**"Rethinking Monetary Policy in a Globalized World:
Coping with Current Challenges and Beyond"**

Remarks by Dr. Tarisa Watanagase, Governor, Bank of Thailand, at the Bank Negara Malaysia High Level Conference 2009, 10 February 2009, Kuala Lumpur

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1. Introduction

I would like to congratulate Bank Negara Malaysia on its 50th anniversary, and the magnificent job the Bank has done both in the domestic and international arenas. I wish the Bank continued success in the next 50 years and beyond.

Thank you for the opportunity to address this distinguished audience on a topic that is a current concern for all central bankers during these turbulent times.

I would like to raise a number of issues which have challenged the traditional thinking behind monetary policy as a consequence of globalization and the current turmoil. In some others I hope to propose solutions – some new, and some old. In many cases I will address the challenges and the blind spots which we face as monetary policy makers, and raise questions to which I myself do not yet know the answer.

The developments that globalization has brought about has tested the limits of conventional monetary policy, both in terms of the current thinking about how monetary policy is conducted, as well as the effectiveness of the current approach to monetary policy. I will discuss these points in detail in a moment. But first of all, let me briefly outline what exactly have been the challenges in recent decades that have required us to rethink the way we conduct policy.

Globalization has been a long and drawn out process. Countries have jumped at the opportunity to reap the benefits of globalization, with advanced countries leading the pack. Jumps in technology in recent decades, particularly in information and communications, have ensured that services – particularly financial services – have become truly borderless for advanced and developing countries alike, in a much shorter period of time.

2. Challenges to traditional monetary policy under globalization

We are all familiar with the benefits of globalization, with the past few decades seeing cheap exports from emerging markets fueling global trade and growth, albeit with some hiccups along the way. China's accession to the WTO and the subsequent flux of Chinese exports to the rest of the world, as well as oil exports from the Middle-East, helped to create an environment of prolonged low global prices and low global inflation.

We are all familiar with this episode and have given it a few names: the great moderation, the Goldilocks' economy — not too warm and not too cold, and stable disequilibrium. This is an episode in our history where variability of growth in real output has declined along with the variability in inflation.

Along the way, imbalances in the global economy began to build up. The imbalances manifested themselves in huge trade surpluses and an accumulation of foreign exchange reserves in the countries which relied on export-oriented growth – including those in the Asian region. They were reflected in the dollar revenue which was subsequently reinvested in US financial markets – which in turn helped to finance the US saving deficit, permitting these imbalances to remain uncorrected for a prolonged period of time. And as a result, asset price bubbles were also allowed to persist for a prolonged period as well.

All was well as long as everyone continued to grow. However, as emerging markets opened up, global demand, and particularly demand from growing economies like China and India, drove up the prices of oil and other global commodities. Many economists began to predict a structural shift in global demand and changing dynamics of global inflation which would effect domestic prices and make inflation higher and more persistent.

3. Coping with the global financial crisis

At the same time, problems were brewing on the financial side in the advanced economies. I will not lay out the causes of the financial crisis here, as that has been discussed widely elsewhere. In a nutshell, the slowdown in the US housing market, coupled with a mix of troubled banking practices, regulatory blind spots, and absolute faith in the market mechanism, among other things, led to a financial crisis in advanced economies. But the important point here is that financial innovations, coupled with technological advances in communications, helped to link financial markets across the globe. This globalization of financial services allowed the collapse of major financial centers to spread to the rest of the globe so efficiently. In fact, these very financial instruments which had been earlier used to diversify risks turned out to be the very means for spreading contagion.

The spread of the impact of the financial crisis onto the global real economy through the trade channel changed the world's economic outlook rapidly and dramatically. This had a drastic impact on the inflation outlook, and the threat of inflation has rapidly shifted to one of possible deflation. At the same time, central banks are running out of traditional monetary policy ammunition to fight the slowdown in growth and potential deflation – namely cutting interest rates.

Given the increasing influence of external factors on global inflation dynamics, traditional monetary policy which focuses on domestic dynamics of inflation needs to be reconsidered. As a result of globalization, the prices of important commodities and goods tend to move together, making external price shocks a more and more important determinant of domestic inflation. Fluctuations in oil prices and other commodity prices, or even a sustained period of cheaper or dearer exports, can change global inflation dynamics. The spike in oil and commodity prices last year, which initially appeared as a supply shock at the individual country level, in fact represented economic overheating at the global scale, and domestic monetary policy tightening may not have been the most effective way to deal with this situation in the *global* context.

In addition, at the present juncture, the unprecedented and contagious slowdown in each country's economies as a result of global linkages means that monetary policy now needs to respond to the monetary policy stance in other countries. This has added an extra international dimension to policy making, in addition to previous considerations such as the impact via capital flows and trading partners' economies.

4. Testing the limits of monetary policy under globalization

But what exactly are these changes that globalization has brought about to traditional monetary policy? And in particular, how have these changes affected central banks?

