

## Special Feature A

# Asian Monetary Policy Forum 2023— Challenges for Monetary Policy in a World of Uncertainty

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The Asian Monetary Policy Forum 2023 highlighted challenges for central bankers and monetary policy analysis in today's economic landscape. This Special Feature reviews the discussion of challenges in three critical domains: the nexus of monetary policy and financial stability policies, the determination of policy neutral interest rates, and the formation of inflation expectations. The insights from the Forum offer valuable lessons for navigating the uncertain terrain of the present economic context.

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## 1 Introduction

The Asian Monetary Policy Forum (AMPF) 2023 served as a stage for insightful discussions on the intricate challenges and uncertainties that shape the world of central banking. Against the backdrop of a complex global economic landscape, central bank policymakers, academics, and financial sector executives convened to discuss critical aspects of monetary policy. This Special Feature summarises the essence of these deliberations, focusing on three key areas: the nexus of monetary and financial stability policies, the determination of neutral real interest rates for monetary policy, and the formation of inflation expectations in the real world.

Central to these deliberations is the ongoing debate over the most effective approach to maintain both price and financial stability. Finding a practical balance between these objectives gains increasing significance as the real economy and the financial system become increasingly intertwined. The key challenge is how to design policy frameworks and instruments to secure both monetary and financial stability.

This Special Feature also considers one of the most critical areas of uncertainty currently facing central banks today—the neutral rate of interest, its relationship with the long-run natural rate of interest, and the implications for monetary policy. The Special Feature also reconsiders the formation of inflation expectations in the real world, with heterogeneous agents and imperfect information. Are households and firms forming inflation expectations consistent with the central bank inflation target? What factors influence inflation expectations and how can the central bank communicate better?

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Through these discussions, the AMPF not only illuminated the evolving landscape of monetary policy but also provided valuable lessons for central banks navigating the turbulent seas of uncertainty in today's global economy.

## 2 Securing Monetary and Financial Stability

The opening remarks at the Forum by Ravi Menon, Managing Director (MD) of MAS, considered the appropriate approach to addressing the close nexus between monetary and financial stability. In an advanced economy such as Singapore, monetary stability, especially current and prospective price stability, is crucial for financial stability, while systemic financial stability is also essential for macroeconomic and monetary stability. Recognising this interdependence, MD Menon stressed that an integrated policy framework, including monetary, fiscal, and macro-financial policies, is needed to secure both monetary and financial stability. An integrated approach would help to take account of spillovers between policies, including for exchange rates and capital flows, which are of particular importance in emerging markets. An integrated approach can also help mitigate short-term conflicts between policies, as well as jointly work against the risky and unsustainable build-up of public and private debt.

MD Menon suggested that macro-financial policies should include a combination of macroprudential measures, forex interventions, and capital flow management measures, with macroprudential tools used pre-emptively to curb excessive lending and borrowing. Meanwhile, forex intervention focuses on curbing excessive volatility in currency markets, and capital flow measures are used sparingly to dampen large and potentially destabilising cross-border capital flows.

Under this integrated framework, the main objective of monetary policy should be price stability, while considering its implications for financial stability. Lengthening of the monetary policy horizon might facilitate taking financial stability considerations into account, so long as it does not undermine monetary policy credibility. Central banks may also need to be more tolerant of inflation outcomes close to zero, to avoid excessively loose monetary policy stances.

Finally, fiscal policy can support both monetary and financial stability by credibly ensuring that public debt is sustainable. Sound fiscal policy strengthens the focus of monetary policy on its price stability objective. Additionally, fiscal measures can also support macroprudential policies in dampening excessive demand pressures, especially in property markets.

Although it does not have a formal integrated policy framework, Singapore has long relied on close consultations between the central bank and relevant government agencies, which has in turn facilitated an intuitive medium-term coherence among monetary, macro-financial, and fiscal policies.

## 3 Uncertainties Around the Benchmark Rate of Interest

In his commissioned paper, "Natural and neutral real interest rates: Past and Future", Professor Maurice Obstfeld distinguishes between the natural and the neutral rate of interest. The natural rate of interest is the rate that would hold in the long-run or 'steady state' equilibrium of an economy with full employment and flexible prices and is determined by the underlying structure of the economy and the global economic environment. At any given point

in time, however, the economy is unlikely to be in long-run equilibrium. In such situations, the neutral interest rate is the level of the policy rate below which the monetary policy setting is inflationary and above which it is deflationary. It is accordingly a crucial benchmark for central banks in the formulation of their monetary policy decisions and is often referred to as 'r-star' ( $r^*$ ). The neutral rate is related to the natural rate but is also affected by cyclical and transient influences. Neither the natural nor the neutral interest are directly observable, which means that central banks need to estimate—sometimes by trial and error—the level of the neutral rate.

