

Navigating monetary policy trade-offs: some conceptual and practical considerations for Asia-Pacific economies

Average consumer inflation in developing Asia-Pacific economies was at a multi-decade low level of 4.1% in 2015. The deep plunge in global commodity prices, especially the prices for crude oil, mainly accounted for the lower inflation. In economies where official data on core inflation, or overall inflation excluding food and energy items, are available, there is some evidence that an economic slowdown also contributed to softer inflationary pressure. Without the rationalization of energy price subsidies that took place in many net oil-importing economies, the pass-through from declining producer prices to consumer prices would have been stronger, resulting in even lower consumer inflation in 2015.

Not surprisingly, therefore, in economies with low inflation and weak domestic demand, monetary policy has eased notably. The Republic of Korea, Sri Lanka and Thailand lowered their policy interest rates by 50 basis points in 2015, while India reduced them by 125 basis points and Pakistan by 300 basis points. In all of these economies, the policy rates reached their multi-year low levels by end-2015. In the early months of 2016, Bangladesh also reduced its policy rate by 50 basis points, while Indonesia lowered its policy rate by 75 basis points.

Monetary policy is more than just inflation stabilization

A low-economic growth, low-inflation environment in the region would generally suggest that there is further room for an easy monetary policy stance in the coming few years. Of the 48 Asia-Pacific economies, 22 are expected to experience lower output growth and inflation rates in 2016 and 2017 relative to their past trends recorded during the period 2010-2015. These economies include, among others, China; Hong Kong, China; Indonesia; the Republic of Korea; Singapore; and Turkey. As far as monetary policy goals of maintaining price

stability and promoting steady economic growth are concerned, monetary policy support can be deemed desirable in these economies given below-trend growth and inflation prospects.

However, monetary policy considerations should go beyond concerns of near-term economic growth and inflation, and be mindful of other issues, such as financial stability, exchange rate movements and capital flows. In particular, a monetary policy stance that is kept too loose for too long could undermine domestic financial stability because firms and individuals tend to undertake riskier investment decisions when their balance sheets look stronger than they would otherwise. In many regional economies, financial stability is already being closely monitored. For instance, amid excessive growth of broad money, Sri Lanka reversed its easy monetary policy stance by raising the policy rate by 50 basis points in February 2016 after a reduction of a similar magnitude in April 2015.

The need to strike a balance between the role of monetary policy in supporting economic growth and ensuring financial stability is especially relevant in economies where household and/or corporate debt levels are already relatively high or rising rapidly, such as China, the Republic of Korea and Singapore, as well as those with currently high loan default ratios, such as Armenia, Maldives and Mongolia.

Monetary policy and related liquidity generating developments in advanced economies also tend to have a bearing on the conduct of monetary policy in emerging economies. The key channel of influence is external account stability via sharp changes in capital flows and exchange rates, which in turn has implications for domestic financial stability in terms of changes in the balance sheets of corporates and banks. In this context, as interest rate increases in the United States move forward gradually, the

gap between interest rates in the United States and the region could narrow further and potentially result in greater capital outflows and currency depreciations.

In such circumstances, it could become difficult for developing economies in the region to lower their interest rates further despite low inflation and weak economic growth. They may consider continuing with current levels of interest rates provided a weaker exchange rate is accepted and external account stability is maintained. Such conditions seem quite constrained in some economies, such as Turkey, where the size of external debt and reliance on foreign funds have increased markedly since the global financial and economic crisis of 2008.

In short, increasingly interconnected global financial markets means that nationally optimal policies, such as interest rate reductions to promote economic growth, are neither possible to implement nor ideal when taking into account cross-border spillover effects, such as heightened risk of capital outflow.

Conventional thinking on monetary policy needs to be revisited

The effectiveness of conventional monetary policy – reducing short-term interest rates in the wake of low inflation – seems to have decreased amid rising economic uncertainty due to concerns over an uneven economic rebound in advanced economies, growth deceleration in the region and heightened volatility in financial markets. Moreover, in several countries where short-term interest rates have decreased following monetary policy easing, the evidence on the link between borrowing costs and domestic credit growth is mixed. For examples, in large economies such as India, Indonesia and Thailand, domestic credit growth decelerated in 2015 despite lower short-term interest rates. Investors remained cautious as a result of uneven progress on policy reforms and/or weak domestic demand that led to low industrial capacity utilization rate.

Unusually low inflation also means that real interest rates have increased despite lower nominal interest rates. For instance, in Hong Kong, China; Malaysia; the Philippines; Singapore; and Thailand, inflation-adjusted lending rates increased and domestic credit growth slowed in 2015. Moreover, it appears that real earnings growth has decelerated or has been negative in economies such as Hong Kong, China; Indonesia; the Republic of Korea;

and Thailand, likely because subdued economic activity and low inflationary expectations limited nominal wage adjustments.

In this context, conventional monetary policy thinking has been questioned in recent years. According to the dominant framework regarding the conduct and design of monetary policy, at least until the 2008 global financial and economic crisis, a rule-based policy implemented through adjustments in short-term interest rates with flexible exchange rates and focused primarily on price stability was considered superior in keeping both inflation and economic activity stable. At the same time, the financial markets were largely de-regulated, the role of monetary and credit aggregates de-emphasized, and institutional arrangements, such as independence of central banks and their distance from the fiscal authority, were taken as a given.

