Priorities for Emerging Nations in a New Global Environment

Remarks by Veerathai Santiprabhob, Governor of the Bank of Thailand

34th Annual G30 International Banking Seminar

Enrique V. Iglesias Conference Center, Inter-American Development Bank
20 October 2019

I would like to first thank the Group of 30, especially Chairman Tharman, for inviting me to be a part of this panel on a very important topic: what should be the priorities for emerging nations in a new global environment, which is changing rapidly, full of unknowns, and driven mainly by factors beyond control of emerging nations.

As we all know, the world is changing rapidly, especially in technology, demography, climate, international trade pattern, domestic politics, and international geopolitics, which affect the structure of our society and economy and the way we conduct our business and policy. All of these rapid changes are challenges for all of us advanced economies and emerging market economies alike.

But let me speak from the perspective of an emerging market central banker: within this new landscape, how do I see the priority economic areas for EMs. In the short time I have today, I would like to highlight three issues that should be among the top items on an emerging nation's economic policy agenda.

Safeguarding SMEs competitiveness from global challenges

The first issue is the supply chain disruption which comes as a result of the technological changes and is further complicated by the ongoing trade tension. While this is definitely a concern for every country, we open-economy EMs are especially concerned about how SMEs—particularly medium-size firms—would cope with the trade and supply chain disruptions.

Medium-size manufacturing firms are the backbone of EM economies. Prior to the onset of the trade tension, the new global environment has already brought upon these firms considerable pressure. Technological disruption tends to favor large corporations who better understand the technology and have the resources needed for the adaptation. Low interest rate environment also allows large firms to access bond financing at very low funding costs. These factors have increased market power of large firms and forced smaller firms to quickly redefine their business model in order to stay afloat.

Amidst these structural changes, the ongoing trade tension becomes an additional burden to medium-size firms' survival both directly and through the disruption of the supply chains. Moreover, the increased uncertainty that forces firms to diversify their production locations and hedge against the growing risks together with the ongoing economic downturn have squeezed the profit margins. In such a circumstance, medium-size firms are in a much more difficult position than large firms that have deeper pockets and larger buffers.

Trade tension might be comparatively short-lived when compared to other structural changes like demographic shift and technological disruptions, but these short-term factors could result in a long-term impact to medium-size firms and the structure of the economy through channels such as changes in competition landscape, market dominance power, and investment and employment patterns.

Of course, the big question now is what roles could policymakers play to support this transition. I see SMEs capacity building as one key area where the government needs to be actively involved. This includes proactive consultation and coaching, providing incentives for productivity-enhancing investments, prohibiting abuse of market dominance power by large firms, promoting digital adoption, as well as eliminating outdated laws and regulations hindering SME's competitiveness.

Although enhancing SME competitiveness might not be a direct mandate of a central bank, the Bank of Thailand has stepped up our policy focus on SMEs and worked with the banks on a number of initiatives. New digital payment platforms have been developed to lower costs of payment services, enhance payment efficiency, and provide a foundation for information-based lending and supply chain financing. A new database on system-wide SME loans by contract was set up to improve understanding of SME financing behavior and analysis of SME credit risks. We have also expanded the range of foreign exchange hedging products for SMEs and, recently, taken steps to encourage preemptive rescheduling and restructuring of SME loans to help facilitate their transition during this challenging period.

Dealing with financial spillovers

The second issue for emerging nations in this new global environment is the size and volatility of financial spillovers that result from unconventional monetary policy after the GFC.

Capital flows, especially portfolio flows, now account for a much larger portion of cross-border flows than current account flows, and have a much larger effect on the exchange rates for EMs. These capital flows—a significant portion of which are non-resident activities—are more sensitive to global financial conditions which have been dictated largely by monetary policy stance of AEs and global investors' sentiment rather than textbook-determinants like macroeconomic conditions in EMs and interest rate differentials. Moreover, due to the large foreign-exchange activities by non-residents relative to the size of domestic foreign exchange markets and increases in derivatives and algorithmic foreign exchange trading activities, exchange rate could at times act as an amplifier as opposed to a stabilizer of shocks and capital flows, especially in EMs with strong external positions that are considered as safe haven like Thailand.

While capital flows in and out of EMs might be small relative to global financial activities, they could have real and significant impacts on the EM economies through the exchange rate channel. Concerning volatile exchange rate movements that could undermine financial stability, capital flows could affect EMs' monetary policy stance. For example, in the low-for-long interest rate environment, EMs may need to follow AEs in delaying or reversing normalization of monetary policy to avoid appreciation of their currencies. Because of spillovers, monetary policy of EMs could be distracted from their core domestic policy mandates.

The delayed normalization in the low-for-long or negative-for-long interest rate environment further exacerbates financial stability risks. Debts—both household and corporate— are now reaching historic highs. Emerging nations, often with nonbank financial activities outside the regulatory perimeter, are more susceptible to risk buildups.

