Marzunisham Omar: Comprehensive approaches to monetary and financial policy making in ASEAN-5 countries

Welcome remarks by Mr Marzunisham Omar, Assistant Governor of the Central Bank of Malaysia (Bank Negara Malaysia), at the third BNM-IMF Seminar, Kuala Lumpur, 17 July 2019.

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In his remarks at this seminar last year, Odd Per quoted the book Enchanted; "First time is luck, second time is a coincidence and third time is a tradition." Here we are gathered today for the third BNM-IMF Seminar to celebrate this "tradition", a tradition I hope will continue for many years as we can all agree that candid and open dialogue between the IMF and ASEAN-5 central banks is mutually beneficial.

Let me take this opportunity to thank the IMF and the team at Bank Negara Malaysia for organising this Seminar and to my colleagues from the region for being highly supportive of this effort.

The topic today – "Comprehensive Approaches to Monetary and Financial Policy Making in ASEAN-5 Countries" – is indeed timely given the ongoing work at the IMF on the "Integrated Policy Framework". I hope today's Seminar will help shed greater insights on how central banks in ASEAN economies, which are small, open economies, navigate through increasingly complex, interrelated issues in our pursuit of preserving monetary and financial stability. I have no doubt that we in ASEAN will also find today's Seminar useful in understanding the IMF's latest thinking on these issues.

There are two parts to my brief remarks today. First, I will touch on the increasingly complex policy making environment given the openness of our economies. Second, I will posit three issues that we need to grapple with in considering the optimal policy mix towards achieving monetary and financial stability.

Our mandates are to preserve monetary and financial stability, which are critical conditions for sustainable growth. In the pursuit of these mandates, a key consideration is the openness of our economies. While the integration of our economies with the global economy and international financial markets has yielded substantial benefits, it has also made our economies more susceptible to external shocks and spillover effects from global developments.

Let me briefly touch on some of these external factors:

- First, global growth momentum is slowing. A key issue is how deep and prolonged the slowdown will be. A key risk is the ongoing trade tension and its impact on global trade, investment and sentiments. For many of our countries that depend heavily on international trade, the impact is already being felt in the slowdown of our exports and growth.

- Second, major central banks have indicated intentions, or a few have taken steps, to relax their monetary policy to support growth in an environment of low inflation. While this has helped to loosen the global financial conditions, the question is should emerging economies be prepared for another round of surge in capital inflows?

- This brings me to my third point. For emerging economies, capital flow volatility is a fact of life and something that policy makers have to deal with; and we have to acknowledge that the size and volatility of capital flows will only intensify.

While the transmission of global shocks to the domestic economy through the real economy channel – that is through trade and investment – is something that we have been dealing with for decades, policy makers today are confronted with the increasingly dominant channel of transmission of shocks through the financial markets, at least in the immediate term. All of us have experienced how spillovers from external developments that were manifested through capital flow volatility have adversely affected domestic financial markets, asset prices, liquidity conditions and importantly, exchange rates.

All these challenges make for a complicated policy environment for ASEAN central banks. Gone are the days when keeping our own house in order is enough. Sure, good fundamentals matter as they have no substitute. They are, however, no longer sufficient. As Keynes rightly pointed out a long time ago, “the market can stay irrational longer than you can remain solvent.” Often, we have seen how external developments that are beyond our control, such as the unprecedented quantitative easing by the advanced economies and the subsequent Taper Tantrum, triggered periods of large inflows followed by sharp reversals in emerging economies with severe consequences. For small open economies, these flows can easily overwhelm the domestic financial markets and lead to build-up of vulnerabilities in the economy.

Facing this new reality, the policy reaction function of central banks from the emerging market economies could, to quote BIS General Manager Carstens, be described as a multi-instrument reaction function responding to multiple-indicator variables, including the exchange rate.

Given these increasingly complex and interconnected challenges and the risks of policy trade-offs, what should guide policymakers going forward? Allow me to pose three questions on this.

Question 1: The assignment problem

First, the assignment problem – how do we assign policy tools to policy targets appropriately? The Tinbergen principle suggests that policymakers trying to achieve multiple economic targets need to have at least one policy tool for each policy target. Robert Mundell went one step further and suggested that each policy instrument should be assigned to the policy target on which it has the greatest relative effect. This may sound good in theory, but we know it is much more complex in reality given the multifaceted and often interconnected risks confronting us.

For ASEAN policymakers, how can we assign the tools available to us to our expanding objectives/mandates in the most optimal way? How do we avoid overburdening any single policy tool? If multiple tools are needed, how do we sequence them? Is there a case to be made for an optimal order of policy based on prioritising of objectives? Or is a pre-agreed sequenced policy order too restrictive?

Question 2: Rules versus discretion

Second, is the old question of rules versus discretion. While rules-based frameworks are easier to enforce and do not require recurring justification of explicit decisions once in place, a purely rule-based framework can be too constraining and rigid. The inherent rigidity reduces policy space for policymakers to maneuver in times of stress. On the other hand, while a discretionary, principle-based framework accords policymakers the necessary flexibility and space to maneuver, there is a risk that policymakers may overstretch this flexibility. Perversely, there is also the risk of inaction by policymakers.

I have always viewed policy making as akin to designing an earthquake-proof building, whereby the stability of the building (the economy, in our context) is not achieved by increasing rigidity, but by allowing flexibility. This pertinent question of rules versus discretion is one that we should continue to ask ourselves.

Question 3: Dealing with large capital flows: proactive or reactive?

Third, in dealing with risks emanating from large capital flows, is it better to be proactive or reactive? Should policymakers pre-emptively lean against the wind to tackle capital inflows before it manifests in the build-up of domestic imbalances, or should we take a more reactive stance by tackling domestic vulnerabilities and manage the fall-out from capital inflows? Being reactive may be too late, but pre-emptive measures may be viewed negatively.

I recognise that I have raised more questions than answers in my remarks this morning. I do not have the answers for all of them but I believe these questions are important and relevant for us to address today and in days ahead.

What I can tell you definitively is that the work on the integrated policy framework (IPF) is highly important as the environment that ASEAN policymakers are navigating through becomes increasingly challenging. On this note, I look forward to an engaging and fruitful discussion today. To my ASEAN colleagues, let us use this opportunity to share our views and experiences with the IMF. To our IMF colleagues, it is my hope that you will consider these views and continue to engage with regional policymakers as you work towards finalising the work on the IPF.