Budi Mulya: Exit strategy in advanced countries and their implications for the EMEAP region

Remarks by Mr Budi Mulya, Deputy Governor of Bank Indonesia, in the 6th Executives' Meeting of East Asia-Pacific Central Banks (EMEAP) Monetary and Financial Stability Committee (MFSC) Meeting, Chiang Mai, Thailand, 14 November 2009.

*   *   *

Let me start by commending Dr. Krishna Srinivasan and Dr. Eli Remolona for the excellent presentations on this very timely and important issue. A vast discussion on exit strategy has been hovering around us recently, which involve so many ways and aspects. However, today, I will focus on three main aspects; first, **the strategy itself**; second, **the implications it will bring**; and third, **the challenges it will leaves us with**.

The strategy for exit

Let me begin with the first part: the strategy for exit. The biggest challenge is determining the timing to exit. On this issue, I believe we share the same understanding that it will depend on the state of the economy and the financial system of a country. Nonetheless, given the still uncertain and fragile global economic recovery, especially those of the advanced economies, I have a conviction that we should err on the side of further supporting demand and financial repairs. Accordingly, the exact answer would be **don't rush**. In relation to this, it is always relevant to ask about the authorities' commitment, especially the Fed, to err on the side of being too late, rather than too early, in starting their tightening cycle.

The next issue is the sequence of exit. In this respect, **the complexities lie on the interaction between fiscal vs. monetary, and conventional vs. unconventional policy**. It is relevant for us to ask which one will come first. Should credible commitments to medium-term fiscal consolidation precede monetary tightening? Would withdrawal of current extraordinary liquidity support and deposit guarantee accelerate or offset monetary tightening? Similarly, should central banks raise interest rates before they unwind unconventional monetary policies, or the other way around? In this respect, let me recall that the G20 recommends that central banks can raise interest rates before they dry up liquidity. However, let me also balance this view with the fact that abundant liquidity inside the system tends to impede any central banks attempt to raise short term interest rate, like the one occuring in the US. Thus, credibility would be the issue.

How to exit is another issue. In this respect, **unwinding the central bank's elevated balance sheet amidst slowly adjusted potential output, will always be economically difficult and politically complicated**. Of course, there are several options to take, e.g. whether utilize either reverse repo, issuing central bank bill, or start to explicitly declare medium to longer term inflation target. But different consequences may arise from the way those factors are decided and implemented. To begin with, it is important to distinguish between the long term risk and the short term consequences. As I pointed out earlier, the extent to which exit strategies take place is not an easy issue and involving vast complexities as these strategies will always be contradicted with the pace of the recovery itself. Problems exist when the perceptions about the exit builds up and feeds up the tail risk where market players are irrationally exuberant in responding the way the recovery runs. First, the perception that the authorities in advanced economies, mainly the Fed, will maintain their loosening stance in an extended period has become a sort of long-run certainty. Second, the perception that market mechanism will efficiently make automatic correction against short-run dynamics. As a result, risky asset prices have risen too much, too soon, and too fast compared with macroeconomic fundamental. Simply to say, **asset price bubbles fueled by this too enthusiastic retort is and will always be our main short-run implication of the speculation builds up around the exit strategy issues**.

The implications and policy dilemma

The impact of major economies' exit policy to EMEAP countries **will depend on the degree of openness of a country from the point of view of both trade and financial account**. In Indonesia, for instance, this financial account channel has become substantial as short term cross border flows has been sizable in domestic financial market. In addition to economic openness of a country, two other aspects that should be taken into account are economic characteristic and policy regime being implemented. In terms of the latent economic characteristics, the nature of the role of each economic sector to GDP, the level of exchange rate pass-through, the role of expectation in inflation formation which would provide unique level of shock absorber specific for each country from global shock.

