Ponder the Improbable since 1996

EVOLUTION OF FINANCE AND CENTRAL BANK POLICIES

INDIA AND SOUTHEAST ASIA

February 2021

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Executive Summary

Development experience from around the world evidences a strong correlation between financial sector development and economic growth, with the causation running both ways. Economic growth generates demand for financial services and spurs financial sector development. In the reverse direction, a well-developed financial sector promotes growth by facilitating the efficient allocation of resources.

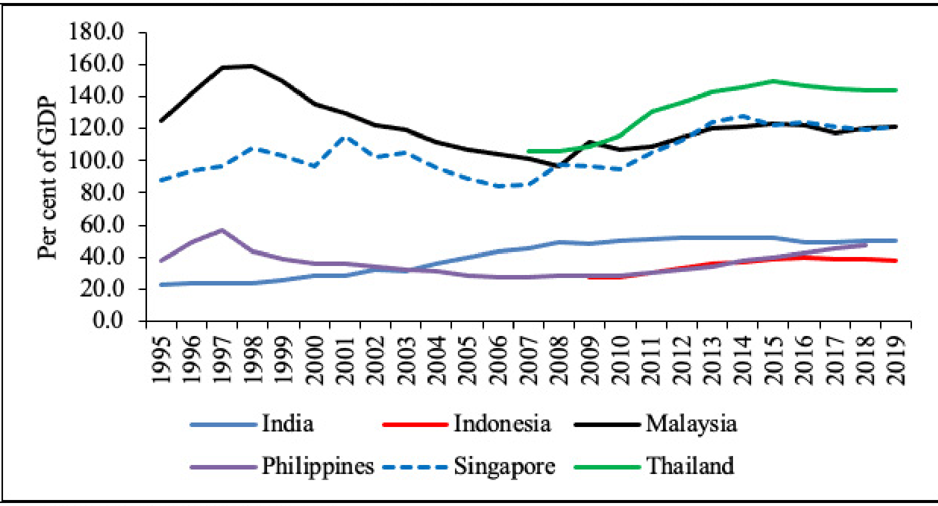
Links Between Real And Financial Sector Growth

India's experience illustrates this bidirectional causation. India embarked on broad-based economic reforms following a bruising balance of payments crisis in 1991. Very soon it was realised that the growth impulses generated by the liberalising real sector might not be sustainable unless they were accompanied by financial sector reforms, clearly demonstrating how growth would trigger financial sector development.

India's experience also illustrates the causation in the reverse direction — from financial sector reforms to growth. India clocked 9-plus per cent growth during 2003–2008. This remarkable growth acceleration was usually attributed to a higher savings rate, improved productivity, growing entrepreneurism and external sector stability. But one of the unacknowledged drivers of that growth acceleration was the impressive improvement in the quality and quantum of financial intermediation, evidencing how the financial sector had powered growth.

Indeed, experiences across ASEAN buttress the argument about the link between the growth of the real economy and the financial sector. Across major ASEAN economies, bank credit increased through the 1990s reaching peak levels in 1997–1998 (Chart 1). This was a period of strong growth as well with average growth for Indonesia, Thailand and Malaysia being 8 per cent, 8.5 per cent and 9.5 per cent, respectively during 1990–1996 illustrating how the real sector and the financial sector spurred each other.

Chart 1: Domestic Credit to the Private Sector



Source: World Bank database.

How the ASEAN region emerged as the engine of world growth through export-oriented industrialisation is now the stuff of textbooks. In the nearly four decades between 1980 and 2019, ASEAN-5 expanded at an average rate of 5.3 per cent as compared with the world average of 3.5 per cent. Many factors facilitated this phenomenal expansion, including importantly the growth of the financial sector. Over the last 25 years, the region's financial systems were deepened — as reflected in market capitalisation — and more diversified in terms of institutions and instruments, as encapsulated in the financial development index at Table 1.

Table 1: India and ASEAN — Financial Deepening

Country	Market Capitalisation (Percentage of GDP)			Financial Development Index		
	1995–2004	2005–2014	2015–2020	1995–2004	2005–2014	2015–2018
India	50.3	81.5	76.2	0.39	0.44	0.43
Indonesia	25.3	39.8	46.3	0.32	0.33	0.37
Malaysia	161.2	139.6	122.2	0.52	0.39	0.33
Philippines	41.3	63.2	77.8	0.36	0.45	0.56
Singapore	150.2	236.7	202.1	0.67	0.51	0.47
Thailand	45.8	74.4	103.1	0.47	0.41	0.36

Notes:

(1) As data for India became available from 2003 onwards, the average for 1995–2014 was based on the data for 2003 and 2004 only.

