

PROCEEDINGS OF THE 3RD SEACEN-CEMLA CONFERENCE ON “NEW PARADIGM IN CENTRAL BANKING”



21-22 October 2013

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BANK NEGARA MALAYSIA
CENTRAL BANK OF MALAYSIA



The **SEACEN** Centre



CENTRO DE ESTUDIOS MONETARIOS LATINOAMERICANOS

FOREWORD

With globalization, re-regulation, innovation in informational technologies, the economic and financial landscape is fast evolving. Since the global financial crisis, many argue that we face a “new normal” for most economies which is now characterized by below-trend economic growth, high unemployment, and ultra-low interest rates.

Given the above scenario, central bankers are now challenged by a new paradigm in terms of the economic and financial environment which will affect key aspects of future central banking policies. The economic structure, business processes and the way economic agents react to the changing phenomena is systemically different under this new paradigm. The highly interconnected world of macro-financial linkages and the uncertainty they create are making central banking policies based on the old paradigm, less effective. In response to this new environment, many central banks have planned or have already explicitly expanded their mandates to include maintaining financial stability.

There has been a growing call for a revival of the subdued and even abandoned role of the central bank in promoting sustainable economic growth and full employment by providing an environment conducive to supporting new areas of growth stemming from the rebalancing growth strategy. In addition, there is evidence of uneven distribution of assets and wealth following the crisis in emerging markets. Given this scenario, the roles and responsibilities of central banks in the new era are expected to expand considerably. Hence, the expanded mandates have brought about new and different challenges for the conduct of monetary policy. For example, what is the best nominal anchor for monetary policy and what is the implication of that choice of anchor for the mandate of the central banks? How and to what extent can central banks cooperate to achieve their given mandate?

These were some of the important questions that were raised and addressed at the **3rd SEACEN-CEMLA Conference** on “New Paradigm in Central Banking” sponsored by Bank Negara Malaysia and Banco Central de Chile (Central Bank of Chile) in Kuala Lumpur, Malaysia, on October 21-22, 2013. SEACEN is privileged to have played host to this Conference which was held back-to-back with the SEACEN 30th Anniversary Conference.

The SEACEN-CEMLA Conference provided a unique opportunity for central banks from the Asian, Latin American and Caribbean regions for the sharing of experiences and deliberating on the shaping of central banks in the new paradigm, rethinking of monetary policy in the new economic environment and challenges for economic growth and financial stability in the Asian and Latin American economies in the “new normal”.

We are happy to share the discussions and presentations via the publication of these proceedings. Indeed, it is hoped that this annual Conference will continue to promote cross-regional collaboration and cooperation between the two regions, leading to further initiatives to strengthen networking and central bank learning.

Hookyu Rhu
Executive Director
The SEACEN Centre

Fernando Tenjo Galarza
General Director
CEMLA

February 2014

SUMMARY OF PROCEEDINGS

Since the breakdown of financial stability during the global financial crisis (GFC), the traditional role of central banks as guardians of monetary stability and financial sector regulation and supervision has come under scrutiny. Under a new paradigm, a redefinition of the role of central banks is needed, a broadening of mandates, comprising monetary as well as financial stability and other functions.

This Conference addressed this issue in five subtopics – (i) the current macroeconomic developments and outlook, (ii) shaping central banks in the new paradigm, (iii) rethinking monetary policy in Asia and Latin America, (iv) exchange rate and competitiveness in a world of high liquidity and finally, (v) challenges for economic growth and financial stability in Asia and Latin America under the 'New Normal'.

Ever since the GFC, the Federal Reserve (FED) has moved into the limelight of public interest in the USA and also globally. This interest is manifested in the growing number of financial reporters in the USA up from some 2500 in 1980 to more than 12,000 last year. The growing interest of the public in monetary policy decisions can be explained by the growing number of home ownership (some 68% of family units) as well as equity ownership in the USA. Monetary policy has thus become a political issue. The increasing transparency has also called for a clarification of what monetary policy can and cannot do. There are obvious limits, most notably fiscal policy.

A dilemma of this increased prominence of monetary policy is that political pressures should not compromise central bank independence. When the going was good, monetary policy received praise, but after the GFC struck, the FED was blamed for neglecting the downside risks. These were the deterioration of asset quality, the mis-identification of new and pyramiding risks, the single point of failure of underwriting these risks by an insurance company (AIG) and the historically low teaser rates which turned out to be the trigger of the GFC. The lessons from the GFC and the protracted recovery have given rise to challenges to an independent monetary policy and the adequacy of micro-prudential regulation.

Resisting political pressure is also in the interest of the global central banking community. Their cooperation has come under strain because of increase in global liquidity and the transfer of this liquidity to emerging markets (EME) through capital flows. Signs of withdrawal of this liquidity have caused stress in financial markets of EME. There is a danger of over-reaction by central banks, from excess liquidity to scarce liquidity, from lax regulation of the financial sector to overly strict regulation. However, the new leaders of the FED are well qualified to balance the domestic concerns with those of the international central banking community.

Comparing the economic outlook in Asia with that of Latin America, there are commonalities as well as differences. The major players in Asia have been caught up in the slow-down of global growth. In addition, China has reined in the excessive credit growth since the GFC, while India grapples with structural problems which dampen investment. However, thanks to the shift to domestic growth in Asia, the fallout of the above mentioned slow-down did not affect the rest of Asia too sharply. Growth in Latin America is slowing and converging to more sustainable levels. In the past, the limited progress in expanding potential growth has acted as a growth impeding factor.

Inflation has been in check in both Asia and Latin America with a wide dispersion among countries, even rising inflation in isolated cases. In Latin America, inflation is mostly in line with

targets set by central banks, but any further decline is unlikely as the perceived output gap has already turned positive. Current accounts remain positive in Asia, whereas deficits prevail in Latin America reflecting opposite savings patterns.

The major difference between the two regions is the overall savings pattern. Whereas Asia (mostly China's households and enterprises) has excess domestic savings, Latin America has low and decreasing savings. This results in financial surpluses in Asia, whereas Latin America relies on external financing for its growth. This has allowed Asia to build up its foreign exchange reserves. However, Asian savings continue to be intermediated by the global financial system rather than in the region.

Weak commodity prices are having a positive impact on raw material importers in Asia as in Latin America. However, the widespread high dependence on commodity prices might pose problems in the future as necessary structural reforms might be postponed in such a benign environment. Lack of progress in governance reform might also be a draw on future growth. Asia has done a fair bit in structural reforms, but improving on governance might be needed as a way out of the middle income trap. These might be resisted by vested interests, which puts structural reforms well beyond the mandate of central banks.

Chile as a commodity exporter is a case in point for allowing adjustment to work. It has faced the maturing commodity boom (the supercycle is over), falling commodity prices and deteriorating terms of trade as well as capital flow reversals as in other EMEs. Thanks to a freely floating exchange rate, unrestricted capital flows, solid banking supervision and deep and liquid financial markets the overall impact of these adverse external developments has been manageable. The exchange rate absorbed the thrust of the shock and domestic investors have filled the gaps left by foreign withdrawals.

After setting the stage, the discussion turned to the core topic, shaping central banking in the new paradigm. There is broad agreement among central banks that although managing inflation will remain the key objective of monetary policy, recent experience has shown that price stability is not enough to ensure financial stability. Persistent low inflation and interest rates might even provoke financial instability. The search for yields and returns might lead to excessive leverage and increase of risk taking. Buoyant asset prices lead to overvaluation of collateral and over optimistic assessment of risk. Thus, benign monetary conditions have contributed to the build-up of financial risks which struck, once a more realistic assessment set in.

The lessons from the GFC have led to a better appreciation of macro-financial linkages. Monetary policy failed to detect the build-up of financial stability risk even during stable macro-economic conditions as noted earlier with the FED experience. Central banks have to preempt financial instability, to operationalize surveillance and policy responses. In addition to interest rates, policy measures should include macroprudential regulations and other regulatory measures once such build-up of financial risk is perceived. International coordination of macroprudential measures is called for in order to prevent foreign banks undercutting domestic lending standards.

Bearing in mind the present global monetary policy stance, spillovers from the AE are causing problems for the conduct of monetary policy in EME, manifested in negative effects such as exchange rate overshooting, volatility of exchange rates, loss of export competitiveness, rapid credit expansion and asset prices bubbles. The reversals of capital inflows exacerbate these negative effects. Policy makers in EME are left on their own to protect themselves by applying capital flow management measures. These were finally endorsed even by the IMF.

This complex policy environment with strong interactions of monetary and financial stability has led to a rethinking of central bank mandates. The main challenge is how to integrate the two functions? A first step would be to adopt an explicit financial stability objective in the central banking laws. Although many central banks in advanced economies (AE) and EME have done so (some 82% of central banks have some form of financial stability mandate), financial stability remains a shared responsibility with other agencies. Therefore, a collaborative mechanism has to be found to apportion accountability.

Many EME central banks already have responsibility over multiple mandates. A broader financial stability mandate involves a wider and more ambiguous range of outcomes, compared with the simplicity of an easily quantifiable monetary policy target. In pursuing multiple tasks, the central bank needs to engage with many different stakeholders. Malaysia has already established an inter-agency committee, the Financial Stability Executive Committee. Central banks might face risks of moral hazard when it comes to systemically important financial institutions (SIFIs). Finally, the central bank's independence might be compromised with respect to exercising shared responsibility for crisis prevention, management and resolution.

Wider central bank mandates might include the management of capital flows, leaning against the wind during the build-up of financial risk, financial sector development, promoting deep and liquid financial markets, financial inclusion, market conduct and consumer protection. In pursuing financial stability would the central bank be as independent as it is in its pursuit of monetary stability? Reining in the build-up of financial imbalances might meet political resistance as a buoyant economy is sign of success of a government's economic policies. Government revenues are buoyant during such times and any curtailing of such a boom would be politically unpopular. Would the central bank be able to regulate and monitor the shadow banking which finances a growing share of this boom?

The downside of multiple mandates of central banks cannot be neglected. Central banks will be held accountable for less well-defined financial stability outcomes. Communication and transparency become more challenging, as unrealistic expectations might arise. If a financial crisis occurs, the central bank might be blamed by the general public for the loss of welfare during the crisis. The resolution of insolvent banks will need funds other than from the central bank, first and foremost from the ministry of finance. There might be cross-policy contagion such as compromising of monetary policy in order to save financial institutions. Finally, the organizational culture in a central bank might not be conducive for these multiple tasks.

Adopting a multiple task mandate by a central bank requires safeguarding the central bank's independence, observing strict corporate governance and strengthening risk management. The potential sources of risk are strategic (e.g., failure to anticipate adverse developments), policy (e.g., failure to adopt proper policy response), financial (e.g., from rescuing insolvent institutions) and operational (e.g., failure to involve all affected parties). Once the risks have been identified, how should they be flagged to the stakeholders of a central bank? Moving from single mandate to multiple mandates in a central bank will be a major challenge ahead, and sharing of experiences such as the present Asian-Latin American dialogue will be very helpful.

The experience of the Banco Central do Brasil (BCB) has been enlightening. Even before the GFC, the BCB created a Financial Stability Committee within the Bank, adopted a 'twin peaks' supervisory model, covering regulation as well as consumer protection, and improved credit and trade data depositories. If the central bank takes on additional mandates, this requires more instruments. Regarding monetary stability, the IT framework has served the BCB well; however,

projection models, such as DSGE need to incorporate the financial sector. In addition, the BCB has adopted macroprudential measures targeting both credit markets and capital flows (such as taxes on capital inflows). These helped to reduce short-term, risky flows and moderate credit growth to sustainable levels. The BCB also helps to cushion the foreign exposure by offering foreign exchange hedges. These measures are part of the BCB's response to the imminent 'tapering' in AE. These measures have resulted in significantly lower exchange rate volatility and lower risk premiums in asset markets.

In view of multiple mandates for central banks, their traditional role of preserving monetary stability needs rethinking as well. The GFC has shown that focusing on low and stable inflation has not led to economic growth at its full potential. As the relation between output gap and inflation has weakened, central banks might consider targeting economic growth more directly. The phenomenon of fiscal dominance has re-emerged and central banks might be under pressure to delay the exit from QE and/or delay raising interest rates. In times like this, the central bank has to reassert its independent monetary policy decision making. If fiscal consolidation is delayed and the central bank continues its easy monetary policy, markets might react by forcing higher real interest rates.

In the past microprudential regulation of individual institutions was considered sufficient for the transmission of monetary policy signals. New insights into the interactions among financial institutions and between the financial sector and the real economy have shifted the focus from monetary policy instruments (notably the interest rate) to macroprudential instruments (such as LTV ratios) to rein in excessive credit growth. In actual fact, low policy rates have led to excessive credit growth and risk taking which could be reined in by central banks only through macroprudential measures. There is still no consensus what is included in macroprudential instruments and how these actually work. So far, central banks have managed to avoid suboptimal solutions (too lax or too tight policies) resulting from the disconnect between the two types of measures.

Comparing the performance of monetary policy in Asia with Latin America after the GFC, Asian central banks have been rather successful in managing inflation and growth. In the wake of the Asian crisis, Asian central banks have tightened supervision, improved controls on leverage, bank capitalization and various prudential instruments. Asian central banks also acknowledge the risks posed by volatile capital flows. These are: i) macro-economic risks due to the expansion of domestic liquidity, exchange rate appreciation due to capital inflows; ii) risk of financial instability due to currency and maturity mismatches; and, iii) the risk of sudden stops and reversals. Asian central banks have taken macroprudential measures to manage capital flows.

While some advanced EME in Asia have deep and liquid financial markets, obviating the need for capital controls even in the short-term, other central banks have resorted to temporary use of capital controls. Asian EMEs have been successful in preventing excess volatility of exchange rates, but sterilized intervention had limited effectiveness as it proved costly and resulted in central bank losses.

Latin American central banks have faced the same challenges as Asia since the GFC. They also observed a weaker relation between inflation and output, calling for policy instruments other than the traditional interest rate policy. It was necessary to improve the coordination of monetary policy with other macroprudential instruments. Overarching committees such as the Macroeconomic Coordination Committee and the Financial Stability Committee were established. In addition to this institutional strengthening, Latin American central banks have

benefitted from anchored lower inflation, continued growth, low external deficits, reserve accumulation and fiscal consolidation in most cases. Finally, a flexible handling of IT regimes and freely floating exchange rates have facilitated an adequate monetary policy response.

Central banks in both regions have weathered the fall-out from the GFC so far, but the big challenge will be how they will be able to manage the 'tapering', a return to more normal global monetary policy.

In order to strengthen central bank cooperation between Asia and Latin America, some form of institutionalized sharing of experiences was proposed. These include a joint SEACEN-CEMLA website, joint research as well as mutual technical assistance to share best practices. As mandates for central banks become broader, there is lots of scope to share experience, such as the role of central banks in financial sector development, in the deregulation of financial markets, in promoting financial inclusion as well as consumer protection.

One of the major challenges for EME since the GFC was the fallout of high global liquidity on their exchange rates and competitiveness. Central banks have become specialized in national monetary policy but did not see the complex way financial risks were emerging at a global systemic level, with a surge in systemic liquidity stoking credit expansion. It is still unclear how global liquidity and liquidity shocks can be measured in a world where a substantial amount of financial intermediation takes place outside the well regulated sphere. This can be either off-balance sheet (by the shadow banking system) and/or off-shore (outside major jurisdictions). The financial environment in which central banks operate has changed their functions. Although targeting the exchange rate by central banks is, in most cases, not an explicit goal, it is a by-product of monetary policy. All central bank mandates, including employment and economic growth are affected by exchange rate movements.

Foreign exchange reserves invested in currencies of deficit countries make up the bulk of Asian central bank assets. These have been earned from current account surpluses and are more than adequate to cover the short-term debt. However, a growing share of the foreign exchange holdings are the result of portfolio capital flows. These react to mis-pricing of currencies through carry trade, the arbitrage of prices, taxes and regulation and add grey market/illicit flows. The real problems are leveraged capital flows which magnify risks in terms of volatility, speed and scale. This leveraged high frequency trading and hedging by institutional investors create a 'tsunami' of inflows and outflows. These can be overwhelming for EME central banks.

In response, no single country can cope with this global problem. Derivatives and off-shore non-deliverable forwards (NDFs) erode the capacity of central banks to monitor and defend against speculative attacks. The predominant over-the-counter (OTC) markets for trading foreign exchange mean that prices and flows can be manipulated without official oversight. Individual country action such as capital controls will not deal with the root of the problem, which is private gain and social losses. One way to slow the flows and monitor manipulation would be a global turnover tax on financial transactions (Tobin Tax). It can only succeed if it is supported by big players, such as Japan, India and China.

The internationalization of the Renminbi (RMB) can either support real economic growth or stoke asset bubbles. The role of the RMB in international trade lags behind China's importance in trade. In Asia, China is counterparty to 53% of cross-border trade while only 9% of trade is settled in RMB. China's current account surplus has been narrowing towards 2-3% of GDP recently. It has thus made a major contribution towards reducing global imbalances. However,

there is agreement that enhancing the role of RMB and of any other EME currency depends on financial account liberalization and opening of government bond markets.

Lasting solutions can only be systemic cooperative solutions which address the following: global imbalances offer arbitrage opportunities and thus evoke capital flows; capital flows are volatile because they are highly leveraged; the systemic problem arising from private shadow banking credit creation; a combination of tools, including surveillance and regulatory measures is needed as well as a Tobin Tax on financial transactions. Asia needs to re-design a system which is tailored to Asian needs.

In the search for a solution to exchange rate volatility, the old question of global adjustment to imbalances resurfaces again. Would one currency be best or multiple currencies? Who bears the burden of adjustment, the deficit countries or surplus countries? Obviously one cannot expect markets to solve the underlying problem as markets just exploit these imbalances. The massive swings in real exchange rates impacted small open economies (such as New Zealand) with major problems, notably a decline in growth, rise of indebtedness, rise in unemployment, widening of current account deficit. In such an environment, monetary independence is rather an illusion. A case in point will be the effect on small open economies of 'tapering'. Raising interest rates might possibly result in falling asset prices, triggering a global recession.

During this process, the financial sector (well supervised with adequate capital and liquidity buffers) and the public sector (sovereign wealth funds and prudent public debt management) can act as shock absorbers. Measures for shock avoidance can be taken well before the shock hits. These include reducing currency mismatches, deeper domestic financial markets, macro-prudential limits to private risk and capital flow management. Asian central banks are well placed in using both, monetary policy as well as macroprudential instruments. They are well prepared for shock avoidance but the ability for possible shock absorption will be key.

The framework for central banking has changed for good and they will need to target economic growth and financial stability in a 'New Normal' environment. The transition to 'New Normal' is defined as 'tapering' of the quantitative easing (QE) in AE. First signs in the second quarter of 2013 have shown that this process is marked by volatility and risk correlation among returns on assets. The reaction of financial markets to both is highly unpredictable. As a result, policy making by central banks in the 'New Normal' should combine risk management with pragmatism to counter market over-reaction. Emphasis will be on assessment of risks and their potential impact, evaluating policy options, implement risk-based regulations and enforce these in a coordinated approach (with other agencies). Financial Stability Committees, which have been established in several Asian and Latin American central banks, are useful institutional approaches for such coordination.

They need to coordinate the three pillars which make up a financial system. These are the institutions, the various financial markets and the market infrastructure, such as the payment and settlement system. Financial stability is achieved when a framework of governance is in place to ensure the smooth functioning of the whole financial system and is conducive to sustainable and equitable economic growth. The risks in each of these pillars have to be addressed by monetary, i.e., liquidity management. It is through the provision of liquidity that central banks are inherently concerned (if not the lead agency) for financial stability. Liquidity is essential for the general public, as funding liquidity for the banks and the non-bank intermediaries, the various financial markets and for calculating the yield curve. There needs to be sufficient liquidity in the payment and settlement system to prevent a gridlock. All these

demands have to be balanced with the inflationary outlook which remains the core concern of central banks.

Pursuing monetary policy under the 'New Normal', central banks need to deal with possibly adverse scenarios (such as an impaired transmission channel), design and communicate robust policy responses (to coax market reaction in an uncertain environment), to reconcile monetary policy and macroprudential instruments and finally to enhance cooperation and exchange of experience among central banks in a forum such as the present one.

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**SESSION 1:
OPENING ADDRESSES AND
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WELCOME REMARKS
MR. HOOKYU RHU
EXECUTIVE DIRECTOR
THE SEACEN CENTRE



**WELCOMING REMARKS BY
MR. HOOKYU RHU,
EXECUTIVE DIRECTOR, THE SEACEN CENTRE
21 October 2013, Sasana Kijang, Kuala Lumpur**

Your Excellencies Governors and Ambassadors

Dr. Fernando Tenjo Galarza, General Director, CEMLA

Distinguished Guests

Ladies and Gentlemen

On behalf of The SEACEN Centre, I would like to extend a warm welcome to all of you to Sasana Kijang, Kuala Lumpur and the 3rd SEACEN-CEMLA Conference with the theme “New Paradigm in Central Banking”

Ladies and Gentlemen,

Since the global financial crisis, many have argued that we face a “new ‘normal” which can be characterized by a set of new trends such as below trend economic growth, high unemployment, rising imbalances and heavy indebtedness, increasing financial market volatility and growing need to manage capital flows searching for higher returns.

Apart from what I have already mentioned, one thing is sure. What we do know is that although we, central bankers, try to return to normality moving forward, it will most probably be different from the “old normal” that we witnessed before the global financial crisis. Now, there is an emerging consensus that the framework underpinning conventional central banking must be rethought.

The relationship between price stability and the broader goals of macroeconomic and financial stability clearly needs to be redefined. Central banks are also being pulled into new roles by the post-crisis environment, which features high levels of public and private debt in advanced economies and concerns about volatile capital flows and currency fluctuations in emerging markets.

One country’s monetary policy can spillover to other countries, especially when central banks follow inconsistent frameworks, with massive cross-border capital flows serving as the transmission channel. All these suggest that the conventional framework for central banking is inadequate. It is too narrow to meet domestic and global needs. There may be broad consensus on this point, but there is still only a little agreement about the particulars of the new paradigm in central banking. It is those particulars that we seek to elaborate in this Conference.

Ladies and Gentlemen,

Since the crisis, due to the increasing linkages between the macroeconomic environment and the financial sector, it is now recognized that price stability can no longer be the single focus of central banks and a greater role of fostering financial stability must be emphasized.

The expanded central bank mandates in the post-crisis era will bring about new and different challenges for the conduct of monetary policy, the bread and butter of central banking. Also, under the new paradigm, many questions arise on the expanded mandate of central banks

and the effectiveness of monetary policies. Among them (1) What are the successful monetary policy responses and the transmission of monetary policy under heightened uncertainty? (2) What are the monetary policy instruments which central bankers can effectively use to achieve financial stability? (3) Can monetary policies be used to preemptively tackle developing financial imbalances (4) How should central banks rebuild their macroeconomic models, without a sophisticated financial sector, in order to better reflect macro-financial linkages?

Ladies and Gentlemen,

In addition, take a look at the realm of monetary and financial stability policies in today's environment which I have just described above. We can no longer look at policy implementation in isolation, like what central bankers of yester years did. There is an explicit need for monetary and regulatory policies to be complemented by macro-prudential measures to realise both price and financial stability. In other words, more than ever, we critically examine synergies and trade-off between them. Central banks' analytic models, policy frameworks, tools and instruments need to properly account for linkages between price stability and financial stability and the repercussions of their policy choices to the regional and global economy. Only through a holistic view and global perspective, central bankers can find and apply new practical and effective solutions.

Definitely, we are entrusted with much more responsibilities now. But what is needed for us, as central bankers under the new paradigm is to rethink the appropriate scope of the central banks' mandates to ensure that central banks are being tasked to do what they can properly do and are supposed to deliver.

Ladies and Gentlemen,

Indeed, the issues to be discussed at hand are timely and we are confident that this conference for cross-regional collaboration between Asia and Latin America would promote a greater understanding of central banking issues at hand.

We are indeed honoured to host the 3rd SEACEN-CEMLA High-Level Conference with the theme "New Paradigm in Central Banking". Please allow me to thank the CEMLA General Director, Dr. Fernando Tenjo Galarza for the collaboration to make this conference possible and to Her Excellency Governor Dr. Zeti of Bank Negara Malaysia and His Excellency Governor Dr. Rodrigo Vergara of Central Bank of Chile for co-sponsoring the event. I would also like to register our appreciation to Bank Negara Malaysia for rendering invaluable assistance in organizing this conference.

We are indeed very honoured to have Mr. Mark Olson, Co-Chair, Trelia Risk Advisor LLC and former Governor of the Federal Reserve Board to share his tremendous experience and expertise with us in the keynote address. We are also very grateful to their excellencies, Governors, Deputy Governors, heads of internationally reputable institutions as well as from the academia for being our speakers, discussants and moderators. We also hope that the conference delegates will use this opportunity to exchange views and share experiences.

I wish everyone here a productive and rewarding conference. Lastly, I also hope that you will be able to find the time to enjoy the beauty and rich culture of Malaysia.

Thank you.

WELCOME REMARKS
DR. FERNANDO TENJO GALARZA
GENERAL DIRECTOR
CEMLA



**WELCOMING REMARKS BY
DR. FERNANDO TENJO GALARZA
GENERAL DIRECTOR, CEMLA
21 October 2013, Sasana Kijang, Kuala Lumpur**

Dear Ladies and Gentlemen, on behalf of the Center for Latin American Monetary Studies, it is with great pleasure that I welcome you all to the Third SEACEN-CEMLA Conference “New Paradigm in Central Banking”.

Particularly, I would like to express our appreciation and gratitude to Governor Zeti for hosting the Conference for the second occasion in the last three years in the magnificent city of Kuala Lumpur.

Also, I wish to mention our gratefulness to Dr. Rodrigo Vergara, President of the *Banco Central de Chile* for the enthusiasm with which he accepted to co-host the event.

I would also like to point out our appreciation to Dr. Hoo-Kyu Rhu and SEACEN’s team for their high spirits and interest have been a key factor to enhance the collaboration between our Institutions, making it possible for this Conference to take place.

It is worth mentioning that it was in fact in this city and with the kind auspices of Governor Zeti that the meeting between Asia and Latin American Central Bank Governors was first held in 2006. Said idea was the seed that developed later on in the need of strengthening the joint collaboration between our regions and thus, the importance of holding the joint SEACEN-CEMLA Conference.

Being this the first opportunity I have to come in direct contact with our partners from SEACEN, I went back to see the outcome of the two previous Conferences so as to better understand the significance of this event and the importance of the collaboration between the two centers.

In doing this, I soon realized how fortunate we have been in choosing the sequence of the main topics or themes of our three conferences. In 2011 we joined the general inquiry into the lessons and challenges emerging from the crisis. A year later, in 2012, the organizers took a step forward and focused the conference in perhaps the most important of those lessons and challenges: the role of central banks in macroeconomic and financial stability. With this, they introduced us all into one of the great puzzles of modern monetary theory and policy, a puzzle that calls into question the current policy frameworks of many central banks.

For this third conference, the idea seems to be to take a look at the main conclusions of the previous conferences but this time from our own perspective, that is, from the point of view of the South East Asian and the Latin American economies. Together with the questions concerning the objectives, instruments and scope of monetary policy and central banking in general, and the room for financial stability considerations, new relevant issues are considered such as the exchange rate and global liquidity. These two topics are at the heart of our policy concerns and bring to the forefront some of the main sources of instability that our monetary authorities have had to confront with in the recent past.

Important as these new issues are, there is, however, an even more significant ingredient in the menu for this year's conference. Despite the fact that we will be addressing relatively similar questions as in the previous years, the backdrop for the discussions today is a lot richer because it starts from two assumptions that, if valid, would dramatically change the basic scenario for monetary policy in the future. The first assumption is that the world is not going back to where it was before 2007 and that it is moving to a "new normal". The second assumption is that somehow our citizens now have mixed feelings about the traditional public goods of low inflation and stable growth produced by central banks, and that they now demand more from them and their policies. I would argue that it is in part from these two assumptions that this conference points at a "new paradigm in central banking".

South East Asian and Latin American economic authorities have successfully withstood the worst head winds coming from advanced economies and the global crisis. It is now said that we have learned our lessons from previous crises and made an enormous effort to improve our policy frameworks. Furthermore, we are supposed to have graduated to the point of being able to conduct counter-cyclical policies. It could even be argued that we are leading the way for advanced economies because for years our monetary policies have taken into account financial stability considerations, just as we have also experimented with what are now known as macro-prudential policies. We proudly exhibit low levels of debt, controlled inflation, more stable economies, solid and tightly regulated financial sectors and, until very recently, the belief that we had decoupled from advanced economies. With differences of nature and degree, and travelling along dissimilar paths, it could be argued that we invented a "heterodox orthodoxy" and gave the latter term a new and more practical meaning. It goes without saying that this convergence to better economic policies and performances through different routes is one of the pivots of the alliance and collaboration between SEACEN and CEMLA.

With this in the background, this third SEACEN-CEMLA conference presents us with an interesting challenge that invites us to come to terms with a paradox: doing things right, as a good number of our central banks and economic authorities have done in the recent past, is not enough anymore. Just when we thought that our task had been successfully completed, we are told that the international economic setting and the national political and social environment may be driving us to think in terms of a new paradigm in central banking. What is the nature of this paradigm? Should we readily adjust our policy frameworks to the new conditions or, alternatively, stick to our newly acquired better fundamentals, resist the temptation to promise more than we can deliver, and wait until the crisis is over and the dust has settled down? This 3rd Conference is then a timely effort to revisit the main conclusions of the previous two conferences from a new and fresh perspective.

I have no doubt that the speakers, discussants and moderators will make valuable contributions to help us find answers to these new challenges. Our thankfulness to them for accepting the invitation to join us and share their experiences with us. We are very much looking forward to listening to your interesting presentations and comments, which without a doubt will raise thought-provoking discussions that will contribute positively to the challenges faced by our central banks within this new paradigm.

Thank you.

KEYNOTE ADDRESS

MARK W. OLSON

CO-CHAIR

TRELIANT RISK ADVISOR LLC

AND FORMER FEDERAL RESERVE BOARD MEMBER



**KEYNOTE ADDRESS BY
MARK W. OLSON¹
OBSERVATIONS ON THE NEW PARADIGM
VIEWS OF A FORMER FEDERAL RESERVE GOVERNOR
*21 October 2013, Sasana Kijang, Kuala Lumpur***

First, my thanks to Executive Director Hookyu RHU for the kind invitation to appear here today and a particular thanks to Mike Zamorski for reaching out and suggesting the opportunity. Despite postings both here and in Dubai, Mike continues to be well known and well regarded among banking industry regulators in Washington DC and I appreciate the opportunity to participate with him today.

As this is the Third Joint Conference of the SEACEN-CEMLA, your combined organizations have realized the necessity of joint evaluation and understanding of what your advance description of this conference accurately describes as a “highly interactive world of macro-financial linkages”. For my participation today I would like to reflect on how I witnessed the paradigm change during the period when I served on the Federal Reserve Board and my perception of the impact of changes in recent years. Of course, these views are my own and do not reflect the opinions of any other former or current members of the Federal Reserve Board of Governors, or of my current employer, Treliant Risk Advisors.

It would be an obvious oversight to discuss the United States Federal Reserve and not deal first with the current discussion of anticipated leadership change. As you may know, when Chairman Ben Bernanke succeeded Alan Greenspan as Chairman of the Federal Reserve in January of 2006 he received two concurrent appointments by former President George W. Bush. The first appointment was for a fourteen year term as a Member of the Fed Board, and a second four year term as Chairman. Upon the conclusion of his first four year term he was re-appointed to a second four year term as Chairman by President Barack Obama. His current term as chairman expires this coming January, though his term as a Board member has an additional six years before it expires. It is the common wisdom in Washington DC that Chairman Bernanke will not request an additional term as Chairman, and will choose to leave the Board upon the conclusion of his Chairmanship and the appointment of his successor.

In my mind, it is a reflection of the changing paradigm of central banking that speculation on Bernanke’s successor has been front page news and feature stories in newspapers across the United States and, in some instances, around the world. In this regard I would like to discuss several elements of this change, and how it affects central banking. The first point I would like to review is the explosion of financial news coverage. Second, I will then discuss how the expansions of capital markets around the world have increased the focus on the impact of monetary policy decisions. These two factors, in my judgment, are primarily responsible for the intense focus on leadership change at the Fed. Third, I will observe two elements of central bank authority that are fundamental and do not change: the continuing need for independence of the central bank, and the limitations of the potential impact of monetary policy decisions. Finally, I will review how the globalization of markets and financial institutions mandate cooperation and centralized policy making among central bank and financial supervisory agencies around the world.

¹ Co-chair, Treliant Risk Advisor LLC, former Federal Reserve Board Member, Chairman of the Public Company Accounting Oversight Board, Chairman of American Bankers Association, Bank President and CEO.

Let me begin with the explosion of financial reporting. When I joined the Fed Board in December of 2001 I was reminded of an old economic axiom – that supply creates its own demand. If ever that axiom was proven to be true it was in the growth of the numbers of financial reporters in recent years. It was estimated that roughly 2500 people represented themselves to be financial reporters in the United States as recently as 1980. By year 2000 that number was estimated at 12,000 and growing. The growth occurred in significant part due to the expansion of the numbers of news outlets in the ever increasing technological sophistication of news delivery. Financial news delivery is now a 24 hour phenomena with instantaneous communication around the globe. The increases in financial news people and financial news sources have assured that changes in leadership at the Fed will be a major news item.

Every bit as important a factor as expanded news dissemination is the reality that an ever increasing number of people are impacted by monetary policy decisions. In the United States, home ownership has now stabilized at roughly 68% of family units. At that level a vast majority of the adult population is impacted by monetary policy decisions that affect interest rates and therefore the cost of home ownership. An active market of mortgage originators then responds to monetary policy decisions by encouraging activity either in reaction to or anticipation of interest rate movement. Further, through the expansion of defined contribution profit sharing plans and other forms of equity ownership the United States has experienced a significant increase in the numbers of households now participating in our equity markets. The cost and availability of capital, therefore, generates immediate attention from an audience far beyond corporate chief executives and chief financial officers. I have also noticed this pattern being repeated around the globe, particularly in the last two decades. Indeed, the interest of individuals in monetary policy decisions is not limited to the decisions made in their home jurisdictions. Individuals can invest easily in funds that give them exposure to overseas markets and there is an increasing general understanding that the decisions made in one jurisdiction can have significant repercussions across the globe, the recent shutdown of the U.S. government being one example.

As an unapologetic capitalist I welcome the positive impact of the democratization of finance and capital markets. Increased access to financial products and equity opportunities has allowed a growing number of people to realize the goals of education, home ownership and economic security. But this increased focus on the monetary policy has come with a price. It has elevated monetary policy as a political issue. While many of us may regret the increased political focus on monetary policy decisions my advice is to accept that as decisions made by government entities in a democracy impact a greater number of people, their decisions will become increasingly high profile. It is part, therefore, of the changing paradigm of central banking and I do not look for diminishing focus on central bank policy decisions or leadership in future years.

In the case of the Fed, and similarly at the Bank of England and the European Central Bank, the leadership has already adjusted their communication protocols in order to increase transparency. At the Fed, Chairman Bernanke, as with Chairman Greenspan before him, has initiated a number of changes to make the process more transparent. Federal Open Market Committee transcripts are made available with less of a lag time than in the past and the style of communication has become more direct and open. These developments are positive and should be welcomed.

However, while we can applaud the increased access to information about and public focus on monetary policy, it is important to acknowledge and point out the limitations of monetary policy.

Monetary policy does not create demand. It is not solely responsible for job creation. Monetary policy alone cannot offset damaging fiscal policy. And, as we are now witnessing in the United States, it cannot be the sole entity responsible for rescuing the economy in the absence of prudent fiscal policy. But given those limitations, central banks maintain the critical role of managing the money supply in a manner that can minimize volatility.

I believe the United States experience provides an important lesson on the impact of appropriate policy. As many of you know, the Federal Reserve System is relatively young among central banks of developed nations. It is about to celebrate its one hundredth year. The first monetary policy challenge occurred only a few years later when the great depression started in 1929 and extended through much of the next decade. By all current evaluations, the depression caught the Federal Reserve unprepared and inappropriate policy then exacerbated the depression. In the forty years following the depression, the general public in the United States was so intent on not repeating that painful history that it tolerated inappropriate levels of inflation. It was only after the high inflation years of the late 1970s when inflation robbed people of their lifetime savings and interest costs precluded necessary capital investments that United States policy makers reverted to Milton Friedman's dictum that inflation is once and always a monetary policy phenomena. Under Paul Volcker's leadership during the late 1970 and early 1980s Fed restrictions on the money supply broke the back of inflation. Since then the US has enjoyed an economic climate where inflation has been well contained. It is a tribute to the people in this room and your peers that low inflation is now the norm throughout the world.

The experience of the 1970s in the United States also points to the need to ensure that political pressures do not compromise the independence of Central Bank monetary policy authority. Former Fed Chairman William Martin is credited with the observation that it is the responsibility of the Federal Reserve to remove the punch bowl just as the party is getting started. It has been years since I have attended a party featuring an actual punch bowl, but the theme of his analogy is still relevant. In many cases, appropriate monetary policy decisions run contrary to the dominant public sentiment and the decision making process must therefore be independent of political input. While recognition of this necessity has long been recognized, it is much easier to maintain in good economic times than during more difficult times such as we are experiencing today. When the United States economy was enjoying years of strong growth, monetary policy decision making by the Fed was applauded and credited with much of the success. Credit given to monetary policy in those times probably exceeded what was deserved. Today, when we are experiencing a protracted recovery period – and particularly following a period of unprecedented expansion of the money supply to avoid a deeper crisis, the decision making process has been challenged and the continued independence questioned. Like American football quarterbacks, the Fed gets too much credit in good times, and too much blame in bad.

Better insulation of the central bank from domestic political pressures can also facilitate global cooperation among central bankers. International cooperation and communications has been a vital part of bank regulation and central banking for many years, but the need is even greater today. One of the factors contributing to the global economic crisis of the past several years was the impact of global pools of liquidity. Capital is increasingly borderless as investment opportunities and market arbitrage opportunities present themselves. In recent years we have witnessed the rapid growth then sudden declines of financial institutions and national economies as capital flows have responded to pricing opportunities that provide short term advantage to the investor and then withdraw just as suddenly when signs of stress emerge. The speed at which markets adjust to new information creates the potential for cross-border systemic risk contagion.

The efforts of SEACEN-CEMLA to foster central bank cooperation and communication are important mechanisms to combat potential sources of systemic risk and I applaud the SEACEN-CEMLA Conference for working to assure that policies are administered based on consistent understanding of policy implications. I particularly commend your efforts through the SEACEN Expert Group to promote information sharing on capital flows among member jurisdictions – this is a model that could and should be replicated.

Let me conclude this presentation where I began – with a final observation about the change in leadership at the Fed in Washington. As of this writing, President Obama has not named a successor to Chairman Bernanke. The two most commonly suggested successors are current Vice Chairman Janet Yellen and her predecessor as Vice Chairman, Donald Kohn. Also prominently mentioned is former Fed Vice Chairman Roger Ferguson. In my opinion, these are the three most capable people in the United States to fill that position. It is a tribute to the Fed, and a recognition of the importance of the Fed that the selection process has focused on our best talent and that all of them might be willing to serve in that role.

This example is one reason why I continue to have great confidence in the Fed's ability to adjust to the changing paradigm, and by extension why I have confidence in the central banks around the globe to also meet these daunting challenges.

SESSION 2: CURRENT MACROECONOMIC DEVELOPMENTS AND OUTLOOK



JOSEPH E. ZVEGLICH, JR.
ASSISTANT CHIEF ECONOMIST
ASIAN DEVELOPMENT BANK



ASIAN DEVELOPMENT

Outlook 2013 Update

Governance and Public Service Delivery



Asian Development Bank

Asian Development Outlook 2013 Update

Governance and Public Service Delivery

Joseph E. Zveglich, Jr.

Assistant Chief Economist

Asian Development Bank

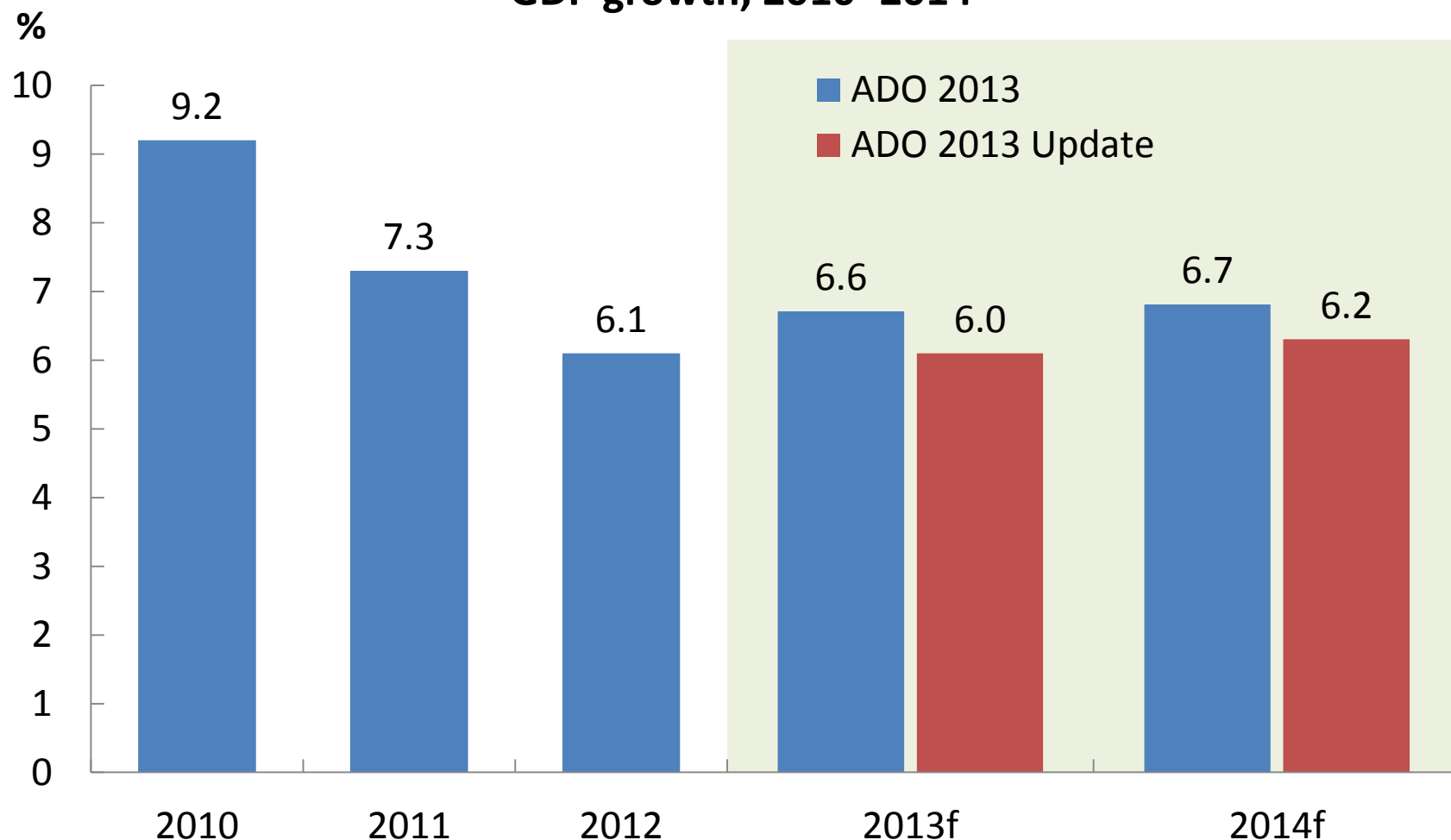
October 2013

Key findings

- Asia's growth is declining to 6% in 2013 from 6.1% in 2012 before picking up to 6.2% in 2014
- The two giants' growth is moderating despite signs of advanced economies' recovery
- Inflation easing to 3.6% and 3.7% in 2013 and 2014, though country variations exist
- Talk of US quantitative easing taper shook emerging markets, but Asia can weather the storm
- Structural reforms—including governance—are needed to safeguard financial stability and sustain future growth

Asia's growth slower than expected...

