

Post-crisis challenges to Emerging Markets: What are at stake for central banks? *

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First, I want to thank SEACEN, the Centre for Central Banking Studies of the Bank of England, and Ministry of Finance, Brunei Darussalam for inviting me to deliver this morning's keynote address. The SEACEN's advanced course and seminar have always been an important learning forum for central bankers in Asia to discuss common challenges as well as to share practical experience. So, I very much appreciate the opportunity to be speaking to all of you today.

On a personal note, it has also been a few years since I last spoke at this forum, as my responsibility at the Bank of Thailand as a deputy governor up to October last year changed from monetary policy to financial regulation and supervision. This brief tenure of overseeing financial stability, especially managing the financial system at the height of the global

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financial crisis, has been a valuable experience and makes me appreciate even more the responsibility, the complexity, and the challenge to central banking. And it is a reflection of this experience that I want to share with you this morning, on the post-crisis challenge to emerging economies and what are at stake for central banks. My address today will focus on three issues. The first is the lessons learned from past crises. The second is the post-crisis environment and their implications for emerging markets. And, the third is the challenge for central banks going forward.

First, the lessons learned,

Those of you who have been at central banks fifteen years or more will by now have witnessed at least two major financial crises that put the task of central banks in managing the economy under the spotlight. The first is the Asian financial crisis of 1997-98, and the second is the current global financial crisis. Although the two crises share many similarities as well as exhibit important differences, they both have a common origin in globalization and in the inability of the global financial system to deal effectively with the consequences of globalization. In the Asian crisis, the origin was in external imbalance of individual economies, private sector indebtedness, currency mismatch, and a sudden reversal of capital flows. In the current crisis, the origin lay in a large global imbalance, excessive-risk

taking by financial institutions, and the accumulation of large systemic risk. In the context of policy, the two crises have produced many useful lessons on what needs to be done to prevent the recurrence of crises. While there is no shortage of lessons learned, having been at the Bank of Thailand through the two crises, my own list of lessons learned comes down to four important lessons.

The first is that nobody is above crises. This is to say that crises can happen in any economy, whether it is large or small, developed or emerging, with or without a sophisticated financial system, and regardless of whether the country has a fixed or flexible exchange rate system. And once a crisis happens, the impact will be large because of the globalized nature of markets that drives the spillover and contagion. For emerging markets, this means that the risk of future crises is wide-ranging and can be both internally and externally induced. The externally-induced crisis can either be because of imprudent policy choices elsewhere or because of failures of systemically important markets or institutions. And we have seen in the current crisis, the impact from an externally-induced crisis through contagion can be as, or even more severe, as an internally-induced or a home-grown crisis.

Therefore, to lessen the risk of future crises, prudent and good policy choices must be made in all countries. If not, the chance of crises repeating will remain high in this globalized world because of the interdependence between economies in policies, and because of the interconnectedness of countries in trade and financial flows.

The second lesson is that, while monetary policy must remain focused on maintaining low and stable inflation environment, which is crucial for sustainable growth, it is clear from the current crisis that low and stable inflation alone is not sufficient for ensuring financial stability. This is because the risk to financial stability can come from many sources other than domestic inflation. In the current crisis, it was the housing bubble and excessive risk-taking by financial institutions that precipitated the crisis in the environment of stable prices. Therefore, to maintain financial stability, attention must be paid to all the key sources of risk and imbalance, other than price stability, that can have systemic implications for the economy's growth and stability. This is the second lesson.

The third lesson relates to the importance of having a robust and resilient financial sector at all times. For emerging markets, this means a strong banking sector. In the current crisis, it is the strength of the banking sector that has enabled the Asian economies to cope more successfully with

the impact of the global crisis. These strengths are underpinned by the sector's strong capital base, its limited exposure to subprime-related and other toxic assets, and its low reliance on external funding. Such strength and qualities are no accident. They are the results of deliberate policies to reform the financial system, strengthen supervision of financial institutions, and revamp financial regulation, risk management, and governance after the Asian financial crisis. The point I want to stress here is that these are the qualities that helped us through the current global financial crisis and they are the qualities that we need to keep.

The fourth lesson is the benefits to long-term growth and stability that come from disciplined policy management and the pursuance of policy that enhances flexibility in the economic system. The 1997- 1998 crisis has been an important lesson for Asia on this point. Disciplined policy reduces the risk of an internally-induced crisis due to policy error and provides the authorities with greater room and flexibility to deal with unexpected events or shocks. In the current crisis, the ability of many Asian economies to respond aggressively to the impact of the crisis without undermining policy credibility is a case in point.

From my own experience, policy discipline relates closely to decisions that are made with a long-term perspective. The lack of discipline

more than often reflects policy that focuses overwhelmingly on short-term outcome. In economics, emphasis on short-term outcome tends to reduce volatility initially but a cost of a much larger volatility and welfare loss at a later date as the needed adjustment is postponed. A long-term perspective, on the other hand, allows the adjustment to be spread out with lesser volatility and effects on economic welfare.

Next, enhancing flexibility in the economy through policy that raises the role of the price mechanism in the allocation of resources is another crucial policy choice that can make important differences to the economies of emerging markets. Again, we in Asia learned this lesson well in the 1990's. Since then, reform of the policy regime to increase flexibility, especially the exchange rate, has contributed importantly to greater resiliency and abilities of the economies in Asia to adjust to changes in the external environment. So, the fact that the Asian economies have done better this time is not only because of the policy response during the crisis, but also because of the policy choice that was made long time ago to increase flexibility.

Let me now turn to the **second** part of my talk on the post-crisis environment and the challenges for emerging markets.

