Tarisa Watanagase: The road ahead for central banks – meeting new challenges to financial stability

Luncheon talk by Dr Tarisa Watanagase, Governor of the Bank of Thailand, at the Foreign Correspondents Club of Thailand, Bangkok, 20 July 2010.

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Distinguished FCCT Members and Guests,

Ladies and Gentlemen,

First of all, I would like to thank the FCCT Board for inviting me to deliver this luncheon talk as part of the Club's newly established Speaker's Lunch Series. To this, I am honored as well as delighted to be back. It was exactly two years ago when I was here for the Club's dinner program in July 2008, and let me tell you that I very much enjoyed our Q&A session then. I certainly look forward to participating in such a lively exchange again this afternoon.

The topic of my talk today is "The Road Ahead for Central Banks: Meeting New Challenges to Financial Stability," in which I will share with you my views on the roles of central banks regarding the maintenance of financial stability, with particular reference to those at the Bank of Thailand during the past few years and going forward. This talk will be divided into three parts. The first part will be about the changing global view on financial stability policies as a result of the recent global financial crisis. The second part will be a summary of what the Bank of Thailand has done with regard to the maintenance of Thailand's financial stability. The final part will be a discussion about the challenges ahead.

Ladies and Gentlemen,

Since my previous FCCT address, things have changed dramatically. Two years ago, the main policy issue surrounding the economy was the sharp acceleration in inflation due to drastic increases in oil prices. Two months after my talk, starting with the fall of Lehman Brothers, the world went into the deepest recession never seen since the Great Depression. Thailand was not spared, as the Thai economy last year experienced negative growth for the first time since the 1997 crisis. In tandem with the slowdown of the global economy, oil prices collapsed and inflation was no longer an issue. Over the past two years, policy focus would be on how to restore the stability of the global and individual country's financial systems and how to prevent such a systemic crisis from happening in the future. In other words, the spotlight has turned from price stability to financial system stability, or in short, financial stability.[1]

The global financial crisis has a significant impact on central banks' thinking of economic and financial stability policies in three major areas. **First,** it is now widely accepted that monetary policy also needs to take care of financial stability concerns. The pursuit of price stability alone is not enough to ensure a smooth progress of the economy. **Second**, traditional "micro" prudential regulation which aims to limit the distress of *individual* financial institutions is not enough to ensure that the financial system as a whole will be able to cope with large systemic shocks. There is the need for regulation that takes care of interactions between financial institutions, markets, and the real economy. The latter is known as macroprudential policy, a new buzzword that you may have heard of or will be hearing increasingly more often in the future.

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[1] Unlike price stability which refers to low and stable inflation, there is no universal definition of financial stability. One commonly used definition of financial stability is a situation in which the financial system is robust to shock and the stable provision of various financial intermediation services to the wider economy is ensured.

The **third** policy rethinking concerns the separation of banking regulation and supervision from central banks. Before the crisis, an increasing number of countries had adopted a model where a central bank only takes care of monetary policy and a separate independent authority takes care of regulation and supervision of financial institutions. That model, which promises superior performance in terms of financial stability maintenance, is now in question.

Let me elaborate on these three issues in a bit more detail. In the realm of monetary policy, the conventional wisdom before the crisis, based on the long-standing success of former Fed Chairman Alan Greenspan, was that monetary policy should stay away from direct financial stability responsibility, particularly the management of asset price bubbles, and let the financial markets take care of themselves. And if things go wrong, policymakers can always clean up the mess after a bubble has burst by cutting interest rate aggressively.

As we all know, the severity and the costs of this global financial crisis have very much discredited the so-called Greenspan Doctrine. Talk of risks to financial stability has now been mentioned frequently in several central banks' monetary policy statements. Equally important, signs of financial imbalances have become parts of a watch list for many central banks. These developments stood in sharp contrast to the pre-crisis orthodoxy where financial stability would factor into monetary policy decisions only to the extent that it affected growth and inflation.

