

The Financial Sector Needs to Be a Step Ahead of Economic Actors and Government

Dasho Penjore, the recently appointed Governor of the Royal Monetary Authority of Bhutan (the country's Central Bank), spoke with journalist Gyalsten K. Dorji on the role of the financial sector in Bhutan and whether it is fulfilling its role. This interview, however, took place in November 2015 when Dasho was still the CEO of the National Pension and Provident Fund (NPPF).

Q. Until very recently, we regularly saw loan defaulters being displayed publicly on television. Today, we still see a number of properties like land and equipment being auctioned by the banks. Is this indicative of a problem with the economy?

I think this has to do with the investment climate. The people's income depends on how much they can consume and of that income how much is left for investment after consumption. Currently in Bhutan, our consumption is much higher than our savings and people are actually dissaving. They are in pursuit of additional income. They try to borrow money from the banks, for instance, for housing or some small medium enterprises.

So in pursuit of additional income or income enhancement coupled with the opportunity of borrowing in the market, they borrow. Here a typical scenario is you are borrowing from a bank in pursuit of some return. But because of the nature of the market,

the investments are not able to generate the promised returns which they have promised the bank. Or the business is not operating as they wished, perhaps because of structural or policy problems. So then they become defaulters.

Defaults are not desirable and they have very serious consequences for the banks as well as the borrowers. At the national level, it's not good because defaults reflect the indebtedness of the public to the banks—the higher the indebtedness, the more vulnerable the households and the individuals.

From that angle, however, I don't see it as a very alarming situation as of now. This is a natural phenomenon. There is a tolerance level of up to five to seven percent for bad loans. There are guidelines from the Royal Monetary Authority (RMA) also to contain non-performing loans. But such incidences indicate that there are some difficulties in the investments that the people are making, either in the housing market,

in the industries, or in the service sector. But these occurrences are not alarming in the sense that there are no huge defaults and there is no prospect of banks collapsing. These incidents should not be recognised as a big threat. If the ratio or the percentage is large enough to shake the private sector or the households, then corrective measures have to be taken by the RMA.

The World Bank and the Asian Development Bank have realised that the financial sector has slowed down. It's not only the fault of the individual who has borrowed. It's also the fault of the banks that lend because it's also about the quality of appraisal and the quality of market access. Should we encourage you to borrow this money for housing, knowing that there is a housing bubble arising? Or give you a loan to do a business knowing that it is going to suffer because of the domestic, regional, or international markets? If somebody wants to set up a five-star hotel, do you lend it just because you have money to lend? Or do you let the borrower know if it is the right time to make an investment or not?

If the banks are prepared, more educated, if they are more market oriented, if there is more leadership, more research, they can guide their lenders better. And the borrowers can rely on lenders. So there is a partnership. But just now the banks' ambition is only to lend because they want to get

returns. When a loan goes into default, if it's contained within tolerable limits it's normal, but when it goes beyond the threshold we need to question if it's the fault of the banks or the market.

Q. You are saying that there's a need for the banks to have a "call" and that they have to be more dynamic and vibrant. Could you explain what that means?

Financial sector development is a very important anchor for economic development. Economic development is one of the strongest pillars of GNH (Gross National Happiness). No doubt, everybody accepts that of the four pillars, economic development matters the most personally because your fundamentals are met through economic development. At an individual level, one of the prerequisites to enjoy GNH at the personal and national levels is to have some reasonable economic growth. Not only growth, but long-term sustained growth that generates employment and redistribution of income.

One of the engines of the economy is the financial sector. And there's a need for this sector to do much more to help this engine run faster, more efficiently, and dynamically. We may be content with whatever the financial sector is providing now but if you're really serious about economic growth as a strong impetus for GNH and economic development, we need to have a vibrant financial sector because this sector

provides all the elements of economic growth.

We have an underdeveloped financial sector to an extent. We are not able to come up with the instruments and market that are available in developed countries. Our capital market like the Stock Exchange is still not active enough to provide this efficiency in the financial sector. That is one aspect. Do we have enough markets and instruments? Do we have enough financial institutions to cater to this kind of economic growth?

The second aspect to run the financial sector efficiently is leadership—a leadership that will understand the fundamentals of economic growth, and bring about efficiency. As much as good governance applies to other sectors, it applies more so to the financial sector because we are dealing with transparency, accountability, defaults, and access to credit. So a dynamic financial sector is essential to give a boost to economic development, whether it is driven by a mix of public and private sectors or by the private sector alone. How the private sector and households can mobilise savings and how the mobilised savings are used will depend on policies to promote financial literacy, how the banks can branch out, and how the money mobilised can be redistributed.

