UNCONVENTIONAL CENTRAL BANK POLICIES IN EMERGING ASIA

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Summary

- Targeting Inflation is well enshrined as a principal central bank objective, but other goals are also acknowledged to be important, notably financial stability.
- In small and highly open (both in terms of trade in goods and financial assets) economies, capital flows and exchange rate volatility can be important sources of macroeconomic and financial instability.
- Central bank policy is therefore conducted not only by using a short-term interest rate as in conventional Inflation Targeting, but also by using capital flow management policies and interventions in the foreign exchange market.

Context: Challenges facing traditional IT strategies

Inflation Targeting:

- Use a short-term policy interest rate to steer inflation towards a well-articulated target.
- Let the exchange rate float, i.e. do not intervene in the forex market
- Allow for unfettered international capital flows

Challenges:

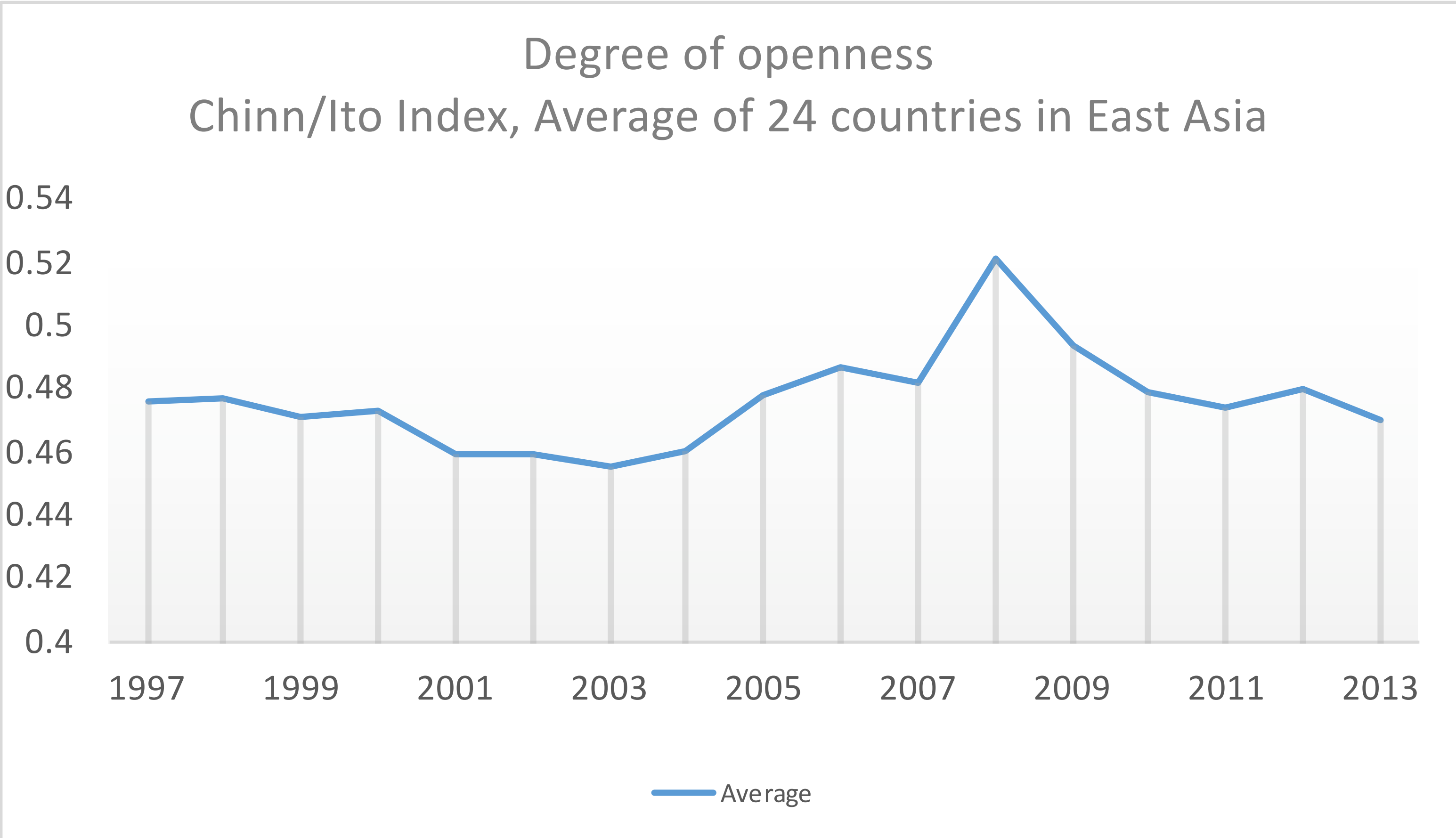
Advanced Economies

- Financial Stability as a second objective. Leaning vs. not leaning. Macroprudential policies. Coordination.
- Effective lower bound on the policy rate. Unconventional monetary policy, read asset purchases. ‘Going direct’, i.e. a form of ‘helicopter money’. Issues: domain of fiscal policy, should this be decided by ‘unelected technocrats’?

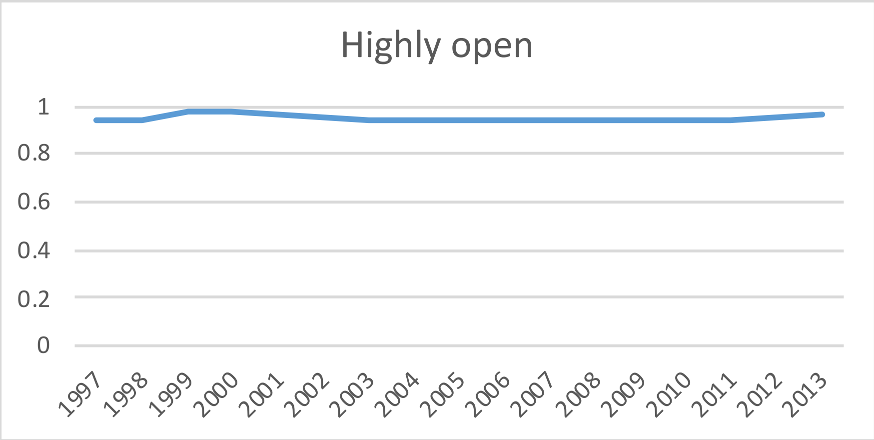
Emerging Economies

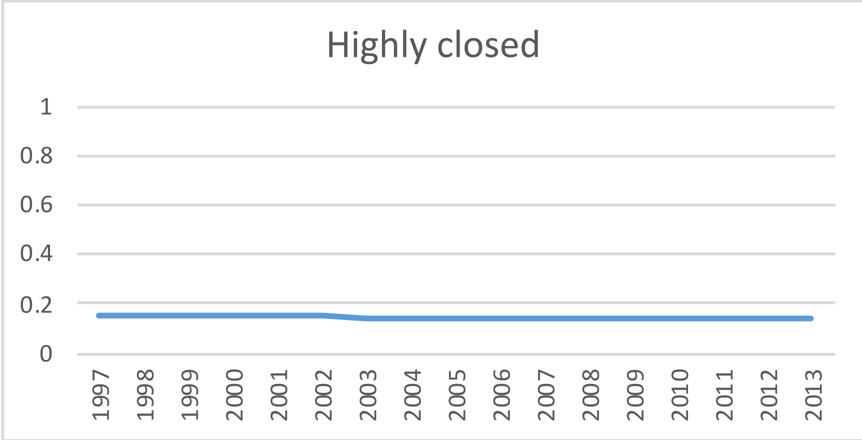
- Spillovers from advanced economies. Capital flows -> exchange rate volatility (misalignment), asset price fluctuations -> financial instability and macroeconomic instability.
- **Central bank response: unconventional policies in the form of capital account management policies and interventions in the foreign exchange market.**

