Monetary and Currency Policy Management in Asia
Monetary and Currency Policy Management in Asia

Highlights

Masahiro Kawai, Peter J. Morgan, and Shinji Takagi
Editors

About this volume

This booklet condenses the book *Monetary and Currency Policy Management in Asia* down to a quick introduction for anyone interested in the issues dealt with in this volume.

Readers interested in purchasing the full length book can order it from Edward Elgar Publishing, details of which are at the back of this booklet.
Monetary and Currency Policy Management in Asia

Masahiro Kawai, Peter J. Morgan, and Shinji Takagi

Introduction

Monetary and Currency Policy Management in Asia brings together empirical and theoretical studies that discuss a number of monetary and currency policy issues resulting from Asia’s experience with the global financial crisis. The studies were originally prepared for two international conferences on the global financial crisis hosted in 2009 by the Asian Development Bank Institute. Most of the empirical works have a specific focus on Asia, but the issues they discuss are by no means region-specific. The Asian region’s recovery ahead of other regions has led to a resumption of strong capital inflows and attendant appreciation pressure, thus presenting challenges for macroeconomic policy management. It is appropriate and timely that the volume should consider both the crisis experience itself and forward-looking issues related to macroeconomic policy.

The volume is organized into five parts. Part I deals with monetary policy issues, including the effectiveness of unconventional policies and medium-term policy frameworks. Part II is devoted to exchange rate policy and reserve management issues. Part III discusses policy choices related to the “impossible trinity,” the proposition in the economic literature that an open economy cannot simultaneously achieve all three objectives of (i) exchange rate stability, (ii) capital mobility, and (iii) monetary independence. Part IV deals with policy implications of Asia’s global macroeconomic linkages. Finally, Part V discusses prospective regional cooperation issues. The chapters, though initially prepared in 2009, were subsequently updated for inclusion in the volume.

The Asian region was severely impacted by the global financial crisis when it spread to the real sector and caused the volume of world trade to collapse from late 2008. Among the hardest hit was Japan, whose real gross domestic product (GDP) growth fell from 2.4% per year in 2007 to -1.2% in 2008 and further to -5.2% in 2009. Likewise, many of the region’s other exporters
of manufactured goods suffered a substantial output decline in early 2009. Though the People’s Republic of China (PRC), India, and Indonesia continued to grow at a steady pace throughout 2009 (ranging from 4.5% to 9.1%), even they experienced a significant deceleration of growth from previous years. This experience has demonstrated how interdependent the world economy is, and appeared to undermine the decoupling hypothesis — that is, Asia’s economic growth is so dynamic and autonomous that it is little affected by developments outside the region.

But the decoupling hypothesis seems alive again: Asia has recovered much more quickly than other regions. In fact, recovery was already evident by mid-2009 in much of the region, with even some of the hardest hit economies showing signs of a pickup in growth. For 2009 as a whole, for example, real GDP declined only moderately in Malaysia (-1.7%) and Singapore (-1.3%), while the Republic of Korea (henceforth Korea) managed to escape negative growth. In 2010 Asia was by far the fastest growing region. Among the most impressive performers are the PRC and India, both of which registered growth approaching or exceeding 10% for the year. The performance of several other economies, notably Singapore and Taipei, China, has been no less impressive.

The eurozone sovereign debt and banking sector crisis has provided new grounds for concern about possible negative impacts on Asia through the financial and trade channels. Although Asian holdings of sovereign debt of the crisis-hit countries were limited, European banks have a high exposure to emerging Asia, raising the risk of a disruptive capital outflow as those banks repatriate capital. Emerging Asia’s share of exports to the eurozone ranges from 16% for the PRC to 9% for ASEAN countries, a significant exposure. Therefore, emerging Asia cannot decouple from the cyclical ups and downs of advanced economy performance, although it has clearly decoupled in a structural sense as it exhibits much higher potential growth than advanced economies.

Though the global financial crisis is becoming a thing of the past for Asia and the eurozone financial crisis may eventually be resolved, the legacy of the crisis remains. First and foremost, the extent to which the massive simultaneous easing of monetary and fiscal policies in the region contributed to the region’s relatively quick recovery will no doubt be debated over the coming years. Of equal interest to the academic and policymaking community is the fundamental question of whether or not Asia’s policy mix until 2007 had contributed to the
global financial crisis in the first place. An important postcrisis agenda for the Asian region involves building a consensus on appropriate macroeconomic policies over the medium term. Should a country pursue a more flexible exchange rate policy? Should it target both price and financial stability as objectives of monetary policy? Should it continue to accumulate foreign exchange reserves as an insurance against a sudden outflow of capital? What is the role of regional policy cooperation? It is to these and other macroeconomic policy issues that the volume is dedicated.

