Bandid Nijathaworn: The future of monetary policy

Remarks by Mr Bandid Nijathaworn, Deputy Governor of the Bank of Thailand, at "South East Asia Central Banks/Bank for International Settlements (SEACEN/BIS) Seminar on Central Bank Challenges in Emerging Market Economies in the Post-Crisis Era", Kota Kinabalu, Malaysia, 21 January 2010.

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First, let me thank SEACEN and the BIS for asking me to lead off the discussion on this important topic. For the SEACEN economies, I think two important questions stand out. The ***first*** is what went wrong with monetary policy and what can we learn from it? And the ***second*** is what more can we do to improve our understanding of monetary policy so that long-term price stability can be assured while the risk of financial instability is avoided?

Although the current global financial crisis has been a dramatic experience for central banks, it also offers an opportunity to reassess both the intellectual underpinning and the practical implementation of monetary policy. As we all know, monetary policy in the last fifteen years did cover almost the whole of a global business cycle, starting from the period of the so-called "great moderation" when there was a perceived end to economic volatility with interest rates remaining low for an extended period, to the current global financial crisis that saw aggressive use of monetary policy by the major central banks to combat economic contractions with near-zero interest rates and the use of unconventional measures. This reassessment, therefore, is important and will provide a useful starting point for a better deliberation of monetary policy going forward.

For this morning, I want to focus my remarks on three issues: ***first*** the lessons we can learn from the crisis; ***second*** how to move forward to strengthen monetary policy framework in light of the crisis to ensure long-term price and financial stability; and ***third*** the relevance of inflation-targeting as a monetary policy framework in the post-crisis era.

From the crisis, there are a number of important lessons that can be drawn. The ***first*** is that monetary policy remains the right instrument to maintain a low inflation environment which is crucial for sustainable growth. But the most important lesson from the crisis is that low and stable inflation alone is not sufficient for ensuring financial stability. This is because the risk to financial stability can come from many sources other than domestic inflation. In the current crisis, it was the housing bubble and excessive risk-taking by the financial institutions that precipitated the crisis in the environment of stable prices. Therefore, to maintain economic and financial stability, in addition to price stability, attention must be paid to all the key sources of risk and imbalance that can have systemic implications for the economy's growth and stability. This is the ***first*** lesson.

The ***second*** lesson is the inadequacy of the current approach in monetary policy analysis that focuses over-extensively on macroeconomic analysis and models. In the period leading up to the crisis, what was missing clearly was the recognition of the implications that a stable growth and inflation environment could have on developments in the financial sector in terms of its impact on risk perception and on the risk-taking behavior. As it turned out, the reduced volatility of growth and inflation did not tell a complete story. In addition, the intellectual underpinning of central bank's approach to policy, based on efficient market hypothesis, did not encourage policy makers to look beyond the focus on inflation risk. As a result, the interaction and feedback between the real economy and the financial sector were not given the needed attention in the deliberation of monetary policy. A case in point is the typical absence of the financial sector, especially banks, in the macroeconomic models used in the analysis of monetary policy. This absence leaves a big gap in our understanding of the interactions between the financial side and the real side of the economy which, as a result, can lead to an underestimation of risk in the good time, and an overestimation of risk in the bad time.

The ***third*** lesson is that monetary policy is a powerful tool for managing growth and stability, but it can also be a double-edged sword. In the current crisis, monetary policy is said to have played a role in contributing to excessive risk-taking behavior in the period leading up to the crisis, but monetary policy is also powerful in handling the economic and financial downturns through aggressive actions on interest rate and the provision of liquidity. This shows that it is crucial to get the stance of monetary policy right early by formulating monetary policy in a forward-looking manner. This, of course, is easier said than done.

And the ***last*** lesson is communication. One lesson we learnt clearly from the crisis is that policy actions alone cannot ensure a successful outcome without the support of an effective communication strategy. In this crisis, the Fed has demonstrated the importance of this to the highest level through its ability to articulate its understanding of the situations, to communicate the rationale for the use of unconventional measures, its approach to making the results of the stress-testing exercise public, as well as its ability to manage market expectations while maintaining policy credibility. All these have been instrumental to the success so far of the Fed's policy response. It is, therefore, clear from the crisis that well-executed and credible communication can help anchor market expectations.

