Comments on Shyamala Gopinath's paper "An internationalised rupee?" and Ric Battellino's paper "A generation of an internationalised Australian dollar": a journey through time[1]

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Introduction

I would like to thank the Bank of Korea and the BIS for organising this seminar on currency internationalisation and for inviting me to be a discussant for Session 6: "Monetary policy challenges with an internationalised currency". It is my privilege to discuss the two papers for that session, namely: "An internationalised rupee?" and "A generation of an internationalised Australian dollar". Instead of discussing these two interesting papers individually, I would rather focus on the issues and lessons that can be drawn from the contrasting experiences of Australia and India with currency internationalisation. And since their experiences cover a lengthy period (for Australia, since 1971; and for India, since 1959), I have entitled my remarks: "'An internationalised rupee?' and 'A generation of an internationalised Australian dollar': a journey through time."

The first issue I would like to stress is that there appears to be an evolutionary process involved in currency internationalisation.

For the Australian dollar, floating practically took place after 12 years, from 1971 to 1983 (from pegging to the pound sterling, to pegging to the US dollar, then pegging to a trade-weighted exchange rate index, followed by a crawling peg to the same index and periodic realignments). Capital controls were dismantled in 1983 after many years.

It is worth noting that, in the case of Australia, reforms did not always follow a preset plan. They were often a response to external forces exposing deficiencies in the prevailing system. The Australian dollar has been an internationalised currency since 1983 (Battellino and Plumb (2009)).

The Indian rupee, on the other hand, started as an official currency of other economies (Kuwait, Bahrain, Qatar, the United Arab Emirates and Malaysia) and remained so until 1959. Effective markets for the Indian rupee exist; anecdotal evidence shows that it is accepted in Singapore, Malaysia, Hong Kong, Sri Lanka and the United Kingdom. It should be noted that the Indian rupee is not part of the proposed Asian Currency Unit (ACU). India is considered small in terms of GDP, trade volume and foreign exchange turnover. Moreover, India considers micro/macrostabilisation paramount over directly pursuing currency internationalisation. We cannot argue against that.

The experience of India therefore underscores an important point: currency internationalisation cannot be decided in one day and pursued the next; it comes about after a long evolutionary process, when all the building blocks are in place.

Let me touch on my second point: whether currency internationalisation is an end in itself.

[1] Extemporaneous remarks based on a PowerPoint presentation.

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Allow me to quote Battellino and Plumb: "The Australian economy has benefited greatly from an internationalised currency." Its floating exchange rate has served as a buffer to external shocks, particularly shifts in terms of trade, which can be substantial in the case of Australia. It has also allowed the economy to absorb these shocks without the large inflationary or deflationary pressures (Battellino and Plumb (2009)).

Note that events between 1971 and 1983 (ie foreign exchange pressures, external shocks, output and inflation volatility, repressed financial markets) were no different from the conditions faced by emerging economies today. However, reforms were pursued, including those in the product and labour markets, as well as improvements to the policy frameworks for both fiscal and monetary policy. Caballero et al (2004) argue that country trust is an important element in making the Australian dollar an internationalised currency. What are we saying here? Steadfast commitment to reforms is critical, if only to generate market confidence in a country's currency.

In the case of India, according to Deputy Governor Gopinath (2009): "Internationalisation of a currency is a policy matter and depends upon the broader economic objectives of the country." This is the reason why India employed a calibrated approach to the capital account given the obtaining macro imbalances and the current global financial crisis; the sequencing of reforms is indeed very important. Thus, while the Indian rupee is not fully convertible, it is flexible. Consistent with this regime, India adopted full but gradual current account liberalisation.

With the adoption of a flexible exchange rate, India has established an important prerequisite for currency internationalisation. However, internationalisation of the Indian rupee still has a long way to go. The Indian rupee accounts for a very small proportion of total foreign exchange turnover, while its infrastructure for hedging is still emerging.

Will a more aggressive approach in lifting remaining capital controls promote growth, trade and openness, and improve output performance, etc? Or should India further complement this with significant economic reforms? My view here is that, by themselves, policy reforms are useful to the economy. Whether they could/would be likely to lead to currency internationalisation may have to be a secondary consideration. It is an added bonus.

The third issue that I would like to raise is whether currency internationalisation is stabilising or destabilising.

In the case of Australia, there was an initial instability when the government dismantled capital controls and moved to an auction system for debt issuance. But the openness and transparency of the system quickly established government credibility, resulting in higher demand for bonds and lower yields – the ingredients of a stable bond market.

It should be emphasised that the development of a cross-currency swap market is critical for investors to hold a certain currency without taking excessive risk. The development of a cross-currency swap market in Australia can be attributed to its adoption of the following formula:

Deregulated bond market + floating exchange rate – capital controls

= cross-currency swap market

Recent events, not necessarily currency internationalisation, could be destabilising (in terms of output, employment and distribution) if an aggressive policy towards currency internationalisation were pursued. At this time, increased capital account liberalisation may instead increase India's vulnerability to external shocks and fund withdrawals.

It should be pointed out, though, that a floating exchange rate and open capital account may not necessarily be destabilising, depending on market confidence. However, given the severity of the crisis, the elements of currency internationalisation could contribute to amplification and financial vulnerability.

The fourth issue that I would like to address is whether currency internationalisation poses challenges to the conduct of monetary policy.

For Australia, the floating exchange rate has mitigated the impact of external shocks and minimised output variance. But the nominal anchor disappeared until inflation targeting was adopted, and the inflation target replaced the exchange rate as the nominal anchor.

It can be argued that, based on the Australian experience, currency internationalisation has minimised the terms of trade shocks and, in the process, has helped to maintain an internal balance. With lower pass-through of the exchange rate to inflation, the Reserve Bank of Australia became more tolerant of exchange rate variations and, as a result, it became less interventionist. However, the authorities also lost control over the composition of the balance of payments. Capital outflows initially surged in 1983 but, over time, capital flows have reversed. This was possible only because of sustained policy, institutional reforms and market confidence.

The challenges of an internationalised currency should encourage corporate and financial sectors to smooth significant exchange rate gains and losses.

In the case of India, Gopinath (2009) offers a different view on the impact of currency internationalisation on monetary policy: “Effectiveness of monetary policy may be undermined. For example, OMO effectiveness may be reduced in an environment where both residents and non-residents are free to buy and sell domestic currency especially when the government debt is neither large nor liquid.”

India’s experience, particularly in 2007, has demonstrated that volatile capital flows could complicate monetary policy. Lack of developed financial markets, especially in emerging market economies, could not effectively prevent some spillover effects to the real sector.

It is worth emphasising that, without the ongoing global financial challenges, a floating exchange rate and liberalised current/capital account may not necessarily be destabilising or complicate monetary policy. If complemented by confidence-boosting measures, such as market and institutional reforms and the development of financial markets, these elements could, in fact, offer a market-based stability solution.

Finally, let me discuss the vision for Australia and India. For Australia, currency internationalisation has worked. In fact, it has helped to manage the economy, spurred financial market development and facilitated subsequent reforms. I should say that Australia will no doubt marry the elements of currency internationalisation for another 25 years. For India, its courtship with currency internationalisation is expected to continue (hopefully not for the next 25 years!). Thus, we need to allow romance to blossom in its own time!

References

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