**Monetary Policy Issues**

*Effectiveness of unconventional monetary policy*

Although all economies in the region eased monetary policy in the latter part of 2008, most came into the onset of the crisis with a tight monetary policy stance. Their pressing concerns in mid-2008 were the inflationary consequence of overheating and rising commodity prices. When the real impact of the crisis was felt, however, all central banks shifted to monetary easing. The softening of energy and commodity prices allowed the monetary authorities to cut policy interest rates aggressively. At the same time, some Asian central banks also attempted to increase the flow of credit through conventional quantitative measures (for example, removing limits on credit growth and lowering reserve or cash requirements). These monetary policy measures for the most part appear to have worked reasonably well, especially in economies that came into the crisis with a relatively tight policy stance.

However, in the economies where the level of interest rates was already low, such as in Japan, the interest rate transmission mechanism became impaired by the zero lower bound, requiring the use of “unconventional” monetary policies. There are two types of unconventional policies. First, quantitative easing refers to policies that aim to increase free reserves of the banking system, through open market operations or foreign exchange market intervention. Second, credit easing refers to policies aimed primarily at affecting the composition of a central bank’s balance sheet, for example, through an exchange of government bills for government bonds or purchases of private sector assets. In Asia, only Japan has used quantitative easing, but some other Asian economies also adopted credit easing measures. To the extent that central banks purchase private sector assets, they assume significant credit risk. The effectiveness of
These unconventional policies, used not only in Asia, but more importantly in the United States (US) and Europe, is perhaps the single most important monetary policy issue that came out of the crisis experience.

Morgan, in Chapter 2 of the volume, discusses the effectiveness of unconventional monetary policies by reviewing the empirical literature and recent experience. First, he cites empirical evidence to show that, among the several channels through which unconventional policies might operate, the commitment or duration effect (where verbal commitments by central banks to maintain very low interest rates for a certain period affect market expectations) seems to work. Second, the author states that evidence on quantitative easing is less conclusive, while observing that, after the announcement of a target for reserve deposits by the Bank of England in March 2009, the spread between the 3-month sterling London interbank offered rate (LIBOR) and the base rate did narrow.

Third, as to credit easing, the impact of outright purchases of government bonds on bond yields looks limited. In contrast, credit easing successfully relieved credit-related stresses in other market segments, as evidenced by reduced credit spreads across different markets (for example, between LIBOR and Treasury bill rates; US and European interbank rates) in the US, the UK, and Japan. Likewise, swap arrangements with the US Federal Reserve were successful in easing the shortage of dollar funds in Korea, where a rapid fall was observed in the spread between the Korean interbank rate and the US Treasury bill rate when the facility was used. Morgan concludes that unconventional monetary policies are promising for Asian economies mainly as a tool of relieving blockages in specific markets, though not as a stimulus measure.

Medium-term issues

Filardo and Genberg, in Chapter 3, discuss medium-term issues for monetary policy, including the type of regime Asia’s central banks should adopt, going forward. Prior to the global financial crisis, almost all central banks in the Asian region had aimed for price or exchange rate stability as the overarching objective of monetary policy. Empirical evidence suggests that inflation rates in Asia were well anchored for both inflation-targeting and non-inflation-targeting central banks. Moreover, both types of central banks saw considerable improvement in independence and other aspects of governance. The authors argue that as long as there is a right policy focus, inflation targeting is not the
only way to achieve price stability.

Much less consensus exists on the extent to which central banks should take account of asset prices in the conduct of monetary policy. The conventional wisdom until recently, particularly in the US, was that central banks should not lean against possible financial imbalances as they build up but should respond aggressively once they collapse. This view is based on the assumption that significant imbalances are nearly impossible to detect with confidence in real time and the costs of the clean up are expected to be low and manageable. But the crisis has opened up the debate regarding “leaning versus cleaning.” There is now a widely held view that too narrow a focus by central banks on price stability created a speculative bubble in the asset market and led to excessive risk taking in financial markets, and that monetary policy should therefore give greater attention to financial stability.

