Prasarn Trairatvorakul: Regional trends for monetary policy and the possibility of regional collaboration

Speech by Dr Prasarn Trairatvorakul, Governor of the Bank of Thailand, at the 14th International Convention of the East Asian Economic Association (EAEA), Chulalongkorn University, Bangkok, 2 November 2014.

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Distinguished Guests,

Honorable Speakers,

Ladies and Gentlemen,

It is my pleasure and privilege to speak at the 14th International Convention of the East Asian Economic Association. First of all, I would like to express my sincere gratitude to the hosts for inviting me as a part of this esteemed forum, which brings together economists, academics, and officials from all over the region.

Our countries have been overwhelmed by clouds of uncertainties in both domestic and external fronts. So far, the question we have repeatedly asked ourselves is "***What can 'WE' contribute to sustain the recovery and better safeguard our economies?"*** And as "WE" gather here today***,*** I am confident that this is an opportunity for "US", to exchange knowledge and experiences, that would greatly support the development of regional economies and strengthen our regional cooperation.

Today, I would like to share my thoughts in pursuit of the answers to our question from a policymaker's perspective. I will begin with what I see as the major contributors to the past global financial crisis. Then I will touch upon the conduct of monetary policy amongst Emerging Market Economies in response to the past crisis as well as its spillovers. Last but not least, I will share my views on good policy preparations and highlight the importance of policy collaborations, so that we, collectively, could better withstand the impact of the crisis going forward.

Part I: Major developments that have contributed to the past global financial crisis

Ladies and Gentlemen, looking back on what we have experienced in the past decade, the recent crisis has caused tremendous impacts with repercussions at the global level. On a more positive side, however, the crisis has revealed ***three major developments in the financial system, which have shaded some light on the inadequacy of existing policy framework for our future preparations.***

First is innovation, in response to the shift in the global financial system landscape. The ***sophisticated financial instruments*** have been developed to serve rising demands from all types of investors with different risk-return appetites. However, such a creation ***has resulted in products that disguised the genuine financial risks***. Moreover, systemic risk stemming from complex nature of such products have led to increasing contagious consequences in global economic and financial system.

Second is the institutional shift represented by an ***increasing role of non-banks and shadow banks***, especially in some Advanced Economies. This ***has long been a trade-off for policymaking between economic and social considerations.*** On one hand, the shadow banking sectors undoubtedly provide financial opportunity to those with limited access. This institutional development also has encouraged higher competition in the financial system, leading to greater efficiency. On the other hand, this informal financial sector remains under-regulated and may incentivize risky activities, such as overleveraging, which could become systemic and prone to produce adverse outcomes to the system.

The third development is what has taken the forefront role as an underlying driver of the recent crisis and policies that follow. It is the ***increasing interconnectedness amongst economies and financial markets***. Rapid integration of international trade and finance has led to promising economic prosperity. However, the increasing co-movements of business and credit cycles globally also played an important part in ***amplifying and spreading booms and busts cycles across the economies.***

This new financial environment has set stage for possible negative impacts both in terms of magnitude and depth on the real and financial sectors, especially those of the advanced economies. To that extent, we have witnessed, the deployment of unconventional sets of monetary policy instruments in order to shore up the economies and financial markets.

Part II: Responses to crisis and policy spillovers to EMEs: New trends of monetary policy

Ladies and Gentlemen,

The implementation of the extra-ordinary policies and financial reforms in Advanced Economies to tackle the crisis has generated ***momentous spillovers upon Emerging Market Economies.*** These unintended effects are, mainly, (1) ***liquidity surge*** that drove up financial market volatility and created significant demand for safe assets, and (2) ***regulatory reforms in the financial system, mostly the banking sector,*** which raised the operating costs of financial institutions amidst heightened risks in the financial system. ***Moreover, the situation had worsened as it added*** to the direct impact of weakened global demand.

Although the spillover impacts to individual economies have been uneven, ***monetary policy in most emerging markets have faced a tradeoff between achieving domestic objectives and managing external spillovers.*** The limited and, in many cases, stretched monetary policy tools have been designed to mitigate financial imbalance and vulnerability, and to restore economic growth and maintain targeted inflation.

Our experiences from various Quantitative Easing (QE) episodes remind us that the traditional monetary policy at hand may not be sufficient to address these multiple objectives. Alongside policy interest rate as a primary tool, ***central banks in emerging markets have additionally relied more on non-traditional, tools and measures***. One is macro-prudential policies, mostly related to real estate and the banking sector, to help address pockets of vulnerability in the short-term. The other is a more market oriented approach by allowing greater exchange rate flexibility to counter large and volatile capital flows.

