MONETARY POLICY WORKSHOP ON STRENGTHENING MACROPRUDENTIAL FRAMEWORKS

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Both Asian and advanced economies have learned from the 1997 Asian crisis and the recent 2008 global crisis the importance of financial stability and the need to prevent financial imbalances by active use of macro-prudential policy measures. Most countries have now entrusted their central banks to have either the sole or shared responsibility in pursuing financial stability in addition to its traditional mandate of monetary stability.

A central bank can pursue and maintain financial stability by preventing financial imbalances from building up, by reducing systemic risk arising from inter-linkages, from common exposures and from pro-cyclicality of the financial system and by discouraging risk taking behavior of financial institutions that may have systemic implication. This may sound straight forward but it is not.

First, how does one define, identify and measure financial instability?

Unlike price stability, which can be clearly defined as the extent of price increase, measured and monitored using inflation rate as an index, it is difficult to do so for financial instability. Financial indicators, indices or even some early warning data are mostly about individual risk or individual institution risk and may not be able to flag financial instability issues which are of systemic nature and have multi-dimensions.

Secondly, how can we integrate the information or data into a formal model for vigorous analysis of imbalances or instability or the analysis and implementation of monetary policy, given the limited knowledge we have about the linkages between the real economy

and the financial sector? How do we decide what tools to use and what the quantitative impacts of the selected tools are?

Institutional constraints is another major challenge in mitigating systemic risk, if the responsibilities of micro and macro-prudential supervision do not reside in the same agency and coordination between responsible agencies is not well established. How does one ensure effective and efficient coordination mechanisms for close consultation, coordination and sharing of information of the micro and macro prudential supervisors so that interests of all agencies are well aligned and necessary prudential measure can be implemented?

In the next two days, this workshop will explore these difficult issues. But here, drawing from my experience, I'd like to offer some recommendations for the enhancement of financial stability, from an emerging market's point of view:

1. Regularly monitor the threat of financial imbalances as they can lead to financial instability if left unchecked. The Bank of Thailand regularly monitors seven areas that are vulnerable to the buildup of financial imbalances, such as the housing and property market, capital market and the extent of indebtedness of various sectors.
2. Use macro-prudential measures, which are powerful tools and have been widely used in emerging markets, to pre-empt the buildup of systemic risk. The most commonly employed macro-prudential tools are loan-to-value ratio (LTV), debt-to-income ratio (DTI), and ceilings on credit or credit growth to address threats from excessive credit expansion in the system, limits on maturity mismatches, caps on foreign currency lending, and levy on non-core funding to address key amplification mechanisms of systemic risk.
3. Capacity building in analytical skill and technical expertise for early detection of systemic risk is an urgent need. Staffs with the skill set and competency for risk identification usually work in different departments in a central bank, such as examination, supervision and economic policy. At the Bank of Thailand, we pull these staffs to form a working group, who meet regularly to assess the risk of potential financial instability building

up. Although it's difficult to integrate the information or data into a formal model for vigorous analysis of imbalances, the dialogues and views form the important basis for policy formulation. No doubt, significant technical challenges remain and building up our knowledge base and technical expertise is necessary to better understand the complexity in maintaining financial stability.

4. Capital flows are posing a significant challenge for EMs. Although there are other policies to deal with capital flows they are not always effective and may pose conflicts at time. Clearly, using monetary policy to cut interest rate in order to reduce interest rate differentials is not an option now because of the relatively robust economies in most EMs and some may even face the threat of inflation and imbalances. Inflows can lead to financial excesses and disruption can be even bigger when there is a reversal of the flows. It is important that EMs take steps, including macro-prudential measures, to further strengthen their resilience and ensure that imbalances do not develop as a consequence of the inflows.

5. Appropriate monetary policy is a necessary condition for financial stability. It's now well accepted that monetary policy that keeps interest rates low for too long can sow the seed of instability. If financial imbalance is building up because of such an accommodative monetary policy, changing the course of the monetary policy is the right approach. Macro-prudential measures must not be used to substitute for the necessary adjustment of monetary policy to achieve financial stability.

6. There must be legal clarity in the mandate of micro and macro prudential supervisors and clear procedures for coordination and information exchange between them, if they are not the same agency. In fact, even if both mandates belong to the same authority, which is the case of a central bank with a bank supervision function, such clarity is also very useful to ensure effective implementation of policy measures for both mandates without concerns on conflict of interests.

7. Outside interference and threat to central bank independence from having financial stability as a mandate can arise. Financial stability tools usually affect only certain economic sectors, where financial imbalances are judged to be building up. Hence, central banks

could face with immense lobbying and resistance against such measures. Therefore, proper legal provision and governance structure need to be in place.

At the Bank of Thailand, monetary stability is under the responsibility of the MPC, whereas policy formulation and micro and macro-prudential supervision of the financial sector are under the Financial Institution Policy Committee (FIPC). Both committees are headed by the Governor. Two Deputy Governors also sit in each committee. For the sake of supervisory coordination, the heads of the SEC and Office of Insurance Commission also sit in the FIPC. Other remaining members are outsiders, who outnumber internal members.

The mandates of each committee are clearly spelled out in the law, Hence, the independence of each committee is guaranteed by law. Since the Governor and deputy Governors are in the minority camp, pressuring them would be futile interference. As each outside member is proposed, based on his or her integrity among other things, by the Governor for selection by the Board and is accountable by law for his or her decision, the risk of external members being successfully interfered is deemed minimal. So far, this governance structure has worked well.

8. What is most important in maintaining financial stability is the will to take away the punch bowl when the party gets interesting with monetary policy and/or macro-prudential policy, which are unpopular measures. Without such a will, any simple excuses can lead to delayed actions or non-actions. Clear legal mandates and governance structure as discussed above make it somewhat easier for the relevant authorities to make tough decisions. In addition, during normal times, the macro-prudential supervisor and/or the central bank need to have frequent communication and dialogues with bankers and the general public to build the acceptance that the boom and bust cycle is detrimental to the economic well-being and it would be in the best interest of all, for the authorities to take unpopular measures when needed. It may sound highly idealistic and naïve to hope for such an acceptance but with the memories of the global crisis still fresh, now is the best time for such a strategy. The fact that most Asian economies have been able to safeguard

financial stability with unpopular macro-prudential measures may well suggest that they were able to get the support from the masses who still remember the pain of the 1997 crisis. This is the case with Thailand where there have been campaigns for prudent risk management of households and the business sector, both banks and other corporations, risk awareness and the willingness to trade short-term gains with long-term sustainability are much higher today.

The last important message that I'd like to leave before I end today is that the market only behaves according to the incentive in place. For example, monetary policy that is perceived by the public to remain accommodative for a prolonged period irrespective of economic developments provides a fertile ground for speculation. Similarly, a policy that leads the public to believe that any asset price burst will be subsequently supported by accommodative policy can fuel speculation. This is the issue of moral hazard, which policy makers must be very mindful about. Central bankers need to think about these long-term implications even in their pursuit of monetary stability. It is of course technically difficult to extend significantly the horizon of monetary policy, with our limited ability to see into the future. But without such awareness, the implementation of monetary policy may have significant adverse impacts in the long run.