GDP growth, 2010–2014



f = forecast

...despite firming recovery in advanced economies

GDP Growth (%)	2011	2012	2013f		2014f	
			ADO 2013	ADO 2013 Update	ADO 2013	ADO 2013 Update
Major adv. econ.	1.3	1.5	—	0.9	—	1.8
United States	1.8	2.8	—	1.7	—	2.4
Euro area	1.5	-0.6	-0.3	-0.5	1.2	1.2
Japan	-0.6	2.0	1.2	1.9	1.4	1.4

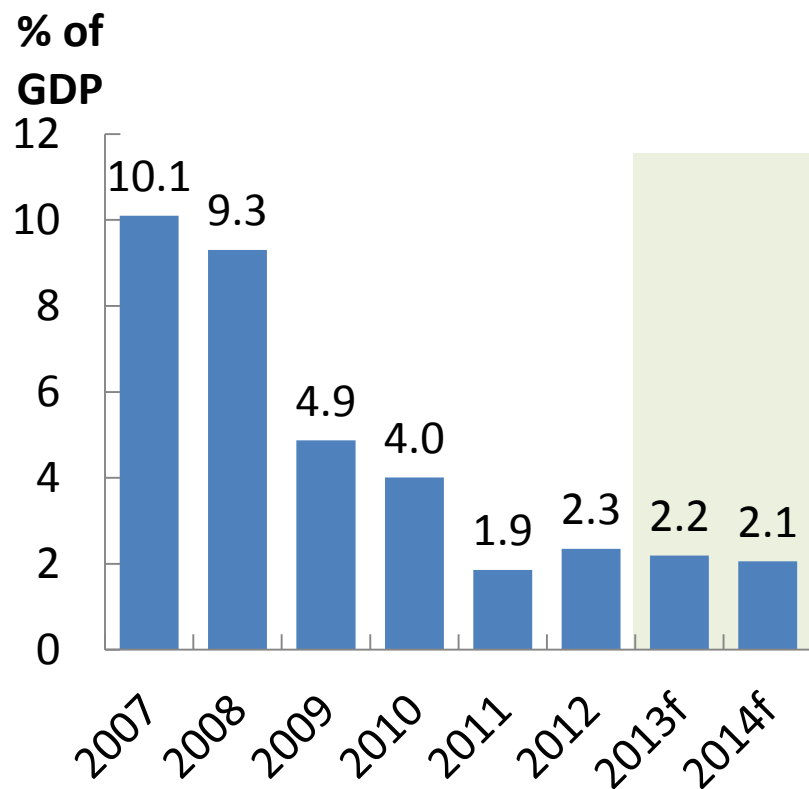
Note: The US rebased national accounts data in July 2013, resulting in a much higher 2012 growth rate and rendering ADO 2013 forecasts incomparable with the forecasts for the Update.

Growth moderation notable in the PRC and India...

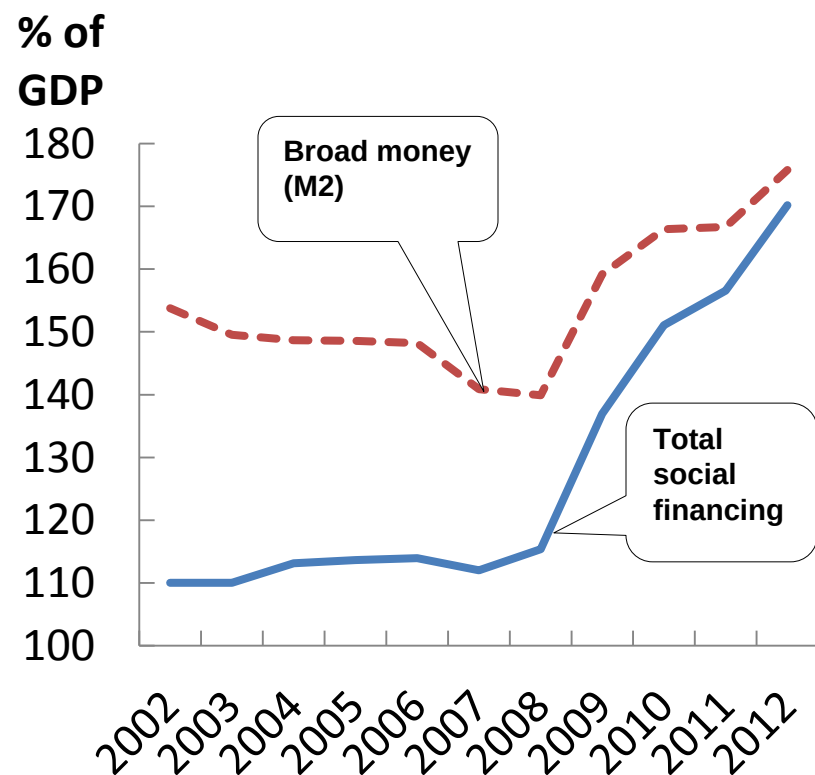
	2012	2013 ^f		2014 ^f			2012	2013 ^f		2014 ^f	
		ADO	ADOU	ADO	ADOU			ADO	ADOU	ADO	ADOU
South Asia	5.1	5.7	4.7	6.2	5.5	Central Asia	5.6	5.5	5.4	6.0	6.0
India	5.0	6.0	4.7	6.5	5.7	Kazakhstan	5.0	5.2	4.8	5.6	5.6
Pakistan	4.4	3.6	3.6	3.5	3.0	Kyrgyz Republic	-0.9	5.5	7.5	4.5	4.5
Sri Lanka	6.4	6.8	6.8	7.2	7.2	East Asia	6.5	7.1	6.6	7.1	6.6
Southeast Asia	5.6	5.4	4.9	5.7	5.3	PRC	7.7	8.2	7.6	8.0	7.4
Indonesia	6.2	6.4	5.7	6.6	6.0	Hong Kong, China	1.5	3.5	3.2	3.8	3.8
Malaysia	5.6	5.3	4.3	5.5	5.0	Korea, Rep. of	2.0	2.8	2.8	3.7	3.5
Philippines	6.8	6.0	7.0	5.9	6.1	Taipei, China	1.3	3.5	2.3	3.9	3.3
Singapore	1.3	2.6	2.6	3.7	3.5	The Pacific	7.5	5.2	5.2	5.5	5.5
Thailand	6.5	4.9	3.8	5.0	4.9	Fiji	2.2	2.0	2.8	2.3	2.4
Viet Nam	5.2	5.2	5.2	5.6	5.5	Papua New Guinea	9.8	5.5	5.5	6.0	6.0

...as the PRC undertakes structural reform and reins in credit growth...

Current account balance, PRC



Liquidity levels, PRC



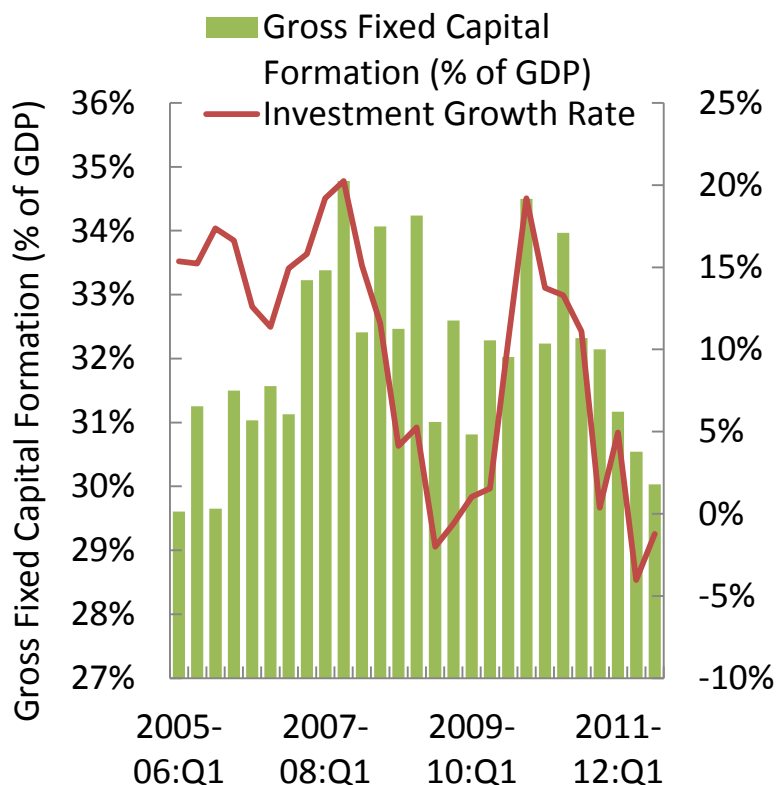
Sources: CEIC Data company; ADO database.

Note: Total social financing represents the total fundraising by PRC non-state entities.

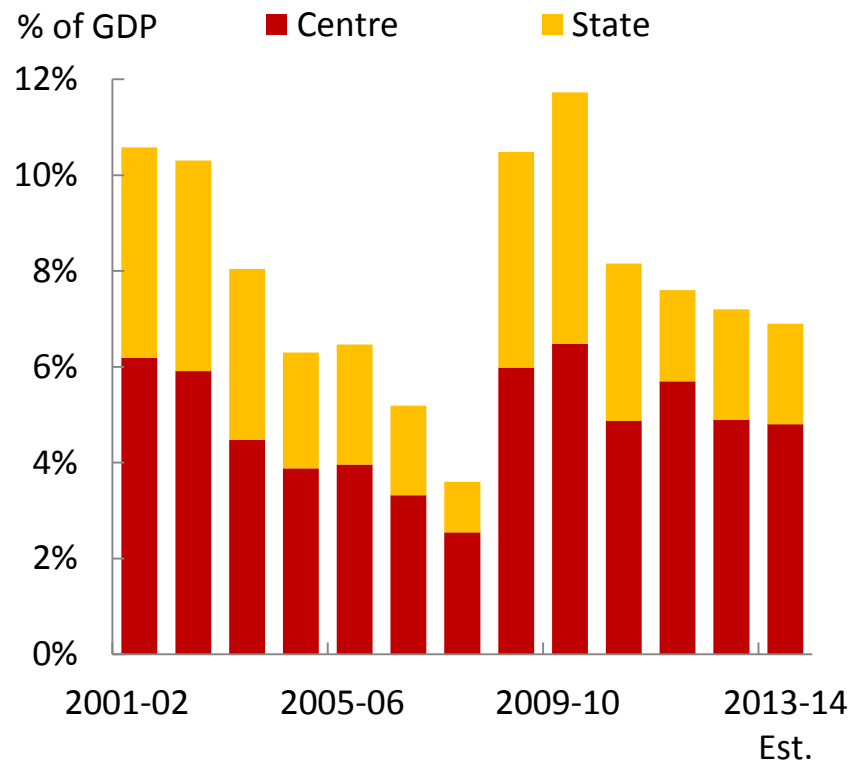
Sources: People's Bank of China, Asian Development Bank staff estimates.

...and India's structural problems dent business confidence

Fixed capital formation and investment

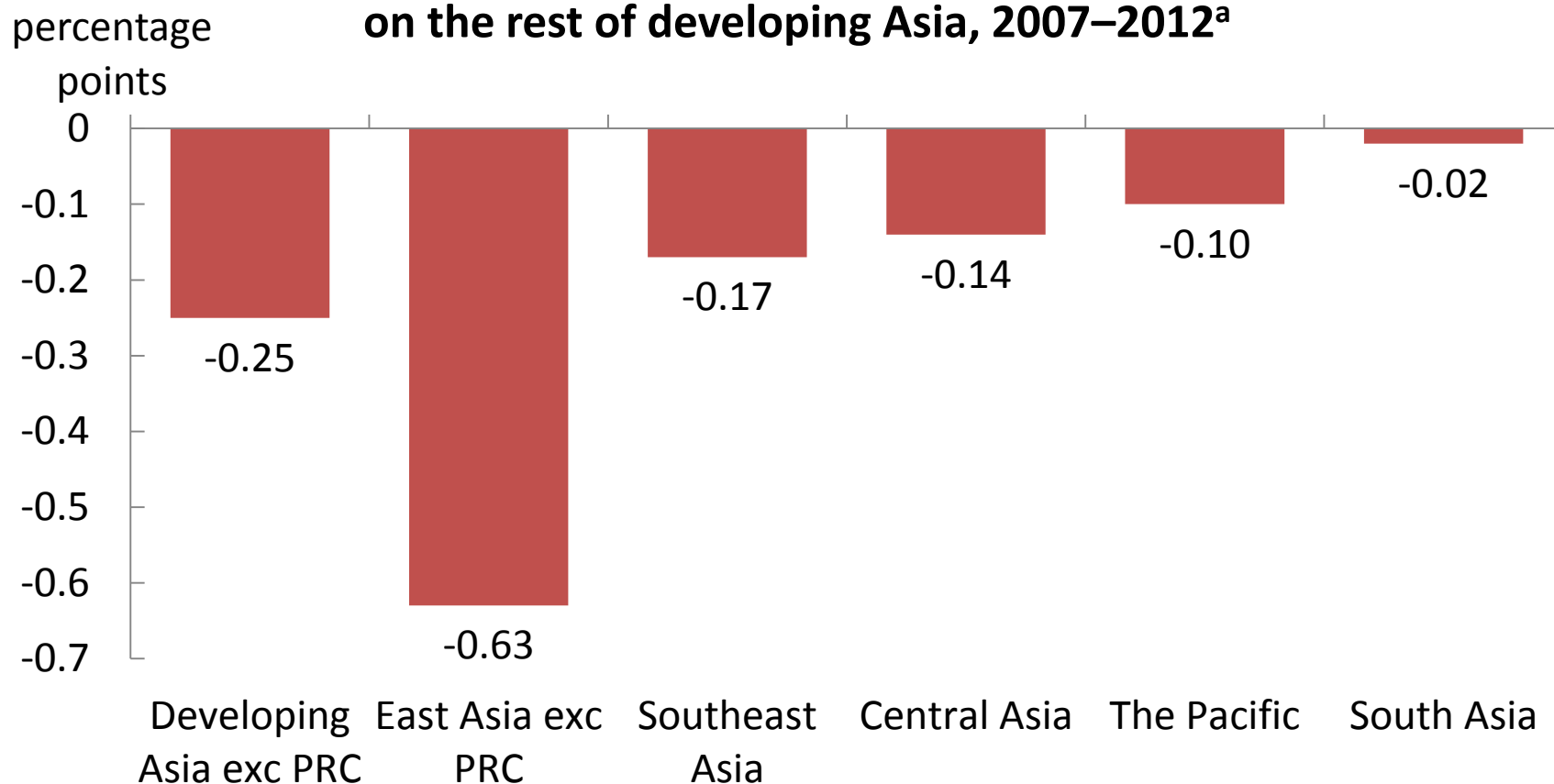


Consolidated fiscal deficit



East and Southeast Asia more vulnerable to slower PRC growth...

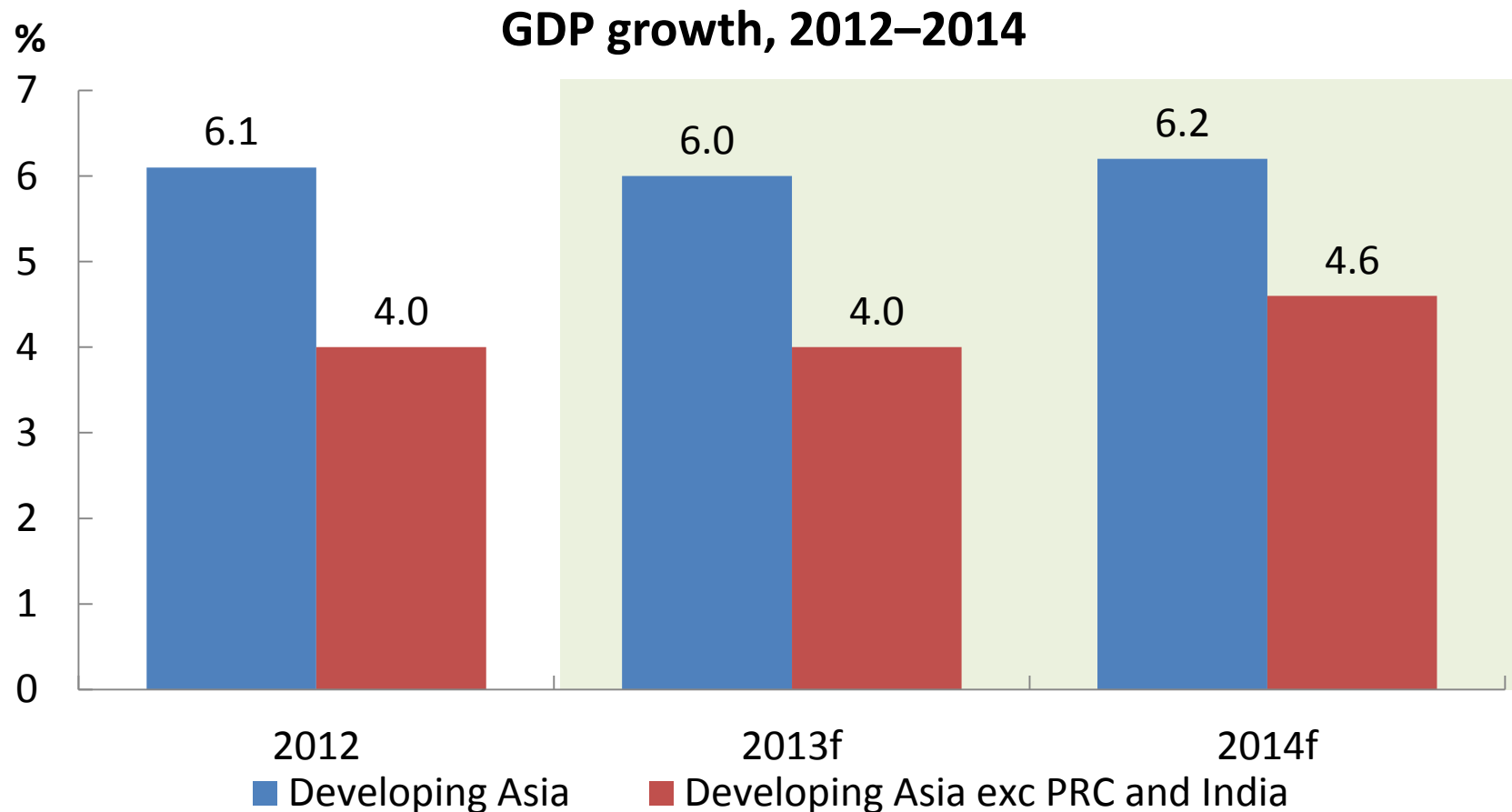
Impact of PRC growth slowing by 1 percentage point
on the rest of developing Asia, 2007–2012^a



PRC = People's Republic of China

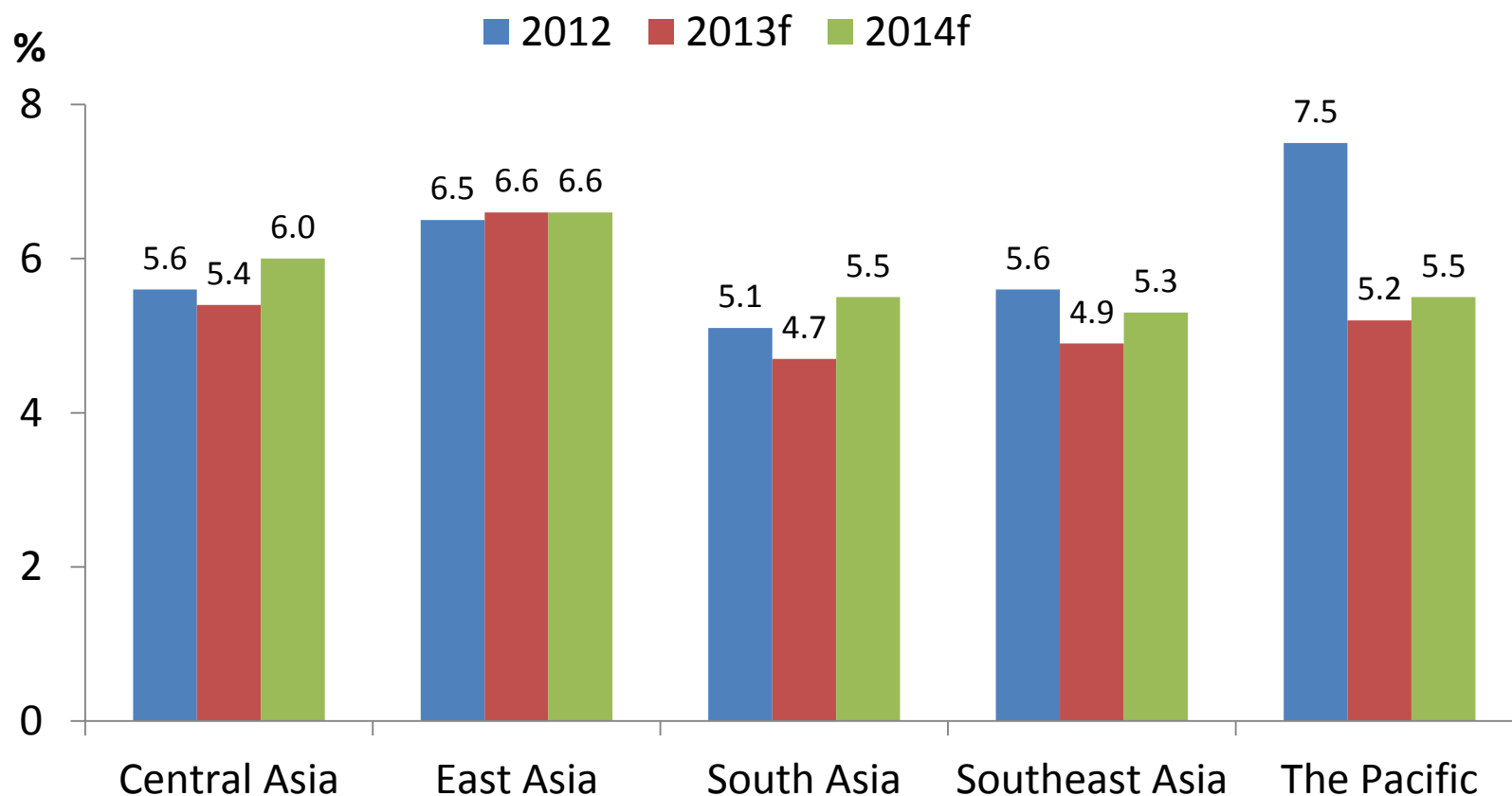
^a Weighted predicted values.

...but two giants' slower growth will not hobble rest of Asia's growth



f = forecast

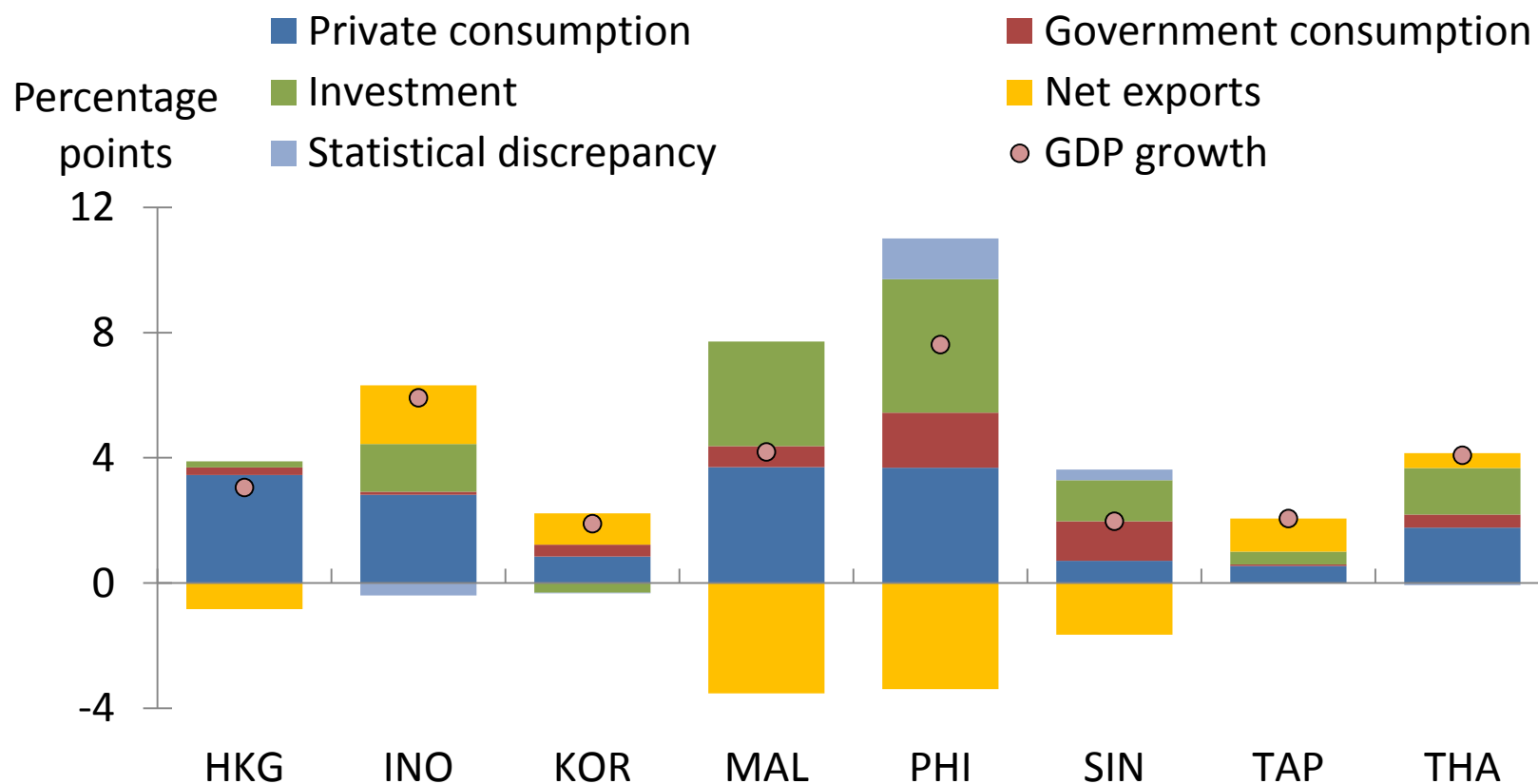
Growth variation across subregions



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Growth driven by domestic demand...

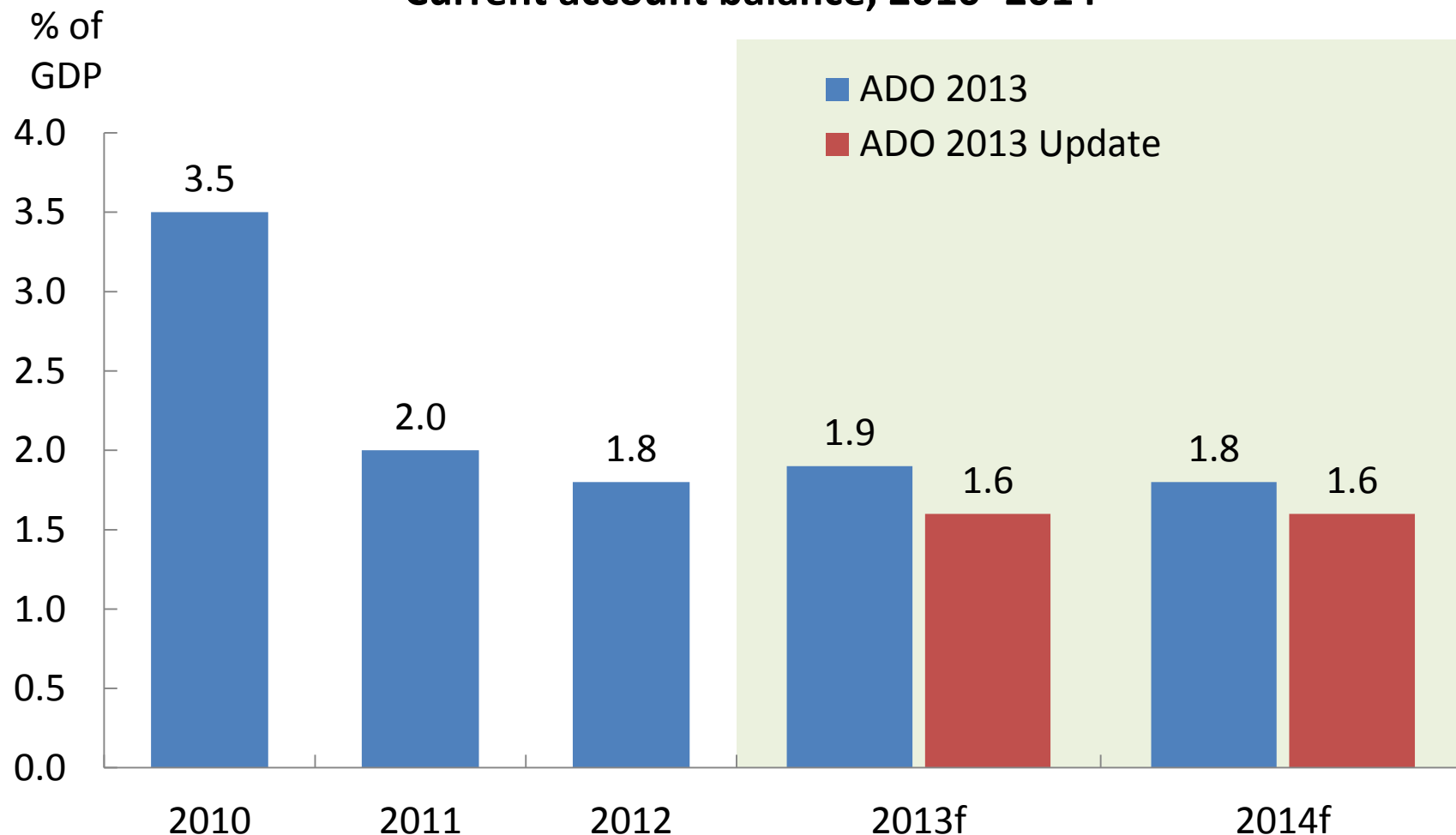
Contributions to growth (demand), first half-2013



HKG=Hong Kong, China; INO=Indonesia; KOR=Rep. of Korea; MAL=Malaysia; PHI=Philippines; SIN=Singapore; TAP=Taipei, China; THA=Thailand.

...as Asia's rebalancing continues

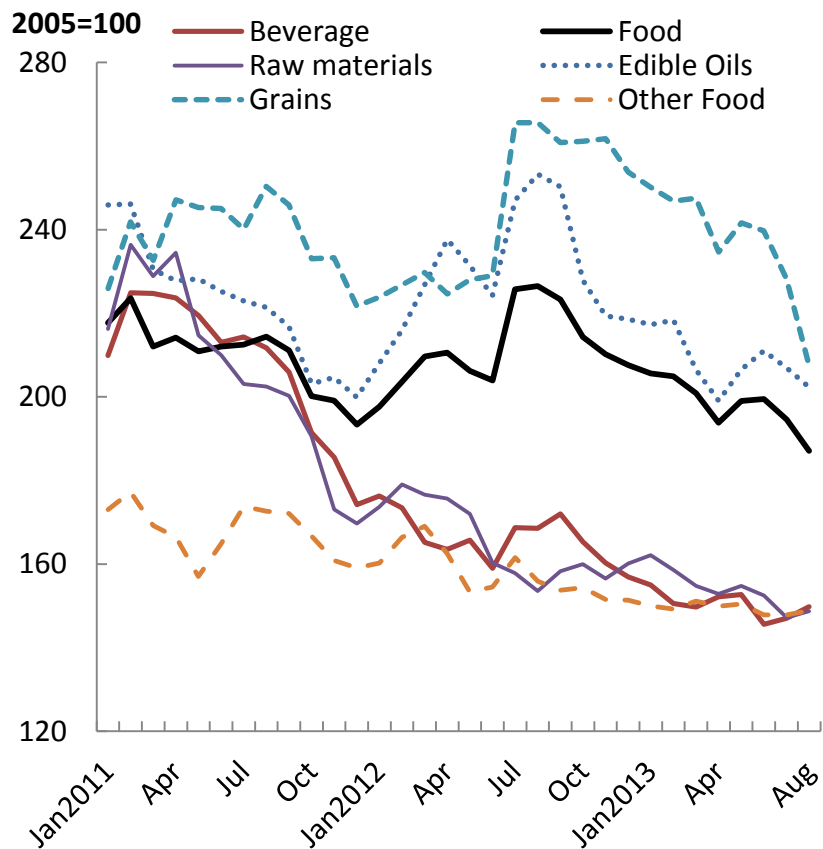
Current account balance, 2010–2014



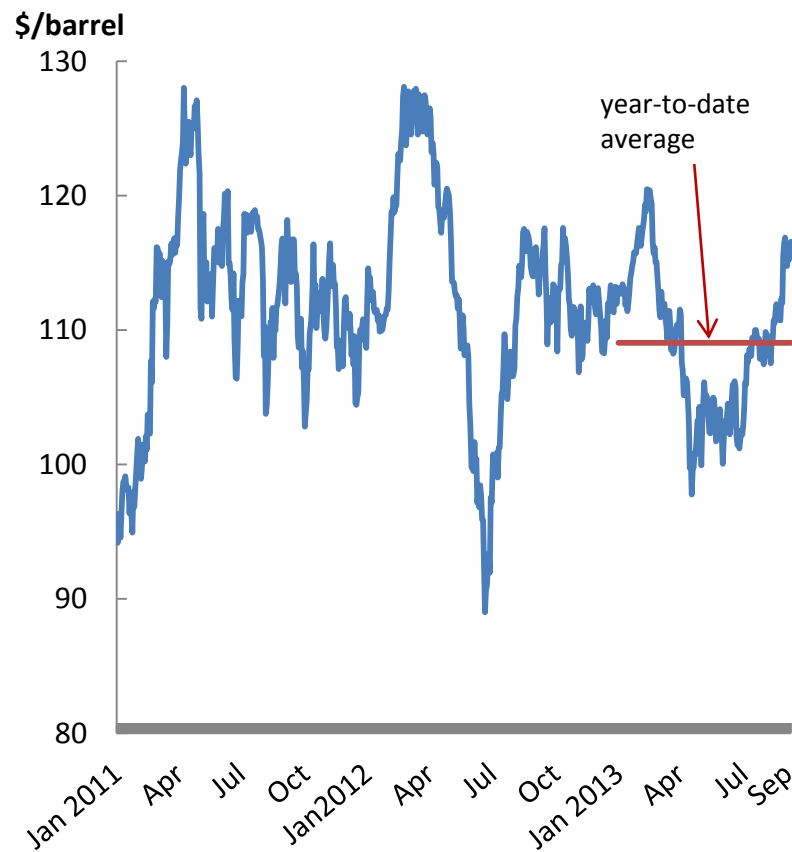
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Weaker growth and tepid commodity prices...

Selected commodity prices

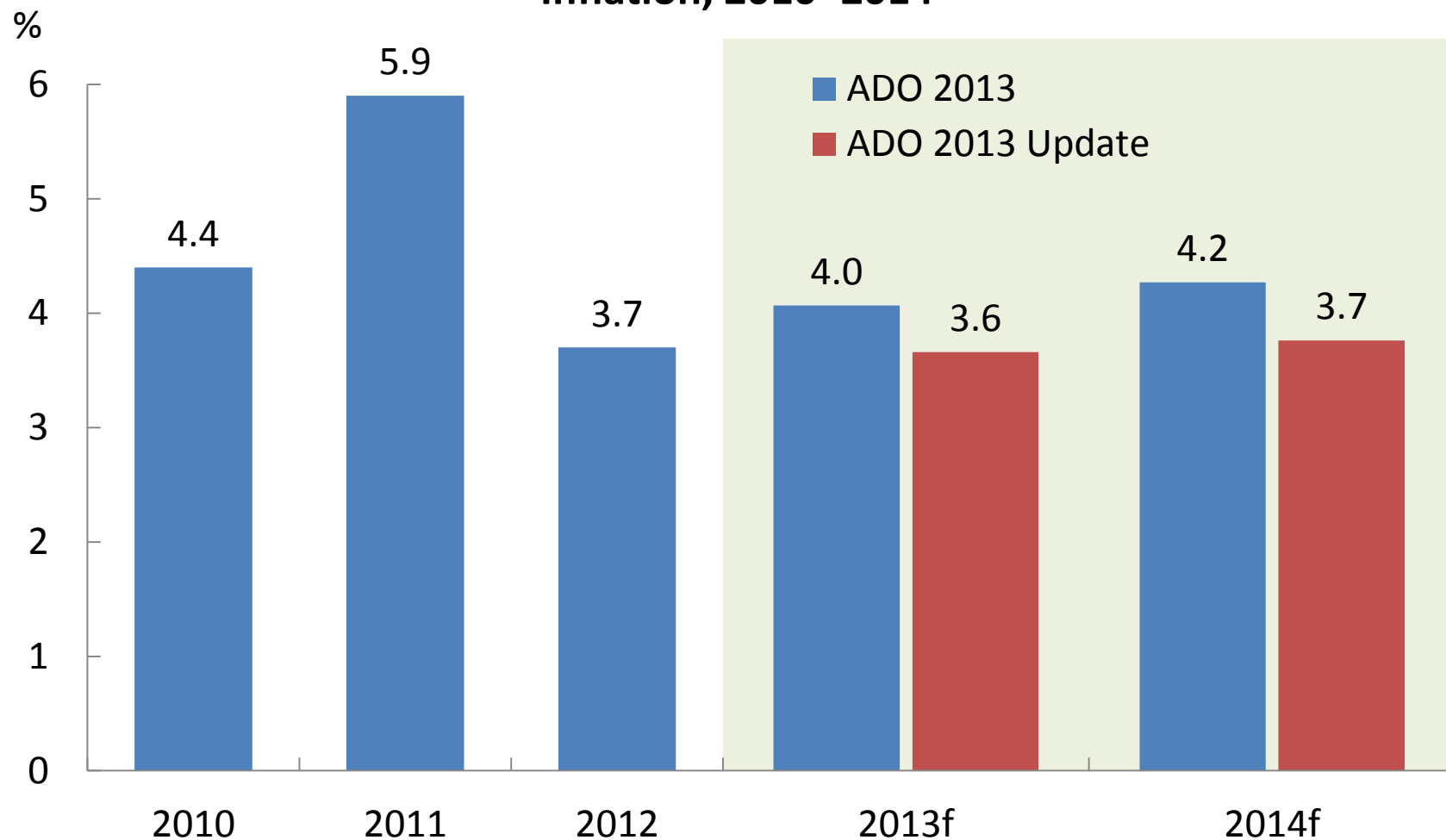


Brent crude spot price



...keeping inflation in check...

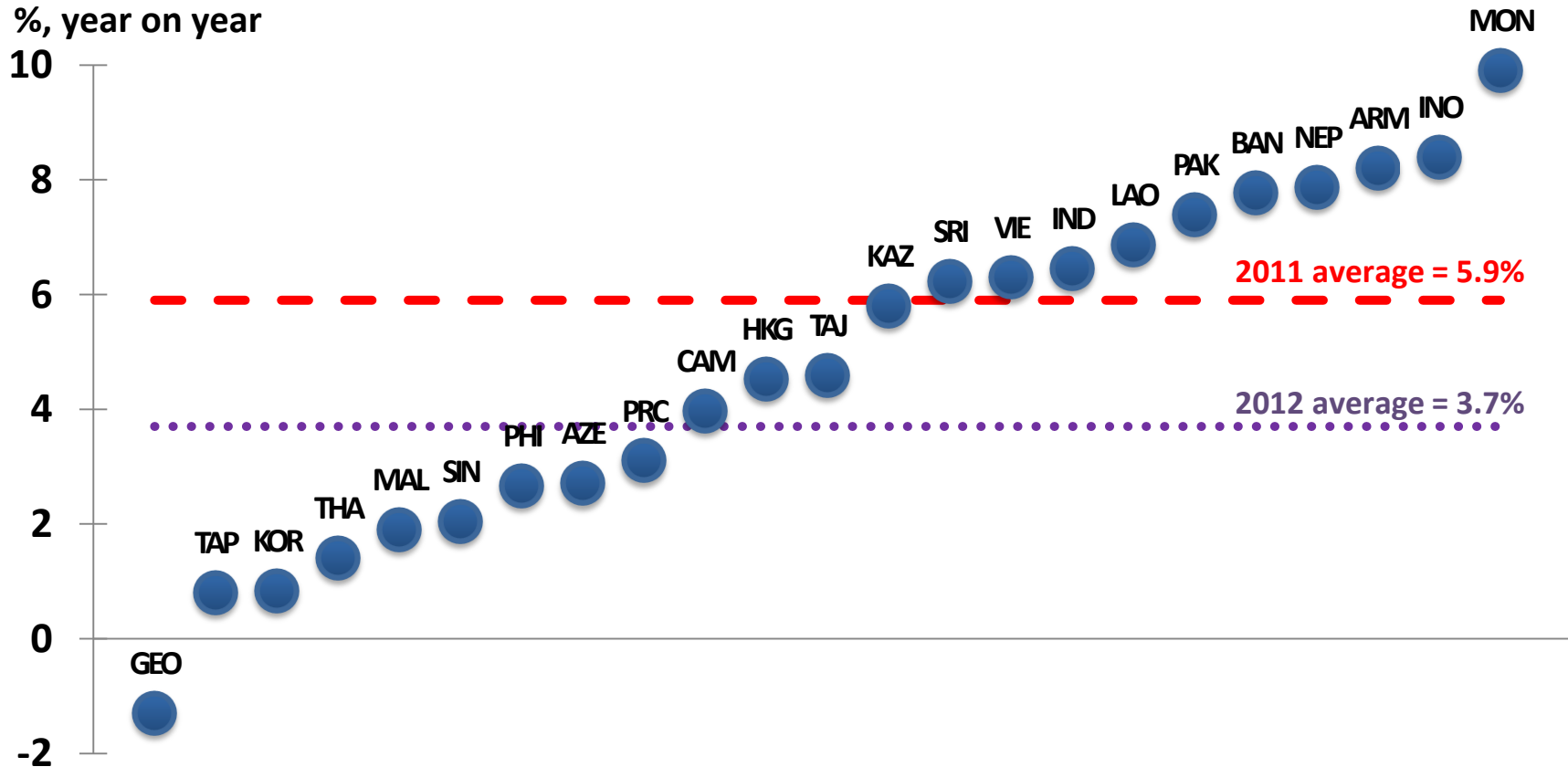
Inflation, 2010–2014



f = forecast

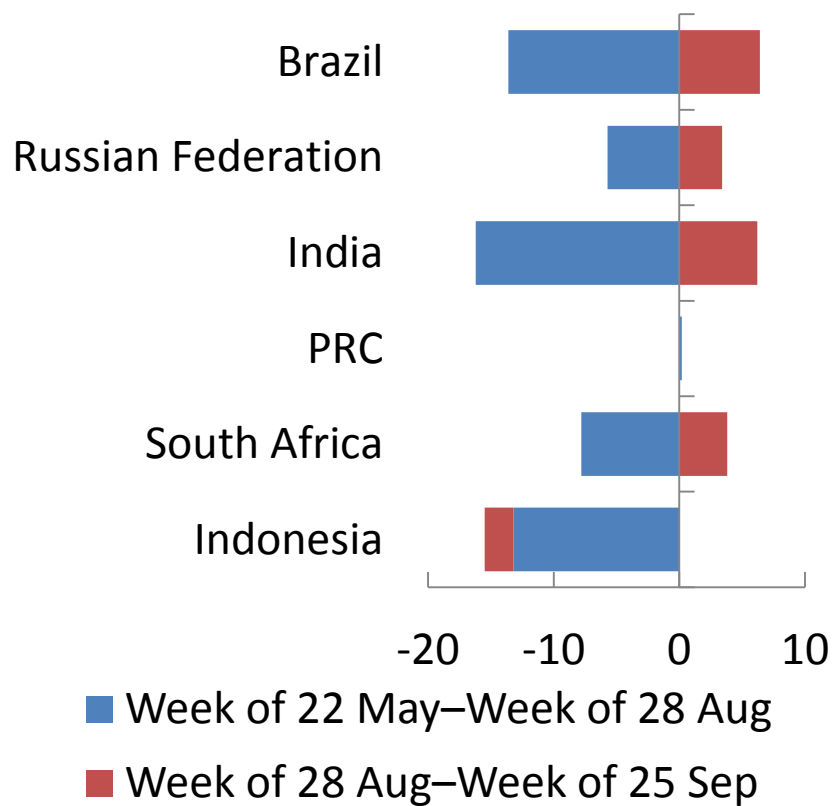
...but considerable variation remains

Inflation rates, latest month

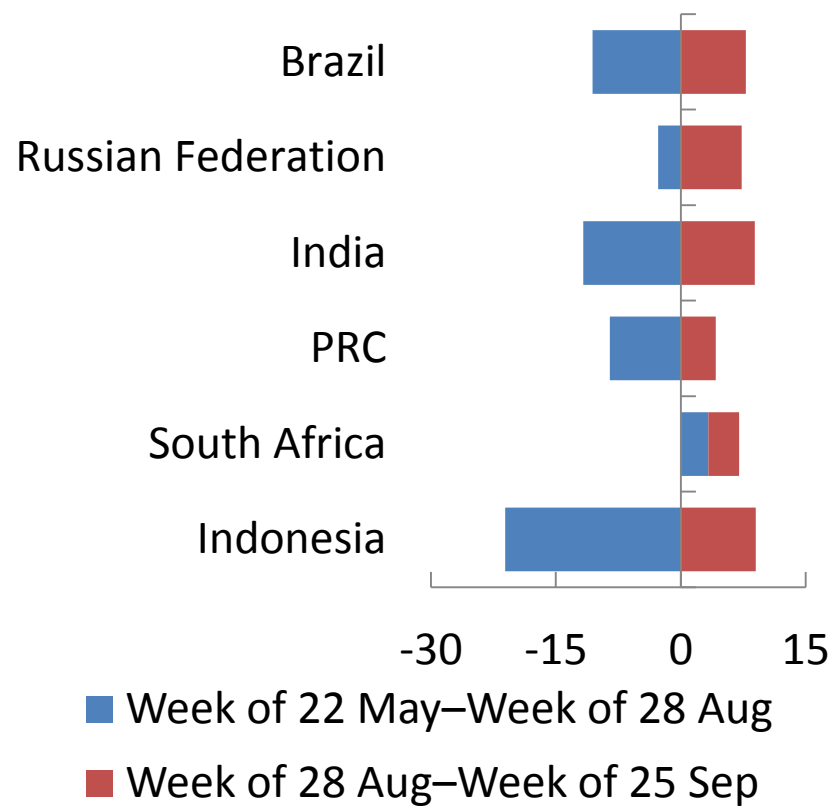


Talk of quantitative easing taper shook financial markets...

