Monetary Policy Challenges During the Great Transition:
Perspectives from an Emerging Market Central Bank

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Ladies and Gentlemen,

It is a great pleasure for me to be here in London and to have a chance to contribute to the City Lecture series. Firstly, I hope it is not too late to wish you all a happy and prosperous new year. Secondly, I would like to thank OMFIF for the invitation and also express my appreciation of the work that OMFIF has done in providing a vibrant and informative platform for policymakers to exchange their views on issues relevant to the future of the international monetary and financial system. Given the economic and political challenges that we face today, I feel that the need and importance of such platforms for open dialogue is as important as ever. For it is only through constructive dialogue that the diversity of perspectives inherent in modern society can be harnessed to drive meaningful progress.

In that spirit, I would like today to reflect on the prevailing monetary policy paradigms that have guided central bank actions over the recent past and highlight some of the tensions and limits of such framework. In policy, we are often preoccupied with the technical and tactical management of our instruments. Most of our energy is devoted to analyzing latest economic developments and deciding on the size and timing of our actions. **Yet over time, if one gets the paradigm right but the details wrong, the damage will be largely limited.** Moving the policy instruments slightly too much or too little or a few months too soon or too late won't matter very much in the long term. But if we get the paradigm wrong, the resulting harm will be severe because we will make the same mistakes over and over again. **Questioning prevailing paradigms now and then is therefore healthy.**

Nine years on from the global financial crisis, it is remarkable that policy interest rates in major advanced economies are essentially at zero or negative and central banks continue to seek innovative ways to further stimulate the economy. Economic developments are still cast in terms of "the recovery" and the crisis mentality has yet to fully abate. With growth repeatedly disappointing on the down side and inflation stuck below targets, a sense of déjà vu permeates policy discussions. **On this long journey towards normalization, the destination never seems to arrive. And during this period, which could aptly be called the *Great Transition*, we have seen some remarkable things.**

If someone had asked you back in 2007 what you would expect to see if the major central banks in the world cut policy rates to zero and held it there for almost a decade, triple the size of their balance sheets, and bought up roughly a third of all outstanding government bonds in their jurisdiction, very few of us would have thought that subdued price pressure and tepid growth would be the outcome. Yet that is what we have seen. **Across the major advanced economies and some emerging market ones, inflation has been persistently below targets and growth weak for many years.** What does this say about the influence of monetary policy over cyclical variations in the economy?

The prevailing view is that inflation is low and recovery weak because the zero lower bound prevents central banks from lowering real interest rates enough to re-equilibrate the economy. That is, the actual real interest rate is too high relative to the equilibrium or natural real interest rate. This view rests on two key propositions. First, the problem besetting economies is one of aggregate demand deficiency. Second, low interest rates can offset this by encouraging people to bring future expenditure and investment forward. This logic underpins the unprecedented monetary accommodation that we have witnessed. But this prism, based on prevailing macro models, for viewing recent developments is rather narrow.

Consider the broader context where structural forces are at play. At the global level, changes in the structure of world trade, rising competitive pressures, and common forces such as falling oil prices have for a long time increased the influence of external factors on inflation. In individual jurisdictions, changes in labor market fundamentals mirroring changing demographics and reduced wage bargaining power have exerted a powerful downward force on price dynamics. Meanwhile, the digital revolution has driven the prices of many modern services, such as telephone calls, news, and entertainment to essentially zero. **These forces have contributed to a weakening, and in some cases the disappearance altogether, of the link between inflation and measures of economic slack, as traditionally captured in the Phillips curve. Low inflation cannot be attributed primarily to insufficient aggregate demand.**

Some of these same structural forces also account for weaker growth. For highly open economies, slowing world trade has undermined export as a growth engine. At the same time, the transition to services has also contributed to growth headwinds given that modern services is less labor and capital intensive than manufacturing. Think of Facebook's 15,000 workforce compared to Coca-Cola's 150,000 despite the former having twice the market valuation of the latter. Or how the Ubers and AirBNBs of the world can generate immense value added without hardly any capital outlays. Given that investment is relatively interest sensitive, to the extent that the transition to services has dampened investment, it may have also made the economy less responsive to monetary policy. Rising income inequality, insofar as it translates into more purchasing power being in the hands of those less likely to spend at the margin, also acts as an additional drag on growth. Finally, the legacy of debt overhang and an impaired banking system has both weighed on growth and hampered the transmission of monetary policy.

The upshot is that much of the forces driving inflation and output are structural and not easily amenable to monetary policy. The returns to monetary ease may be limited and most likely diminishing in the face of these headwinds. That would not be so much of a problem if extended monetary accommodation entailed no costs. **But there *are* side-effects and they are pervasive.** Persistent ultra-low interest rates and the increased presence of central banks in markets raise concerns that they are distorting market prices away from fundamental values. Very low interest rates has driven a search for yield that has boosted asset prices globally, compressed risk premiums, and supported high leverage. It is striking that global leverage, at 225 percent of world GDP in terms of gross debt of the nonfinancial sector, is presently higher than it was *before* the onset of the global financial crisis. For institutions that have committed liabilities, such as insurance companies and pension funds, sustained low rates threaten their long-run viability and compels them to take more risk.

