Transcript of Luncheon Address by
Dr. Zeti Aziz, Former Governor of Bank Negara Malaysia,
at the Monetary Policy Conference 2019:
***Policy Space Given Multifaceted Risks: Between A Rock and A Hard Place*, **
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Ladies & Gentlemen,

Introduction

It is a great pleasure to be here with old friends that I have met during the course of my more than three decade career as a Central Banker. This is the first time to be back at Bank Negara Malaysia since I left office more than three years ago. Just weeks before I left the Bank we launched an Automated Currency Centre that is predominantly being managed by robots. Embedded in the wall of the Centre is a time capsule to be opened at the Bank's Centennial, which will be in the year 2059. I was asked to write a message to the Bank on this occasion of its 100th Anniversary.

The message turned out to be seven pages long and its contents will only be known by our next generation of Central Bankers. Suffice however, to say that in the first line of the message, a momentous congratulations was conveyed to the Bank for what it had achieved during the decades leading up to its centennial. In essence, it is my firm conviction that Central Banks will continue to exist going far forward into the future. This is despite the many changes that will likely occur that will continue to transform the environment in which Central Banks will be operating in.

Allow me, first of all, to thank Bank Negara Malaysia for the invitation to deliver this luncheon address at this conference on Monetary Policy. My remarks today will cover three aspects. The first relates to the lessons that we can draw from the experience in Monetary Policy in these three recent decades, during which time we have seen three major financial crisis, major changes in the international financial system and the significant advancement in technology that has had substantial implications on the financial system. The second aspect relates to the importance of other economic and financial policies so that there will be an optimal policy mix to deliver the desired outcomes. The third relates to a subject matter close to the heart of every Central Banker – its autonomy and independence.

Monetary Policy Lessons

The first important lesson is to recognise what monetary policy can actually deliver. This relates to having clarity on the objectives to be achieved by monetary policy which in turn will allow for an indication of the effectiveness of the policy as well as the measurement of its success in delivering the expected outcome. Most Central

Banks describe with great clarity their mandate being that of preserving price stability, which in turn provides the pre-conditions on which sustainable growth can be achieved. In relation to this, it needs to be recognised, that price stability, and indeed financial stability are but a means to an end – with the ultimate goal surely being that of stable and sustainable growth of the economy. There is therefore a need to look beyond the goals of price and financial stability to that of achieving a lasting sustainable growth.

In this recent decade, the experience has shown that the highly accommodative monetary policy being pursued has however not produced the economic recovery being envisaged, while inflation has been persistently below the stated objectives. This reflects the complex nature of monetary policy. The lesson to be drawn here is that the effectiveness of monetary policy is dependent to a large extent on the conditions and context in which it is being implemented.

There are three important determining factors of the conditions and context of the environment. Firstly, the effective functioning of the asset markets that will allow for the efficient transmission mechanism for monetary policy. Secondly, is the extent of leverage of the household and corporate sector that will determine the extent of the response to monetary policy and thirdly, is the extent to which the financial institutions are impaired. This will also affect the relative effectiveness of monetary policy. For emerging economies, the stage of development of the financial markets and the extent to which the markets are segmented will also affect the transmission mechanism of monetary policy.

A further lesson that can be drawn is associated with the potential consequences of a prolonged period of low interest rates. During such episodes in a number of the advanced economies in the period referred to as the Great Moderation in the 1990s to the early 2000s, there was indeed stable macroeconomic conditions with low inflation and well anchored expectations. The setting however, resulted in a significant build-up of financial imbalances which in turn created risks to the financial system and the overall economy.

Monetary policy in this low inflation, low interest rates environment created incentives for the build-up of financial imbalances. While there was price stability in the goods market, there was price inflation in the asset markets, both in the financial asset markets and in the real estate sector. It was however never envisaged that these developments would subsequently engulf the financial system into a major financial crisis with devastating consequences to the overall economy.