Thus far, it is evident that emerging market economies have weathered such spillovers quite well, but new challenges keep coming our way. Despite signs of recovery in some Advanced Economies, their paths remain uneven. This called for the divergence of policy implementations with substantial uncertainty, especially to financial market participants. Next, the prolonged stagnation in some Advanced Economies has taken more tolls on emerging economies as reflected by softening growth and heightening vulnerabilities. As such, ***"Policy dilemma" in Emerging Market Economies is likely to become more pronounced, especially as policy rate hikes from external front are imminent.*** Along the way, clear and timely policy communications from Advanced Economies will be useful to prepare for any adverse side-effects going forward.

Part III: Key policy takeaway and the importance of policy collaborations

Ladies and Gentlemen,

In preparation for upcoming challenges, policymakers wish to do better than passively "catching up" with the crisis, but to be actively ***"ahead of the crisis" in order to prevent, or at least, mitigate the impact should one occur.*** Against this backdrop, lines of policy defenses for each economy have to be strengthened.

If we think of the economy as our own house, ***then keeping the house in order is always an effective first line of defense.*** Strong economic fundamentals and macroeconomic policy credibility would play a crucial role in ensuring confidence and the sustainable economic activities. Nonetheless, increasing interconnectedness has made housekeeping more difficult as it creates spillovers. To better deal with the shocks, broader set of policy tools are called for. In a nutshell, sound macroeconomic policy and flexible macro-prudential measures to target vulnerabilities have been employed to minimize unprecedented impact in an appropriate and timely manner.

Nonetheless, these policies are reaching their limits, not only in terms of policy space but also effectiveness. For a better solution, reforms in both the financial and real sectors are essential. With effective reforms, the economy should better withstand shocks and reap more benefits from increasing interconnectedness. It is worth noting that reforms are not complementary, but rather a much needed action to unlock long-overdue potential enhancements, especially on the production side. Additionally, financial reforms and institutional adjustments to new regulations will lay a crucial foundation for efficient management of systemic risks in the financial system.

Once our houses are kept in good order, one might hope that the stable global equilibrium could be reached. [This is what Professor Taylor has dubbed as the "Nearly International Cooperative Equilibrium" or NICE.] Nonetheless, ***with greater interconnections, keeping one's house in order might only be the near-best equilibrium. It should go along with enhancing cooperation in the international community.*** Long before this recent crisis, Emerging Market Economies have been in the process of strengthening the cooperation in both regional and global level. "Coordination" is essential and will facilitate policymakers in staying ahead of the crisis.

In this light, international coordination, I believe, should provide three key policy elements;

Firstly, ***policy dialogue that would serve as a platform for discussions on developments of risk scenarios, and sharing experiences to counter difficulties among members.*** Such cooperation includes the Executive's Meeting of East Asia-Pacific Central Banks (EMEAP), Bank for International Settlements (BIS), and International Monetary Fund (IMF). These platforms have also provided channels for policymakers in the region to communicate their policy conducts, which may also create spillovers to other members, so that one could make the region being more cooperative.

Secondly, ***comprehensive preparations needed to better counter shocks. This includes multilateral surveillance that provides better insights on the increasing interconnectedness, through exposures of banks and corporates.*** For the East Asian region, the ASEAN+3 Macroeconomic Research Office (AMRO) serves as a regional surveillance unit to enhance its members' macro-monitoring systems. And to the global extent, the International Monetary Fund (IMF) has introduced the early warning exercise and cluster surveillance aiming at strengthening a country's capability to monitor tail-risks at a more systemic and regional level.

And thirdly, ***swift and effective resolution*** including multi-layered liquidity provision. The deepest layer within starts from the ASEAN Swap Arrangement (ASA), followed by the Chiang Mai Initiative's Multilateralization (CMIM), and the liquidity provision from the IMF. Not only will it provide safeguard for members, coordination under these collective actions will also offer good will for global investors and enable them to quickly revive confidence, should any shock occurs in the financial markets.

Final thoughts

Ladies and gentlemen, keeping our houses in order is the policymakers' usual business. While economic and financial interconnectedness has become more sophisticated, ***strengthening international coordination would be pivotal to success***. This requires extra effort in building stronger fences for global economic community to effectively handle any unwanted shocks and new generation of crisis in the periods ahead.

Last but not least, I am confident that with knowledge and experiences sharing among us, we will be a step closer to improve our role in promoting economic and financial stability. ***I do see the enhancement of international cooperation as a seed towards success in policy preparation for our region***. I believe that, in the middle of a dark tunnel, with each of us holding a torch focusing in the same direction, we could see better along the way and can be sure that it is the right way out.

Thank you.