Policy Attentions of Central Banks: a decade after the global crisis

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Ladies and Gentlemen,

I'd like to thank the SEACEN and the BIS for inviting me to join this SEACEN-BIS High level Seminar. It's always a pleasure to be back among fellow central bankers especially in this serene setting of Nay Pyi Daw.

We are now close to a decade since the Global Financial Crisis erupted in *2008.* In spite of the massive liquidity injection via unconventional monetary policies of a number of countries to shore up their economies, the path of global recovery is still slow, uneven and fragile. It’s a widespread concern that the world will face low growth and low inflation for some time to come, the so-called “new normal”.

The current global economic and financial landscapes have and still are changing substantially and rapidly, of which the new normal of low growth and low inflation is only one symptom. Today, the topic suggested to me was on the challenges of financial growth for monetary policy. I'd like to look at central banks from a broader perspective and talk about "Policy Attentions of Central Banks: a decade after the global crisis". I’ll start with the changes, both cyclical and structural, which have been brought about as a result of the aftermath of the global crisis, changing socioeconomic conditions and digital revolution. I'll then talk about the challenges that Central banks need to focus their attention to, in order to support their economies and safeguard against risks.

On the cyclical issue, the current slow and uneven global recovery reflects the massive leverage-based imbalances built up before the crisis, debt overhang and the interplay between financial and business cycles.

With widespread unemployment and high debt, deleveraging of consumers, investors, businesses and financial institutions is a continuous process, regardless of the record-low interest rate. Hence, there is a weak link between aggregate demand and interest rate on the one hand, and between credit demand and interest rate on the other. On the supply side, the troubled financial sector lacks the financial ability to support businesses and consumers, in addition to its tightened credit underwriting standards to safeguard capital. Hence, as noted in the literature, financial cycles amplify the depth and duration of business cycles and recovery from a recession takes longer. When the crisis is on a global scale, the recovery will take even longer since a country cannot count on exports as its way out.

A decade of economic slumps, despite large and sustained monetary measures to stimulate demand, suggests that the global low and uneven growth is not just a cyclical business and financial problem that can be fixed with expansionary monetary policy but rather a structural one. The Japanese experience of low growth and low or negative inflation in the last two decades in spite of their very accommodative monetary policy stance is also telling. More recently, the drastic decline in oil prices since 2014 has yet to lead to a higher growth as a consequence of higher consumer spending via the income effect, as would have been the case if the sluggish growth were due to cyclical demand slack.

There are indeed various factors that have caused structural changes in the global economic landscape. The current fast evolving and changing information and digital technologies, for example, are changing business models, market demands and supplies through channels such as e-commerce both domestically and globally, resulting in changing trade patterns and competition. These developments also create significant uncertainties and risks for potential investors for fear of investing in the wrong technologies or products, impacting the timing and / or the size of investment. Population aging and the global expansion of the services sector, which tends to be less capital intensive than the traditional manufacturing sector, also lead to lower demand in investment. Consumption demand may have seen a structural downward shift due to significantly widened income and wealth inequality since the Global crisis as the rich, who are now much richer, have a lower propensity to consume. In emerging economies where urbanization and the middle class are expanding, the increase in consumption needs may not be sufficiently met by income, leading to substantial increases in household debt. The cyclical and structural changes suggest a downward shift in global potential outputs and a weakened monetary policy transmission mechanism.

In addition to the socio-economic and technological factors, the Global crisis itself is likely to have also caused a sustained decline in investment over the long period after the crisis, resulting in a decline in global potential outputs. After a crisis, it usually takes time for excess capacity, investments and inventories to wear off before new investments are added on. The bigger the crisis, the longer it takes for this process. This sustained lack of capital formation also translates into a downward shift of potential output.

Not only the economic landscape but also the financial landscape has changed. Digitalization, Fintech and cryptocurrencies are fast evolving. While new technologies have the great potential to cut costs and improve financial efficiency, they also bring about great challenges in supervision and risks. Cyber security and regulatory arbitrage between banks and non-banks are just some examples of newly emerged threats in the new financial landscape.

Changes in the economic and financial landscapes and their interplay indicate that monetary policy is no longer a very effective tool in managing short-term aggregate demand and inflation. But even more importantly, monetary policy has unintended consequences. Asian economies have learned since the Asian crisis—as have advanced economies since the Global crisis—that a long period of lax monetary policy can sow the seeds of financial instability with the build-up of imbalances, causing tremendous pains and losses. However, that it has unintended consequences on potential outputs, with the likelihood of causing longer term economic pain and losses, needs to gain more attention. This important point could be easily overlooked when attentions are focused on the supply-side factors of declining potential GDP such as population aging.

