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Navigating the Great Recession: what role for monetary policy?

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1. It is my honour to be invited to speak at this year's BIS Annual Conference on this Governors Panel, to discuss the role of monetary policy in this new environment. The most pressing challenge confronting policy makers in the world economy in this current environment is to achieve sustainable growth amid the need to address the risks to financial stability, fiscal sustainability, the orderly functioning of financial markets and the risks associated with the implementation of the regulatory reforms and structural adjustments. My remarks will try to address some of the issues raised by previous speakers on the role of monetary policy during a crisis, its limits and the other policies that are needed for a sustainable recovery. The second part of my remarks will touch on the global policy spillover effects, in particular, on emerging economies.

2. It is well recognised that the synchronised and aggressive monetary accommodation and the earlier fiscal expansion at the start of the crisis have successfully prevented the global economy from plunging into a deep recession. It has also restored the functioning of financial markets that has since experienced improved performance, although from time to time, the markets have been vulnerable to setbacks. Despite this progress, sustaining a strong recovery has yet to be secured.

3. While an economic depression has been averted, monetary accommodation has continued in an unprecedented scale in several of the advanced economises aimed at producing a stronger recovery. With diminishing fiscal flexibility, monetary policy has been at the forefront of this crisis management. Interest rates across the developed world have been brought to historical lows and this has been accompanied by large scale financial market intervention. The central bank's role, policy tools and instruments have expanded significantly.

4. **The potential effectiveness of further monetary policy action going forward is, however, limited**. We know from our own experience during the Asian Financial Crisis that **the underlying environment will tend to work against monetary policy**. Monetary policy cannot

stimulate consumption and investment when confidence over the future economic prospects is low. The efficiency of monetary policy transmission mechanism is also affected by the fragile financial system, volatile and disorderly conditions in the financial markets and the high levels of indebtedness in the economy. Moreover, as a counter cyclical tool, monetary policy cannot address structural issues such as impaired balance sheets and low levels of economic competitiveness.

5. **At the same time, the overreliance on monetary policy may result in unintended consequences.** Low interest rates reduce the incentive for households to reduce their leverage, hence delaying the necessary balance sheet adjustments. In addition, economic agents tend to actively seek higher yields amid such prolonged low interest rates resulting in a shift of funds to less regulated sectors of the financial system. Other financial imbalances also tend to build up during such periods including the mispricing of risk with the consequent misallocation of resources in the economy. It also may results in the formation of asset bubbles. Abundance global liquidity may also encourage the financialisation of commodities and significant inflows into emerging markets.

6. **These limitations suggest that other policies are needed to complement monetary policy.** During the Asian Financial Crisis, in addition to lowering rates, wide ranging pro-growth measures were implemented. Priority was also given to enhance the flow of credit to the economy. This included the introduction of new institutional arrangements, mechanisms and schemes for funding, guarantees and credit enhancements, debt restructuring and resolution, in particular for small- and medium-scale enterprises. In addition, to the extent that confidence was low and future economic prospects bleak, wide ranging measures were introduced to stimulate consumption demand and investments. The rapid economic recovery that followed in Asian financial crisis increased the potential for the successful implementation of structural and financial reforms. This included the restructuring and resolution of financial institutions and corporate balance sheets. This produced a V-shape recovery for Asia. In the current environment, while it is recognised that monetary policy needs to be reinforced by structural adjustments and reforms, it also need to be complemented by pro-growth measures. It will also increase the prospects for the successful implementation of the structural reforms, in particular, in the labour market and the industrial sector to improve competitiveness.

7. **An area that has not been given significant attention is the redistributive effects of monetary policy.** In this period of low growth, a focus on financial inclusion would also be important. It would ensure that growth is more balanced, equitable and sustainable. A key component to economic opportunity is providing more meaningful access to financial services to individuals and small businesses. This would not only assist the segments of society that are the most adversely affected by the crisis, **but would also contribute towards more balanced growth.** Financial inclusion is, however, not only about access to financial services. The financial crisis is also in part, an outcome of financial inclusion gone wrong as households that otherwise would not have had access to financing were provided with financing that was beyond their means. Financial inclusion must therefore be also accompanied by incentives and education on responsible consumer behaviour as well as the responsible lending behaviour by financial institutions. In addition, a robust consumer protection framework is needed.

8. Let me now turn to the policy spillovers emanating from the unprecedented monetary accommodation. It has generated higher global liquidity contributing to surges in capital inflows to emerging economies resulting in significant strengthening in currencies, rising

asset prices and strong credit growth. In the current environment, there are new risks emerging from these global spillovers arising from the expected scaling back of the quantitative easing (QE). Positive economic developments in the US in the recent months have prompted markets expectations for an early tapering of the quantitative easing. This has already resulted in a reversal of capital flows. Capital outflows have been prevalent across emerging market economies resulting in a retracement in the capital markets and a depreciation of currencies. Going forward, the expectation is for a potential repricing in the bond markets, and amplified volatility in global financial and currency markets.

9. **Most emerging economies in Asia are however in a better state of preparedness to cope with this environment.** This is an eventuality that is expected. Central banking is all about being anticipatory. Following the Asian Financial Crisis, countries in the Asian region have built buffers, and undertaken structural improvements to the economy and to the financial system. The strengthened fundamentals, including greater exchange rate flexibility, a healthy level of international reserves, a more developed capital market as well as a more diversified economic structure, have improved Asia's resilience. As at end-2012,

the international reserves position of ASEAN-5[1] economies were, on average, sufficient to finance 9.2 months of retained imports and 3.5 times the short-term external debt, compared to 4.2 months and less than one times respectively in 1997[2]. More developed capital markets have also enhanced the potential for more effective intermediation of the capital flows. The average size of the bond market to GDP has grown from 49% in 2008 to 64% in 2012. The average size of the equity market to GDP has grown from 62% in 2008 to 121% in 2012[3].

10. **Regional cooperation has also been substantially strengthened**. Efforts have been directed towards enhancing regional surveillance for a better understanding of the risks affecting macroeconomic and financial stability in the region. The introduction of an integrated crisis management framework will also facilitate pre-emptive management of risks of an imminent crisis to the region. In addition, the multilateralism of the Chiang Mai Initiative allows for reciprocal cross-border collateral and swaps arrangements between regional central banks, thereby effectively acting as a regional liquidity support facility.

[1] ASEAN-5 countries comprise Indonesia, Malaysia, Philippines, Singapore and Thailand
[2] Source: Bloomberg
[3] Source: Asian Bonds Online and Haver Analytics

11. Let me conclude my remarks on the questions that were raised by Jaime at the start of this session. Yes, monetary policy is, being overburdened and yes, its effectiveness is not only limited but also diminishing. And yes, monetary policy must be complemented by other policies to produce a sustainable recovery. Finally, the effects of the global policy spillovers from the unprecedented monetary accommodation and its eventual withdrawal have been and are expected to be significant, in particular, to emerging economies. The best line of defence in this highly challenging environment is to be in a high degree of readiness to manage the risks from these spillovers including with strengthened cooperation.

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