Financial spillovers need to be addressed at multiple levels. *On a domestic-level*, financial stability will have to play a more prominent role in monetary policy decisions. This is especially true in the current environment where inflationary pressure is subdued. For EMs that still have a lot of ground to cover in regulating non-bank financial activities, financial stability cannot be addressed by macroprudential measures alone. EMs also need to equip themselves with policy tools to deal with rapidly changing capital flows; these tools encompass macroprudential measures, microprudential measures, capital flow management measures, and at times foreign exchange intervention.

On an international level, we need to recognize the changing landscape and the impact of the financial spillovers on small open economies, advanced economies and EMs alike.

First, the burden of adjustment needs to be proportionately shared by both the source and recipient countries of capital flows. At present, EMs as recipients of flows are often restricted and reproached in their response to capital flows, while source countries have full flexibility in their conduct of monetary policy. In this regard, we very much welcome IMFs' work on the Integrated Policy Framework which will allow small open countries to respond to spillovers more effectively taking into account each country's specific context and circumstances. We would very much hope that source countries of capital flows take into account spillover and spillback effects in their policy deliberation.

Second, assessments of global imbalances and implications for currency valuation need to adopt a "broader view" that takes into consideration not only current account imbalances but also capital flows which have become much larger than current account flows; taking a narrow perspective of current account imbalance alone could lead us to a policy misstep.

And third, central banks should have a collective voice on how much central banks can do, and to what extent further monetary easing can prop up the economy facing with structural challenges and trade disruptions. When we think about policy space, we must not look at the zero lower bound, effective lower bound, or the optimal size of central bank's balance sheet. We must also be aware of the "financial stability lower bound": how much additional financial stability risks we are willing to take. This is so that the financial market would have a realistic view of monetary policy and not expect central banks to engage in excessive easing that might result in long-term financial instability.

Preparing for the new macroeconomic thinking in the world of bilateralism

This brings me to my third and last issue which is the importance of multilateral framework and international cooperation in a world that is becoming more and more polarized, both geopolitically and economically. Multilateral frameworks that have worked so well for us in the past recently got challenged by gravitation towards inwardlooking policies and bilateral economic relationships, and that has sent shockwaves to emerging nations on the periphery.

The drift towards bilateral- and trade-focused international economic policies which bypass existing channels of trade conflict resolution severely undermines global governance of international trade. On their own, EMs have little bargaining power, and engaging in bilateral relationships with large countries could result in trade distortions and uncertainties that lead to inefficient allocation of resources.

In addition to the direct impact on trade, this bilateral- and trade-focused thinking could lead to another serious implication, especially from the perspective of macroeconomists who are well-represented in this room: the distortion of macroeconomic policy framework.

The global imbalance analysis illustrates this issue nicely. The existing framework that was developed by the IFIs prior to the GFC and was adopted internationally has been pivotal in the way we made policies to address global imbalances in the past. I have talked earlier about how the current framework based on current account balance alone needs to progress with the changing environment, the excess liquidity in the global financial system, and take a broader view that includes capital flows.

I am afraid that the current geopolitical environment will not allow us to progress forward in our thinking. Even the existing current-account based framework of global imbalances is being challenged by the bilateral worldview that focuses on bilateral trade. A currency intervention assessment framework that focuses narrowly on current account and bilateral trade balances and disregards other types of fund flows like portfolio flows is an example of thinking that distracts us from macroeconomic reasoning. But this is a thinking that EM policymakers need to be prepared for in the new global environment.

Conclusion

To wrap all of this up, I think we are now living in a very challenging time. Priorities for emerging nations should be to get ready for the world that will be more volatile, more uncertain, more complex, and more ambiguous ahead. With limited monetary and fiscal policy space we have, we need to give more consideration to structural policies that will help safeguard our competitiveness from global challenges. This means providing support to help medium-size firms stay competitive in the new environment. This means preparing digital infrastructure so that EM nations could maximize the benefits of the digital revolution. This means building up resiliency both by maintaining sufficient external buffers as well as strengthening the core financial system. And this means looking more into a combination of policy tools to achieve macroeconomic and financial stability objectives in the changing economic and financial landscape.

The last point I would like to make concerns international cooperation. Indeed, if we could choose, we would wish to return to a world with strong multilateral frameworks, a world with solid international trade governance, and a world that grounds policy thinking with economic reasoning. As small nations in the periphery, we might not have the luxury of choosing the world we wish to live in. I think it is more crucial than ever for small nations—emerging nations and advanced economies alike—to work closer together and make sure that our voices from the periphery are heard and that we make progress on macroeconomic policy frameworks fit for the new global environment.

Thank you very much for your kind attention.