While there has been reliance on macro prudential measures to rein in these unintended consequences of such highly accommodative policies, the conditions of rapid rising asset prices in the decade that followed continued to prevail. In essence, these economies are seeing themselves in a situation of a low interest rate environment with low inflation but with rising asset prices. Additionally, the less promising impact of the low interest rate policies on the economic growth also raise questions on the relative effectiveness of monetary policy. More specifically, it has taken an extended period of time for the growth of the respective economies to resume despite the highly accommodative monetary policy actions. This brings into focus on whether such unconventional policy measures such as near zero rates and quantitative easing are actually able to deliver the expected outcomes.

There has nevertheless been an overwhelming consensus that the unconventional monetary and financial policy measures which were implemented at a time of extreme conditions during the onset of the financial crisis, were indeed successful in restoring stability in the financial markets. It had therefore avoided a generalised declined in asset prices and thus a plunge of confidence in the financial system. This had in turn averted bringing the economy into a deep depression.

The policy measures implemented at the time ranged from bringing interest rates to its lower bounds – including to pursuing negative interest rates and balance sheet policies involving quantitative easing. Forward guidance was also introduced. There were also interventions in financial markets. The pursuit of these unconventional measures in several of the major developed economies however continued for an extended period of time despite having achieved the objectives for which they were originally implemented. It has already been recognised that interest rates had been too low for too long while the consequent impact on growth and inflation had been disappointing. In the years following the financial crisis, none of the economies concerned have resumed their previous growth path.

The lesson to be drawn from the implementation of such unconventional policy measures during the extreme conditions of a financial crisis is that it needs to be targeted and temporary. Two economies in East Asia that implemented unconventional policies during the Asian Financial Crisis in the late 1990s did deliver better outcomes. Not only was stability in the highly destabilising financial markets restored, but it had created the foundations for a stronger recovery in their respective economies. There were three important elements that had increased the potential effectiveness of these measures. The first is that it was targeted to achieve a specified objective, that is, to stabilise the highly unstable financial market conditions. The second was that it was to be temporary. There was a pre-determined plan at the outset for the exit from these unconventional measures.

In the Summer of 1998, during the height of the Asian Financial Crisis, Malaysia and Hong Kong implemented unconventional policy measures aimed at restoring stability in their domestic financial markets. In Malaysia, it involved implementing capital flow management measures in the foreign exchange market, while in Hong Kong, it involved the extraordinary buying of equities in the capital market. These measures aimed to stabilise the foreign exchange market and equity market, respectively. In Malaysia, the exchange rate had depreciated by 35% during a period of more than a year. During the same period in Hong Kong, the Hang Seng index declined by more than 50%. For both markets, it was recognised that if certain threshold levels were breached, it would then trend towards a point of no return.

For both economies, the measures were for a temporary period of time. Careful explanations were given to the public, the financial markets and the financial industry on the rationale for the measures and its temporary nature. The credibility and the validation of the policy measures only came much later following the exit from the measures. These measures were also followed with the implementation of a wide range of other policy measures to support the economic recovery. It however, only became apparent much later that these unconventional measures were not being relied upon to support the economic recovery in the period of the aftermath of the crisis.

This reinforces the important lesson, highlighted earlier, that while monetary policy is able to deal with the downside risks, it is less able to deal with the upside potential of the economy. Yet there has been an over-reliance on monetary policy to do so. A number of reasons have been put forward to explain the reasons for which monetary policy has been overburdened to providing the policy solution. Firstly, monetary policy is able to respond more promptly, relative to other policies. Fiscal policy measures require a more elaborate approval process that involves either the congress or parliament. Similarly, financial and structural reforms will involve several agencies and ministries which again may not allow for a prompt response. This is usually the case for policies that involve institutional change and financial and economic reforms that will not only require political will but also extensive coordination and time for their implementation.