International spillovers have also been prominent. In today's hyper-connected global economy, a problem anywhere can quickly become a problem everywhere. The exchange rate has been an important conduit in this respect, especially for emerging market countries. Through successive rounds of easing, the transmission of monetary policy in advanced economies increasingly came through currency movements. Resistance to unwelcome currency appreciation then spreads exceptionally easy monetary conditions to the rest of the world. Easing begets easing. Hence the frequent references to "currency wars" and "competitive depreciations". For international currencies such as the US dollar, very low interest rates directly boosted credit expansion elsewhere. From 2009 to the end of 2015, US dollar-denominated credit to non-banks outside the United States increased by more than 50%, to about $9.8 trillion; and to nonbanks in EMEs, it doubled to some $3.3 trillion.

Overall, we have a dichotomy between diminished monetary influence on inflation and output on the one hand, and hyper-sensitivity of financial markets and asset prices to monetary policy actions and communication on the other. This raises a dilemma. Against the tide of structural headwinds, inflation and output fail to respond to monetary ease, and the temptation is to do more and more. In the meantime, financial markets respond vigorously to low interest rates and the search for yield accumulates in the form of greater financial fragility over time. This has important long-run implications that current frameworks neglect.

The prevailing paradigm views monetary policy as a stabilization tool for managing cyclical movements in the economy with no impact on the trend. Money is neutral in the long-run. **But it is becoming increasingly recognized that there is a direct link between the financial cycle and long-run output trajectories.** A large body of evidence indicates that financial crises often result in very large economic contractions followed by a long period in which output is depressed substantially, with no rebound on average to the pre-crisis trend over the medium term. Output losses in many cases are permanent. Given that financial instability can have long run impact on the economy, then if monetary policy plays a role in influencing the likelihood of a crisis occurring or the magnitude of its impact once one does occur, it follows that monetary policy has long-run implications.

This perspective calls for a reassessment of prevailing macroeconomic models that focus on flows and shocks but neglect stocks and states. The financial cycle acts as the thread that binds the challenges and constraints of today to the actions and decisions taken in the distant past. This path-dependency sharpens the trade-off between short-term inflation and output stabilization on the one hand, and financial fragility and their impact on longer term economic trajectories on the other.

From this alternative paradigm, the calculus is tilted against unrelenting monetary stimulus. **It calls, instead, for a monetary policy framework that systematically reacts to the financial cycle, both in good times as well as in bad.** This differs from an approach in which policy leans against the wind *only* when financial stability risks become evident. Given the long and drawn-out nature of financial cycles, such an approach would inevitably lead to doing too little too late, as the *cumulative* impact of policy over the whole financial cycle is ignored.

The alternative framework entails more flexibility with respect to the delivery of inflation targets and longer horizons over which the effects of policy are judged. Such a framework could be usefully complimented by the application of macro-prudential tools. Here I stress the word “compliment”. Much of the discussion on macroprudential policy these days view them as a useful way to help *offset* some of the excesses that result from low interest rates. But macroprudential measures were originally envisaged as compliments to monetary policy rather than as instruments to substitute or offset the effects of monetary or other government policies.

It is easy to be lulled into a sense of blissful separation whereby safeguarding financial stability is left to macroprudential tools while monetary policy focuses on inflation and output goals. But this would be like driving a car with one foot on the accelerator trying to reach the destination as soon as possible, and the other foot on the brake making sure that we don’t crash. An even more precarious task if each foot belongs to different drivers. There are limits to what macroprudential can achieve, both economically and politically. **Just as monetary policy has been over-burdened, macroprudential tools too risk becoming overburdened.**

In Asia, central banks have generally become more mindful of financial stability concerns in the aftermath of the 1997 crisis. **The Thai experience is illustrative.** Having lowered our policy rate to 1.5 percent in the second quarter of 2015, we have kept rates unchanged since then even though headline inflation was below our target range and growth relatively soft. This reflects the recognition of the wider context and set of factors which act to mute the monetary transmission mechanism that I have alluded to earlier. Structurally, we share many of the fundamental forces holding inflation and growth down in advanced economies. This includes an aging population, high income inequality, and a rising share of services. The decision to keep rates on hold also reflects ongoing financial stability concerns given high household debt levels and evidence of search for yield behavior leading to risky shadow banking activities. **The preservation of room for manoeuvre reflects a policy framework that embodies the longer horizon perspective and recognition of the limits of monetary policy that I have discussed.**

