Dr Zeti Akhtar Aziz: Response to “Monetary Policy and Financial Stability” by Mr Andrew Crockett

Response by Dr Zeti Akhtar Aziz, Governor of Bank Negara Malaysia, to “Monetary Policy and Financial Stability” by Mr Andrew Crockett, at the Fourth HKMA Distinguished Lecture, Hong Kong, 13 February 2001.

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Mr Joseph Yam, Chairman, Mr Andrew Crockett, Distinguished guests, Ladies and Gentlemen,

Monetary and financial stability is not an end in itself. It is a means to achieving the ultimate objective of a broad based economic prosperity. While there is general agreement that monetary and financial stability are important pre conditions for sustainable growth, there has been less agreement as to how this might be achieved. The means by which monetary and financial stability is achieved involves costs. All too often, the focus on achieving monetary and financial stability has been at all costs. It has been argued that the cost of financial crisis, and the subsequent economic crisis would far exceed these costs. While this may be the case, our quest for monetary and financial stability must take into account the need to minimise the costs of such policy measures on our financial systems and our economy.

Ladies and Gentlemen,

It is my pleasure and indeed my honour, to be invited by the Hong Kong Monetary Authority to comment on the Distinguished Lecture by Andrew Crockett on this subject of Monetary Policy and Financial Stability. Andrew Crockett has provided us with a stimulating analysis of what he terms as the nexus between monetary and prudential policy. He argues that the intensity of this relationship has been underestimated. He makes the point that the failure to appreciate the important synergies between the two objectives of monetary and financial stability has resulted in policies that are less than optimal.

The presentation highlights that while solid macroeconomic policies are important for maintaining financial stability, it is also important to recognise that success in containing inflation is not sufficient to ensure financial stability, that financial instability had in fact in recent years been seen to occur in environments of low inflation. Andrew Crockett goes on to argue that some of the main causes of financial instability were in fact macroeconomic in origin, in terms of both the diagnosis and the remedies. In the former, this resulted from misjudgments on the growth prospects as well as changes driven by market sentiment while in the latter, the pursuit of price stability had infact inadvertently endangered the stability of the financial system. This relationship therefore required an enhanced appreciation of the interdependence of policies in the two areas.

In this context, Andrew raises the question as to whether monetary policy should have as one of its objectives, the prevention of financial excesses and imbalances. While Andrew notes that the end of the debate on this issue is not in sight, he does proceed to suggest that in formulating monetary policy, Central Banks should take explicit account of the impact of financial developments on the balance of risk. When credit expansion is rapid and asset prices are increasing faster than the price of current output, the authorities, he argues should aim for price increases in the lower part of the target corridor. While Andrew does acknowledge that such a policy may be considered excessively cautious, particularly when the potential for inflation is remote, he does however makes the point that the cost of a financial crisis would be far greater than the output forgone by the policy action to constrain such unsustainable growth.

The difficulties with this proposition goes beyond those mentioned in the presentation, that is, the difficulties relating to the proliferation of objectives, of garnering political support for such policies and the difficulty of distinguishing sustainable from unsustainable changes in asset prices. My reservations relate to whether monetary policy is the most appropriate tool to use in the circumstances described in Andrew’s presentation. What he has proposed implies that Central Banks should tighten monetary policy by raising interest rates during times of asset price booms even when this coincides with stable prices of goods and services. The reliance on demand management tools, such as interest rates to correct such financial developments and their consequent imbalances may indeed produce the desired results, but it will do so at high costs. In essence, an over adjustment can be expected to occur.

Over adjustment not only occurs due to the higher than necessary interest rates, but also due to the very reasons mentioned in the presentation, due to the potential for misjudgments about the economy and for market sentiments to move with the business cycle thus amplifying the magnitude of the cycle. Just as irrational exuberance drives asset prices to unrealistic levels, irrational pessimism can reverse the process with equal intensity. The paper further suggests that market participants may also be subject to collective misperception of risks and even if the risk is correctly perceived, the market reaction may not be the appropriate response.

The challenge for policy is to correct any such emerging imbalances in an orderly manner. Consideration needs to be given to alternative policy options. If the concern is with vulnerabilities emerging from developments in the asset market, this can be addressed directly by prudential or administrative measures specific to this sector. Interest rate policy is a blunt instrument that does not discriminate between sectors. The end result is a weaker economy and possibly a weaker financial system. It is important to recognise that policies that may be generally viable in stable market conditions may in fact trigger greater instability under unstable market conditions. Under stable conditions and rational market behavior, such policies can be expected to ensure a high degree of predictability of the desired results. However, under an environment of financial market instability, when the system has been subjected to external shocks, these policies cannot be expected to yield similar results. Given that shocks to the system are by their nature destabilising, policies that amplify this instability should therefore be avoided.

