Discussant remarks: monetary policy and exchange rate issues in Asia and the Pacific

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First of all, let me thank the People's Bank of China and the Bank for International Settlements for inviting me to this wonderful event. My discussion has three parts: a discussion of the two papers presented in this session, a general discussion of BIS research on monetary policy and exchange rates, and some specific comments on the background paper prepared by the BIS Asian office.

Discussion of "Targeting inflation in Asia and the Pacific: lessons from the recent past" by Andrew Filardo and Hans Genberg

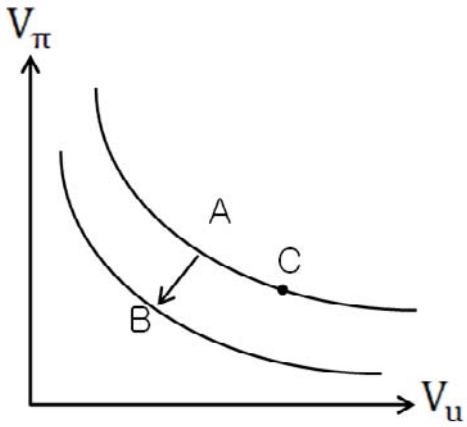
In this paper the authors observe that since the Asian financial crisis, 12 Asia Pacific central banks have performed remarkably well in terms of both the level and the volatility of the inflation rate.

This phenomenon, the so-called Great Moderation, is best illustrated by the Taylor curve (Graph 1). The horizontal axis measures the variance of the unemployment rate, and the vertical axis the variance of inflation rate. The Taylor curve says that there is a trade-off between the volatility of the unemployment rate and that of the inflation rate. When there is an aggregate supply shock, monetary policy makers can stabilise inflation only at the expense of unemployment stability, or vice versa. Central bankers therefore choose one goal or the other, or some combination of both depending upon their preferences.

The Taylor curve shifts toward the origin when monetary policy becomes more efficient. That is, the state of the economy as represented by the variances of the rates of inflation and unemployment moves from point A to point B. The authors argue that the increased

Graph 1

Taylor curve



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efficiency in monetary policy, if there is any, is due to central banks' legal and/or political independence and a general increase in transparency and accountability.

In theory, an inflation-targeting (IT) central bank would prefer the lower variance of inflation rate more than a non-IT central bank would. So, other things being equal, the IT central bank would prefer point C to point A along the Taylor curve. In reality, however, it is not clear that the adoption of IT by itself has led to a qualitative difference in the performance IT central bank compared to that of non-IT central banks.

The author's findings may be explained in the following ways. First, they may be due to the difficulty in identifying points on the Taylor curve. For example, a non-IT country could be at point B while an IT country is at point C. Second, the shape of the Taylor curve may not be the same for all the countries. Third, as countries move towards close financial integration, they lose monetary independence (vis-à-vis a base country, say the United States) even if exchange rates have been allowed to vary further. (Aizenman et al. (2008)).

The authors' conclusion, that an emphasis on price stability may be more important than adopting an IT regime in improving outcomes, can be interpreted as suggesting that an emphasis on price stability may help to enhance the efficiency of monetary policy.

