"The challenges of expanding the boundaries of monetary policy"

Opening address at the Bank Indonesia-BIS Research Conference: Expanding the boundaries of monetary policy in Asia and the Pacific

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Honourable speakers, distinguished guests, ladies and gentlemen,

Good morning to you all.

I am delighted to welcome you to this research conference on "Expanding the boundaries of monetary policy in Asia and the Pacific" co-hosted by Bank Indonesia and the BIS. I would like to especially thank our international guests who have travelled a long way to be with us today.

This Conference will showcase some of the research being conducted as part of a research programme that was endorsed by the Asian Consultative Committee of BIS in February 2014.

The objective of this Conference is to facilitate a discussion of key monetary policy issues of relevance to central banks in Asia-Pacific and beyond.

On this occasion, we will discuss current issues connected with expanding the boundaries of monetary policy, where the key question is how to reshape policy frameworks and formulate optimal policy responses, to cope better with global interconnectedness.

I hope the conference will help shed further light on this.

The global financial crisis that swept the globe in 2008–09 provided a number of valuable insights, including the lesson that merely maintaining price stability alone through monetary policy is insufficient. On top of price stability, financial system stability is also a prerequisite, both of which ultimately determine macroeconomic stability.

Financial spillovers associated with extraordinary monetary policy easing in advanced economies have prompted many central banks and academics to do some soul-searching about the appropriate framework, not just for monetary policy, but also for the regulatory and capital account policies that can best deal with these shocks. Since 2009, the configuration of monetary policies in major countries has created a challenging environment for small open economies in conducting their policy.

In the post-crisis global period, the relative fundamental strength of emerging market economies was already drawing in substantial capital inflows. The additional

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push from this extraordinary stimulus, and the reach-for-yield behaviour associated with it, has compounded the pressure.

Increasing global financial market interconnectedness, including large capital inflows and outflows, has put pressure on the implementation of monetary policy in many emerging economies. Hence, many emerging market central banks have found themselves at a critical juncture where broad reappraisals of their monetary and capital account policy frameworks were necessary.

A surge in foreign capital inflows, for instance, compounds the complexity of challenges faced in terms of domestic monetary management. Large and persistent capital inflows undermine the effectiveness of monetary management, bearing in mind that measures to manage liquidity in the economy, such as an interest rate increase, could subsequently be offset by the sheer magnitude of the capital inflows.

We also have seen an obvious example recently, where a competitive devaluation strategy has been pursued by policymakers in advanced economies and large emerging countries with the aim of boosting economic growth by going for export-led growth. These so-called currency wars have instigated capital outflows and exchange rate pressures in emerging markets, which were already on the back foot because of sliding commodity prices and fears over tighter US monetary policy.

This exposes a dilemma for monetary policy in many emerging markets, as raising policy rates to prevent excessive currency weakness will further worsen the slowdown in economic growth.

Maintaining price stability alone through monetary policy is insufficient. The surge in foreign capital inflows, for example, has significant implications for the domestic economy, particularly in the form of excess liquidity. Unless capital flows are properly managed, the excess liquidity can precipitate financial instability and eventually disrupt macroeconomic stability.

In many emerging countries, the orientation of monetary policy in the midst of dynamic global environment is tactically directed not only at controlling inflation but also at managing exchange rates and capital flows, with the aim of maintaining both monetary and financial stability.

We have seen the monetary authority's preference for shifting from a "corner solution" towards a "middle solution". There should be a more accommodative response that takes into account a certain latitude for managing exchange rate movements within a certain range (not fully flexible) and restricting movements of foreign capital.

The expanding boundaries of monetary policy have further implications. To preserve financial stability, central banks must also take into account fiscal risk, balance of payment sustainability and structural policies.

Thus, monetary policy is also directed at supporting the achievement of objectives such as a target for the current account deficit and sustainable economic growth.

The multiple challenges facing monetary policy due to a surge in capital flow volatility suggest that we should employ multiple instruments. We believe that an instrument mix would allow us to address these multiple dilemmas.

Hence, in some countries in which monetary policy is anchored to the achievement of low and stable prices, there is a good reason to implement a less rigid Inflation Targeting Framework (ITF), known as flexible ITF.

Flexible ITF requires the integration of monetary and macroprudential policy, including a capital flow and and exchange rate management policy. Thus, the policy mix should be an optimal response to tackling multiple challenges in managing monetary and financial stability.

On that note, we at the central bank would be more effective in maintaining macroeconomic stability if we were also mandated to promote financial system stability. Strengthening the monetary and financial system stability framework requires an appropriate integration of monetary and macroprudential policy.