The first aspect has been the challenge to the basis of our traditional monetary policy decision-making process.

Traditional conduct of monetary policy would rely on the accuracy of our forecasts of the economy, of inflation dynamics, and of our understanding of how the economy works. With globalization, making accurate economic forecasts become more difficult.

The recent economic cycle has demonstrated that shocks to the economy and the price level have been both rapid and frequent. This is most clearly demonstrated by the volatility in inflation in the past year. In the case of Thailand, headline inflation peaked at 9.2% in July last year, but has fallen dramatically to -0.4% in January.

While it is natural for forecasts to be revised in light of new developments and information, a concern arises that globalization is likely to have changed the various relationships in the economy. This is particularly timely now, when fear and uncertainty takes over rational behaviour. And if our models are still based on assumptions which have not incorporated these changing relationships, then we are likely to make systematic errors in our forecasts.

As a result of this volatility in inflation and the marked slowdown in global output, many central banks have had to reverse their tightening cycles – originally conducted to tackle inflationary pressures, while others have pursued an aggressive easing of monetary policy to shore up growth and fight off prospects of deflation. Many countries, including Thailand, had to do both.

This in turn, also becomes a concern for the central bank if frequent revisions or the abrupt reversal of the central bank's monetary policy stance affects the public's perception of the central bank's credibility.

As a result of the speed and magnitude of deterioration in economic conditions, central banks across the globe have pursued extremely aggressive monetary policy easing, with the intent of actively supporting their domestic economies against the global slowdown.

This situation has led us to the second challenge to monetary policy – namely the challenge to its effectiveness. Given current economic conditions, all the usual transmission channels have been clogged up. What happens when interest rates cannot be lowered any further? This is the challenge already faced in the US and the UK, and this challenge may need to be addressed by other countries in the near future.

The US and the UK have begun to explore "unconventional measures" now that the traditional ammunition of lowering interest rates has been exhausted. This has included tackling the spread between commercial and government rates directly. The "unconventional" approach taken by Japan in earlier decades – namely purchasing of medium- and longer-term government bonds, is also an option, although the Japanese experience has shown that this has led to an increase in base money but did little to stimulate lending, as commercial banks have increased short-term liabilities and too many illiquid and undervalued long-term assets on their balance sheets. On the other hand, recent easing, as in the case of the US, has resulted in a more targeted, direct lending to businesses through purchases of commercial paper, and indirectly to households through purchases of mortgage-backed securities.

5. Lessons from the current crisis: where do we go from here?

So what are we to do going forward on this issue of monetary policy in a globalized world?

I believe that there are a few issues that need our immediate attention amid the unprecedented crisis that we are in.

First, recent monetary policy actions around the globe have included the aggressive, and in many cases unprecedented easing of policy interest rates, as well as measures to extend and improve banks' access to long-term liquidity, limit systemic risk, and increase banks' willingness to lend.

But the use of these unconventional measures remains in unchartered territory, and few countries have had actual experience with their use, or to identify which ones are the most effective. Therefore, we need to significantly improve our understanding about how these measures might or might not work, what the conditions or indicators are that they aim to achieve, such as a pickup in growth or inflation, or a narrowing of short- and long-term bond spreads, for instance.

Second, given that such measures are relatively new and unconventional, communications with the public and investors are important so that they understand what these unconventional measures mean in terms of monetary policy stance and when to expect an exit once these conditions or indicators are met. Clear understanding will improve confidence, which we need to restore as soon as possible.

Third, the feasibility of unconventional measures such as credit easing may be limited in emerging markets, where the stock of such assets for purchase is limited. What then, are the alternatives should emerging economies run out of interest rate ammunition, and are there other options before the traditional ammunition runs out?

Fourth, taking a longer term perspective, beyond the current crisis, we need to continue to improve our understanding of monetary policy in a globalized world. What other important ingredients need to be considered when implementing monetary policy or when forecasting growth and inflation ahead? The role of external shocks is likely to become more important and needs to be considered more carefully. We need to find ways to anticipate these shocks including the future financial architecture and improve upon limitations in our foresight and in the forecasting ability of our models.

Fifth, the role of policy makers in other countries which will add to these external shocks opens up room for greater policy coordination and cooperation at the international level. Like other previous crises, the current crisis is likely to be followed by discussion about intensive reforms at the international level. We should grab this opportunity to highlight the need for international cooperation in monetary policy in maintaining global financial stability. I don't need to point out that international cooperation in the area of supervision is far ahead, both in normal times and in time of crisis.

In order to secure international cooperation in monetary policy, we need more research and dialogues on how to make early warning and surveillance really work at a global level. In addition, coordination may not be enough; a redesign of global financial architecture may be necessary, and we need to work on this area as well.

One last point before I end, I believe that most of us now agree that central banks need to maintain financial stability in addition to price stability. Therefore, we also need to improve our understanding of the implications of globalization on financial stability, as well as the tools to conduct monetary policy in addition to the interest rate tool for stability purposes.