(2) As data for Philippines became available from 1996 onwards, the average for 1995–2014 was based on the data from 1996.

Source: World Bank database and Sahay *et al* (2015).

Finance cannot get ahead of the real world

Given this historical experience, it is tempting to believe that if financial sector development aids growth, more of it must be better. That conclusion could be a costly miscalculation. We must look for a more nuanced response, especially in light of lessons from the Asian Financial Crisis (AFC) in the late 1990s and the Global Financial Crisis (GFC) in 2008/09.

A big lesson of the AFC is that unbridled growth of the financial sector out of sync with the real sector can be disruptive, or even catastrophic. The AFC originated in Thailand and then rapidly engulfed Indonesia, Korea, Malaysia and the Philippines. A critical vulnerability common across the five economies was the opening up their financial sectors without a corresponding tightening of regulations. For instance, Thailand, Indonesia, Malaysia and the Philippines liberalised their capital accounts in the 1990s even as the domestic financial sector was relatively shallow. This led to unbridled capital flows with credit growth outpacing GDP growth. As the real sectors across these countries were unprepared to absorb this gush of inflows for productive use, they ended up in real estate and equity markets, triggering speculative bubbles and driving up asset prices.

In hindsight, it seems clear that the ASEAN regulators were guilty of two errors. First, they failed to see that the capital flows, being short maturity loans, were inherently fickle. Second, given the impending build-up of currency and liquidity mismatches, they should have allowed the exchange rate to adjust to throw sand in the wheels of inflows. Instead, they stuck with the dollar peg and set themselves up for speculative attacks and the inevitable collapse.

The GFC that erupted a decade after the AFC was too complex to be attributed to a simple or a single cause. But at its core was the popular view that the growth of the financial sector was desirable and real growth could be achieved through sheer financial engineering. The public's faith in the financial alchemy grew to such extent before the crisis that the financial sector was seen as a solution for every real sector problem, no matter how complex. In the euphoria of indulging in the illusion of financial engineering, it was forgotten that the goal of all development efforts was the growth of the real economy and that the financial sector was useful only to the extent it could help to deliver strong and steady growth in the long run.

The Mandate of Central Banking

Everyone should heed the above lesson of experience, particularly central bankers whose job it is to preserve financial stability. But in hindsight, it seems clear now that central bankers too were carried away by the irrational exuberance of the financial sector leading up to the GFC.

In the years before the crisis, central bankers took credit for the Great Moderation — steady growth and low inflation in advanced economies (AEs), and rapid growth and stable inflation in emerging market economies (EMEs). This seemed to vindicate the central banks' single-minded pursuit of inflation targeting — central bankers thought they had discovered the Holy Grail to perpetual growth and stability.

In the event, they declared victory prematurely. The crisis challenged the theology of inflation targeting. It exposed central banks' failure to correct for the rapidly growing global imbalances and keep regulations in pace with financial innovations. Indeed, some even argued that the extended period of steady growth and low inflation blindsided central banks to the financial instability brewing in the underbelly of the global financial system.

The ideal central banking model for emerging market economies

The crisis also raised an important question on the model of central banking that EMEs should target. Central banking in EMEs has historically differed from that of AEs in many important ways. Even as they are focused on inflation, they cannot ignore concerns about growth and equity. Furthermore, the less developed financial markets in EMEs also undermine the monetary policy transmission to the real economy. Notwithstanding the benefits from globalisation, EME central banks have to contend with all too frequent financial instability transmitting through volatile capital flows. Many of them also have a development mandate of building institutions, deepening financial markets, modernising financial sector infrastructures and furthering financial inclusion.

The varied mandates and objectives of central banks in India and ASEAN are listed in Table 2.