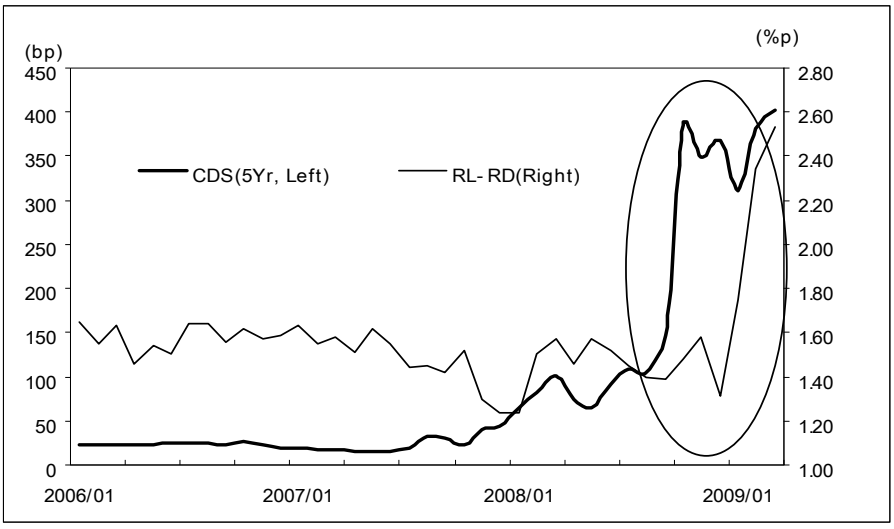
I think the paper nicely documents the performance of monetary policy in the Asia Pacific region after the Asian Financial Crises and gives an excellent evaluation of the IT and non-IT regimes. It also provides important policy implications for the conduct of future monetary policy.

Discussion of "Financial deleveraging and the international transmission of shocks" by Michael B. Devereux and James Yetman

The authors have built a 'double drain' model in which international financial shocks easily cause domestic credit crunches. After the collapse of Lehman Brothers double drains emerged not only in developed countries but in emerging market countries as well. In Korea, as seen here, when the CDS premium sky-rocketed in October 2008, the difference between lending and deposit rates in the banking sector also rose sharply, with a three-month lag (Graph 2). In fact, the liquidity of the inter-bank market dried up immediately after the Lehman collapse.

Graph 2

Double drain: Korea



The core assumption of the paper is the investor's borrowing constraint: $B_t^I = \kappa q_t k_t^I$ where $\frac{1}{1-\kappa}$ is the leverage ratio and $q_t k_t^I$ is the product of a vector of domestic and foreign asset prices and a vector of the amount of domestic and foreign asset invested, respectively.

This borrowing constraint has important implications. It results in a very high correlation across countries in borrowing and investment. The increased diversification leads to a greater sensitivity of home leverage constraint to foreign asset prices. Naturally, greater diversification magnifies the propagation mechanism by which shocks are transmitted internationally. Hence, the greater the leverage ratio, the larger is the deleveraging multiplier.

Negative productivity shocks in the home country result in a reduction in investors' borrowing both at home and abroad. A consequential reduction in investment and a fall in the prices of assets held by foreign investors lead to a tightening of the leverage constraint. The novel feature of the paper is that, even though the leverage ratio does not change, the response to the shock is proportionally much larger than the shock itself. This is explained by the interaction between asset price declines and the binding leverage constraints.

The paper has important implications for the central bank's monetary policy. The central bank should lean against the wind and an aggressive monetary policy response to de-leveraging may be optimal. I think the result of the paper is robust. Kim (2009) has investigated the similar issue using a small open economy model and derived the same policy implication.

General discussion on BIS research on monetary policy and exchange rate

The BIS research has offered us valuable resources to deal with the current crisis, when both academia and the central banks community failed to see it through. Especially, I would like to point out some noteworthy research findings.

Price stability and financial stability

The BIS has emphasised that the pursuit of consumer price stability is not sufficient to guarantee macroeconomic stability, based on the fact that major economic and financial crises have occurred without being preceded by inflationary pressures. The BIS has also stressed the importance of liquidity and credit. The main reason is that, due to financial liberalisation, the adoption of anti-inflation monetary policy regimes, and globalisation, real interest rates have been so low and liquidity has expanded so much without putting pressure on inflation. Here liquidity and credit play a key role in asset price fluctuations, so that unusually rapid credit growth and large increases in asset prices are indicators of financial imbalances. Furthermore, the BIS has pointed out that the issue of household indebtedness needs to be addressed before it becomes excessive, since a high level of household debt increases the sensitivity of a household's financial condition to changes in interest rates. In summary, the BIS has consistently insisted that financial imbalances should not be ignored.

