Challenges to Economies in Transition:
Stabilization, Growth, and Governance
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Session II: Monetary and Exchange Rate Policy in Economies with Newly Independent Currencies: Lessons from Recent History

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Ladies and Gentlemen:

As Mr. Talmaci noted, the starting position is extremely important for an understanding of the specific aspects of monetary policy and exchange rate policy in economies with newly introduced currencies. In an interview with Askar Akayevich Akayev, which was published in the newspaper *Nezavisimaya Gazeta*, it was noted that the republic's starting position was ". . . Very difficult. Because Kyrgyzstan received only direct annual subsidies over the years, at least in the 1970s and 1980s, at a level equal to 10 percent of the gross domestic product . . . But these are just the direct subsidies . . . the overall volume of subsidies to Kyrgyzstan reached 30 percent, if you take into account hidden subsidies provided through energy resources and other raw materials . . ."

Thus, the republic was faced with the following challenges:

• the achievement of macroeconomic stability, one of the main conditions of which was a sharp reduction in inflation;

• the attraction of foreign resources, primarily on concessional terms, and accumulation of international reserves;

• opening up the economy through liberalization of foreign economic activity;

• implementation of structural reforms based on a reduction in direct state interference and stimulating the functioning of the economy in accordance with market principles;

• and making the relevant changes in tax and budget policy: a rejection of subsidies for state enterprises, cutting budget spending on certain other expenditure items, and naturally, a reform of the structure of the revenue side of the budget.

On May 10, 1993, when the national currency was introduced, the central bank, the National Bank of Kyrgyzstan, was also given the opportunity to implement sovereign monetary and exchange rate policies aimed at meeting strategic goals set by the country's leadership. It was at this point that serious macroeconomic reforms began and the structural reform of the economy was initiated.

When there are differences in the starting conditions, economic conditions, institutional structures, and legal foundations, it is entirely natural that there would also be differences in the goals and tasks of monetary policy and exchange rate policy being pursued in various economies in transition. The Kyrgyz Republic Law on the National Bank of the Kyrgyz Republic states that:

• <u>the goal</u> of the Bank of Kyrgyzstan's activities is to achieve and maintain price stability through the pursuit of the appropriate monetary policy;

• <u>the primary task</u> of the Bank of Kyrgyzstan, which contributes to the achievement of this goal (or is subordinate to the primary goal), is to maintain the purchasing power of the national currency, and to ensure the efficiency, security, and reliability of the republic's banking and payment system;

• <u>its primary functions</u> are: the exclusive right to issue currency, possession and management of official foreign exchange reserves, and performing the role of the bank of banks, financial agent of the Government, and financial adviser to the President, the Zhogorku Kenesh [Parliament], and the Government.

The goal of the National Bank was selected in light the following basic considerations:

1. The goal must be controllable, that is, it must be susceptible to instruments that are available to the National Bank and act in a significantly shorter period of time. It should be noted, however, that in the transitional period, in addition to monetary factors, the formation of inflationary processes is influenced by other factors, which are related to the fact that structural reforms have not been completed, there is an objective movement of prices toward world levels, and certain prices are subject to administrative regulation;

2. It is not possible for the National Bank to exert a direct influence on the achievement of other ultimate goals of state economic policy, such as unemployment or growth in real GDP, for example: in the first place, they are values that can be measured only after a considerable lag; in the second place, a longer time is needed for the effects of monetary policy to be felt on these goals, which would make it difficult to evaluate the effectiveness of measures to implement monetary policy based on observations of final results that are achieved;

3. It should be possible to measure the extent to which a goal has been achieved, with little or no delay.

The set of instruments available to the NBKR [National Bank of the Kyrgyz Republic], as well as the priorities assigned to their use, have changed constantly since 1993. At the beginning we stressed the use of the currency auction and credit auction (the latter was discontinued in December 1996), while now the liquidity of the commercial banking system is regulated mainly with the aid of REPO operations with government securities. Today the National Bank has at its disposal the following <u>monetary policy instruments</u>:

→ reserve requirements;
→ open-market operations;
→ mechanisms for lending to banks: Lombard and emergency credits;
→ treasury bill auctions;
→ currency auctions.

<u>Reserve requirements</u> for commercial banks, which have the most direct effect on the money supply, are among the most effective instruments for the control and regulation of monetary relations. At the present time the reserve requirement ratio is set at 20 percent of commercial banks' deposit base. Deposits for which reserve coverage is required include accounts held by Government agencies and local government authorities. Reserve coverage is provided by the balance of funds on banks' correspondent accounts and cash only in the national currency; foreign exchange cash is excluded. Compliance is monitored on an average monthly basis: there is a fee for failure to meet the reserve requirement (set at 1.4 times the NBKR discount rate on the shortfall), as well as compensation for compliance with reserve coverage requirements (100 percent compensation at the weighted average deposit rate of each commercial bank).

