# Comments on Joseph Gagnon's paper "Global imbalances and foreign asset expansion by developing-economy central banks"

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Let me start by thanking the Bank of Thailand and the BIS for organising this conference, and for giving me the opportunity to participate. I would also like to thank Dr Gagnon for his paper and discussion on some of the global implications of foreign asset expansion by emerging-market central banks.

What I like about Dr Gagnon's work is its emphasis on underlying distortions. Current accounts, as we know, are fundamentally endogenous, reflecting the net outcome of a raft of savings and investment decisions taken by households, businesses and government across the whole economy. Similarly, behind the capital (or financial) account is a large array of gross capital flows reflecting decisions taken by both domestic and foreign investors. The current account position reflects the aggregate outcome of all these decisions. If one is concerned about an imbalance, the focus should be on the distortion that creates it. Importantly, however, a balanced current account does not imply an absence of distortions.

Take Australia for example. Prior to the float of the Australian dollar in 1983, the current account deficit generally moved in range of 0 to 3 per cent of GDP. Following deregulation of the financial system, dismantling of protection and floating of the exchange rate, however, the current account deficit has increased and now tends to move in a range of 3 to 6 per cent of GDP. Similarly, Europe's balanced current account position does not necessarily imply an absence of distortions.

For Australia, deregulation and floating the currency have been beneficial. Notwithstanding some significant transitional difficulties, the move away from using direct controls to implement monetary policy to a system based on market operations has given Australia greater scope to manage its economy. The exchange rate bears the brunt of the adjustment to external shocks, freeing up domestic monetary policy to meet domestic objectives.

Looking back over the past thirty years, it has done this. The system has been reasonably tested by the financial crisis of the late 1990s, and the more recent North Atlantic crisis. Australia has also experienced a doubling in its terms of trade over the past decade. But growth has been steady, and inflation generally well behaved.

At the same time, deregulation has resulted in improvements in the operation of the financial system. Once regulations were removed, the financial sector eventually became not only more efficient but also more responsive to the financial needs of the economy. New financing techniques and markets developed, resulting in a more diversified and resilient financial sector.

The ability to hedge foreign-currency liabilities has been very significant in terms of minimising the risks of floating the Australian dollar and helping businesses manage a sometimes volatile exchange rate. Fledgling currency-futures markets (including an active non-deliverable forward market) existed prior to the float, but floating the exchange rate was

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always going to be a precondition for these markets to develop in any meaningful way. Importantly, these things came *after* the event rather than before.

I relay this story because while we are discussing the global implications of foreign asset expansion, the solutions are essentially national. The case for a change in exchange rate arrangements has to be made domestically. So how might that case be made?

It rests on a number of propositions:

1. The first proposition is that the allocative efficiency of the economy (as opposed to productive efficiency) can be improved by bringing prices closer to marginal costs, allowing the products that consumers want to buy to be sold, and improving the allocation of investment. An undervalued exchange rate results in countries being overly reliant on goods and services produced in the trade-exposed sector, relative to those produced in the non-traded sector. It is essentially a wealth transfer from consumers and businesses that use imported inputs to exporters and the import-competing industries.

   It leaves countries particularly vulnerable to external developments and promotes a banking sector which is overly focused on the export sector. This results in a short-term focus, to the detriment of the maturity transformation of the household sector's financial assets. Credit rationing may also occur outside the trade-exposed sector.

   The allocative efficiency benefits can be measured, though inevitably this has to be over long periods. In Australia, for example, while average growth in GDP has been remarkably constant over a number of decades, the standard deviation of that growth is now one third what it was in the decade prior to the float of the currency. While this trend is evident elsewhere, the movement is sizable, and it has occurred at a time when the industry make-up of the economy has changed markedly.

2. The second proposition is that private capital flows can be viewed as a positive. It's not surprising that the experience of extremely volatile capital flows in the late 1990s plays in the mind of policy makers in the region. As a result, decision makers need to feel comfortable that there will not be a repeat of that episode (possibly with the direction reversed).

