Monetary Policy in an Interconnected Global Economy

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Distinguished Participants, Ladies and Gentlemen,

I am delighted to welcome you to this conference on "Monetary Policy in an Interconnected Global Economy," co-hosted by the Bank of Thailand and the International Monetary Fund. I would like to especially thank our international guests who have travelled a long way to be with us today. This conference will focus on several issues pertaining to cross-country linkages, international shock transmission, and how monetary policy should be conducted in response to global spillovers.

One of the most important trends over the past decades is the rapid integration of international trade and finance. Trade in goods and services, as a share of world GDP, increased from around 15 percent in the early 1980s to around 25 percent before the start of the crisis in 2007. These developments reflect, in part, the increasing internationalization of production through vertical trade linkages. We have also seen a significant increase in financial integration. While the annual growth in world trade over the past 40 years has exceeded the growth in world GDP by around 2.6 percent on average, growth in international external positions outpaced growth in world GDP by almost double that—around 4.8 percent.

What are the implications of these tighter trade and financial linkages? Most prominently, global interconnectedness implies large and swift transmission of shocks across countries. A seemingly localized **supply shock**, such as the tsunami in Japan or the floods in Thailand two years ago, created ripple effects in various parts of the world by disrupting the global supply chain of production. From the perspective of most Asian economies, the abrupt economic contraction in the US and the euro area during the financial crisis were examples of external **demand shocks**.

While such "real spillovers" generated by supply or demand shocks can be quite damaging, the avenues for dealing with them are apparent and relatively uncontroversial. Fiscal automatic stabilizers should be allowed to work fully and monetary policy could be eased to cushion the impact so long as medium-term inflation expectations are contained. Calibrating the policy response to these shocks may not be straightforward, but they do not, in of themselves, pose challenges to the underlying framework of policy. **On the contrary, "financial spillovers" associated with extraordinary monetary policy easing in advanced economies have prompted many central banks and academics to do some soul searching about the appropriate framework, not just for monetary policy, but also for regulatory and capital account policies that can best deal with these shocks.**

It has been around five years that the US federal funds rate has been kept at the zero lower bound, and this has been supplemented with multiple rounds of large-scale asset purchases. The federal funds rate would likely remain unchanged for another year or two, based on the information available today, and the winding down of the bond-buying program will come eventually. Monetary authorities in other advanced economies have also employed policy tools with similar features albeit with some variations in the timing, scope, and size.

This configuration of monetary policies in major countries has created a challenging environment for small open economies to conduct policy. In the post-crisis period, the relative fundamental strength of emerging market economies was already drawing in substantial capital inflows. The additional push from this extraordinary stimulus, and the reach-for-yield behavior associated with it, has compounded the pressure. Many emerging market central banks have found themselves at critical junctures where broad reappraisals of their monetary and capital account policy frameworks were necessary.

Take Thailand as an example. Since the beginning of the episode, we have adopted a multi-dimensional response to the spillovers. Currency appreciation was the main cushion against rising inflows. At times when exchange rate volatility became excessive in our view, we undertook some foreign exchange intervention. But we were mindful of intervention costs and its limited effectiveness. We also further deregulated controls on outflows. This was part and parcel of our longer-term plan to encourage outward investment by Thais. At the same time, we raised the policy interest rate in response to expanding domestic demand, rising price pressures, and strong credit growth. There was a spirited public debate whether such rate increases would invite more capital inflows. But we viewed that other factors, such as the strength of the domestic economy and high risk appetite of international investors, played a larger role in inducing capital inflows than a gradual increase in the policy rate. Our concern for medium-term financial stability was also a key element of policy deliberations at the time.

Subsequently, things became more challenging as the Thai economy suffered domestic setbacks. As the boost from the government's temporary stimulus measures dissipated at the start of this year, domestic demand slowed down markedly. At the same time, domestic credit growth was still quite high, stock prices continued to advance, and activity in the housing market remained brisk. Moreover, portfolio capital inflows continued and the baht was appreciating. **This presented a dilemma and was an example of the difficulties posed by policy spillovers.** Against the backdrop of weak global demand, we cut the policy interest rate. We contemplated the use of certain prudential measures, including those on capital flows, in order to complement domestic monetary policy as well as offset some of the impact of capital inflows on domestic financial conditions. But since the QE tapering talk began in earnest in May, the global financial environment changed dramatically, and with it the nature of the policy trade-offs.

The communication by the Federal Reserve about possible tapering of its bond purchases was a key turning point for global financial markets. Financial conditions suddenly tightened in response. Long-term interest rates rose in the US and emerging market yields increased even more, reflecting a reversal in risk appetite. The prospect of Fed tapering became a key consideration for monetary policy in emerging market countries. In most countries monetary policy remained tight in order to lean against excessive currency depreciation; a few countries raised their policy rates in an attempt to stem capital outflows. For some countries, as economic activity softened and inflation fell, monetary policy may have ended up being tighter than intended as a result of tensions caused by policy spillovers.

At this juncture, the key question is how to design or adjust policy frameworks to cope better with global interconnectedness while preserving monetary policy independence. I hope the conference will help shed further light on this.

In doing so, we have to be mindful that global liquidity conditions will continue to largely depend on the macroeconomic conditions of the reserve-issuing countries. Currently the US dollar dominates the international reserve system as a safe asset. The continuation of this role rests on some basic requirements. A reserve-issuing country has to illustrate a good track record of prudent macroeconomic policy. And as recent events have reminded us, there is a large fiscal element to this. **One cannot separate the status of a reserve currency from the solvency of the sovereign**. The use of the US dollar as an international store of value and medium of exchange very much depends on the continued credibility of the US Treasury in honoring its debt obligations.

In terms of monetary policy, it is understandable and will continue to be the case that the Federal Reserve will focus on its own mandate in setting policy. But as the US dollar is used heavily abroad, the effective US dollar currency area extends well beyond US borders. The Federal Reserve sets policy for this wider currency area, not just the 50 US states. There have been a lot of discussions about how policy cooperation and coordination may offer scope for improvement. But a practical solution still seems elusive.

Ladies and Gentlemen,

In closing, let me offer my special thanks to the distinguished speakers for taking part in this important endeavor and for sharing with us your expertise. All of us here very much look forward to your contributions throughout today and tomorrow. I would also like to thank the IMF—in particular, the Regional Office for Asia and the Pacific—for kindly co-hosting this event. To all conference participants, I welcome your spirited discussions as I have already noticed there are many experts present among us. Thank you for being here. I wish you a fruitful conference and a pleasant stay in Thailand.