Policies to Reinforce Monetary Policy

Building financial and economic resilience requires the reliance on a comprehensive set of policies. For the economy, it would need to involve not only structural adjustments but on the need to address the vulnerabilities confronting the economy, including those that would affect the effective transmission of monetary policy. Such structural adjustments need to involve the diversification of the sources of economic growth and the policies to promote domestic demand. The latter would involve policies to improve the investment climate and the measures to increase efficiency and productivity. Such policies would contribute towards generating the efficient functioning of the economy and towards strengthening its competitive advantage. Most importantly, these structural reforms would also increase the economic flexibility of the economy. Economic resources will be more able to effectively and efficiently shift to the areas of comparative advantage.

Similarly for financial reforms and policies. These would involve policy actions taken to diversify the financial system, not only so that it will best serve the economy but also so that it will diversify the risks to the financial system. For an emerging economy such as Malaysia, significant attention was accorded to developing the bond market. The experience has shown this has allowed for an enhanced ability to absorb the effects of the policies taken by major economies, including that of quantitative easing and then its tapering, and that of the normalisation of interest rates. The effects had become less destabilising and more disbursed throughout the financial system.

Wide ranging financial reforms have also been implemented in most of the emerging economies that has contributed to the strengthening of the financial intermediation process and its resilience. The financial reforms have involved deregulation and the transition to greater market orientation, liberalisation to allow for greater foreign participation in the financial system and the adoption of more flexible exchange rate regimes. These reforms have generally been accompanied by more extensive surveillance mechanisms, strengthened regulatory and supervisory regimes, the necessary toolkits and legal powers, and the development of talent capability for both the financial industry and the regulatory authorities. Additionally, financial intermediaries were significantly strengthened, while financial safety nets were also put in place. Equally important is putting in place the resolution mechanisms to deal with impaired financial institutions and having the debt restructuring mechanisms for not only the corporate sector, but also the medium and small sized enterprises and the household sector. These were amongst the policy measures and reforms that contributed to the resilience of most of the emerging economies during the time of the great financial crisis.

Finally, is on the greater role of communications and thus the need for a robust communications framework and infrastructure. Policies need to be explained to the public, financial markets, the financial industry and to the Government. Extensive communications are required with clear and coherent explanations on the basis for the policy decisions and on the assessments of its outcomes. Most of all, there has to be a matching of actions to the words. During the great financial crisis, forward guidance was introduced with the aim of providing information to the market about the intentions of policy makers about the future path of policies. In particular, interest rate adjustments would be contingent upon qualitative or quantitative measures. However, in an environment of heightened uncertainties and unclear measures of the developments taking place arising from the ongoing fundamental changes occurring in the environment, this approach has become challenging.

It needs to be mentioned that integral to the effective implementation of an optimal policy mix is the institutional competence and organisational capability of the respective institutions, authorities and agencies concerned. This includes that of Central Banks. Investment needs to be made for the strengthening of the organisational capability not only for the effective functioning of the institution but the investment in talent development. This is to enable the ability to rise up to the new challenges that are likely to continue to emerge on the horizon.

Central Bank Independence

The third and final part of my remarks is on Central Banks' independence, something that is cherished by any Central Bank. When we have a Central Bank that is independent – it means that we have a Central Bank that we can believe in to deliver its long term goals. Essentially, the Central Banks can be counted on to stay focused on the medium term goals and that it will not be distracted by short term developments or influenced by political and populist forces or succumb to market pressures, all of whom have short term horizons.

Let me now touch on some of the institutional arrangements that could contribute to such independence. Allow me to highlight six such elements. First, is to have clarity of mandate so that the Central Bank can be judged as to whether its actions taken have been appropriate and effective. For most Central Banks, the independence is with respect of the pursuit of monetary policy. While there is clarity of mandate, there is the broader expectation that it also will support economic growth. Then for the emerging economies, the Central Bank has in many cases been accountable for multiple mandates. Therein lies the importance of having clarity on these accountabilities. Second, is having the necessary powers and tools to achieve these mandates. Third, is the clarity of the governance arrangements, including for when coordination is required. For this purpose, there has been a transition to having a committee-based decision-making structure to allow for a more efficient decision-making process.

