

**Exchange rates, multilateral policy surveillance,
and central bank policy in South-East Asia**

Hans Genberg
Executive Director, Research
Hong Kong Monetary Authority

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*The views expressed are those of the authors and do not necessarily represent the views of the Hong Kong Monetary Authority.

The very interesting and timely conference deals both with global issues and with policy strategies of small open economies, and in my remarks I would like to touch briefly on each of these topics. In a first part I will argue that for multilateral consultations and surveillance of economic policies to be effective, they must have a basis in an appropriate pairing of instruments and objectives. In particular, the surveillance work of the IMF should de-emphasize the assessment of exchange rate levels, and instead focus on fundamental fiscal and monetary policy choices. The reason is that focusing on exchange rate levels to address current account imbalances is based on weak analytical foundations and is likely to be ineffective at best, and may in fact divert attention away from more fundamental policy adjustments required for lasting solutions to global imbalances. The surveillance work of the IMF should therefore de-emphasize the assessment of exchange rate levels, and instead focus on fundamental fiscal and monetary policy choices.

In the second part of my remarks I will discuss some aspects of monetary and exchange rate policy in small open economies with particular reference to economies in East Asia. The major point I would like you to retain here is that there has been a substantial shift in the monetary policy strategies in the region in recent years, towards the adoption of price stability as the primary objective of policy away from focusing on the exchange rate as a nominal anchor. This switch has important implications for monetary and financial cooperation in the region as well as for how one should interpret their growth strategies.

I. International surveillance of economic policies: the importance of a proper pairing of objectives and instruments.

One of the recurring themes in recent discussions of international economic policy is the need for adjustments of exchange rates between the US dollar, the Euro, the Chinese renminbi, and the yen. The basic premise is that observed current account imbalances are unsustainable, and that coordinated exchange rate adjustments are needed to unwind them.

My contention is that the usual practice of translating goals for current account adjustment into specific recommendation for exchange rate adjustments is inappropriate. There main reasons for this are

- (i) Exchange rate changes have weak and uncertain effects on current account imbalances
- (ii) Even if an exchange rate adjustment would influence the current account, the exchange rate is either not a policy instrument or, when it is, the pairing of instruments to policy objectives according to the principle of comparative effectiveness suggests that the exchange rate should be used for other purposes than current account adjustment
- (iii) It is often argued that a country with a freely floating exchange rate should not be bound by an assessment of the appropriateness of its exchange rate level. If this argument is carried to its logical conclusion, it would mean that there would be no need for international policy coordination if all countries adopted floating exchange rates.

Allow me to spend some time to elaborate on each of these points.

(i) *Exchange rate changes have weak and uncertain effects on current account imbalances.*

From an analytical perspective, it is almost certain that exchange rate policy does not have a particularly strong effect on current account imbalances. The current account by its very nature is the result of intertemporal decisions regarding savings and investment by the private sector and the government. As such it is influenced by variables that have an explicit time dimension; for example the real rate of interest, expected income in the future relative to income today, the preference for consumption today relative to consumption in the future, or government taxes in the present versus government taxes in the future. The exchange rate on the other hand, be it the nominal rate or the real rate, measures current relative prices of monies or goods. For example, it would measure the price of a barrel of oil measured in Euros versus the same barrel of oil measured in US dollars or the price of a bottle of California wine relative to a pair of shoes made in China. The link between these atemporal relative prices and aggregate savings and investment decisions is indirect at best.

To appreciate this we must leave the confines of the partial equilibrium elasticity model and conduct the analysis in a general equilibrium setting, because then the tenuous link between exchange rate policy and the current account becomes evident. Let me just list some of the issues that must be taken into account:

- The real exchange rate is not a policy instrument once we consider a horizon beyond the short- to medium term. Therefore the degree and duration of nominal price and wage rigidity must be explicitly considered.
- Pricing to market is prevalent in many countries and industries. This will reduce the impact of nominal exchange rate changes on relative prices in the importing country.
- Net international asset positions can be affected by exchange rate changes. The resulting changes in wealth can in turn influence savings behaviour. For example, an appreciation of the RMB relative to the USD will almost surely reduce the net foreign asset position of Mainland China as a whole. Will this loss of wealth lead to an increase or decrease in the savings rate in China? How does the answer to this question depend on the fact that China's foreign assets are mainly held by the official sector, whereas the liabilities are more concentrated in the private sector?
- In some economies production of exportables uses imported inputs. In this case a nominal appreciation of the domestic currency will raise production costs and thereby partly offset whatever benefits to profitability the appreciation brings when the good is exported.

This list of complications can be continued but the message should already be clear, namely that in a general equilibrium setting the link between exchange rate policy and the current account balance is precarious.

To avoid misunderstanding, note that asserting that autonomous exchange rate changes have limited effects on the current account does not imply that changes in the current account will have no exchange rate consequences. Several celebrated papers by Obstfeld and Rogoff, for example, demonstrate this very forcefully. Obstfeld and Rogoff set out to show what would happen to relative prices if changes in aggregate

expenditures relative to output brought about a reduction in the current account deficit of the US from its current level of some 5.5% of GDP to some lower number which may be judged to be more sustainable?

The Obstfeld-Rogoff model is very useful because it reminds us that the correlation between the current account balance and the real exchange rate will depend crucially on exactly how the current account is altered. To make the point by means of an example: it is surely uncontroversial to suggest for example that the real exchange rate consequences of increases in expenditures in China on Boeing aircraft, Humvees, and French wine would be different than those which would result from increases in expenditures on non-traded goods in China even if their effect on the current account balance were the same.

