

Exchange-Rate Regimes and Capital Flows in East Asia

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* These remarks are the presenter's personal views only and not necessarily views of the U.S. Treasury Department. Indeed, Treasury colleagues with responsibilities in this area have already expressed reservations about positions taken in the accompanying paper. The presenter drafted these comments and the accompanying paper quickly to stimulate discussion. He looks forward to corrections and suggestions for improvement.

This Session's Assignment #1

- Identify deciding factors of a specific exchange regime for an emerging Asian Economy
 - Linkage: x-rate regime & domestic financial maturity?
 - How to cope with the “trinity problem”
 - What accounts for “Fear of Floating” in Asia?
 - If crawling band –width of crawling band?
 - increase or decrease band width over time?
 - What currency baskets for a reference rate?

This Session's Assignment #2

- Intra-Asian Exchange-rate Integration/Coordination
 - Can the Japanese yen become an anchor for Asian currencies, as the Deutsch mark did for ECU/euro
 - Mutual Asian x-rate stability while keeping effective exchange rates competitive w/ rest of the world?
 - Endogenize Asian trade integration w/ an FTA for ASEAN +3?
 - How about financial integration in Asia?
 - Seek a single common currency in Asia?

Major conclusions

- This is not a scholarly paper; a policy essay:
 - domestic pressures push for a rigid exchange rate and freer short-term capital flows
 - Bad combination: monetary dependence & exposure to currency & maturity mismatches
 - Domestic regulatory systems too weak to help
 - FDI and net exports help allow policy flexibility
 - Maximum flexibility with hedging tools is ideal
 - Japan-China regulatory & policy gap makes common currency many decades away

Idealized Regimes not Feasible

- Common Currency: benefits & costs
 - Transaction predictability & no mismatches
 - Loss of monetary/fiscal policy independence
- Free float with full hedging possibilities
 - Complete monetary and fiscal independence
 - Risk of exchange-rate volatility and mismatches
- For foreseeable future, neither appears attainable

East Asian Regimes

- All lie in between the two extremes
- Pegs or managed floats
- Significant interventions
- Different degrees of exchange rate variability
- Many factors are responsible

Capital Flows & the “Trinity”

- Capital flows are a major factor
- The “Trinity” or “Triangle”
 - Capital flows
 - Exchange rate flexibility
 - Monetary policy independence
- Peg and free capital flows → problems
 - International interest rates set domestic rates
 - Vulnerable to speculative “bets”

Capital Controls & Leakage

- Capital controls remove peg's problems
- Break down or leakage bring them back
- This seems to be China's situation
 - Outward leakage present for many years
 - Inward leakage is now very obvious
 - Difficulties for China to use interest-rate policy to cool off its over-heated growth
- With leakage, pegs become a problem

Flexible Rate can Help

- For example: Speculative Inflows
 - Quick strengthening discourages new flows
 - Interest-rate differentials less attractive
- Herd behavior can hurt small economies
 - With underlying fundamentals misaligned
 - Adjustment can overshoot
- China: unclear how much leakage is for interest rate differences

Evolution of Regimes

- How to get from rigidity with capital controls to flexibility and freer capital flows?
- Flexibility-first before freer capital flows
 - Many advantages, but faces resistance
 - Market forces don't have full play
- Capital-flows-first is popular but dangerous
 - Foreign capital appears cheap
 - Exposure to capital flow volatility

Both Dimensions Together

- Incremental steps for freer capital and more exchange-rate flexibility
- This has been the pattern in most of Asia
- This solution runs into real-world complications
 - Resistance to flexibility
 - Leakage and popularity of freer capital flows
 - System leans toward dangerous combination

Real World Complications

- Economic, Political & Social Factors
 - Economic: currency out of line with fundamentals
 - Rigidity means domestic prices and wages must adjust
 - Real depreciation requires unpopular contraction
 - Real appreciation requires unpopular inflation

Capital Flows worsen Complications

- Capital flows popular and hard to stop
- More difficult to defend rigidity in either direction
 - International investors sense directions of change and accelerate capital flows
 - In either direction, flows undermine efforts to adjust real exchange rate through shifts in domestic economy

Risk of Crisis

- Rigid rates with freer capital flows are crisis-prone
- Maturity mismatches lead to capital withdrawals that can't be covered
- Currency mismatches lead to severe payment problems and financial failure when devaluation finally comes
- Currency rigidity hides these risks

Currency Flexibility Avoids Crisis

- Speedy revaluation with capital inflows is a warning to pay attention to mismatches
- Speedy devaluation with initial outflows makes further devaluation less likely
- Speedy devaluation promises medium-term improvements in current account

Hedging is a Partial Answer

- Derivatives can help transaction predictability and counteract currency mismatches
- Availability of instruments is less of a problem – China is working to supply them
- Hedging can be costly and inconvenient
 - Costs go up with expected volatility
 - Exchange-rate rigidity undermines recognition of their necessity

Regulatory Weakness & Capital Controls

- Good regulatory systems would guard against currency and maturity mismatches
 - Emerging market regulatory systems are technically unequal to the task
 - Corruption and Political resistance
- Some capital controls seen as a substitute
- Neither World Bank nor IMF calls for Capital Account Convertibility in China

FDI & Exports Help

- “Cushion” of Foreign Reserves helps policy flexibility
- Good FDI investment climate is essential, but it is missing in important economies
- Export strength can help build reserves
 - Requires deficits in ultimate markets
 - U.S. has played important role
 - Japan & Europe need to do more

Long-cycle Regime Evolution

- Cycle of rigidities & crisis can mislead analysis of current situation
 - Cycle involves weak fiscal revenue systems, eventual inflation, currency defense, crisis, devaluation, capital inflows
 - After some years, weak fiscal system, inflation and currency rigidity start the cycle again
- Work on regulatory fundamentals and institutional flexibility must continue

Pan-Asian Currency Unlikely

- Key currencies likely to be both Chinese renminbi and Japanese yen
- Gap in regulatory systems and macro policy requirements are huge
 - China's exchange regime will go through complicated evolution
 - China will want policy independence for a long time
- Harmonizing fiscal and monetary policy is unrealistic for many decades

Policy Hypotheses

- Short-term exchange-rate flexibility can:
 - Promote medium-term exchange-rate stability
 - Help develop hedging instruments & lower their costs
 - Increase the popular use of hedging instruments
- FDI in financial services makes two contributions
 - Help strengthen the financial regulatory system
 - Speed the introduction & use of hedging instruments
- Multi-national exchange-rate harmonization:
 - Makes good sense for developed economies
 - May make less sense for low-income economies with poorly developed institutions