Table 2: Core and Developmental Responsibilities of Central Banks in India and ASEAN	
India	The core objective is to maintain price stability while keeping in mind the objective of growth. The central bank also aims to promote financial stability; fair and universal access to various financial services; and a robust, dynamic and responsive financial intermediation infrastructure. Some of the policies adopted in this regard are: • Strengthen credit flow to the priority sectors and capture untapped business opportunities among the financially excluded sections of society. • Expand financial inclusion and financial literacy. • Increase credit flow to micro, small and medium enterprises (MSME) sector, and rehabilitate sick units through timely credit support. • Strengthen institutional arrangements to facilitate achievement of the above objectives.
Indonesia	The core objective is to establish and maintain rupiah stability guided by the following three pillars: • Formulate and implement monetary policy. • Regulate and ensure smooth payment system. • Ensure financial system stability. The central bank maintains a level of community care in the form of its corporate social responsibility (CSR), which supports Millennium Development Goals: • MSME-focused CSR aimed at reducing poverty by 50 per cent by 2015. • Education-focused CSR aimed at improving public education. • Environment-focused CSR aimed at preserving the environment through public awareness.
Thailand	Primary objectives and responsibilities are to maintain price stability, financial system stability and payments system stability. The central bank aims to promote inclusive and sustainable growth of the Thai economy as laid out in its Strategic Plans.

Philippines	The core objective is to maintain price stability conducive to a balanced and sustainable economic growth. The central bank aims to promote and preserve monetary stability and the convertibility of the national currency. Other developmental roles include: • Increase access to financial services for entrepreneurial poor by mainstreaming microfinance in the banking sector since 2000. • Embraced the more ambitious goal of financial inclusion since 2007.
Singapore	The core objectives are to maintain price stability conducive to the sustained growth of the economy, and to develop and promote Singapore as a regional and international financial centre, through the following initiatives: • Develop key focus areas such as enterprise financing, infrastructure financing, asset and wealth management, sustainable finance, etc. • Support FinTech and innovation through various initiatives, like innovation grants, trade finance, regulatory sandbox and IP protection initiatives. • Provide incentives and grants to financial institutions, including start-ups, for expanding of their operations in Singapore. • Work with tripartite partners to build a sustainable pipeline of professionals and leaders in the financial sector.
Malaysia	Promote monetary and financial stability conducive to sustainable growth. Plays an active role in the development of a progressive and inclusive financial sector. Key initiatives include: • Development of financial market infrastructure, including a facilitative regulatory environment, comprehensive market infrastructure and continuous market developments to ensure product diversity, liquidity, and innovation. • Financial inclusion initiatives to meet the diverse financial needs of all segments of the society, particularly the underserved and rural communities. • Human Capital Development by actively establishing various institutions to develop human capital.
Source: Websites of respective central banks.	

It is clear from Table 2 that the mandates and functions of central banks in India and ASEAN are broader than the minimalist mandates of AE central banks, which are typically restricted to price stability and employment. These are important differences. Nevertheless, the standard argument is that these differences will eventually whittle down as EMEs progress and their incomes converge with those of AEs. A consensus has developed around the view that the way forward for EME central banks is to approach the central banking model of AEs.

The GFC called that consensus into serious question by denting the credibility of the AE central banking model. Central banks in AEs were so exclusively focussed on inflation that they were completely blindsided to the financial instability brewing in the underbelly of their financial systems which exploded spectacularly. Given this huge failure of the AE central banking model, the question for central banks in emerging markets, including India and across the ASEAN, is this: Should the AE model of central banking continue to be the ultimate goal for them or should they adopt their own ideal model keeping in view their specific macroeconomic circumstances and institutional challenges?

This essay will focus on three challenges central banks confront in discharging their mandates: (i) Managing the growth-inflation balance; (ii) Managing monetary policy in a financially open world; and (iii) Central banking in coronavirus times. The experiences of India and ASEAN countries will be used to illustrate these challenges.

Managing the growth-inflation balance

The core mandate of a central bank, whether in an AE or an EME, is to maintain price stability because price stability is a necessary condition for consumers and investors to make informed decisions, which in turn are necessary for sustained growth. The experience of the GFC alluded to earlier has resulted in "strict inflation targeting" giving way to "flexible inflation targeting" which requires the central bank to deliver on price stability keeping in view the concerns of growth and financial stability.

India and ASEAN central banks have adopted some version of this flexible inflation targeting as their monetary policy reaction function. Their experience is shown in Table 3.

Table 3: Inflation Targeting (IT) – India and select ASEAN economies

Countries	IT Mandates	Experience
India	To maintain price stability while keeping in mind the objective of growth. Accordingly, flexible inflation targeting (FIT) framework was adopted in 2016 and CPI inflation target was set at 4 per cent ± 2 per cent for the period 5 August 2016 to 31 March 2021.	India's performance has remained remarkable since the adoption of the IT regime. During April 2015 to March 2020, India's average inflation stood at 4.2 per cent, less than half of the 8.9 per cent average in the preceding five years. Even the volatility in monthly inflation was lower in recent periods.