So to return to my main theme, current account imbalances and exchange rate changes may be correlated, but this does not mean that autonomous exchange rate movements will bring about current account adjustment. If such adjustments are judged to be necessary, other policies will have to be employed. There is no reason to translate current account targets into exchange rate assessments or targets for exchange rate adjustment.

(ii) *Pairing policy instruments with policy objectives.*

So what should guide national and international efforts to design policies to deal with global current account imbalances? As the current account inherently reflects intertemporal decisions, it would seem natural use policy instruments that have direct effects on savings and investment decisions. In previous research I have carried out with Alexander Swoboda and Michael Devereux we have elaborated on this point in some detail, and shown that the basic intuition is robust to variations in modelling approaches. Policies that directly influence incentives to save and invest, for example tax incentives to saving, have reliable impacts on current account imbalances.¹ Similarly expenditure-reducing or expenditure-increasing policies such as government expenditures also have reliable effects on current accounts. On the other hand, expenditure-switching policies such as commercial policies or policies designed to alter the nominal exchange rate, have more limited effects on current account balances but can have stronger effects on relative prices.

(iii) *Multilateral surveillance in a world of freely floating exchange rates.*

The third reason why I believe it is unhelpful to translate current account objectives into exchange rate objectives stems from the practise of governments to argue that freely floating exchange rates can not be judged over- or undervalued as they are set by market forces. I do not wish to enter into a discussion of the validity of this notion, but I simply take current practice as given and invite you to think about the fate of international policy coordination in a world where all (relevant) currencies are floating without interventions by the authorities. Imagine also that fiscal or other policies are generating current account imbalances that are judged unsustainable. The current practice of conducting surveillance by translating current account imbalances into an assessment of the appropriate level of the exchange rate would then fail. Countries would simply refer to their floating exchange rates to argue that they would not need to make any policy adjustments.

¹ See Genberg and Swoboda (1989) and Devereux and Genberg (2007).

Let me finish this first topic of my remarks by repeating the main conclusion. To the extent that international surveillance and cooperation on economic policies aims to resolve major current account imbalances, it should not be translated into exchange rate objectives and assessments. Instead it should focus on economic policies that are under the control of policy makers and that influence current accounts directly and robustly. The surveillance mission and advice of the IMF must reflect this fundamental reality.

II. Monetary and exchange rate policy in small open economies with particular reference to economies in South-East Asia.

In my remaining time I would like to bring some information about monetary and exchange rate policies in East Asia. In the interest of not taking too much of your time I am going to restrict my comments to just one issue. This is that, contrary to what was the case before the financial crisis 10 years ago, monetary policies in the region are now clearly focused on domestic objectives best described as domestic price stability. From this it follows that the enthusiasm for and the likelihood of exchange rate cooperation in the region is quite limited, and rightly so in my view. Let me elaborate.

When we look at official pronouncements as well as investigate actual behaviour, it is clear that there has been a shift in monetary policy strategies in the region in the past ten years. Central banks have now adopted policy strategies in which domestic price stability is the principal objective of monetary policies. This contrasts with the period before the 1997-98 financial crisis when exchange rate stability vis-à-vis the US dollar was quite prevalent, and to some extent a contributing reason for the crisis. At present six central banks in the region characterize their monetary policy as one of 'Inflation Targeting'. These are the central banks of Australia and New Zealand which comes as no news to you but also those of Indonesia, South Korea, Philippines, Thailand. The Monetary Authority of Singapore can also be characterized as targeting inflation albeit by using the effective exchange rate rather than a short term interest rate as the policy instrument. Although it has been struggling to avoid deflation rather than inflation, the Bank of Japan has domestic price stability as the principal policy objective. This leaves three economies in the region where currency stability is mentioned as the policy objective. In two of them Mainland China and Malaysia currency stability is mentioned alongside price stability, whereas in the third, Hong Kong, the only objective is exchange rate stability.

There are important implications that follow from the predominant focus on domestic price stability. First, there is little official enthusiasm for any form of coordinated exchange rate policy, and rightly so. Such coordination would run the risk of creating conflicts with domestic objectives that would lead to a loss of central bank credibility and possibly speculative attacks on participating currencies.

In a recent paper with a colleague at the HKMA we discuss these issues in more detail, and suggest an alternative vision for regional cooperation.² Rather than focusing on exchange rates, we suggest an approach that centres on developing more

² Genberg and He (2007).

liquid financial markets in the region in the foreseeable future. In the longer term, with a high level of both trade and financial integration, business cycles in the region will be more synchronized; in such a scenario, consultation and coordination in defining policy goals and institution building can be beneficial.

If exchange rate coordination or complete monetary unification is desired by some subset of central banks, they can formally agree to centralize monetary policy decisions in a common central bank or they can decide to delegate it to an existing central bank. Adopting a common exchange rate policy or a single currency by all economies in the region is not required. The benefits from financial integration and monetary stability will be forthcoming anyway even without a common exchange rate policy or a single currency.

The advantages of this approach to monetary integration are that it is compatible with increasing integration of financial markets, it naturally evolves from a system where central banks pursue similar objectives in their own self interest which makes it incentive compatible, and it allows for a 'variable geometry' of the final area that adopts a common currency. Speculating on whether such a common currency area will eventually emerge in the region is however something that I will have to leave for another occasion.

Thank you very much for your attention.

References

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