Change in local currency unit/\$



Change in main stock index



...with India and Indonesia hit hard due to widening current account deficits

Current account balance, % of GDP



Region stronger than in 1997...

Select Vulnerability Indicators (1997 vs. latest available data)^a

	Fiscal Balance (% GDP)		Current Account (% GDP)		Import cover (months)		Short-Term External Debt / Reserves	
	1996	2012	1997Q2 ^b	2013Q2 ^c	Jun-97	Latest ^d	1997Q2	2012Q4
China, People's Rep. of	-1.8	-1.6	0.8	2.3	10.6	22.1	28.8	12.4
Hong Kong, China	2.1	3.2	—	-0.3	4.0	6.9	280.6	65.3
India ^a	-7.0	-7.5	-3.1	-3.6	0.6	6.8	—	54.0
Indonesia	1.0	-1.8	-1.8	-2.4	5.7	5.2	191.0	49.0
Korea, Rep. of	0.2	-2.9	-2.1	6.7	2.6	5.1	232.0	44.1
Malaysia	0.7	-4.5	-4.4	1.1	4.0	7.7	69.2	25.5
Philippines	0.3	-2.3	-4.2	5.3	3.5	14.5	105.5	21.2
Singapore	21.3	1.1	20.0	20.0	7.4	8.3	245.4	75.1
Taipei, China	-1.4	-1.6	1.5	11.9	9.3	19.4	26.6	12.1
Thailand	2.1	-4.1	-7.9	-5.1	5.4	7.6	157.7	15.8
Viet Nam	-0.9	-6.9	-8.2	4.6	—	2.3	53.3	56.3

^aFor India, latest figures are compared with 1991, not 1997. Fiscal data is for central and state governments.

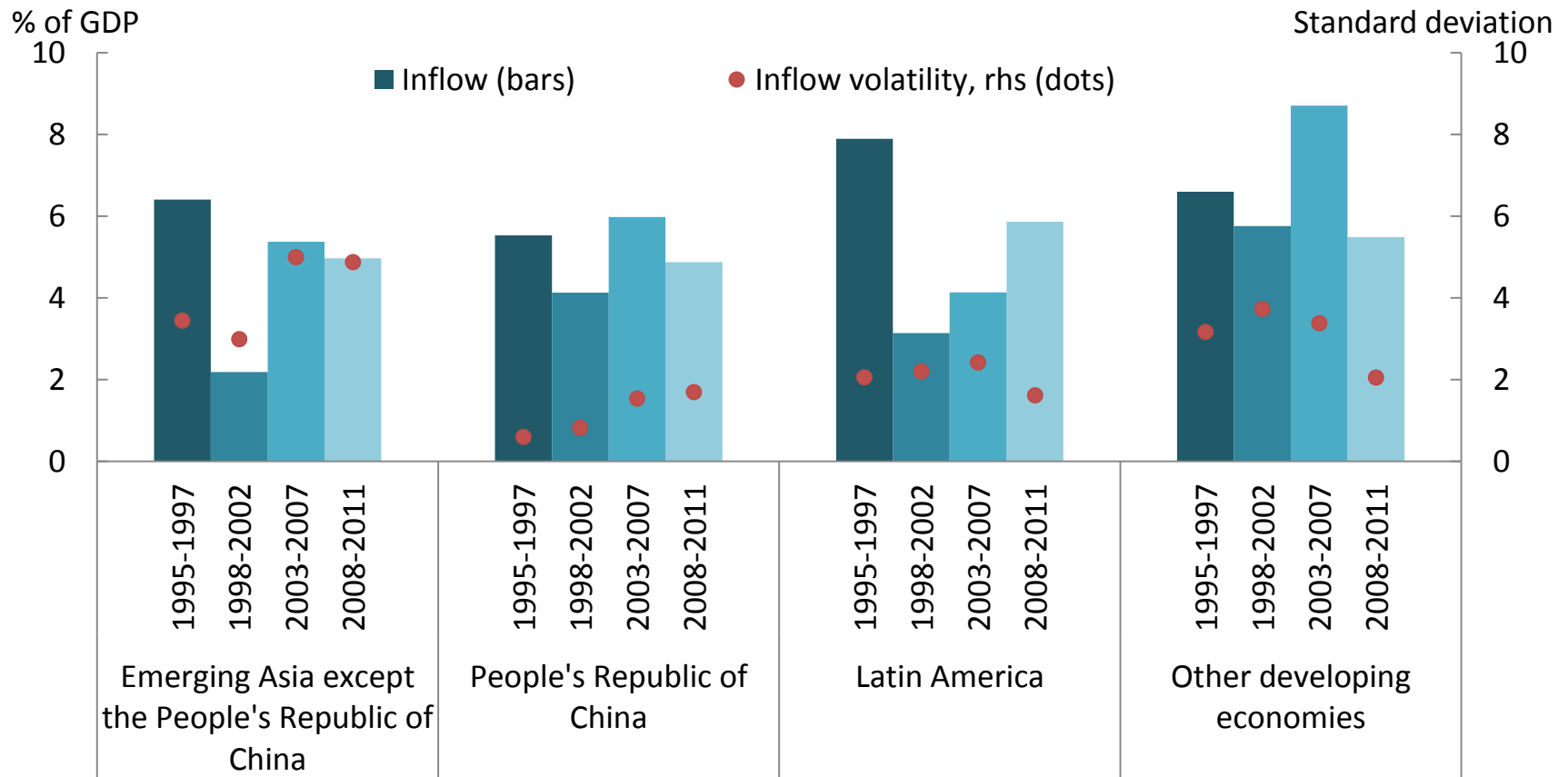
^bAnnual 1996 current account as % of GDP data for the People's Republic of China; Hong Kong, China; India; Malaysia; Philippines; Thailand; and Viet Nam.

^c2012Q4 data for Viet Nam; 2013Q1 data for Hong Kong, China; India; Indonesia; Malaysia; and Philippines.

^dRefers to June 2013 except for Viet Nam (May); Hong Kong, China; and Malaysia (July); India; Indonesia; and Taipei, China (August).

...but growing financial volatility calls for vigilance

Capital inflow and volatility

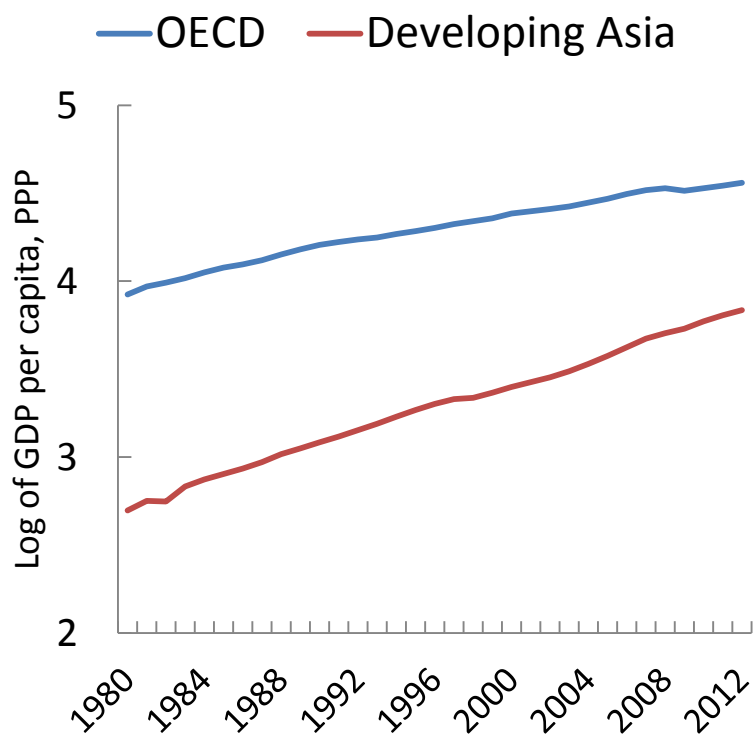


Lessons from the recent global crises

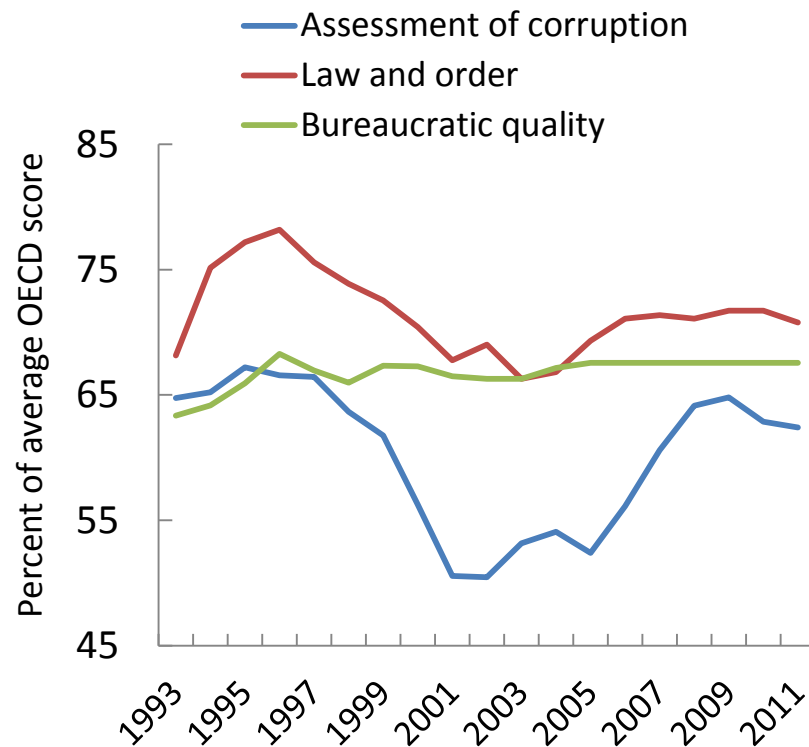
- **Monetary policy:** Crisis response cannot rely solely on easier monetary policy.
- **Exchange rate policy:** Allow exchange rate flexibility while balancing inflation and external debt.
- **Fiscal policy:** Periods of relative calm are times to firm governments' fiscal positions.
- **Bank restructuring:** Respond quickly to asset bubbles; be aggressive in bank restructuring; and recapitalize surviving banks.
- **Safety nets:** Better coordinate multilayer safety nets – domestic (reserve holdings), regional (ESM, CMIM), and global (IMF).
- **Macroprudential regulation:** Monitor capital flows; harmonize and improve transparency and quality of financial market data.

Governance and public service delivery

Developing Asia closing income gap faster than governance gap

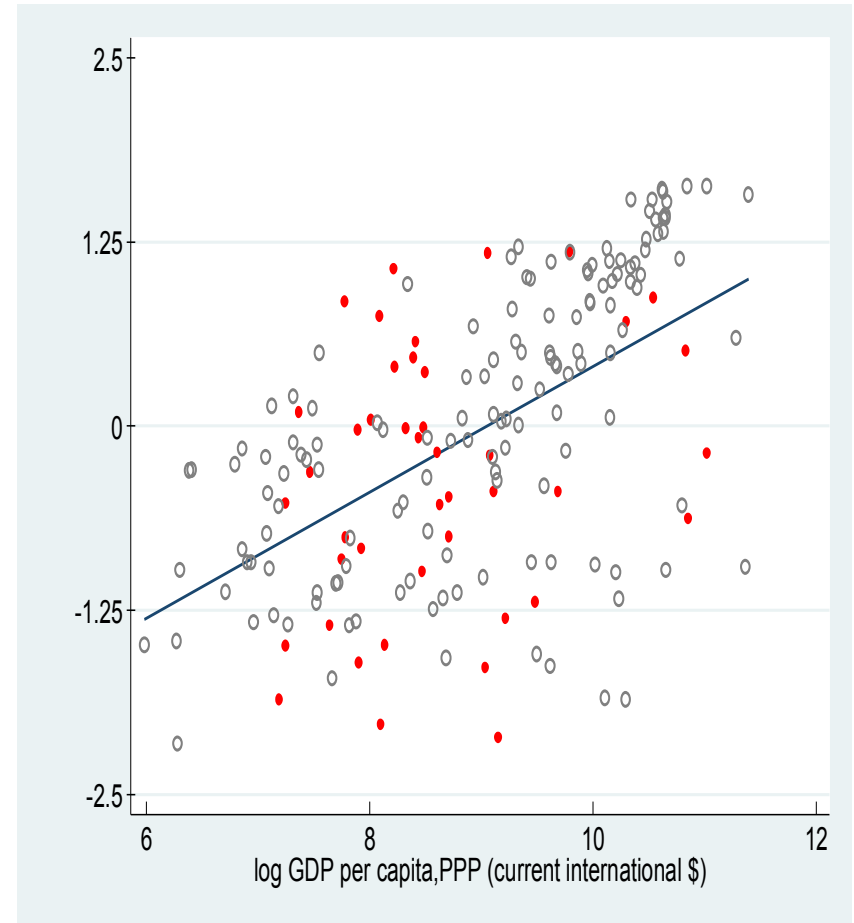
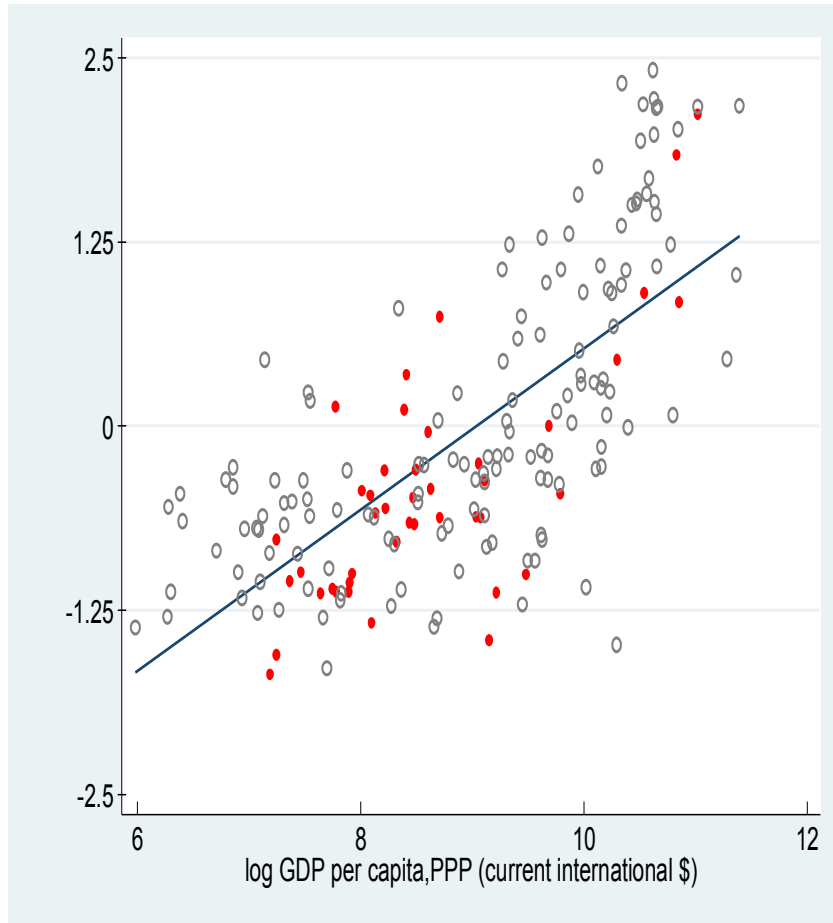


- Developing Asia's GDP per capita increased from 5.5% that of OECD economies in 1980 to more than 18% in 2012.



- But the region has seen less progress in closing the measured perceived governance gaps.

Governance deficits remain even after controlling for income



Sources: ADB estimates using data from World Bank, World Governance Indicators online database.

Globally, governance matters for growth and development

- Governance matters for attaining high levels of income and better social outcomes
- Good governance associated with more rapid growth
- Governance–development relationship is complex

➡ **Asia is no exception**

Public service reform is an effective entry point for governance reforms

- Citizens perceive the quality of governance through the quality of public services.
 - Corruption has been cited as the main driver of poor governance and service delivery.
- Weak governance in turn undermines public service quality.
 - Absenteeism of doctors in health clinics and teachers in public schools is high.

Tailor governance reforms to maximize development impact

- Focus on governance deficiencies that hold a country back from its next stage of development.
 - **Low Income:** Growth-supporting aspects of governance reform take center stage.
 - **Middle Income:** Benchmark advanced economies for wider participation and greater accountability.
 - **All Economies:** Aim governance reforms at actionable areas like improving public service delivery.

➔ **Governance reforms cannot be delayed**

Key findings

- Asia's growth is declining to 6% in 2013 from 6.1% in 2012 before picking up to 6.2% in 2014
- The two giants' growth is moderating despite signs of advanced economies' recovery
- Inflation easing to 3.6% and 3.7% in 2013 and 2014, though country variations exist
- Talk of US quantitative easing taper shook emerging markets, but Asia can weather the storm
- Structural reforms—including governance—are needed to safeguard financial stability and sustain future growth

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CHIEF REPRESENTATIVE FOR THE AMERICAS
BANK FOR INTERNATIONAL SETTLEMENTS





BANK FOR INTERNATIONAL SETTLEMENTS

3RD SEACEN-CEMLA Conference “New Paradigm in Central Banking”,
Kuala Lumpur, 21-22 October 2013

Current Macroeconomic Developments and Outlook for Latinoamerica

Jose Luis Escrivá
Chief Representative for the Americas



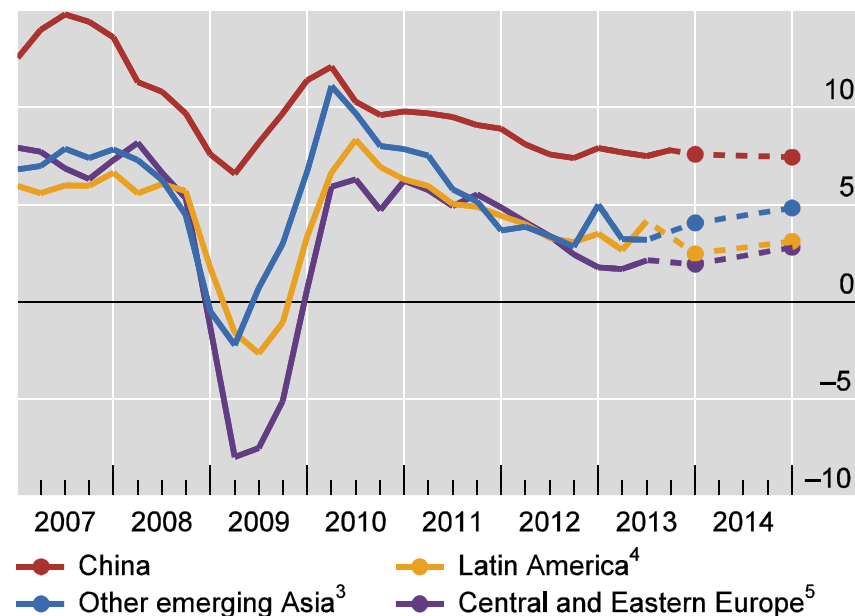
Central scenario: growth is converging to potential

Output growth¹

Annual changes, in per cent

Graph 1

Emerging markets²



¹ Actual real GDP (quarterly) data through 2013:Q2 or 2013:Q3. Full-year forecasts shown as dots. ² Aggregates are weighted averages based on 2005 GDP and PPP exchange rates. ³ Hong Kong SAR, India, Indonesia, Korea, Malaysia, Singapore, Thailand and the Philippines. ⁴ Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela. ⁵ Hungary, Poland, Russia, the Czech Republic and Turkey.

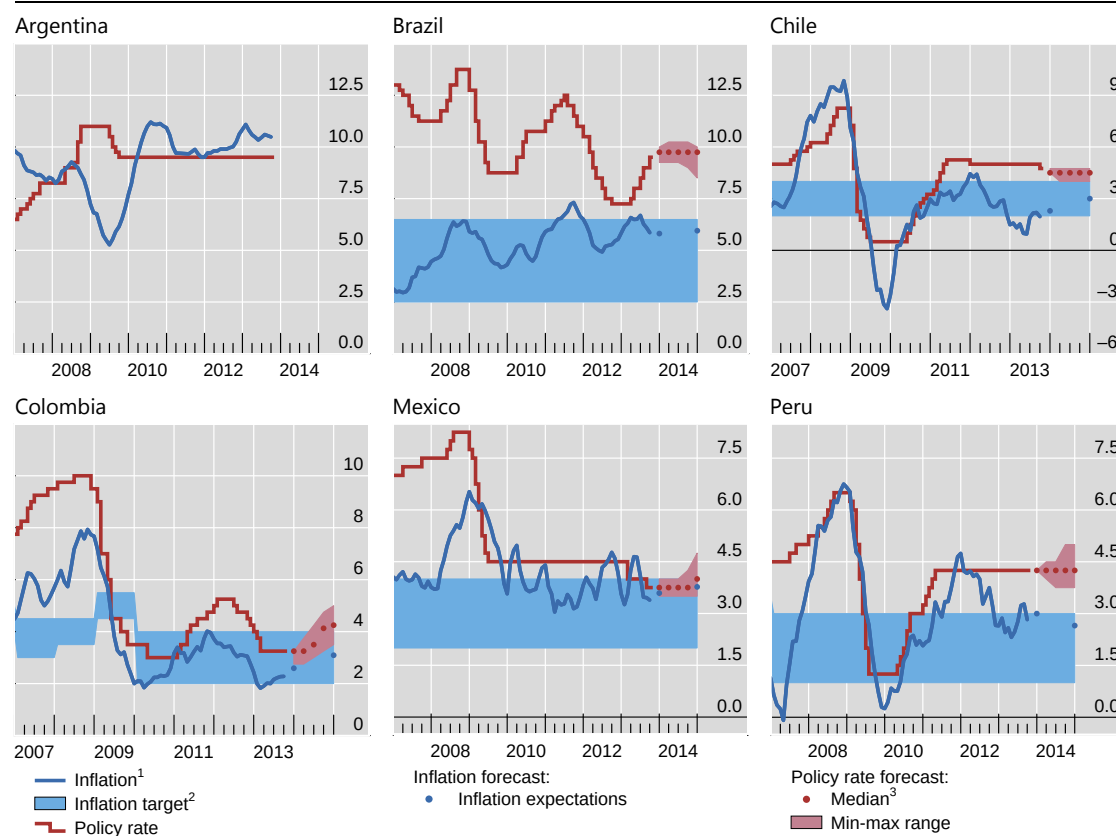
Sources: Consensus Economics; Datastream; national data; BIS calculations.

Inflation in Latin America broadly in line with targets

Inflation and policy/reference rates

In per cent

Graph 2



¹ Year-on-year changes in consumer price index. ² Announced targets, in terms of CPI. ³ Median of the pooled analyst answers

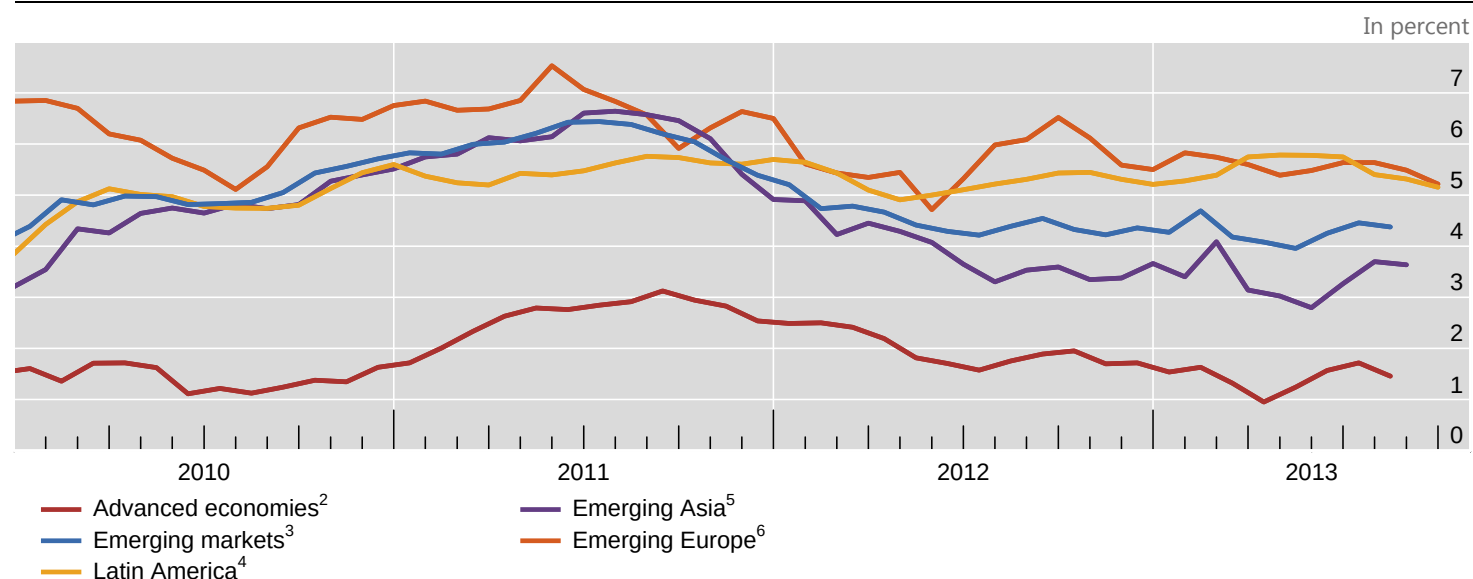
Sources: Bloomberg; Datastream; national data.

Resistance of inflation to further decline from current levels might be indicative of an already positive output gap

Global inflation¹

Year-over-year changes

Graph 3



¹ Aggregations based on 2005 GDP and PPP exchange rates. ² United States, the euro area, Japan and the United Kingdom. ³ Argentina, Brazil, Chile, Mexico, Peru, China, Hong Kong SAR, India, Indonesia, Korea, Malaysia, Singapore, Thailand, the Czech Republic, Hungary, Poland, Russia, South Africa and Turkey. ⁴ Argentina, Brazil, Chile, Mexico, Peru. ⁵ China, Hong Kong SAR, India, Indonesia, Korea, Malaysia, Singapore, Thailand. ⁶ The Czech Republic, Hungary, Poland, Russia and Turkey

Sources: Datastream; national data.

But potential growth might be lower than thought

- The region has made a great deal of progress in ensuring macro stability. This removes more adverse tail scenarios from the outlook.
- However, limited progress has been made in expanding potential growth by means of appropriate supply-side reforms.



But potential growth might be lower than thought

- The region has benefited over the last decade from two major (at least partially) external shocks:
 - 1) a decline in real interest rates of 3 percentage points
 - 2) a 25% improvement of the terms of trade
- It remains to be seen how much
 - of 1) was the result either from permanent decline in risk premia stemming from macro stability credibility gains or from extraordinary loose global financial conditions.
 - of 2) results from a relatively permanent shift in the global demand for commodities.

In this context, there might be no room for countercyclical fiscal and monetary policies

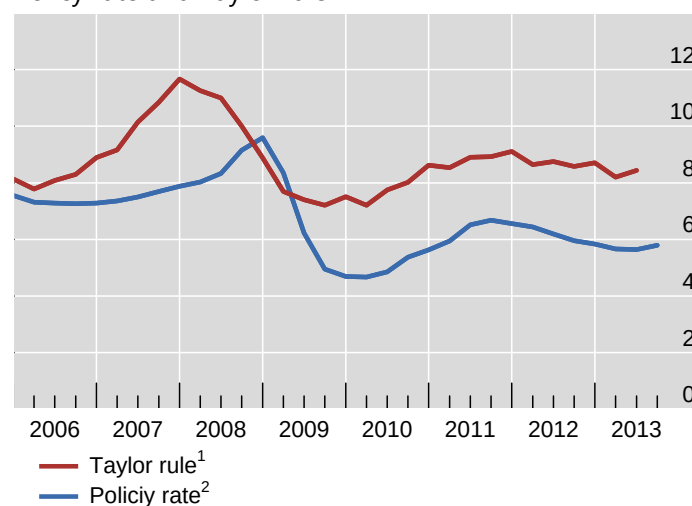
- Certainly, far less space than in 2008

Policy rate, Taylor rule and general government balances for Latin America

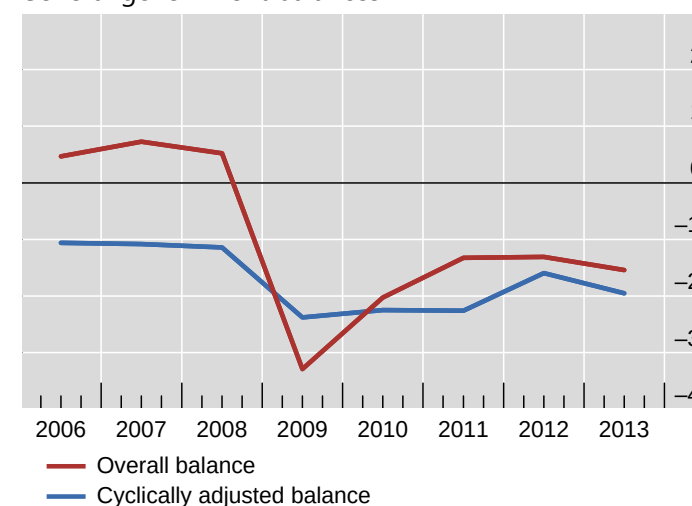
In per cent

Graph 4

Policy rate and Taylor rule



General government balances



Average for Argentina, Brazil, Chile, Colombia, Mexico and Peru

¹ Taylor rules are calculated as $i = 0.75 \cdot i_{t-1} + 0.25 \cdot [(R^n + \pi^*) + 1.5 \cdot (\pi_{t+4} - \pi^*) + 0.5 \cdot y]$, where π is a measure of inflation and y is a measure of the output gap. R^n is defined as natural interest rate. The term π^* is calculated for Argentina as the average level of inflation since Q1 2001, and as the target rate of inflation for other countries. Seasonally adjusted real GDP is used for measures and HP filter is used as the detrending method. ² For Argentina, BCRA seven-day reverse repo rate; for Brazil, SELIC overnight rate; for Chile, monetary policy rate; for Colombia, expansion minimum intervention date; for Mexico, overnight policy rate (prior to 2008, bank funding rate); for Peru, reference rate; for Venezuela, central bank certificates of deposit.

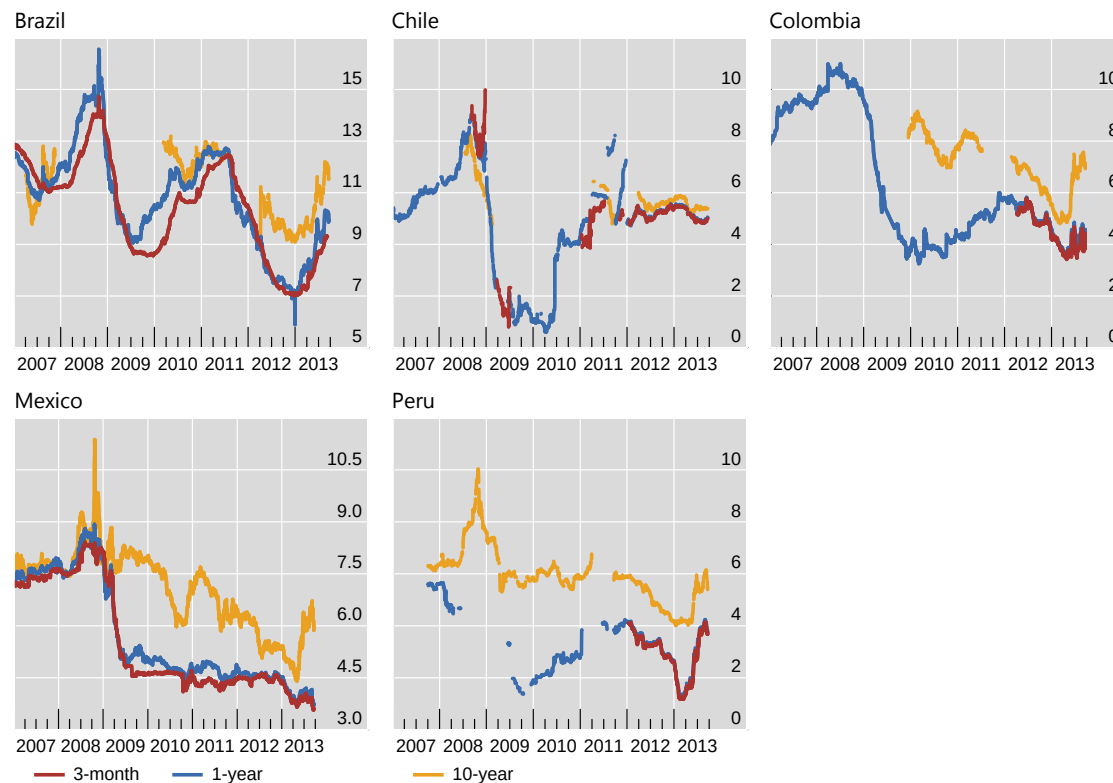
Sources: DataStream; IMF, World Economic Outlook and Fiscal Monitor Databases, October 2013.

Financial turbulences have primarily affected long-term interest rates

Government yield curve^{1,2}

In per cent

Graph 5



¹ BVAL and generic Government yields; for Brazil 3-months yield, generic yield is used; for Colombia 6-months yield, BVAL yield used ² Series are joined using generic and BVAL yields. Generic yields are used prior to following dates: for Brazil and Colombia, 4 April 2012; for Chile, 29 March 2012; for Mexico and Peru, 13 January 2012. After these dates, BVAL yields are used.

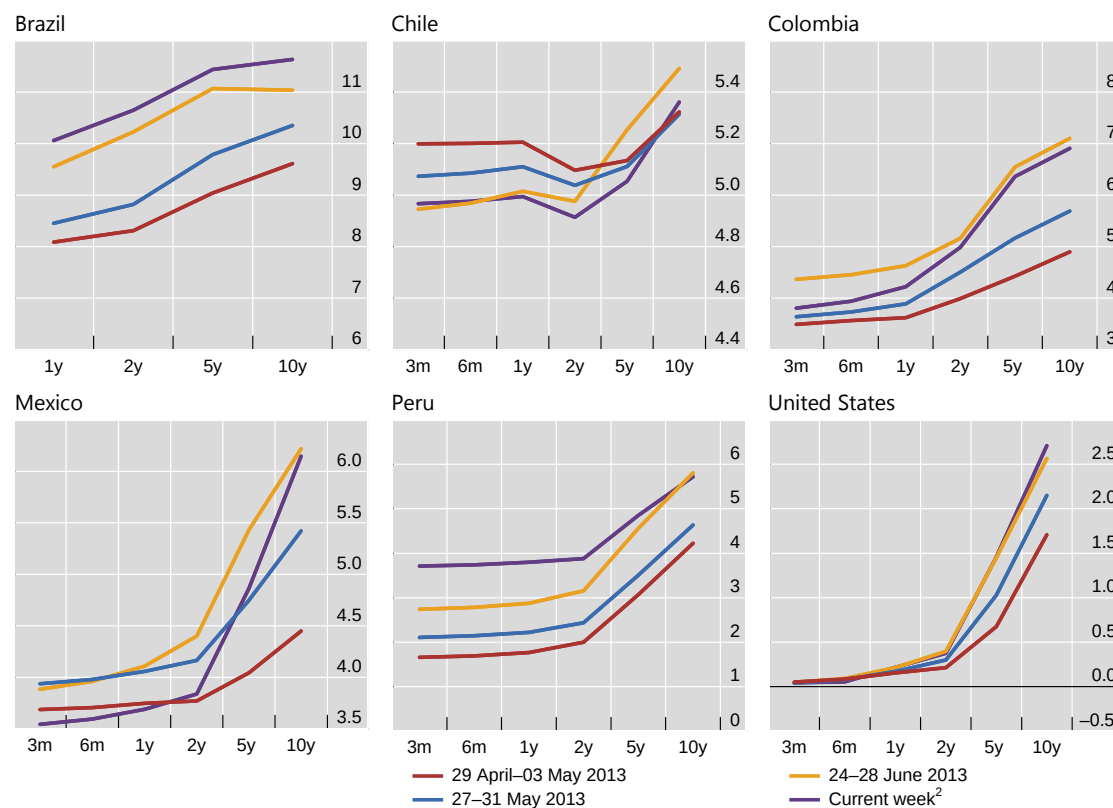
Source: Bloomberg.

Financial turbulences have primarily affected long-term interest rates

Sovereign yield curves (local currency)¹

In per cent, mid yield

Graph 6



¹ Period average; BVAL government curves ² From 07 October 2013 to 11 October 2013.

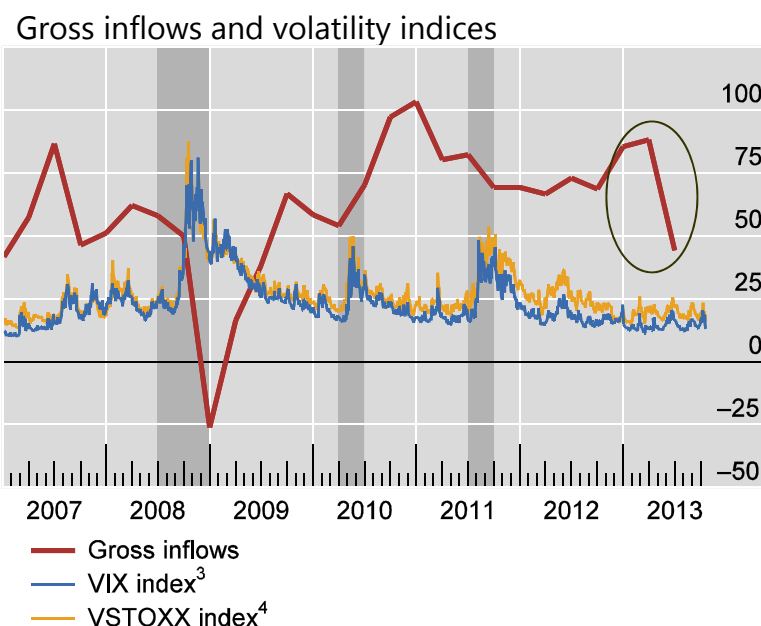
Source: Bloomberg.

But tapering fears after May might result in a sort of a blessing in disguise, leading to more manageable capital inflows, and interest and exchange rate levels closer to domestic needs

Capital flows to Latin America and global financial conditions¹

In billions of US dollars²

Graph 12



¹ Aggregation for Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela up to 4Q2012. From 1Q2013 to 2Q2013 aggregation does not take into account Argentina nor Peru due to lack of data. ² For capital inflows. ³ Chicago board options exchange SPX volatility index. ⁴ Euro stoxx 50 volatility index. ⁵ Bank of America Merrill Lynch US high yield master II index option adjusted spread.

Sources: DataStream; IMF; national data; Bloomberg; Merrill Lynch.



BANK FOR
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SETTLEMENTS



Restricted

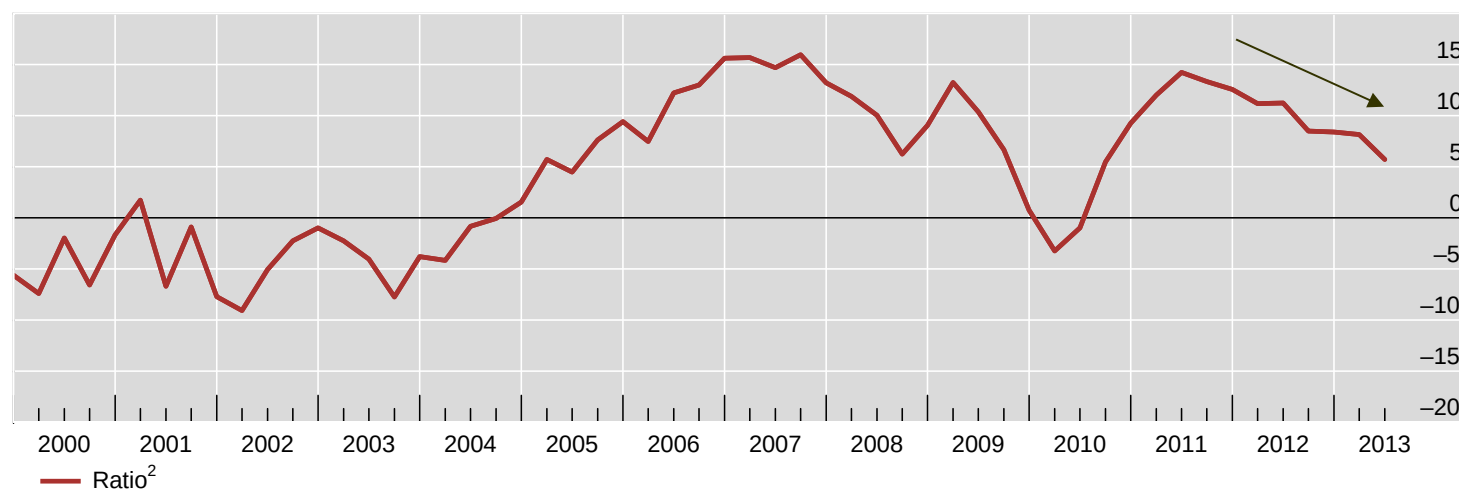
53

These corrections help cool off strong dynamics in domestic credit markets

Excess growth of credit over GDP^{1,2}

In per cent

Graph 8



¹ Total credit to the private non-financial sector deflated using CPI. ² Weighted average based on 2005 GDP and PPP exchange rates for Argentina, Brazil, Chile, Colombia, Mexico and Peru.

Source: IMF, *International Financial Statistics*; national data; BIS calculations.

Remaining vulnerabilities

- But the region remains vulnerable to stronger reversal of flows, particularly if combined with a decline in commodity prices.
 - It is still highly dependant on external financing
 - Its specialization in commodities has further increased

Highly dependant on external financing

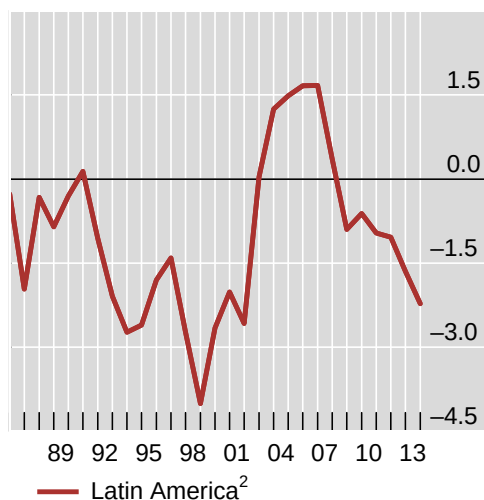
- Savings in the region are low and decreasing

Latin America: Current account and savings¹

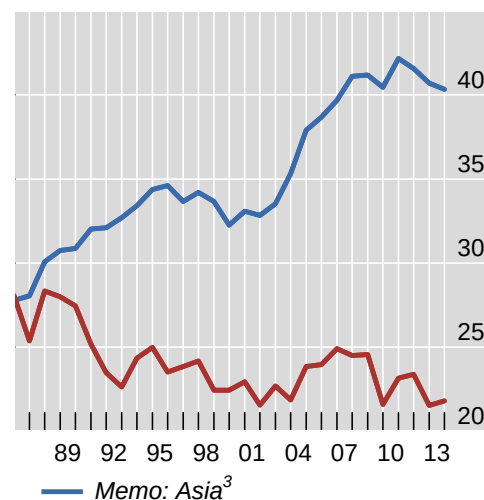
As a percentage of GDP

Graph 9

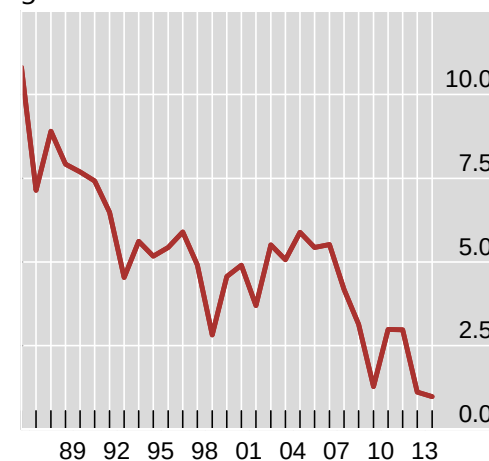
Current account balance



Gross domestic savings



Gross domestic savings minus gross investment



¹ Weighted average based on 2005 GDP and PPP exchange rates of the countries listed. For 2013, estimated data. ² Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela. ³ China, Hong Kong SAR, India, Indonesia, Malaysia, Philippines, Singapore and Thailand.