Indonesia	To achieve and maintain the stability of the rupiah. Accordingly, an IT framework was adopted in 2005, while adhering to the free-floating exchange rate system. Bank Indonesia, in coordination with the government, set the inflation target for a three-year period. For 2020, the target corridor for inflation was 3 per cent ±1 per cent.	Inflation remained mostly within the narrow tolerance band of ±1 per cent of the target since the formal adoption of the IT framework since 2005. While it did deviate in 2008–2009 and 2013–2014 reflecting the impact of GFC and taper tantrum, it had remained well within the tolerance band since 2015 as deviations were mostly down.
Thailand	To ensure price stability through inflation target, along with preserving economic growth and financial stability. Thailand adopted FIT in 2000. In December 2019, the target range of 1–3 per cent for headline inflation was proposed for 2020 replacing the point target of 2.5 per cent with a tolerance band of ±1.5 per cent, which was set since 2015.	At the time of adoption of the IT framework, Thailand targeted core inflation. However, it shifted its target to annual average headline inflation with a corresponding tolerance band in 2015. Thailand's CPI headline and core inflation rates eased sharply since the early 2000s. However, since 2015, deviations from the target had been quite large as the actual inflation mostly undershot the target during the period 2015–2020.

Philippines	To promote price stability conducive to a balanced and sustainable growth of the economy, an IT framework was adopted in 2002. The annual inflation targets were defined as the average year-on-year change in the consumer price index (CPI) over the calendar year, which was set at 3 per cent ± 1 per cent for 2020–2022.	Philippine's performance under the IT framework remained largely successful. The country experienced low average inflation and relatively higher GDP growth during 2001–2019 when compared with the period 1991–2000. Even the volatility in GDP growth and inflation somewhat reduced in the recent periods, reflecting better anchoring of inflation expectations since the adoption of the IT regime.
Note: Among the major ASEAN countries, Singapore and Malaysia did not adopt the IT framework formally, although price stability was one of their primary objectives.		
Source: Websites of respective central banks; Corbacho and Peiris (2018); and Reserve Bank of India staff calculations.		

Flexible inflation targeting, notwithstanding its definition, is incredibly difficult to interpret and implement, mostly because there is no clear indication of the degree and nature of flexibility or when and how the monetary policy should factor in growth and financial stability concerns. This has been a particularly complex challenge for EME central banks.

Emerging markets are characterised by rapid growth but they typically have higher inflation than AEs. The numbers for India and ASEAN over the last 25 years are shown in Table 4. Managing the growth-inflation balance is a bigger challenge for low-income countries since sacrifice in growth or compromise on inflation can inflict disproportionately more pain and hardship on the poor. Inflation being a regressive tax hurts the poor the most. On the other hand, the most effective way of lifting incomes is through higher growth. This apparent tension between supporting growth and restraining inflation with a single instrument — the interest rate — poses a dilemma for EME central banks. But that is only in the short term. In the long run, there is no dilemma because higher growth is sustainable only in an environment of price stability.

Table 4: Growth vs inflation						
	GDP growth (%)			Inflation (%)		
Country	1995 - 2004	2005 - 2014	2015 - 2019	1995 - 2004	2005 - 2014	2015 - 2019
India	6.2	7.7	6.7	6.5	8.4	4.2
Indonesia	3.1	5.9	5.0	14.2	7.2	4.0
Malaysia	5.3	4.9	4.9	2.5	2.7	1.9
Philippines	4.1	5.3	6.4	5.8	4.7	2.5
Singapore	5.3	6.1	2.9	0.9	2.7	0.1
Thailand	3.5	3.5	3.4	3.4	3.0	0.3
Source: World Economic Outlook database, IMF and the author's calculations.						

Central banking in a financially open world

The best way to understand the challenge of central banking in a financially open world is through the "impossible trinity" trilemma which asserts that a country cannot simultaneously maintain all three policy goals of free capital flows, a fixed exchange rate, and an independent monetary policy.

Given the "impossible trinity", countries have made varied choices. The most common choice, typical across advanced economies, is to give up on a fixed exchange rate so as to run an open economy with an independent monetary policy. In contrast to the corner solutions of AEs, EMEs have typically opted for middle solutions, giving up on some flexibility on each of the variables to manage the overall macroeconomic outcomes.

