Navigating the Great Transition: An Emerging Market Perspective
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October 5, 2016

Ladies and Gentlemen,

It is a pleasure for me to be here in New York and to have a chance to participate in the policy discussion at SIPA. Given the increasingly complex policy challenges facing the global community, the contribution that SIPA makes in educating future leaders to serve the global public interest is critical. I would like to thank Professor Ito for inviting me. He was one of my early mentors at graduate school and I have benefitted from his many insights ever since.

This coming weekend I will be attending the Annual Meetings of the IMF and the World Bank. As you know, this is one of the biggest global forums for addressing issues related to the global economy and world financial market. The discussions will be especially pertinent this year given the complex and highly unpredictable state of the world that we face. **Former premier Wen Jiabao once described China's growth performance as "unstable, unbalanced, uncoordinated, and unsustainable". This seems like an apt description of the global economy at this juncture.**

Unstable because the proliferation of popular discontent fueled by rising income inequality amidst ongoing international conflicts have greatly elevated geopolitical uncertainty. ***Unbalanced*** because with anemic recovery of advanced economies, much of the growth in the global economy continues to be driven by emerging markets. In many cases, most prominently in China, this growth has been fueled by increasing leverage. ***Uncoordinated*** because in a highly integrated world, monetary policy and financial regulatory policy generate substantial cross-border spillovers yet they are being conducted with almost exclusive focus on domestic mandates. And finally, ***unsustainable*** because a world in which up to a third of all government bonds in some advanced economies are held by their own central bank and over a third of all developed-country government bonds trade at negative nominal yields cannot be a viable long run equilibrium.

This precarious state of affairs is, to a large extent, **a reflection of key fundamental forces that have been at play for some time, with their impact now becoming increasingly self-evident.** What I want to do today is to set out these underlying forces, draw out their implications for monetary policy, and offer some tentative suggestions of how central banks may respond. In doing so, I will focus from the perspective of emerging markets.

As the old saying goes, the only constant is change. But the speed of that change is not constant. The pace of change tends to pick up around major transitions before settling down again when some sort of equilibrium is reached. The *Great Moderation* was a period of relatively steady change during which world output grew steadily and inflation was low and stable. The global financial crisis created a major upheaval that led to the *Great Recession*. **The subsequent recovery has been remarkably drawn out and almost 10 years on, you could say that we have been living through a *Great Transition*.**

I would like to highlight three pivotal transitional forces that have shaped our economic and political landscape.

First, after decades of rapid expansion, world trade has slowed down considerably. During 2012 to 2015, world trade volumes grew at around 3 percent per annum, much less than the pre-crisis average of 7 percent for 1987-2007. Cyclical factors have certainly been at work, but the slower pace of growth relative to world GDP points to deeper structural forces at work. Chief among these is the waning impact from the integration of China and central and eastern European countries into the world economy, as well as the diminished room for further international fragmentation of production through global-value-chain trades. More speculatively, rising protectionism may have also dampened trade in recent years. Nevertheless, the level of trade integration across the world is as high as it has ever been.

Second, economies the world over have seen a rising contribution of the service sector to growth. A key driver of this transformation has been technological innovation, especially in digital communication. For the world as a whole, the share of services as a proportion of GDP is now as high as 70 percent. This shift has not been confined to advanced economies but can also be seen in emerging markets. In China, for example, the service sector has grown to more than half of GDP in 2015, much of it driven by a surge in e-commerce and the expansion in logistical services required to support it. Moreover, as the cost of digital technology declines, a wider range of services are becoming more tradable including design, marketing, business processes, and education. Thus not only has the service sector become more important within a country, the share of international trade in services has also increased markedly.

The third, and perhaps most unsettling transitional force, is the ultra-accommodative monetary policy stance adopted by major advanced economies. What started out as extraordinary responses to a precipitous crisis, unconventional monetary policy measures have not only been maintained, but in many cases have been applied more intensively with ever greater degree of experimentation and radicalism. It is striking that after all this time, the crisis mentality among policy circles has yet to fully abate.