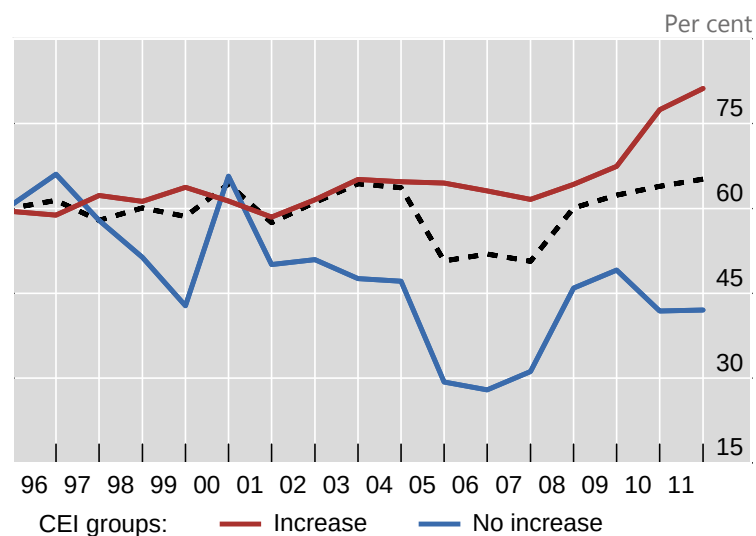
Source: IMF, World Economic Outlook (October 2013).

The region has increased commodity export intensity (CEI) after 2007, especially in some countries

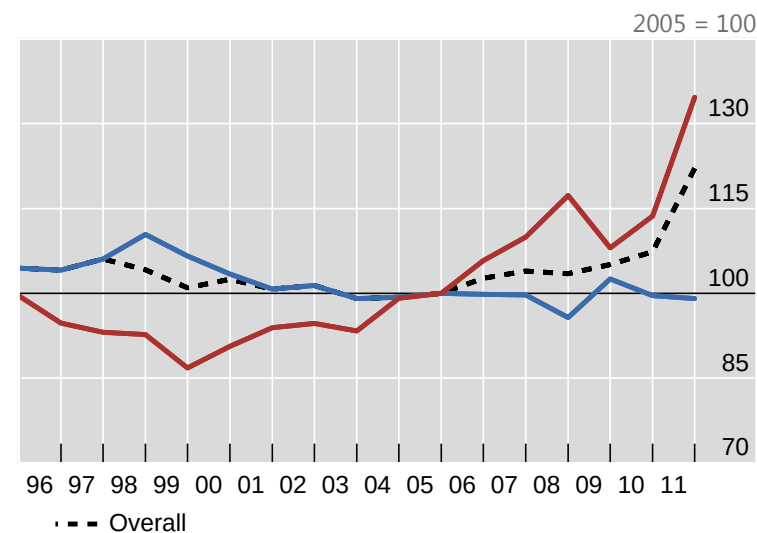
Latin America: Commodity export intensity and terms of trade¹

Graph 10

Commodity exports / Total exports



Terms of trade



CEI = Commodity export intensity.

¹ Group median.

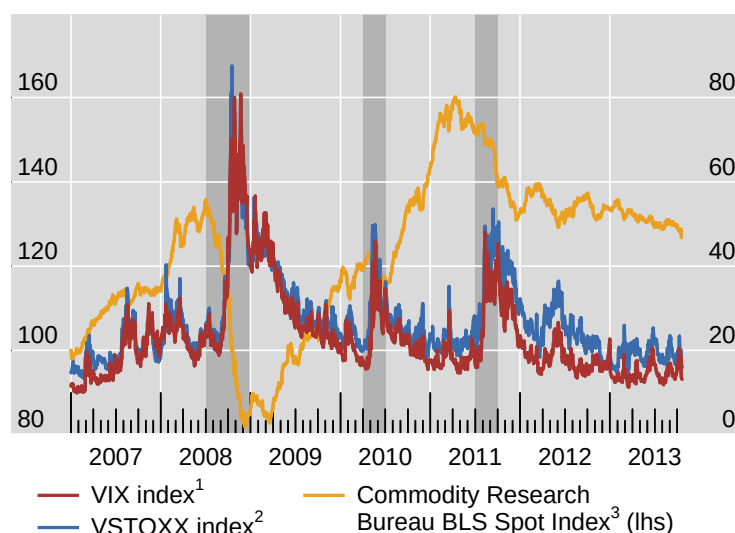
Sources: UN Comtrade database; IMF, WEO (October 2013); BIS calculations.

So far downward adjustment in commodity prices has been modest

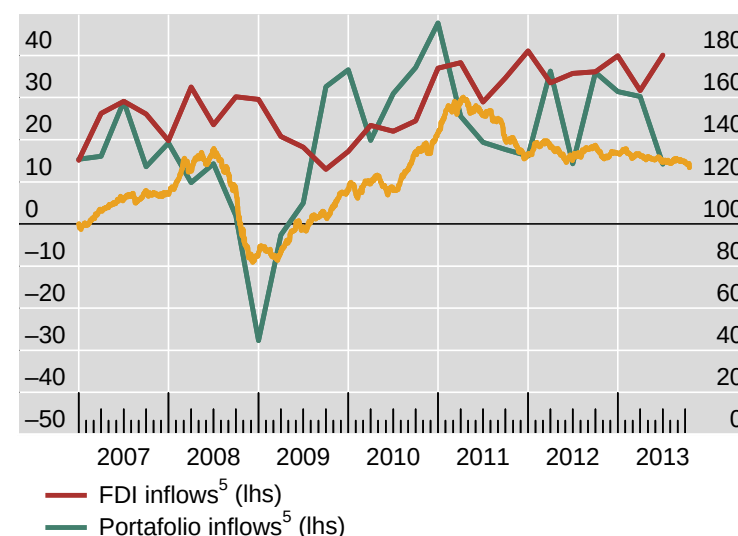
Capital flows, risk aversion and commodity prices

Graph 13

Commodity prices and risk aversion



Commodity prices and capital inflows⁴



¹ Chicago board options exchange SPX volatility index. ² Euro stoxx 50 volatility index. ³ For commodity index January 2007=100. ⁴ Aggregation for Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela up to 4Q2012 From 1Q2013 to 2Q2013 aggregation does not take into account Argentina nor Peru due to lack of data. ⁵ Billions of US dollars.

Sources: DataStream; Bloomberg.

However, there is a risk of further adjustments.

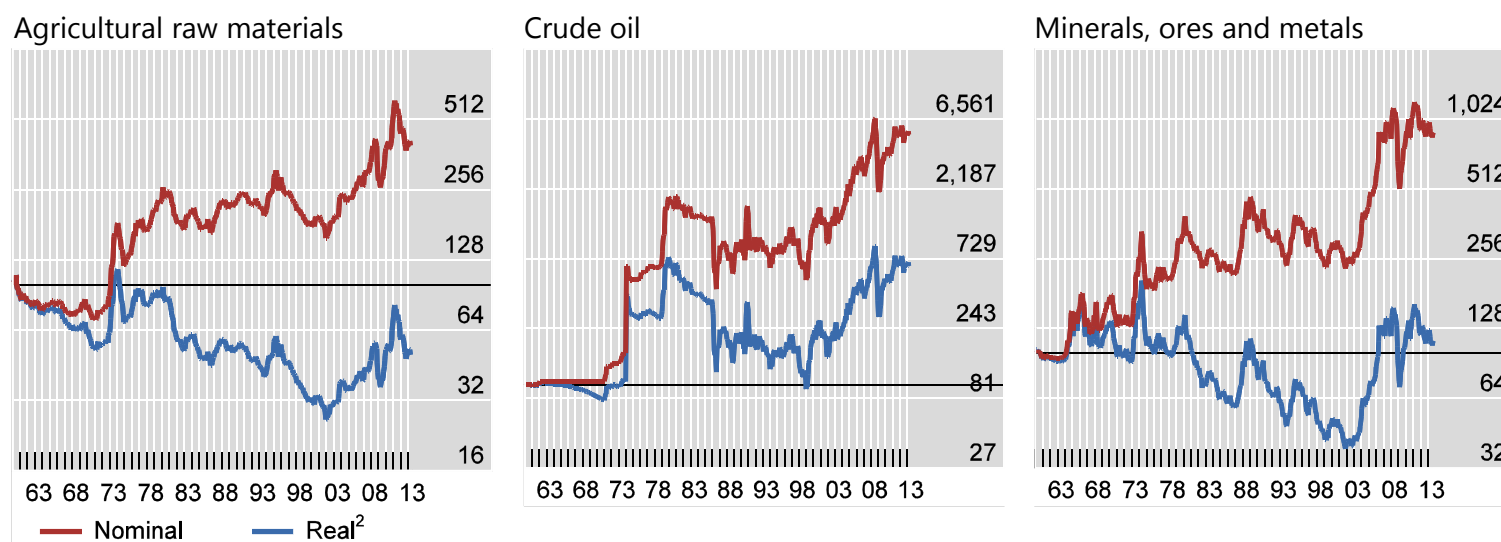
- Commodity prices in real values are around the maximum levels in the 1970s

Nominal and real commodity prices¹

1960 = 100

Graph 14

Logarithmic scale



The horizontal lines mark index value equals to 100.

¹ Free market commodity price indices; monthly data. ² Deflated using the United States CPI.

Sources: Datastream; UN commodity prices statistics; BIS calculations.

Conclusions

- Growth is converging to more sustainable levels.
- Macroeconomic stability seems to be firmly anchored, limiting risks stemming from financial markets turbulences.
- However, some vulnerabilities remain: 1) limited progress on supply-side reform;; 2) extremely low level of savings; and 3) high dependence on commodity prices.



LUNCHEON ADDRESS



RODRIGO VERGARA
GOVERNOR
CENTRAL BANK OF CHILE





**LATIN AMERICA AND THE GLOBAL TRANSITION
RODRIGO VERGARA
GOVERNOR
CENTRAL BANK OF CHILE
LUNCHEON ADDRESS
21 October 2013, Kuala Lumpur**

I would like to thank SEACEN and CEMLA for inviting me to participate in this Third Conference and to the Bank Negara Malaysia for its hospitality.

I will take the opportunity to share with you some thoughts on the current state of the world economy and how it reflects on emerging markets economies in Latin America and Chile.

1. EMERGING ECONOMIES AND THE GLOBAL TRANSITION

The world economy is undergoing a transition process.

In Latin America, this transition involves a moderation in the external impulse coming from high international commodity prices and ultra-expansionary monetary policy in advanced economies.

Although attention has been focused generally in those economies experiencing short term financial tensions, and indeed this transition may create some short term risks, in the medium term it will create a healthier environment for sustained global growth in emerging and advanced economies.

a. Rebalancing of Global Growth

One aspect of the rebalancing is the shift in the composition of growth between emerging and advanced economies, in the context of subdued global growth.

Certainly, the outlook for advanced economies looks more promising today than it did six months or a year ago.

The United States economy is gathering momentum, the Eurozone is stabilizing, and there are some encouraging indicators in Japan. The fact that they are moving forward is good news for the world economy as a whole. However, there is still a lot to do in these economies in terms of structural reforms and fiscal adjustment.

And there are also many unsolved risks in the fiscal and financial areas of advanced economies. As we have seen in recent days, the US lacks a working framework to guide fiscal policy not only in the medium term but even in the short term, which poses considerable risks for the US economy, the world economy and global financial markets.

The outlook for emerging market economies looks like the reverse of the coin.

China and other emerging market economies continue to lead global growth but, after several years keeping the world economy afloat, they are losing momentum.

Some emerging countries are experiencing a welcome shift toward more balanced and sustainable growth after some years of rapid expansion driven by internal demand.

Others are suffering an “after party hangover” as they have accumulated domestic and financial imbalances that made them more vulnerable to the recent surge in market turbulence.

Other countries are facing structural restrictions to growth related to low rates of investment or slow productivity growth.

The outlook for Latin America has deteriorated over the last six months. IMF growth forecasts for the region have been reduced from 3.7% to 2.9% per year in 2013 and 2014.

b. Tightening of financial conditions

Another relevant aspect of the rebalancing is the tightening of global financial conditions.

In a not so distant future, the Federal Reserve will start reducing its asset purchases, and markets are already pricing in hikes into the Fed funds rate over the next few years.

Even though the Fed has taken no action yet, global financial conditions for emerging markets have tightened already. Long term Treasury rates in the United States are 1percentage point higher than they were at the start of the year.

Also, since last April there has been a negative shift in sentiment towards emerging markets in general.

Capital has been flowing into these markets at a slower pace while sovereign and corporate bond yields have picked up, and currencies and stock markets have declined. There are no signs of a sudden stop in the making. Corporate and sovereigns have continued to tap international markets although at a higher costs.

Credit spreads for Latin American Sovereigns have increased over the last six months but there has been some differentiation. Latin American currencies have depreciated since last April and in most economies, domestic long-term interest rates have risen with international rates. Chile has been an exception: over the last six months we have seen a mild decline in long term interest rates, in line with a softer economy and expectations of an easing of monetary policy.

Notwithstanding these short term tensions, a smooth Fed tapering and tightening of global financial conditions is a welcome development for many economies in Latin America.

First, it would be an indication of a stronger and sustained recovery of the United States economy.

Second, it will promote a normalization of global financial conditions.

The exceptionally loose monetary policy in the United States and other advanced countries has meant significant financial spillovers on emerging market economies. Since 2010, there was a surge in capital inflows towards emerging economies.

Abundant global liquidity and the search for yield may create an environment of over-appreciation of the currency, over-leveraging in the private sector and excess lending by banks. These imbalances might jeopardize the stability of the domestic financial system.

The tighter external financial conditions will help cool off economies that were showing signs of overexpansion, and prevent the creation of further imbalances down the road.

However, we need to be mindful that markets may overreact to further action or communication of policy in the United States.

Emerging markets will continue to face considerable uncertainty in the near future. Successive rounds of monetary unwinding in the U.S. could bring new episodes of market volatility and repricing of currency, credit and stock markets.

It is reasonable to expect that portfolio adjustments will continue to affect emerging economies differently according to their fundamentals. Countries with better macroeconomic foundations and growth outlooks will probably suffer less than those characterized by financial or fiscal imbalances, large external funding needs, high inflation or asset price bubbles.

However, we must be prepared for a scenario where capital flows from abroad may become much more scarce, costly and volatile.

c. Mining Investment is Leveling Off

Finally, the third aspect of rebalancing for mineral exporters like Chile is that the worldwide 'mining boom' is maturing.

Since last April, commodity prices have declined in response to the downward revision in Chinese growth projections. Currently, consensus projections assume that China will continue to grow at around 7½% per year. Recent economic indicators point to a stabilization of growth prospects.

Latin America's terms of trade have declined with the fall in commodity prices.

Whether the "super-cycle" of commodity prices is over or not, will continue to be debated. What seems clear though is that the "super-cycle" in mining profits is over.

Lower metal prices and the increase in production and investment costs have squeezed profits out of the mining sector. Global companies have been reducing their capital expenditure budgets.

After peaking in 2012, the investment boom is showing signs of abating in several mining countries, including Australia, Chile and Peru. This development is reducing pressures on labor markets and also on capital imports. At the same time, as increased capacity is brought into line, mineral production and exports are starting to expand at a faster rate.

As I just said, this should help ease pressure on the labor market and capital imports, rebalance demand from domestic demand to net exports, and level off the current-account balance. A depreciation of the real exchange rate is part of this new equilibrium.

To sum up, the external environment is becoming less expansionary for emerging markets and commodity exporters.

2. CHILE

Despite Chile's sensitivity to the global economy, the response of the economic and financial variables has been quite satisfactory.

During 2013 so far, domestic output and demand have evolved along a gradual and welcome deceleration process, growing below 2010-2012 rates during the first half of the year. The deceleration reflects mainly the slowdown in investment, while private consumption remains relatively dynamic. The Central Bank's baseline scenario foresees Chile's GDP growth for this year between 4.0% and 4.5%. For 2014, the projected range is between 4.0% and 5.0%.

Headline CPI inflation is inside the tolerance range, but the core CPI measure has remained near 1% annually. It is estimated that headline inflation will rise gradually to reach 3% during 2014 and remain stable, while core CPI inflation will take a while longer to hit the target.

In recent months the peso has experienced a mild depreciation and today the real exchange rate is fluctuating around its long-term average.

The depreciation of the peso has occurred without adversely affecting inflationary expectations. Over the last decade, as our inflation target has gained credibility, the sensitivity of expectations or nominal wages to transitory supply shocks (e.g. exchange rate, oil prices, and specific taxes) has declined.

Over the last decades, Chile has built a policy framework designed to help an efficient adjustment of the economy and dampen down the impact of external shocks on domestic growth, fiscal accounts, inflation and finance.

This policy framework encompasses a fully-fledged flexible inflation targeting regime, a "clean" floating exchange rate, a widely supported fiscal rule and a conservative fiscal position, open trade and capital accounts, and a well regulated and supervised financial system.

In recent years, this framework has proven effective in dealing with large fluctuations in world commodity and financial markets.

Another important element in our policy framework is our open capital account.

Chile is an interesting case. Twenty years ago the country was seen as an example of capital account policies, using an unremunerated reserve requirement to stem the spillover effects on the domestic economy of short term capital inflows and lax monetary policy in advanced economies.

After the Asian and Russian crises, the Chilean authorities moved to further liberalize the capital account. So in the past decade and a half—and most noteworthy in the past few years— capital account restrictions have been conspicuously absent from the actual implementation of policies.

One striking result of the process of capital account liberalization in Chile over the past decade or so is that, instead of resulting in massive net inflows of capital, what has

occurred is a very substantial increase in gross foreign assets (to over 100% of GDP), mostly held by the private sector, particularly institutional investors (i.e. pension funds, insurance companies, mutual funds), but also by Chilean FDI abroad.

In times of global financial stress and market volatility, we see compensation between the behavior of foreign and domestic investors. As foreigners reduce their holdings of domestic assets, domestic investors return to the local market providing a stabilizing force to the domestic money market and the public debt market.

3. CONCLUDING REMARKS

To conclude I will summarize my main points:

Number one: the world economy is undergoing a rebalancing process. This rebalancing may create some short-term risks during the transition period but over a medium-term horizon it will create a healthier environment for global growth in emerging and advanced economies.

Two: Some emerging market economies are facing tighter financial conditions. It should help to reduce pressure on the labor market and capital imports, bring a rebalance of demand, shifting from domestic demand to net exports, and level off the current account balance. A depreciation of the real exchange rate part of this new equilibrium.

Third, a flexible exchange rate system and an open capital account for both inflows and outflows, in addition to sound fiscal policy and strong banking supervision, have been key to many emerging market economies to pass successfully through this cycle of high global liquidity, and stand prepared to the challenges posed by the tightening in global conditions that we have seen in the last months and that will probable prevail and could even get tighter in the future.

**SESSION 3:
SHAPING CENTRAL BANKS
IN THE NEW PARADIGM**



SUKUDHEW (SUKHDAVE) SINGH

**DEPUTY GOVERNOR
BANK NEGARA MALAYSIA**



DRAFT

**3rd SEACEN-CEMLA Conference on
A New Paradigm in Central Banking**

Shaping Central Banking Institutions in the New Paradigm

**Sukudhew (Sukhdave) Singh
Deputy Governor
Bank Negara Malaysia**

21-22 October 2013

The view expressed in this paper are those of the author and do not necessarily reflect the official views of Bank Negara Malaysia.

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- Markets may deliver optimal economic outcomes some of the time, but not all the time

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- Policy risks
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A. What is the new paradigm?

A paradigm is commonly understood to be a system of beliefs or theory related to a particular discipline. It is the conventional wisdom. Therefore, when we refer to a “new paradigm,” we are effectively referring to a change in underlying system of beliefs and theory, or “paradigm shift.” In the world of central banking, the crisis has been a watershed event in thinking about what the mandates of central banks should be and how those mandates should be achieved. In the aftermath of the crisis, central banks in the advanced economies have been very creative in finding new ways to use monetary policy to try to resuscitate their economies and deal with the fallout in the financial system; the unconventional has very quickly become quite conventional. At this stage, what we can see is that the paradigm is changing, but we do not know yet by how much and what the final form of the new paradigm would be. Here, I will look at six areas where I think such a paradigm shift is occurring, and which could have a significant impact in terms of how central banking will look like in the future.

Price stability is not enough

Increased focus on the nexus

It is clear now that a consensus has emerged that price stability is insufficient for macroeconomic stability – that monetary policy can have an impact on financial conditions that not only lead to financial instability but also ultimately undermine the very macroeconomic stability that central banks seek to preserve. There has also been a paradigm shift with respect to financial stability mandates, which have increased in prominence and there is now recognition that left on their own, financial systems can generate large risks which they do not necessarily manage very well; that distorted incentives can drive participants in financial markets into very short-term risky behaviours that are ultimately very costly to the economy; that without adequate regulation and supervision, the financial system can generate large systemic risks. There is, however, as Eichengreen *et al.* (2011) noted: “consensus on dissatisfaction; disagreement on solutions”, especially with regard to the extent of the separation of the monetary and financial stability policy domains.

The ideological debate of whether to lean or clean appears to have shifted in favour of the former, with clear recommendations for central banks (either on their own or as part of a cross-institutional committee) to deploy both, macro-prudential and micro-prudential measures. The role of monetary policy within the context of this debate is still contentious although there is

support for a more pre-emptive role in containing the build-up of financial imbalances. There is recognition that low interest rates are not benign even if inflation is low, as they influence financial institutions' funding costs, risk appetite and credit extension¹. This has two immediate implications. From a policy horizon perspective, it means looking beyond the usual two-year business cycle-related policy horizon and taking into consideration the slow-burning developments in the financial cycle that may portend future disruptions to the financial system and economic activity. As such, a dip in inflation below target may need to be tolerated as policy tightening is implemented to curb excesses in the financial cycle. It may also imply a practical minimum level and possible maximum duration for low interest rates, in order to promote balanced and sustainable growth in an environment of reduced financial risks. It means that interactions between the instruments associated with price stability and financial stability (policy interest rate and macro-prudential measures, respectively) must be taken into account as neither is neutral on the financial system and business cycle, and each has implications for the other.

Increased focus on economic growth

In the current environment of protracted low growth and high unemployment in the advanced economies, beyond the initial response at the onset of the crisis, fiscal policy has underwhelmed in terms of its support for growth. Central banks have had to step in to take a disproportionate share of the role of supporting growth. This raises questions about the appropriate role of central banks in supporting growth and employment. Are price stability and financial stability necessarily the limits of the central banks' contributions toward supporting growth? Can central banks do more?

There is an on-going debate about the possibility of changing the target of monetary policy from inflation to nominal GDP. A number of central banks in the crisis-affected advanced economies, notably the Fed and the Bank of England, have started targeting the unemployment rate, assuming that inflation remains benign. While I believe that this is a crisis related strategy to use monetary policy as a lever to lift growth and reduce unemployment, and that it does not reflect a fundamental change in the thinking of how monetary policy can support growth over the longer term, it does reflect a recognition on the part of central banks that monetary policy has to be

¹ Under the risk-taking channel of monetary policy, prolonged low interest rates leads to an increase in the supply of credit to borrowers with riskier profiles due to the search for yields and given the impact on valuations (asset and collateral values increase leading to downward modification of probabilities of loan defaults and losses).

flexible with respect to its choice of targets and the policy responses depending on the nature of the shocks affecting the economy and the state of the economy.

Also, while monetary policy is crucial for output stabilisation, it cannot replace structural policies that are more relevant in maximising the long-term growth potential of the economy. Central banks can nevertheless play a key role in determining the character and sophistication of the financial sector, by facilitating development of the institutions, markets and infrastructure necessary for the financial system to thrive; and mitigating market failures such as asymmetric information, misalignment of incentives and lack of access to financing and financial products. The financial stability function in that sense goes beyond just regulating and supervising financial institutions to also include building a resilient and diversified financial infrastructure that serves the needs of the economy. The later developmental role is particularly important in emerging market economies.

A better appreciation of macro-financial linkages

In order to pre-empt financial instability, and to operationalize surveillance and policy responses, we must have a better appreciation of not only of the implications of innovations, incentives, and the inter-linkages within the financial system (including parts of the financial system that are outside the central bank's regulatory boundaries), but also of the macro-financial linkages. Arguably, the causes behind the relatively low volatility of real output and inflation during the great moderation were not well understood, and too much credit was given to good policies and not enough to the overall benign macroeconomic conditions and favourable supply shocks. The increasing focus of monetary policy on inflation, which remained benign, created the justification for reducing interest rates to historically low levels. In hindsight, the loose monetary conditions were the seeds of financial vulnerability that were sown during this period; which then germinated into increased risk appetites, loosening of financial standards, excessive leverage and a build-up in financial excesses; before finally blooming into a full-blown financial crisis.

Recent research has attempted to identify interactions between business cycles and financial cycles. While the extent of synchronisation varies, there is evidence to suggest that financial crises of domestic origins occur at, or close to, the peak of the medium-term financial cycle and that recessions coinciding with downturns in financial cycles are especially severe (see Drehmann *et al.* (2012) and Claessens *et al.* (2011)). In light of this, the paradigm before the

crisis that monetary policy and financial stability were two distinct functions, and that the formulation of monetary policy does not need to take into account financial considerations, is no longer valid. A new paradigm would require central banks to give careful consideration to the interactions between the business cycle and the financial cycle in determining the appropriate stance of policy and in terms of the choice of instruments that would most effectively mitigate the risks to the economy and the financial system. A corollary of this is that central banks would have to develop appropriate surveillance frameworks and indicators to provide information on financial conditions in a timely manner. The focus, to paraphrase Eichengreen *et al.* (2011), is to determine whether prevailing monetary and financial conditions are raising the likelihood of sharp reversals in asset prices and access to credit which will be disruptive to economic activity. Such disruptions may be particularly severe if policy inertia allows the build-up of momentum in the financial cycle, which contributes to an unsustainable output path.²

Greater acceptance of the need to manage capital flows

Global capital flows have increased in recent years with increasing financial integration. After a brief reversal during the global financial crisis, capital inflows to emerging market economies resumed once again, with unconventional monetary policy measures by advanced economies as a major driving factor. Volatility and concerns over sudden stops were heightened in the recent period following expectations of tapering in the Federal Reserve's quantitative easing programme. While many emerging market central banks have used foreign exchange intervention and sterilisation to limit exchange rate volatility and manage domestic liquidity, these policies do not prevent large portfolio flows from creating sharp movements in the prices and returns on financial assets. What the post-crisis period and the quantitative easing in the advanced economies have done is to highlight the problem of the externalities these policies create for emerging market economies in a globalised world. What could be denied during times of more normal monetary policy could no longer be denied when the global economy was being flooded with liquidity originating in the advanced economies. The paradigm shift on the need for economies to be able to undertake measures to prevent capital flows from undermining financial and macroeconomic stability has been evidenced by the International Monetary Fund (IMF) finally endorsing capital flow management measures as acceptable "last resort" policy

² Borio *et al.* (2013) estimate a measure of output gap that takes into account the effect of financial factors which may be "artificially" boosting output and therefore leading to the over estimation of potential output.

responses (IMF, 2012). It has also generated new research that questions the conventional wisdom about the benefits of capital flows and the degree to which policies are compromised by these flows. For instance, recent work suggests that even with floating exchange rate regimes, monetary policy independence is still complicated by the global financial cycle (see Rey (2013) and Bruno and Shin (2013))³.

Monetary policy can do more than earlier thought, but how much more?

While supporting growth is well within the monetary policy mandate, compared to the pre-crisis paradigm of monetary policy being conducted purely through changes in interest rates, it is possible that in the aftermath of the crisis, the paradigm shift will be that central banks can go further. After a major financial shock, besides traditional monetary policy measures, central banks may have to undertake direct intervention in the markets to unclog the transmission mechanism and prevent a damaging credit crunch. In particular, it is very important to remove credit constraints facing bank dependent small businesses, which employ a significant proportion of the workers in the economy. The Bank of England's "Fund for Lending" is one example of this. Aside from rehabilitating the balance sheets of banks, central banks could potentially also play a similar role for private sector balance sheets by, for example, creating mechanisms for debt restructuring and resolution.

However, there are limits. The financial crisis has once again underlined the need for macroeconomic policies to have sufficient flexibility to act as effective policy tools against shocks to the economy. At the beginning of the crisis, aggressive monetary accommodation and fiscal expansion had prevented the global economy from falling into a deep recession. There was a sharing of the policy burden of supporting the economy. However, because fiscal positions were either not healthy before the crisis or deteriorated significantly during the crisis, fiscal policy flexibility quickly reached its limit in the advanced economies. Consequently, monetary policy has been left to do much of the heavy-lifting in trying to stimulate an economic recovery. The readiness with which central banks have jumped into the breach reflects their

³ The global financial cycle is characterised by large co-movements in asset prices, capital flows, leverage, and credit growth. These movements are negatively correlated with risk aversion and partly determined by US monetary policy. The global financial cycle transmits monetary conditions which may conflict with domestic cyclical needs in individual countries. This complicates national monetary policy even under floating exchange rate regimes (Rey, 2013). Global banks are key players in the transmission of global liquidity, obtaining funds cheaply and then supplying wholesale funding with lenient conditions to national banks. Currency appreciation can fuel further capital inflows rather than stem them as it strengthens local-borrower balance sheets (Bruno and Shin, 2013).

deep concern about the health of the economy, but after more than five years of near zero nominal policy rates and multiple rounds of quantitative easing, which have been rewarded by persistently weak growth, it begs the question of whether monetary policy has over-promised on what it can deliver – whether monetary policy can do it alone. This is a particularly relevant question in a balance sheet recession, when economic agents are deleveraging, and monetary policy is trying to stimulate further debt creation and risk taking. The unintended consequences of highly aggressive monetary policy that are evident in the post-crisis environment include over-investments in the real economy, delays in fiscal reform, and distributional effects which favour high-income debtors over creditors and low-income debtors (White, 2012). Sustained financial repression could also bring lasting changes in the behaviour of savers and investors, which may not necessarily be favourable to the sustainable growth of the economy. Furthermore, can central banks return to normal monetary policy in a non-disruptive manner after having pushed the boundaries? Is quantitative easing a monetary quicksand, easy to fall into but difficult to get out of? The answers to these questions are not known yet, but when they are known, we will also know much more about what monetary policy can and cannot do.

No one size fits all⁴: a needs-based approach to central banking

No central banker wears the “one ring that rules them all.” Prior to the crisis, central banks with different monetary frameworks have had fairly similar success with managing inflation. The crisis has underlined this by showing that even the so called “best practise” monetary frameworks were not infallible. The new emerging paradigm may be that we need to look less at form and more at substance when it comes to monetary regimes.

Pre-crisis, inflation-targeting was the leading monetary policy framework. It was adopted by both the advanced economies and emerging market economies (EMEs), irrespective of whether they are closed or open economies. Post-crisis, from the “neatness of inflation-targeting and light-touch financial regulation” (Mohan, 2012), we have moved to an acceptance of (i) “interventionist” unconventional monetary policy measures to support growth and address market dysfunction; and (ii) the need for an expanded and more discretionary toolkit to increase the reach of policy to meet various other challenges that include, but are not confined to, managing expectations, managing capital flows, and limiting systemic risk in the financial system. Furthermore, what works well in normal times may not be best in periods of turmoil.

⁴ This borrows from Mohan (2012).

During crisis times, there is a case for putting more weight on financial stability and tail risks than on short-term price stability.

Central banks in emerging market economies have traditionally had wider mandates than those in advanced economies, including those that relate to national development goals (BIS, 2009). The developmental role of central banks in emerging market economies has been particularly important given the need to build resilience.

Markets may deliver optimal economic outcomes some of the time, but not all the time

Prior to the crisis, the dominant view was that markets could efficiently and effectively intermediate funds, allocate resources, and manage risks. This is indeed the case most of the time but not always. The financial crisis in the advanced economies demonstrated that even in the most developed financial systems, excesses happen, do not self-correct and tend to cumulate over time until there is a collapse. There is greater appreciation that market behaviour that appears rational and efficient at the micro-level may in fact lead to systemic risks. That understanding has led to increased scrutiny of how financial markets operate and led to the introduction of more rigorous oversight and tighter regulatory standards – overall, a more interventionist approach.

B. What does it imply about the scope of central bank mandates?

A clear implication of these paradigm shifts is a move away from the narrow model of central banking to one where central banks would carry a broader scope of mandates. How broad remains to be seen and probably will vary among countries. Price stability will continue to be an important policy objective for central banks but monetary policy will no longer be only about price stability. There will be a financial dimension to monetary policy decisions. Aside from considering developments related to the business cycle, central banks will also have to consider what is happening with the financial cycle. How monetary policy frameworks will be adapted to accommodate this remains to be seen.

At this stage, monetary policy mandates have remained broadly unchanged, although there has been an implicit shift in the relative weights on inflation and output stabilisation towards the latter in line with the pro-growth stance many central banks have undertaken. There have also been some explicit changes with regard to the incorporation of financial imbalances with a couple of central banks making modifications to their loss functions. The thinking appears to be that as long as central banks can manage inflation expectations over the medium to long term and remain credible, they have leeway in adjusting their relative focus on different objectives that enter their loss functions. However, there could also be intellectual and institutional inertia, and these are still the early days where many of the debates remain unsettled.

Even if mandates are little changed, the way central banks carry out those mandates is likely to. Much has already been written about how the macro models used by the central banks prior to the crisis failed to take into account financial developments and consequently created a vulnerability in policymaking. Will these models survive in the new paradigm; will they succeed in overcoming their weaknesses? They may, but I am not optimistic. Models will remain the holy grail of macroeconomics. They are intended to simplify and assist policymaking, but they can also narrow the peripheral vision of central bankers.

There are other developments in the post-crisis period that could transform the nature of the monetary policy mandate. How will the experiment with forward guidance turn out? Will it become a standard part of the conduct of monetary policy, or will it be an experiment relegated to monetary history? The same questions can be posed about the adoption of unemployment goals by the Fed and the Bank of England. The quantitative easing by the major central banks is a policy experiment that is still in progress. Can such monetary policy bring about a lasting economic recovery, or will it create such large distortions, particularly in the financial markets,

that it will ultimately undermine economic growth? The unwinding of QE is still in the future, as is the normalisation of the balance sheets of the major central banks. Whether this can be done in a non-disruptive manner is not only of interest to central banks but also to governments, financial markets, businesses and households. Will the large scale purchases of government debt by the major central banks set a precedent, and how will that affect the manner in which central banks carry out their mandates in the future.

For emerging markets central banks, the exercise of their monetary policy mandates will continue to be influenced by the large spillovers effects of the monetary policies of the major central banks. The post-crisis acceptance of the justification for capital flows management measures does not mean that such measures are easy to implement or do not carry risks. Nevertheless, such measures are a useful addition to the toolkit of central banks when these spillovers endanger domestic macroeconomic and financial stability. Central banks have also been more willing to admit that with very low interest rates in the major economies, maintaining domestic interest rates that are sufficiently low as to not attract large capital inflows has become a policy objective.

Although there is a notable increase in the number of central banks with explicit financial stability-related objectives in laws (BIS, 2013), the mandates have evolved differently across central banks – some clearly have broader mandates than others. Among most Asian central banks, financial stability has core part of their mandates since the 1990s. In the post-financial crisis period, having this broader mandates does appear to have been useful in dealing with the challenges and complexity that has characterized their operating environment. Aside from having a greater variety of tools, multiple functional areas also provide a richer information set to support policy making, make policy trade-offs and manage incipient risks. However, multiple mandates and a complex operating environment, combined with institutional structures, does raise some issues that have implications for the independence of central banks, the exercise of internal governance and the nature of risks faced by central banks. This would be covered in the next section, but before moving on, just a couple of more thoughts on central bank mandates in the new post-crisis normal.

Recent dialogue that dwells on generating growth that is more inclusive and equitable in the post-crisis environment provides some vindication of the increased involvement by central banks in financial inclusion, a key aspect of financial sector development. It has become fairly common for regulators to have financial inclusion as a mandated objective or at least

recognised as an important implicit goal (Hannig, 2013). This is reflected in the strong central bank participation in the Alliance for Financial Inclusion (AFI)⁵, a global network of policymakers in developing countries, established in September 2008, which is committed to identifying and adopting financial inclusion policy solutions. The financial crisis in the advanced economies can be framed, at least in part, as being the outcome of financial inclusion gone wrong. Households that otherwise would not have had access to financing were provided with financing that was beyond their means to service. Savers and investors were sold fancy financial products the risks of which they did not fully comprehend until they were landed with large losses. This last point also highlights another aspect of financial regulation that could be a central bank mandate: consumer protection and education. Greater access to financial services for those that do not enjoy such access will only enhance their economic welfare if they are able to make good financial decisions and there are protected against any predatory behaviour on the part of those providing them the financial services. The central bank can play key roles in this regard – regulation and supervision, guiding institutional arrangements that support financial inclusion, and ensuring that functioning and effective mechanisms for consumer protection and education are in place.

⁵ Members of the AFI include approximately 60 central banks representing Africa and the Middle East, Asia, Eastern Europe and Central Asia, and Latin America and the Caribbean.

C. Implications for Central Bank Independence

As a matter of practice, the level of independence enjoyed by the central bank would be determined by three factors: (1) the powers conferred by legislation, (2) the central bank's reputation as a competent authority in the eyes of the public and other stakeholders (i.e., its performance in delivering on its mandates), and (3) the strength of the balance sheet that provides operational autonomy for monetary operations without having to depend on government funding.

How will the new paradigms and multiple mandates affect the independence of central banks? Blejer (2013) notes that central bank independence to carry out multiple mandates raises the issue of democratic deficit because the reasons for it in the context of monetary policy – namely, that politicians can exploit the short-run effects of expansionary monetary policy at the expense of long-run inflation, and that central banks have a clear comparative advantage in dealing with monetary policy issues – do not apply to other mandates. However, similar arguments can be made for the independence of the central bank with respect to financial stability-related policies – politicians may choose not to react to financial imbalances because of the potential unpopularity of such decisions, or because financial booms tend to have a positive impact on the fiscal balance through increased revenue collection, or because the buoyant financial conditions would be taken as reflecting market confidence in the government's economic policies. Also, while there is no similar adage as “inflation is always and everywhere a monetary phenomenon”, the central bank is well-placed to manage risks to financial stability, more so if the mandate is clearly spelt out⁶.

Nevertheless, there are challenges. First, a broader mandate with multiplicity of objectives makes establishing accountability for outcomes more challenging. A narrower mandate, focused on monetary stability, allows the central bank's performance to be accessed against measurable indicators of inflation which are widely available. This fact also facilitates regular communications with the public and other stakeholders. Thus accountability for delivering on the price stability mandate can be clearly established. The broader financial stability mandate involves a wider and more ambiguous range of outcomes⁷. The central bank may be held to

⁶ Bank Negara's Central Banking Act 2009 Section 29 stipulates “risk to financial stability” means a risk which in the opinion of the Bank disrupts, or is likely to disrupt, the financial intermediation process including the orderly functioning of the money market and foreign exchange market, or affects, or is likely to affect, public confidence in the financial system or the stability of the financial system.

⁷ ‘Strengthening Financial Stability Indicators in the midst of rapid financial innovation – Updates and Assessments’, Edited by Dr. Yuthika Indraratna, The SEACEN Centre, August 2013

account for all manner of shortfalls in the financial system and economy, while at the same time find itself constrained by confidentiality requirements from being transparent in communicating its assessment of the health of financial institutions. Central banks may be seen to be accountable even for developments in financial institutions that are outside their regulatory powers. All manners of financial pyramid schemes and scams could end up being placed at the central bank's doorstep. Under such circumstances, it may be difficult to define the boundaries of its accountability.

Second, the central bank will need to engage with many different stakeholders given that, unlike interest rate changes, macroprudential policies are intended to be affect only the problematic sector, and within that sector would affect different groups differently. For instance, prudential measures introduced to curb sharp rises in property prices would be welcomed by first-time house-buyers, but not by powerful interest groups who benefit from the price increases: speculative investors, housing developers, bankers, etc. Measures to impose stricter credit standards to curb over-indebtedness of households may be welcomed by few, especially if they are seen to be hurting economic growth. Effective implementation of macroprudential policies would require extensive stakeholder management to prevent such policies from being discredited by political groups and other vested interest parties.

Third, there is the challenge of limiting the risks of moral hazard, or 'regulatory capture' due to financial institutions deemed as being *too-big-to-fail* or too systemically connected to be allowed to fail. In the post-crisis period, there have been attempts to address this by requiring the systemically important banks to come up with "living wills" to facilitate their orderly demise should they become insolvent. Counter-cyclical capital buffers and other prudential rules may also help to contain the risk. Nevertheless, central banks may be compelled to take action to rescue institutions because of the broader implications of their failure on financial and economic stability. This could create other problems for the central bank. Such actions may be seen as favouring the banks, especially during a crisis, when the general public may be suffering from erosion in economic welfare due to reduced incomes or loss of employment opportunities.

Finally, the central bank's independence is complicated with respect to exercising shared responsibility for crisis prevention, management and resolution at the systemic level or institutional level. The resolution of institutions deemed insolvent or near insolvent has economic and social costs, and elected officials and the Ministry of Finance may want to have a say in the policy measures implemented by the central bank. This is particularly the case when resort to public funds is needed to support financial institutions. This could limit or complicate

ability of the central bank to manage the resolution of financial system problems in an autonomous manner.

Measures to strengthen central bank's independence

There are measures that can be taken to address some of these challenges to central bank independence. Controls must be put in place so the central bank can implement financial stability policy without undue hindrance by third parties and yet remain accountable as a public institution. These measures need to focus on at least the following five areas:

1. **Institutionalise the boundaries of accountability and powers** through legislation which is specific in its purpose and scope, including the standards of transparency and oversight over the central bank.
2. **Strengthen the central bank's internal governance structures and processes** for decision-making and sharing of information to ensure that there is consistency in policies to address monetary and financial risks and that the risks of policy blind spots are minimised.
3. Establish clear policies, roles and accountabilities with respect to **crisis prevention, management and resolution**, particularly when they are different agencies involved. For instance, the central bank, the capital market regulator, the deposit insurer, the Ministry of Finance, and other relevant parties, should have a clear understanding of who is accountable for what.
4. Put in place more **effective institutional infrastructure** that can support the central bank's broader mandate, and thus diffuse the risks of overloading the central bank with too many diverse responsibilities. An example would be the crisis resolution function being taken over by an autonomous deposit insurance entity. Efforts put into consumer financial education and the establishment of credit bureaus can mitigate risks of over-indebtedness and strengthen retail credit risk management practices. The adoption of robust risk management and strong governance frameworks by regulated financial institutions can increase their resilience and make them less likely to get into trouble. Such efforts to create focus and reduce risk could be rewarded by increased independence for the central bank, given that the absence of bank failures and crisis makes it unnecessary for other parties to intrude on the central banks policies. In short, if consumers and financial institutions are more likely to stay out of trouble, the central bank will be less likely to have to deal with complex policy trade-offs, and is therefore

more likely to be able to manage its broader mandates with a high degree of independence.

5. Adopt a **long term perspective on financial sector development** to ensure the financial system evolves to meet the emerging needs of the economy as opposed to creating a world of frenzied financial activity which is not directly related to real economic activity. A financial system that develops to serve the needs of the economy, and is appropriately regulated, is less likely to lead to innovations and excesses that ultimately lead to huge economic losses. The fact that the financial system is serving the economy and that there is less likelihood of crisis should reduce the possibility of external intervention and thereby enhance central bank independence.

D. Governance

“Wider responsibilities require greater accountability. Financial stability actions are by their nature more political than monetary policy ones. The challenge in the coming years will be to refine and develop the governance mechanisms for central banks so that they retain the independence they need for both their monetary policy and financial stability roles. This will require greater clarity about their financial policy strategies. It will also require well-articulated mechanisms for cooperating with other public authorities. And it implies greater use of independent, impartial oversight boards and committees.” (Bingham, 2010)”

While design of governance arrangements is not an exact science, and depends on individual institutional characteristics, having more or broader mandates will require central banks to think about a number of areas to enhance their governance and organisational structures to ensure that they are able to effectively deliver on those mandates. These are:

- i. Clear mandates and policy objectives that are backed by a comprehensive and sound legal framework
- ii. Strong institutional arrangements, governance and coordination
- iii. Effective communications framework
- iv. International collaboration and coordination
- v. Business planning to provide policy focus and effectively use resources
- vi. Effective talent management

i. Clear mandates and policy objectives that are backed by a comprehensive and sound legal framework

In reflecting on the Malaysian experience of enhancing the legal and regulatory infrastructure for the financial stability mandate, I would say that it is important to put in place:

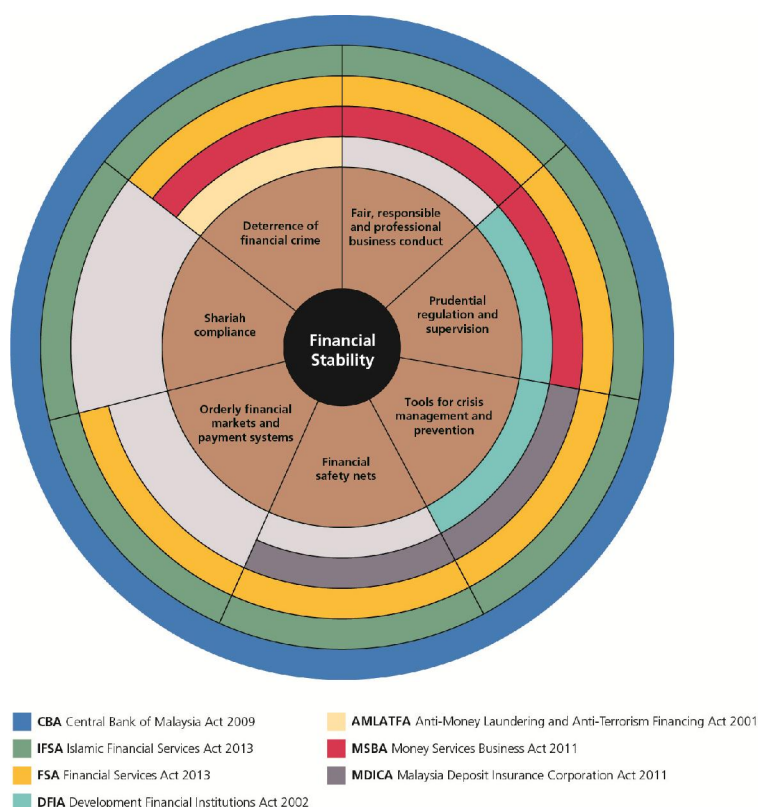
- 1) Ex-ante surveillance powers to ensure access to information, either directly or indirectly, for timely risk identification;
- 2) Power to enter into arrangements with other supervisory authorities in order to co-operate and coordinate financial stability measures and avoid regulatory blind spots;
- 3) Pre-emptive powers to avert or mitigate systemic risks such that the central bank can act to undertake corrective measures for the purpose of

financial stability, which could include liquidity assistance and capital support; and

- 4) Ex-post powers to minimise impact of instability such that the central bank can order the compulsory transfers (part or whole of business, shares, assets and liabilities) to a bridge institution.