According to Filardo and Genberg, assigning a central bank the responsibility for financial stability would be difficult because there is no generally agreed definition of financial stability, let alone a single numerical indicator (such as the rate of inflation) that could serve as a measure of success or failure. But it is possible to aim for financial stability broadly defined without sacrificing price stability; the two objectives need not be incompatible in the authors’ view. To the extent that a central bank’s objective is to minimize some combination of fluctuations in inflation around a target value and fluctuations of output around its natural level, all relevant information, including asset prices, must serve as the basis for monetary policy decisions. At the same time, as central banks lack a direct instrument to achieve financial stability, the authors make a case for developing a mechanism to limit the procyclicality of a market-based financial system which in their view is an important source of vulnerability.

**Exchange Rate Policy and Reserve Management Issues**

**Exchange rate regime choice**

In explaining the cause of the global financial crisis, some observers, especially those in the US and Europe, have argued that Asia’s choice of exchange rate regime was a factor. According to this argument, many of the region’s emerging market economies pegged their currencies to the US dollar (or at least stabilized
the exchange rates relative to the US dollar) when they faced appreciation pressure. As a result, central banks intervened in the foreign exchange market on a sustained basis to purchase US dollar assets, which effectively provided the US with a plentiful supply of low-cost savings. The global imbalances were therefore allowed to persist in part because of the exchange rate regime choice of Asian countries. Moreover, the plentiful supply of savings allowed the US private sector to borrow at low cost and led to reckless behavior on the part of market players as they attempted to earn higher yields.

This conventional view of the exchange rate regime choice of Asian countries is confirmed by analyses presented in the volume. Kim and Yang, in Chapter 4, approach the issue of regime choice from the point of view of monetary independence. If a country pursues a fully flexible exchange rate policy, it should be able to pursue a fully autonomous monetary policy, such that domestic interest rates should not be significantly affected by monetary developments abroad. Building on this line of reasoning, the authors obtained evidence that before the global financial crisis, most Asian economies had indeed limited the flexibility of their currencies against the US dollar because their interest rates were significantly influenced by US interest rate developments. This conclusion receives further support from the analysis in Chapter 7, where Patnaik and Shah conduct a statistical test of 11 Asian currencies to find that the degree of exchange rate flexibility in Asia increased only marginally after the Asian financial crisis.

**Costs and benefits of reserve accumulation**

The propensity of Asian countries to manage exchange rates under appreciation pressure meant that they accumulated large amounts of foreign exchange reserves following the Asian financial crisis. In fact, the rise in foreign exchange reserves held by Asian authorities was spectacular indeed: the outstanding stock for 10 major economies (which excludes Japan but includes Hong Kong, China) rose from a mere US$560 billion at the end of 1998 to over US$3 trillion at the end of 2007. With Japan included, Asia’s stock of foreign exchange reserves amounted to over US$4 trillion when the global financial crisis broke out. It further rose to US$6.5 trillion by the end of 2011. The questions discussed in the volume concern the costs and benefits of maintaining such large amounts of foreign exchange reserves.

Fukuda and Kon, in Chapter 5, mainly focus on the costs of reserve
accumulation. They start out by noting that, from the point of view of a country with external debt, the probability of a currency crisis is lower with a smaller proportion of short-term debt in total debt, but the interest rate on short-term (liquid) debt tends to be lower than that on long-term (illiquid) debt. Thus, the benefits of holding foreign exchange reserves are to reduce the probability of a currency crisis and thus to allow the country to borrow from abroad in short-term (hence low-cost) maturity. But holding foreign exchange reserves would entail a cost in terms of foregone interest as they typically earn lower yields than comparable domestic instruments. The ability to borrow at lower cost would certainly change the behavior of private agents. Fukuda and Kon show, in a two-sector model of a utility maximizing agent, that an increase in foreign exchange reserves would lead to an increase in external debt, a permanent decline in consumption (resulting from smaller interest income), and a transfer of labor from the non-tradable to the tradable sector (in order to earn foreign exchange to pay off debt). These theoretical predictions are broadly supported by data from 130 countries during 1980–2004.

**Recommendations Related to the “Impossible Trinity”**

*Role of reserve holdings in easing policy constraints*

Aizenman, Chinn, and Ito, in Chapter 6, approach the issue of reserve accumulation within the framework of the impossible trinity. By using what they call “trilemma indices,” the authors observe that, as a result of holding large reserves, Asian emerging market economies achieved the intermediate levels of monetary independence, exchange rate stability, and financial integration in the 2000s. They interpret this result as indicating the ability of foreign exchange reserves to mitigate the binding constraints of the impossible trinity. Patnaik and Shah’s analysis in Chapter 7 concurs with this assessment but notes that the combination of exchange rate stability and moderate financial integration in the process created procyclicality in monetary policy in much of Asia prior to the global financial crisis.