The goal of <u>open-market operations</u> performed by the National Bank is to ensure financial stability and lower the inflation rate by regulating the level of liquidity in the commercial banking system through the purchase and sale of government securities on the secondary market. When there is a high level of liquidity, the main purpose of open-market operations by the NBKR is to remove excess reserves from the banking system. To this end, the National Bank employs, for example, the sale to commercial banks of government short-term and medium-term bonds, or securities, which were used to convert part of the government debt to the National Bank. The sale of government short-term bonds is executed in the form of a REPO agreement, that is, with a provision for their repurchase at a later date. The transactions are usually for a term of 1 to 6 months. A total of 69 transactions were effected in 1997, as a result of which excess liquidity in the amount of 183 million soms was absorbed.

Trends in the development of the government securities market provide evidence of the effectiveness of measures undertaken by the National Bank to attract more funds from the public for the <u>financing of budget expenditures</u>, as well as the expanded role of the NBKR as financial agent of the Government:

a) at the beginning of 1997 the weighted average yield on all types of government treasury bills was 57.6 percent, but by the end of the year it had fallen to 28.3 percent;

b) significant positive changes occurred in the structure of government treasury bills in circulation on the secondary market. In 1997 the weighted average time bills were in circulation increased from 151.5 days to 237.5 days, or by 86 days;

c) in the past year the proportion of nonbank investments in government securities increased from 19.6 percent to 39.1 percent of the total volume of government securities in circulation.

The National Bank's discount rate serves as a reference point in determining the cost of money in the economy. Since January 1, 1997 the simple interest rate on 3-month government treasury bills reached at NBKR auctions has been used as the NBKR discount rate (before 1997 the discount rate was determined at NBKR credit auctions and was called the NBKR refinance rate). The main factor influencing the decision to use the interest rate on 3-month government treasury bills as the NBKR discount rate was the fact that they are the closest to interbank credits in terms of their maturities and interest rates. In addition, the fact that rates on short-term money market instruments are the most sensitive to changes in supply and demand and the liquidity of the financial market was also taken into account.

With a view to maintaining the necessary level of liquidity in the banking system, the NBKR may meet the demand of commercial banks for short-term credits through the granting of:

- Lombard credit;
- emergency credit (the NBKR performs the role of lender of last resort).

The Lombard credit mechanism used by the National Bank allows commercial banks to respond quickly to short-term problems, up to 14 days, in the demand for borrowed funds against the security of liquid government securities. The interest rate for Lombard credit is set at a level higher than the National Bank discount rate.

The emergency lending mechanism may be used only in exceptional cases, when a commercial bank is not able to maintain its liquidity at a level sufficient to meet its obligations through the sale of assets or raising funds on the interbank market. In the event that an emergency credit is granted, the NBKR performs its function of lender of last resort with a view to preventing systemic risk and preserving the stability of the banking system. The NBKR imposes an entire set of stringent requirements when granting an emergency credit. It is gratifying to note that this mechanism was not requested by commercial banks in 1997, and correspondingly, was not employed by the NBKR.

Currency auctions, which the NBKR uses to perform currency interventions on the domestic currency market, remain one of the primary instruments for implementing the monetary policy that has been outlined, although it is gratifying to note that their role is gradually declining and by the end of the year we plan to discontinue them.

On the one hand, in addition to providing coverage for a current account deficit, the sale of foreign currency has made it possible to sterilize the excess liquidity of commercial banks.

On the other hand, in smoothing out seasonal fluctuations in the exchange rate of the dollar against the som, the National Bank has held back the inflationary expectations of the public, thus preventing the outbreak of an inflationary spiral and stimulating savings in the national currency.

As of January 1, 1998, under the terms of the new Law on the National Bank of the Kyrgyz Republic, passed on July 2, 1997, the Bank of Kyrgyzstan <u>does not have the right to grant credits to the Government</u> of the Kyrgyz Republic and other government agencies, and government securities issues are the only form allowed for domestic financing of the budget deficit.

