# Foreword

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Bank Indonesia and the Bank for International Settlements (BIS) co-hosted a research conference on "Expanding the boundaries of monetary policy in Asia and the Pacific" on 20–21 August 2015 in Jakarta. The event was the wrap-up conference of a research programme of the BIS Representative Office for Asia and the Pacific that had been approved by the Asian Consultative Council of central bank Governors in February 2014.

The topic was motivated by the increased importance of financial stability in the conduct of monetary policy and the expanding set of monetary policy tools being employed. Within this overall theme, the following issues for the Asia-Pacific region were identified: (i) monetary policy objectives and strategies; (ii) instruments to manage monetary conditions; (iii) the assessment of monetary conditions; and (iv) transmission mechanisms.

The conference brought together senior officials and researchers from central banks, international organisations and academia. This volume is a collection of the speeches, papers and prepared discussant remarks from the conference. This foreword summarises the contents of the conference and provides a synopsis of the discussions for time-constrained readers.

## Objectives and strategies

Monetary frameworks remain primarily focused on price stability, but financial stability considerations have become more prominent. This raises questions about how monetary policy strategies should develop to incorporate these new considerations, including the choice of analytical frameworks and tools, and communication strategies. In his opening address to the conference, Agus Martowardojo (Bank Indonesia) stressed that price stability on its own has proven insufficient to bring about successful outcomes. Emerging market central banks have increasingly sought to find a "middle solution" that also moderates exchange rate movements and resists extreme capital flows.

In the first conference paper, Soyoung Kim (Seoul National University) and Aaron Mehrotra (BIS) analyse the question of how central banks deal with policy trade-offs resulting from potential conflicts between price and financial stability objectives. The Asia-Pacific region represents fertile territory for this topic, as many economies with inflation targeting central banks have adopted macroprudential policies in order to safeguard financial stability.

Using structural vector autoregression techniques, Kim and Mehrotra show that tighter macroprudential policies aimed at containing credit growth also have a significant negative impact on inflation. The results suggest that the trade-offs for policymakers are binding, given the high frequency of episodes where low inflation coincides with buoyant credit growth. Kazuo Momma (Bank of Japan), in his discussion of the paper, emphasises the challenge of defining the social loss function,

in particular with respect to the costs of deflation, and the very divergent views within the central banking community regarding this.

Incorporating financial stability considerations into monetary policy does not necessarily imply that monetary policy should be tightened in response to asset price bubbles. In his keynote address to the conference, John Williams (Federal Reserve Bank of San Francisco) outlined the limitations of using policy interest rates to resist asset price bubbles. He provided new evidence on the effect of monetary policy on property prices across a wide set of OECD countries, based on a novel identification strategy. Williams' conclusion was that using interest rates to resist a house price bubble can be unacceptably costly. His estimates indicated that preventing the run-up in house prices seen in the US before 2007 using interest rate tools would have required sacrificing more than 10% of output.

## Instruments to manage monetary conditions

The range of monetary policy instruments used by central banks in addition to the interest rate has grown, as has the use of prudential and capital flow management tools. There has been greater focus on how to influence long-term rates, which are seen to play a more important role than in the past. All this raises questions about the demarcation, interaction and effectiveness of the various tools.

The paper by Ken Kuttner (Williams College) and James Yetman (BIS) uses bank data to investigate the effects on bank lending of different liquidity management tools used by central banks in seven Asian economies. The authors find that hiking reserve requirements to sterilise foreign exchange purchases retards lending growth by more than the issuance of central bank bills does, and smaller and weaker banks are affected disproportionately by changes in reserve requirements. Discussant Martin Bodenstein (National University of Singapore) concludes that central banks need to think more deeply about how to correct the distortions between banks that are introduced or exacerbated by the choice of sterilisation tool.

Juda Agung, Solikin Juhro, Harmanta and Tarsidin (Bank Indonesia) contributed a paper to the programme that illustrates the Bank's efforts to include macroprudential tools into a model of the Indonesian economy. Discussant Iikka Korhonen (Bank of Finland) notes that the paper takes a relatively optimistic view of policymakers' ability to use a mix of monetary policy and macroprudential measures to achieve price and financial stability objectives. Korhonen asks whether the next step might be to assess the relative importance of macroprudential measures related to foreign exchange operations and short-term capital movements in place of measures related to domestic lending.

