



SPEECHES & INTERVIEWS

Governor's Luncheon Address at Bank Negara Malaysia Monetary Policy Conference 2017 - "Monetary Policy Autonomy: Intricacies, Instruments and Independence"

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Speech Date: 24 Jul 2017

Monetary policy was thought to be a relatively simple and straightforward business. It was widely concluded that all that the central bank needed to do was conduct monetary policy in a way consistent with the inflation-target and ensure that employment levels are satisfactory. Life should have been easy for central banks. The holy grail of monetary policy was achieved. Central banks had finally understood how monetary policy should best be conducted. This was one of the primary explanations for the Great Moderation – the period of prolonged macroeconomic stability that preceded the 2007-2008 Global Financial Crisis.

Today, the situation is markedly different. Conducting monetary policy is anything but easy. For the advanced economies, despite almost 10 years of easy monetary policy, inflation is still persistently below target and economic recovery remains slow and fragile. The latest enigma is strong growth devoid of inflationary pressure.

For open economies, especially in emerging markets, we are left to manage the spillovers of extraordinary policy measures implemented in the advanced economies. These spillovers have had tremendous implications on emerging market central banks through macroeconomic and financial instability, financial and foreign exchange market volatility, and more importantly, the ability and autonomy of central banks in the region to conduct monetary policy.

So much attention has been focused on the advanced economies – the growth recovery, policy trajectory and political uncertainty. Not enough has been discussed on the countries at the receiving end of these uncertainties, and the difficult circumstances under which emerging market central banks have had to operate in recent years. This will be the focus of my remarks today.

I intend to describe a few reasons on why it has been a real challenge for emerging market central banks to conduct monetary policy in recent years than in the period prior to the global financial crisis. I will then discuss the policy thinking and tools from the perspective of an open economy when facing the challenges that emanate from global policy-spillovers. Lastly, I will share my view on the importance of having utmost autonomy in policy-making and suggest what we and the global community can possibly do to improve independence in policy decisions.

Global developments since the crisis have added extra layers of complexity in policy-making

For most emerging economies, structural changes in the economy over the past two decades such as diversification of sources of growth, wider set of policy tools and deeper domestic financial markets have all contributed to greater independence in the formulation of monetary policy. Nevertheless, the transmission of global monetary conditions to emerging economies is unavoidable given the open nature of the economies and the increasingly open and interconnected financial markets.

To fully appreciate the changes in the global landscape since the Global Financial Crisis and the challenges and risks they entail, let me suggest five important developments that emerging market economies have been facing in conducting domestic monetary policy.

- First, global financial markets are more interconnected than before. Financial openness in the Emerging Asia, as measured by the sum of assets and liabilities in the international investment position to GDP, has grown from around 800% of GDP to now more than 1000% of GDP. Emerging Asia cannot escape the vagaries of the financial markets around the globe.
- Second, global capital flows have increased in size and volatility. Cumulative non-resident capital flows to the region have reached USD2.1 trillion in 2016, compared to only USD400 billion in the period prior to the Global Financial Crisis. More importantly, capital flows have also become more fickle than before. Debt flows now contribute to 66% of capital flows. These flows are short-term in nature and carry higher propensity of reversals. Emerging markets had never experienced such phenomena before.
- Third, the volume of global foreign exchange trading has grown by more than four times in the last 15 years alone. The global foreign exchange market has become bigger, more complex and increasingly disconnected with economic realities. Today, exchange rate overshooting is the norm rather than the exception. Emerging economies' trade volume relative to the global market is, at best, minuscule.
- Fourth, non-resident participation has increased tremendously in most emerging markets. Non-resident holdings of Government bonds in Uruguay for example. In a little over a year, non-resident holdings surged from 2% to 45% of the outstanding bonds in

May 2013. Closer to home, non-resident holdings of Malaysia and Thailand Government bonds increased from 10.2% and 2.5% in 2009 to 32.2% and 14.1% in 2016 respectively . These non-resident investors tend to be driven more by global rather than domestic factors, motivated by the search for yields. As participation becomes too high, it brought heightened risks to domestic markets through the distortion in asset prices. The disproportionate influence of NR investors further amplified the disconnect between domestic interest rates and economic fundamentals.

- Fifth, asset prices in emerging economies are increasingly correlated with global factors, exposing emerging markets to shocks in the advanced economies. Stock market indices and long-term bond yields in emerging markets have shown strong co-movement with the indices and bond yields in the advanced economies, particularly the United States. This has led to signs of weaker monetary control. The increasingly correlated yields between advanced economies and emerging market economies have weakened the transmission from policy rate to domestic yields.