As the crisis unfolded, many analysts questioned the validity of this simplistic framework and argued that “unconventional” monetary policies are needed to help lift crisis-affected economies out of deep recession. Among other tools, unconventional monetary policies typically refer to zero interest rate policy, quantitative easing, credit easing, forward guidance, negative deposit rate, and sustained foreign exchange intervention. Studies often suggest that these policies have helped to raise output growth and warded-off deflationary concerns in advanced economies after the global financial crisis.¹

Thus, in a sense, what was deemed conventional before the 2008 crisis has now become unconventional, and what was considered unconventional may have become part of the central banking toolkit. However, a consensus view on this issue has not fully emerged yet. Some analysts believe that the conduct of monetary policy should return to a rule-based strategy,² partly because unconventional policies target certain sectors only, for instance, the housing market through purchase of mortgage-back securities, and that is beyond a central bank’s mandate. They argue further that the positive effects that unconventional monetary policies have had on output in advanced economies may turn out to be state-contingent and become less certain once normal macroeconomic conditions resume.³

On the other hand, economists who support the use of unconventional policies argue that traditional monetary stimulus works only when the channels

of transmission of monetary policy function well. When such channels are impaired, there is room for unconventional policies.⁴ Moreover, for traditional monetary stimulus to be effective, this must be accompanied by temporary fiscal stimulus (particularly infrastructure investment)⁵ and/or structural policy reforms,⁶ but both tend to be absent or weak in many economies.

Even among those analysts that support the use of unconventional monetary policies, there is debate on the extent of their implementation and range of instruments being used. For example, while measures such as currency swap lines among central banks to accommodate liquidity shocks are generally viewed as desirable, other measures such as incentivized lending schemes are often viewed as too costly.⁷ On the conditions of implementation, policies to promote financial stability, such as liquidity provision to credit markets, are considered as appropriate only in economies with effective regulation and supervision.⁸ Similarly, policies to promote macroeconomic stability, such as bond purchases, are effective when central banks are highly credible.

It is perhaps too early to tell whether unconventional monetary policies should become part of standard monetary policy toolkit in emerging economies, including those in Asia-Pacific. As highlighted above, the effectiveness of unconventional policies is contingent upon having appropriate monetary policy institutions and framework in place, which is not always the case in many emerging economies in the region. Moreover, the unintended, medium-term consequence of unconventional policies, both in countries that implemented them and in countries affected by spillover effects, are still not well understood.⁹ For example, unconventional policies have inflated asset prices, which favour bond holders and property owners relative to savers and wage earners, thus altering income distribution.¹⁰ However, what is clear is that many central bankers' key concerns go beyond inflation

stabilization and include considerations such as financial stability, minimal exchange rate volatility, and sovereign debt sustainability. Incorporating such changes in domestic monetary policy framework may require a new set of monetary policy instruments and enhanced international cooperation on reforming international monetary system and strengthening financial regulation. The progress on this front has been slow so far.

¹ See Mark Stone and others, "Should unconventional balance sheet policies be added to the central bank toolkit? A review of the experience so far", IMF Working Paper WP/11/145 (Washington D.C., 2011), and Leonardo Gambacorta and others, "The effectiveness of unconventional monetary policy at the zero lower bound: a cross-country analysis", BIS Working Papers No.384 (Basel, Switzerland, Bank for International Settlements, 2012)..

² John Taylor, "A monetary policy for the Future", *Economics One blog*, 16 April 2015.

³ Andrew Haldane, "How low can you go?", Speech made at Portadown Chamber of Commerce, Northern Ireland, 18 September 2015.

⁴ European Parliament, "The (not so) unconventional monetary policy of the European Central Bank since 2008" (Policy Department, IP/A/ECON/2014-02, 2014), and Jean-Claude Trichet, "Unconventional monetary policy measures: principles—conditions—raison d'être", *International Journal of Central Banking*, 9(S1), January 2013.

⁵ Nouriel Roubini, "An unconventional truth", *Project Syndicate*, 1 February 2015.

⁶ Duvvuri Subbarao, "Central banking after the crisis: the challenges ahead", *Think Business*, National University of Singapore, 29 July 2014.

⁷ Kei-Ichiro Inaba and others, "The conduct of monetary policy in the future: Instrument use", OECD Economics Department Working Paper No.1187 (Paris, 2015).

⁸ Mark Stone and others, "Should unconventional balance sheet policies be added to the central bank toolkit? A review of the experience so far", IMF Working Paper WP/11/145 (Washington D.C., 2011).

⁹ See G30, "Fundamentals of central banking: lessons from the crisis", Group of Thirty (Washington, D.C., 2015), and John Williams, "Will unconventional monetary policy be the new normal?", Presentation to UC San Diego Economic Roundtable on 3 October 2013.

¹⁰ See Bloomberg Business, "Central banks fight to ensure crisis tools become the norm", 19 November 2015, and PWC, "At a crossroads: the future of central banking", Summary report of PWC's 2014 Central Bank Forum (2015).

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