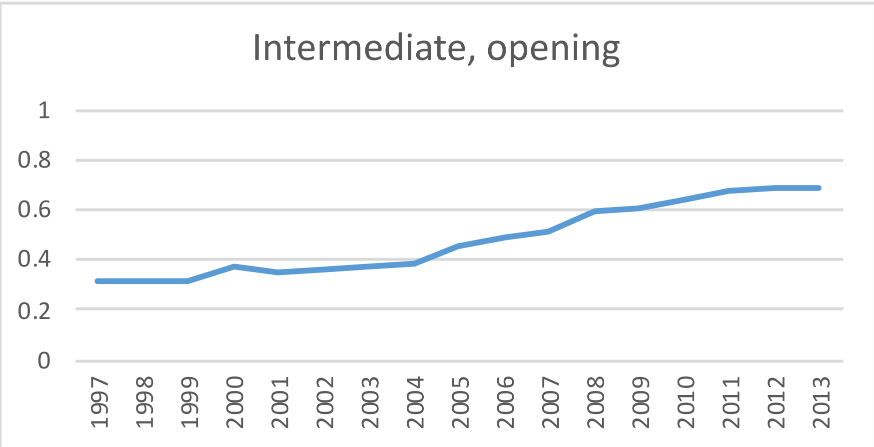
Examples from Asia: Capital account management (aka capital controls)

