as challenges still exist due to their supervisory capacity constraints, incomplete legal frameworks, and limited ability to supervise financial conglomerates. Moreover, some EMEDCs may not yet have well structured central designated body with adequate legal mandate and powers to implement macro prudential policy.

---

[2] IMF-FSB-BIS (2011), "Financial Stability Issues in Emerging Market and Developing Economies". http://siteresources.worldbank.org/EXTFINANCIALSECTOR/Resources/G20_Report_Financial_Stability_Issues_EMDEs.pdf

- Dealing with foreign banks, especially in cases of resolution, demands greater cooperation and information sharing between home and host supervisors.
- The expansion of Non-Bank lending and deposit-taking institutions and their complex connectedness with rest of the financial system has evolved over time. The rapid pace, coupled with fall in asset quality, could pose challenge to the stability of the entire financial system. The separate regulatory structures for banks and non-bank institutions not only provide opportunity for the regulatory arbitrage but may also create upstream risk.
- The external sector spillover with small size of foreign exchange markets and limited hedging opportunities in emerging markets creates potential foreign exchange risks. It has been observed that in such cases, often, monetary policy becomes hostage to exchange rate considerations.
- The capital markets in emerging economies are neither deep nor liquid enough and are often sentiments driven. This causes boom following bust type of situations to repeat themselves quite frequently shaking the confidence of the existing and potential investors.

The key policy measures to address these challenges may include strengthening supervisory independence, enhancing resources and capacities of regulators, strengthening the management of foreign exchange risk, and ensuring robustness of the infrastructure for clearing and settlement systems.

Ensuring the complementarity between macroprudential policy and other policies, especially, monetary policy is also imperative. Theoretically, the two policies can be complementary, conflicting or independent, depending upon the state of business and financial cycles. Recent literature suggests that monetary and macro prudential policies are complementary.[3] However, in case of financial shocks leading to financial stability concerns, macroprudential policy could have precedence.

- In case of financial sector distortions, for example asset price booms, a specifically targeted macroprudential policy may be used optimally compared with the monetary policy, which may prove to be 'too blunt a tool' for this purpose.
- In terms of tools, the asset price booms can be contained via lowering the Loan-to-value (LTV) caps, Debt-to-Income ratios, and raising sectoral capital requirements etc.
- In case of a productivity shock, the appropriate policy mix will depend upon both the strength and the expected persistence of economic shock, and the riskiness of balance sheets, including capital buffers and leverage.
- In the event of an aggregate demand shock, however, monetary policy alone would be optimal if it can stabilize both inflation and output.

At SBP, we introduced the "interest rate corridor" regime in August, 2009 and strengthened it further in May, 2015 by introducing the SBP Target rate which was set 50bps below the ceiling rate.[4] The main purpose of introduction of IRC was to strengthen the transmission of monetary policy and have the desired effects on the term structure of interest rates.[5] In addition, IRC was supposed to reduce the volatility in money markets thereby strengthening financial stability. Since the introduction of IRC, money market has remained quite calm with the

[3] See IMF (2013). The interaction of monetary and macroprudential policies, IMF Policy Paper No. 29 and references therein.
[4] http://www.sbp.org.pk/m_policy/2015/MPS-May-2015-Eng.pdf
[5] http://www.sbp.org.pk/dmmd/interestRateCorridor.pdf

volatility of the overnight rate remaining range bound. This is just one example of Monetary Policy framework complementing Macroprudential framework.

In the end, I would like to sum up here by asserting that addressing key challenges to financial stability in EMEDCs is essential for maintaining un-interrupted availability of financial services, raising investors' confidence and enhancing reach of financial access to potential areas. In doing so, resolving country specific idiosyncratic structural issues along with strengthening institutional capacity is quite imperative. Moreover, keeping in view the cross border presence of financial institutions, there is a need to enhance cross boarder supervisory corporation. A forum such as SAARCFINANCE could also play an effective role in this regard.

During the course of this seminar, I urge you to please actively engage in sharing of ideas and mutual learning experiences you have had, and I hope we will continue to have more such events at the SAARC level in the future.

Thank You.