Many countries have formalised the financial stability mandate, either by legislation or by explicitly including it in their mission statements (BIS 2011). In the Malaysian case, the central bank's statutory responsibilities with respect to its financial stability mandate are clearly spelt out in the Central Bank of Malaysia Act 2009 (CBA)⁸, namely to regulate and supervise financial institutions, provide oversight over the money and foreign exchange markets, exercise oversight over payment systems, and to develop a sound, progressive and inclusive financial system. It is upon these responsibilities that the regulatory laws administered by the Bank are founded.

Figure 1: Establishing a comprehensive legal framework for the financial stability mandate in for Bank Negara Malaysia



⁸ Bank Negara Malaysia has had a financial stability mandate since its inception. Over time, the scope of the mandate has been broadened. The CBA 2009 formalises these mandates.

The legal framework for the Malaysian financial sector, depicted in Figure 1⁹, has overarching laws - the CBA 2009 and the Financial Services Act 2013 (FSA), as well as the Islamic Financial Services Act 2013 (IFSA) – which have provisions that broaden the Central Bank’s regulatory oversight over financial holding companies and non-regulated entities to take into account of systemic risks that can arise from interaction between regulated and non-regulated entities. These are complemented with laws that address specific areas of financial stability, including crisis management and prevention. Where financial institutions are regulated by other Malaysian financial sector regulators, Bank Negara Malaysia has in place comprehensive arrangements with each regulator for collective decision making. These laws enable the Central Bank to act swiftly and decisively in addressing systemic risks. For instance, the provisions were used in 2013 where the central bank issued macro-prudential regulations limiting the maximum tenure for personal loans, and extended their scope to non-regulated entities, in order to more effectively mitigate the risks related to rising household indebtedness.

ii. Strong institutional arrangements, governance and coordination

When there are multiple mandates, the institutional governance frameworks would be a critical element in determining the quality of the decision making in each of the areas of responsibility. The pre-crisis view that monetary policy and financial stability are two separate functions that can be done independently is obviously now obsolete. As is the view that there must be a strong Chinese wall between the two types of decision making when both functions reside in the central bank. However, what should be the governance arrangements when both functions reside in the central bank. There is no one answer to this, but we can get a sense of the possible options by looking at some existing arrangements.

Again with reference to the Malaysian situation, the institutional arrangements for these two functions within Bank Negara Malaysia include the Monetary Policy Committee (MPC), the Financial Stability Committee (FSC) and the Joint Policy Committee (JPC). The JPC is a joint committee comprising of the members of both the MPC and the FSC. While the MPC and the FSC deliberate and makes decisions relating to monetary policy and financial stability, respectively, the JPC looks at issues where there could be both macroeconomic and financial stability implications. The joint forum framework facilitates broader surveillance and a more comprehensive risk assessment of issues by combining macroeconomic surveillance with micro

⁹ Bank Negara Malaysia Financial Stability and Payment Systems Report 2012, p91

and macro level analysis of the financial sector. This is very helpful when policy issues are related to the financial cycle. The introduction of macroprudential measures is deliberated at the JPC to ensure proper consideration of both the macroeconomic and financial perspectives in the decision making.

The Financial Stability Executive Committee (FSEC) is an inter-agency committee established under the CBA to decide on policies to avert/reduce systemic risk involving entities outside the regulatory purview of the Central Bank, or where the provision of capital support is necessary and would have fiscal implications. The FSEC is chaired by the Governor and other members currently comprise a Deputy Governor of the central bank, the Secretary General to the Ministry of Finance, the Chairman of the Securities Commission Malaysia, the Chief Executive Officer of the Malaysian Deposit Insurance Corporation (MDIC), and one external member.

In Malaysia, the resolution of Central Bank licensed commercial and Islamic banking institutions, insurers and takaful operators (all of which are also members of the MDIC) will be undertaken by the MDIC in accordance with the Malaysia Deposit Insurance Corporation Act 2011 (MDICA) in the event the Central Bank gives MDIC a notification of non-viability under section 98 of the MDICA.

In cognizance of the importance of timely information flows and coordinated policy responses, section 40 of the CBA empowers the Central Bank to enter into arrangements with other supervisory authorities to coordinate financial stability measures and to share any information with other supervisory authorities for purposes of promoting financial stability. The Central Bank has in recent months strengthened its cooperation arrangements e.g. through the establishment or enhancement of memorandums of understanding with the Securities Commission Malaysia, the Malaysia Deposit Insurance Corporation, the Malaysia Cooperative Societies Commission and the Labuan Financial Services Authority, particularly in the areas of surveillance and supervision.

A similar approach in substance, although different in form, is the case of Mexico (Sepulveda, 2011). Financial stability is part of the Central Bank of Mexico's mandate as it is responsible for promoting the sound development of the financial system. In 2010, a financial stability council known as the Council for the Stability of the Financial System (CESF) was formed made up of several financial authorities covering banking, insurance, savings institutes and pension, and chaired by the Secretariat of Finance and Public Credit. The CESF is a coordinating body that does not have regulatory or supervisory powers by itself. Instead it aims at coordinating efforts

including analysis of data, assessment of methodologies and macroprudential indicators, provides recommendations for prudential policy and delivers an annual report of state of financial stability. It is supported by a Technical Committee that makes proposals to the CESF in areas related to financial stability and crisis management. The 14 members of the Technical Committee are drawn from the same agencies.

Similarly, in the United States, the Financial Stability Oversight Council (FSOC)¹⁰ was established with a clear statutory mandate that creates for the first time collective accountability for identifying risks and responding to emerging threats to financial stability. It is a collaborative body chaired by the Secretary of the Treasury and brings together the expertise of the federal financial regulators, an independent insurance expert appointed by the President, and state regulators. Apart from coordination and sharing of information, the FSOC has a significant role in determining whether action should be taken to break up those firms that pose a “grave threat” to the financial stability of the United States.

These examples, while dependent on existing regulatory frameworks, clearly give recognition to the need for coordination among the different agencies involved in financial stability. The central bank plays a key role in all of these arrangements. Such arrangements would hopefully reduce the type of regulatory blind spots that reduced the effectiveness of financial oversight in the lead-up to the crisis.

iii. Effective communications framework

While there is considerable empirical research on communications in the context of monetary policy, there is little as yet in relation to financial stability or the development mandates of a central bank. Drawing on lessons learnt from monetary policy communications, Blinder (2008) observes “These remarkable strides in transparency have been powered by two principal rationales. One is the notion that greater central bank independence implies a greater need for democratic accountability, e.g., that independent central banks have a duty to explain both their actions and the thinking that underlies those actions. The second is the notion, that clearer communication enhances the effectiveness of monetary policy.”

Like monetary policy, financial stability needs appropriate communication avenues, but not necessarily replicating those of monetary policy. For instance, it may be infeasible to release a

¹⁰ <http://www.treasury.gov/initiatives/fsoc/about/Pages/default.aspx>

financial stability statement after every meeting of the Financial Stability Committee given that many times the issues discussed at these meetings are highly confidential and pertain to individual financial institutions. Nevertheless, broad macro-level indicators of financial sector health and trends in these indicators can be released at regular intervals. Unlike monetary policy, where the changes in policy stance are communicated through the post-meeting monetary policy statement, there needs to be a greater diversity of approaches when communicating for financial stability. As an example, where prudential measures are issued, it may be necessary to communicate with the affected industry only. However, when macroprudential measures are introduced, a broader range of stakeholders are affected, and the central bank has to anticipate the reaction of these stakeholders and undertake appropriate communications to ensure that these policies are properly understood.

Like the annual reports, monetary policy reports or inflation reports that central banks produce every year in relation to their monetary function, periodic financial stability reports (annual or biannual) can serve as an important tool for communicating the central bank's views on financial developments and in explaining its management of financial stability. As with monetary policy, these communications can be further reinforced through speeches by policymakers, briefings to the media and analysts. Such communications can successfully influence market expectations, and build confidence in the financial system as a whole (BIS 2008). Pitfalls to be wary of include saying too much or saying it at the wrong time or place, which may amplify risks, or even create new risks.

Ultimately, communications is about reaching out to all the different stakeholders with clear, consistent and factually accurate information to explain the actions and implications of the regulator's actions. A good example of such transparency is the congressional testimony by the Chairman of the Federal Reserve, which allows the people's representatives to maintain proper oversight that the regulator is exercising due care in the use of its powers.

iv. International collaboration and coordination

With increased financial globalisation, it is increasingly necessary to collaborate internationally with regulators in other countries to effectively deliver on the financial stability mandate. As financial globalisation continues to shape central banking institutions, there is greater need for international collaboration and coordination for financial stability purposes in relation to information sharing, development of common standards and crisis management. This is already

happening. At the regional level, examples in Asia include the EMEAP (Executives Meeting of East Asia Pacific Central Banks) forum and the more recent Financial Stability Board Regional Consultative Group for Asia. National authorities are focusing on strengthening the framework for resolving systemically important, internationally active financial groups. The college of supervisors likewise continues to be a platform for coordinating supervisory activities, and to mitigate cross-border transmission of risks.

Policy spillovers from the monetary policies of the advanced economies can have a negative impact on both macroeconomic and financial stability in EMEs. However, I am not optimistic that there will be any significant progress to limit these spillovers, for it would involve the major central banks taking into consideration the global ramifications of their actions in setting monetary policy. We have to live with the fact that while economies and financial systems are more globalised, monetary policy remains largely national.

Advancing regional financial integration and deepening the regional financial markets through bilateral or multilateral platforms can contribute to financial stability, by diffusing institution specific risks and having clear procedures to intervene collectively to address market volatility or crisis situations. The ASEAN Financial Integration Framework (AFIF) endorsed in 2011 is anticipated to drive regional financial integration in a manner that will strengthen cross-border regulatory collaboration and cooperation amongst home and host countries to facilitate sharing of information and supervision of ASEAN banks. Key to this is that the AFIF initiative explicitly includes capacity building to support the readiness of member countries to participate in the Framework without overly compromising on their domestic concerns.

v. Business planning for focus and effective use of resources

An important aspect of governance is how to manage multiple mandates in a manner that leverages on the diversity of expertise and perspectives to enhance overall policy effectiveness without compromising the ability to deliver on any specific mandate. Central banks are adopting tools and methods from the world of corporate management by having business plans and strategies to augment policy planning, formulation and implementation. The business planning process is the means to improve organisational performance in a systematic way, by detailing what we want to do and how we propose to do it; and assigning responsibilities over specific outcomes to specific functional areas and individuals. The business planning process complements the policy forums by providing an organisation level view of resource

management and performance indicators. Management can periodically decide what outcomes and associated activities are to be given greater priority, and what can be stopped if there is no further purpose to allocating resources for those activities. The ability to create focus, prioritise outcomes and then to channel resources into those priority areas is an important contribution to organisational effectiveness in delivering on multiple mandates.

Effective talent management

The paradigm changes that are occurring and the impact they are having on central bank mandates are raising two important issues with respect to talent management in central banks. First, the existing talent that has been used to working on narrower mandates needs to adapt to the new realities, and change their mindset on past theories and paradigms about central banking mandates and policies. Intellectual inertia and the inability to grasp the nuances posed by the new paradigm can shackle highly talented individuals to dogma that has ceased to be relevant. This can be a difficult transition but it is a necessary transition. Without a change of mindsets and a broadening of perspectives, major risks can be overlooked or underestimated.

The second issue has to do with the imperative to identify, design and implement new job structures and competencies to deliver on the new mandates. The management of job designs is made more complex given the greater need for integrated thinking and collaboration across functions in the central bank. The new jobs must be properly positioned within the organisation, and this may call for restructuring of the organisation to ensure efficiency and effectiveness in work processes, information management and good governance.

Challenges faced in the management of competencies include the learning of new technical skills, as well as the inculcation of behavioral competencies driven by the right set of values. The economist, supervisor, actuary, risk manager, human resource trainer, accountant and dealer, each schooled in a different technical language, need to interact effectively, respecting the diverse and potentially conflicting viewpoints of their colleagues, yet seeking to build on complementarities to achieve a common set of objectives. This requires integrated thinking skills, greater environmental awareness and the capacity to act for the greater good, thus enabling the central bank to be agile and responsive to incipient risks in the economy and financial system.

This leads to the most critical aspect of the governance challenge related to talent management: leadership. As the mandates and governance structures change, so must the leadership. In a

more challenging work environment, the leadership will set the tone in terms of the priorities and the distribution of resources. With multiple mandates, there is a need to manage the fight for organizational resources, to encourage greater collaboration between different job functions, to create greater acceptance for diversity in views. The quality of leadership in central banks will be an important determinant to their success in managing these issues. In looking at the talent pipeline and succession plans, it will no longer be sufficient to focus solely on technical and intellectual capacity; leadership ability will also be a key consideration. Like the technical skills, central banks will have to ensure that they provide ample opportunities for leadership development.

E. Implications for Risk Management

With a broader range of mandates, evolving policy frameworks and a highly challenging economic and financial environment, effective risk management is not an option but a necessity for central banks. If central banks want to be pre-emptive in their policy response, they will have to be anticipative and sensitised to potential risks in their major policy areas and potentially, beyond. At the organisational level, I see at least five types of risks to central banks, namely reputational risks, strategic risks, policy risks, financial risks and operational risks.

Reputational Risk

This is the mother of all risks for central banks. Virtually every other risk, if manifested, will likely result in reputational risk. Reputational risk is critical because public confidence is a critical determinant of the central bank's ability to carry out its mandates effectively. Protecting against reputational risks requires being very clear about what the central bank is doing and why it is doing it. It must also communicate its policies clearly to the affected stakeholders. Managing perception is another key element of reputational risk management. Perception is driven by what people think or believe, and not necessarily by what the reality is. It is also necessary to think beyond the intended impact of our policies to consider the potential secondary (and potential unintended) effects. It was noted that in cases where reputation was affected, only 22 percent were due to primary causes, and 78 percent was due to consequential causes¹¹, over which we may have little knowledge or control. In a multi-mandate policy setting, failure in delivering on one mandate can have contagion effects on public perception of the central bank's

¹¹ 8th International Operational Risk Working Group Conference

effectiveness in delivering on its other mandates. Therefore, reputational risks may not be mandate specific but rather, may affect the entire organisation.

The importance of having good corporate governance is critical to ensuring the highest level of integrity in all the central bank's activities, and therefore is also a critical component of the defence against reputational risks.

Strategic Risks

A central bank having multiple mandates must be strategic in its focus. New types of strategic risks will arise as the central bank tries to manage the complexity related to each mandate, ranging from intellectual and institutional inertia in a fast changing environment to a failure to properly take into account the possible interactions between policies implemented under the different mandates. In the current circumstances, are the major central banks making a strategic error in basing their policies on macroeconomic outcomes and ignoring the financial risks that their policies are creating both at home and abroad? Does the monetary policy strategy to provide forward guidance represent a strategic misstep in terms of how the policy makers thought such a policy would be perceived by the market and how it was actually perceived? There are ample strategic risks related to the implementation of macroprudential measures, ranging from negative reactions from stakeholders, cross-mandate impact, avoidance actions by financial institutions that erode the effectiveness of the measures, and the shift of speculative pressures to other parts of the economy.

Again, some of the things discussed earlier with respect to governance are important to mitigating strategic risks. Having a robust framework for decision making, active engagement with stakeholders, cross-functional collaboration and ensuring an appropriate diversity of talent and skills are important. So are having collaborative working relationships and information sharing arrangements with other regulators. Where appropriate, industry consultation before the introduction of regulations can flag potential problems and unanticipated outcomes that may have strategic and reputational implications.

Policy Risks

Policy risks can come from the implementation of incorrect policies, failure to undertake policy actions, failure to be pre-emptive in policy actions, or even failure to anticipate unintended consequences of policy actions. For example, did central banks in the period leading up to the crisis make a policy error in keeping interest rates too low for an extended period in the belief that such interest rates were justified by the calm inflation conditions? Are they making a policy error now by persisting with near-zero interest rates and QE even as economic conditions have improved? Even when policy decisions are undertaken through policy committees, the presence of a dominant policymakers, or “group think” among members of the policy committee, or having policymakers that all subscribe to a single policy paradigm, can all create a fertile ground for policy errors. Lack of coordination and information sharing between different regulatory agencies is another such risk.

When there are multiple mandates, the natural assumption is that managing policy risks can become more complicated. This may certainly be the case. However, it could also potentially become easier. To illustrate with the example of financial stability, when the responsibility for regulation and supervision of financial institutions and financial markets is split between different agencies, the difficulty of coordination and sharing of information, as well as the possible existence of grey areas where no one may be accountable, creates a high risk for policy mistakes. On the other hand, having all these functions in a central bank or a single regulatory agency that is accountable for both micro and macro risks can address these concerns and lead to better policy outcomes. If these functions reside in the central bank, it could also lead to a better understanding between policymakers responsible for monetary policy and those accountable for financial stability, reducing the likelihood of one policy compromising the other. Certainly, to reach such an outcome, a sufficiently robust governance framework would have to be put into place, which while allowing collaboration and information sharing also clearly lays out where the responsibility for each mandate lies within the organisation.

Financial Risks

Financial risks in arise in central banks from many sources. Like corporations, central banks have to be well-managed to ensure that their financial resources are optimally used to achieve their policy objectives. However, there are other sources of potential financial risks. The rescue

of insolvent financial institutions can lead to losses for central banks. For emerging market central banks, the post-crisis environment characterised by large spillovers from the monetary policies of the advanced economies, have created not only the policy risks highlighted earlier, but also creating financial risks. Intervention and stabilisation measures impose a fiscal cost given the higher domestic interest rates compared to those in the major reserve currency economies. The accumulation of reserves can lead to higher interest rate and credit risks, as well as to exchange rate revaluation losses.

The central bank balance sheet is not like that of a corporation – losses are incurred in pursuit of policy effectiveness and need not reflect financial mismanagement. Furthermore, central banks can always meet their obligations, other than their foreign currency liabilities, by issuing the domestic currency (Belke, 2010). However, such self-recapitalisation is may carry risks to the reputation and credibility of central banks.

Careful use of monetary instruments can reduce the fiscal costs related to mopping up large capital inflows. In the management of reserves, central banks do invest their reserves across a range of asset types and currencies¹². In the post-crisis period, with assets of the traditional reserve currencies offering very low returns, central banks have been investing their reserves in the bond markets of emerging market economies, as well as diversifying into a broader range of assets compared to the past. Others have created sovereign wealth funds to allow for greater flexibility in investments.

Operational Risks

Operational risks as defined by the Bank for International Settlements refers to ‘the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events (Wytenbury, 2013). In the case of central banks, operational risks can arise from multiple sources. Examples of potential sources would include its monetary operations,

¹² For example, in the case of Bank Negara, changes have been made to the profit distribution policy in light of greater exposure to financial risk as a result of carrying substantive foreign currency-denominated assets. The CBA 2009 (section 7(3)) allows transfers from net profits to reserves as deemed prudent or necessary. The net profit available for distribution is after such transfers and less any unrealised gains. The Bank has set a capital adequacy target ratio (CAR) where transfers from net profits to reserves shall be guided by the CAR.

operations related to currency issuance, the management of its data and information systems, as well as disruptions in the payments system.

A greater diversity of mandates could potentially increase the number of areas where operational risks can arise. It is therefore essential to have a sound risk management framework to identify, assess and respond to risks faced by the organisation, and ensure there are dedicated resources with appropriate competencies to manage those risks. Integrating risk management with strategic planning can also be helpful in identifying the key risks related to the policy priorities of the central bank, enabling pre-emptive actions to minimize such risks. Instilling a strong risk awareness culture within the organisation can create increased awareness of the possible sources of risks and also create a more proactive risk management environment within the organisation. Contingency and crisis planning are therefore important aspects of operational risk management, and central banks need to invest time and money in this area. Building of financial buffers as a pre-emptive measure could be valuable in increasing institutional resilience. Apart from the conventional business continuity planning elements, such as disaster recovery sites, offsite storage, mirroring of transaction data, personal and device security standards, the individuals involved in core policy and operations work must know what to do during a crisis. The escalation procedures must involve national authorities where relevant.

Conclusion

While the debates are still raging, it is obvious that the world has changed in dramatic ways for central banks. The paradigm shifts will result in increased responsibilities for central banks and possibly more mandates. For those that did not have a role in maintaining financial stability, they will likely now have to assume such a role. How big a role that is will probably vary from country to country. Whether they have additional responsibilities or new mandates, there are implications to how central banks go about their business and how they are run. In looking at these consequences from the perspective of independence, governance and risk management, the conclusion is that focusing on these areas makes sense for central banks irrespective of how many mandates they have, but that it is especially important when central banks have multiple mandates. In particular, robust governance and risk management practices will ensure that enough resources, focus and accountability is provided for each mandate, increasing the

likelihood of success and offering the best chance of central banks maintaining their independence.

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Shaping Central Banking's Institutions in the New Paradigm

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3rd SEACEN-CEMLA Conference

October 2013

Outline

- Pre and Post-Crisis Views on Central Banking
- Main Open Questions
- Brazil: Policy in the Post-Crisis Period

Initial remarks

- The global financial crisis led to a reevaluation of central banking practices. Some initial conclusions can already be drawn
- There is still no consensus on the implications for monetary and macroprudential policy frameworks. I will lay out our pragmatic views on this issue
- These views are reflected in Brazil's monetary and macroprudential policies in the post-crisis period

Pre-crisis view: full separation of roles

	Monetary Policy (MP)	Prudential Regulation (PR)
Price Stability (PS)	Price stability assures macroeconomic stability Instruments and their impacts well-understood	
Financial Stability (FS)	No interaction: <i>clean</i>, not <i>lean</i> against asset prices	Sound individual institutions assure financial stability

Post-crisis view: initial observations

- Price stability insufficient to assure macroeconomic stability
- Microprudential regulation proved procyclical
- Prudential regulation must take systemic view
- Rekindled debate on optimal coordination of monetary and prudential policy

Central banks and financial stability

- Advantages of dual mandate for central banks:
 - o Financial market and macroeconomic intelligence useful for macroprudential policy
 - o Easier information-sharing and coordination during a crisis
- Central banks have gained (or increased the relative importance of) financial stability mandates
- In Brazil (and in other emerging markets), financial stability mandate even before crisis
 - o Created financial stability committee within Bank
 - o Adopted “twin peaks” supervisory model
 - o Improved credit and trade data repositories

Optimal policy coordination

- No consensus
- Pragmatic view: 2 goals, 2 instruments
 - Monetary policy → price stability
 - Macroprudential policy → financial stability
- But do need to take into account interactions between instruments and goals

Monetary policy: IT framework still optimal

- Monetary policy focus should continue to be price stability: vertical long-run Phillips curve
- Short-run: has flexibility to absorb shocks
- Transparency and simplicity (of target) favor accountability
- Post-crisis, major central banks adopted elements of the IT framework (US, Japan)
- Projection models need to incorporate financial sector more deeply

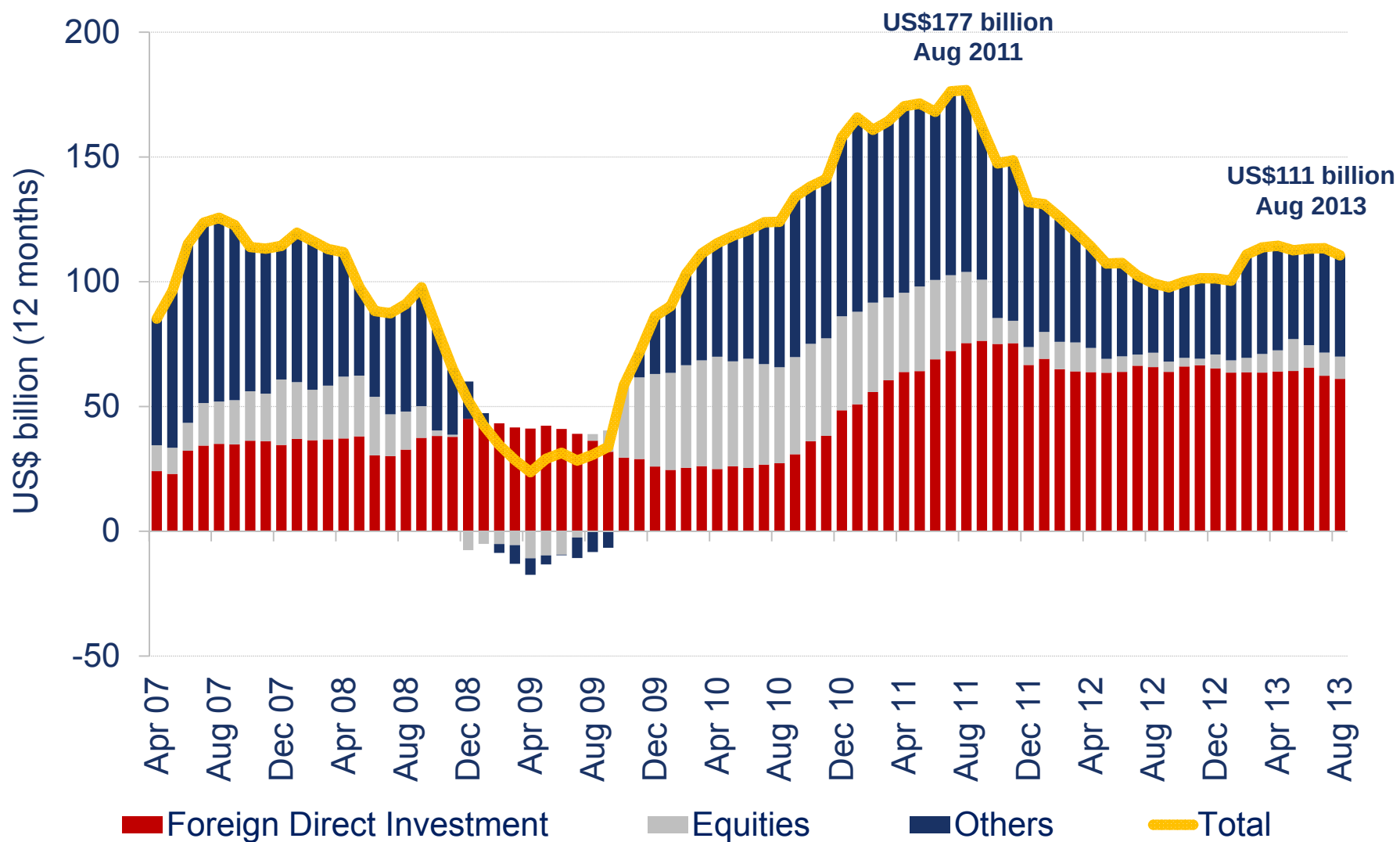
Post-crisis view

	Monetary Policy (MP)	Prudential Regulation (PR)
Price Stability (PS)	Price stability insufficient for macroeconomic stability Need more detailed financial sector information in projection models	Financial stability precondition for macroeconomic stability Need to consider interactions between policies
Financial Stability (FS)	No consensus, but my view is two instruments for two targets Need to consider interactions between policies	Systemic orientation

Brazil: policy in the post-crisis period

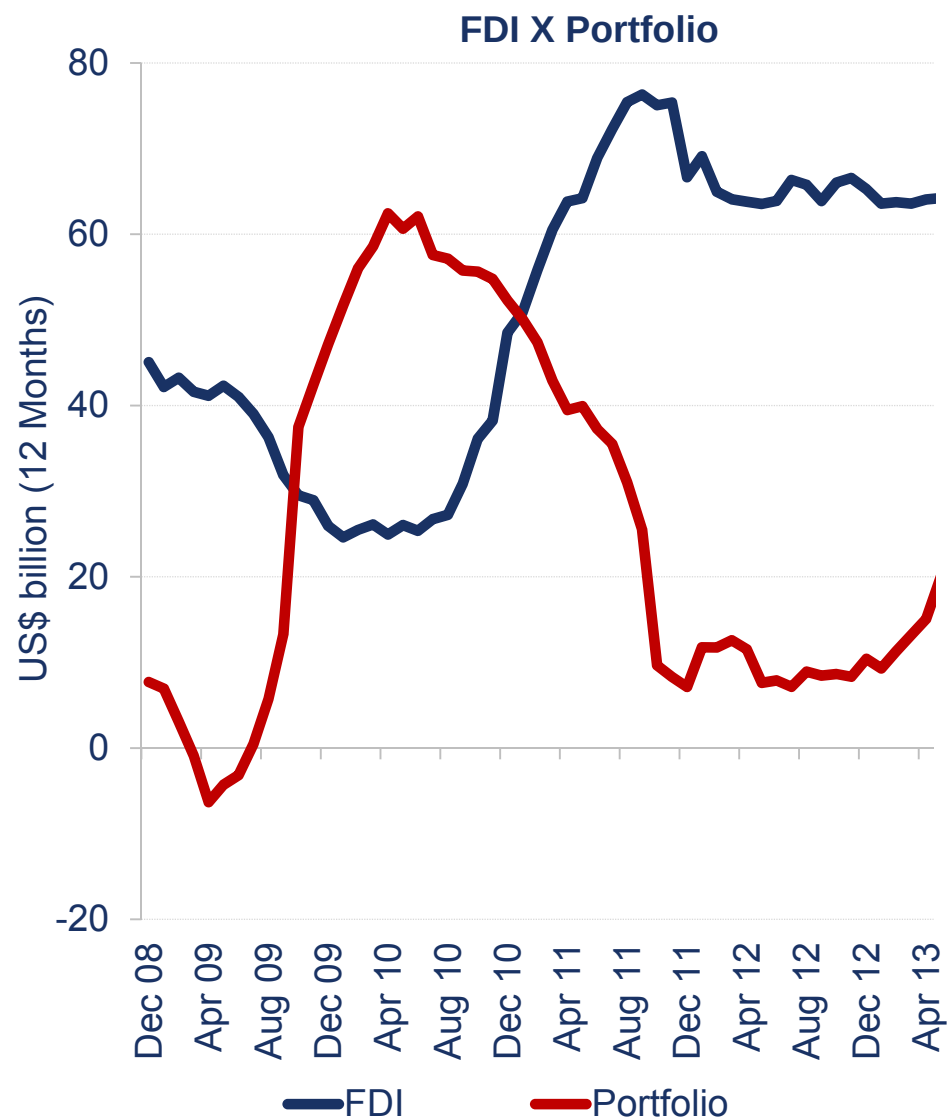
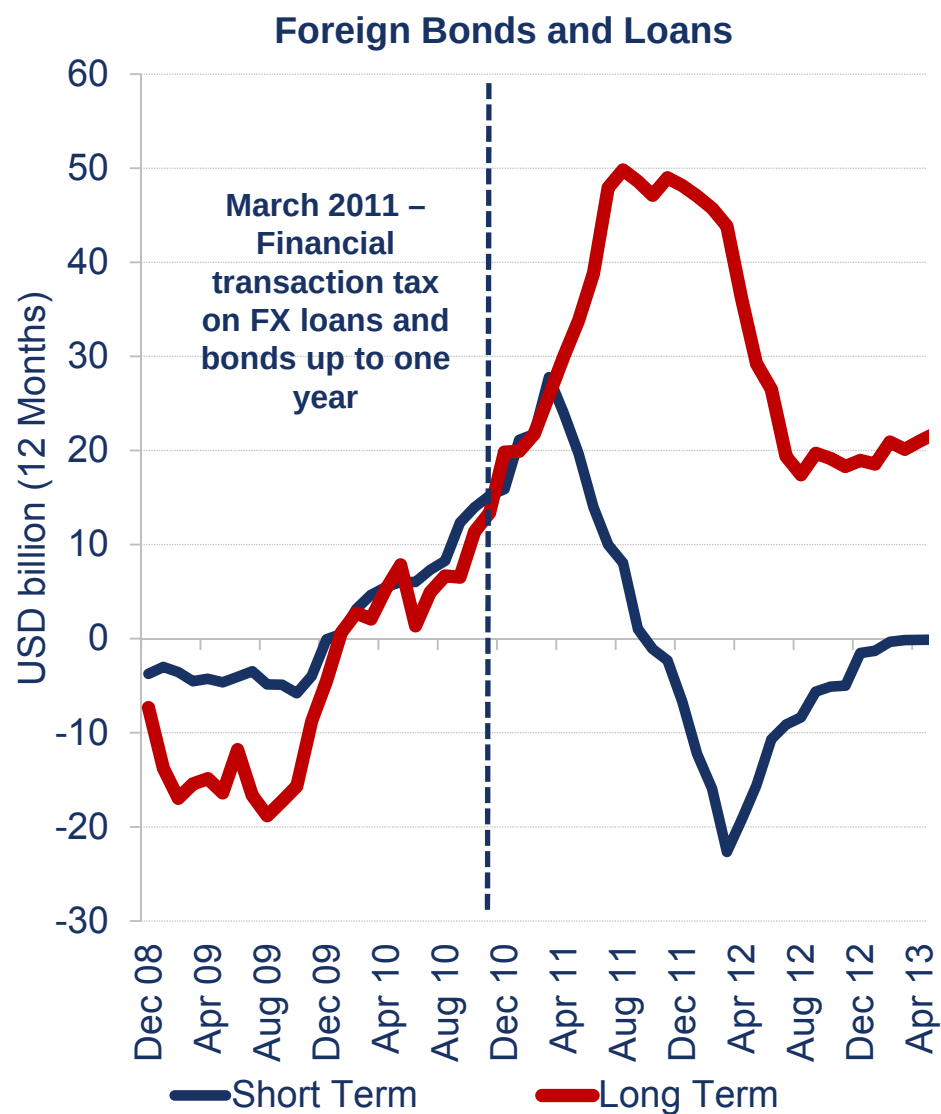
- Intense, volatile capital flows which could lead to excessive credit expansion and asset price distortions
- Macroprudential policies targeting both credit markets and capital flows directly. Helped reduce short-term, risky flows and moderate credit growth to sustainable levels
- UMP exit: Brazil is removing risk by offering foreign exchange hedge
- Goal of monetary policy continues to be price stability

FX flows in the post-crisis period



Source: BCB

FX flows rebalance

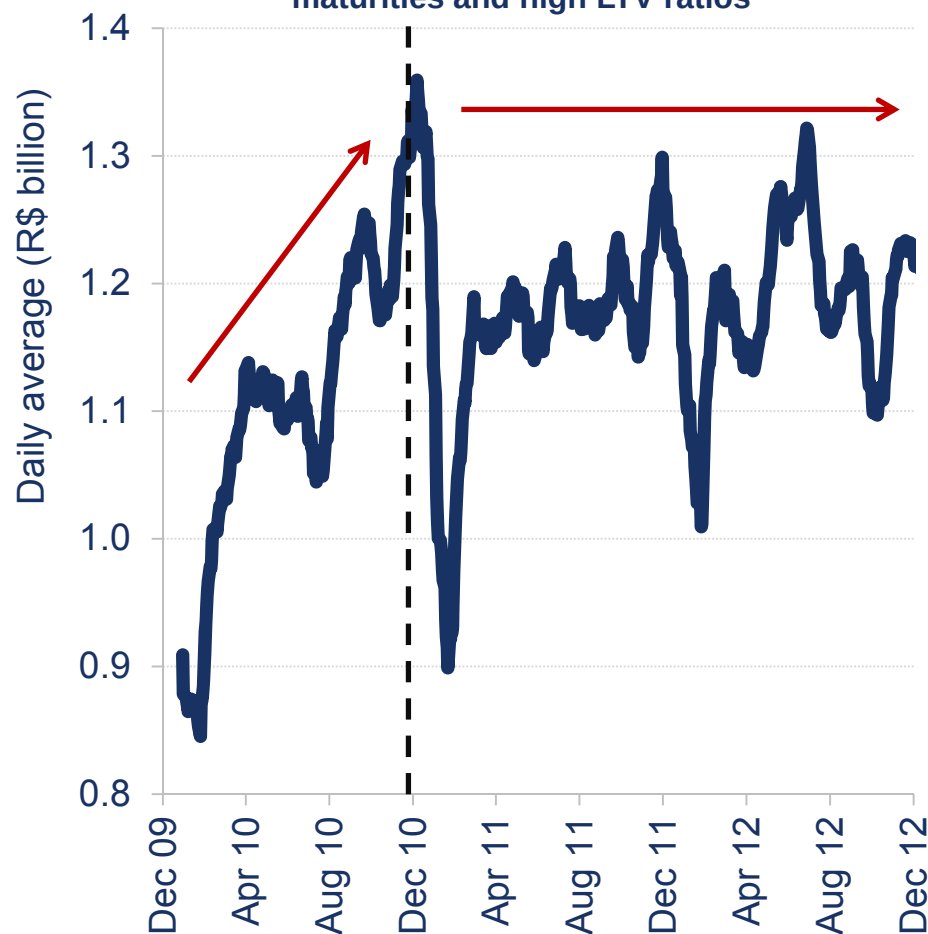


Source: BCB

Credit growth slows to sustainable pace

New Lending, Auto and Personal Credit

December 2010 - Increased capital requirements for specific consumer loan operations with long maturities and high LTV ratios



Total Outstanding Credit Growth

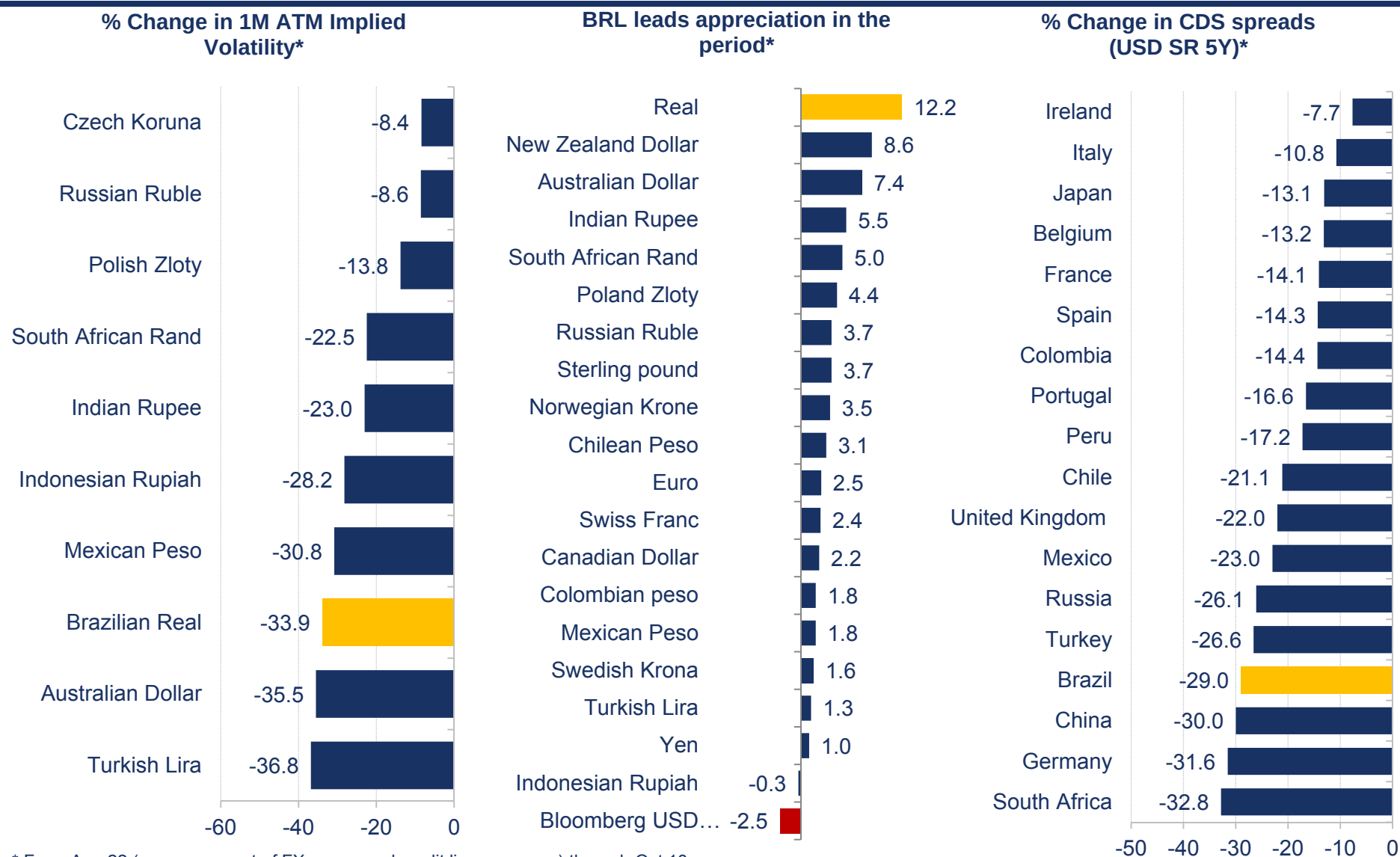


Source: BCB

UMP exit and the BCB's response

- Federal Reserve signaling about tapering asset purchases led to global EME sell-off, impacting asset prices
- Brazil's policy response focused on reducing interest rate and especially FX risk
- Launched program of regular FX swaps and FX credit lines
- The program resulted in significantly lower FX volatility and risk premiums in asset prices

Lower FX volatility and risk premiums



* From Aug 22 (announcement of FX swaps and credit lines program) through Oct 18

Source: BCB

1/ The Bloomberg U.S. Dollar Index tracks the performance of a basket of ten leading global currencies versus the U.S. Dollar (JPY, MXN, AUD, GBP, CAD, SGD, CHF, CNH, KRW and EUR).



Concluding remarks

- Crisis led to a reevaluation of central banking mandates, tools, and policy frameworks
- Inflation targeting remains best framework for monetary policy
- Macroprudential policy has been effective in safeguarding financial stability in the post-crisis period



Shaping Central Banking's Institutions in the New Paradigm

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SESSION 4:
RETHINKING MONETARY POLICY IN
ASIAN AND LATIN AMERICAN ECONOMIES
IN THE NEW ECONOMIC ENVIRONMENT



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**RETHINKING MONETARY POLICY IN ASIAN ECONOMIES IN THE
NEW ECONOMIC ENVIRONMENT
BY
DELANO S. VILLANUEVA¹²**

In this paper, I talk about two aspects of rethinking economic policy in the light of the Global Financial Crisis (GFC). First, rethinking monetary and macroeconomic policy in general terms. And second, rethinking monetary policy in Asian economies in particular.

1. Mainstream Macroeconomic Theory Under Assault

According to modern macroeconomic theory³, given expected inflation and no price shocks, inflation reflects the excess of real GDP over its potential level. If aggregate demand, measured by real GDP, exceeds potential output, inflation results. If the positive output gap increases, inflation accelerates. The price adjustment is symmetric: if aggregate demand falls short of potential GDP, prices fall. If this negative output gap is large enough, deflation ensues.

Before the GFC occurred in 2008-09, when overheating in the U.S. real estate sector push construction activity into a frenzy, the output gap grew larger positive. According to the price adjustment equation, inflation should have accelerated.

Enter GFC. Large declines in real GDP resulted in smaller output gaps. Further declines in real output brought about negative output gaps. Accordingly, inflation should have decelerated, followed by a deflationary period. However, actual inflation both before and after GFC hovered around 1-2 percent annually. Why has inflation been stable at this low level when the output gaps showed significant non-zero levels, invalidating the price adjustment equation?

There are two logical explanations. First, potential output may have risen or

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² Recognizing that all four institutions (SEACEN, CEMLA, BNM, and BCC) co-organized this timely conference, I wish to acknowledge with appreciation Mr. HooKyu Rhu, Executive Director, The SEACEN Centre, for inviting me as a speaker, BNM Governor Dr. Zeti Akhtar Aziz for hosting the conference in impressive Sasang Kijang, Kuala Lumpur, Malaysia and for her hospitality, Dr. Fernando Tenjor Galarza, General Director, CEMLA and BCC Governor Rodrigo Vergara. Special thanks go to Vincent Lim and Dongkoo Chang for making my stay in Kuala Lumpur both pleasant and productive. Finally, I am indebted to conference participants for valuable comments.

