

Tarisa Watanagase: Issues important to small and open emerging market economies

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My discussion will focus on the issues important to small and open emerging market economies. The first is regards to whether the present situation of sustained inflows into emerging markets is really sustainable. What do these seemingly sustained inflows tell us, particularly in terms of investors' assessment of riskiness of the region? Or from another angle, have risks in the region declined? I will discuss this in the context of financial innovations in risk management, and conclude with a few remarks on how these developments affect central banks across the globe.

My first question, therefore, arises from the observable reduction of risk premia for financial assets in the region. On the surface, this low risk premia implies lower risks. But does, it, really?

We all realize that the international financial system is currently in an environment with low risk premia across a broad set of asset classes, combined with low volatility in the prices of these assets.

Furthermore, this low risk premia has been sustained despite the various episodes of risk aversion in the recent past. This raises concerns about whether prices – and consequently the risk premia themselves – accurately reflect actual risks.

Of course, it is arguable that the search for yield in riskier assets is due in part, no doubt, to the historically low interest rates and abundant global liquidity, partly a result of recent expansionary monetary policy around the world. This has encouraged greater risk-taking, resulting in a substantial reduction in risk and liquidity premia over the entire maturity spectrum.

On the other hand, however, low risk premia could also reflect changing risk appetite. More importantly, it is unclear whether this change in risk appetite has arisen from permanent or transitory factors. I make this distinction because permanent factors would imply that this reduction in risk premia is here to stay. Transitory factors, on the other hand, imply that the risk premia would rise once these factors reversed.

Let me try to identify some of the permanent factors that have resulted in the shift in risk appetite and preferences. These include, firstly, changing demographics. The aging population has led to a larger volume of pension funds, which need to seek higher returns in emerging market assets. Secondly, technological advances, such as the IT revolution and decline in costs of telecommunications and transportation, have substantially lowered costs for cross-border financial transactions. Thirdly, changes in exchange rate regimes and capital account liberalization over the years have lifted many of the previous obstacles to crossborder financial transactions. Fourthly, financial innovation has made credit risk transfer mechanisms more widely available, increasing the appeal of riskier assets. Fifth, the high level of liquidity may be a result of structural factors, or in some cases, policy factors, making savings in emerging markets persistently higher than in developed markets, given the lack of social welfare, healthcare, etc. This has resulted in a higher marginal propensity to save for consumers in emerging markets and contributes to a persistent global savings glut. Sixth, greater diversification in international reserves management, as well as sovereign wealth funds, may have led to increased investment by authorities in more diverse assets as well.

On the other hand, numerous transitory factors may also have been responsible for this change in risk appetite and risk premia. A reversal in any of these factors could result in risk aversion away from emerging markets and destabilizing capital flows, and a rise in risk premia. Let me name a few factors. Firstly, the situation of global imbalances and slide of the USD has led to preference for investment in emerging markets, particularly given ongoing – but by no means sustainable – expectations of appreciating currencies in emerging market economies. Secondly, low interest rates worldwide and the high level of global liquidity have led to search for yield in riskier investments. This may be a temporary phenomenon if we believe that the extended period of accommodative monetary policy worldwide is unsustainable, and eventually monetary would need to tighten to compensate for this era of profligacy. Thirdly, similar investment strategies employed by hedge funds and other funds could

lead to momentum trading and herd movements, both in terms of inflows and outflows. Any shocks that trigger a change in these strategies could result in large movements of capital.

In any case, whether owing to the changes in risk appetite or not, we must remind ourselves that the current pricing of risk is based on the expectation that strong growth and contained inflation will continue to prevail. Any unexpected deterioration of the macroeconomic environment, however, could trigger a rapid turnaround in sentiment.

This leads me to my next point, which I had raised earlier, of whether the increase in capital flows to emerging markets was likely to result in an increase in risks? This seems the likely case. For example, local investors do not usually provide counter-trade to hedge funds but rather take similar positions, hence increasing the overall risks.

In addition, investment of hedge funds in a particular country is usually only a small fraction of their whole portfolios, and inflows reversals may take place easily. Individual risk management can also collectively induce systemic risks, and central banks may be required to resolve such problems to avoid adverse impacts from sudden reversal of capital flows.