If you are serious about pursuing sustained growth, you need strong financial policies and for that reason, there's

a call for the financial sector to be more dynamic, vibrant, and for appropriate policies to be in place, so even the financial leaders and institutions can function within that vibrant framework.

Q. What are your other recommendations to make the financial sector a more active player in economic growth?

If the economy is to be dynamic, I think the financial sector should in fact be more dynamic—a step ahead of economic players, because it is the engine that runs economic growth. From that perspective, there is no point where we would be able to say that the financial sector is now efficient or good enough to match economic development. It's a continuous, dynamic process, particularly in our context with rapid economic development taking place with the development of hydropower and tourism sectors.

There is a lot of focus by the government on small and medium enterprises as well. While the government makes all these ambitious plans to boost economic growth, it has to all filter through the financial sector. The financial sector has to match the plans that are being made by the economic players and the government. Unless we have good leaders in the financial sector we will not be able to do this.

So I always use a term: Either you want to be led or you want to lead.

And here the financial sector should lead so that it is ahead of the economic players to provide the market, facilities, instruments, networking, electronic spectrum, and expertise. We want to lead the economy because the government is making the decisions on the economic fundamentals and it's going to pass through this bridge of the financial sector. There's a need for leadership to understand the fundamentals of the government's policies, decisions, and even regional and global events. If this is not there then we are being led. We're only following and being asked to do things by the government.

The financial sector is a business house actually and not a government entity. If not ahead of it, we should be at a par with the economic policies and aspirations of the government. Now with changing governments, each make promises which the financial sector should have the wherewithal to help operationalise. For instance, take the case of the Bhutan Opportunity and Information Centre (BOIC). Did the decision precede the availability of the requisite capacity of the financial sector to provide this kind of credit? The government came up with an Economic Stimulus Plan but they didn't know how to implement it. So the preparedness of the banks to handle such situations is required.

Q. What is the role of the Central Bank?

All of us have to accept that in this

changing economic scenario—a high pace of development, rural to urban migration, businesses concentrating in urban areas, the large volume and velocity of money changing hands in the urban areas, and the available credit within the domestic market—the fundamentals of the economy are changing. An efficient leadership in the Central Bank is absolutely necessary and it's more necessary now in a free economy. Since all transactions are transmitted through the banking system and the system's soundness depends on some of the policies issued by the Central Bank.

The Central Bank has three primary roles in the economy.

One, to strengthen the financial sector. The banks are owned by shareholders and shareholders' interest is limited to profitability. They wouldn't be interested in opening a branch in Gasa. So one of the strongest agendas for the Central Bank, is how to actually strengthen the financial sector and prepare it to accommodate the economic developments taking place in the Plan periods, and how they plan for the multiplier effect. When you're talking about leadership in the financial sector it has to originate from the leadership of the Central Bank. That's why in any country the Central Bank plays a very important role when it comes to policy debates, especially on economics because economic policy depends on two other

pillars, monetary and fiscal policies.

Fiscal policy is the prerogative of the finance ministry and the government. But monetary policy is the autonomous, independent policy of the Central Bank. The reason the two policies are kept independent is, so that there is no collusion and no undesirable effects on the market; to ensure that the government doesn't overspend and that the Central Bank doesn't go overboard on the fiscal front. The attempt is to ensure a balance. If you want to generate sustained long-term economic growth that will provide employment and redistribute income, the Central Bank's role is crucial because it has to strengthen the fundamentals.

The second role of the Central Bank is to regulate and supervise the banking sector—formulate rules and laws so that the banks are not contained and controlled to an extent that their efficiency is affected, but controlled sufficiently so as to keep them within the framework of international norms.

The third component of a Central Bank's role is very important: maintaining the value of currency. The ngultrum is issued by the Central Bank and all ngultrums in the hands of the public are a liability of the Central Bank. And against that liability they've been issuing some assets like maintenance of US dollars or Indian rupees. To maintain the stability and predictability of the exchange rate

is the role of the Central Bank. If the exchange rate fluctuates, it creates much uncertainty in the market; people lose confidence in the currency. People cannot predict investment or predict trade because every day there is an exchange risk. So the Central Bank has a very important role vis-a-vis Bhutan and the rest of the world in maintaining the value of our currency.