India's approach to the "impossible trinity"

India's approach to managing the "impossible trinity" has been to veer towards a middle solution with the following contours: (i) Let the exchange rate be largely market-determined, but intervene in the market to smooth excess volatility; (ii) Keep the capital account partly open; while foreigners enjoy mostly unfettered access to the equity markets, access to debt markets is relatively restricted; there are limits, albeit quite liberal, to the quantum of funds resident corporates and individuals can take out for investment abroad; and (iii) Amid liberalisation on the exchange rate and capital accounts, some monetary policy independence is forfeited.

ASEAN's approach to the "impossible trinity"

In practice, "impossible trinity" is best understood in terms of capital flows. EMEs, especially those with current account deficits (CAD), need capital flows. In an ideal world, they will want capital flows just about sufficient to finance their CADs. Also, they will typically prefer equity flows over debt flows and long-term flows over short-term flows. But in the real world, countries seldom find themselves in such a Goldilocks situation — capital flows are either too much or too little.

Not only are capital flows too much or too little, they are volatile, responding to both push and pull factors. The important push factors are the monetary stance of AE central banks which determines the liquidity in the global system and investors' needs for asset diversification. The pull factors include growth in EMEs, their stable and credible policy environments and improved governance.

Nothing illustrates the challenge of managing the "impossible trinity" in practice more than the AFC of the 1990s. As discussed earlier, the Asian economies liberalised their financial sectors without paying attention to effective regulation. First, they maintained high interest rates to attract foreign investment but failed to see (or care) that what they were getting was hot money that would flee at the first sign of trouble. In an ideal world with no policy distortions, this should have self-corrected through an exchange rate adjustment. But their second mistake was to prevent such an adjustment by maintaining fixed exchange rates pegged to the dollar. Because of rigid choices on two of the variables in the "impossible trinity" — a fixed exchange rate and an open capital account — they lost control of their monetary base.

An implosion was inevitable; all that was needed was a trigger and that came by way of the US Federal Reserve raising interest rates following recovery from a recession. This set off an exodus of capital back to the US. The massive capital outflow caused a depreciation pressure on ASEAN currencies pegged to the dollar. The Thai government was the first to run out of foreign assets to support its exchange rate, forcing it to float the baht. The value of the baht collapsed immediately afterwards. As the contagion spread, the AFC came into full play taking a devastating toll on growth and welfare.

The policy responses of select ASEAN countries to the AFC are listed in Table 5.

Table 5: Policy responses during the East Asian financial crisis				
Policy Tools	**Indonesia**	**Malaysia**	**Philippines**	**Thailand**
Policy Rate	Lowered.	Lowered.	Lowered.	Lowered.
Exchange Rate	Devaluation.	Pegged the ringgit at 3.8 per US dollar and curbed import and export of the currency.	Devaluation.	Devaluation.
Foreign Exchange Interventions	Rupiah was allowed to float.	On 1 September 1998, Malaysia enforced capital controls to shield its economy from currency speculators.	Peso was allowed to float.	Baht was allowed to float under the IMF programme.
Expansion of Deposit Insurance Coverage				Sovereign guarantee to bank depositors under the IMF programme.

Other Measures	Three-year standby arrangement with the IMF; Large amounts also pledged by other multilateral institutions and by bilateral donors; Structural reforms under the IMF-assisted programme to improve monetary policy and exchange rate, financial and banking sector.	Structural reforms to improve monetary policy and exchange rate, financial and banking sector.	More structural reforms to improve monetary policy and exchange rate, financial and banking sector.	Financial support by IMF; Assistance from bilateral donors and multilateral institutions; Structural reforms under the IMF-assisted programme to strengthen monetary policy and exchange rate, financial and banking sector.
Source: Websites of respective central banks.				

Following the AFC, the capability of central banks in India and across ASEAN to manage capital flows was tested once again during the GFC when they experienced another wave of capital flight. The ASEAN countries came out relatively unscathed as they had by then acquired self-insurance by building foreign exchange reserves. India, however, was affected because its fiscal pressures had spilt over into the external sector.

The responses of major ASEAN countries to managing the "impossible trinity" following the experiences of the AFC and the GFC are listed in Table 6.