The agglomeration of these transitional forces has had profound impacts on economies the world over. **Together, the slowdown in world trade and the shift to services have underpinned important changes in inflation and growth dynamics.**

In terms of inflation, globalization has for many years increased the importance of foreign factors in price dynamics. Persistently low and more synchronized inflation is partly attributable to the effects of rising competitive pressures in world markets as well as common forces such as falling energy prices. As global trade adjusts, the influence of external factors has regained prominence. At the same time, the rising importance of services has impinged on the inflation process. Services prices tend to be more rigid than goods prices because they embody a larger share of labor input, and wages tend to be sticky. This may have contributed to inflation having become more persistent. At the same time, the digital revolution has driven the prices of many modern services, such as telephone calls, news, and entertainment to essentially zero.

The upshot is that the link between inflation and domestic measure of economic slack, as traditionally captured in the Phillips curve, has weakened and disappeared altogether in some cases.

In terms of growth, slowing global trade and the rise of services implies slower and less capital intensive economic growth. For highly open economies, slowing world trade has undermined export as a growth engine. At the same time, the transition to services has also contributed to the growth headwinds given that modern services is less labor and capital intensive than manufacturing. Think of Google's 40,000 workforce compared to General Motors' 800,000. Or the fact that Uber is the world's largest provider of auto transport without owning any cars. Or that AirBNB is one of the world's biggest provider of accommodation without owning a single hotel. Given that investment is a relatively interest rate sensitive activity, to the extent that the transition to services has dampened investment, it may have also made the economy less responsive to monetary policy.

Finally, the ultra-accommodative monetary policy stances of advanced economies have contributed towards greater global asset price co-movements and increased cross-border financial spillovers. In the context of a highly globalized financial system, extreme monetary easing has 'pushed' capital to other parts of the world, particularly emerging market economies where yields are higher, and boosted asset prices globally. The exceptionally long period of zero interest rates has also led to a buildup of financial positions that are attractive or justified only if yields remain low. As a result, **global bond yields and exchange rates have become acutely sensitive to shifting expectations about monetary policy**

changes in advanced economies. Such excessive sensitivity has put global markets on a knife edge with frequent bouts of volatility.

These developments have critical implications for the transmission mechanism of monetary policy and its conduct. On the one hand, the greater influence of global factors and structural growth headwinds may have made inflation and output less responsive to monetary policy. On the other hand, financial markets and asset prices globally have become more sensitive to monetary policy actions and communication.

This raises a dilemma. With inflation and output below targets, monetary policy is eased. Against the tide of global factors and growth headwinds, inflation and output fail to respond, and the temptation is to do more and more. In the meantime, financial markets respond vigorously to low interest rates and the search for yield accumulates in the form of greater financial fragility over time. Something will eventually have to give. **The relevant monetary policy trade-off at this juncture, then, is not the traditional one between inflation and growth but between inflation and growth on the one hand, and financial stability on the other.**

How, then, should central banks respond to this new trade-off? **I see three main avenues.**

First, central banks need to expand their set of policy tools. Measures to limit excessive risk-taking in the boom and limit losses in the bust, such as counter-cyclical capital requirements, leverage limits, and stable funding ratios are the most obvious additions. These fall under the heading of macroprudental tools. For emerging markets where the brunt of the impact from excess global liquidity has been felt in exchange rates, capital flow management measures would help to alleviate these pressures. Moreover, central bank operational frameworks – such as collateral rules that dictate which types of securities can be pledged for central bank liquidity, the types of assets central banks choose to hold, or the structure of liabilities that they choose to issue – offer ways to influence certain segments of financial markets directly. **The challenge going forward is to operationalize these micro and more targeted policy tools in a systematic way.**

Here it is important to stress that any one set of instruments working alone is unlikely to be sufficient. Interest rate policy, macroprudential levers, and capital flow management measures all interact and their application should be viewed as a whole rather than in isolation. More broadly, the underlying institutional and legal frameworks that govern financial markets must be taken into account. These include financial product regulations, deposit guarantee systems, as well as the resolution framework for troubled financial institutions. **A national financial stability framework that brings together and assesses the whole spectrum of financial regulation serves this important function.**

The second response to the more complex monetary trade-off is greater policy coordination. The underlying rationale for coordination is that in certain situations, the collective outcome of central banks acting individually according to their mandates may be inferior because cross-country spillovers are not internalized. The current aggressive monetary easing of advanced economies are a case in point. Whether intended or simply a by-product, the outcome has the semblance of competitive devaluations.