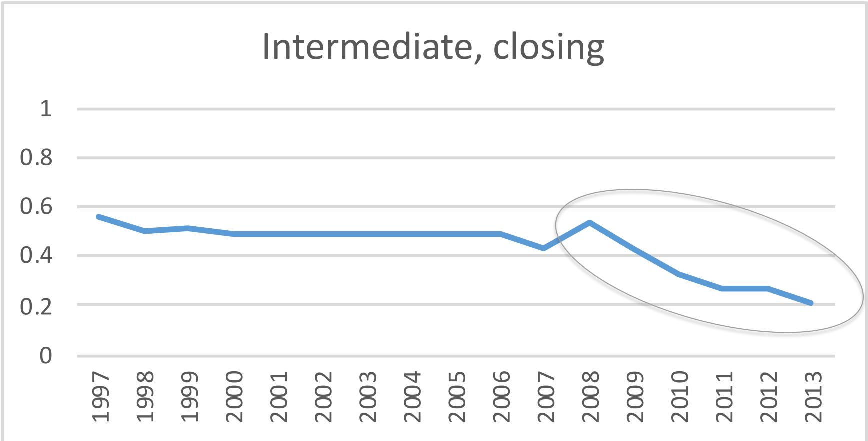


Averages hide heterogeneity









Intermediate opening: Cambodia, Korea, Mongolia, PNG, Vietnam

Intermediate closing: Sri Lanka, Indonesia, Malaysia, Philippines, Thailand

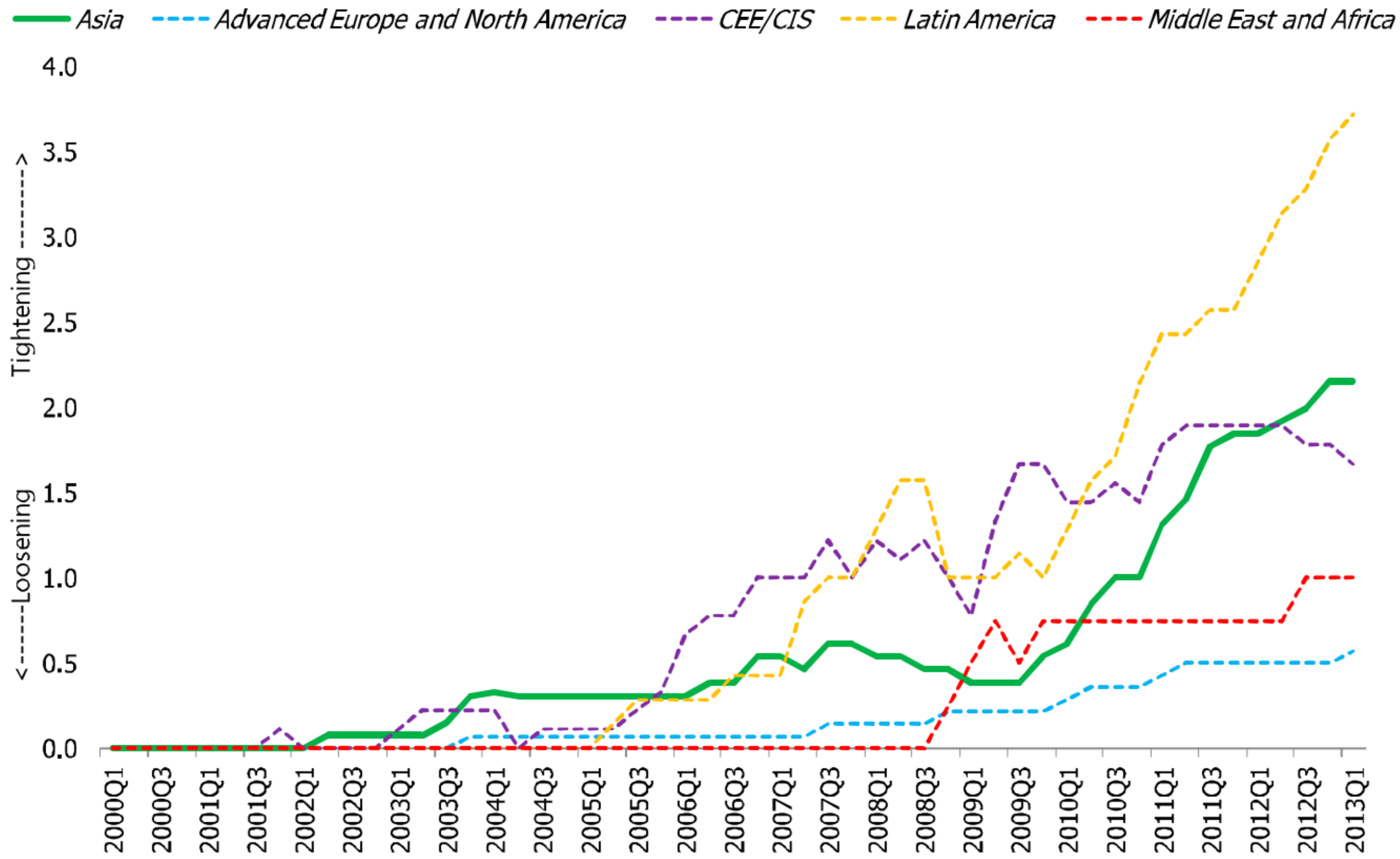
Hioghly Open: Japan, Australia, New Zealand, Hong Kong, Singapore, Maldives

Highly Closed: Bangladesh, Bhutan, Myanmar, India, Lao PDR, Nepal, Pakistan, China

The Use of Capital Flow Management Policies.
Source: Zhang and Zoli (2014)

Figure 8: Capital Flow Management Measures: Cumulative Actions

(Average per country in each region; 2000-2013Q1)[1]