³ The price adjustment equation is $\pi = \pi^e + \phi Y^\Delta + Z$, where π is inflation rate, π^e is expected inflation rate, Y^Δ is output gap $= Y/Y_p - 1$, Y is real GDP, Y_p is potential GDP, and Z is a price shock term.

declined to the level of higher or lower output, such that the output gap was near zero. This interpretation has not been tested since, by assumption of modern macroeconomic theory, potential output is determined exogenously by existing capital stock and fully employed labor. I submit that, in the long run, the standard assumption is untenable. Consider the macroeconomic model described by Villanueva (2008, pp. 211-220).⁴

The relationship between monetary policy and potential output can be traced as follows:

Monetary policy affects inflationary expectations. Expected inflation enters the user cost of capital (bank lending rate or corporate bond rate minus expected inflation). In addition, there exist negative effects on investment of the distortions and instabilities associated with expected inflation, including (i) increased riskiness of long-term investment projects; (ii) decreased average maturity of commercial lending; (iii) distorted information content of relative prices; and (iv) pronounced macroeconomic instability and a country's inability to control macroeconomic policy. Thus, if monetary policy lowers inflationary expectations, investment will be stimulated. In the long run, the capital stock expands and, given the labor force and technology, potential output increases. On the other hand, if monetary policy raises inflationary expectations, investment will be discouraged, the capital stock shrinks and potential output declines.

There are two factors that could support the second interpretation that the relation between the output gap and inflation has changed. The first is that credible monetary policy has anchored low and stable inflationary expectations. The second factor is that the relation between output gap and inflation is weaker. This is of particular concern because stable inflation may exist side by side with non-trivial, non-zero output gaps.

2. Safe Levels of the Public Debt

Safe public debt levels appear to be lower than originally thought. Considering the large public debt and rising interest costs of such debt, government can exert pressure on central banks to limit borrowing costs that may lead to fiscal dominance, either via delayed exit from QE and delayed interest rate increase, leading to inflation and lower real interest rates on government debt.

Fiscal dominance should be avoided by ensuring that monetary policy decisions are independent of political considerations. Empirically, there are large fiscal multipliers associated with fiscal consolidations—spending cuts and tax increases.

⁴ I modify and extend the modern macroeconomic model of economic fluctuations by Hall and Taylor (1997) and link it formally to the Solow (1956)-Swan (1956) growth model.

The timing of fiscal consolidation is also debated. In the U.S. two major parties have opposite ideas on timing, with one party arguing for faster and the other slower pace of consolidation.

In many countries, the timing is decided by the markets via higher real interest rates. Empirically, the speed of fiscal consolidation remains unanswered. However, given the large size of public debt reduction, fiscal consolidation should be part and parcel of a credible medium-term plan that includes reforms, such as an increase in the retirement age.

3. Prudential Regulation

Micro-prudential regulation does not take into account interactions among financial institutions and between the financial sector and the real economy, which are the main areas of concern of macro-prudential tools.

The effectiveness of macro-prudential instruments and the nature of their interaction with macroeconomic policies depend to a large extent on the specific financial structure and institutions of a given country.

Regulatory ratios must reflect not only risks facing an individual institution but also risks for the financial and real sectors of the economy, i.e., in the context of interconnections of the financial sector and the state of the real economy.

Macro-prudential tools include instruments that influence lenders' behavior - (1) capital requirements; (2) leverage ratios; and (3) dynamic provisioning.

Instruments that influence borrowers' behavior are loans-to-values ratios (LTVs), debt-to-income ratios (DTIs) and capital flow management measures (CFM).

Have macro-prudential tools been effective? Evidence is mixed—they have been more successful in less developed financial markets, owing to the inability to have significant recourse to nonbank intermediaries, foreign banks and off-balance-sheet activities. They have not been successful in situations where banks already hold capital well in excess of minimum, and when there are political difficulties that may not allow banks to reduce risk weights during downturns.

Tighter capital requirements and dynamic provisioning have typically not stopped credit and real estate booms. However, particular types of loans have been curbed, e.g., foreign exchange denominated loans. LTVs and DTIs have been effective in curbing borrowers' appetite for bank credit.

Jonathan Ostry (IMF, 2010) et al. have concluded that CFM tools, combined with other macro-prudential tools, can be appropriate if macro-policies are sound and if capital flows are having undesirable effects on macroeconomic and financial

stability.⁵

If low policy rates lead to potentially excessive risk taking, macro-prudential tools could increase cost of credit, dampening aggregate demand. If macro-prudential tools decrease aggregate demand via higher cost of credit, policy rates could be lowered.

Lack of coordination between policy rates and macro-prudential tools can lead to sub-optimal solutions—interest rates that are either too low or too high, and macro-prudential measures that are either too tight or too loose. The obvious solution is to put both policy rates and macro-prudential tools under one roof—central bank.

4. Rethinking Monetary Policy in Asian Economies

In his recent paper, Morgan (2013) concludes that “East Asian central banks have generally managed inflation and growth well over the past decade, but the difficulties faced by central banks of advanced countries in the aftermath of the global financial crisis suggest that not all problems have been solved yet.”

The relative success of emerging Asian central banks in managing inflation and growth in the wake of the global financial crisis and the relative failure of the more advanced central banks can be explained as follows:

The failure of more advanced countries, except a few like the Bank of Canada, to supervise banks effectively, and the relative success of Asian central banks in banking oversight.

Owing to lessons learned from the 1997 financial crisis, Asian central banks have managed to improve controls on bank leverage, bank capitalization, and various prudential instruments. They also have more centralized banking supervision (either within the central bank or another government agency) as opposed to, say, the U.S. wherein supervision is shared among different entities, resulting in lack of uniform and consistent enforcement.

The rethinking of monetary policy in the wake of the global financial crisis is more the response of advanced central banks, e.g. the U.S. Federal Reserve, where price stability went alongside with financial instability and systemic risk.

Even the emphasis on macro-prudential as opposed to the traditional micro-prudential supervision reflects more the advanced central banks' efforts to contain systemic risk owing to highly leveraged, undercapitalized, and interconnected

⁵ The Brazilian experience with taxes on short-term risky flows appeared to have slowed such flows and limited exchange rate appreciation.

financial institutions. In emerging Asia, although risks from a specific sector, e.g., housing bubble, are by and large contained owing to stringent sector-specific controls and regulations, the threat posed by volatile capital flows entails three types of risks:

Macroeconomic Risk. Capital inflows expand domestic liquidity that may result in inflation. Capital inflows may also lead to exchange rate appreciation which may dampen export and hence output growth.

Financial Instability Risk. Capital inflows may result in currency and maturity mismatches, higher equity and real estate prices.

Sudden stops. Capital flow reversals following sudden stops may lead to fast reserve drawdowns and currency depreciations.

The strengthening of financial oversight following the Asian crisis of 1997, little or no use of sophisticated financial derivatives, little or no unregulated parts of the financial system, little or no wholesale funding by banks, and more than adequate bank capitalization explain why emerging Asian economies did not suffer crises similar in magnitude to the U.S.-led GFC.

However, owing to trade and financial linkages with the advanced economies, Asian markets could not escape the unwelcome GFC repercussions on them. Economic downturns in the advanced economies reduced Asian exports, and global liquidity engendered by advanced central banks' near zero interest rates and quantitative easing spill over Asian markets as capital inflows.

Such inflows have created challenges for emerging Asian central banks in terms of managing risks, exchange rates, and profits/losses. Thus, although the new paradigm applies to the central bank policy frameworks of advanced economies, the need to (1) minimize adverse repercussions of global financial instability, and (2) further strengthening financial oversight in emerging markets cannot be overemphasized.

Asian central banks have took kits to achieve financial stability, including monetary policy, exchange rate and capital flow management, as well as macro-prudential tools. In emerging Asia characterized by greater financial frictions and segmented markets, policy interest rate may target inflation, foreign exchange intervention may target the exchange rate, and macro-prudential and micro-prudential tools may target financial stability.

As I mentioned earlier, Jonathan Ostry and others (IMF, 2010) have argued to separate capital flow management from domestic prudential instruments. Capital controls can be used as a last resort when other market-based policy instruments are exhausted. Temporary use of capital controls is predicated on preventing their distorting effects on capital markets and exchange rates, while shielding shallow

and unsophisticated financial sectors from adverse effects of capital flow volatility.

When domestic financial markets in EMEs deepen over time, such as in Hong Kong, Japan and Singapore, their resilience to capital flow volatility will be enhanced, obviating the need for capital controls even on a short-term basis.

Monetary policy can also affect market expectations. A central bank “commitment”, announcement of “policy duration”, or “forward guidance” can help achieve low long-term interest rates to boost the economy not only in the advanced but also in emerging economies.⁶

Sterilized intervention has been used by many Asian EMEs to avoid strong pressure for exchange rate appreciation. While successful, it has proven costly and has resulted in significant central bank losses.

5. Likely Scenario for the Near Future

A broad dual mandate for macroeconomic and financial stability, making active use of monetary and macro-prudential tools, and active use of fiscal policy for stabilization.

An experimentation period, with learning pains but with expected successful results.

⁶ Advanced Asian central banks like the Bank of Korea, have benefitted from swap arrangements with the U.S. Federal Reserve, Bank of Japan and People’s Bank of China in response to liquidity shortages in 2008.

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WASHINGTON RIBEIRO
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Commentary: Challenges for monetary policy in Latin America

Washington Ribeiro

3rd SEACEN-CEMLA Conference
“New Paradigm in Central Banking”
Kuala Lumpur - 21 October 2013

- Comments on Villanueva's presentation (more during my presentation on Session 6)
- Context for the conduction of monetary policy in Latin America countries
- Exposure, capabilities and limitations for macroeconomic policy management

Comments

- ❑ Rethinking monetary policy under the “new normal”
- ❑ Orthodox monetary policy loses potential:
 - ❑ Product and inflation: weakened relationship
 - ❑ New, complex problems: financial stability, balance sheets of central banks
- ❑ Greater flexibility of traditional IT regimes is required:
 - ❑ Calibration of multiple objectives under volatile conditions
 - ❑ Choice of policy instruments (e.g. aggregates)

Monetary policy requires complementarity with other policies



BCU

- ❑ Financial stability as important as price stability
- ❑ Bidirectional relationship between price and financial stability
- ❑ Monetary policy requires coordination with other macro-prudential instruments

- ❑ Effectiveness lies on institutions as well as on the structure and context of financial system
- ❑ Latin America has been improving policy institutions:
 - ❑ Macroeconomic coordination committees
 - ❑ Financial Stability Committee
 - ❑ Integrated, risk-based financial supervision under central banks' roof

Context for the conduction of monetary policy in Latin America countries

- The 80s:
 - Monetary tightening in USA implies recession and fall in commodity prices
 - Latin America confronted a demand as well as a financial shock
 - Result: deep financial and real crises

- ❑ The 90s:
 - ❑ Abrupt rise in USA interest rate
 - ❑ Sudden stops in Latin America and Asia
 - ❑ Credit boom, external deficits, currency overvaluation and mismatches in several countries
 - ❑ Result: several countries fall into financial and real crises again

- ❑ Slow recovering in advanced economies, ...
- ❑ ... which face difficulties to find the way to exit the crisis
- ❑ The most likely scenario is a gradual and relatively ordered reversion of the lax liquidity conditions

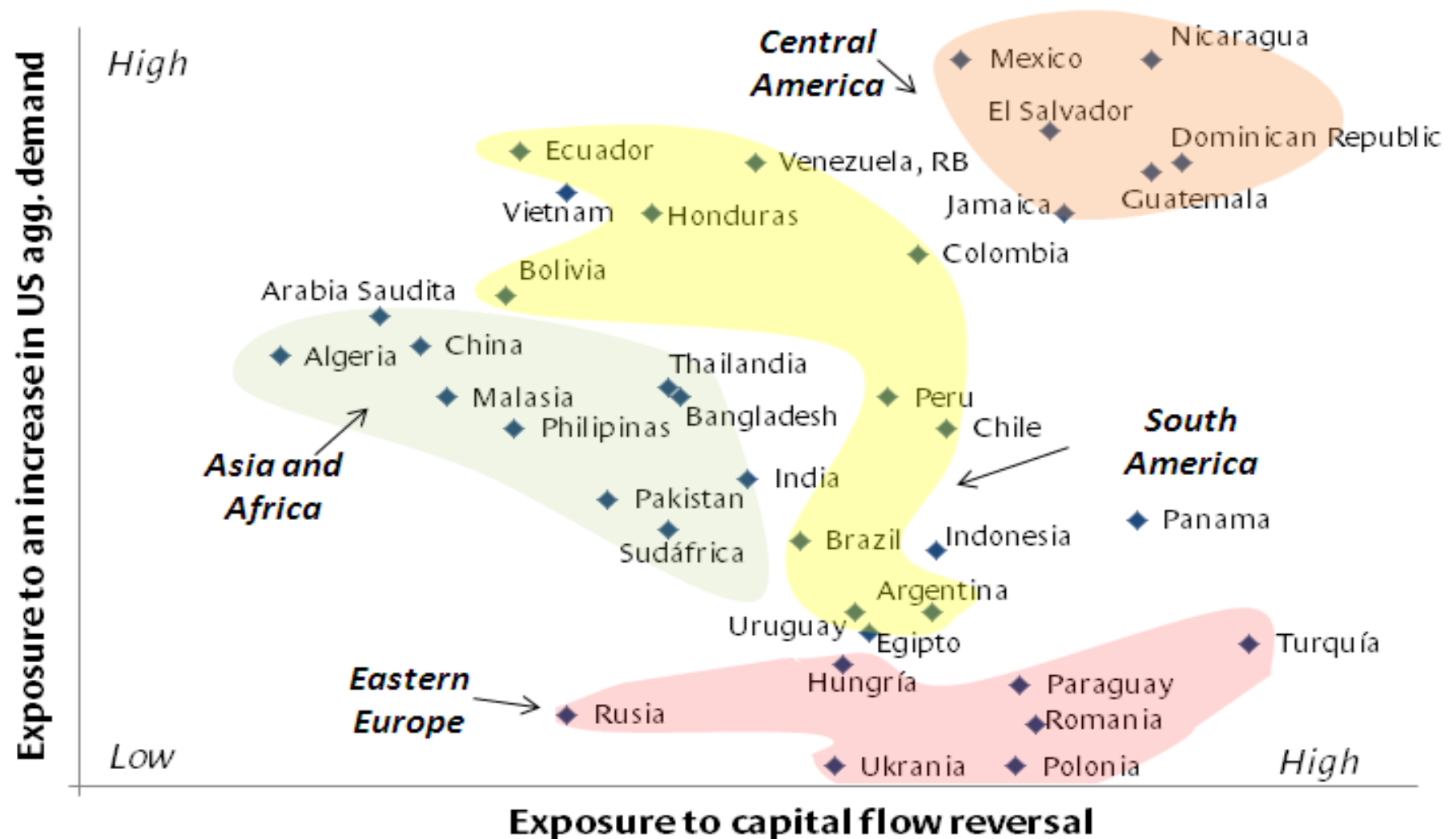
- ❑ Latin American countries have improved their policy frameworks and capabilities:
 - ❑ Institutional strengthened (already commented)
 - ❑ Low and under-control inflation
 - ❑ Continuous growth in the last decade
 - ❑ Relatively low external deficits
 - ❑ Reserve accumulation
 - ❑ Sustainable public debt and reduction of mismatches
 - ❑ “Graduated” on fiscal consolidation, with few exceptions
 - ❑ Result: countries are in better position to manage risks

Exposure, capabilities and limitations of macroeconomic policy management

Exposure is different across regions



BCU



- ❑ South America:
 - ❑ Moderate impact due to diversification of FDI sources
 - ❑ Flexible exchange rate and IT regimes allow for a flexible calibration of monetary policy
 - ❑ Key role of macro-prudential policies (micro and macro)

- North and Central America:
 - Mexico: flexible exchange rate and IT regimes allow for a flexible calibration of monetary policy
 - Central America:
 - Fixed exchange rate regimes makes flexible calibration impossible ...
 - ... but commercial links with the USA may compensate

Commentary: Challenges for monetary policy in Latin America

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DINNER ADDRESS



DR. ZETI AKHTAR AZIZ
GOVERNOR
BANK NEGARA MALAYSIA



**“CENTRAL BANKS AND SUSTAINABLE GROWTH”
GOVERNOR DR. ZETI AKHTAR AZIZ’S DINNER REMARKS AT THE
SEACEN-CEMLA CONFERENCE ON ‘NEW PARADIGM IN CENTRAL BANKING’
21 October 2013, Kuala Lumpur**

Fellow Governors,
Distinguished Guests,
Ladies and Gentlemen,

1. It is my honour and great pleasure to welcome you to Kuala Lumpur for the 3rd SEACEN-CEMLA Conference. Since the onset of the Global Financial Crisis more than five years ago, significant attention has been focused on central banks – in both the advanced and emerging economies – from our roles in crisis management and resolution, to engineering and supporting an economic recovery. Amid the considerable number of challenges that have confronted the global recovery process, there has been profound shifts in the expectations of what central banks should do in navigating the recovery path. There has been much debate on what central banks *can* do, against what central banks *should* do. In the midst of carrying out our mandates, it is often overlooked that all central banks ultimately share a common ultimate objective – that is, to ensure an environment that is conducive for sustainable, balanced and inclusive growth. My remarks this evening will discuss the role of central banks in achieving sustainable growth, in a more complex and constantly evolving global landscape.

Ladies and Gentlemen,

2. Globalisation is not new. What is new is the speed and pervasiveness of globalisation, where technological advancements, and economic and financial liberalisation, have accelerated economic interactions and the cross border integration of financial markets. Post-crisis, the world has entered into a new phase of globalisation. Firstly, amid the uneven pace of growth in the advanced and emerging economies, the global environment has become more multi-polar. In 2012, the emerging economies accounted for half of global output, and almost half of this share was from the SEACEN-CEMLA economies. Secondly, while the growing inter-connectedness of economies within and across regions has presented considerable benefits, risks associated with globalisation have also intensified. Following the crisis and its management in the major advanced economies, heightened uncertainty has amplified the volatility in the global economy and the international financial system. The slow and uncertain recovery in several of the major economies and the recent developments in the global financial markets exemplify these trends with its reverberations being felt significantly in most emerging economies.

3. The most pressing challenge for policy-makers in this current global environment is to generate sustainable growth. In the developed world, the financial crisis has resulted in tremendous damage to their economies. Five years hence, a sustainable recovery has yet to be secured. While most emerging economies have experienced strong growth during this period, the slowdown in world trade in 2013, and the policies by several emerging economies to rein in excesses and emerging imbalances following the surges in capital flows have resulted in a more moderate pace of growth. Most emerging economies nevertheless continue to remain on a solid growth path with sound and resilient financial systems.

Ladies and Gentlemen,

4. Amid this changing global landscape, much attention has been placed on the role of central banks. Fundamentally, the goals and objectives of central banks have not changed.

Notwithstanding varying institutional arrangements, central banks share a common goal of facilitating an environment that is conducive for sustainable growth. The recent global financial crisis however, has offered alternative perspectives of sustainability. Prior to the Global Financial Crisis, the focus of central banks was primarily on containing inflationary pressures amid the growth phase of the business cycle. The crisis has however shown that financial imbalances can build up even in an environment of price stability and which can present significant risks to financial stability and thus to economic growth. In addition, not only has the experience shown that there are limits to what monetary policy can achieve, but that an over-reliance on monetary policy could also lead to unintended consequences. A prolonged low interest rate environment could in fact delay the necessary structural adjustments and encourage a build-up of financial imbalances. As a counter-cyclical tool, monetary policy also cannot address structural issues, such as impaired balance sheets and economic competitiveness.

5. In the aftermath of the crisis, the mandate of Central Banks has become broader. Beyond macroeconomic stability, there has been increasing emphasis on the role of central banks in ensuring financial stability, containing the build-up of financial imbalances and in the management of financial crisis. In emerging economies, particularly in Asia, the mandate is even broader, to include financial sector development, including the financial infrastructure and payments system and the development of financial markets, the implementation of financial reforms and initiatives involving deregulation and liberalisation, and measures to achieve a more balanced and inclusive growth. As with central banks in the developed world, the expectation is that central banks will also have a major role in managing risks arising from a more integrated global environment, and containing and managing a financial crisis.

6. Increasingly, it is recognised that a comprehensive approach is needed to achieve sustainable growth. There is tremendous calls for structural adjustments and reforms by the international communities to the emerging economies as being important for achieving such sustainable growth. Indeed, such structural adjustments are also relevant for the developed economies. These adjustments will generally however, involve costs to growth in the immediate and short-term. Other pro-growth policies therefore needs to be pursued to support growth during such periods. During the Asian Financial Crisis, priority was given to policies that enhanced the flow of credit, particularly to small and medium-sized enterprises. This included the introduction of new institutional arrangements, mechanisms and schemes for funding, guarantees and credit enhancements, and debt restructuring and resolution. Other measures by the public sector have ranged from temporary measures to promote private sector consumption and investment activity. Projects that generate jobs, including retraining the unemployed with new skills, have been important during such periods of transition and transformation.

Ladies and Gentlemen,

7. Beyond macroeconomic management and such short-term measures, central banks are in a position to contribute meaningfully to raise the long-term economic potential through financial sector development. The mandate to develop a strong, efficient and effective financial system is not uncommon for central banks in the emerging economies. This broadly includes institutional building, financial market development and the strengthening of financial infrastructure, including the payment systems and legislative framework. Efforts to broaden and deepen the financial sector will contribute towards facilitating the more effective and efficient intermediation of funds towards productive investments in the economy. As the financial sector develops in sophistication to provide a wider array of financial products and services, the ability to cater to the more varied and complex needs of households and businesses would also better support economic activity. A more developed financial system also reinforces monetary and financial stability. For Asian economies the more developed

financial systems and better developed financial markets are now able to better intermediate larger and more volatile volumes of financial flows, with little disruption to financial intermediation and the functioning of our markets. The more diversified financial systems also reduce the over-concentration, and thus vulnerability, of any particular segment of the financial sector.

8. Financial inclusion is also a key development agenda. Amid efforts to develop a financial sector that best serves the economy, considerable emphasis has also been placed to ensure that the financial system is inclusive. By creating opportunities for wider economic participation and wealth creation, greater access to financial services contributes to enhance the long-term sustainability of growth. The recent crisis and ongoing reforms have placed much attention on the need to minimise the disproportionate impact on various segments of society. Equally important is to ensure that households and small businesses are not marginalised or excluded by market forces during periods of relative stability. Beyond the provision of improved access to financing, the financial inclusion agenda has also made progress on two fronts. First, to ensure that financial services meet the changing needs of an individual, and, thereby, are effective in improving individual welfare. Second, to reduce the risk of vulnerable groups from being financially excluded, particularly in a rapidly changing financial and social landscape.

9. With financial sector development also comes greater financial innovation. Commensurate regulatory and supervisory oversight is therefore needed to avoid a build-up of systemic risks emanating from such financial innovation. Such supervisory frameworks including the surveillance arrangements and enforcement powers of central banks will need to be enhanced and modernised, to remain relevant and effective in a changing financial landscape. Our own experience has shown that this needs to be complemented by high standards for responsible lending practices, an effective consumer protection framework and enhanced financial education. This is to not only ensure that financial innovation is undertaken in a responsible manner, but would also protect the financial system against systemic risks and support greater financial inclusion.

Ladies and Gentlemen,

10. Given the greater demands on central banks, SEACEN and CEMLA, as learning institutions and repositories of knowledge, can have an important key role in preparing central bankers for the challenges ahead. The operating environment is rapidly evolving, and the challenges confronting us are unlike those that we have faced before. Central bankers need to be equipped with new skills and knowledge to navigate through the challenges ahead. Certainly, greater agility will be required to cope with a more dynamic and ever changing landscape, and to enable us to carry out our task of fostering sustainable economic growth effectively. Indeed, we need to stay ahead of developments to shape the economic and financial environment.

11. SEACEN and CEMLA can reinforce each other in progressing this agenda. The active exchange and accumulation of knowledge provides a solid foundation for supporting and strengthening further the foundations of our Central Banks. Asia and Latin America have a wealth of experience in macroeconomic management, safe-guarding financial stability and, collectively, the regions have endured many forms of economic and financial challenges. We have emerged from these challenges stronger, and our economies and financial systems have become more resilient. There is much that can be learned from sharing these experiences. SEACEN and CEMLA Governors have agreed on three initiatives namely to have a joint website to share experiences, to conduct joint research initiatives, and to provide cross-regional technical assistance. We look forward to the introduction of these initiatives.

Conclusion

Ladies and Gentlemen,

12. Allow me to conclude. As our economies become more integrated in the global economy, through our policies that deliver sustainable growth, the SEACEN-CEMLA central banks can enhance its potential role to support the overall global economic growth process. Beyond macroeconomic management and promoting financial stability, the Central Banks in our regions can contribute meaningfully to increase economic potential through financial sector development and facilitating the financial inclusion agenda. Through the friendship and partnership that we have forged with our counterparts in Latin America, let us carry this forward and find ways to deepen our mutual learning from each other's experiences. As learning institutions that are both originators and repositories of knowledge relevant to central banks, SEACEN and CEMLA are critical channels that can work together to spread experiences and ideas. Such cooperation will also greatly facilitate the member central banks in their quest to achieving sustainable growth.

Thank you.

21 October 2013

SESSION 5:
EXCHANGE RATE AND COMPETITIVENESS
IN A WORLD OF HIGH LIQUIDITY



ANDREW SHENG
PRESIDENT
FUNG GLOBAL INSTITUTE



Exchange Rate and Competitiveness in a World of High Liquidity

Andrew Sheng

President, Fung Global Institute

22 October 2013

3rd SEACEN-CEMLA Conference “New Paradigm in Central Banking”

How the Future of Finance is Unfolding

- Crisis was formed by excessive leverage through nexus between banks and shadow banks
 - shadow credit not monitored and understood for their systemic (endogenous) instability within financial system
- Response was QE + Macro-Prudential Measures (incomplete)
- Emerging markets in huge dilemma
- **Crisis was systemic crisis** and can only be understood, not in neo-classical terms (back to perfection, equilibrium and self correcting) but from perpetual evolution of **Complex Adaptive Systems (CAS)** – of which national systems are parts and have large feedback mechanisms.

Source: Andrew Sheng, 2013, *Outlook for Global Development Finance – Excess or Shortage*, United Nations High-Level Panel on the Post-2015 Development Agenda.

Section 1

Changing Role of Central Banks – the need for new thinking

*How financial sector is changing and being
changed by central banks*

Functions and Roles of the Central Bank

Goodhart (2010)

Objectives: (1) Maintain Price Stability, through monetary policies
(2) Maintain Financial Stability, and foster financial development
(3) Support state in crisis, and restrain misuse of state financial powers.

Functions: (1) Interaction with government through

- (i) bank tax;
- (ii) sanctions
- (iii) debt management
- (iv) bank resolution
- (v) interest rate setting

(2) Interactions with regulators at home and abroad
(3) Structural Development in the financial sector

Changing Role of Central Banks

- Operating in hugely distorted environment
- Need to deal with global shadow banking and reduce financial repression, especially impact on long-term pension rights.
- Dealing with systemic risks – not clear how to monitor and measure liquidity and liquidity shocks
- Deleveraging and impact on capital markets – how to deal with global concentration
- How to finance SMEs, trade, long-term infrastructure and environmental change?
- How to handle financial inclusion [inequity in financial access]?
- *How has Financial Environment changed Central Bank functions?*

Segmentation and Specialization versus Integrative System-wide views

- As the world became more complex, both academic disciplines and government agencies or even corporate departments became more and more specialized – they knew more and more about less and less. They drill deep but not wide.
- On the other hand, generalists who understand the big picture (which may not be available because of inadequate statistics), know less and less about more and more. They look wide, but cannot understand the details.
- This situation is like blind men describing an elephant by touching the parts.
- Banking is Global in Life and National in Death – Mervyn King.
- We need to look both deep and wide.
- Central banks became specialized only in (national) monetary policy, and did not see the complex way financial risks were emerging at a global, systemic level, with huge system liquidity and credit implications.

Exchange Rate and National Competitiveness

- Central banks are in charge of exchange rate stability, which has implications on both flows and stocks. That stability is maintained through intervention using foreign exchange reserves, interest rate policy, macro-prudential tools or direct exchange controls.
- Generally speaking, in the flexible exchange rate regime, central banks should not have exchange rate targeting, but the exchange rate is a by-product of monetary policy.
- Note that advanced country central bank functions do not include national competitiveness, since using exchange rate for competitiveness is considered “mercantilist”.
- Central banks have mandates that include employment and economic growth, which are also affected directly or indirectly by exchange rate movements.

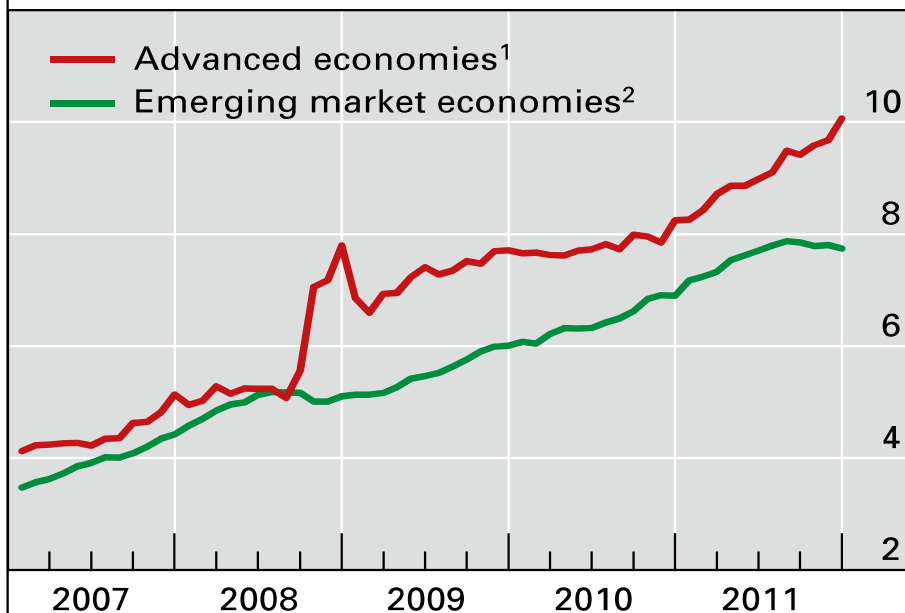
Section 2

Dealing with Capital Flows

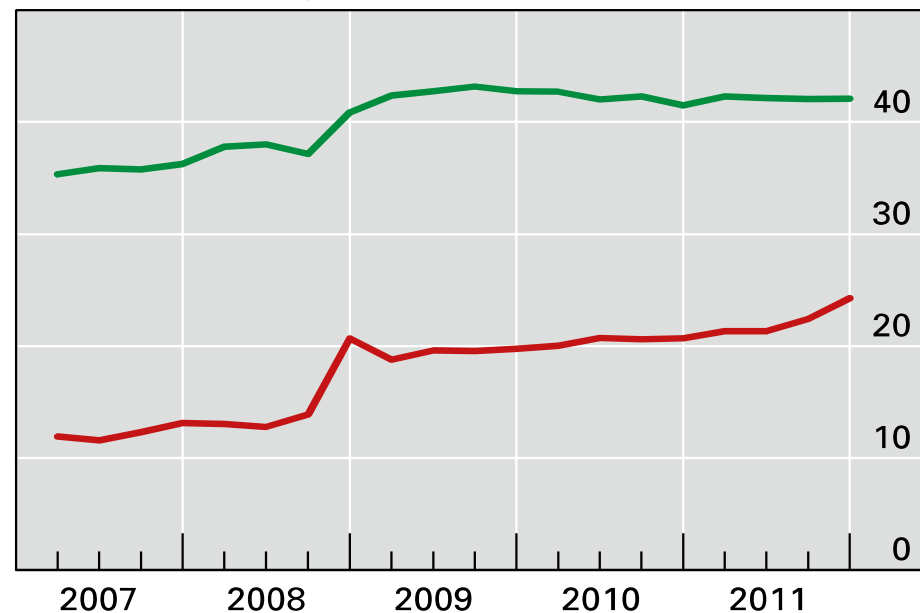
Reversal of QE leads to bubble deflation

Central bank assets

Total assets,
in trillions of current US dollars



Total assets,
as a percentage of GDP



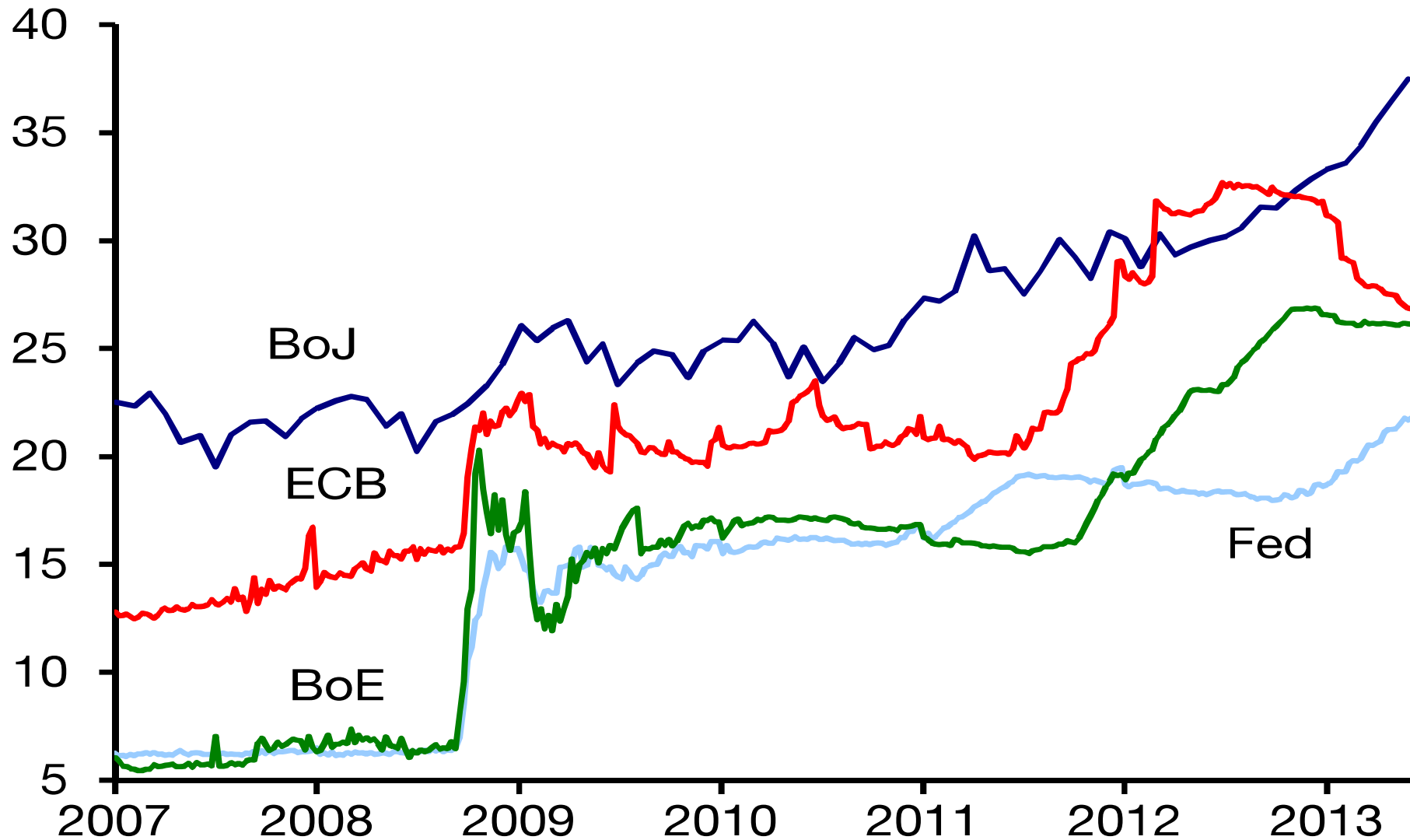
¹Total of major advanced economies (see Graph IV.6). ²Total of major emerging market economies (see Graph IV.6).

Sources: IMF, *International Financial Statistics*; Datastream; national data.

Graph IV.7

G4 Central Bank Balance Sheets: Total Assets

percent of GDP



CB Balance sheet large relative to currency, M2 and bank credit

Table 1					
Central bank total assets in 2011					
	In billions of USD	As a percentage of quantity indicated			
		GDP	Currency in circulation	M2	Bank credit
China	4425	62	621	36	49
Hong Kong	315	129	1063	40	65
Indonesia	161	19	352	53	72
Korea	417	35	1177	48	37
Euro area	2994	24	227	23	15
United Kingdom	391	16	523	9	8
United States	2857	19	288	21	32
Source: IMF, International Financial Statistics; national data.					

Table 2
The composition of central bank assets¹
 As a percentage of total assets

	Foreign assets		Domestic assets; claims on							
			Government ²		Private sector		Banks ³		Others ⁴	
	2001	2010	2001	2010	2001	2010	2001	2010	2001	2010
China	46.5	85.6	6.6	6.1	0.5	0.0	26.5	3.8	20.0	4.5
Hong Kong SAR	100.0	100.0	...	...	...	...	...	...	...	...
Indonesia	48.5	74.4	42.9	24.0	5.8	1.1	2.8	0.4	...	...
India	56.1	77.6	37.5	22.0	...	...	1.7	0.3	4.7	0.1
Korea	86.7	93.4	6.3	4.5	...	...	7.1	2.1	...	...
Malaysia	78.4	84.3	1.0	0.6	18.4	2.7	2.3	12.4	...	...
Philippines	74.1	87.5	18.1	8.7	2.8	2.7	5.1	1.1	...	...
Singapore	95.7	97.5	4.3	2.5	...	...	...	...	...	...
Thailand	73.2	94.3	6.2	5.4	18.4	0.0	2.2	0.2	...	...

¹ Data less than 0.04 is shown as 0.0; unavailable data is shown as '...'. ² Claims on government and public enterprises. ³ Deposit money banks. ⁴ Other financial sector entities.

Sources: IMF, *International Financial Statistics*; national data.

Source: SSGA, "Asia's Foreign Reserves: 2009 Reserve Allocation Update" Hon Cheung, 2010

Chart 2: Asia's Balance of Payments and Foreign Reserves (\$ Billions)

Market	Start Year	Opening Reserves	Capital Account	Current Account	Errors and Omissions	Closing Reserves	Interest income
		[A]	[B]	[C]	[D]	[E] = [A]+[B]+[C]+[D]	
China	1997	105.0	559.0	1,797.7	(62.7)	2,399.0	259.6
Hong Kong	1999	89.6	(25.7)	189.2	2.7	255.8	51.4
India	1998	24.2	311.4	(71.5)	(5.4)	258.7	44.6
Indonesia	1999	23.6	(11.0)	70.9	(17.4)	66.1	15.1
Japan	1985	22.1	(1,948.9)	2,839.8	83.5	996.6	337.2
Korea	1997	29.4	42.8	185.5	12.3	270.0	66.5
Malaysia	1999	26.2	(111.4)	211.6	(29.6)	96.7	22.6
Philippines	1997	11.7	17.5	19.0	(4.0)	44.2	9.3
Singapore	1995	58.3	(215.1)	332.3	12.3	187.8	61.9
Taiwan	1995	92.5	(44.5)	280.2	20.0	348.2	100.9
Thailand	1993	21.2	54.0	41.1	22.1	138.4	31.9
Total (US\$ bn)		503.9	(1,371.7)	5,895.8	33.7	5,061.5	1,000.9

Sources: Bloomberg, National Bureau of Statistics of China, State Administration of Foreign Exchange, Census and Statistics Department, Hong Kong, Hong Kong Monetary Authority, Reserve Bank of India, Bank Indonesia, Bank of Japan, Ministry of Finance, Japan, Bank of Korea, Bank Negara Malaysia, Bangko Sentral ng Pilipinas, Department of Statistics, Singapore, Monetary Authority of Singapore, Central Bank of China, Taiwan, Bank of Thailand

Asian FX Reserves more than adequate to cover short-term debt

Foreign reserve adequacy					
Outstanding year-end reserves position in 2010					
	In billions of USD	As a percentage of quantity indicated			
		GDP	Imports	Short-term external debt	Broad money
Asia	5,394	37	83	348	29
Latin America	547	13	81	253	42
Central Europe	180	25	47	232	40
Other	558	17	88	332	33
Source: IMF; Datastream; BIS, Consolidated banking statistics; BIS, Securities statistics; national data					

Policy Options for Managing Capital Flows

Tool

1. Allow currency appreciation
2. FX intervention + reserve accumulation
3. Sterilization
4. Monetary loosening
5. Fiscal tightening
6. Tighten regulation
7. Capital Controls

Cons

1. Japan-style boom-bust
2. Currency manipulation?
3. Limits
4. Accelerate bubble
5. Limits to fiscal tightening
6. Limited impact
7. Controversial

Capital Flows Taxonomy

- Capital flows outcome of *Flow* adjustments to *Balance Sheet* imbalances or *Price Misalignment*
 - *If exchange rates are seen to be over-valued or one-directional, huge opportunities for carry trade*
- Balance Sheet – Global Imbalances at macro-level, but also mismatches at national and institutional levels
- Price Misalignment – Arbitrages of prices, taxes, regulation and even grey markets/illicit flows
- But real problem is **LEVERAGED** capital flows, which magnify risks in terms of volatility, speed and scale!

Growth in Scale of Portfolio Capital Flows comes from Proprietary Trading and Hedging

- Unleveraged Real flows have less risks and externalities.
- Hedging of real risks (FDI FX exposure) means that hedger is borrowing from the banking system in specific currency.
- However, large leveraged prop trading and hedging by institutional fund managers, whose cumulative momentum pro-cyclically create the “tsunami” of inflows and outflows.
- Such momentum play overwhelming for EME central banks, without sufficient FX reserves to handle these flows. Hence, huge SELF-INSURANCE with higher than necessary FX reserves post-Asian crisis.
- Problem of GLOBAL Private GAIN, LOCAL Public PAIN.

Dealing with Capital Flows is Collective Action Trap

- No single country can cope with this global problem, unless one is perfectly closed economy.
- Derivatives and off-shore NDFs erode capacity of central banks to monitor and defend against speculative attacks.
- Non-transparent OTC markets mean that prices and flows can be manipulated without official oversight.
- Individual country action in terms of capital controls will not deal with root of problem – private gain at social loss.
- Solution has to be global taxation and better oversight.
- EMEs learning to use macro-prudential tools to reduce leverage and funding for FX transactions by speculators, e.g. Korea.

Turnover Tax is good way of slowing flows and monitoring manipulation

- Lord Adair Turner (UK Financial Services Authority):
 - Since the financial sector has become the “perpetual prosperity machine”, with massive moral hazard, a “Tobin tax” or a turnover tax is the first step in the Global Fiscal reform.
- FTT now supported by EC for global public goods. UK position supports uniform global FTT.
- Uniform Global Tobin Tax will succeed if Japan, India and China supports.

Channels of Central Bank Balance Sheet changes

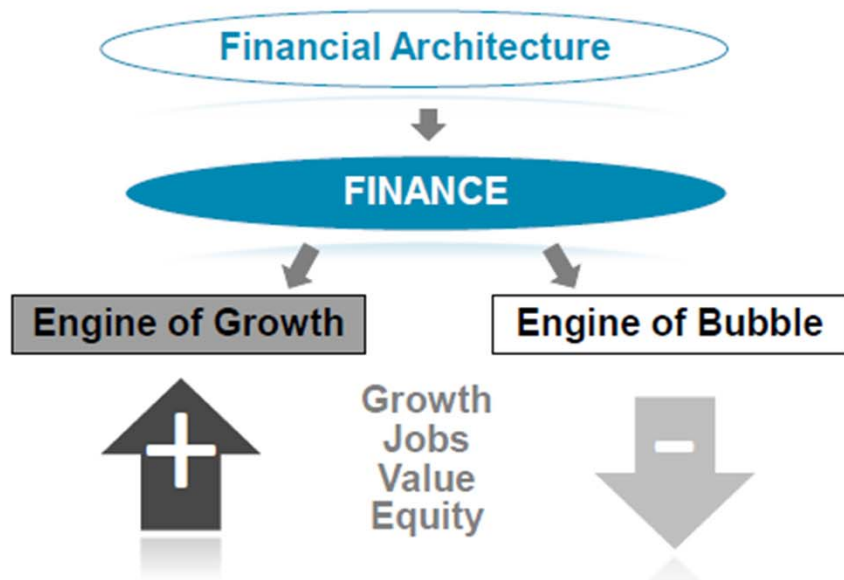
- Changes in central bank balance sheet affect the real economy through three channels
 - Inflation
 - Credit creation that may impact trade and employment
 - Recapitalization of banking system through interest rate subsidy, but lower interest rates create losses for long-term holders of debt (e.g. pension funds and insurance funds) particularly if they have “guaranteed” returns to stakeholders
- Exchange rate changes have impact on balance sheet of corporate and public sector, especially if there are large net foreign borrowings.
- Hence, prudential regulation over FX position of banks, and leverage provided for margin FX trade can reduce speculation.



Section 3 | Role of RMB to facilitate trade and investment

The progress of RMB internationalization can support either real sector growth or asset bubbles

Finance: Engine of growth or bubble?