Global financial stability remains a concern. Global nonfinancial sector debt has significantly increased and is now higher than the pre-crisis level. The increase came from both advance and emerging economies, but more from the latter. Yield searching capital flows, which are immense at times, have the potential to cause financial imbalances, currency appreciation and other risks associated with volatility in emerging economies.

What then are the policy implications that follow from these changes?

1. Central banks need to be very careful in deploying monetary policy for futile short-term demand management and be more aware of the adverse long-term output consequences and financial stability issues.

Furthermore, inflation risk is likely to be on the low side with the new normal, Therefore, preserving policy space, especially for those with already low policy rates is necessary. The quantitative and qualitative impacts of unconventional monetary policy tools and negative interest rate are a terrain neither the authorities nor the markets know very much about and one should try not to be pushed into that corner. In addition, negative interest rates put strains on a bank's profitability since it may not be able to pass it on to its depositors even when it gets a negative return, say, from its treasury operations, as well as compelling it to take higher risks for higher yields. This could potentially lead to instability of the financial sector.

The Bank of Thailand last cut its policy rate in the second quarter of 2015 and has since maintained its policy rate at 1.5% even though there have been calls for a rate cut to spur growth and discourage capital inflows and currency appreciation. The MPC has made the right decision to preserve policy space. The correlation between rate cut and growth is weak as discussed and empirical study indicates low correlation between interest rate differentials and capital flows.

2. Since financial stability is still very much a concern, efforts to safeguard against the risk must be vigorously continued with a solid framework covering the governance arrangements for effective prevention

and management when financial instability is detected. Pertinent issues include institutional setup and processes for risk monitoring, analysis, policy decision and implementation, internal and external coordination and communication.

The Bank of Thailand has set up a Financial Stability Unit tasked with the monitoring, analysis, tools and policy developments, and internal and external coordination with regards to financial stability issues. Dialogues, exchange of information and views must also take place at the top both internally and externally. Bank of Thailand's top management across different functions meets quarterly to assess systemic risks. The MPC or Monetary Policy Committee, tasked with maintaining price stability and the FIPC or Financial Institution Policy Committee, tasked with maintaining the safety and soundness of individual financial institutions, apart from their own meetings to carry out each committee's mandates, also meet bi-annually to share information and views on systemic issues, and if needed, decide on the macro-prudential measures. Note that the Heads of the supervisory agencies for the stock market and insurance business, the SEC and OIC, sit on the FIPC, hence all parties responsible for different segments of the financial markets are kept abreast of the markets' developments. The importance of internal and external communication and coordination cannot be over emphasized. Since macro-prudential policy relies on micro prudential regulation, the framework must facilitate a very high level of coordination across agencies and provide adequate respect for their policy autonomy.

Identification and analysis of financial stability risks, which are systemic, are much more difficult than the similar exercises on individual risk. Therefore staff competencies and analytical capacity strengthening are critically important. Apart from the formal training of core staff in this area, it's important that departments must not work in silos. Open dialogues must be encouraged so that staff can broaden their perspectives beyond their backgrounds and trainings and help foster a culture that focuses on systemic risks. Sharing of information and views helps expose systemic vulnerabilities that may not be easily identified by a single department or discipline. Regular staff rotation also serves such a purpose. At the Bank of Thailand, open job posting for a vacancy and staff exchange programs with other regulatory agencies are in place to promote staff agility, which serves the fast-changing environment brought about by technologies as well.

3. Macro-prudential policy must only complement, not substitute monetary policy. As we know, many macro-prudential tools are now being

used, especially by emerging market economies. In addition, there are rule-based measures such as counter-cyclical capital buffer and dynamic provisioning. These tools are likely to have different transmission mechanism. Integrating these policy measures into a vigorous analytical framework to gauge their quantitative impact and lead or lag times is often difficult. In addition, they work on certain targeted segments and may become less effective when the market finds ways to go around them. A loan-to-value requirement on the banking sector, for example, may lose its effectiveness in discouraging mortgage loans if the non-banking sector which may be less well regulated, starts to take up the decline in the banking sector. Using macro-prudential measures with continued lax monetary policy will only shift the imbalances from one area to another.

The BOT has utilized macro-prudential tools on a number of occasions with success including loan to value ratio, minimum income and monthly payments for credit card loans and consumer loans and dynamic provisioning. In the interest of time, I’d like to highlight only two unique experiences of implementing macro-prudential measures.