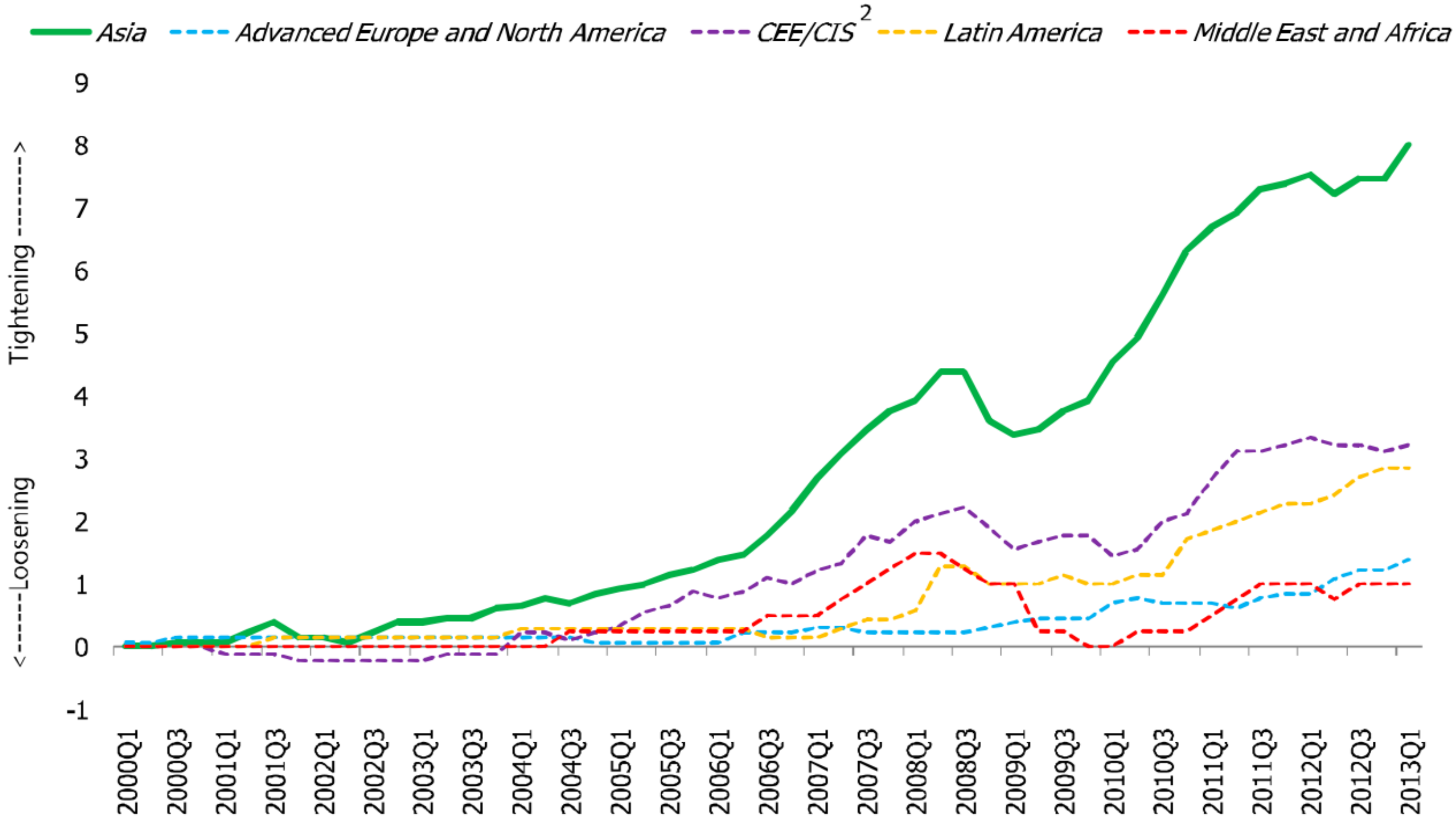


[1] Index summing up foreign currency and residency-based measures. Average across countries within country groups.

The Use of Macro-prudential Policies.
Source: Zhang and Zoli (2014)

Figure 7: Macroprudential Policies: Cumulative Actions by Region

(Average per country in each region; 2000:Q1-2013:Q1)[1]



Source: IMF staff calculations.

[1] Index summing up housing-related measures, credit measures, reserve requirements, dynamic provisioning and core funding ratio. Simple average across countries within country groups.

[2] Central and Eastern Europe and Commonwealth of Independent States.

(When) Are Capital Flow Management Policies Appropriate?