Given this new landscape, policymakers in highly open economies are often caught in a “catch 22” situation. Raising interest rates to manage rising inflation and the central bank may stoke capital inflows and further currency appreciation. Cutting interest rates to manage economic slowdown, only to find that it worsens capital reversals, exchange rate depreciation, and potentially reignite financial imbalances that policymakers have tried so hard to tame.

These are some amongst the many challenges to any policymaker, which brings me to my next point – the importance of policy pragmatism.

The importance of policy pragmatism

Our own experience suggests that in dealing with multifaceted challenges, a broad array of policy instruments is critical. The idea is that no single policy tool should be overburdened. The region’s experience theorises that despite great strides in achieving price stability and sustainable growth since the Asian Financial Crisis, an open economy with sizeable financial market invites volatile capital flows that adds layers of complexity in policy-making. We have expanded our policy toolkit to include micro and macroprudential as well as financial market stability measures. This additional arsenal of policy tools has helped to maintain the effectiveness of monetary policy and safeguard domestic financial and macro stability.

But having a broad policy toolkit is not enough. It may be tempting for us to treat these challenges as linear strings of events in order to cope with the complexity. But breaking the challenges into digestible fragments of their own and tackling them in isolation using our various policy tools seem a futile attempt. Given the closely interdependent and constantly evolving nature of the challenges, solving one part of them may amplify the risks in others. In this environment, it is imperative for policymaking to also be agile and pragmatic.

One aspect of pragmatism is the need to be bold and timely in introducing new policy tools, even unconventional ones when it becomes necessary. When a new crisis occurs, it is likely that the factors causing it are unprecedented. It goes without saying, that the solutions required to remedy the problem requires new measures as well. Using conventional and 'consensus thinking' are unlikely to be an effective remedy.

Policy-making is also increasingly characterised by shorter time horizon. With the rapid developments in the financial markets, the window of opportunity and effectiveness for policy has shrunk considerably. Gone are the days when policy-making can take months to formulate and implement, let alone years. As financial markets evolve, the shelf-lives of policies have also become shorter as policies can become ineffective very quickly. Such an uncertain environment necessitates the deployment of new and untested policies.

The "audacity of pessimism" – as Mervyn King calls it – a situation when policymakers start scrambling to address problems only when things have gone terribly wrong – may prove too little too late to salvage the situation. Constant, holistic and courageous assessments of implemented policies are therefore crucial in ensuring that policies remain relevant.

Another area of policy pragmatism that seldom gets discussed is the ability and conviction in reversing policies when deemed appropriate. In my years as a central banker, there seems to be an unspoken rule among global policymakers that certain policy paths are one-way, no-return endeavours. Any policy reversals are seen as a backward move that is time inconsistent, which could risk a permanent damage on trust, reputations and credibility of the central bank.

For me, this mindset is not tenable and counterproductive. It is imperative to realise that under extreme circumstances, a reversal of policies may be beneficial and in fact, necessary for the greater good and wellbeing of the society. Sometimes, taking a step backward may be the best way forward.

A case in point is in the area of liberalisation. While we have benefitted from an open market, and are strongly committed to the principles of this approach, we believe that countries should be cautious in its adoption, giving due consideration to the various trade-offs and preconditions. There might be a situation where a 'short moratorium' for further liberalisation becomes necessary. As with everything else, a balanced approach is always the preferred and wiser option. Liberalisation is not a 'cure all' for economic development. It is not a panacea for economic sustainability either. Liberalisation requires patience and sequenced planning. Greater openness needs to be phased in and be consistent with the readiness of the domestic market. Should expanded relaxation of policy become a source of financial instability, policymakers must be decisive and have the boldness to change course. This brings me to my final point of my remarks today.

Policy autonomy

It is now widely accepted that a broad policy toolkit and pragmatic policymaking are paramount in dealing with multiple challenges. Unconventional and unprecedented policies are no more heresy. This shift in mindset is a very welcome change. If only this mindset had persisted during the AFC, our experience in the region would have been much more positive. Experience also suggests that policy autonomy is critical in deploying measures in an environment with no precedent. Especially when the essence of the problems is domestic in nature, compounded by the specificity of each economy's operating and legal environment, political and social structures. Policy prescriptions will be least effective when it is not 'owned' by the domestic policy maker or when it is not independent of external influence and coercion or when policy being administered is more a reflection of 'consensus economic' thinking.