## Assessment of monetary conditions

Even as the boundaries of monetary policy expand, the assessment of current monetary conditions remains an essential prerequisite for informing policy direction. In particular, the equilibrium real interest rate – often referred to as the natural rate of interest – provides a benchmark against which policymakers can compare policy rates and evaluate the monetary policy stance.

The paper by Feng Zhu (BIS) estimates the natural interest rates in Asia-Pacific economies. Relying on frequency domain techniques, and focusing on the relationship of the interest rate with long-run components of population characteristics, globalisation and a range of macroeconomic and financial variables, Zhu finds that, with the exception of China and also Thailand since 2005, the natural interest rate has declined substantially in Asia-Pacific economics since the early or mid-1990s, by over 4 percentage points on average. That said, Zhu emphasises the large uncertainties surrounding these estimates, and calls for monetary policy rules which are robust to such uncertainties. Discussant Solikin Juhro (Bank Indonesia) supports the idea that policymakers should not rely excessively on these intrinsically noisy indicators when making monetary policy decisions.

## Transmission mechanisms

Understanding the transmission mechanism of monetary policy, particularly as policy takes unconventional forms and is conducted in the midst of increasingly globalised financial markets, remains a work in progress. Important research questions include how the evolving funding structure of banks influences interest rate pass-through, the effects of deepening capital and of long-term domestic bond markets, the role of institutional investors and asset managers and external factors more generally, the strength of the risk-taking channel and changes in expectations formation and investor sentiment.

The paper by Enisse Kharroubi and Fabrizio Zampolli (BIS) estimates the sensitivity of domestic interest rates to foreign interest rates at both short and long maturities, as well as the degree of pass-through from domestic short-term to long-term rates. Accounting for heterogeneous effects across countries as well as common factors, they find that central banks tend to have less leverage on long-term rates when their exchange rates are volatile as well as when their economy is more financially open, suggesting a world closer to Rey's dilemma than Mundell's trilemma. In her discussion of the paper, Mardi Dungey (University of Tasmania) emphasises that network effects themselves may be very important in transmitting information. She also suggests that controlling for ambient news transmission might improve estimation.

The paper by Piti Disyatat (Bank of Thailand) and Phurichai Rungcharoenkitkul (BIS) asks whether globalisation has compromised central banks' ability to manage domestic financial conditions. Studying the dynamics of bond yields in 31 advanced and emerging market economies, and isolating a contagion component from co-movements unrelated to economic fundamentals, the authors conclude that emerging market economies are less susceptible to global contagion than advanced economies. In his discussion, Paul Mizen (University of Nottingham) suggests more work would be useful to confirm how robust the results are, particularly to assumptions behind the decomposition of yields into their various components. He asks whether similar results would be obtained if bond premia were assumed to depend on market and bond characteristics as well as macro and financial factors, along the lines of some other studies from the finance literature.

## Panel discussion

The conference also included a policy panel discussion by senior central bank officials focusing on the boundaries of monetary policy as they apply to economies in the Asia-Pacific region. The panel was chaired by Perry Warjiyo (Bank Indonesia). John Williams suggested that, if low interest rates are the new normal, consequences for central banks include: (i) increased periods with policy rates stuck at zero; (ii) QE actions no longer being "unconventional"; (iii) growing concerns about the link between low rates and excessive risk-taking; and (iv) the need to question whether 2% is too low an inflation target. On multiple goals, he suggested that there are legal and resource limits to what a central bank can do. Sukhdave Singh (Central Bank of Malaysia) argued that central banks should not be afraid of broader mandates as the risks that they face are multifaceted. Having narrow mandates could restrict the peripheral vision of central banks, which could lead them to ignore risks and fail to address them pre-emptively. In fact, the policies of central banks with narrow mandates could themselves have unintended side effects and be a source of risks that ultimately undermine both financial and macroeconomic stability. Diwa Guinigundo (Bangko Sentral ng Pilipinas) emphasised the complementarity of monetary and financial stability tools and welcomed the ongoing expansion of the central bank toolkit.