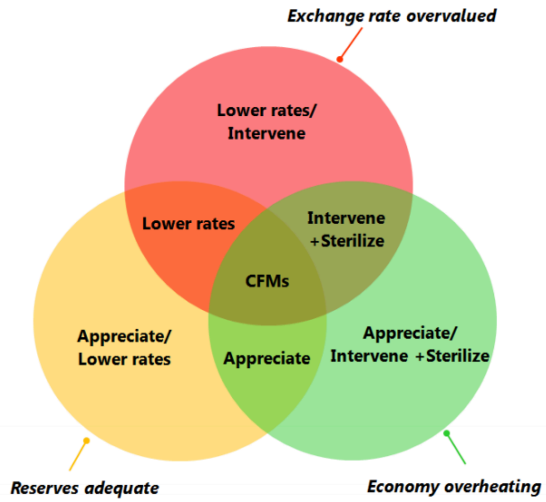
IMF: Only as a last resort when all other policies have been found wanting

ASEAN: As a part of a considered policy package without an inflexible hierarchy

IMF Institutional View of CFM Policies

- “Appropriate macroeconomic policies to respond to inflow surges would include rebalancing the monetary and fiscal policy mix consistent with inflation and growth objectives, allowing the currency to strengthen if it is not overvalued, and building foreign reserves if these are not more than adequate.”

Figure 3. Managing Capital Inflow Surges



Each circle represents cases where the relevant condition is met. For example, the top circle ("Exchange rate overvalued") represents cases where the exchange rate is assessed to be overvalued. The intersection of all three circles reflects cases where the exchange rate is overvalued, reserves are judged to be adequate, and the economy is overheating.

In such cases of limited policy flexibility, as represented by the intersection of all three circles, CFMs can be useful to support, and not substitute for, the needed macroeconomic adjustment.

CFMs could also be useful **to safeguard systemic financial stability** under certain circumstances. At other times, CFMs can help gain time when taking the needed policy steps requires time, when the macroeconomic adjustments require time to take effect, or when there is heightened uncertainty about the underlying economic stance due to the surge.

- “CFMs should not substitute for macroeconomic policies that are needed for warranted external adjustment, domestic macroeconomic stability, and effective operation of the international monetary system.”

- “In certain circumstances, introducing CFMs can be useful for supporting macroeconomic policy adjustment and safeguarding financial system stability.”

Source: IMF (2014), ‘The Liberalization and Management of Capital Flows: An Institutional View’, November 14.
https://www.imf.org/external/np/pp/eng/2012/111412.pdf

Criticisms of the IMF's Institutional View

- Too accommodating
  - Gives countries a green light to impose capital controls
- Does not take account possible spill-over effects
  - Diversion of capital flows to neighboring economies
- A view from ASEAN, too rigid and too focused on recipient countries
  - "Based on the experience of ASEAN, **views and guidance** of International Financial Institutions (IFIs) on managing capital flows **remain rather rigid** and only applicable when countries surpass a certain development threshold in their financial system infrastructure. Such guidelines or models at times **do not adequately capture country-specific issues** and do not sufficiently take into account prevailing macroeconomic circumstances. In addition, the existing IMF frameworks on capital flow management tend to be **more directed at recipients rather than source countries**, with only a handful of studies and policy papers that call for a more coordinated approach to regulate these flows by both source and recipient countries."
    (Capital Account Safeguard Measures in the ASEAN Context , February 2019. https://asean.org/storage/2012/05/2019-02-25-ASEAN-Paper-The-Role-of-Safeguard-Measures-in-ASEAN.pdf)
- My own view: The use of CFM tools must be disciplined and transparent lest they become a backdoor avenue for politically motivated credit allocation.
- Future report by the IMF's Independent Evaluation Office on 'IMF Advice on Capital Account Flows'

Exchange rate policy

1. Context: In many EME Central Banks, exchange rate changes do influence monetary policy decisions

2. Why?
   a. The exchange rate as a shock absorber
   b. The exchange rate as a shock transmitter

1. Should Central Banks mandates include the exchange rate?

EME Central Banks do take the exchange rate into account when setting monetary policy. How do we know?