Estimating the neutral rate is far from straightforward. The main approaches are based on inferring either the natural rate or the neutral rate from historical trends, asset or bond pricing models, calibrated structural models like dynamic stochastic general equilibrium (DSGE) models, and semi-structural methods. Each approach has its limitations and may yield imprecise estimates, particularly in distinguishing between cyclical or transient developments and structural determinants of the neutral and natural rates.

Obstfeld also emphasises that central banks cannot be guided solely by their estimates of the neutral rate; they need to take account of other factors influencing overall financial conditions, including asset prices and, especially in small open economies, exchange rates.

Global factors play an important role in shaping interest rates. With international capital mobility, natural interest rates are bound to be linked internationally, and substantially driven by the evolution of global savings and investment. There has been a synchronised decline in real interest rates among advanced and emerging economies. Factors such as diverging savings rates between advanced and emerging economies, capital flows, and portfolio preferences contribute to this trend. Central banks, especially those in advanced economies, have been used to formulating monetary policy based on domestic macro-financial conditions. Increasingly, however, it is important to take global phenomena into account.

Challenges in identifying the neutral rate are further exacerbated by currently high global inflation. Previously the focus was on combating deflation by lowering interest rates. However, the current situation presents challenges as high uncertainty and external drivers of inflation come into play. Although headline inflation fell in most countries during the pandemic, core inflation remains elevated due to disrupted supply chains and the lingering impact of commodity shocks. In this environment of complex global shocks, the task of determining the neutral rate is even more complicated.

The paper contends that although long-term real interest rates have recently increased, the underlying factors that have pushed real interest rates down since the 1990s are unlikely to reverse. The decline in interest rates from the early 1990s were characterised by higher global saving, lower investment, and growing inequality. In the 2000s, interest rates were low because of easy financial conditions. After 2007, interest rates remained low due to the global financial crisis, along with increased private risk aversion and slower economic growth. Additionally, researchers have identified several potential drivers of lower natural real interest rates globally, including lower population growth, aging, lower productivity growth, income inequality, falling investment goods prices, corporate market power, and monetary policy changes.

Obstfeld's assessment is that the natural rate of interest is likely to remain relatively low, given the long-lived structural factors at play. Consequently, he does not expect that real interest rates will return to the levels of 30 years ago. This presents a cause for concern for both monetary policy and financial stability. Central banks in most advanced nations have less room to use traditional monetary policy tools, such as lowering interest rates, to stimulate economic activity. As a result, "the effective lower bound [is likely to remain] as a recurring challenge for monetary policy."

## Box A1: The Global Economy in the Next Generation: The Growth Report at 15

Professor Michael Spence of the New York University Stern School of Business presented the Luncheon Address, reflecting on lessons from the Growth Report by the Commission on Growth and Development fifteen years after its publication in 2008.<sup>2</sup> The 2008 Growth Report examined experiences across countries to identify essential characteristics that enabled economies to sustain high GDP growth. Broadly, Spence assessed that the characteristics identified in the Growth Report remain important today, with two—macroeconomic stability and high investment rates—being especially salient.

Nevertheless, global shifts have meant that several other characteristics that received less attention in the 2008 Report have since come to the fore. For example, the inclusiveness of growth is now seen as a much more important precondition for sustained growth than it was in 2008. This is partly because climate change, as well as the policy response to it, will likely adversely affect lower-income groups disproportionately and worsen income inequality. However, he cautioned that attaining inclusive growth would be hindered by persistently low productivity growth in the non-tradable sector. This includes areas like retail and hospitality that have a significant share of employment but generally slow productivity growth.

Finally, Spence highlighted new technologies that could help to raise long-term growth. Notably, he argued that generative artificial intelligence (AI) had tremendous potential to accelerate scientific discovery in a wide range of areas, including image recognition, DNA sequencing, and gene editing. If these discoveries could be effectively harnessed for industrial applications, they could be a significant driver of productivity growth in the economy.

## 4 Uncertainties Around Inflation Expectations

Inflation expectations refer to the anticipation of future price increases by households, businesses, and investors. These expectations play a significant role in shaping economic behaviour, such as spending, saving, investment, and wage setting. Managing inflation expectations is a critical aspect of monetary policy and economic stability. The AMPF policy note session titled "Inflation Expectations and Implications for Monetary Policy" was presented by Professor Ethan Ilzetzki of the London School of Economics and Professor

<sup>2</sup> A Nobel laureate, Professor Spence was the Chair of the Commission on Growth and Development, informally known as the Growth Commission, when it was formed in 2006. The mandate was to gather the best understanding about the policies and strategies underlying rapid economic growth and poverty reduction. The Growth Report was published in 2008, which examined thirteen economies that had sustained real GDP growth of at least 7 per cent p.a. for 25 years or longer over the period 1950–2005.

Michael Weber of the University of Chicago Booth School of Business, who discussed recent research findings on the complexities and uncertainties surrounding the formation of inflation expectations.