Policy responses

The BIS has urged implementation of countercyclical monetary policy. Specifically, it has suggested that it is more appropriate for central banks to respond to asset price bubbles, given that tightening monetary policy when asset prices are inflating and easing when they collapse may increase social welfare under certain circumstances. In addition to monetary policy strategy, the BIS has suggested that macroprudential policy needs to support

monetary policy in ensuring price stability and financial stability. This is because, to effectively restrain the build-up of financial imbalances during a low-inflation era, a macroprudential policy is needed. It is also essential that macroprudential policy tools be devised to alleviate procyclicality. In this regard, forward-looking measures are desirable since the usual prudential policy tools, such as loan provisions and minimum capital requirements, etc, are procyclical.

Exchange rates

The BIS has stressed that, to emerging market economies (EME), exchange rates matter not only with regard to macro variables such as inflation and foreign trade, but also for financial stability. Real exchange rate misalignments and currency mismatches have particularly important implications for financial stability. EMEs have used various policy tools to cope with volatile capital flows and volatile exchange rates. Monetary policy, market intervention, and regulations have been used, for example, and all have their pros and cons.

To cope with global imbalances, institutional changes are needed to strengthen the international adjustment process. For example, more formal currency blocs could be established, in which exchange rates are relatively freely floated against each other. Other more informal cooperative solutions can also be discussed, with a view to avoiding circumstances that may lead to systemic disruptions.

Discussion on the background paper prepared by BIS Asian office

In the morning session, the BIS Asian office raised and discussed important research issues. They included the new monetary policy framework, the exit strategy, financial instability, and foreign reserves and international cooperation among others. These cover a substantial portion of what many of us are concerned about, although there are some remaining issues that need to be elaborated on and thought out further.

New monetary policy framework

The BIS has emphasised the extended role of central banks. As we have seen through the global financial crisis, central banks are called on to deal with crises. But this gives rise to new concerns and questions: is there a risk that the independence of central banks will be weakened by their enhanced role in crisis management weakening? How can we deal with private sector moral hazard problems? What would be the best institutional arrangement between the central bank, the government and the regulatory authorities? These concerns and questions need to be appropriately addressed.

Regarding the inflation targeting regime, I think it should not be abandoned altogether. Abandoning IT would have a negative impact on inflation expectations and ultimately on central bank credibility. What we need is a better communications strategy, to help the public understand that our pursuit of other goals in the short run does not mean that we are ignoring price stability in the long run. Equipped with this better communications strategy, we can pursue multiple objectives.

Central banks may also need new monetary policy instruments, given that it may not be sufficient simply to manipulate short-term interest rates in order to prevent and/or deal with credit expansions and asset price boom-bust cycles. Here as well questions naturally arise. What are the alternatives? Can the central bank's bill be used as a new liquidity control measure? Should interest be paid on reserves? Or should the reserve requirement be asset-based? Furthermore, before employing any new instruments, we need to know how to

implement these alternative measures. We should also consider whether they are at odds with the conventional monetary policy tool, ie adjustment of short-term interest rates.

Exit strategy

How and when we signal our exit may be crucial because this influences the way that agents form expectations. The exit sequence – interest rates first or liquidity reduction first – also matters. It is also necessary to assess how the reversal of the monetary policy stance will affect the financial strength of households and financial firms, given that their balance sheets are still weak. The balance sheets of central banks are also at risk, mainly due to the huge size of our rescue programs. After taking all these factors into account, the speed of exit also has to be calibrated.