In this recent few years, we have seen this independence has been subject to an increased degree of pressure. For some, it has resulted in the resignation or removal of the Governor. In many of the cases, it has been either the opposition to higher interest rates or pressures to lower the rates. This trend is not exclusive to emerging economies. Recent statements have been made by the political leadership in a number of the advanced economies on the desired direction of Central Bank policies and on the security of the tenure of the leadership at the Central Bank. This has prompted four of the former Federal Reserve chairs to issue a statement to the effect that they are "united in their conviction that the Fed and its chair must be permitted to act independently".

The role of the Central Bank has evolved over time with the greater reliance on unconventional measures and with being accorded with a wider mandate that includes financial stability. This has resulted in an augmentation of the authority of Central Banks. These evolving roles have required increased interface with the different parts of Government. Furthermore, the environment has also become more interconnected and interdependent resulting in the demand for greater coordination of policies.

There therefore needs to be clarity on when such coordination is required with other agencies; or when Central Bank actions may have fiscal implications or even when the actions of Central Banks will have differential implications on society. Such decisions are often considered to be the domain of an elected official. A useful framework for such coordination is to have in place an 'alliance agreement' which is grounded by law. Such an agreement would detail with great granularity on who is accountable for the specific outcomes to be achieved. A respective deliverable framework which details the accountability matrix will allow for rapid decision making, particularly during unstable conditions. Such formal arrangements for cooperation and coordination can be entered into between the Central Bank and other authorities with such an agreement that would spell out how the respective authorities intend to cooperate.

Let me elaborate further on accountability. The issue of independence is particularly contentious when the framework to hold the Central Bank accountable has yet to be fully developed. The clarity of the goals, the manner by which the goals are to be achieved, and the governance arrangements and hence the accountability will provide the essential underpinnings for the independence. The accountability framework also involves the oversight arrangements over the performance of the Central Bank in achieving its goals. Certain countries have parliamentary committee or congress hearings for this purpose. This would also involve an increased level of transparency to mitigate the misuse of power and any inappropriate conduct by the Central Bank.

Finally, allow me to highlight two important consequential challenges. The first is on the growing demand for greater transparency. This includes the demand for prior consultation, especially before measures are prescribed to the industry. This is, of course, possible for planned structural changes that have a medium term horizon. However, in a crisis-related situation, or when the policies have market-sensitive consequences, the speed of action may not allow for advance consultation. Under these circumstances, a robust decision-making process, clear communication on the assessment of the risks to the financial system and to the economy, and further explanations on the policy decision after the fact, will lend support and increase the trust and confidence to the Central Bank, and the respect for its independence.

The second concern relates to the increasing need for Central Banks to coordinate with other agencies, including with the government, while at the same time avoiding being compromised so as not to undermine the policy objectives to be achieved. Central Banks from different parts of the world have addressed this with coordination committees and councils, such as in the United States, where the committee is chaired by the Treasury Secretary, and in Australia where it is chaired by the Governor. It was suggested by Alan Blinder in Jackson Hole in 2012 that Central Banks should have independence for financial stability during normal times but during crises this is impossible and not even desirable. Therefore, the Central Bank should then re-establish its independence after the crises.

Conclusion

In conclusion, Monetary Policy will no doubt continue to provide a stable anchor to the economy. But it cannot be the provider of the total solution. The rehabilitation, resolution, restructuring, growth and development will need to involve a comprehensive mix of policies and the collective efforts in the implementation of these policies across the board. Key to advancing forward in a more uncertain and highly dynamic environment is the building of financial and economic resilience. This will be integral for Central Banks in particular, and for economies in general, to survive and secure a growth and development that will be sustainable going forward into a much more challenging future.