First, the policy session emphasised that when inflation expectations deviate significantly from central banks' targets, it can lead to self-fulfilling inflation. If people expect higher future prices, businesses may increase their prices and workers may demand higher wages, creating a cycle of rising inflation. Unanchored expectations complicate central banks' efforts to control inflation, as they involve market psychology, as well as require tighter monetary policies for central banks to regain credibility.

The policy note used several case studies to investigate whether inflation expectations have become unanchored in the face of global inflation surges. While some countries have ensured that inflation expectations remained anchored, others faced greater challenges. A specific example of the former is the implementation of the American Rescue Plan (ARP), a large relief program in the United States in 2021. Inflation expectations had been increasing before the ARP announcement, but inflation did not pick up upon implementation of the program itself. Moreover, while short-term inflation expectations rose, it did so to a lesser extent than long-term expectations, indicating that inflation expectations remained anchored. A specific example of the latter is the implementation of large support programs in Brazil. Inflation expectations in Brazil initially appeared anchored around 4% but collapsed at the beginning of the pandemic. Since then, they have been steadily rising, with long-run expectations exceeding the target and tolerance bands set by the central bank. This indicates a risk of inflation expectations becoming unanchored, potentially due to factors such as high levels of debt and fiscal dominance.<sup>3</sup>

Another challenge highlighted by the policy session is that inflation expectations tend to be highly variable in nature. Expectations by households and firms tend to overestimate future inflation rates and to vary significantly across individuals. A US survey found that less than 20% of respondents correctly identified the average inflation rate targeted by the Federal Reserve, and nearly 40% reported a number larger than 10%. Women tend to have higher inflation expectations than men, and this gender gap is even more pronounced in 'traditional households' where men do not engage in grocery shopping. The immediate price changes observed during grocery shopping can influence inflation expectations, leading to changes in consumption patterns and wage bargaining.

Another factor influencing the formation of inflation expectations is individuals' understanding of economic policies. Conventional fiscal policies, such as pre-announced increases in future consumption taxes that are typically easily understood, have a more immediate impact on inflation expectations and consumer behaviour compared to forward guidance on monetary policy, for example.<sup>4</sup>

The policy note emphasised that central banks need to carefully consider the content, medium, and sender of their messages when communicating with the public. Straightforward messages are more easily understood. The main challenge for central banks is reaching ordinary households who are not actively engaged with official releases or monetary policy

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<sup>3</sup> Fiscal dominance refers to a situation where a country's fiscal policy (government spending and taxation) exerts significant influence or control over its monetary policy, and consequently, the overall direction of the economy.

<sup>4</sup> Forward guidance is a monetary policy tool used by central banks to communicate their intentions and provide guidance to financial markets and the public about the likely future path of interest rates and other policy measures.

news in the media. More creative communication methods could help to increase the effectiveness of engagement with the general public.

## 5 Conclusion

This Special Feature highlights important lessons and observations from AMPF 2023 regarding the key challenges faced by central bankers.

First, the Forum focused on the challenges of formulating a practical policy approach to achieving and maintaining the objectives of price and financial stability. The intertwined relationship between the real economy and the financial system necessitates a more integrated policy approach. A framework encompassing monetary, fiscal, and macro-financial policies could offer a comprehensive and coherent strategy to address these challenges.

The second type of challenge concerns the factors determining natural and neutral interest rates. Policymakers must grapple with imprecision in the estimation of the natural and neutral rates of interest, the impact of various structural determinants, including global factors, the role of other determinants of financial conditions, including asset market prices and exchange rates, and the challenges posed by a likely return to low rates. These uncertainties highlight the need for flexibility, adaptability, and a comprehensive understanding of the ever-changing economic landscape.

A third challenge for policymakers is that of measuring and influencing inflation expectations. Expectations of households and firms play a crucial role in monetary policy transmission but are generally not well-understood. Evidence presented at the Forum indicates that expectations are influenced by a multitude of factors, including gender, policy complexity, information sources, and the credibility of messengers. The case studies illustrate their diversity across countries and their responsiveness to economic events and policies. Clear, straightforward communication from credible sources, tailored to diverse audiences, is essential for shaping expectations and ensuring economic stability amid complexity and uncertainty.

The Forum also considered the opportunities provided by remarkable advancements in technology such as gene editing, semiconductor evolution, and generative AI. Generative AI, in particular, could play a significant role in the knowledge economy and make a material, enduring impact on productivity performance.

The issues discussed at the 2023 Forum highlighted important challenges to the framework for monetary policy in achieving both price and financial stability, the formulation of policy amid uncertainty about the neutral rate of interest, and the effectiveness of policy when the inflation expectations of households are biased and unanchored. The wide-ranging discussions reflected the complex nature of central banking and the critical importance of research to strengthen understanding of challenges being faced. They also underscore the evolving nature of the challenges. Central banks must continue to adapt and refine their strategies to effectively navigate these challenges and uphold economic stability.

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