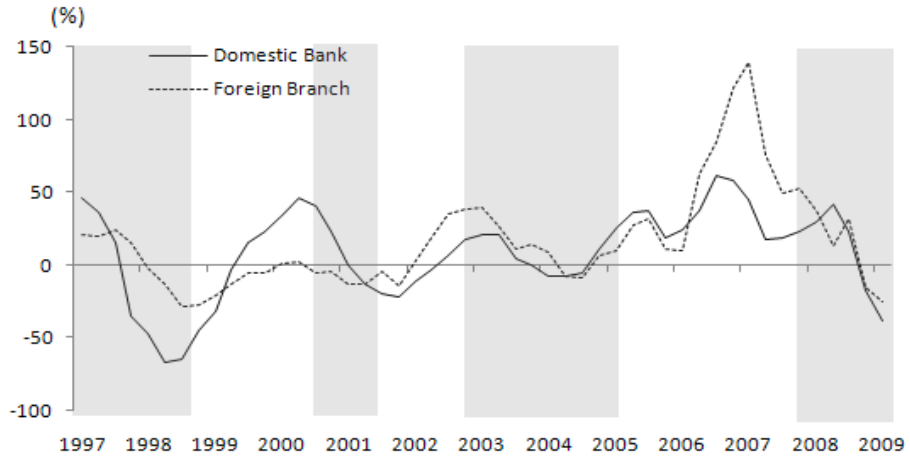
Financial instability and foreign reserves

Since the Asian financial crisis, EMEs have amassed great volumes of foreign exchange (FX) reserves. It is well appreciated that FX reserves serve as a self-insurance against the adverse side effects of deeper financial integration of EMEs (Aizenman and Lee (2005), Rodrik (2006)). However, the maintenance of excessive FX reserves has its own costs. In order to reduce the incentives for increased accumulation of FX reserves, enhancement of international cooperation alone may be insufficient. Other measures such as the strengthening of prudential regulations and the promotion of currency internationalisation are also necessary.

In EMEs, macro-prudential regulation should be extended to external sectors because they tend to generate procyclicality (Kaminsky et al (2005)). In Korea, short-term debt accumulation by the banking sector has shown strong procyclicality (Graph 3).

Graph 3

Growth of short-term external debt in Korea's banking sector



Note: Compared with the same period of the previous year

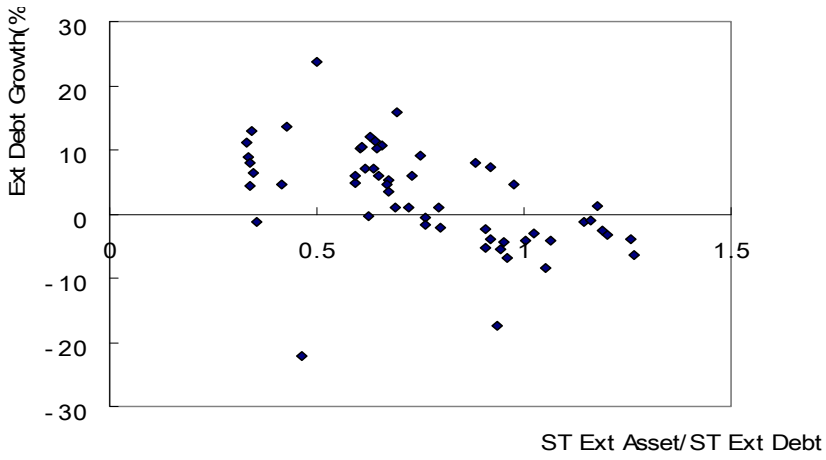
Source: BOK ECOS

Furthermore, the negative association between external debt growth and the ratio of short-term external debt to short-term external assets in the banking sector suggests that the risks of currency and maturity mismatch are positively correlated and should be considered as key vulnerabilities in Korea (Graph 4). This is the so-called 'capital inflow problem' (Kaminsky et

al (2005)). As strengthened microprudential regulation cannot prevent the capital inflow problem, macroprudential regulation in this area has to be introduced.

Graph 4

Banking sector's external debt growth and maturity mismatch



Note: Compared with the same period of the previous year

Source: BOK ECOS

Finally, I would like to add several possible issues for future consideration: how to suppress excessive external borrowing without dampening financial deepening; how to prevent exchange rates from acting as a financial accelerator; and, finally, how to minimise regulatory arbitrage among countries for cross-border capital flows.

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