The <u>floating exchange rate policy</u> for the som against foreign currencies, which was adopted in May 1993 when the national currency was introduced, makes it possible to respond promptly to problems of adaptation to changes on world markets and in the domestic macroeconomic situation. Adoption of the floating exchange rate system means that the exchange rates of foreign currencies, and particularly that of the U.S. dollar, against the som, are based on supply and demand on the domestic currency market. The National Bank of the Kyrgyz Republic, without interfering directly in the process of setting exchange rates, fixes the rate that was set on the free market. At the same time, this does not mean that the central bank plays an absolutely passive role here. When considering the medium-term, and particularly the short-term regulation horizons, one can say that the National Bank has a definite influence on exchange rate fluctuations by regulating the liquidity of participants in the currency market, interest rates, and the size of interventions. During a period of sharp seasonal exchange rate fluctuations it is possible to implement measures that even out the amplitude of the fluctuations, if this does not run counter to the current situation in the monetary sphere.

The fact that exchange rates in the cash and noncash segments of the currency market have drawn closer together is a positive achievement of the past five years. For example, the average deviation of the exchange rate for the sale of noncash U.S. dollars from the sale of U.S. dollars in cash in 1997 was 0.06 percent, while in 1996 this indicator was 0.85 percent.

The average deviation of the selling rate on the interbank currency market from the official rate in 1997 was 0.07 percent.

Last fall’s financial crisis on international markets did not have any noticeable impact on Kyrgyzstan’s currency market. There were no changes on the government securities market, either. This can be explained to a great extent by the lack of development of the stock market and the fact that nonresidents account for a small share of the emerging corporate securities market.

The National Bank has adhered to a conservative policy in the management of gold and foreign exchange reserves, governed by the principles of ensuring liquidity, minimizing risk, and maximizing the return on its international operations. An investment committee is responsible for management of the NBKR's gold and foreign exchange reserves, in accordance with decisions of the NBKR Board.

Taking a closer look at the issues in the development of legal aspects which were raised by the speaker, I would like to note that the first stage in the formation of the republic's banking legislation was completed with the adoption and entry into force of the new version of the Law on the National Bank of the Kyrgyz Republic and the Law on Banks and Banking in the Kyrgyz Republic. A significant step was taken when the independent status of the NBKR, which is comprehensive in nature and arises from its special organizational and legal formation, was secured by legislation.

Parliament's passage of a new version of the Law on Security in 1997 is contributing to a strengthening of financial discipline and the positions of the private investor, who in the distribution of his investments is concerned about reliability and guarantees for the return of invested capital.

At subsequent stages in the development of the republic's banking legislation, it will be necessary to continue work on the formation of legislative principles pertaining to banking, through the preparation of draft laws on bank deposit insurance, electronic funds transfers, the prevention of money laundering through the banking system, banking secrecy, and mortgages. It is also important to establish the legal foundations for the creation and development of the republic's payment system, the use of different types of payment instruments, and effecting payments in electronic form.

The economic reform program in Kyrgyzstan also includes the creation of a normative base for nonbank financial institutions and further development of the capital market, and improving the operation of investment funds and providing for better regulation of these funds. In connection with this, it is also important to create the corresponding legal framework for the development of nonbank institutions, such as credit unions, private pension funds, insurance companies, investment funds, and other financial organizations.

In conclusion, I would like to express the hope that together we all will be able to discuss the question raised by Mr. Talmaci regarding the interconnection between the goal of monetary policy and the goal of general economic stability, and to this I would like to add stable economic growth, its following aspects in particular:

• **the effectiveness of monetary policy with an emphasis on money aggregates and monetary policy oriented toward interest rates:** I believe that this particular issue is relevant to economies in transition since, on the one hand, you have the process of the formation of a capital market and the development of financial instruments, and on the other hand, the process of structural changes aimed at stable growth. And after all, different sectors of the economy react differently to a change in interest rates;

• **nuances in the use of the Fisher equation**, the speaker noted certain peculiarities of its practical application. Assumptions about the invariability of the velocity of turnover (which was acceptable only in the days of the gold standard), about the stability of the volume of production (it is difficult to speak about proximity to the potential level of production under the conditions of a fundamental break in the structure of the economy, a labor market that continues to be tight, along with the social orientation of the expenditure side of the budget), and finally, the overall price level, which is a variable dependent on the market (under our conditions both state regulation of certain prices and the activities of monopolies have a significant influence, and will probably continue to have a significant influence for some time to come);

• the need for central banks of countries with economies in transition to perform a closer **analysis of the interconnections with economic development**. That is, not only to observe, analyze, and try to understand the change in the dynamics of money aggregates, on the one hand, and inflation and production on the other, but also to devote more serious attention to the cost of capital (for example, growth in interest rates resulting not only from actions by the central bank, but also the subsequent increase in interest rates by banks and other financial institutions); to the availability of credit resources (interest rates are not the only signal of availability; there needs to be a more detailed analysis of the proposed repayment schedule and maturities, as well as accompanying servicing rates); and finally, from the consumer's standpoint, the effect of market interest rates on welfare (how the level of welfare falls as interest rates rise).