- The financial architecture of the overseas RMB determines whether it will serve as an engine of growth, or an engine of bubble creation
- The objectives of policymakers should be to design a financial architecture that will:
 - **Foster sustainable economic growth in an inclusive manner**
 - **Meet the needs of the real economy**
 - **Minimize and withstand systemic risks**

The key to sustainable growth is a financial architecture that supports the real sector

Source: Fung Global Institute

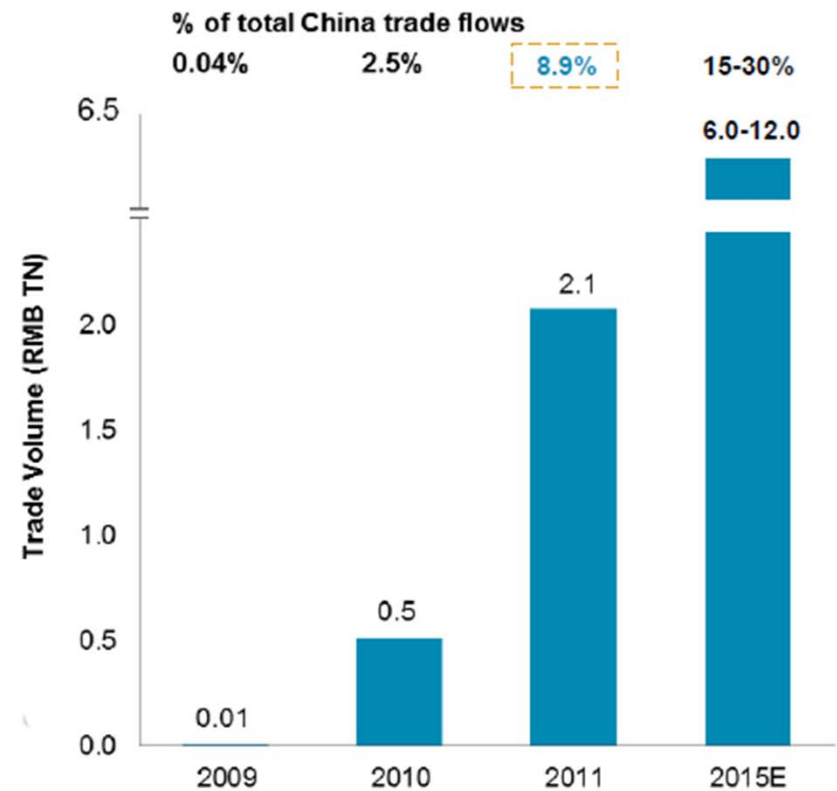
Source: Oliver Wyman

Source: Oliver Wyman

Share of intra-Asia trade that is with China, % (2010)



RMB cross-border trade settlement volume
RMB TN

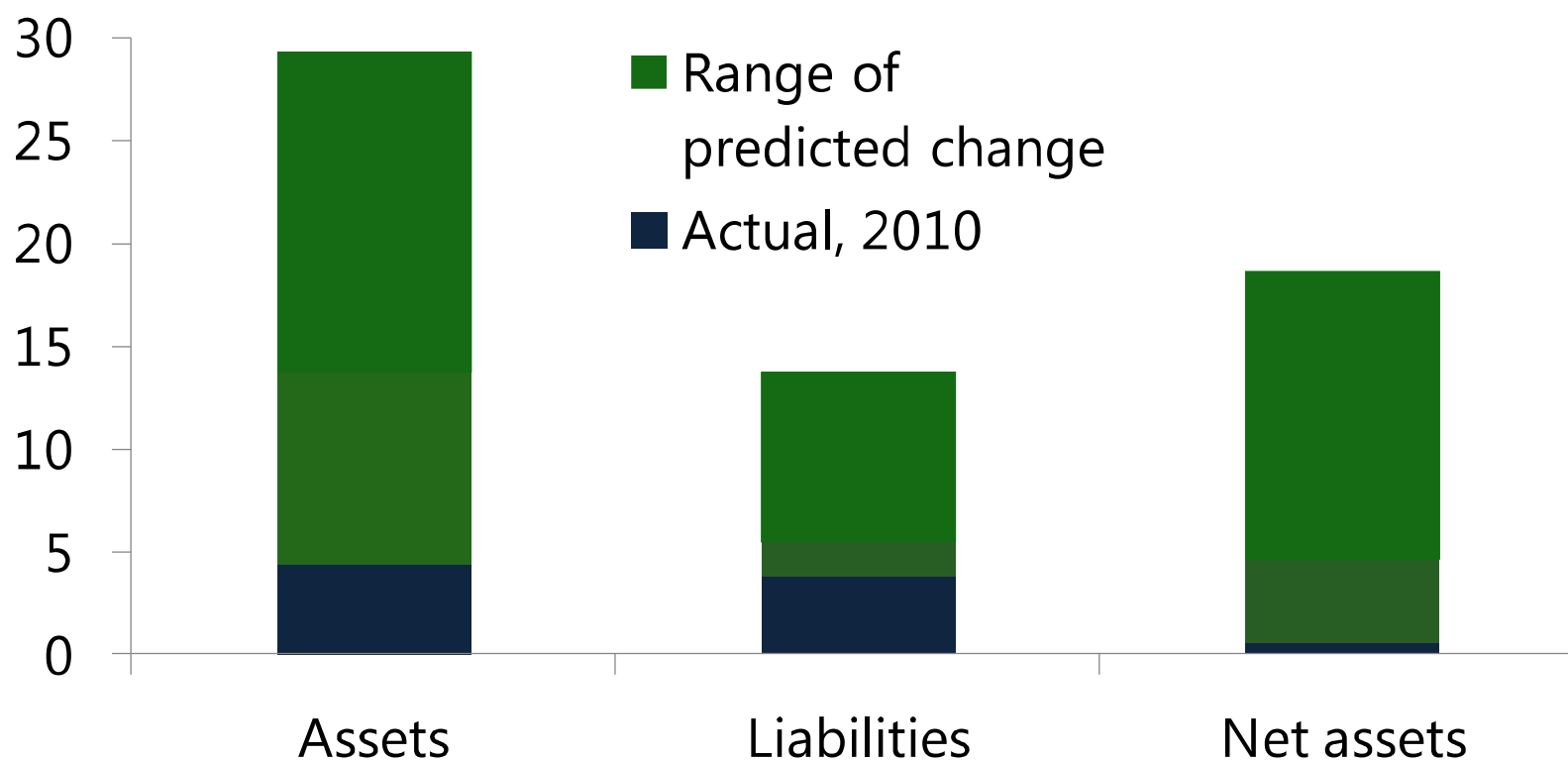


Source: ITC, HKMA, PBOC, Fung Global Institute, Oliver Wyman analysis

Bayoumi and Ornsoghe (2013) – IMF Working Paper

Predicted Impact of Capital Account Liberalization on China's International Portfolio Assets and Liabilities 1/

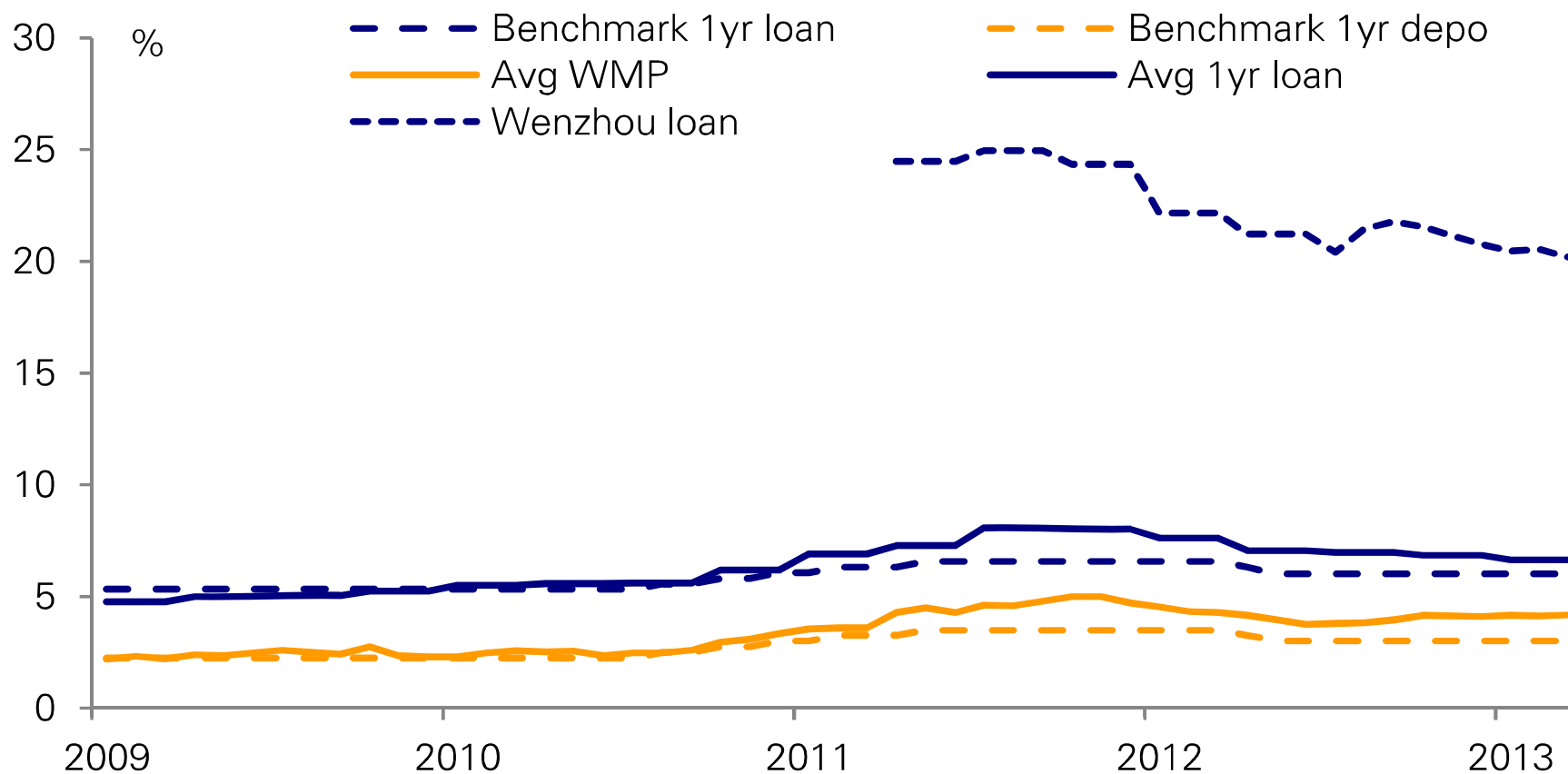
(Percent of GDP)



Note: Range of changes in gross international debt and equity assets and liabilities predicted by regression coefficients of regressions in Tables 3 and 6.

1/ Portfolio assets and liabilities exclude official reserve assets.

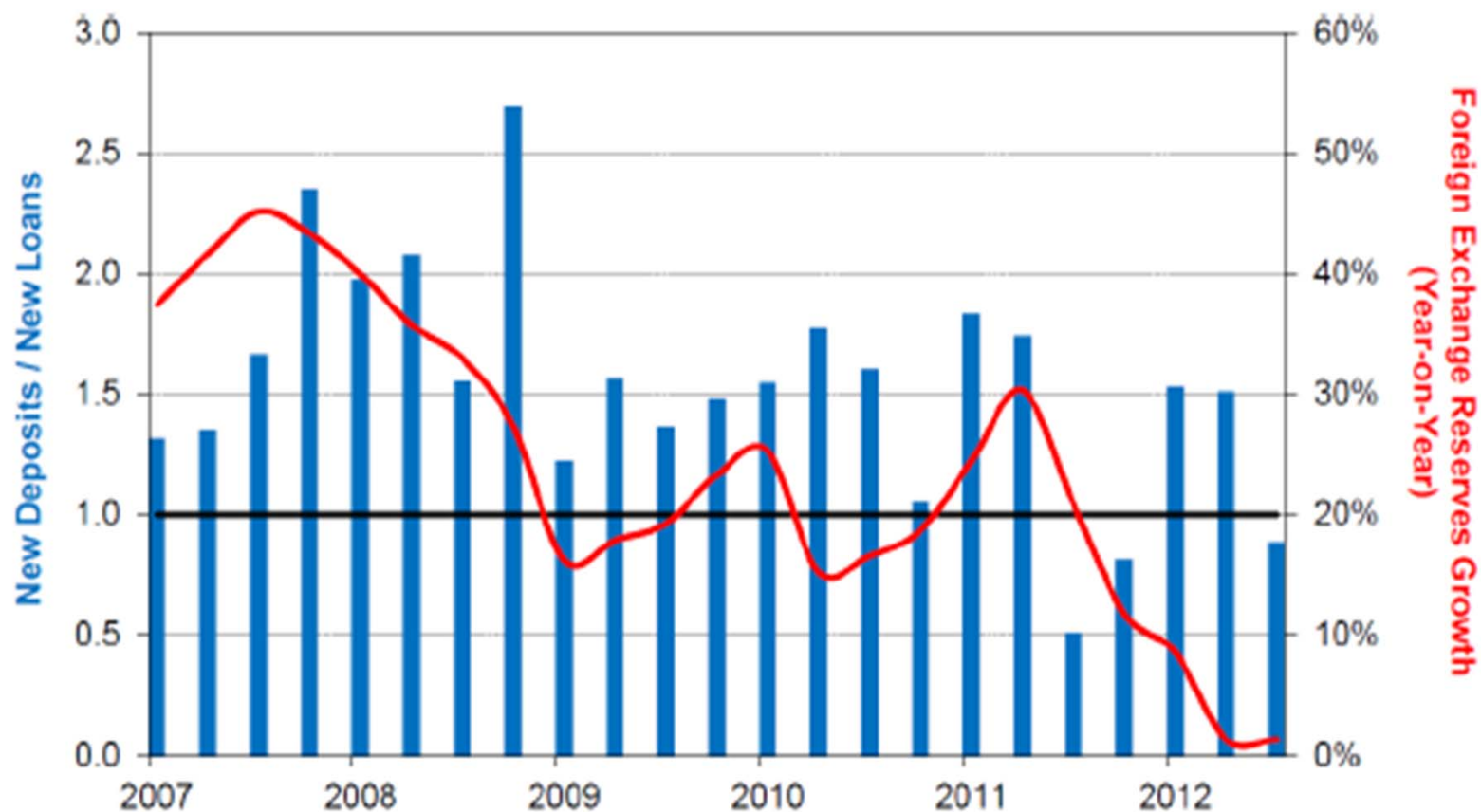
Official and 'shadow market' interest rates



Sources: CEIC and Deutsche Bank

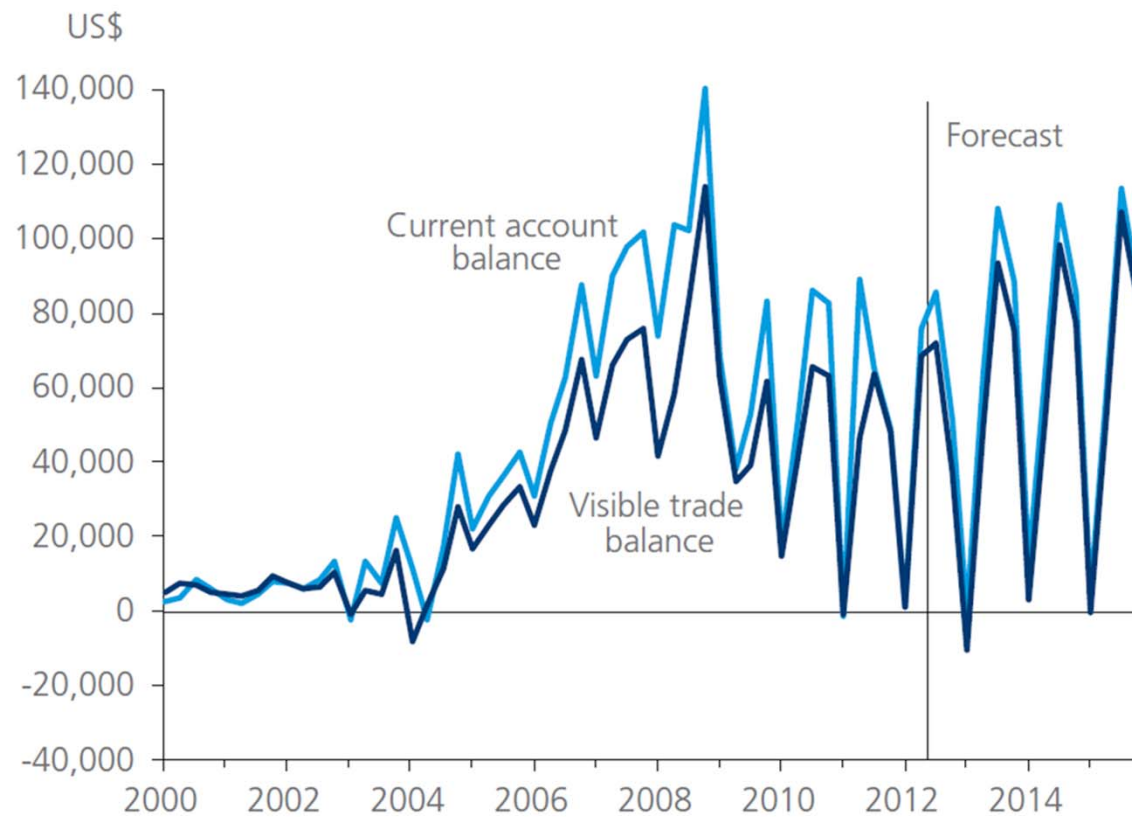
Exhibit 6

Declining Capital Inflows Constrain Banks' Capacity to Lend



Source: Deutsche Bank, PBOC

China: Balance of payments



Source : Oxford Economics/CEIC

Need for systemic cooperative solutions

- Capital flows arise when there are global imbalances, which means that there will always be arbitrage opportunities.
- Capital flows are volatile, because they are highly leveraged and therefore speculative, and if there are policy inconsistencies and unsustainable balance sheet fragilities, accidents will happen.
- The underlying problem arises from private shadow banking credit creation with public underwriting of losses. This is a systemic problem. System problems cannot be fixed piecemeal – systemic cooperative solutions are needed.
- There is no one size fits all solution, but we need to fix fiscal and incentive issues through Financial Transaction Tax, and a combination of tools, including surveillance and regulatory measures.

Concluding Thoughts

1. Emerging Asia is facing a structural rebalancing in Global economy.
2. We have to work together to escape from Collective Action Trap.
3. This begins with a Tobin Tax to limit leverage and provide friction to capital flows.
4. Reduction of leveraged carry trade will give some traction to domestic monetary and structural policies to buy time for adjustment of real sector.
5. Current theory does not give enough guidance to this messy crisis of (unfettered) global leveraged speculation that adds volatility to systemic risks.
6. Next step is to re-design system to Asian needs.



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EXCHANGE RATE STABILITY IN A VOLATILE WORLD¹

BY

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The global financial crisis has increased the drive for stability in economies round the world, particularly in regions such as Asia-Pacific and Latin America which thought they had addressed their own problems but were affected adversely by problems in the US and in Europe. What economies are looking for is some middle way which allows them to pursue a path of largely uninterrupted growth, protected from external shocks on the one hand, yet open to external trade on the other, as such growth is likely to be heavily driven by exports. This implies a search for two main features: the ability to avoid adverse shocks in the first place and the ability to absorb those that do get through with only limited impact on the real economy in the second. This paper reflects on the contradictions and suggests a way forward for the SEACEN-CEMLA economies.

1. Introduction

In this search for greater stability, economies have moved on from simply seeking to smooth out the real cycle and achieve stable inflation (real and nominal stability) to adding stability in the financial system, not just internally but also externally through the exchange rate. Financial stability has now become a second pillar for most central banks, standing alongside price/monetary stability.³ Exchange rate stability on the other hand has received a much more mixed press. For many countries, seeing their exchange change has been a major part of the ability to absorb the shock of the global financial crisis at a lower cost. For others, particularly in the euro area, the inability to allow the exchange rate to vary has been a source of anguish and very substantial real costs. It is a well known question that countries need to pose to themselves: 'Are fluctuations in the exchange rate the cause of the problem or part of the solution to the problem?' For many Asian and Latin American countries, the exchange rate and capital flows have most certainly been the cause of the problem on occasion, with sudden stops and reversals in capital flows and exchange rate 'speculation' leading to major disruption to the real economy. However, in the decade following the 1997 Asian crises, considerable steps were taken by those countries to reduce their vulnerability. Moreover, Latin America, traditionally a source of international financial difficulty, has got through the global financial crisis rather well.

In any event, the exchange rate is only a useful adjustment mechanism when some countries are hit much more substantially by a shock than others. With a common shock, all countries cannot vary their exchange rate in the same direction at the same time. If they try to do so, they merely end up in a counterproductive world of competitive devaluation and probably increasing protection as occurred in the interwar period.

¹ Paper prepared for the 3rd SEACEN-CEMLA Conference on "New Paradigm for Central Banking", 21-22 October 2013, Kuala Lumpur.

² Professor, University of Auckland.

³ However, financial stability has always been a central objective of central banks even if not formulated in modern terms. Indeed some central banks, such as the Bank of England, were set up primarily for financial stability before monetary policy was viewed in modern terms.

The current wish for greater stability and the avoidance of harsh downward adjustment is very much reminiscent of the 1930s after the last major peace time financial crisis in 1929. Some reflection on the findings in that period is therefore worthwhile, in trying to find an appropriate route to great stability and shock absorption in the future. The rest of this paper therefore revisits these earlier answers before considering five facets of the problem that are high on the present agenda before drawing conclusions on the way forward:

- the balance between stability and shock absorption
- imbalances between and within countries
- the pressures that are likely to come as the world exits the global financial crisis and exits quantitative easing and other extreme monetary policies in particular
- shock absorption
- shock avoidance

In many respects, this might be thought to be ducking the concerns of the Conference relating to the 'New Normal' in international financial arrangements. There are two reasons for this. The first is simply that, with historical precedent in mind, we have in many respects been here before and what has happened over the last five years has reminded us of aspects of the old normal, which have been neglected in the period of unjustified enthusiasm in the run-up to the problems that exploded in the third quarter of 2008. The second is an attempt to distinguish between the process of change that will extract the world from the clutches of the global financial crisis and the post-crisis environment. Because of the scale of the crisis and the major responses to it by both fiscal and monetary policy, we have created circumstances that are far from normal and will take a long time to unwind. Indeed, because of those extreme actions, there are non-trivial dangers of further disruption, as some financial markets have recovered well in advance of the real economy and well in advance of the return of monetary policy to some semblance of normality in the US and Europe.

2. Revisiting History

The search for more stable exchange rates is very reminiscent of the discussions that took place between 1915 and 1945, trying to find some means of replacing the gold standard in a greatly changed world. In another respect, it also reflects the process of replacing the UK by the US as the hub of the world's financial markets. We are again seeing the balance of power changing, this time towards Asia but the process of establishing a post-US dominated world is not likely to be a quick one. Without the Second World War, the transition from the UK-dominated system would have taken longer and it is by no means clear that the solution would have been so US-centric, perhaps with Keynes' idea of the Bancor being more favorably received.

The Gold Standard has been viewed by some as a 'golden age' in which international stability was achieved with a system that was not dominated by a single country and where adjustment was automatic and to a large extent symmetric. However, it is worth remembering some of the downsides. Downward adjustment was difficult as the price level had to fall and economic cycles were the norm, sometimes exaggerated by financial crises. Thus removing one problem came at the expense of others.

The attractiveness of the world currency proposals by Keynes was that the pressure on those on the downside was not necessarily as great. Like the Bretton Woods system, it would be possible to devalue under certain circumstances. The key issue for such systems is how much mutual assistance is available for a country that has to make a downward adjustment. The role of the IMF in enabling countries in difficulty to get a short-term loan at good rates for a short period while they restructured to take advantage of the new found competitiveness was essential.

It is this whole aspect of asymmetry which revealed the heart of the problem and constituted the heart of Keynes' fame. He recognized that making the downwards adjustments to wages and prices were extremely costly, as there were important asymmetric rigidities in the system. While countries could to some extent try to ameliorate the problem by deficit spending, if the entire onus was on the countries who needed to depreciate, then the consequences not just for their standard of living but for that of the rest of the world would be worse. It is interesting to look at the detail of the development of Keynes' ideas as his views about the relative importance of flexibility and fixity changed (as revealed for example in Ben Steil's book on *The Battle of Bretton Woods*).⁴

Those on the upside have a choice about whether to act, those on the downside however do not. Thus there is not a simple market solution which will necessarily act in the best interests of the global system. The success of the current major initiative by Japan will be interesting to observe – assuming that the structural reorganization part of the three pronged policy is actually implemented as otherwise the changes will not be sustainable. By following considerable monetary and financial expansion at a time when the zero bound already applies and public debt is at record levels in global terms, this is an unusual policy. It would certainly fail if other countries followed suit in the short-run and hence offset the attempt to reignite growth through depreciation of the exchange rate.

That aside, the old dilemmas remain. If exchange rates are largely fixed or there is a common shock, then the countries that are faring better (less badly) have a greater opportunity to help the global system recover. As in the euro area, there is little mileage in pointing out to the countries in difficulty that they are to a large extent responsible for their own problems. Making them entirely responsible for their own recovery would simply slow the recovery of everybody.

3. How Much Stability is Needed?

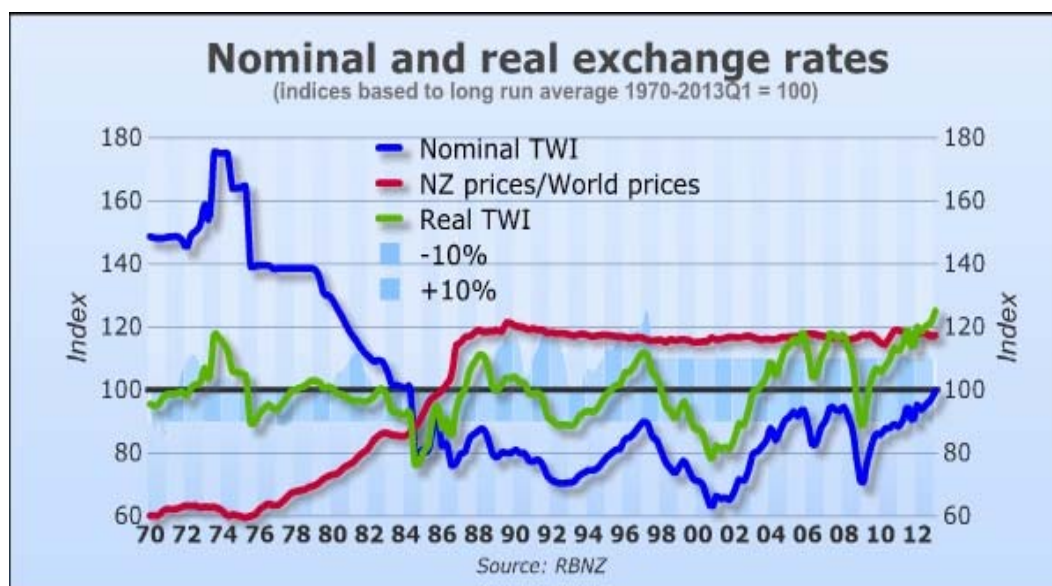
The volatility from external shocks has to be absorbed somewhere in the economic system, although to an extent the system can be closed against them, so that they bounce off, but then usually at the cost of not being able to get some of the benefits off an open system. However, even those countries which welcome the shock absorbing capacity that a freely floating exchange rate brings can get rather distressed by the extent of the variation.

New Zealand is a case in point. New Zealand started a free float in 1984 and, as is clear from Figure 1, the real exchange rate (TWI stands for trade weighted index) has fluctuated round an average value both before and after the float. The problem is the extent of these fluctuations, which have been of the order of 30-40%. With the free float and New Zealand's controlled inflation since the end of the 1980s following the

⁴ Princeton University Press, 2013.

introduction of inflation targeting, the nominal and real exchange rates have moved together.

Figure 1
Exchange Rate Variation in New Zealand



However, variations on this scale are hard even for a country with a strong agriculture sector, used to wide fluctuations in income for climatic reasons. One of the problems for a small country for which the economic cycle is not well coordinated with the major countries is that macroeconomic policy is expensive. Setting higher interest rates than elsewhere could draw in major capital inflows, so the exchange rate rises substantially. Similarly, if interest rates are low compared to alternative locations, the exchange rate falls a long way. Monetary policy independence from major trading partners is thus very difficult to achieve.

On the other hand, a look at the behavior of the exchange rate round the time of the global financial crisis shows the advantages of flexibility. There was a 30% fall in the exchange rate in the early days of the crisis, helping to turn the economy round quickly. Real GDP only fell by 2% and the economy has been recovering since then, growing by 3% in 2013. Unemployment increased by 3 percentage points to 6.4%, the government budget balance went from a 4% surplus to a 5% deficit but it is expected to be back in surplus by the end of the next financial year. As a result, the debt to GDP ratio increased from 17.5% to 36% but is now falling.

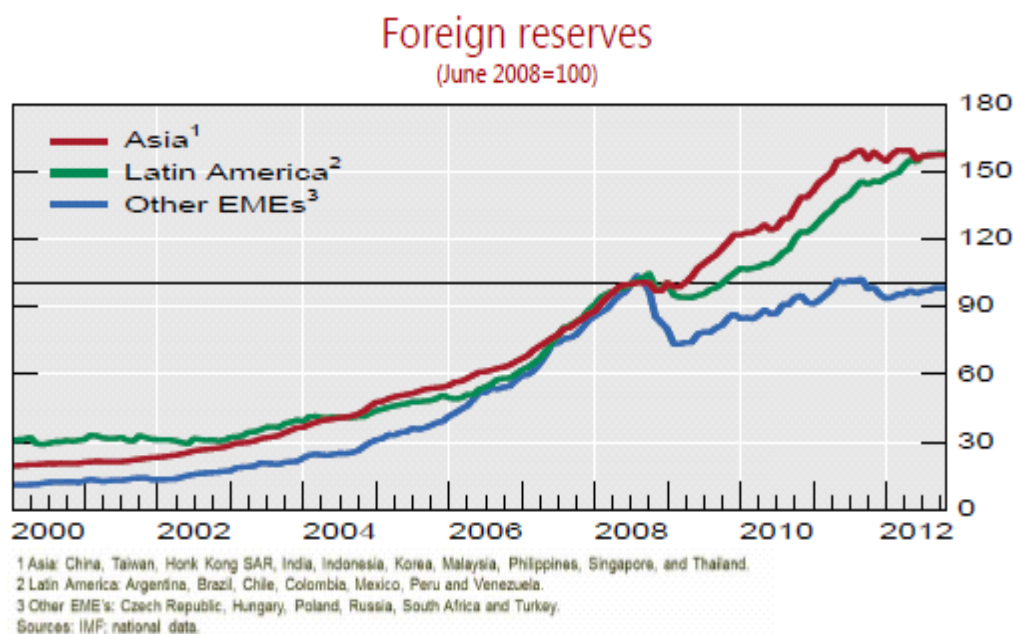
Admittedly, there was little direct impact of the financial crisis as the banks had little exposure to the US but nevertheless, the country has come through the crisis reasonably well despite/because of the flexible exchange rate. Others could do likewise. Other structural imbalances remain with household debt at 150% of GDP and current account deficits in each of the last 40 years.

4. Building Imbalances

Considerable imbalances round the world contributed to the global financial crisis and if anything, have been widening since it occurred. One consequence of these imbalances has been the accumulation of foreign exchange reserves, particularly in parts of Asia. These represent a helpful ability to absorb shocks but they also allow the countries on the other side of the inflow, primarily the US, to maintain their own unsustainable position. If this were a means of providing breathing space while necessary changes take place, these funds would be of clear benefit to both sides. But it is neither clear that the changes required for sustainability have been occurring in the US nor that the reserves have a particularly temporary aspect to them.

Figure 2 suggests that, outside the other emerging markets, both Latin America and Asia have seen their reserves climb further during the crisis. However, in the case of Latin America, it is not clear that these increases in official reserves actually represent the cushion that they apparently are, as net foreign assets held by the rest of the economy are negative and becoming more negative since the global financial crisis started (Figure 3).

Figure 2
The Continuing Build-up of Foreign Exchange Reserves

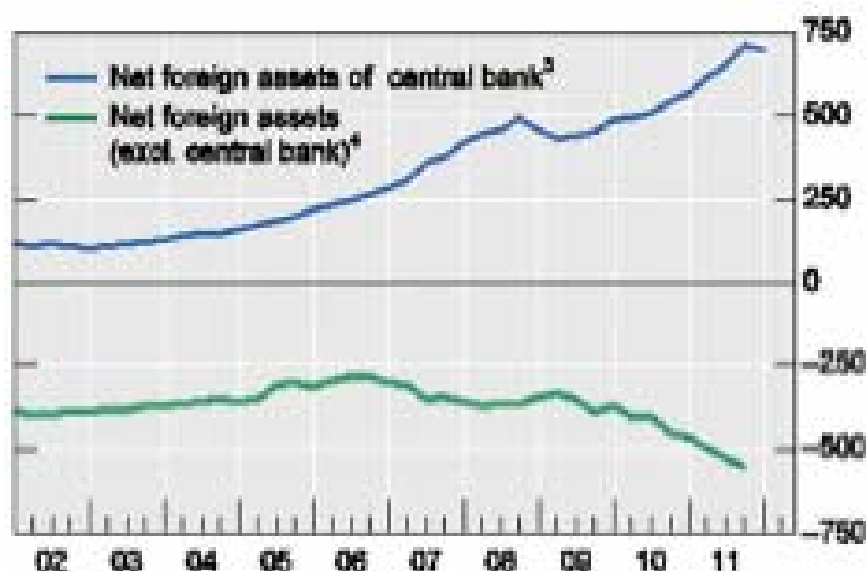


There are thus two impending problems. In the Latin American case, the net buffer is actually relatively small, while in the Asian case the question is whether, as the imbalances are run down or cease to grow, the process will be as smooth as it was on the way up. On the way up, the imbalance provided relief for the counterparty. On the way down, it depends very much what the counterparty's position is. If the counterparty is under pressure, the position could be difficult. Furthermore, work at the BIS⁵ suggests that beyond a certain point, increased foreign exchange reserves

⁵ Baba, N. and F. Packer, (2009), "From Turmoil to Crisis: Dislocations in the FX Swap Market Before and After the Failure of Lehman Brothers," *BIS Working Paper*, No. 285.

have little impact on sovereign spreads or credit ratings. Indeed, if these countries simply wish to stabilize foreign exchange markets, this may be more readily achieved through swaps than through reserves beyond some limit.

Figure 3
Offsetting Movements in Foreign Exchange Reserves in Latin America



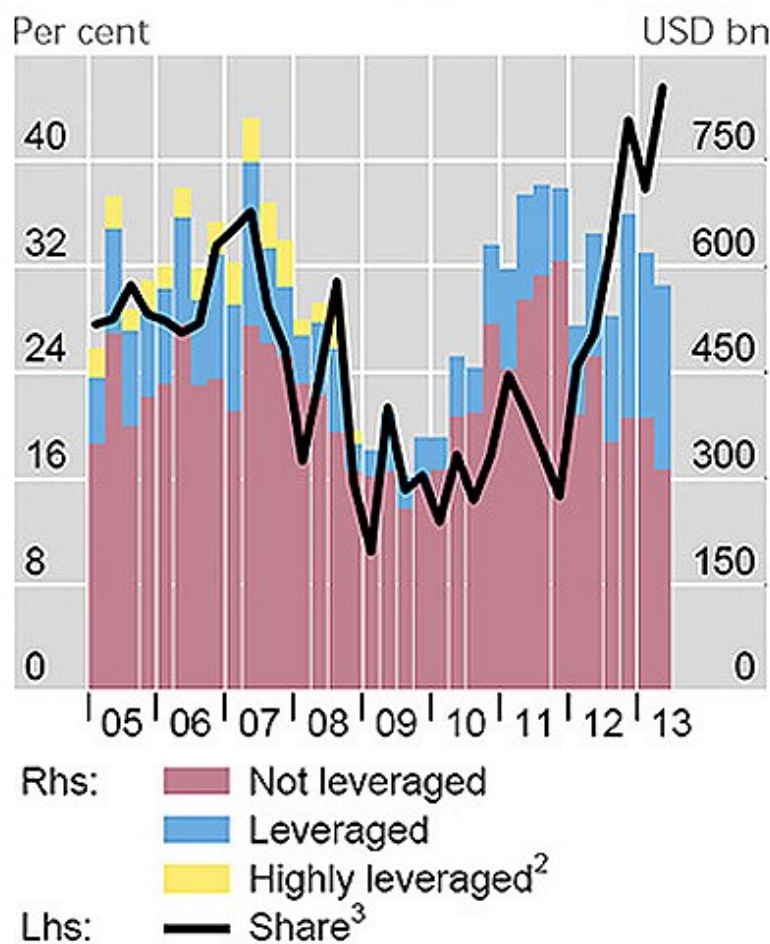
Source: BIS.

What makes the problem worse from the counterparty point of view is that the BIS in its most recent (September 2013) *Quarterly Review*, suggests that exposures and riskier instruments are not merely on the rise again in the US but in some respects are even higher than they were before the global financial crisis (Figure 4). In this case, the worry is that there could be a second crisis if there is an adverse shock in the recovery process. On top of this, we have already seen fragility in markets as soon as the Federal Reserve started to discuss how slowing down the rate of quantitative easing might go and what factors would be borne in mind in deciding upon the timing and size of the change. India was particularly affected. It is therefore likely that it will be necessary to be prepared for further adverse external shocks.

5. Exiting the Global Financial Crisis

Exiting the global crisis is clearly going to be slow, after all it has lasted 5 years already. History from the Great Crash in 1929 suggests that it might take a generation. What is worse in that case is that it contributed to some extreme reactions, some of which are apparent at present yet fortunately not in the ascendant. However, further adverse shocks might change this. Given the extreme nature of some of the policies which have been applied particularly in monetary policy and the fact that both announcement and implementation moved markets internationally when they were introduced, we can expect the same as these measures are removed. We have already seen that a simple discussion of the way the tapering process is likely to go announced by the Chairman of the Federal Reserve, designed to prepare markets and help make the process smooth, actually caused a disturbance in May. We can, therefore, expect that further announcements will have an unpredictable effect.

Figure 4
The Evolution of Risk in the Corporate Loan Market in the US



Source: BIS Quarterly Review, September 2013.

In some respects, since quantitative easing achieved a lot less than was hoped and much of the new funding has remained on bank balance sheets and not been lent out, we might expect that the rundown of the balances would be relatively straightforward. Nevertheless, it is clear that behavior on the exit from cycles is not a mirror image of that on entry. There are many explanations of this asymmetric behavior across the cycle but one which is appealing is that by Tom Sargent in *The Conquest of American Inflation*.⁶ He argues that the sustainable equilibrium in the economy is relatively subdued with relatively low growth rates. Secondly, people are inherently somewhat optimistic. Hence, as an economy recovers and slowly begins to grow more rapidly, people's views about what may happen in the future become more enthusiastic. The better the performance of the economy and the longer it lasts, the more this enthusiasm builds up and actual behavior moves away from the equilibrium in an upwards direction.

⁶ Princeton University Press, 2001.

Eventually the bubble this enthusiasm generates is burst and the economy slips back to the pessimistic but sustainable equilibrium. The Minsky view of financial cycles has a similar line of argument.⁷ The key feature of the asymmetry is that the optimism emerges slowly and although it picks up momentum on the way up to the bubble, there are no sudden steps. On the way down on the other hand, sentiment changes abruptly. People become much more risk averse and there is a sharp downturn.

If this line of argument is correct, then again we can expect the responses to the slowing and then reversal of quantitative easing to be cautious and hence the disruption to the economy relatively limited as the actual extent of the impact of the easing on behavior is limited because of the caution that has been engendered. That would imply the external impact on Asia and Latin America will be limited thereby limiting the need for either extensive protection against the shocks or active measures to offset the impact when it occurs. However, according to some analysts,⁸ when the policy was being introduced, those countries that had an active monetary policy response seemed to fare rather better than those which maintained fixed exchange rates. Moreover, even if fixed exchange rates are maintained, it is possible to use some of the macroprudential tools to mimic monetary policy. This would imply that even if the need is not so great on the running down of quantitative easing, there is some scope for active policy.

The Fratzscher et al. (2012) results indicate that quantitative easing tended to exacerbate the procyclicality of capital flows to emerging markets and hence the same could be expected on the reversal of the policy. However, the effects varied from measure to measure and across countries, so generalization is difficult. Moreover, while quantitative easing raised both asset prices and exchange rates in emerging markets, it was not the largest factor in those increases. So, on this rather inconclusive basis, we can move on to considering how the shocks might be absorbed.⁹

6. Shock Absorption

The key requirement in the structure of the economic system is that when external shocks strike they should be absorbed with as little cost as possible to society as a whole and that the distribution of that impact should be seen to be fair. In the US (where the shock was internal) and in Europe, the experience in the global financial crisis has been decidedly negative on both counts. First of all, the financial sector, which is normally the prime immediate shock absorber, actually magnified the real impact of the shock. Secondly, the taxpayer ended up meeting a substantial proportion of the cost even though much of the excess risk taking was the responsibility of stakeholders in financial institutions. It is clearly arguable that the authorities made major mistakes in financial regulation and supervision which contributed to the genesis of the crisis and that therefore having the taxpayer bear a portion of the costs is only appropriate.

However, in future, one would expect the financial sector, not simply to absorb the shocks but to do so in a manner that was both thought fair and with little spillover onto the real economy. In the first instance, that will come from having capital and

⁷ H.Minsky, (1986), *Stabilizing and Unstable Economy*, McGraw-Hill.

⁸ Fratzscher, M.; Lo Duca, M. and Straub, R., (2012), "A Global Monetary Tsunami? On the Spillovers of US Quantitative Easing," *CEPR Discussion Paper*, 9195.

⁹ The Fratzscher et al. sample included China, Hong Kong, India, Indonesia, Korea, Malaysia, Pakistan, Philippines, Singapore, Chinese Taipei, Thailand and Vietnam, as well as Australia, New Zealand and Australia.

liquidity buffers that are genuine shock absorbers, in the sense that they can absorb the losses without the firm having to cease trading. If the shocks are bigger than that then the recovery and resolution mechanisms that are being put in place round the world will enable further loss absorption by the creditors, in order of priority in an insolvency, in a way that enables operations that are vital to financial stability to continue. These will primarily take the form of 'bailing in', either through contingent capital instruments such as CoCos that switch from debt to equity if capital ratios fall too far or through mandatory conversions as part of a special insolvency procedure where the authorities can step rapidly into a failing financial firm before the losses mount too far.

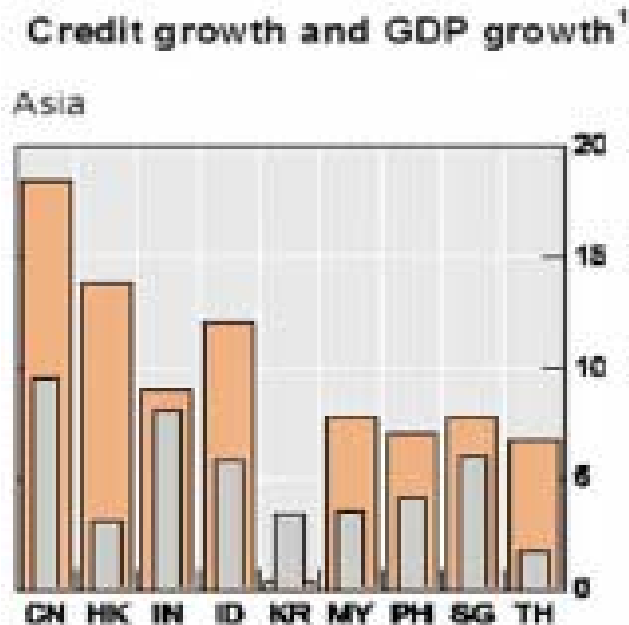
Most countries feel that ordinary depositors should be excluded from this bailing in process, both because they cannot afford the losses and hence there will be serious real consequences as they cut back on their consumption and because they are unlikely to have knowingly taken the risks. Not only are bank deposits normally thought completely safe but ordinary depositors would not be able to interpret the signals early enough to exit before the bank fails. (New Zealand is an exception in the OECD in not insuring deposits at all.) Only if the bank begins to run out of bailable funds or the supervisors are clearly at fault would one see the taxpayer stepping in as the loss absorber.

One needs to recall that taxpayers are actually very effective loss absorbers. First of all the loss is spread widely so that the chance of having a major impact on those with low incomes is small. With a progressive tax structure, the rich, who can absorb the loss, pay proportionately more. Secondly, most of the impact is postponed, as the government issues new debt and the cost is only borne through higher interest payments and then later repayment of the debt itself. This is in sharp contrast to bailing in, where the losses tend to be immediate and can actually exceed 100% of the final cost. Typically the authorities will write down creditors according to a conservative valuation of the failing bank's net position as they will have only one chance of intervening in this manner. If the valuation turns out to be too conservative then the creditors will get a larger payout from the insolvency process at a later date. (This has already been illustrated in the case of Amagerbanken in Denmark, which failed in 2011.)

Secondly, in addition to this microprudential policy which makes sure that there is adequate absorptive capacity in each individual institution, macro-prudential policy can seek to ensure that the system as a whole tends to absorb shocks rather than magnifying them through contagion. Macroprudential policy itself comes in two parts, one part concerned with the structure of the system to limit contagion and the other to reduce the vulnerability of the system to shocks by ensuring that financial pressures do not build up too far, either generally or in particular asset markets. One important facet of macro-prudential policy for emerging markets is to avoid excessive foreign currency exposure especially for those without foreign currency income.