The first episode took place in 2006, which I’m proud to have initiated. The Bank of Thailand required banks to observe IAS39 on impaired asset and provisioning, two years ahead of the Thai accounting body's planned schedule. Under this accounting standard, assets are to be measured at fair value and as a result banks would have to meet higher provisioning requirements. Since the economy had been growing well, at the rate of 5% per year and above, since 2002 and banks had been paying out handsome dividends, we decided to adopt the requirement early while banks were in good shape and willing to comply. This was clearly a forward-looking measure, building or preserving capital for a rainy day, in line with the concept of a cyclical capital buffer, even before it had become an important element of Basel III.

The second episode took place in 2014, when housing and car loans were expanding rapidly and household debts were becoming a concern. From regular bank visits, examiners suspected that this may not have been an industry-wide phenomenon but only attributable to some aggressive banks. Hence, instead of imposing some macro-prudential tools to the banking industry, the Bank of Thailand decided that it would take a more targeted approach. It launched a simultaneous special audit of the entire banking sector looking into each bank's housing and car loans portfolio, focusing on their underwriting standard, loan quality and rate of expansion. The result confirmed examiners' earlier suspicion. Only about half of the Thai banks and a quarter of the foreign banks were aggressive in those lending, with their loan to value ratio of over 70% and debt service ratio of over 40%, both above the industry average. Loan quality did not indicate a major problem, which is usually the case in the early life of a loan. Those aggressive banks were asked to bring their underwriting standards to be more in line with the industry average. This was a unique exercise in preventing potential problems both at the micro and macro levels. The launch of an industry-wide special audit in itself was a strong signal to the industry about the Bank of Thailand's concerns on this loan segment and discouraged banks from their aggressive lending.

Here I'd like to add that even when the banking system is healthy, there could be pockets of risk from nonbanks and other sources. Therefore, developing a comprehensive financial stability framework that goes beyond a bank-centric and micro-prudential point of view is necessary.

4. Emerging economies must strengthen their economic and financial resilience as a safeguard against buildup of imbalances as a result of global spill-over. Inflows can be very disruptive especially for smaller countries but a sudden reversal of the flow can be even more so.

After the Asian crisis, the Bank of Thailand moved from a fixed exchange rate regime to a flexible one, revamped bank supervision from compliance-based to risk-based, making a bank's management and directors accountable for their own risk management and more recently has adopted stress testing as a tool to ensure financial sector stability. All these reforms have resulted in significant improvement of economic and financial sector resilience. The banking sector is well capitalized, currently with a capital ratio of over 18%. Public debt is relatively low, around 44% of GDP and foreign exchange reserves are about 3.2 times of outstanding short-term foreign debts.

5. Although the implementation of structural reform measures to revitalize long-term growth is outside the realm of a central bank, the latter can and should play an important supportive role by promoting efficient and safe financial infrastructure, which leads to productivity increase and in fact, enhances financial stability as well. Relevant laws and regulations need to be amended to accommodate new players with new technologies while risks are safeguarded.

The Bank of Thailand has actively embraced digitalization and Fintech into the country's payment and financial system to improve convenience and regional connectivity and lower costs. Regulatory sandbox has been set up to enable non-bank providers and Fintech startups to test and work together with the supervisor for risk management of their new products and services, with more flexible regulatory practices to avoid stifling innovations.

Last but not least, I'd like to talk about data mining, which is not monetary policy, doesn't appear to be a central bank's role and seems out of place in today's seminar. But this is a powerful supporting tool for a central bank to play its role in promoting growth and stability. After a pilot project last year, the Bank of Thailand embarked on several data mining projects earlier this year, such as the mining of export invoice data to better understand the nature of exports and exporters, and of electricity bill payment data. These exercises give insights into different segments and transmission channels of the economy in ways that were not possible before. Analysis of electricity bill payment big data, for example, sheds light on whether a booming condominium market is due mostly to residential or speculative demand from the different patterns in electricity consumption. Fluctuation in electricity consumption in apartment buildings and condominiums in line with the country's tourist seasons may suggest the prevalence of units being rented out as Airbnbs, a source of tourism revenue that was not captured before. Electricity consumption in different regions and industries can give important economic information. Text mining in social media with reference to certain key words can give useful information on unemployment and job hunting. It goes without saying that clear data governance arrangements must be in place to earn the trust of data providers and users for these exercises.

I’d like to end my talk today with a quote by Jimmy Dean that says “I can’t change the direction of the wind, but I can adjust my sails to always reach my destination”. The ultimate goal of a central bank is to improve economic well-being of the country. The means toward that end and the intermediate goals have been adjusted along the way. Decades ago, central banks, especially those of emerging economies today, played an active role in developing the financial market, instruments and infrastructure. Before the Asian crisis the focus was on growth and price stability, and financial stability was added on after the crisis. With the effectiveness of monetary policy on growth and price diminishing, while the risk of financial instability remains high a decade after the global crisis, it’s inevitable that central banks adjust their focus of attentions accordingly.