

Central Banks Challenged by Global Financial Volatilities

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Hundreds of finance ministers and central bank governors around the world will next week gather at the International Monetary Fund and World Bank Annual Meetings in Washington, D.C. to discuss the implications of the present financial turmoil originating from advanced economies. Today, the challenges from financial turmoil have intensified and become more pressing. With the advent of globalization, innovative financial products with complex risk profile, and technological advancement, the identification and management of risks have presented major challenges for policymakers in maintaining economic and financial stability.

Resilient and robust financial sector helps an economy to manage and mitigate risks from financial market turbulence on the financial as well as real sectors. This is because well-developed capital markets can allow financial risks in the economy to be spread out, shared, and more efficiently managed. However, this is being tested in today's financial markets, as the world's largest and most developed capital markets is being hit by series of financial market turbulence.

Thus far, the effects on emerging market economies in Asia have been minimal due to limited exposure and considerable advancement on structural reforms in the past 11 years, including greater trade diversification of exports, along with an increasing intra-regional trade. Nevertheless, risks relating to the financial market turmoil have heightened, particularly the global repricing of risk by investors. Risk premiums for investors have increased as witnessed through widened sovereign bond spreads of a number of Asian countries against the US. Against this background, there remains a risk that higher volatility could trigger greater risk-aversion and lead to sudden stops or reversals of capital flows.

The increasing uncertainty, risks, and volatilities in the global financial markets have increasingly complicated the conduct of monetary policy, as policy rules may become too rigid in highly volatile environment, hence greater reliance on discretion may become more necessary for policy setting and application. In this connection, Governor Tarisa Watanagase of the Bank of Thailand highlighted, in her speech at the 27th SEANZA Governors' Symposium on 20

September 2008, four very important principles for central banks to be mindful of in weathering against the financial market turbulence.

First is the need to carry out prompt and preemptive actions with the best set of available information in dealing with changes in the market conditions and practices. Second is the maintenance of policy flexibility in using a traditional fiscal-monetary policy mix, supplemented by prudential measures on financial institutions. Third is the need for good central bank governance with clear and effective communication. The last is greater cooperation among central banks in the region to maintain economic and financial stability.

The world is now at an important juncture as the global financial landscape continues to go through its transformation process. If authorities are not equipped with tools for managing greater volatilities, the intensive reforms and institutional building during the past decade may prove inadequate to help economies withstand external shocks.

(Views expressed are the author's own.)