The changing consensus on monetary policy does not mean that central banks will be using interest rates aggressively to fight off asset price misalignments and financial imbalances, however. By all means, interest rate policy is probably too blunt to be a "corrective" tool for financial stability given that, to materially impact asset prices, a substantial increase in the interest rate is required. Using the policy interest rate to actively steer asset prices would therefore have adverse consequences on the economy as a whole. Instead, the post-crisis consensus emphasizes the use of monetary policy as a "preventive" tool for financial stability, that is, not to allow monetary policy to sow the seed of asset price bubbles. An important lesson from this crisis is that an over-extended period of low interest rates can distort risk perception, leading to excessive risk taking and costly financial imbalances.

Beyond the reorientation of monetary policy, the post-crisis consensus advocates the use of macroprudential policy as the first line of defense against the buildups of financial imbalances. In comparison to interest rate measures, macroprudential policy can address sector-specific financial stability concerns more directly without excessive side effects on the overall economy.

Macroprudential policy differs from traditional prudential regulation in that it adopts a system-wide or systemic perspective. The idea behind macroprudential policy is that while financial institutions may be individually safe, collectively they may be at risk due to herd behaviors and their interconnections. Here, the U.S. subprime crisis serves as a case in point. Regulators thought banks were safe because they had off-loaded their subprime credit risk exposures through securitization and unknowingly allowed the market to grow out of hand. From a system-wide perspective, the risk did not go anywhere as banks, in search for good yields during the low interest rate environment, invested in securitized assets issued by other banks. The situation was further exacerbated by the complex interconnections among U.S. financial institutions whereby the failure of one institution greatly increased the probability of failure of others.

To maximize its effectiveness, macroprudential policy should cover all types of financial institutions that make up a financial system, not just banks, but also the likes of securities companies, insurance companies, and hedge funds, to name a few. This is because modern financial systems are complex and intertwined. In fact, one root cause of the global financial crisis can be traced to loose regulation of the so-called shadow banking system in the U.S.

One key purpose of macroprudential policy is to limit excessive exuberance that could come about during "good times," for example, by requiring financial institutions to hold extra capital or by putting a cap on how much they can lend during an economic upswing. An implicit

message behind this is that these policies will not only help strengthen the financial system's resilience, but also moderate financial institutions' actions from being too optimistic during an economic upturn or too pessimistic during an economic downturn – the behavior known as "procyclicality" of the financial system that exacerbates the business cycle. All in all, it is envisioned that the combination of monetary policy and macroprudential policy will effectively safeguard financial stability and hence macro stability at large.

On institutional arrangements, the global financial crisis clearly shows that the independent regulator model does not live up to its promise. Some countries would have been better off in dealing with this crisis had the regulatory power remained with the central banks. The most notable example here is perhaps in the UK where the government will abolish the Financial Services Authority (FSA) and transfer its regulatory responsibility back to the Bank of England.

While the UK may be an extreme case, a growing consensus has emerged that central banks should play a key role in preserving the overall stability and smooth functioning of the financial system. In this respect, having supervisory authority over systemically important financial institutions, such as commercial banks, would make the central bank's job a little easier. Clearly, having monetary policy, lender of last resort function, and macroprudential policy under the same roof allows for better policy coordination.

Ladies and Gentlemen,

Against the backdrop of the changing policy philosophy in the global central banking community, let me now turn to the second part of my talk which is what the Bank of Thailand has been doing in the past few years with regard to the maintenance of financial stability.

Through the 1997 Asian financial crisis, we learnt firsthand the importance of financial stability to the real economy as well as the need to preserve it. Indeed, that the Thai economy recovered rapidly from the global financial crisis this time can be attributed in part to policies that put a strong emphasis on the health of the financial system.

In July 2004, upon an assessment that the booming economy may result in the buildup of certain financial imbalances, the Monetary Policy Committee made the monitoring of "factors contributing to financial imbalances" a permanent part of its assessment and policy formulation process. As part of this macro-financial risk surveillance, signs of financial imbalances in seven key areas are regularly monitored: the property market, the stock market, the banking sector, the non-financial corporate sector, household-sector balance sheet, government finance and public debt, and the external sector, with the goal of establishing an early warning system for potential threats to financial stability, especially if the underlying imbalances are related to monetary policy actions.