External influence can be viewed from two aspects. External developments that transcend national boundaries; and external players that may directly or indirectly suppress domestic autonomy. The former has been greatly discussed, where financial liberalisation and globalisation have worsened the trade-offs for monetary policy to achieve its multiple domestic objectives. Some consensus has also been reached on the ways to regain autonomy, in the form of broad policy toolkit to prevent overburdening of any single policy instrument, the building-up of buffers and instituting the necessary structural reforms that serve to fortify the economy. What is less represented, but in no way less relevant, is the potential for external players to suppress national autonomy. Let me elaborate.

Despite great strides in global integration bringing the benefits of reduced inter-country disparities, differences still exist. As much as we can categorise economies based on common characteristics, be it by geography, or by level of development, no two countries are identical. Even if countries may seem similar, their reaction to a certain phenomenon, in all likelihood, will not be the same.

This reminded me of the doctor-patient relationship, grounded by the classical "Principle of Biomedical Ethics" that emphasises respect for the patients' autonomy. A doctor may well know all the treatment options available, and would prefer some over others, but it is ultimately the wishes of the patient that needs to be considered. The doctor, rather than vehemently working against the patient, should upon exploration of options and sharing of information, wholeheartedly respect and support the decision of the patient. Underlying this bilateral covenant is the crucial recognition of the shared humanity of doctors and patients.

In a similar manner, we can all agree that as policymakers and regulators, macroeconomic and financial stability is a shared goal. We have been very grateful for the wealth of information and quality of debate that multilateral institutions bring to the table, which have immensely aided our decision-making process. However, individual countries should not be starved of policy autonomy to manage challenges. Domestic policymakers have greater understanding of the local economic and financial conditions, with the necessary experience

in dealing with country-specific circumstances. In this regard, multilateral institutions must respect that individual countries, as independent institutions, have made the tough but necessary choices after careful and deliberate considerations.

Multilateral institutions possess great breadth of cross-country information to dispense prescription for its member countries. But there is no such thing as a 'one-pill-cures-all' remedy. Instead, tailored policy responses are essential given the unique and diverse nature of emerging economies. As the world becomes increasingly more integrated and harmonised, we welcome the value of global coordination and interaction if it adds to the betterment of society at large. But where peculiarities exist, member institutions ought to be given the space to exercise their autonomy.

We must also avoid the rush towards greater cross-country standardisation that impinge on policy flexibility or where policies are judged based on pre-subscribed narrow definitions, theories and concepts rather than the actual outcomes. The never-ending debate on the categorisation of policies as capital flow management measures or macro prudential policies is one such contention. In an increasingly integrated and complex environment, the impact of shocks varies between countries. The policy would also vary. Even if policies are similar, the outcomes might be different. The work of multilateral institutions becomes even more difficult and complex. For instance, any mis-categorisation of policy could prematurely reverse the effectiveness of that policy, given the impact it might have on investor perception and sentiment. Beyond the potentially arbitrary labelling, the efficacy and desirability of a given policy should be judged solely by its outcome and its effectiveness in correcting market failures and imbalances. Only then can policies be evaluated intelligently, fairly and measurably.

Today I have talked about how it has become more difficult for central bankers in open economies to conduct monetary policy. I attempted to highlight that in order to manage these difficult challenges, there needs to be sufficient pragmatism and agility by central bankers. Most importantly, policymakers have to be given sufficient space and autonomy to address rising challenges to our respective economies.

I am reminded by John Baldoni's article on "The Secret to Team Collaboration: Individuality". The author warned about the risks of confusing between collectivism and collaboration. Collectivism leads to confined "group-think" and decisions; collaboration on the other hand breeds innovation. While collectivists do work towards a single goal, they ignore alternate paths to achieve that purpose. Collaborators, however, while similarly focused on a single purpose, arrive at their goals by incorporating different points of view and creative solutions. In short, collectivists value ideology over results. Collaborators are pragmatists that look for alternative ways to get things done.

As we move forward and fight for greater policy autonomy, we might be tempted to think that integration and collaboration come at the expense of individuality and domestic autonomy. In my opinion, it is the exact opposite. Collaboration thrives with individuality and autonomy. This is not wishful thinking. With the right instruments and tools, and considerable agility, policy autonomy is not only attainable; it can be the perfect catalyst for powerful collaboration as we move forward. Let us collaborate rather than be restrained by collectivism.

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