The objectives achieved through monetary and macroprudential policies should be mutually reinforcing. Steps to empower financial system resilience will also improve monetary policy, including protecting the economy from destructive fluctuations in the financial system. On the other hand, macroeconomic stability will lessen the vulnerability of the financial system, which has procyclical characteristics.

Now, I will move to home issues by sharing our experience in implementing the policy mix.

The global financial crisis signified that central banks are clearly required to take a more active role, primarily in developing new capability to confront a more complex and interconnected global financial market.

Bank Indonesia has the specific role of supporting the sustainability of economic development through three elements, namely: (a) monetary stability, (b) financial system stability, and (c) a reliable payment system.

Within the dynamics of the global economy and financial market uncertainties, Bank Indonesia has since mid-2013 consistently implemented monetary policy with a tightening bias. This stance is imperative in preserving market confidence, mitigating the second-round impact of fuel price increases, and coping with the current account deficit.

The pro-stability policy stance and the assurance of financial system stability has underpinned investor confidence in the quality of Indonesia's macroeconomic policy management.

In 2014, capital inflows in the form of portfolio investment continued to be abundant. These inflows have sustained bullishness in the stock market and government securities market.

Our policy also aims to ensure the current account deficits that have occurred in the last three years will be maintained within the range of 2.5–3% of gross domestic product (GDP).

We believe that a well maintained current account is crucial for the achievement of a strong and balanced economic growth as well as the continuity of job creation.

Furthermore, through "ahead of curve" policy action, we aim to preserve the strong confidence of investors in the consistency and quality of our macroeconomic policy management amid the prospect of a higher global interest rate in the near future.

These efforts are important in maintaining the stability of global fund flows into our capital market, and particularly into the government bond investments that finance the current account deficit.

We also observe that efforts to maintain macroeconomic stability need to be supported by the observance of prudential principles by business sectors, particularly sectors that have access to foreign debt.

In this regard, corporates are obliged to conduct hedging by implementing hedging ratio rules and maintain adequate foreign exchange liquidity by applying liquidity ratio rules.

As mentioned earlier, the global economy recovery remains uneven and uncertain, and the risks of volatility can be rapidly propagated through the financial market channel.

On the other hand, the Indonesian economy is still struggling with structural issues that disrupt the efficiency and competitiveness of the supply side. Under these circumstances, an accommodative monetary policy would trigger inflationary pressure and increase the current account deficit.

Considering the overall constellation of the global and domestic economy that is still confronted with formidable challenges, future economic policies should remain focused on measures to ensure the sustainability of economic growth.

This requires at least two key aspects: the orientation of monetary policy towards stability, and a bold structural reform policy aiming to promote capacity, capability and competitiveness on the supply side.

Through the synergy between the monetary and structural policies, we are confident that our economy will be able to achieve sustainable growth.

Going forward, Bank Indonesia is committed to pursuing a consistent and prudent monetary policy as well as macroprudential policies that promote stability.

The integration of monetary and macroprudential policies will be further strengthened, given that monetary policy in some circumstances is less effective in mitigating financial system risks and imbalances.

The global crisis taught us that the achievement of low and stable inflation does not necessarily deliver financial system stability, an important lesson.

Excessive risk-taking and the loosening of credit standards can occur even in circumstances where macroeconomic stability is preserved and interest rates are low.

Efforts to maintain macroeconomic stability cannot be separated from efforts to safeguard the financial system, and vice versa. In this context, macroprudential policy is very important in filling in the gaps that cannot be reached by monetary policy, especially in relation to the risk of financial imbalances.

On that note, we will improve our capability to prevent and mitigate key risks which are potentially systemic and can create financial imbalances. Hence, the macroprudential policy framework will be strengthened to support policy formulation, regulation and supervision.

Macroprudential policy, regulation and supervision will be more effective if coordinated with the policies of other authorities. Therefore, the coordination with Financial Services Authority (OJK) will continue to be strengthened in a number of areas including data and information exchange as well as the development of an integrated information system. Likewise, the effectiveness of coordination with the Ministry of Finance and the Indonesia Deposit Insurance Corporation (LPS) will be enhanced through the Coordination Forum on Financial System Stability (FKSSK).

The expanding boundaries of monetary policy are a challenge to all of us. Central banks need to explore the issue deeply through research and analysis. That is the objective of this conference, to discuss these issues based on our research.

In closing, let me offer my special thanks to the distinguished speakers for taking part in this important endeavour and for sharing with us your expertise. All of us here very much look forward to your contributions through today and tomorrow. I would also like to thank the BIS for kindly co-hosting this event.

To all conference participants, I welcome your spirited discussions as I have already noticed there are many experts present among us. Thank you for being here. I wish you a fruitful conference and a pleasant stay in Jakarta.