On the regulatory side, fully aware of the implications of systemic risk, we have incorporated macroprudential elements into our regulatory framework well before the concept became popular in the wake of the global financial crisis. Although we did not use the term, some of the prudential measures that we have deployed in the past few years were in the spirit of macroprudential policy of enhancing the resilience of the financial system over the cycle and of restraining the buildup of systemic risks. For example, in 2003, when we observed rising high-end real estate prices along with strong mortgage lending, we imposed a ceiling on the loan-to-value (LTV) ratio for residential property with the transaction price exceeding 10 million baht. Later in 2004, observing a significant credit card loan growth, we placed limits on credit card borrowing by instituting a minimum income requirement, among others. More recently in 2006, seeing that banks were strong enough, we asked them to further set aside sizable provisions for loan losses in compliance with a new international accounting standard. This had an adverse impact on banks' bottom line at the time, but the extra provisioning would later provide cushions for Thai banks during last year's economic downturn. Regarding all these instances, it should be noted that in choosing the specific macroprudential measure to be used, the Bank of Thailand has exercised great caution in

terms of market friendliness, for a fine line exists between the balance of financial efficiency and financial stability.

Here, I would like to note that having both monetary policy and regulatory responsibilities together allows us to see the big picture when making policies, whether monetary or macroprudential ones. This synergy has also enabled us to act quickly and decisively with an informed judgment, which served us well during the global financial crisis. In Thailand, talk of removing regulatory duties from the Bank of Thailand surfaced from time to time after the 1997 crisis, and I think we were fortunate that the government did not go through that path.

In addition, with regard to the purview of our regulation, the new Financial Institutions Business Act (Section 5) allows room for the Bank of Thailand to regulate any unregulated financial businesses that may have significant impacts on the economic and financial systems. This means that, we will be able to take care of systemically important financial firms outside current regulatory purview if the situation warrants.

Ladies and Gentleman,

Lastly, let me share with you what I see as major challenges for the maintenance of financial stability in Thailand. While we may have a head start over many countries, we are not in anyway complacent. In particular, three important challenges loom on the horizon.

First, the global economy, while doing much better than a year ago, still have many vulnerabilities which could give rise to the next round of global financial instability. Most importantly, the public debt problems in certain European countries constitute a major risk factor. At the other end of the spectrum, the growth and interest rate disparity between Asia and advanced economies amidst the still abundant global liquidity from the unprecedented monetary policy stimulus around the world could attract de-stabilizing capital inflows that will put pressure on exchange rate, encourage a buildup of financial institutions' short-term debt, and fuel bubbles in various sectors.

Second, in light of the possible buildups of financial imbalances, there is a need to further enhance the ability to identify potential threats early on. For example, at least in its early phase, bubbles are almost always associated with favourable economic fundamentals. Effective monitoring of bubbles therefore calls for better data collection, market intelligence, and risk analysis. While timely bubble identification remains very difficult, the good news is that better identification techniques are being developed and will continue to improve.

Finally, there is a need to watch the developments in international regulatory reforms very closely. It is true that a plethora of proposals have been discussed in the world stage, but some may impose more costs than benefits to Thailand. After all, many regulatory pitfalls that gave rise to the recent global financial crisis do not apply to us, for example, those related to securitization. In addition, some proposals may be more stringent than necessary given the nature of financial transactions in Thailand. For example, the currently proposed leverage ratio requirement treats banks' letter of credit (L/C) the same as complex derivatives, which will impose substantial

costs on Thailand's trade finance business. The challenge here is therefore to weigh carefully the benefits, the costs, the necessity, and the appropriate timing for the adoption of the new international standards so as to ensure that our financial system is not overburdened by unnecessary rules. Again, this highlights the tradeoff between financial stability and financial efficiency

Ladies and gentlemen,

In closing, let me reiterate that the Bank of Thailand gives great care to both price stability and financial stability. The policy responses undertaken by the Bank over the past few years have helped preserve the Thai financial system's resiliency which in turn contributed to the economy's turnaround. Despite challenges in the period ahead, we will try our best to ensure

that Thailand's economic and financial stability continues to remain intact so as to support the economy's sustainable long-term growth.

Thank you very much for your attention.