   The argument is that greater exchange rate flexibility offers an important buffer against the risks posed by large capital inflows, as it can reduce the contribution to domestic demand overheating from large capital inflows, can curb expectations of a large step appreciation, and can lessen the need for foreign exchange intervention.

   The considerable development of local currency yield curves in the region over the past decade has given countries a greater capacity to manage the risks around these flows by providing a basic building block for development of the forward foreign exchange market, which in turn can facilitate borrowing from non-residents in local currency. The yield curve also promotes the appropriate pricing of risk by providing a long-term risk-free interest rate, and it enables governments to borrow long term to fund infrastructure.

   In Australia's experience, this cannot be done overnight. It usually means a gradual re-weighting of the three main means of managing capital flows – capital controls, reserve accumulation and movements in the exchange rate.

3. The third proposition is that the implementation of monetary policy may well be compromised should the accumulation of foreign assets continue. That is, there may well be limits to how much sterilization can be undertaken. Given the very large accumulation of foreign exchange reserves in the region over the past decade, the sterilization effort has been reasonably successful, to the extent that the standard transmission from foreign exchange asset accumulation to reserve money growth to inflation does not seem to have operated. Thus the emerging Asian economies have

been able to adopt intermediate exchange rate regimes while retaining some degree of monetary autonomy, even as greater financial openness was achieved. Sterilisation has been aided in no small part by the ability of central banks to issue their own securities, and by overfunding budgets and placing government deposits at the central bank.

But is it sustainable? At the extreme, banks will only hold central bank liabilities (a number of central bank balance sheets in the region are already in excess of 50 per cent of GDP). Even leaving this aside, the build-up in high-quality, relatively low-yielding liquid assets comes at a cost to banks, which they in turn pass on to customers. This leads to growth in financial intermediation outside of the regulated sector. It also means that banks are cashed up, ready to lend once the demand for credit increases. This could quickly lead to unstable financial conditions that promote excess credit expansion, rapid asset price growth, and eventually financial instability.

A more ominous development is the financial narrowing that occurs within the financial sector as the central bank *becomes* the short-term money market and creates a dependency that is hard to wean institutions off. This stifles the development of a true risk-based market that responds to price signals, and increasingly influences the term structure of interest rates. The risk of re-regulation going too far is also a risk.

4. Finally, there is a fiscal cost associated with the build-up of foreign exchange assets which is potentially very large given the size and un-hedged currency exposures of the relevant central banks. This cost, which can be quantified, has the potential to produce large swings in the public sector's net worth.

Underpinning all of this, of course, there needs to be a plan.

Even though the intellectual climate within the Reserve Bank and other economic policy agencies was already moving in favour of deregulation in the early 1970s, wider community acceptance of the case for change did not come until after the Government set up a broad-ranging inquiry, conducted by a group of independent experts. This was important in harnessing public and community support for change. Its guiding philosophy (and that of the subsequent Martin and Wallis reports) was a stable, better-informed and fairer financial system, yet one that is adequately flexible and responsive to changing needs and conditions.

It gave everyone an idea of where the reforms were headed, as the process can take a long time to implement, since controls are typically removed sequentially. While it is possible to take a 'big bang' approach and remove many regulations simultaneously, such a process can be difficult to manage. In Australia's case, it was not regarded as feasible to remove regulations simultaneously, mainly because of uncertainty about the consequences, and in fact the process of deregulation started in the early 1970s.

While public inquiries had mapped out a range of reforms that needed to be introduced, the sequencing of these reforms was determined in a pragmatic way, in response to unfolding events and the consequences of previous reforms. The plan guided policy responses as the consequences of reforms are not always entirely predictable. Australia's experience was that the removal of one set of controls often put pressure on other controls. This meant that the reform process, once it had begun, developed its own momentum.

As Keith Campbell, the author of the original plan, said: you never make the right decision, you just take a decision and make it the right one!

Thank you.