

Foreword

This conference volume contains the eight papers presented at the BNM-BIS Conference on Financial Market Developments and their Implications for Monetary Policy. The theme of the conference is motivated by the rapid pace of change that we have observed in both the domestic and global financial systems over the last decade, and our own ongoing discussions within Bank Negara Malaysia about how these changes impact on our monetary policy.

Financial globalization and the integration of financial markets across different countries have greatly increased the complexity of the environment in which national monetary authorities operate. As countries have liberalized their capital accounts, there has been a change in the nature of capital flows in favour of more portfolio and other short-term flows. Cross-border capital flows have increased in response to differentials in interest rates and returns on other financial assets. For instance, in recent years, such capital flows have been driven by the low interest rate environment and a global liquidity surplus which has fuelled the search for yields. It has also led to a proliferation of new players and new financial products that have changed the dynamics of the global financial markets in ways that are not well understood. Increased integration has also led to the contagious spread of volatility across financial markets. Arising from these developments, monetary policy makers, particularly in small open economies, face challenges in terms of building resilience to volatile capital flows, managing surplus liquidity, maintaining orderly adjustments of exchange rates and avoiding boom-bust cycles in the asset markets. From the monetary policy perspective, there are open questions about how these developments have affected the way central banks in open economies conduct policy and how that policy is transmitted to the economy. For instance, we have already observed long-term interest rates in the bond markets being increasingly influenced by foreign interest rates and yields rather than domestic factors.

Changes have also occurred in domestic financial systems as a result of liberalization and innovation, leading to the appearance of new players and products. In Malaysia, over the last ten years we have seen the emergence of diversified banking groups arising from consolidations and mergers in the banking industry, while mergers of stock broking companies with merchant banks have created investment banks. The bond market has grown substantially, creating new avenues for financing, but at the same time resulting in some disintermediation from the banking system. Securitization has increased significantly, particularly for housing loans, but increasingly also for other assets. Islamic banking, with its promise of non-interest-rate-based financial intermediation, has grown rapidly. The spread of electronic banking and new payment mechanisms is gradually changing the payment and banking habits of the public. Such financial market developments could potentially influence the way monetary policy works, for instance by changing the relative effectiveness of the different transmission channels. The deepening of the financial system, aside from widening the choice of monetary instruments, could also enhance the role of the financial sector in determining economic outcomes. This could result in a need for changes in the monetary policy framework, for instance in terms of the communication strategy adopted with respect to the financial markets. The conduct of monetary policy itself may have an increasing influence on, and be increasingly influenced by, developments in the financial markets, requiring a greater effort in financial market surveillance on the part of the central banks than may previously have been the case.

Given the broad range of the issues raised by these developments for monetary policy makers, the conference focused on addressing four main areas. It first looked at some of the key recent developments in the financial markets, especially at the global level. The next two sections then covered the implications of financial market developments for the formulation and the conduct of monetary policy, respectively. The final section examined how central banks could extract policy-relevant information from financial markets. The emphasis of the

papers is very much towards providing policy-relevant research and observations that would be useful to central bankers in thinking about the monetary policy implications of developments in their own financial systems.

The success of the conference is owed first to the speakers, whose dedicated efforts produced the papers presented in this volume. I take this opportunity to express my appreciation to all of them. I would also like to thank the BIS, particularly the Hong Kong office, for collaborating with us in organizing the conference. A note of thanks also to my colleagues from other central banks who participated in the conference. Finally, special thanks to my own staff in the Monetary Assessment and Strategy Department of Bank Negara Malaysia, who worked tirelessly on the organization of the conference and the preparation of this conference volume.

Sukudhew Singh
Director
Monetary Assessment and Strategy Department
Bank Negara Malaysia