It is noticeable for Asia that in the years since the start of the global financial crisis there are potential pressures from credit building up a lot faster than GDP (Korea excepted) as shown in Figure 5, also drawn from the September 2013 BIS Quarterly Review. Furthermore, the necessary buffers as required by Basel III will only be built up slowly over the period up to 2019. Similarly making sure that banks are initially properly capitalized and have adequate access to bailable funds will only occur steadily. There will therefore be a period before the new system with better absorptive capacity comes into being, where the international financial system is still fragile because it has not returned to 'normal' from the global financial crisis.

Figure 5
Increasing Credit Risk in Asia 2008-11



Source: BIS Quarterly Review, September 2013.

Note: wider bar is credit growth and narrower bar GDP growth.

During that period, public sector absorptive capacity will have to stand in place of the private sector system. In Asian countries with relatively low debt, that is a reasonable prospect but for the euro area countries that have already reached or come close to their feasible debt ceilings it is not. There, therefore, one could anticipate that any new shocks would have unfortunate real consequences without the absorptive capacity.

In any event there may be excess optimism at present about the absorptive capacity of the stakeholders in banks. Clearly interbank transactions have to be excluded and many creditors will be collateralized. Indeed as the prospect of being bailed in increases so we can envisage that the demand for collateral will rise, thereby squeezing the size of the cushion of bailinable debt.

The two groups in the private sector who can absorb shocks readily are the rich and pension funds. Pension funds in particular offer a helpful absorptive capacity, not just because they have quite a long time in which to rebuild their fund and rematch their liabilities but because they are likely to have a spread of assets across currencies and hence be in a good position to act in the swap and other derivatives markets to help the rest of the financial sector manage risks.

With the continuing importance of the public sector, not just in production but in investment in many countries, sovereign wealth funds also act as helpful shock absorbers, as they are likely to have a currency mix that hedges at least some of the likely shocks.

7. Shock Avoidance

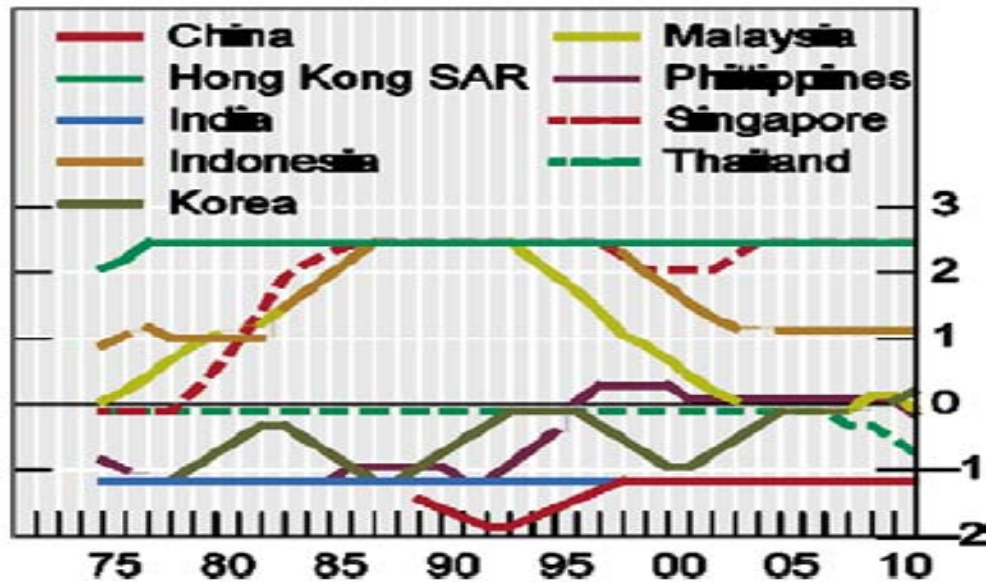
This leads me to my last topic of shock avoidance. In some respects this is a misnomer as it does not necessarily imply that somehow the shocks do not take place, but simply that the shocks which do occur have less importance. For example, if the extent of currency mismatch is reduced then currency shocks will have less impact. In many countries, banks have been working steadily to reduce their own exposures, in which case they may be able to get round the fact that their customers still have very considerable exposure. Nevertheless what can often happen in these circumstances is that the currency risk is replaced by a credit risk. Dependence on short term external funding is a perennial problem even in New Zealand. But, as a result of the global financial crisis bank funding has been switched both to longer term sources and to deposits.

Simply having deeper financial markets will help. As mentioned earlier, pension funds will be good loss absorbers and have assets which work as a foreign exchange hedge. This in itself will weaken the impact of the shock as well as help absorb the impact that does occur. Macro-prudential regulation will limit risk as will micro-prudential exposure limits and requirements to hold more liquidity.

Capital flow management – a term that has replaced the more direct ‘capital controls’ – has been coming back into fashion. If the flows are smoothed then this may limit the extent of reversals in them, as extreme positions are more difficult to build up. It is however difficult to decide where smoothing segues into trying to fight against the trend. However, all the objections which were advanced earlier still apply. The simplest observation is that the more effective the measures are, the more they are likely to increase the cost of capital. Thus such protection comes at a cost, even if it is not needed.

It appears from the work of the BIS that despite the change in rhetoric, there have not been strong moves towards greater capital controls, as suggested in Figure 6, with the exception of Malaysia and to a lesser extent Indonesia. Those who have been strongly convinced by them, such as India, have maintained them while those that make little use of them, such as Hong Kong and Singapore have also retained their views.

Figure 6
Changes in the Chinn-Ito Index of Openness



Source: BIS.¹⁰

8. Concluding Remarks – Choosing the Balance

We can expect substantial problems as quantitative easing is wound down. Several of the imbalances across the world have been covered up by a combination of very low borrowing costs and excess liquidity provided by central banks. While such problems may well emerge again in the US and Europe, where recapitalization of banks has still not been fully addressed, it can also occur in other markets, including Asia and Latin America.

Clearly there are a number of measures that are worth taking in any circumstances but in others choices have to be made when trying to minimize the impact on the real economy. For example, normal micro and macro-prudential anticipation is required, first through building up the capital and liquidity buffers in the banks. The lesson that has been very firmly learnt is that once the problems start it is too late to try to increase buffers. That needs to occur while the economy is doing relatively well and when it seems unnecessary from current circumstances. The implementation path suggested by Basel III may well be too slow if problems start emerging in 2014. In the same vein it makes sense to reduce strains in the domestic financial system in the face of potential external shocks. Then, when the shocks hit the system is less vulnerable. History of course suggests that this sort of pre-emption is the exception rather than the rule.

Secondly, this paper has suggested that an important step is to assess where the losses are likely to fall and how well those who will incur the losses are able to bear them without there being unnecessarily large impact on the real sector. (The paper also argues that regard has to be paid to the fairness of where the impact hits, so

¹⁰ I am grateful to Ramon Moreno for this Figure.

that it is those who knowingly took the risks who should bear the costs in the same sort of order that they would in an insolvency.) Where the losses cannot be readily absorbed resolution methods normally consider how the losses can be reallocated in a manner which is both fair and minimizes the overall costs to society. There may well have to be a trade off between the two, especially if cost minimization entails some element of taxpayer funding.

Much of the international effort in redesigning the system has gone into trying to make sure that it is the private sector that absorbs the losses directly, first of all through equity holders and then through the creditors, whether through voluntary (i.e. agreed in advance) or mandatory bail ins. However, this process is not foolproof. Creditors may have insufficient absorptive capacity and it may prove simply impossible to organize such a private sector solution in time. Experience in the viability of living wills and 'funeral plans' has fortunately not been built up yet, so these ideas may turn out to have practical drawbacks, not least that what is technically feasible may prove to be politically unacceptable at the time. Hence it will not be possible to write off the idea of shock absorption through the public sector, whether by running down assets or more likely by increasing debt to provide temporary assistance to banks, probably through purchase of new equity rather than simply a loan that keeps the present owners and management in post.

Even in preparing for this eventuality it is worth considering which parts of the private sector are best/least able to absorb the shocks and make sure that the structure of the impact is moved in a favorable direction – e.g. away from ordinary depositors and towards pension funds. Not in the sense that pension funds are penalized simply because they are good shock absorbers but simply that their asset structures are such that others may be able to benefit from them, either through insurance or through the development of the derivatives markets that the holding of substantial pension portfolios is likely to entail.

However, the major issue raised in this paper is on the managing of the real impact on the economy after all such attempts to maximize the help that the financial sector can offer to absorb the shock have been taken into account. First of all, as we have been reminded by the experience of Cyprus, Greece, Ireland, Portugal and Spain in the euro area, trying to regain competitiveness under fixed exchange rates is an extremely painful process although very flexible countries such as Estonia have managed it. Those with more flexible exchange rates, including Iceland and even the UK, have been able to recover more readily and at a lower cost. Allowing many routes to flexibility, including the exchange rate may be appropriate. Certainly if the exchange rate route is to be cut off then it needs to be very clear that the alternative routes will work well, something which is often not the case, as euro area countries other than Ireland demonstrate.

There is a considerable temptation to try to provide the complementary measures to avoid exchange rate flexibility through capital 'management' and other means of restricting the response to shocks. In so far as these restrictions inhibit the building up of unsustainable balances and exposures, under the guise of macro-prudential measures then this is likely to make eminent sense. Indeed all the measures to try to ensure that the structure of the financial system limits contagion and offers alternative mechanisms should a key player fail are all part of a prudent framework for good shock absorption. Measures which lead to financial repression can be much more costly and the calculation of whether it is more efficient to have such repression (or the threat of it) on a continuing basis or the low probability of a costly wide exchange rate shift needs to be undertaken very carefully and reviewed periodically.

All protective measures, whether simply capital buffers or deposit insurance, are likely to impose some costs, both on the wider economy in general, and on financial institutions in particular. While I have been very critical of aspects of New Zealand's new Open Bank Resolution, the Reserve Bank's assessment of the likely impact of the regulation, even if inevitably inaccurate, is an essential precursor for any such change.¹¹

I have deliberately left one consideration out of the discussion, not because it is unimportant but because it would require a substantial discussion. This is regional moves to try help absorb the shocks and provide measures of mutual help. There is a lot which can be achieved, as discussed in my book with Peter Morgan and Masahiro Kawai.¹² However, it is worth noting that the conditions for regional stability of exchange rates are just the same as those for a common currency. Indeed in some respects they apply more strongly as the possibilities of involuntary exit are much greater should there be strong speculative pressure. Thus the countries still have to have relatively similar structures and be subject to the same sorts of external shocks. They need good real and nominal flexibility. They need to run prudent fiscal and monetary policies. One important possible difference is over who decides, as in a fixed rate arrangement those who disagree can always leave. But in practice it is always the large countries which decide or have the most weight in the decision. Thus in the euro area it is still Germany that is the most important voice and has the major impact on the single monetary policy even though most of the decision makers are non-German. Small countries do not really have much monetary policy freedom in practice, whatever the sovereignty in theory. Nevertheless, regional measures are something that can add to the somewhat pessimistic argument I have advanced.

My conclusion remains, however, that while people hope that the exit from the global financial crisis and the unusual monetary policy measures will be smooth and steady it is necessary to prepare for its having unpredicted and substantial adverse effects not just in the countries where the unusual policies exist but in the rest of the world as well, which have either been counterparties to the transactions or seen the pattern of financial flows distorted.

While some avoidance of this impact is possible, shock absorptive capability is still the key to avoiding a substantial adverse consequence for the real economy. That is a challenge under fixed exchange rates.

¹¹ Mayes, D.G., (2013), "The Funding of Bank Resolution," Paper Presented at the Symposium on 'Bank Recovery and Resolution in Europe,' University of Tuebingen, October 18-19, 2013, Available at http://www.jura.uni-tuebingen.de/professoren_und_dozenten/binder/Symposium/presentationen-symposium-18.-und-19.-oktober-2013/mayes-the-funding-of-resolution/view.

¹² Kawai, M.; Mayes, D.G. and Morgan, P.J., (2012), Implications of the Global Financial Crisis for Financial Reform and Regulation In Asia, Cheltenham: Edward Elgar.

ENRIQUE BÁTIZ
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EXCHANGE RATE AND COMPETITIVENESS IN A WORLD OF HIGH LIQUIDITY

BY

ENRIQUE BÁTIZ¹

- The role of central bank in promoting regional competitiveness
- Coordination of exchange rate in the region
- The role of Chinese Yuan as a key currency in the global economy

Let me start by congratulating the Board of Governors, Executive Director and staff of the South East Asian Central Banks (SEACEN) Centre for their 30th Anniversary. In particular, I would like to congratulate this Centre for introducing the first issue of the SEACEN *Financial Stability Journal*. I very much sympathize with the view that there is a need to promote practical implementations of policy measures related to financial stability and systemic risk from a central bank/monetary authority perspective. High-quality empirical research contextualized to the Asia-Pacific region provides a useful tool for supporting regional financial stability. Moreover, the Journal will be useful for policymakers and researchers of other regions to learn about financial policy in Asia and, in so doing, it will extend its coverage to support global financial stability.

I am honored to participate in this Conference organized jointly by SEACEN and CEMLA. In my view, regional associations benefit from sharing experiences and promoting networks and relationships among people. I would also like to thank our host for their excellent organization and hospitality. I really appreciate the chance to discuss about an interesting and topical issue such as “exchange rate arrangements and competitiveness in a world of high liquidity”. The importance of this topic stems from the fact that exchange rate arrangements play a pivotal role in determining growth, employment, inflation and the balance of payments. Since exchange rate regimes have both merits and shortcomings, this underscores the need for continuous debate on exchange rate performance or for simply reviewing each country’s experience in using a specific exchange rate regime.

Before starting I would like to note that my remarks are entirely my own responsibility and do not necessarily reflect the views of Banco de México or its staff.

I have been asked to discuss about: (i) the role of central banks in promoting regional competitiveness; (ii) the coordination of exchange rates in the region; and (iii) the role of the Chinese Yuan as a key currency in the global economy. However, I will focus my remarks on the actual or future importance of the Yuan for the global economy. In my view, discussing this element is useful to think through and to start figuring out how this event may lead to a completely new and different financial architecture.

Having clarified my approach, I have decided to structure my intervention in three parts. First, I will discuss about the importance of the Chinese Yuan for the global financial system. I will focus on China’s challenges and progress in implementing exchange rate regime reforms. In essence, I argue that Yuan globalization is closer than expected and that the process may accelerate under the condition that reforms continue as outlined

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below. Second, I will briefly depart and I will share with you some similarities that I find particularly interesting between the transformation of the Mexican exchange rate regime and the fears inherent in 1994 related to adopting flexible exchange rate regime. Although the Mexican experience applies on a very different scale and context, I hope that it serves to remind about the advantages of implementing a free float exchange rate. Finally, I will provide some concluding remarks.

1. Yuan Globalization

As of today, a globalised renminbi can transform not only China but also have implications for other major financial centers. One of the main tenets of the so-called modern portfolio theory is that diversification reduces the risk of the portfolio. In practice, any investment opportunity provides both risks and returns, and assets have to be available and attractive for investors to acquire them. The renminbi will be an attractive asset that will present an investment opportunity for: (i) financial centres that intend to act as trading hubs, (ii) central banks that intend to diversify their currency reserves holdings; and (iii) the investor's community that intend to expand the number of asset classes in their portfolio.

In this regard, the Chinese government has followed important steps. In a recent paper, Gang Yi (2013) described China's progress in implementing exchange rate regime reforms. I will summarize the most important achievements made to date:

- ✓ In 1994, China moved away from a system where two different foreign Exchange prices of the renminbi were offered to a managed floating Exchange rate regime.
- ✓ In 2005, strong economic conditions and financial reforms allowed China to de-peg the renminbi from the U.S. dollar and this decision led to a more flexible Exchange rate.
- ✓ As a consequence of the global financial crisis, the daily floating band of the renminbi was narrowed and this helped in preventing the renminbi from depreciating as much as other currencies of other emerging markets.
- ✓ In 2010, China promoted market-based exchange rate mechanism reform with reference to a currency basket.
- ✓ Since 2012, Bank of China has significantly reduced market interventions.
- ✓ On April 16, 2012, China widened the renminbi daily floating band from ± 0.5 percent to ± 1 percent.

These facts suggest that China's exchange rate regime is moving towards a more market oriented approach. Moreover, as highlighted by Gang Yi (2013), China is planning to increase the floating band in the near future to let market supply and demand play a more important role in the exchange rate formation process.

It is convenient to point out that there is certainly a demand from reserve managers for investing in renminbi. A recent survey made by RBS shows that 14% of the reserve managers that answered have already invested in renminbi.² China's economic outlook, characterized by relative high growth rates and strong potential for continuing growth, and its privileged position as a key player in global trade constitute by themselves an attracting factor for investment purposes.

² See RBS (2013).

Another issue that is worth highlighting is the fact that the People's Bank of China has signed a number of bilateral currency swap agreements, including one with European Central Bank on October 9, 2013, for the purpose of promoting bilateral financial cooperation, facilitating bilateral trade and investment, and maintaining regional financial stability.³ Previously, another swap agreement was signed with the Bank of England on June 22, 2013.⁴ The establishment of a bilateral local currency swap arrangement will provide liquidity support for the further development of RMB market in the euro area, promote the use of RMB outside China, and facilitate bilateral trade and investment. Hence, there is a clear sign that China's market is expanding. As of today, the PBOC holds 24 swap line arrangements with different counterparts around the world. Although to the best of my knowledge these lines have not been used, they represent a future commitment that will be helpful for improving liquidity. Central Banks should look for establishing new swap agreements and improving the conditions of current signed agreements.

However, although progress has been made in moving towards a more flexible exchange rate regime, there are at least two key steps that the renminbi will have to follow to play a more active role. First, there is the need to make further progress in liberalizing the capital account for Chinese investors to invest abroad whenever they like and without any restriction on the amount of their investment. Second, China needs to continue its efforts to deepen and make more liquid the market for government, similar in nature to that of the US treasuries. A liquid market is of paramount importance for trading securities especially during periods of economic and financial stress. As of today, the only way to participate in the renminbi is through Hong Kong's offshore market (see Nagel (2013) for further details). In the future, I expect to see the renminbi trading directly against not only vis-à-vis hard currencies such as the US, YEN and Australian Dollars, but also against currencies such as the Peso, which according to a recent triennial survey on foreign exchange turnover published by the BIS⁵ occupies the 8th position in the world currencies with the highest turnover, closely followed by the Chinese yuan which occupies the ninth place in the BIS statistics. It is convenient to point out that the increase in the peso's share in global FX trading was unthinkable twenty years ago and I cannot recall any economist who dared to predict that the peso would gain enough investors confidence in order to be placed among the top ten most traded currencies in the world. This fact serves as a natural link to introduce the second part of my talk, namely, the Mexican experience in transforming its exchange rate regime.

2. Transformation of the Mexican Exchange Rate Regime⁶

Since December 1994 Mexico abandoned the pegged exchange rate against the US dollar (US\$), which had been in place since 1987. In contrast to Chinese progress towards implementing a flexible exchange rate regime, the decision by Mexican authorities to adopt a flexible regime arose as an economic need rather than as a result of a strategic decision. In 1994, efforts to defend the pegged exchange rate had caused the depletion of net

³ In particular, the terms of the swap agreement with ECB are as follows: the swap line has a maximum size of 350 billion yuan or 45 billion euro, while the agreement will be valid for three years and can be extended by mutual consent.

⁴ The size of the swap facility is 200 billion yuan or 20 billion pound. The agreement is valid for three years and can be extended by mutual consent.

⁵ For further details see BIS (2013).

⁶ Most of this section remarks were borrowed from Sidaoui (2003).

international reserves and the accumulation of large amounts of short-term liabilities denominated in foreign currencies. It is worth highlighting that some market participants at the time feared that a floating exchange rate would be an additional source of volatility and this would in turn undermine the effectiveness of macroeconomic stabilisation policies.

Nevertheless, history proved them wrong as the flexibility of the exchange rate has helped to soften the effects of external shocks, in the aftermath. In implementing foreign exchange policy Banco de México has adhered to two main principles:

- (1) not to interfere with the normal functioning of the market⁷ and
- (2) to foster the development of the market through the creation of new instruments and by encouraging the entrance of new participants.

In a nutshell, the overall strategy of Banco de Mexico is based on stressing the need to minimize interference with the foreign exchange market and to foster its development. In addition, Banco de México took a number of steps to promote investors confidence in the PESO. The most well known are:

- ✓ In April 1995 Banco de México authorised: (1) the operation of foreign exchange markets dealing in US\$ derivatives involving Mexican pesos and (2) deposits in local currency with foreign financial institutions. The main rationale for this was that derivatives contribute to trade and hedge specific risk exposures, allowing the spread of risk among different players and hence mitigating the uncertainty regarding the exchange rate.
- ✓ Banco de México's authorisation to operate derivatives allowed the Chicago Mercantile Exchange (CME) to launch a Mexican peso futures contract, which was the first emerging market product of its kind to be traded on the Exchange.
- ✓ Launching of the Mexican Market of Derivative Products (Mexder), which in December 1998 began the operation of a futures contract involving the Mexican peso against the US\$.
- ✓ Banco de México also supported the development of foreign exchange derivatives through regulation and supervision of the over-the-counter forward market.
- ✓ A further step in market development was the decision to modify in 1996 the computation of the Fix exchange rate, a quote published by the central bank that is widely used as a reference, to better reflect actual market conditions.
- ✓ For promoting market information disclosure and policy transparency, from April 1995 on, Banco de México has been issuing a press release presenting, among other data, the main items of its balance sheet. In particular, the press release also includes a breakdown of the factors that explain the weekly flow of international reserves.
- ✓ Banco de Mexico also publishes detailed data related to the foreign exchange market.

The adoption of a flexible exchange rate did not prevent the authorities from achieving a significant disinflation during the last decade. One of the main fears surrounding the adoption of the floating regime was the possibility that the nominal anchor of the Mexican economy would be lost. In the event, monetary policy has been able to guide inflation

⁷ See García-Verdú and Zerecero (2013) for details about central bank interventions in the peso/dollar foreign exchange market.

expectations through the adoption of an inflation targeting scheme, a strategy that appears to be a suitable complement to the flexible exchange rate.

It therefore appears that, in the case of Mexico economic agents learnt quickly to live under the float. Contrary to the initial concern that a flexible exchange rate would increase volatility, the fact that the currency can depreciate or appreciate in any given period, and that these movements can be both reversed and/or hedged, has changed the behaviour of firms, workers and investors alike and induced a rather stable environment. In this context, one of the most important achievements of the floating regime has been to decouple to a large extent the pricing of goods and services from the exchange rate, with the resulting significant reduction in the pass-through of depreciation onto inflation.

The development of local currency debt markets is another development worth highlighting. While in the years after the crisis the issuance of bond with maturity of months would have been considered successful, today Mexico issues bond with up to 30 years maturity and the duration of Mexican liabilities has increase significantly. Also, during this time, the currency composition of Mexican debt has changed dramatically. In this regard, the floating exchange rate regime has not prevented the shift towards local currency instruments. Today most of Mexico's debt is denominated in Mexican pesos.

Concluding Remarks

In a single word, from my perspective, the Renminbi internationalization can be described as “intriguing” or extremely interesting, because we don't know how it will happen nor how long will it take before it happens. However, we know that this event has the power to transform the global financial architecture.

Chinese strategy in adopting a flexible exchange rate can benefit from revisiting the experience of other countries. The Mexican case provides a good example of the convenience for adopting a flexible exchange rate regime and on the measures that should be taken to promote the use of the currency in different fronts. It is important to highlight that the shift can be managed without negative repercussions in the short run while proving benefits in the long run.

Due to the good experience of Mexico with its flexible exchange rate arrangement, we fully endorse the G20 commitment to move more rapidly toward more market-determined exchange rate systems and exchange rate flexibility to reflect underlying fundamentals, and avoid persistent exchange rate misalignments and to refrain from competitive devaluation.

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SESSION 6:
**CHALLENGES FOR ECONOMIC GROWTH AND
FINANCIAL STABILITY IN ASIAN AND LATIN
AMERICAN ECONOMIES IN THE NEW “NORMAL”**



WASHINGTON RIBEIRO
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THE "NEW NORMAL": RARITIES, RISKS AND UNPREDICTABILITY
BY
WASHINGTON RIBEIRO¹

1. Policymaking in the "New Normal": Consistency and Pragmatism

Both on Sunday, for those of us who participated in the conference to mark the 30th anniversary of SEACEN - and yesterday and so far this morning much has been said about the implications that the crisis has had for the economic policy, in particular for the monetary policy, for competitiveness, for the policy instruments and for financial stability. We have discussed about the consequences of the measures adopted by developed countries.

Firstly, I will summarize the future environment in which central banks will have to operate, and secondly I will talk about "governance" regarding financial stability at domestic, regional and international levels.

It would be very ambitious of me to outline a future agenda but at least I will try to discuss the issues that should be taken into account to shape that future agenda, particularly according to the new financial architecture, as well the new reality, the "new normal", prevailing in the markets.

I will start by describing what I believe are the most outstanding elements that characterize and will characterize the new financial reality.

2. Uncertainty and Risk Aversion

Why didn't the monetary expansion of developed economies lead to an increase in their inflation? Clearly because this expansion offset the prior destruction of assets, as we all know.

The current monetary expansion will not be permanent. I am not saying anything new here.

The removal or reversal of Quantitative Easing policies generate a double - or triple - source of uncertainty: when it will happen, what it will be like, and how long it will last. So far no one can give an accurate answer to these questions. Surely not even those responsible for the implementation of these measures are clear about these issues.

The fact is that it is enough to "wink" – make signals - in one way or another for the financial markets and consequently for the capital flows to react quickly.

Although the announcements by the Japanese economy about a monetary expansion of a similar magnitude to that of the United States caused some uncertainty, why didn't such announcements cause similar consequences to those of the United States?

In any case, designing policies in this new reality must take into account that the present situation will not be permanent.

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Therefore, the policy instruments applied by emerging countries to protect themselves from the consequences of monetary expansion – the measures applied and the measures that may be applied in the future- must have a fundamental feature: the ability to adapt to changing circumstances quickly.

What are the signals that central banks in emerging countries make to markets? Can the policy swing to the beat of public statements made by the policy makers of developed countries?

How much credibility can the central banks of emerging countries lose in our rational attempts to adapt to sudden and given changes?

Information, transparency, clarity of purpose and correct institutional communication more than ever before become important in this new and uncertain world which is rapidly changing. The purpose is preserving credibility.

3. Volatility and Risk Correlation

As mentioned, monetary expansion will not be permanent and the reactions of emerging countries will not be permanent either.

High volatility, high correlation among financial assets – that went unchecked in the past decades-, and high uncertainty will be long lasting. These peculiarities of the international financial system stemmed from the crisis, they were and are in effect in relation to monetary expansion, will remain in effect until the expansion is not removed, but they will also catch up with the times of removal and probably go beyond that time until developed countries consolidate sustained growth paths.

Therefore: firm decisions, the ability to adapt, and the strength and clarity of communication in the "new normal" will be critical.

Orthodoxy holds for times of calm, but heterodoxy is necessary in times of high volatility. In fact, at present it is accepted and even recommended by those who penalized it in the past.

You, SEACEN member economies, Malaysia in particular, know perfectly well what I am talking about. In the crisis of the 90s, particularly in response to the Asian crisis of 1997, heterodox measures were implemented and later criticized. However, their resistance to this criticism and their conviction that it was the right path has allowed them to face the crisis of 2008 with a different strength from the strength they would have had if they had been consistent with the orthodoxy to be imposed on them.

At present, as in some Latin American economies, they are considered examples to follow. Our policies, which were nothing but ways of reacting vis-à-vis the reality surrounding us then, are in the center of the discussion. They are no longer considered stigmas against deregulation and free movement of capital, but as study cases and a reason for research.

Clearly each country knows its realities and needs. Each country has its own peculiarities. The crisis of 2008, a result of the deregulation that started in the 80s, the absence of macroprudential regulation and the failure of microprudential regulations brought about consequences for our economies. The expansionary policies have had and are having consequences. Their removal -yet unknown in relation to their time and form- will also have consequences and surely lead to the removal of the heterodox network of policies that we

applied. So, is it that we, the emerging countries, have nothing to say about this? Is it that we, who have backed up global growth in recent years, do not have to be a part of the way out?

Can the world continue waiting expectantly for the Fed's announcements? The international organizations are also expectant.

4. Liquidity and Sudden Stops

Liquidity, its management and offsetting the consequences of resulting flows become a predominant variable.

In case of "sudden stops" and the need for reaction in order to prevent contagion to the rest of the economy, managing the reserves, managing the sovereign debt and macroeconomic stability in the "traditional sense" become more important than in pre-crisis times. And it was not because little importance was attached to them before.

The robustness of the economies will determine the reaction capacity in times of a liquidity "drought".

At present the independence of central banks is in discussion. The discussion is not about the justification of such independence, about which there is no doubt, but about the limit of their actions in relation to fiscal implications. The instruments associated with the "balance sheet" have tabled the discussion about the independence of central banks.

Thus, we have to understand that the independence of central banks in times of instability and crisis depends on the degree of coordination and cooperation with other government agencies in times of calm.

Governance and the institutionality of financial stability must not only be integrated by the Central Bank, the regulator and the deposit insurer but the Ministry of Finance has to be part of it.

5. Unpredictability

A deep financial system that is regulated and focused on financing economic growth is essential for productive development.

A meaningful financial system whose sole purpose is to pursue profitability independent of the real sector acquires the ability to generate a large battery of financial products at a much higher speed than that at which the regulation moves.

Do individually sound institutions make a sound financial system? The 2008 crisis answered this question.

Is micro-prudential regulation sufficient to prevent systemic crisis? Again, the 2008 crisis answered this question.

Do price stability and macroeconomic balances per se protect economies from possible crises? Clearly not.

Therefore, the definition and implementation of macro-prudential measures in a coherent, coordinated and balanced manner – suited to the needs of each economy - are necessary in a world of ongoing and rapid financial innovation, but also in a world -like the present and the future world- where the removal of monetary expansion will generate a lasting source of uncertainty and unpredictability.

A deep financial system has advantages and disadvantages. The advantages are in relation to its contribution to productive development; the disadvantages lie with its ability to create derivatives and structured products of a difficult "traceability" and therefore regulation.

I am using the concept of a balanced macro-regulation because over-regulation may lead to disintermediation.

Again, coordination among government agencies, with clear roles for each of its participants contributes -as counterweights- to fine-tune regulation with interests and objectives inherent to economic growth and social development.

The "guarantor" call of regulators must be harmonized with the search for price stability – a fundamental mandate of central banks- and with the political interests of the Ministries of Finance.

6. Policymaking in the "New Normal": Consistency and Pragmatism

Now I will refer to the second part of my presentation. I hope that this brief and summarized characterization of the "new normal" let us table issues that have, in my opinion, to be part of the future agenda.

6.1 Policy, Objectives and Challenges

Macroeconomic stability alone is not sufficient to ensure financial stability.

The mandates of central banks, in general, are associated with price stability, the preservation of the payment system, in some cases issues related to the exchange rate stability are introduced, and when the supervisor is part of the central banks, their mandates include oversight and regulation of the financial system.

In recent years, financial stability has been introduced explicitly in the mandate of some Central Banks.

The force of law –the legal mandate- is critical.

In this new reality central banks face new challenges: to lead governance associated with the financial stability, to choose the appropriate instrument or instruments for the monetary policy in order to stabilize prices, to manage the balance sheet, to manage reserves, to manage surplus reserves, etc.

In fact, the policy instruments that are now on the table are not different from those already known in the past. The difference is that they are all accepted now. None is stigmatized. The challenges associated with a more volatile and unpredictable world are linked to a set of policy options much broader in scope than before.

Using one or another according to the time and the needs may be read as erratic behaviors. Institutional communication is positioned as a key axis in the new agenda of central banks.

7. Risk Management and Pragmatism

7.1 Adaptability and Pragmatism

As I said earlier, orthodoxy may make sense in times of calm; amid a storm, heterodoxy, a quick response capacity, and adaptability to any given change are fundamental.

The "dashboard" must include risk indicators in various management areas, especially early warning indicators.

A reaction-based policy entails late responses and the "damage done".

A policy based on risk analysis provides a shield against undesired situations.

It is important to build capacity and strengths to face the risks: reserves, macro stability, borrowing capacity, etc. The design of regulations must take into account both micro and macro risks. To mitigate the impact of arbitration -and arrive late- oversight should be risk-based and in a unified and consolidated manner.

The ability to adapt and pragmatism will allow us to react in case of unknown and unforeseen situations.

8. Consistency of the Policy Mix

Independence cannot be synonymous with isolation.

The constant search for price stability cannot be imagined with apathy in relation to the function of supervision, fiscal management, bank resolution processes and deposit insurance schemes.

Coordination among government agencies to define common purposes and coherent goals is critical. At all times. But to ensure independence in turbulent times it is essential that there is strong coordination in times of calm.

Institutionality plays a fundamental role in this regard.

The financial stability committees, with clear-cut roles and limits for each of the participants, with a proper network of conflicting interests seem to be the appropriate level to carry out this coordination task.

Can central bank policies be designed independent of their fiscal implications? If so, then it may happen that the reality of public accounts will impose limits on the actions of central banks.

But furthermore, shouldn't the capital buffers required of private institutions also be on the table - with specific peculiarities- when designing the fiscal policy? Can central bank reserves cope with different objectives in difficult times? In this sense, sovereign funds administered independently of reserves, with preset destinations, with rules on taxation in some Latin American economies - Chile and Colombia, among others - may become powerful "stabilizers" and relieve pressure on managing any possible "excess reserve" of central banks.

So, must monetary authorities just be decision takers in areas that are not part of their competencies? Or is that central banks have something to say about it?

Clearly I am not referring to the management or administration of matters that are not within their competence, but central banks must work in the Financial Stability Committees, at least, as an advisor on debt limits, on expenditure, even on salary policies, inter alia.

In fact, these issues play a fundamental role in price stability and rigidities are part of the choice of one policy instrument or another.

9. Implementation in Stable Times

The topics listed in this slide, among others, and any other that each of you may consider necessary, must be part and parcel of a central bank agenda from now onwards.

In fact, that has always been the case; perhaps the difference now is the need to systematize them following a system of institutionalized governance.

Now, is efficient domestic governance enough?

If that is not the case, as the global environment indicates, especially in economies with deep financial systems, who must lead the process to create international safety networks?

Clearly not all economies are equal and therefore, the policy frames will be specific to each one of them.

But also clearly there are similarities among groups of countries, similar problems, similar risks, production structures that can be similar.

Can a single institution be the lender of last resort at international level?

I would like to highlight and give an example of certain initiatives which even though they will not solve the problems alone they are part of the protection network and contribute to the financial stability in groups of countries, especially emerging countries.

The Chiang Mai Initiative and its transformation into a multilateral scheme for ASEAN + 3, the MOUs of bilateral regulation agreements, the oversight committees for Southeast Asian countries, FLAR (Latin American Reserve Fund), CAF (Development Bank of Latin America) but with a focus on investment in infrastructure, regional economic and monetary study centers focusing on our circumstances – CEMLA -, etc. are initiatives to deepen.

Macroprudential domestic schemes are not enough; we must dare go further and generate macroprudential rules among countries with similar conditionalities.

Central banks are called to lead this process.

Surely at present none of these agencies are themselves the fire brigade, but they are fire extinguishers. When a building catches fire it is important to have a fire brigade to put it out, but it is also important to know how to access that fire brigade and know where the closest fire extinguisher is located to have quick access to it. That is the overall governance of financial stability.

What will the major damage from the recent crisis be? The crisis itself, the reactions through monetary expansion, or the removal of that monetary expansion? History and time will tell. Today we are not able to quantify it because there are stages that have not occurred yet.

Meanwhile, we the emerging countries have supported global growth. In the resulting scheme, the new financial architecture, new players that did not exist before will be present. China is clearly the best example.

Therefore, and as a final thought, governance and the "tool kit" of central banks and domestic financial stability are not enough.

The generation of cooperation networks, the creation of Regional Financial Stability Committees, consolidated regulatory schemes among countries will dominate the agenda of the coming years.

We do not know how long this process will take; the damage caused by its absence is known partially; we, the emerging countries, have earned the right to participate; we have learned from our past crises; that gives us the moral authority to be part of the way out.

The type of institutionality leading the global financial system will depend on the humility with which the present organizations face reality.

Thank you very much.

CLOSING REMARKS



**CLOSING REMARKS
MR. HOOKYU RHU
EXECUTIVE DIRECTOR
THE SEACEN CENTRE**



**CLOSING REMARKS BY
MR. HOOKYU RHU,
EXECUTIVE DIRECTOR, THE SEACEN CENTRE
FOR
3RD SEACEN-CEMLA CONFERENCE ON
“NEW PARADIGM IN CENTRAL BANKING”
22 October 2013
*Sasana Kijang, Kuala Lumpur***

Dr. Fernando Tenjo Galarza Galarza, Director General, CEMLA

Mr. Mark Olsen, Co-Chair, Trelia Risk Advisor, LLC

Your Excellencies Governors of SEACEN and CEMLA member central banks and monetary authorities

On behalf of The SEACEN Centre, I would like to thank CEMLA, and two co-sponsors Bank Negara Malaysia and the Central Bank of Chile making the 3rd SEACEN-CEMLA a successful event. I would also like to thank Governors, Deputy Governors and all speakers and discussants for taking precious time to be with us and sharing their experience and knowledge with us. I would also like to thank all the delegates for their active participation in exchanging of views and sharing of experiences.

Indeed, I believe that this conference which has fostered cross-regional cooperation and collaboration has managed to promote not only a greater understanding of central banking issues at hand but also strengthened ties between the central banking fraternity in both SEACEN and CEMLA regions.

Ladies and Gentlemen,

Allow me to make a few salient points regarding the outcome of this Conference.

The opening address covered the experience of the FED before and after the Global Financial Crisis (GFC) and the changing. Monetary policy has shifted to attract more public attention because increasing ownership of houses and equity.

As the development of interest rates matter for these assets, more and more financial reporters cover central banking news. However, due to this increase in public focus on monetary policy, it has become more important to acknowledge the limitations of monetary policy. Although financial instruments, such as mortgages do not pose risks by themselves, the prevailing conditions may lead to a compilation of risk in those instruments partly triggered the GFC. As a result, the pendulum might swing to the other extreme for policy makers, from too lax regulation to potential over-regulation which should be avoided.

Attention was also paid to a possible link between governance and growth. Strengthening governance could be one way out of the middle income trap.

There was broad consensus that central banking after the GFC was not the same as before. Limiting themselves to monetary stability was not sufficient any more. Financial stability has been incorporated into central bank mandates in different ways. Independence of central banks may be good for both, monetary and financial stability. However, taking on new functions may have implications for the governance and risk management in central bank. It was stressed that central bank roles before and after the crisis evolved. Central bank should

include systemic stability orientation in addition to the traditional prudential policy. Macro-prudential policies are targeting both credit markets as well as capital flows.

Then there was some rethinking on monetary and macro-prudential policy in Asia and Latin America. Macro-prudential should take into account interactions among financial institutions as well as between financial sector and the real economy. Lack of coordination between different agencies on monetary policy and macro-prudential policy can lead to sub-optimal solutions, either too low interest rates or too tight prudential measures.

This morning we reiterated the changing role of central banks in a hugely distorted environment, where leverage in the financial system has escalated due to flawed incentives. The exchange rate is key but central banks should not target it directly, and rather oversee it as an outcome of monetary policy, intervention, macro-prudential policy or direct exchange controls.

Ladies and Gentlemen,

I would like to thank the CEMLA General Director, Dr. Fernando Tenjo Galarza for collaborating with SEACEN to make this conference possible and to Her Excellency Governor Dr. Zeti of Bank Negara Malaysia and His Excellency Governor Dr. Rodrigo Vergara of Central Bank of Chile for co-sponsoring this event.

Ladies and Gentlemen,

I am sure you will agree with me that the conference has raised many issues that are thought provoking and would require further discourses and discussions which I hope we will be able to do so in further foras, including the 4th SEACEN-CEMLA Conference. I certainly look forward to seeing more cooperation between SEACEN and CEMLA in areas of research and mutual technical assistance.

Thank you.

CLOSING REMARKS
DR. FERNANDO TENJO GALARZA
GENERAL DIRECTOR
CEMLA



**CLOSING REMARKS BY
DR. FERNANDO TENJO GALARZA
GENERAL DIRECTOR, CEMLA
FOR
3RD SEACEN-CEMLA CONFERENCE ON
“NEW PARADIGM IN CENTRAL BANKING”
22 October 2013
*Sasana Kijang, Kuala Lumpur***

To close this 3rd SEACEN-CEMLA Conference, I would like to put together some of the ideas that could help us move into the next Conference.

However uncertain the future seems to be, the presentations of these two days made clear that, for the time being, the causes of uncertainty are more on the side of the advanced economies. We listened carefully to very determined statements proposing the things that we in developing Asia and Latin America have to do if we want to build on the good performance and policies of the recent years and be less vulnerable to the spillover effects of changes in the world economy and in policies in advanced countries.

I hope I am not misinterpreting many of the comments in this Conference that suggest to me that the notion of a "new paradigm" basically applies to the central banks and policy frameworks of advanced economies. I am aware that this contention may be criticized of partial equilibrium bias. But I think that the most important result of this Conference is having put the notion of a "new paradigm" in its proper context.

And, within this context, what we were presented with here is a group of healthy economies that, far from having to wait passively to the timing and details of the process of normalization or overhauling of economic policies in advanced economies, should address their own limitations on growth, economic, political, institutional or otherwise.

All the references made to supply-side policies and lower structural growth, governance, preservation of independence in a more politicized context, expanded mandates for central banks, convergence with flexibility and pragmatism, more than expressions of hesitation or doubt, I see as expressions of awareness by more mature societies of the need or urgency of doing more to shape their own future.

To help pave the way in this direction, we would do well if we took another step forward and, once we have come to terms with them, move from these labels a search for a better knowledge of how our economies function and our policy actions are transmitted in an interconnected world.

Let me illustrate the message I am trying to convey with a few examples. A crucial element in the presentations of these two days is the emphasis on the importance of capital flows. However, our perspective on this issue is totally different now that the old approach of global imbalances and surplus and deficit countries has been complemented with a view that stresses the importance of gross flows of capital, leverage cycles, pro-cyclicality, international banks, and global liquidity and its relationship with monetary policies in advanced economies. This new approach, which, by the way, owes much to a group of Asian economists, helps us focus better on our macroeconomic policies, as shown in various presentations that dealt with capital flows.

We also have now a better understanding of how global factors affect the transmission of monetary policies, which in turn shows how macro-prudential policies can complement necessary interest rate decisions. The case made by Governor Tombini that capital controls in Brazil make the transmission of interest rate increases more effective is very illustrative.

I could argue that the time when our central banks believed that necessary increases in interest rates could be substituted, perhaps in response to political pressures, with, for example, reserve requirements, is now history. As true as this can be, central banks in emerging markets have also learned the limits of interest rates as the only policy instrument, and not precisely from a zero lower bound experience. In this, as in other issues, there is an ocean-wide difference between our situation and that of advanced economies.

The last example has to do with this idea of being afraid of the uncharted waters of the so-called tapering. On the contrary, after this conference, and knowing that it will not be smooth nor painless, we should be anxious for this process to begin because, as Governor Vergara and others stressed, the "new normal" of advanced economies may be a better normal for our economies, now with improved fundamentals, experience in counter-cyclical policies, and more awareness of the need to have better institutions and policies.

These are some of the things I learned in these two days. However, an element that should have given more weight in the presentations, rich as they were with ideas of how central banks can improve and are improving, is the need to permanently enhance the technical and analytical capabilities of our central banks, as an integral part of their new governance and accountability requirements and in response to the complexity of the global economy and its processes.

Dear Ladies and Gentlemen, I consider without a doubt that this has been a fruitful and successful event, enhancing the relevance of the opportunity of gathering together the central banks of Asia, Latin America and the Caribbean to exchange experiences particularly in view of the challenges both regions face within this new paradigm.

I wish to reiterate my sincere gratitude to Governor Zeti for hosting this Conference and for being an enthusiastic promoter since 2006 of strengthening the relation between our regions. We have been delighted to be here and we would like to thank *you* for the warm hospitality of both the staff of *Bank Negara Malaysia* and SEACEN's team.

Particularly, I would like to mention our appreciation to the staff of *Bank Negara Malaysia* for organizing with excellence the event and making us feel at home.

A special thanks to Mr. Rhu and SEACEN's staff, of which I would like to point out Mr. Brian Nunis, Dr. Vincent Lim and Ms. Yun Yee, whose outstanding professionalism and efficient dedication made it once again a very pleasant experience for CEMLA to collaborate with.

On behalf of CEMLA and its membership, I also wish to thank President Vergara and the *Banco Central de Chile* for co-hosting the event and for their invaluable collaboration to make it possible.

To our distinguished speakers, discussants and moderators our special thanks for sharing your experiences with us and making each session an interesting and fruitful one.

To all participants for joining us, your presence and comments contributed to a successful Conference.

Thank you all.

PROCEEDINGS OF THE 3RD SEACEN-CEMLA CONFERENCE ON “NEW PARADIGM IN CENTRAL BANKING”



21-22 October 2013

Sasana Kijang, Kuala Lumpur



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