Monetary policy frameworks in Asia-Pacific: beyond inflation targeting?

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Do frameworks matter? From one perspective, the answer is 'no' – provided that the relevant frameworks are all based on prudent principles. Asia has had a diversity of frameworks but, irrespective of the differences, most Asian economies have enjoyed low to moderate inflation in the period since the Asian financial crisis. In the pre-Lehman period, central banks in the region were assisted by global developments. That is, monetary policy frameworks were less important than the economic environment in which monetary policy operated: more benign global conditions, fewer large supply shocks, globalisation and the importation of lower inflation through the trade channel. Economic liberalisation led to increased domestic and international competition, while an expansion in regional labour supply and increased cross-border mobility of low-skilled workers helped to dampen wage growth.

From another perspective, the answer is 'yes'. Not only have differences in the actual conduct of monetary policy narrowed, the overall quality of the policymaking frameworks has improved. Irrespective of frameworks, many central banks in the region have adopted certain best practices: primary focus on inflation, committee-based decision-making, increased transparency and regular communication on issues related to monetary policy. Asian central banks have generally adopted more flexible policy frameworks that have responded to other risks besides those related to inflation. They have undertaken foreign exchange intervention to manage pressure on their exchange rates and some have implemented measures to manage large capital flows. They have also responded to asset prices – not always with interest rates, often using macro-prudential and other administrative measures. Better-regulated financial systems contributed to the effectiveness of monetary policy. In the case of Malaysia, these improvements have included things such as the setting-up of a centralised borrower information database accessible to all financial institutions, improved risk management practices by the financial institutions, more rigorous supervisory practices and improvements in the knowledge and quality of board members of banks.

A reduction in fiscal dominance was probably the single most important factor in terms of improving the monetary policy performance in the emerging economies of Asia. In economies that continue to experience persistent inflation, it is often the case that monetary policy is still subservient to fiscal policy. In a dismal global growth environment, fiscal dominance remains a key risk to monetary policy and long-term sustainable growth.

A long-running debate related to monetary policy frameworks has been about the role of monetary policy in managing asset prices. My own view has always been that central banks cannot afford to ignore asset prices – key financial variables that affect asset prices are under the control of central banks and the bursting of asset bubbles undermines key objectives of central banks related to macroeconomic and financial stability. While I agree that one would not want to aggressively use interest rates to manage housing bubbles, having a reasonable level of interest rates is still a good starting point to reduce incentives for risky behaviour. If real interest rates are not too low but there are nevertheless incipient signs of asset price bubbles and rapid credit growth, then targeted macro-prudential measures may be warranted. But you have to get the level of interest rates right first.

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This raises a potential issue for exchange rate based frameworks. From an inflation perspective, exchange rate based frameworks are useful if the major influence on domestic inflation is external. However, given that interest rates are set elsewhere under such frameworks, the usefulness of such frameworks may be less when inflation is being driven by domestic factors. Furthermore, if interest rates are too low, they can lead to financial imbalances, increased risk-taking, and asset price bubbles. In these circumstances, macro-prudential tools can be useful, but they do not address the core issue of low returns on bank liabilities. Because of this, macro-prudential measures alone may drive speculation into other assets or lead to capital flight to assets in other countries.

Historically low interest rates characterised much of the decade prior to the crisis, with real rates often dipping below zero for extended periods. During this period, irrespective of the monetary policy frameworks, real interest rates were also low in much of Asia. From 2002–2007, there was relatively strong GDP growth across Asia, inflation was on a rising trend, but real interest rates were declining, low and often negative. Surges of large capital flows into many regional economies did not help the situation. It should be no surprise then that in the period before the crisis, the availability of ample liquidity and low returns led to a search for yields and risky behaviour in some economies. Real interest rates are again very low in the major economies and these are being transmitted to the economies in Asia. As in the past, sustained low interest rates raise concerns about excessive risk-taking and over-leveraging. Asia is also vulnerable to other risks; given its high saving rate and the concentration of those savings in the banking system – low interest rates could lead to a disintermediation of these savings into the asset markets and other risky investments. Financial scams also proliferate when savers' desperation for higher returns on their savings increases their vulnerability to such schemes.

Why were interest rates so low before the crisis? There could be a number of possible reasons, and it is not possible to go through all of them here. Let me mention just three. First, the major economy central banks had largely adopted an inflation focused policy framework, and with inflation falling, interest rates were correspondingly allowed to fall to historically low levels. These focused monetary frameworks did not accommodate the other potential risks to the economy arising from having such low interest rates. Second, monetary policy had developed an asymmetric perspective on the level of interest rates. Low interest rates are considered good for economic growth and high interest rates are viewed as being bad for growth. The manifestation of this was a tendency to ease quickly but to tighten only gradually, and more broadly, complacency about keeping interest rates at low levels for extended periods. Third, there is a high degree of uncertainty surrounding the setting of monetary policy, which then raises the question of what exactly is the basis for determining an appropriate level of the policy rate? Central banks have their models and Taylor rules, but at the end of the day, monetary policy setting is still very much a process of judgment in an environment of significant uncertainty. The widely adopted practice of gradualism in monetary policy setting recognises the risk of making errors. In the current circumstances, with nominal policy interest rates already at close to zero in many advanced economies, their central banks have still not been able to state with certainty if there is some optimal level of their interest rates that will get economic growth going again. The problem is even worse if we consider the possibility that the level of interest rates may no longer be relevant as a solution to the problem.

For emerging markets, globalisation has made it more difficult to set appropriate interest rates. Real globalisation has led to a higher frequency of inflationary and growth shocks coming from the global economy. Financial globalisation has increased vulnerability to yield-seeking and speculative capital flows as well as to the overshooting of everything from exchange rates to the prices of bonds and commodities. The spillovers from the policies in the advanced economies have always been a source of added complexity for policy setting in small open economies. In the current circumstance, while we understand what policymakers in advanced crisis-affected economies are trying to achieve, the consequence of these policies, in terms of financial repression, a global search for yield/safety and volatility in global markets, are creating risks for our own economies and limiting the policy space available to us. We cannot escape these externalities.

Finally, within the constraints of the global factors I have just outlined, let me briefly share my thoughts on what a monetary policy framework should look like. A robust monetary policy framework must have three elements (3 pillars):

Price Stability *plus* **Exchange Rate** *plus* **Financial Conditions (Credit)**

The framework tries to take on board the lessons from the crisis and reflects the policy trade-offs that are inherent in policy setting. Many regional central banks may have already been operating on such a framework, with differences perhaps in the amount of attention devoted by each central bank to the different components. In this framework, price stability continues to be a primary objective of monetary policy, but it is not the only objective. Price stability reflects the traditional focus on the domestic purchasing power of the currency. However, in a globalised world with growing trade dependence, the external purchasing power of the currency is also important to national economic welfare. Increased short-term capital flows and the risk of exchange rate misalignment make the monitoring and management of the exchange rate a desirable policy objective. Under normal circumstances, the optimal response would be to allow the exchange rate to respond flexibly to developments, but intervention may be necessary when the exchange rate becomes too volatile or is at risk of overshooting (appreciation or depreciation). The third component of the monetary framework would be for the central bank to monitor both the quantity and the direction of flow of credit within the economy, and to take action if credit is growing too strongly or is being excessively concentrated in a particular sector, especially one that poses risks to asset prices. Bringing this third objective into focus may prevent the repetition of the mistake of dropping interest rates too low when inflation is low. It would ensure that monetary policy develops a holistic and symmetric response to financial conditions – not only easing when financial conditions deteriorate but also tightening when financial conditions are too buoyant.