- They say they do
  - "My priority in the short term is to strengthen steps required to immediately stabilize the rupiah exchange rate". Governor Perry Warjiyo, Bank Indonesia
  - "At times, we might have to intervene in the foreign exchange market…". Governor Veerathai Santiprabhob, Bank of Thailand
  - "The peso continues to be flexible and market-determined,… Nevertheless, we are cognizant that the peso can also be subject to excessive volatility…. We have to take [this] into account." Former Governor Nestor Espenilla, Bangko Sentral ng Pilipinas

How do we know? (cont.)

- Estimated policy reaction functions

$$i_t = c + \alpha(\pi_t^f - \pi^T) + \beta y_t^{gap} + \gamma i_{t-1} + \delta i_t^{foreign} + \varepsilon e_t$$

- Edwards finds that δ > 0 for a number of EMEs, close to 1 in Latin America but smaller in Asia
- Mohanty and Klau obtain estimates of ε imply leaning against exchange appreciations

Why?

1. Importance of the exchange rate in the inflation process
    a. Monetary Authority of Singapore
    b. Hong Kong Monetary Authority

2. The exchange rate as a shock transmitter as opposed to a shock absorber

The exchange rate as a shock absorber

- The standard case for exchange rate flexibility
  - A shock that decreases the relative demand for domestic goods should lead to a real currency depreciation, an increase in e $= \frac{EP^*}{P}$
  - It is more efficient if this real depreciation comes about by a nominal depreciation (and increase in E) rather than by a decline in the domestic price level (P)
  - A corresponding argument holds for an shock that requires a real currency appreciation

The exchange rate as a shock magnifier

- The standard case for exchange rate fixity
  - Consider an decrease in the demand for the domestic currency due to
    - Speculation that the domestic currency will depreciate even if domestic 'fundamentals' have not changed (Cf Philippine Peso during the Latin American crises)
    - Capital outflows due to 'risk-off' in international financial markets perhaps as a result of tightening monetary policy in advanced economies
  - If left alone, the domestic currency will depreciate in nominal terms, and if prices are sticky, also in real terms which will have undesirable real consequences
  - A more efficient solution is to lean against the nominal depreciation either by direct interventions in the forex market or by adjusting the domestic policy interest rate

Bottom line

- Benign neglect vs Leaning in relation to the exchange rate depends on sources of shock as well as how equipped the economy is in dealing with exchange rate fluctuations.
  - Availability of hedging instruments
  - Price and wage flexibility

- The challenge for central bankers is to determine in real time when to intervene and when to let go.

Should Central Banks mandates include the exchange rate?

- The short answer is NO.
  - Mandates should be broadly aligned with ultimate objectives such as macroeconomic and financial stability
  - How the Central Bank should achieve these objectives should not be mandated
  - The exchange rate should be taken into account to the extent it helps achieve the ultimate objectives, not for its own sake.

Wrap-up

1. Capital Flow Management and Exchange Market Intervention is increasingly seen by South-East Asian central banks as legitimate and useful tools monetary policy tools.

2. In South-East Asia, the IMF’s Institutional View on CMF policies is seen as too rigid and too focused on recipients of capital inflows

3. The use of CFM tools must be disciplined and transparent lest they become a backdoor avenue for politically motivated credit allocation.

4. In EME Central Banks, exchange rate changes do influence monetary policy decisions, rightly so.

5. They do so because
   a. The exchange rate affects the domestic inflation process
   b. The exchange rate can act as a shock transmitter in certain circumstances.
   c. However, it can also be a shock absorber, so some flexibility is essential.

6. The exchange rate should not, however, be elevated to a mandate for the Central Bank.

THANK YOU FOR YOUR ATTENTION

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