Table 6: Managing the "impossible trinity" — country responses	
Indonesia	Before the AFC, Indonesia had a crawling peg exchange rate system and an open capital account, which constrained its ability to set interest rates. After the crisis, Indonesia adopted a more flexible exchange rate regime, which allowed for greater independence in setting interest rates. Since the GFC, Indonesia has increased its exchange rate flexibility and introduced capital flow management measures, which improved its autonomy for setting interest rates.
Malaysia	Prior to the AFC, Malaysia had a managed exchange rate and an open capital account, which provided limited scope for setting domestic interest rates. After the crisis, Malaysia fixed the exchange rate and managed the capital account to retain monetary independence. In 2005, Malaysia de-pegged its exchange rate, adopting a more flexible exchange rate regime, and liberalised its capital account, which provided greater autonomy for setting interest rates during and after the GFC.
Philippines	The Philippines had a relatively closed capital account and a managed exchange rate regime before the AFC, which allowed for a fair degree of monetary policy independence. After the crisis, the Philippines gradually liberalised its capital account restrictions and continued to manage its exchange rate to build up foreign exchange reserves, which constrained its ability to set interest rates independently. In recent years, the Philippines adopted a more flexible exchange rate regime, granting itself greater autonomy in setting interest rates.
Singapore	Singapore's position in the monetary policy trilemma has remained relatively unchanged. As a financial centre, Singapore has a highly open capital account. It also has a unique monetary policy regime centred on the management of exchange rate. Thus, it has limited control over the setting of interest rates, which are market-determined.
Thailand	Before the AFC, Thailand had a managed exchange rate regime and an open capital account, which provided limited scope for setting interest rates. After the crisis, it adopted a more flexible exchange rate regime and managed its capital account more tightly, which provided some interest rate autonomy. In more recent years, Thailand has allowed even more exchange rate flexibility and gained more interest rate autonomy.
Source: Websites of the respective central banks.	

Central banking in coronavirus times

Financial crises over the last several decades have tested the policy limits of central banks, and each time, central banks have shown that those limits were farther than is commonly believed.

The AFC of the late 1990s tested the robustness of the famed financial integration of the region with the world, but when their currencies started collapsing under stress, the authorities did not hesitate in erecting barriers to capital flows to prevent a free fall. During the GFC (2008/2009), the dominant view was that once the central banks brought down the policy interest rate to the zero lower bound, they would have no policy arsenal left. Again, central banks surprised the markets by going into uncharted territory — asset purchases on an unprecedented scale to restore confidence in markets. When the sovereign debt crisis hit the eurozone (2011/2012), the European Central Bank (ECB) showed that a central bank's policy weaponry is not restricted to calibrating just short-term interest rates, but that it can calibrate longer-term interest rates — what is now called yield curve management.

As this essay was being written (September 2020), the coronavirus crisis had pushed the global economy into the sharpest downturn since the Great Depression of the 1930s, with the global economy expected to contract by at least 5 per cent in 2020. Central banks found themselves in the fray once again, fighting to preserve financial stability and supporting government borrowing.

Once again, Asian central banks found their challenges to be quite different from those of AEs. For sure, they had been using conventional weaponry, like cutting rates and injecting systemic liquidity, but when it came to unconventional monetary policies, they found that their options were more restricted. Enjoying a huge fiscal space and the exorbitant privilege of issuing debt in hard currencies, AEs could throw the kitchen sink at the problem. In contrast, Asian central banks, aware that the market would be less forgiving of such policy excesses, had to be more measured in their quantitative easing as well as in extending regulatory forbearance to financial institutions.

Nowhere is the unequal level playing field more apparent than in the matter of the central bank's support to the government's deficit financing. The low interest rate regime maintained by the Federal Reserve was helping the US government take its fiscal deficit to historically high levels but markets have not raised any concerns about the fiscal sustainability of the US. When the Bank of England announced that it would finance the UK Treasury directly, the markets took that in their stride. In contrast, when Bank Indonesia accepted private placement of government debts, it had to convince the markets that this would be a one-off solution in order to avoid being penalised by market forces.

Central Banking with Asian Values

Central banking around the world is in flux because of structural changes in the global economy and the changing dynamics of international political economy. Tenets that used to be considered sacrosanct, such as the undivided focus of monetary policy on price stability and the autonomy of central banks to steer policy, are being challenged. Governments are questioning the prerogative of unelected central bank technocrats in making decisions that are affecting everyday life with tenuous accountability for results. Meanwhile, central bankers themselves are showing more eagerness than ever before to accommodate political concerns.

The challenges of transformation are not only different but more formidable for Asian central banks because of their different macroeconomic and institutional contexts. Asian central banks need to learn to manage policymaking in an uncertain world over which they have little or no control. They need to learn from the best in the world but adapt that learning to the demands and context of their economies. They need to persistently push the envelope and stay at the frontiers of domain knowledge (oftentimes reinventing it), while constantly remaining sensitive to their core concerns.

In short, Asia needs central banking with Asian values.

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