Q. Why do we peg the ngultrum to the Indian rupee?

That helps maintain stability and certainty, because we are dominated in terms of economic transactions by transactions in the Indian rupee. So it's better to hold the bigger chunk of the transactions stable. The Central Bank has to—no matter how much economic development, prosperity, and happiness is achieved as a result of democracy—to support this arrangement. The Central Bank has to be at the top to show leadership, dynamism, predictability, and display a sound and transparent relationship with India and the rest of the world.

In terms of economic transactions and investments, no doubt, the Central Bank has to, again, have a call. The call is for the Central Bank to be good enough to take up this role, or should we again need to revitalise and reform the Central Bank to take up these kinds of important positions because everyone's wellbeing depends on these kinds

of policies, knowingly or unknowingly, directly or indirectly.

Q. There are some doubts that pegging the ngultrum to the Indian rupee may be a disadvantage for Bhutan given growing trade with third countries.

In general, I'm with those who still hold the opinion that the exchange rate regime that pegs our currency to the Indian rupee, is still the most appropriate policy for us. This is so from two angles: One, we are an import-driven country and 80 percent of our imports come from India. If there is a change in the exchange rate between the ngultrum and rupee our import bills will change, and in nominal terms we may be paying more for goods from India because of the competitiveness. If one rupee is Nu. 1.3, we're paying 30 percent more on imports.

From that perspective, as long as we cannot diversify imports to countries other than India and if we're still dependent on imports from India, —especially essentials like fuel, raw materials, industrial inputs—the exchange rate gives a lot of certainty, assurance, predictability. And then it doesn't really add up to additional costs. From that perspective we still need to remain pegged to the Indian rupee.

Another important aspect we need to consider is that of the debt to GDP ratio. We're a highly indebted country,

in terms of the rupee as well as the dollar. Of course we qualify it by saying that it is self-liquidating because all our debts are in rupees and it's going to be met with hydropower sales. At the same time we've dollar debts. No matter at what concession we got it from the World Bank or Asian Development Bank, it's still a debt.

Although the capacity to pay the debt is not in question now that we can generate enough income, if the exchange rate is a little flexible then we are imposing an additional risk on the debt. If you have USD 1 debt, then as of now, we have to keep Nu. 66 to service this USD 1 debt. Now, say, if the dollar goes to Nu. 70, so for the same USD 1 debt our indebtedness goes to Nu. 70. Since we are still dependent on this kind of external debt to stimulate and facilitate growth, we need to have an exchange rate that doesn't impose additional risk on the debt. So from that perspective, I think we should be quite mindful of the exchange rate that is working now.

Being a small country, with only 700,000 people and a GDP of Nu. 1.4 billion, we do not have the capacity to expose ourselves to these kinds of exchange risks, which are global in nature. Anything that happens in France or China will affect us. To some extent we're cushioned by the exchange rate of the Indian rupee.

In my personal opinion, we should

wait till the point where we have really diversified our international trade, investments from other countries, and when our indebtedness is down to a reasonable level capacity where we can say that the exchange rate risk is not an additional burden. Or, when we reach a point where we see the exchange rate becoming an advantage for us. This is a financial decision but the question is always there if it is a political decision to have it pegged with the Indian rupee. I think here the economic benefits override the doubts of pegging and sovereignty.

Of course, the recent depreciation of the Indian rupee is affecting us. We're paying more for imports and we have higher import bills. Our exporters are benefiting but not our importers. Our tourism sector is benefiting. For every dollar earned from tourists they're getting Nu. 66-67. But only that sector which is exporting and earning dollars is benefiting, and exporters are relatively smaller than the larger community that is dependent on imports. Still we need to be mindful that the present exchange rate we have with India is actually to our advantage.

Q. Is the Central Bank prepared for the changing economic scenario?

I think it has to prepare itself. First, it has to realize that its role is changing. Pre-democracy, there was a good model. Everything was designed, implemented,

and contained within a framework of one government. The Central Bank was able to accommodate slowly to whatever the government desired, and there was a lot of certainty with how the government was moving forward. But with the advent of democracy the governments have become more ambitious. They are putting more plans and policies in place. They are trying to fulfill whatever promises they make in terms of economic growth or employment. So the Central Bank cannot isolate itself within its own thinking and policies. It has to increase the pace of preparedness. If you're not prepared, then you're caught into situations where you don't know how to react.

Suppose the BOIC was part of a better planned agenda, then the Central Bank would have offered advice on the best way to implement this government policy. It is a very wise, very effective, needed policy but the modality may be questioned because there was no preparedness. So from that perspective, we learnt a lesson that the Central Bank should always be prepared to accommodate such policies of the government in future. The financial sector should be at the forefront of translating these policies into reality in the market.