As a starting point, it is important that advanced economies acknowledge the potential spillovers of their policy. The Federal Reserve, in particular, wields outsized influence given the dominance of the US dollar in global trade and finance. Emerging market countries need to coordinate in voicing their concerns and engage in dialogue. At a minimum, consultation minimizes surprises and the exchange of views helps to narrow differences in perceptions. But there is a more implicit form of coordination that I believe holds much potential. **That is the coordination of monetary policy frameworks.**

This brings me to the third and perhaps most profound avenue for dealing with the new monetary policy trade-off. And that is the adoption of a monetary policy framework that systematically takes financial stability into account. Successive boom-bust financial cycles have made it clear that unsustainable buildups of credit and leverage lies at the heart of financial fragility. It is hard to deny the critical role that monetary policy plays in this. **Monetary policy sets the price of leverage and hence has first order implications for the pricing of all financial assets and the evolution of the financial cycle.**

A framework in which monetary policy reacts systematically to the financial cycle, in addition to traditional inflation and output developments, will help to keep the economy on an even keel. This differs from an approach in which policy leans against the wind only when financial stability risks become evident. Given the long and drawn-out nature of financial cycles, such an approach would inevitably lead to doing too little too late, as the cumulative impact of policy over the whole financial cycle is ignored.

Just as the proliferation of inflation targeting frameworks starting in the 1990s helped to bring down the level and volatility of inflation rates worldwide, a general trend towards a more systematic leaning against the financial cycle approach to monetary policy, especially among advanced economies, could yield significant benefits. I believe that if central banks coordinate on such a framework, and thereby adopt a longer through-the-cycle perspective in policymaking, the problems from cross-border spillovers and perceptions of competitive devaluations will be significantly diminished.

The key challenge will be one of communication. As is well known, the long lags of policy creates a need for central banks to "take the punch bowl away when the party gets going". Given the longer duration of financial cycles, the need to act well before the risks become obvious may mean that central banks will have to "take the punch bowl away even *before* the party gets *started*". But that is a political economy challenge that needs to be resolved and managed through careful redesign of central bank mandates. Heed must be paid also to institutional arrangements, especially for central banks where the financial supervision authority lies with another body as coordination will be harder.

This will take time. But the risks to financial stability is immediate. **In the interim, central banks may need to interpret their mandates more flexibly and avoid overly narrow and zealous interpretations of price stability.** Inflation targets need to be implemented flexibly and over longer horizons. All the while explaining clearly and consistently the logic of policy. In doing so, it should be stressed that fundamentally, **macroeconomic and financial stability are two sides of the same coin.** Macroeconomic trajectories cannot be sustainable if the financial sphere is out of equilibrium. And the avoidance of financial boom-bust cycles leads to better economic outcomes over the long run. The perceived trade-off between growth, inflation, and financial stability, therefore, is to a large extent an artifact of the short horizon focus of policy.

Ladies and Gentlemen,

The history of economic thought in the twentieth century has seen macroeconomics evolve through a series of intellectual transformations from the Keynesian Revolution to Monetarism, and finally to the New Classical or Rational Expectations paradigm. Likewise, monetary policy has shifted through successive frameworks. From the system of fixed exchange rates under Bretton Woods, to monetary targeting during the *Great Inflation* in the 1970s, to inflation targeting in the context of the *Great Moderation*, and finally to an assortment of unconventional monetary policies in the wake of the *Great Recession*. Today, as we navigate our way through the *Great Transition*, the search for a new framework is ongoing.

The limitations of prevailing approaches focused on short-term stabilization of output and inflation gaps has become clear. **The onus on our generation is to ensure that the transition leads us to a new and better place, rather than to more of the same.** My contribution to that end today has been to hopefully steer you towards the relevant and pressing questions. At an institution of learning as esteemed as this, it is your role to undertake meticulous scholarship that moves us towards the right answers.

Thank you very much.