Mr Macfarlane talks about exchange rate regimes and Australia's experience with them

Speech by the Governor of the Reserve Bank of Australia, Mr I.J. Macfarlane, to the Asia Pacific Forex Congress in Sydney on 27/11/98.

Introduction

First, I would like to add to what Mr Hawke has already said by extending my personal welcome to Australia for the 1998 Asia Pacific Forex Congress.

I am glad to see that the Asian Pacific Congress is continuing to thrive. A regional association such as this is important because, according to the latest BIS world market survey, the Asian region accounts for about one quarter of global foreign exchange turnover. I am hopeful therefore that, as the practitioners in this region, your discussions here over the next couple of days will make a contribution to resolving some of the issues that recent events have exposed.

When this Congress last met in Hong Kong a year ago, the so-called "Asian crisis" had already started, but few could have anticipated the toll it would eventually take, not only on financial markets but also on these countries' economies more generally. None of us thought that most of the economies of Asia would be in recession by now, or that the effects would have spread to non-Asian emerging markets. I am sure the Congress this year will provide plenty of topics for lively discussion because foreign exchange markets are so central to all that has happened. If we cast our minds back to July last year, we will recall that initially the events in Thailand and elsewhere were seen as a "currency crisis" before they became a general economic crisis.

I am pleased that the Australian Government has been able to play a constructive role in helping to understand the difficulties in the region, and then to assist in efforts to overcome them. Australia was, in fact, the only country apart from Japan which contributed to all three financial assistance packages in the region. The Australian authorities were able to play a useful role because they had been building an understanding of regional developments for many years, in part reflecting the strong trade links with the region, but also a more general interest on the part of our business and academic communities. Bureaucratic ties, including among central banks, had also been strengthened, particularly through EMEAP, the group of 11 regional central banks and monetary authorities that has been meeting regularly since 1991.

This understanding led Australia to see more quickly than most other countries the difficulties with the Indonesian rescue package, and it used what influence it had with the IMF to argue for a more flexible approach. Recently, Australia has pressed for APEC to lend its support to the proposed reforms to the international financial system put forward by the three G22 working parties. We recognise that there is a danger that the momentum could be lost if governments in this region do not keep up the pressure.

Exchange rate systems

One of the areas in which the reshaping of ideas has already begun to occur is that of exchange rate systems. Until 1997, most countries in Asia maintained some form of pegged exchange rate. In the case of Hong Kong, this was a type of currency board, while other countries maintained exchange rates which, although often referred to as floating, were managed within a tight range against the US dollar, or some weighted index dominated by the US dollar.

Most of the latter group of countries have had to abandon their systems under the pressure of recent events. Currency boards such as Hong Kong's (or Argentina's, for that matter) seem to have survived rather better (though at a high price in terms of lost GDP). As a result, it is commonplace to hear these days the view that countries can choose to have a fixed exchange rate by way of a currency board or a pure float, but not any of the possible systems in between.

I confess to some misgivings about this conclusion. I think it is mainly attractive to people who like intellectually pure systems, but we live in a very impure world. I think a lot more analysis needs to be undertaken before we can be confident of such a conclusion. For a start, Hong Kong's version of a currency board is very different to Argentina's. Secondly, we need to examine countries like Singapore, Taiwan or Chile, which do not fall into either of the polar cases, but whose economies seem to have done relatively well in difficult circumstances.

Whatever the solution is, it will involve making very difficult choices. I am reminded of this when I look back over the many meetings I attended with Asian central banks in the middle years of this decade. The ever-present topic of conversation was what to do about the large inflows of capital they were attracting. Everyone knew that they were "excessive" in the sense that they were much larger than needed to cover the relatively small current account deficits, were difficult for the economies to absorb productively, and were putting a lot of upward pressure on their relatively fixed exchange rates. There were basically three alternatives open to them:

Persevere with the relatively fixed exchange rates and sterilise the inflows to make sure that money supply and inflation did not accelerate; put in place some form of control to limit the amount of capital inflow; or float the exchange rate.

As we know, they chose the first alternative. We look at the result and say they made a mistake. But the second alternative – capital controls – was effectively ruled out by international pressure in anything other than a crisis situation. Remember, while the international debate has now reached some form of consensus that "Chilean" style controls on inflows can play a useful role, this is a very recent development.

That leaves the third alternative – a move to a floating exchange rate – and this looked rather daunting to them. I am not aware of any country, including developed countries, that have made the move without being forced to do so by some form of crisis.