In the mid 1990s, in 1995 and 1996, Malaysia implemented prudential and administrative measures supported by fiscal measures to address escalating asset prices. This avoided the formation of an asset bubble. When the crisis occurred in 1997, asset prices had already plateaued. These measures included prudential requirements such as loan margins and credit ceilings. These requirements were then removed when the objectives had been achieved. While it is argued that such measures may involve costs in terms of the distortions and the uncertainty it might generate, it would be far less than any over adjustment following a more significant tightening.

In our quest for monetary and financial stability, consideration also needs to be made of the influence of international factors. For small open emerging economies like Malaysia, with the encroachment of international financial forces on their domestic financial systems, the authorities are confronted with further challenges in the quest for monetary and financial stability. Andrew Crockett’s discussion is for the most part in the context of a closed economy. In an open economy, where there is the rapid flow of speculative capital across borders, national authorities have been confronted with exchange rate volatility or alternatively, having the volatility transferred into bank liquidity and domestic interest rates, both of which have implications on financial stability. In emerging economies with a liberalised capital account, there is the potential for destabilising implications on both monetary and financial stability. Exchange volatility would have implications on foreign exposures in the domestic economy with its consequent implications on the financial system, whereas, the build up of domestic liquidity leads to the increased credit growth and the type of adverse effects on the financial system discussed by Andrew in his paper. In both cases, countries are confronted with the challenge of managing the vulnerability.

The presentation also highlights several challenges that confront prudential regulators. In particular, Andrew highlights the need to recognise the role of common factors in generating financial distress and the need to find better ways of identifying and tackling emerging imbalances. Supervisors, he argues, should focus on developments that generate systemic rather than idiosyncratic difficulties. The concern should be with overall efficiency and resilience not on the performance of individual intermediaries. Systemic problems, he argues are not caused by individual institutions getting into problems and affecting others by contagion. For most cases of financial instability, it was a whole set of institutions that acted in more or less the same way. Financial systems encounter crisis when many institutions operate in a similar way, and collectively fail to detect the common macroeconomic threat. The concern, therefore, ought to be focused on the overall efficiency and resilience and not on the performance of individual intermediaries. He also raised the issue of the time properties of risk over the financial cycle and the endogenous character of risk with respect to the collective decisions of lenders need to be recognised. In addressing these concerns, we can agree with the approaches discussed, in adopting forward looking provisioning practices, use of loan to value ratios or the use of other less cyclically-sensitive measures of value. Stress testing as a tool can also address this concern.

Given the increased volatilities of the financial markets, the scope of surveillance by regulatory agencies over financial activities and developments in financial markets will need to be enhanced significantly. Key information on market development would need to be provided in an integrated manner so as to allow better understanding of the impact of such development on the financial sector as well as the economy. In the Malaysian experience, quarterly stress tests are conducted on the banking institutions under different scenarios to detect potential areas of vulnerabilities and to assess the resilience of the banking system. This stress test provides the authorities with the ability to implement preemptive measures before problems become crisis proportions. More importantly, Malaysia is developing a single comprehensive system of real time information on financial markets that allows tracking of sources of risks in the economy to allow corrective actions to be taken.

Finally, Andrew Crockett argues supervisory techniques need to take a balanced view of the utility of market forces as an aid to stabilising behavior. While it is recognised that greater transparency and disclosure is an important part of this process, equally the appropriate utilisation of information by the market is important. All too often, the market response is biased towards the short and immediate term perspective, due to the rigid adherence to an ideology, the conditioning by multilateral agencies, the inability to distinguish and differentiate, herd behavior and contagion as well as the inability to deal with less familiar contexts. Moreover, there are no incentives to ensure the appropriate use of information. There is also no penalty for misuse and abuse of information. As we move into an era in which there will be increasing demands for transparency, there needs to be a framework in which these concerns are addressed. In this environment, consumer education also needs to be given priority so that better informed assessments and decisions can be made.

Mention has also been made to rely on market discipline to achieve financial stability. For market discipline to play its appropriate role in containing excesses, a change programme would need to be implemented with the objective of building the capabilities of domestic banking institutions and increasing the incentives to improve performance. At the same time, measures that seek to build and enhance financial infrastructure would need to be implemented to better position the financial system to meet the demands of the economy and absorb any destabilizing shocks. This however cannot be achieved overnight. Reasonable time and support has to be given to emerging markets to become more efficient, competitive and resilient. In this regard, market players can play a role in distinguishing the different risk factors and characteristics of an economy.

In this environment of greater uncertainty and change, it will become increasingly more difficult to anticipate future risks. While these future risks may be unpredictable, it is important to understand how the future might change so we can gauge and assess the approach that we have taken, so that we can develop new capabilities to deal with these risks. The ability to recognise the potential future developments and to be able to prescriptively respond and contain these risks would enhance our prospects for achieving stability and, thereby, improve the capacity of the financial system to contribute to growth, and thus secure the prospects for prosperity.