Aizenman, Chinn, and Ito further note that foreign exchange reserves carry additional benefits. First, they can act as an insurance against a sudden reversal of capital inflows as countries partially open their capital account, increase exchange rate flexibility somewhat, and attempt to retain some monetary
independence. The authors show evidence to suggest that countries holding large amounts of foreign exchange reserves are less likely to experience large output loss during a crisis. Second, they present evidence to suggest that a country can offset the volatility of investment and output that comes from keeping the exchange rate stable by holding large foreign exchange reserves. The authors estimate that the threshold of reserves that is required for this purpose is about 12% of GDP.

Medium-term implications

Whatever the benefits of holding large amounts of foreign exchange reserves may have been from the point of view of individual countries, the outcome had some global implications. The policy of many Asian economies to peg their exchange rates to the US dollar, as confirmed by Patnaik and Shah’s analysis in Chapter 7, and thereby to accumulate US dollar assets, allowed the US government and agencies to finance their debt at low cost. This in turn may have reduced US policymakers’ incentives to reduce the rising debt and the buildup of financial imbalances in the US, thereby contributing to the global financial crisis. As Kim and Yang warn in Chapter 4, as long as Asian countries continue to restrict the flexibility of exchange rates, it might sustain Asia’s current account surplus at a high level. The choice of exchange rate regime by one economy could therefore have global implications. Given the costs involved, the region’s economies may benefit from having an alternative mechanism of mitigating the risk of capital flow reversal. This topic is taken up in the next chapter.

Impacts on Asia of the Global Financial Crisis and Policy Responses

Given the unprecedented collapse of real economic activity, and the awareness in some countries that the scope for further monetary easing was limited, most governments in the region, as elsewhere, resorted to aggressive easing of fiscal policy during the global financial crisis. The relatively healthy public finances in many Asian countries made it possible to take decisive fiscal action. Even Japan and India, with relatively large government debt-to-GDP ratios, also eased the stance of fiscal policy considerably. There is an ongoing debate about the effectiveness of fiscal policy, especially as it relates to debt sustainability. Lessons are also being learned about the practical implications of the crisis
experience, for example, concerning the relative size of fiscal multipliers for transfers versus public investment, the lag in implementing large public works projects, and the like.

Among the many issues involved in the debate, an aspect of fiscal policy effectiveness discussed by Kawai and Zhai in Chapter 8 concerns the issue of fiscal policy coordination. The authors built a multi-country dynamic general equilibrium model of the world economy (consisting of the US, Japan, emerging Asia, and the rest of the world) to analyze the impact on Asia of various negative shocks affecting the US or global economy. Calibrating the model to fit the 2004 data, the authors show that fiscal policy, if anchored against fiscal sustainability, is effective against negative shocks, especially when accommodated by monetary easing. But fiscal policy implemented by one country or region alone, such as the US or emerging Asia, would be ineffective, given the large leakage of demand through trade openness. The authors thus conclude that globally coordinated action is the only effective tool of fiscal policy particularly for smaller Asian countries. In one specification of globally coordinated fiscal expansion, the authors estimate that the multiplier of fiscal stimulus (sustained over two years) could be as high as 0.75.

**Regional Cooperation Issues**

In view of the crisis experience noted above, regional policy cooperation must ideally cover the monetary sphere. Kawai and Takagi, in Chapter 9, note that Asia has seen a rise in intraregional trade in recent years and that as a result macroeconomic interdependence has strengthened. This means that the actions of policymakers in one economy to pursue their own interests could more frequently come in conflict with those in the region’s other economies, with exchange rates constituting a critical link. Yet, exchange rate policy has so far been the least developed aspect of regional economic cooperation initiatives. Admittedly, no country in Asia is likely to give up sovereignty over exchange rate policy, but there are steps the region’s economies can usefully take to strengthen cooperation in the monetary area. The immediate step is to incorporate exchange rate issues into the existing policy dialogue process.

An obvious area of policy cooperation is to devise a system in which countries no longer have the incentive to continue accumulating foreign exchange reserves as a buffer against adverse shocks. Reform at the global
level has been progressing since early 2009 in order to improve the global system of providing financial support to countries in need. Despite these global efforts to remove the stigma of IMF borrowing, the prognosis for Asia is not encouraging. Some regional economies lost reserves and many more experienced a decline in the pace of reserve accumulation during the height of the global financial crisis. Yet, none of the economies in East Asia sought International Monetary Fund (IMF) assistance but they all sought alternative sources of liquidity.