The challenges for emerging markets in the post-crisis world will be shaped importantly by the forces of change that will emanate in the new global economic and financial environment. Some of these forces will relate to cyclical shifts in trade and financial flows in response to new configuration of risk and opportunities that arises. Others will represent a more fundamental change as the new structure of economic and financial relations between countries emerges to replace the old structure that had been dismantled by the crisis. Recent discussion on this issue has pointed to the new normal global growth, the rise of Asia, and the increased role of government in the economic system as the new economic realities in the post-crisis world. But amongst these three possible new changes, I think the most important that will have far-reaching implications for emerging economies will be the durability and the composition of global growth.

The new normality of global growth will see a lower average rate of growth, weighed down by slower growth in the advanced economies because of the balance sheet problems of households, banks, and the government. Emerging markets, on the other hand, will see a more rapid recovery and expansion, leading to what has now been described as a two-speed global economy. Implications of this two-speed economy for emerging markets will be two-fold. First, differential growth outlook will provide incentives for a reallocation of investment into emerging market

assets as investors look for higher return. This will result in large and persistent capital flows to emerging markets with important implications for the exchange rate, domestic liquidity, inflation, and asset prices. Second, the two-speed economy will represent a shift in the centre of economic gravity from the advanced countries to the Asian region. But whether such shift is sustainable will depend crucially on how the transition is managed by policies in emerging markets. Chief amongst these are the exchange rate arrangement and the policy to reorient the growth driver from exports to domestic demand. Successful handling of these two issues will significantly reduce the risk and the threat to financial stability in emerging economies associated with strong and persistent capital flows. Therefore, managing this risk and growing safely in this era of new globalization will be the stake for emerging economies going forward.

Let me now turn to the **third and final** part of my talk which is on the challenge for central banks.

The task set ahead for central banks in emerging markets, therefore, are many. First and foremost is to manage the challenge posed by the new globalization in the pursuit of price stability. Important in this context is the monetary policy framework that addresses the challenge to price stability while at the same time allows central banks to pay closer

attention to financial stability. Next is the question on the role that central bank policies can play to support the economy's transition from export-led growth to a more balanced growth. Such transition will require a redirection of economic incentives from exports to domestic consumption and investment. At a minimum, the transition will require a further strengthening of the economy's financial system so as to ensure an efficient intermediation of resources into productive investments.

Against this backdrop, I want to leave you with a few thoughts on the challenges to macroeconomic policy that will be important for emerging market central banks going forward.

The first is monetary policy and the challenge is to have in place a monetary policy framework that can deal effectively with the threat to price stability and the need to oversee the risk of financial imbalance in this era of globalization. In the current crisis, it is clear that no particular monetary policy framework is superior in dealing with such a challenge. Nonetheless, experience of many inflation-targeting emerging economies in this crisis does demonstrate that price stability and financial stability can be preserved even in extreme financial circumstances under a flexible inflation-targeting regime. This is because, under inflation-targeting, monetary policy can be flexibly combined with macroprudential measures to address concerns on

financial stability without undermining the credibility of monetary policy. The Bank of Thailand has pursued this line of flexibility since 2004. Moreover, inflation-targeting also offers flexibility in the setting of the inflation targets in terms of the choice between core and headline inflation, as well as the level of the inflation targets itself. This flexibility means that monetary policy will have greater room to maneuver in responding to shocks. With this flexibility, my view is that inflation-targeting remains useful as a framework for monetary policy in emerging economies.

The second challenge is how to manage the macro-implications of large and persistent capital inflows, especially the risk to financial stability, in the context of a small open emerging economy.

At this time, this challenge is real for most countries in the region and the challenge is more demanding compared to the similar episodes in the 1990's. This is because this time capital flows are not linked to the financing of payments imbalance in the majority of economies in the region, but are a reflection of a global phenomenon of ample liquidity worldwide. Hence, there is a potential for capital flows to be larger and more volatile, and effective management of its impact will require a constellation of policies, both economic and financial.

Under inflation-targeting, a flexible exchange rate system will be a first line adjustment that can help lessen the risk to financial stability. Next, to manage the impact on domestic liquidity, it will be useful for central banks to have a variety of monetary tools to absorb liquidity and influence market conditions. But, to deal effectively with both price and financial stability, two instruments will be needed. The first is monetary policy that focuses on price stability. The second is bank regulation and effective supervision that ensure financial stability through maintaining a robust and resilient financial system. Important in this context for emerging economies is the strengthening of risk management and governance of financial institutions. Furthermore, if needed, monetary and financial policies can be further supplemented by macroprudential measures aimed at reducing procyclical behaviour in the financial system. And finally, running fiscal surpluses is an effective counter-cyclical measure to restrain the impact of demand expansion on domestic inflation and asset prices.

The third challenge is to develop and maintain a robust, efficient, and resilient financial system. As I noted earlier, a resilient banking sector is most crucial for helping the economy to adjust to the impact of external shock. An efficient financial sector will also raise the ability of the private sector to manage risk. In the last fifteen years since the Asian crisis, much has been done to strengthen the region's financial systems. Nonetheless,

much more can still be achieved in the context of financial market development, enhancing competition, and putting in place the needed financial infrastructure to help facilitate better risk management by banks and the private sector. In the Thai case, we are moving in this direction with the launch of our Second Financial Sector Master Plan last year that focuses on improving efficiency, access, and the comprehensiveness of the Thai financial sector. In general, apart from lowering the risk to financial stability through better risk management, a robust and efficient financial sector will also raise the capacity of emerging economies to generate investment from their local savings. This, in my view, is where the real issue lies in solving the problem of global imbalance.

So, this very much concludes what I plan to say to you this morning in my address. I hope it has been useful. Again I want to thank SEACEN, the CCBS of the Bank of England, and Ministry of Finance, Brunei Darussalam, for the invitation, and wish you all a successful seminar as well as a full and rewarding career at your respective central bank.

Thank you.