Bandid Nijathaworn: Challenges for central banks in the new globalisation

Remarks by Mr Bandid Nijathaworn, Deputy Governor of the Bank of Thailand, at the Bank of Thailand International Symposium 2010 "Challenges to Central Banks in the Era of the New Globalisation", Bangkok, 15 October 2010.

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I think it is clear from the discussion we had that the post-crisis global economy will not be the same as the one we remember three or four years ago. The global financial crisis was serious, causing much dislocation to the global economy, the banking sector and financial markets, and the process of regaining full normality will take time. Therefore, at least for the next few years, the post-crisis global environment will be characterized by a world of two halves: the advanced economies and emerging markets, each exhibiting different growth prospects, different economic challenges, and different policy stance. And it is this divergence in policies and performance that will drive uncertainty and volatility in global financial markets, accompanied by shifts in risk appetite, global asset allocation, and relative prices. This, in essence, is the context in which new challenges for central banks are being shaped.

What implications will this post-crisis environment have on central banks' roles and responsibilities in maintaining economic stability? To me, three implications are clear. The ***first*** is the need for central banks to expand their mandates to formally recognize both price and financial stability as their core policy objectives. An important lesson learned from the current crisis is that price stability alone is not sufficient to ensure financial stability. Therefore, financial instability or crisis can occur even in the environment of stable prices and well-anchored inflation expectations. This implies that to ensure overall economic stability, central banks will need to go beyond the primary objective of price stability and to systematically embrace financial stability as another policy objective. The relevance of this dual mandate has become very clear in the last few years, in light of the global financial crisis, implying greater roles and responsibility for central banks.

The ***second*** implication from the global crisis is that, under the new globalisation underscored by more integrated financial markets, the major source of risk and instability that central banks will have to deal with to ensure stability will be external. Typically, this includes the impulse on domestic inflation from global prices, especially fluctuations in commodity prices. Another is the risk to financial stability steming from unintended consequences linked to the spillover effects of policies implemented by other economies.

But for most emerging markets at this time, the most serious external risk is the challenges posed by large and persistent capital inflows. The first challenge involves a macroeconomic dilemma that centres around the tension between appreciation pressures, inflation dynamics, and growth prospects. The second stems from financial stability concerns associated with potential build-ups of macroeconomic imbalances, risk of asset price bubbles, and the possibility of an abrupt reversal of inflows. In the past, as we all know, reversals of capital have trigged serious debt defaults, banking distress, and currency crises.

So, with the nature of risk becoming more external, the abilities of central banks to respond effectively to the new challenge based on domestic measures will be limited. This calls for a reconsideration of policy coordination, both in the context of within-country coordination, and cross-country coordination.

The ***third*** implication from the global crisis is the heightened expectation and trust that the public now has on central banks, as guardian of stability, to do its utmost to avoid financial crisis, and to do it professionally and independently. In the west, the current crisis has diminished public trust on the roles of government and financial institutions in safeguarding and upholding public interest. To this end, central bank independence is seen as an important pre-condition for ensuring safety, continuity, and stability. This is a challenge that central banks will need to recognize in performing their duties.

So, given this backdrop, challenges facing central banks going forward will be more demanding. And to meet these challenges, central banks will need to be thinking clearly on at least two issues.

The ***first*** is the right policy framework to respond to the challenge. In the case of monetary policy, from our experience here in Thailand, combining inflation-targeting with macroprudential measures under a flexible exchange rate regime has proven to be a good workable policy framework for meeting the challenge posed by the dual mandate of maintaining price and financial stability. Nonetheless, in an environment of large and persistent capital flows, having the right policy framework alone may not be adequate. Monetary policy will need to be supported by and coordinated with other policies to ensure the best outcome.

For example, well-aligned fiscal and monetary policy is important at a time of strong capital inflows to help moderate the adverse impact of capital flows on domestic demand. This means fiscal policy will need to be less procyclical as domestic interest rates rise. Next, deeper and more diverse local financial markets will help lessen the chance that volatile capital inflows will create substantial risk to the economy. This calls for the need to continue with policies to strengthen and reform the financial system. And to the extent that sustained inflows generate the need for real resources to be reallocated across the economy in response to changes in relative prices, a high degree of flexibility in the local economy will be needed to support these adjustments, which will lessen the risks of imbalance and price pressures.

The ***second*** issue to think more clearly about is the disconnect between the global nature of the problems facing central banks and the domestic orientation of the policy response. As I noted earlier, effectiveness of the domestic policy response tends to weaken when the challenge is of a global nature. A case in point is the current cycle of capital flows which, in essence, is a global phenomenon driven by exceptionally low interest rates in the major economies. Hence, policy response calibrated with domestic orientation may be of limited use if the problems at the source remain. This means that the thinking on policy needs to broaden to explore possible benefits of a closer coordination of policies between countries, especially when central banks face similar challenges of a global nature like capital flows. Such coordination will elevate central banks' policy-making to a new level, commensurate with the new challenge posed by the post-crisis globalisation.