This leads us to the question of whether we are underestimating the inherent risks of these capital flows? Let me explain why this may be the case.

First of all, net capital flows are small. Gross capital flows, however, are much larger: this may suggest that the economy's degree of vulnerability is actually larger than currently accounted for. Should we therefore be concerned with large two way (gross) flows, as opposed to net flows, and the size of the much larger global balance sheet if counted in this way?

Arguably, large gross capital flows and the flow of surplus capital from emerging markets to more developed markets may be a structural phenomenon, as mentioned earlier. The characteristics of developed financial markets, in terms of lesser financial frictions, better information and fewer borrowing constraints leading to better liquidity and lending, as well developed social welfare systems, are reflected in the persistent gap in savings compared to developing markets. In addition, financial integration has facilitated cross border arbitrage transactions, resulting in easier liquidity conditions globally.

The implications and associated risks of this high level of global liquidity are different depending on whether the current state of affairs is a new equilibrium consistent with the conditions under globalization (e.g. case above), meaning that monetary policy should not try to counteract this phenomenon.

However, if the current phenomenon is due to temporarily excessively accommodative monetary policy that would eventually translate into higher inflation, this would require eventual tightening and lead to the risk of capital reversals.

But there are also compelling reasons to argue that risks have been better distributed, given financial innovation and various credit risk transfer mechanisms. Let me therefore pose another question: has the use of these credit risk transfer mechanism helped to distribute risks, making the financial environment a safer place?

On the plus side, credit transfer mechanisms can "redistribute" risks, as default losses would be absorbed by a larger number of investors than otherwise. Some of the losses may be borne by sophisticated players (such as hedge funds or some institutional investors) who are well diversified and can better bear the losses. Credit transfer mechanisms also allow banks (via credit derivatives) to improve their own risk management and enable them to diversify their risk profiles.

However, the use of risk transfer mechanisms can contribute to opacity in the distribution of risks, especially once risks are transferred to unregulated entities (i.e. non-banks). This could lead to bunching of risks in particular areas. Additionally, the use and constant innovation of credit risk transfer mechanisms has allowed risk to take on more complex forms, making risk less traceable.

My final point will be on the resulting challenges to central banks of small open economies.

Central banks need to understand how globalization affects three main objectives: (1) the domestic inflation process, (2) the transmission mechanism of monetary policy, and (3) financial stability. Let me point out at the outset that empirically, there is still some disagreement to the extent of each effect.

First of all, it has been argued that the domestic inflation process has been largely changed by trade globalization. In particular, increased trade openness and stronger international competition from low

cost suppliers in emerging economies has resulted in lower prices of imported goods and limiting pricing power of domestic firms. In addition, higher international wage competition in labour markets, as well as upward pressure on productivity growth (albeit this is difficult to distinguish from effects of technological developments), have provided downside risks to inflation.

On the other hand, higher commodity prices due to stronger demand for energy related commodities and industrial raw materials pose an upside risk for inflation.

Secondly, the monetary policy transmission mechanism has been changed by financial globalization. Policy interest rates influence short-term interest rates. But recently, the response of long-term rates to changes in the policy instruments has become less apparent. This raises concerns of whether central banks' monetary policy is becoming less effective, particularly given that savings and investment decisions are more influenced by long-term rates.

Additionally, the conduct of monetary policy has become harder in light of financial globalization. A policy rate increase to tame inflationary pressures may induce further capital flows, thus bringing more liquidity into the domestic market.

Thirdly, domestic financial stability is to a greater extent affected by global liquidity conditions. For instance, growth in cross-border financial flows increasingly influences domestic asset prices. However, this effect can be broken down into two main scenarios. The first is through changes consistent with fundamentals. An example of such a change is the wave of worldwide mergers and acquisitions, resulting from globalization, and improvements in efficiency through economies of scale and integration. While this has exerted upward pressure on equity prices, this may not be a great concern for stability.

On the other hand, some changes drive prices away from fundamentals. This includes asset price moves caused by excessive investment in developed financial markets, or short term capital inflows into emerging markets in search of yield, or through carry trades, etc., which may result in asset price misalignments.

In this regard, the question arises whether the central bank's price stability objective is enough for financial stability, given destabilizing asset price movements, coupled with movements in the exchange rate, which may not be in line with fundamentals.