BANK INDONESIA
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Capacity Building Seminar

Monetary Policy in Transition
The Case for a Two-Pillar Monetary Regime

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LECTURE 1
MONETARY POLICY IN FRONTIER ECONOMIES

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OULTINE OF THE LECTURE

- Background: Monetary policy post Global Financial Crisis (GFC)
- Monetary Policy Regimes in Transition

BACKGROUND: MONETARY POLICY POST GFC

- **Six questions arising from the GFC**
  - **Q1. Should there be new objectives for monetary policy?**
  - **Q2. Should current policy decision rules be reconsidered?**
  - **Q3. Should there be greater international policy cooperation?**
  - **Q4. Should unconventional policy tools become conventional?**
  - **Q5. What are the new challenges for central bank independence?**
  - **Q6. What is the optimal arrangement for monetary, macro-prudential, and micro-prudential policy?**

QUESTION 1.

- **Should there be new objectives for monetary policy?**
  - Long-term price stability must remain a primary objective of monetary policy…
  - …but price stability is not a sufficient condition for macro stability.
  - The way forward: greater role for additional intermediate objectives (i.e., financial and external stability)
  - …hence the need for new or rethought instruments (macroprudential tools, capital flow management, foreign exchange intervention).

QUESTION 2.

- **Should current policy decision rules be reconsidered?**
  - Much we do not know about some transmission channels:
    - Effect of low policy rates on bank risk-taking
    - Relationships among important macro variables: weakening of the relationship between inflation and unemployment post GFC
  - Need for a reconsideration of model-based policy-response
  - In the interim, need for policy decision-making involving "more art and less science" than before GFC
  - The design of monetary policy frameworks conditional on the state of the transmission channel is applicable to advanced economies, just as to emerging market or LICs

QUESTION 3.

- **Should there be greater international policy cooperation?**
  - The crisis spread rapidly across countries and asset classes, often in relatively unforeseen ways.
  - The ensuing policy response at the center caused major spillovers at the periphery.
  - This greater-than-expected interconnectedness led to calls for stronger monetary policy cooperation.
  - Yet, while the benefits (especially with regard to avoiding tail risks) are relatively evident, whether and how cooperation can be achieved remains open.

QUESTION 4.

- **Should unconventional policy tools become conventional?**
  - During the GFC, central banks employed unconventional tools (bond purchases and forward guidance) to provide economic stimulus as the policy rate approached zero, and to ensure transmission despite disrupted financial markets
  - This raises the question of whether unconventional tools should also be used in tranquil times
  - Tentative conclusion: with the exception of forward guidance, the costs seem to exceed the benefits?

QUESTION 5.

- **What are the new challenges for central bank independence?**
  - Independence is clearly still desirable with regard to price stability
  - But tensions will arise under expanded central bank mandates, and in some cases due to massive fiscal burdens
  - Critical to independence of central banks, while allowing adequate government oversight over their new responsibilities for financial stability.
  - This will be more difficult in countries where the central bank has traditionally played in important role in raising government revenue

QUESTION 6.

- **What is the optimal arrangement for monetary, macro-prudential, and micro-prudential policy?**
  - Prudential policy needs to acquire a new macro dimension
  - This presents governance challenges in its relationship with monetary policy on one side and traditional prudential policy on the other
  - Best arrangement will depend on what distortions are the most important to address for each country
  - Institutional design will have to balance the need for coordination and information sharing with building safeguards that preserve credibility and protect independence

MONETARY POLICY IN TRANSITION

- **Increasing debate in low and middle-income countries about how to modernize monetary policy**
  - ***Objective***: move away from heavy reliance on fixed exchange rates and operational frameworks not fully market based
  - ***Trends***: many countries with scope for independent monetary policy are moving toward more flexible, forward-looking frameworks with the broad objective of price stability
  - ***IMF recent initiative***: introduction of flexible review-based conditionality as an option for countries with evolving monetary policy, where traditional monetary aggregate-based program become less effective
  - ***Requisite***: importance of building institutional capacity and enhancing data provision and analysis in these countries

MONETARY POLICY IN TRANSITION

- **This evolution raises not fully resolved questions**
  - Q 1. How should countries with shallow financial systems and a history of fiscal dominance, and that face frequent shocks, adjust their monetary policy frameworks to make them more credible, and forward-looking, while also promoting financial market development?
  - Q 2. What is the role of monetary aggregates, exchange rate intervention, and other non-standard features in the transition?

MONETARY POLICY IN TRANSITION

- **This evolution raises not fully resolved questions**
  - Q 3. How can CB independence in providing price stability be preserved, given the fiscal implications of policy decisions, and possible involvement in setting macroprudential policies?
  - Q 4. What can be learned from the experience of countries that have transitioned?
  - Q 5. What are the key factors determining success or failure in adopting new monetary policy regimes?