Journal of Asian Economics 46 (2016) 1–16

Contents lists available at ScienceDirect

Journal of Asian Economics

Monetary analysis and the global financial cycle: An Asian central bank perspective☆

Andrew Filardo[a], Hans Genberg[b], Boris Hofmann[a,*]

[a] *Bank for International Settlements, Switzerland*
[b] *SEACEN Centre, Malaysia*

ARTICLE INFO

Article history:
Received 14 July 2015
Received in revised form 31 May 2016
Accepted 19 August 2016
Available online 24 August 2016

JEL classification:
E42
E58
F42

Keywords:
Central bank mandates
Financial cycle
Financial inclusion
Globalisation
Managed exchange rates
Monetary analysis
Monetary policy frameworks
Emerging Asia

ABSTRACT

Emerging Asia has seen a transformation of its monetary policy environment over the past two decades. By far, the most relevant change has been the maturing of its financial systems and the growing relevance of the global financial cycle: financial inclusion has spread, financial markets have deepened and financial globalisation has linked domestic markets closer to international markets. One consequence of the maturing of the financial systems has been the weakening of the traditional case for the monetarist view of the roles of monetary aggregates in the conduct of monetary policy. In addition, the maturing of the financial systems has elevated concerns of financial stability, as both a source of shocks and a responsibility of central banks. These developments have been further complicated by monetary policy spillovers from the advanced economies. All this points to the need to consider alternatives to conventional inflation targeting frameworks. This paper lays out a policy framework based on a multi-pillar monetary policy approach as a potentially attractive alternative for EM Asia. The three pillars are based on economic, financial and exchange rate stability, respectively. This framework not only offers an alternative conceptual framework but also implies institutional reforms to ensure central banks take a longer term perspective when setting policy.

1. Introduction

Emerging market economies in Asia have been successful in achieving price stability and robust economic growth. They have done so using a variety of monetary policy strategies (Filardo & Genberg, 2010), some declaring themselves adherents to conventional inflation targeting approaches based on inflation forecasts and using an interest rate as the policy instrument, others adopting exchange rate-based strategies, while still others have been following eclectic approaches with respect to multiple goals, indicators and instruments.

☆ This paper was prepared for the SIRE-MMF-RES-HWU Conference on "Monetary analysis and monetary policy frameworks" on 9–10 April 2014 in Edinburgh, Scotland. The views expressed in this article are those of the authors alone and do not necessarily reflect those of the BIS or the SEACEN Centre. We are grateful to Claudio Borio, Joe Byrnes, Paul Mizen, Philip Turner, the editor, an anonymous referee and participants at the SIRE-MMF-RES-HWU Conference for helpful comments on the paper, to Mathias Drehmann for making available the results on the performance of the credit-to-GDP gap as an early warning indicator for financial crises, and to Lillie Lam for excellent research assistance.

* Corresponding author.
E-mail address: boris.hofmann@bis.org (B. Hofmann).

http://dx.doi.org/10.1016/j.asieco.2016.08.002
1049-0078/

Since the Asian Financial Crisis the region has also achieved a good record in terms of financial stability notwithstanding the financial turmoil in many other parts of the world, most notably in the United States and Europe during 2008–2009 and thereafter. Indeed some observers in the region object to the term Global Financial Crisis associated with that period, on the grounds that there was not a financial crisis in Asia. The recession in the region was largely due to the slowdown in the global economy during this period and its consequence for export-dependent economies in the region.

This paper argues that, despite these favourable performances, greater financial inclusion and deepening as well as globalisation of their economies suggest scope for a reconsideration of Asian Emerging Market (EM) monetary policy frameworks in particular with respect to the role of quantitative aggregates. Increased financial market inclusion and deepening and greater financial globalisation have brought important benefits to EM Asia in terms of economic development and welfare. However, there are indications that they have also fostered the build-up of financial and economic vulnerabilities similar to those that preceded the 2008–09 crisis in some advanced economies. This points to the need to monitor monetary and financial developments that may signal the build-up of such vulnerabilities and to analyse the implications of financial deepening and globalisation trends for monetary policy.

Another key development in EM Asia has been the large-scale interventions by monetary authorities in foreign exchange (FX) markets. They have contributed to a massive expansion of central bank balance sheets in several jurisdictions as monetary authorities conducted large-scale interventions in FX markets out of concerns about the consequences of exchange rate volatility for competitiveness and employment. This paper suggests that the expansion is creating a number of significant risks for the central banks themselves and for economies as a whole. This approach to exchange rate management highlights the growing importance of monitoring trends in foreign exchange reserves (i.e. trends in central bank assets) and their implications both for domestic financial and monetary conditions and for price and financial stability oriented monetary policy frameworks.

Asian EM central banks can thus be characterised as being concerned with three important policy objectives, price stability, financial stability, and exchange rate stability, and employing various instruments such as policy interest rates, macroprudential tools, and FX interventions to achieve them. The multiplicity of objectives and instruments raises considerable challenges with respect to how these instruments should be managed when each has an influence on all three objectives, albeit with different intensity, and when attempting to reach one objective may intensify problems associated with the others. These challenges are compounded by developments in financial markets that alter policy transmission mechanisms and magnify shocks to the economy.

This paper is an attempt to outline a monetary policy framework that incorporates the three main concerns of Asian EM central banks and the three types of policy instrument used to deal with them. It does so by first documenting the successful record with respect to inflation and growth in emerging Asian economies. We then focus on the increasing sophistication, inclusion, and depth of financial markets in the region and the greater integration in the global financial system, developments which have affected monetary conditions in Asia in fundamental ways. We argue that monitoring the broad monetary and credit aggregates, and understanding the underlying drivers, has become increasingly important for central banks' medium-term financial stability objectives as well as for the special role played by quantitative measures of monetary policy in current exchange rate regimes; we also draw attention to potential risks associated with the build-up of international reserves resulting from interventions in the foreign exchange markets.

The paper suggests that three-pillar monetary policy frameworks based on economic, financial, and exchange rate stability may offer many advantages worthy of consideration, and that this approach places considerable emphasis on the monitoring and analysis of quantitative aggregates. Specifically, the paper highlights the benefits of monitoring credit and global liquidity conditions to assess financial stability risks. The paper further underscores the need to consider the size of foreign exchange reserve positions, the associated increase in central bank balance sheets, and the way in which central banks sterilise the foreign exchange purchases as important risk indicators in the context of an exchange rate stability pillar.

The remainder of the paper is structured as follows. Section 2 documents the significant changes in the macro-financial landscape in Asian EM economies over the past two decades. Section 3 explores the role of monetary analysis in Asian EM central banks, specifically the role of quantitative aggregates in maintaining price stability, financial stability, and exchange rate management. Section 4 outlines a three-pillar monetary policy framework that may be conducive to successfully managing the trade-offs implied by the three policy objectives. Section 5 concludes.

2. Central banking in a changing global macro-financial environment

The macro-financial environment in EM Asia has been shifting significantly over the past two decades. While the central bank focus on price stability has firmly taken root, financial inclusion, financial deepening, and financial globalisation have progressed.

2.1. Price stability

In the aftermath of the Asian Financial Crisis, monetary policy has increasingly emphasised price stability as a primary objective of monetary policy. Although methods of pursuing this objective vary across jurisdictions, the outcomes have been similar; inflation has been maintained in a range roughly consistent with 'price stability' during much of the recent two decades. (Graph 1, left-hand panel) The exceptions are the years 2008 and 2009 where swings in commodity prices and