Now that capital inflows are recovering, some economies appear to have resumed accumulating foreign exchange reserves again. This only represents a return to the pre-global financial crisis regime. If countries in Asia are reluctant to approach the IMF, a regional support mechanism can assume part of its function. In this respect, a welcome development is the decision of ASEAN+3 finance ministers to multilateralize the Chiang Mai Initiative (CMI) and to create an independent surveillance unit called the ASEAN Macroeconomic Research Office (AMRO) to support the economic review and policy dialogue process as well as the decision-making process in the management of the pooled reserves. Kawai and Takagi argue that Asia’s economies must make this scheme sufficiently user-friendly and cooperative in nature, so as to minimize the incentive to accumulate more reserves for insurance purposes.

Such a scheme is desirable both for macroeconomic management and for global rebalancing. By providing an alternative insurance mechanism, the regional system of mutual financial assistance, in the form of the CMI Multilateralization (CMIM), could potentially play a role in encouraging the region’s economies to assume greater exchange rate flexibility. In this context, economies with a large balance of US dollar reserves may be reluctant to allow a significant appreciation of their currencies against the US dollar because it would entail a significant capital loss. This only strengthens the case for a globally and regionally cooperative solution, which ensures an orderly adjustment of exchange rates and the composition of reserve assets over time. The authors explore alternative modalities of exchange rate coordination in order to achieve the dual objectives of greater intraregional stability of exchange rates and increased flexibility with respect to currencies outside the region.
Conclusion

Asian central banks must now rely on the robust institutions they have built to pursue price and financial stability. But price stability calls for greater exchange rate flexibility as capital inflows are resuming. Neither is maintaining exchange rate stability vis-à-vis the US dollar helpful in facilitating global rebalancing. As we have seen, massive reserve accumulation, though helpful in mitigating the trilemma constraint, can limit the central bank’s ability to control overheating, inflation, and asset price increases, be wasteful in terms of foregone consumption, and result in large exchange losses if the US dollar depreciates steeply in the future. In order not to repeat the same mistake, regional monetary cooperation can be helpful in allowing the governments to overcome the fear of losing price competitiveness through unilateral action. With a strengthened reserve pooling scheme in the form of the CMIM, economies in the region should no longer find it in their interest to continue accumulating reserves for precautionary purposes. By addressing the pre and postcrisis experiences of Asia, the studies reported in the volume have raised our understanding of what constitutes sound macroeconomic policy practices and institutions and proposed components of a grand vision for the region.
AUTHORS AND CONTRIBUTORS

**Joshua Aizenman**, Professor, Economics Department, University of California, Santa Cruz, California and Research Associate, National Bureau of Economic Research, Cambridge, Massachusetts, US.

**Menzie D. Chinn**, Professor, Economics Department, University of Wisconsin, Madison, Wisconsin and Research Associate, National Bureau of Economic Research, Cambridge, Massachusetts, US.

**Andrew Filardo**, Head of Economics for Asia and the Pacific, Bank for International Settlements, Hong Kong, China.

**Shinichi Fukuda**, Professor, Graduate School of Economics, University of Tokyo, and Visiting Fellow, Asian Development Bank Institute, Tokyo, Japan.

**Hans Genberg**, Assistant Director, Independent Evaluation Office, International Monetary Fund, Washington, DC, US.

**Hiro Ito**, Associate Professor, Economics Department, Portland State University, Portland, Oregon, US.

**Masahiro Kawai**, Dean and CEO, Asian Development Bank Institute, Tokyo, Japan.

**Soyoungh Kim**, Professor, Economics Department, Seoul National University, Seoul, Korea.

**Yoshifumi Kon**, Assistant Professor, Aoyama Gakuin University, Tokyo, Japan.

**Peter J. Morgan**, Senior Consultant for Research, Asian Development Bank Institute, Tokyo, Japan.

**Ila Patnaik**, Professor, National Institute of Public Finance and Policy, New Delhi, India
Ajay Shah, Professor, National Institute of Public Finance and Policy, New Delhi, India.

Shinji Takagi, Professor, Graduate School of Economics, Osaka University, Osaka, Japan.

Doo Yong Yang, Associate Professor, College of International Studies, Kyung Hee University, Seoul, Korea.

Fan Zhai, Managing Director, Department of Asset Allocation and Strategic Research, China Investment Corporation, Beijing, People’s Republic of China.
To buy the complete book, please contact:

Edward Elgar Publishing Ltd
The Lypiatts
15 Lansdown Road
Cheltenham Glos GL50 2JA UK

Tel: +44 1242 226934
Fax: +44 1242 262111

Email: elgarsales@e-elgar.com
Website: www.e-elgar.co.uk