The reality is that, even though the theoretical benefits of floating are clear enough, the transition can be, and often is, difficult. Certainly, that was our experience in Australia in the mid-1980s.

In the case of the Asian economies, a move to floating may have brought things to a head sooner in that it would have removed the exchange rate certainty that underpinned the capital inflows that were driven by interest rate differentials. But exchange rates which were already seen as being overvalued would have risen further, compounding the subsequent correction.

With the benefit of hindsight, it now seems clear to me that it would have been difficult to avoid some sort of crisis. With so much internationally mobile capital pouring into economies with relatively small financial sectors, there was virtually no prospect of a smooth return to normality.

Australia's exchange rate

So far, I have talked about possible exchange rate regimes and how difficult it has been for Asian countries to come to terms with these – what of Australia's experience? As most of you will know, Australia spent the first 40 years of the postwar period trying just about every form of fixed exchange rate that was possible. First of all, the Australian dollar was fixed to the pound sterling, then fixed to the US dollar, then fixed to a trade-weighted basket, then a variable peg to a trade-weighted basket. Finally, we floated, and in two weeks' time we will mark the 15th anniversary of the float of the Australian dollar. We are very comfortable with the floating exchange rate, and I know of no serious body of opinion in Australia that would want it any other way now that we have come to terms with it. In fact, it is widely seen as being an important factor helping Australia put in a good economic performance during the Asian crisis.

We certainly have allowed our exchange rate to adjust to reflect economic circumstances, most particularly the international cycle in economic activity and commodity prices. We have not resisted these broadly-based economic changes and the Australian economy has benefited as a result. Since 1986 the Australian dollar has fluctuated around a stationary average value, with the cycle being quite pronounced: peak-to-trough movements of around 30% have been common.

While we are prepared to accept significant moves in the exchange rate, we do not follow an approach of benign neglect. When the exchange rate moves, we ask ourselves if it is telling us anything about policy settings. With our inflation-targeting framework, the central issue is always what the exchange rate move means for inflation, not only in the near term but also in the longer term.

There have been instances when monetary policy has been adjusted in response to exchange rate moves, but they have not been frequent. We have also used intervention to influence the exchange rate, finding it particularly useful in circumstances where market imperfections are resulting in overshooting, as markets tend to do from time to time.

Judging when this tendency to overshooting exists is always difficult at the time, and – like most things in life, including making the sorts of decisions you all make in foreign exchange trading – usually easier with at least some hindsight. As a rule of thumb, however, the exchange rate is *not* overshooting unless it has already moved a considerable way from its "normal" level, or at least a level that can be explained by what is happening in the economic and financial environment.

As you know, there is considerable debate about the effectiveness of intervention, even among central bankers. Some of this stems from a lack of clarity about what it aims to do. Intervention should not be viewed as a substitute for necessary adjustments in monetary policy. It is also expecting a lot of it to think it can support a fixed exchange rate during times of crisis. But, in a floating exchange rate regime, intervention can play a useful role in limiting extreme movements in the exchange rate.

This is the approach we have taken in Australia. The result is that our interventions tend to be infrequent, coming mainly at or near the peaks and troughs of the exchange rate cycle. By and large, judged against our aims, we believe our interventions have been successful. They have also been successful when judged against the test proposed by Milton Friedman, i.e. whether or not they are profitable. The Bank has fairly consistently made profits from its intervention throughout the post-float period.

During the past year, the Bank intervened on three occasions. These occurred after the rate against the US dollar had already fallen by a considerable amount. In other words, our policy on intervention has not prevented the exchange rate from falling enough to do the job we expect a floating exchange rate to do. Australia has been able to maintain growth of about 4% in the past year, at a time when most of our main trading partners in Asia have experienced negative growth.

Our exchange rate system and the robustness of our financial sector have been two of the keys to this performance.

I would hope that countries that have only recently entered the world of floating exchange rates can draw some hope from this. The move from pegged to floating exchange rates is never easy. Soon after the Australian dollar was floated, it fell by over 30%, not dissimilar to the falls recently experienced by some of our Asian neighbours. There is no doubt that this caused considerable dislocation to the economy at the time, requiring strict and somewhat unpalatable policy decisions. But I think that businesses, markets and the authorities all learned from that experience, showing that it is possible to emerge from such disturbances with the economy and the financial system in much better shape. I hope that this will also be true for the countries currently experiencing difficulties. The very recent signs of greater stability in regional markets can give us some confidence that this will be the case.