Nonetheless, I do believe that the EMEAP economies are facing similar immediate problem, i.e. how best manage the increasing volatile short-term capital flows stemming from asymmetry in economic recovery between advanced vis-à-vis emerging economies and the policy responses that go with it. Thus, our **policy effectiveness will be confined by the pace of recovery and the exit strategy in advance economies, mainly in the US**. In the wake of US dollar weakening, letting the domestic currency to appreciate implies inflating the bubbles. On the other side, sterilizing the appreciation to offset the spillovers will also mean putting additional liquidity flush to the financial market, and thus keeping short-term rates lower than is desirable. Yet, tightening monetary policy will also be a hard choice since it will elevate the appreciation trend as well as complicate central bank communication on the back of recovery. Directly limit capital inflows through regulatory approach is also a hard option. A consensus view on this is that it will only be effective as long as there is a policy uniformity across countries, which is in my view far from doable, since countries with closely aligned agendas – i.e. supporting the recovery – are unable or unwilling to take bold steps in terms of coordinating exchange rate policies. That is primarily because the overriding objective of nearly all parties involved is to maintain some level of exchange rate competitiveness, and that is simply not possible. The same concern was also brought forward in the recent G20 meeting.

The challenges for EMEAP

Amidst of all of the complexities around the exit strategy issue we face, we still have to end up with best options. Simply to say, in the current state of the global financial landscape, it is a big challenge for central banks, mainly in emerging economies, to shape their policies. We cannot put the exit policy merely as a long run issue. Rather, current development on this leads me to believe that we have already dealt with its implication since it shapes market perception. Therefore, on the absence of ideal policy, it is always relevant for us to find a better escape clause. And on this respect, **the way we communicate to the market plays a big role in shaping the right incentives to them while maintaining the pace of the recovery**. As a good measure to risk awareness, it is also beneficial for us to always consider the probability of odds scenario to happen. In this respect, let me suggest that **regional coordination and cooperation is a key word**.

While there is much rhetoric on the need for a coordinated exit strategy, such an outcome will be challenging to be delivered given the different recovery rates both in Asia particularly EMEAP countries, and the rest of the world. In the mean time, **EMEAP countries should get ready to receive the impact of exit policies in advance economy which will differ in term of speed and magnitude, depending on each country's specific economic character**. Given this, a faulty exit strategy of the advanced economies could easily spill over into smaller economies, swamping our efforts to deal with the slowdown.

Managing an exit from the current policy settings as growth recovers poses another test for EMEAP central banks to that hard-won credibility. With inflation in the process of bottoming out and the recent data flow in EMEAP countries suggesting a clear recovery in economic activity, we all find ourselves pondering the risk that the economic stimulus provided by fiscal and monetary policy makers might be withdrawn earlier compared to advance economy. In this regard, I believe that monetary policy credibility is particularly crucial to the countries' growth risk premium, which is judged by historical inflation volatilities. For some countries, given the inflation volatilities are historically high, a more pre-emptive monetary policy response is warranted in order to anchor inflation expectations. Provided that improving balance of payment positions, for countries which historically have strong pass-through from exchange rate changes to inflation expectations such as in Indonesia, stronger exchange rates will also be important to keep inflation expectations well-anchored without necessitating to aggressively increase interest rates and hurting the growth recovery. In other words, **a strong exchange rate can serve as an effective anchor to inflation expectations**. This will be important throughout as higher global commodity prices in 2010 could begin to translate into higher inflation expectations.

Finally, every country has a stake in the sequencing and magnitude of the strategies of the large economies. The impact of global exit on smaller economies could manifest in a return of recessionary tendencies as well as balance of payments (BoP) problems, which have generally not been a significant feature so far. IMF programs have conventionally been oriented to dealing with BoP crises. In the current scenario, the larger resource base may have to be deployed with much more flexibility to help particularly smaller economies to deal with the potentially recessionary impact of exit — a kind of global macroeconomic safety net. **Some operating guidelines for such a program need to be quickly developed.**

Thank you.