In terms of the outlook going forward, we forecast continued economic growth this year at broadly similar pace to 2016 while inflation should pickup as the base effect from lower oil prices dissipate. With **available fiscal headroom**, government spending, particularly on infrastructure investment, will provide significant impetus to the growth momentum. On the external front, if the scale and breadth of surprises that transpired last year in the global political and economic landscape is any guide, we will be in for a rough ride. Here, Thailand's **high level of foreign exchange reserves**, which amounts to some 3.2 times of outstanding short-term foreign debt, as well as **strong current account position** should provide adequate buffers for new surprises. The **high levels of capitalization of our banking system** moreover, with average capital to risk-assets ratios of over 18 percent, provides a solid foundation for financial stability and alleviates concerns from the recent pickup in non-performing loans.

Thailand's main challenges are micro, not macro, in nature. A key growth engine over past decades has been the productivity gains from structural transformation, whereby labor moves from low productivity agriculture to high productivity manufacturing and services. This has stalled, and even reversed, of late. **To reinvigorate growth, we need to upgrade education and skills of our labor force, streamline rules and regulation that shackle business productivity, catalyze public and private investment in key infrastructures, and establish platforms that spur innovation.** At the same time, there is great potential for Thailand to leverage on our unique geographical advantage of being in the midst of the Greater Mekong Subregion that includes the rapidly developing economies of Cambodia, Laos, Myanmar, and Vietnam.

The good news is that the government fully recognizes these priorities and is currently embarking on a multi-pronged approach to move forward rapidly. The reform agenda encompasses wide-ranging initiatives to improve efficiency as well as propel growth. Prioritizing on the most binding constraints, a number of legal and governance reforms have already been implemented. These include streamlining of the process involved in obtaining business licenses and the strengthening of laws governing business collateral that expands the range of security interests that can be. Small-medium enterprises stand to benefit most from these, both in terms of lower operating costs and greater financial access.

Under consideration is also a comprehensive reform of the governance of state-owned enterprises. Given their very large size and their critical role as provider of basic infrastructure such as electricity, telecommunications, and transportation, state-owned enterprises exert a significant influence on overall economic efficiency. The existing regulatory framework, however, is complicated with large overlaps and a lack of overriding authority. The proposed establishment of the National State-owned Enterprise Corporation with a clear separation among the relevant government agencies in terms of responsibilities as policymaker, regulator, and owner, therefore holds promise of bringing about tremendous improvements in resource allocation within the economy.

In terms of invigorating growth, a key strategy being pursued is to shore up economies at the grass-roots level through various interventions, including fiscal injections, at the local government level. At a more national level, efforts are underway to shift industrial structure towards certain high value added industries.

For the Bank of Thailand's part, the overriding focus is on strengthening the capacity of our financial system to serve the economy by leveraging on fundamental technological improvements. As the backbone of all economic activities, the payment system and infrastructure is critical to economic efficiency and stability. Among others, we will be rolling out a new Faster payment platform early this year that will encourage greater digital payments as well as lower transaction costs. We will enhance financial connectivity with neighboring countries through various means, including the promotion of local currency usage for regional trade. Moreover, in recognition of the potential for innovative financial platforms to increase efficiency and expand inclusion, we recently launched a "regulatory sandbox" approach to facilitate FinTech.

So the policy strategy is clear: **leverage on our strong macroeconomic fundamentals to push through critical microeconomic and structural reforms that unleash productivity improvements.** The challenge is one of execution. In all this, monetary policy plays a secondary supporting role.

Ladies and Gentlemen,

Marshall Goldsmith in his popular executive coaching book, "What Got You Here Won't Get You There", highlighted the unwillingness to change modes of thought and behaviors as a critical obstacle preventing executives from becoming successful leaders. So too in monetary policy I believe that the frameworks, paradigms, and norms that have gotten us to where we are need to be openly reassessed. **We have arrived at this juncture partly as a result of a financial cycle that was unanchored. We need to seriously rethink the framework that allowed this to take place.** What got you here won't get you there. More of the same will not do.

On a monetary road less traveled, it is important to make sure that our intellectual compass points to the right general direction. Through the years, monetary policy has shifted through successive frameworks. From the system of fixed exchange rates under Bretton Woods, to monetary targeting during the *Great Inflation* in the 1970s, to inflation targeting in the context of the *Great Moderation*, and finally to an assortment of unconventional monetary policies in the wake of the *Great Recession*. Today, as we navigate our way through the *Great Transition*, the search for a new framework is ongoing.

In so doing, the limits of monetary policy as well as its unintended consequences, especially on financial fragility, needs to be better recognized. We would do well to revisit our monetary architecture, both domestically and globally, our optimal policy mix, and structural constraints to ensure that the transition leads us to a more stable, prosperous, and sustainable economic outcome.

Thank you very much.