Let me now turn to my second remark on strengthening the monetary policy framework. I agree much with what has been said about the need to improve bank regulation and supervision going forward, especially to reduce procyclicality in the financial system. But for monetary policy, the framework can also be strengthened to increase its effectiveness in safeguarding price and financial stability.

The ***first*** is that good macro-surveillance process is a must to help identify key risk that might be developing in the economy. This surveillance needs to cover both developments in the real economy and in the financial markets so that any potential risk to financial stability can be identified early. ***Second*** is the need for a disciplined decision-making process that takes into account information from the surveillance process in the deliberation of monetary policy. One key common weakness in the past has been the limited use of information on the financial side in the formulation of monetary policy.

Third, in order to deal effectively with both price and financial stability, the thinking now is to focus monetary policy on its core function of maintaining price stability, while financial stability objective is best served by ensuring a robust and efficient financial system through strong bank regulation and effective supervision.

Nonetheless, to the extent that developments in the financial sector may have systemic implications, monetary policy can be combined with macroprudential measures aimed at reducing risk to financial stability at the source. An example of this is excessive credit growth in a certain sector that can be discouraged by tightening up the relevant lending standards. A number of SEACEN economies have adopted this approach, especially for housing loans. However, there is a concern that this approach is judgemental and lacks a coherent framework; i.e., how can we control both the price of credit through monetary policy and the quantity of credit through macroprudential measures. Another unsettling issue is whether monetary policy should lean against the wind of asset price boom and credit expansion at a cost of somewhat weaker growth and lower inflation. On this, I think our default position should be that we should because the cost of getting it wrong by not doing enough can be very costly.

Finally, information on money and credit aggregates can be made more useful in the formulation of monetary policy. Up to now, a widely shared so-called "best practice" in monetary policy did not pay enough attention to monetary aggregates partly because of the belief that there exists no stable relationship between quantity of money and economic activity. As a result, prior to the crisis there was no attempt to counteract the rapid credit growth even though, in most if not all cases, asset price bubble was a direct result of sustained excessive credit expansion.

This issue in my view is most relevant for emerging markets where the financial sector is typically bank-based, with credit being the major source of funding for businesses, and credit risk being the most important risk to banks. Such factors make the credit channel an important transmission mechanism of monetary policy in emerging markets. Therefore, information content provided in key banking data such as loan demand, rate of loans approval, lending standards adopted by banks, delinquency ratio, and NPL could be useful in helping to assess how risk and activities are evolving in the macroeconomy, and whether the information point to the need for monetary policy to react over and above what the usual price and output data imply, either by an interest rate action or by a macroprudential action.

My final observation is on the relevance of inflation-targeting as a monetary policy framework in the post-crisis era. Recently, inflation-targeting has come under a close scrutiny whether the framework is useful given its narrow focus on inflation whereas risk to economic and financial stability can come from many sources other than inflation. In this crisis, the performance of the inflation-targeting economies does differ widely, but the majority are those that have been more successful in weathering the crisis. Examples here include Australia, New Zealand, Canada and a large number of emerging market economies as opposed to a more difficult experience elsewhere.

My view is that inflation-targeting remains useful as a framework for monetary policy, and experience of many inflation-targeting emerging markets in this crisis demonstrates clearly that price stability and financial stability can be preserved even under extreme financial circumstances. But the framework could be further strengthened so that the need to pay attention to financial stability concerns can be more formally addressed through a flexible inflation-targeting regime. Combining macroprudential measures with inflation-targeting is one area that flexibility can be added. The Bank of Thailand is one central bank that has pursued this line of flexibility since 2004.

Another approach is to have greater flexibility in the setting of the inflation targets, in terms of the choice between core and headline inflation, as well as the level of the inflation targets itself, so that monetary policy will have greater room to maneuver in responding to shocks. If done carefully, the room for flexibility can be added without undermining the credibility of the inflation-targeting framework. But whatever flexibility we add, it is most important that the long-term objective of monetary policy in sustaining a low and stable inflation environment and in anchoring inflation expectations over the cycle is maintained and not compromised.