Opening remarks

Arthur Yuen[1]

Good morning ladies and gentlemen. It is my great pleasure to welcome you to this one-and-a-half-day conference, jointly organised by the Bank for International Settlements (BIS) and the Hong Kong Monetary Authority (HKMA). I would especially like to thank our international guests, who have travelled a long way to be with us today.

The annual research conference of the BIS's Asian Office showcases high-quality papers resulting from the collaborative efforts of leading academics and BIS economists. The HKMA is honoured to host this important and interesting event and we would also like to take the opportunity to present our own work and to participate in the discussion.

The theme of today's conference is "The price, real and financial effects of exchange rates". Since the collapse of the Bretton Woods System of fixed exchange rates in the early 1970s, the importance of understanding exchange rate movements and their international spillovers has increased enormously. Cross-border trade and capital flows have surged in recent decades, driven by globalisation and capital account liberalisation.

In line with these trends, our understanding of the role and nature of exchange rates has evolved substantially since the 1970s. Exchange rates were initially thought of as reflecting and responding to changes in macroeconomic fundamentals, such that they act as a buffer when external shocks hit the economy. Through this lens, the exchange rate was initially perceived to be like an automatic stabiliser, responding and adjusting to external shocks and imbalances, rather than itself being a source of instability. Unfortunately, we have since repeatedly seen wild swings, herding behaviour and persistent misalignments of exchange rates. These experiences, together with numerous currency crises, ranging from speculative attacks against Asian currencies in 1997 to the collapse of the Icelandic krona in 2008, have led to a re-think of the nature and role of exchange rates, away from being just a shock absorber.

The idea that the exchange rate itself can be a source of exogenous and destabilising effects on the economy means that it is also important to understand how exchange rate movements are transmitted to the real economy, and with what results. In the rapidly changing global macro-financial environment, our thinking on the transmission channel and effects of exchange rates has indeed evolved from the relatively simplified perspectives of impact through trade, capital flows and uncovered interest parity (reflecting interest rate differentials) to the recent more sophisticated view of transmission through financial channels, for example, through balance sheet effects and risk-taking behaviour.

Today, the increasingly integrated global financial markets, abundant global liquidity since the Great Financial Crisis (GFC), and large and volatile international capital flows mean that our understanding of such financial transmission channels is particularly important for thinking about the macro-financial vulnerabilities that have

[1] Deputy Chief Executive, Hong Kong Monetary Authority.

built up in recent years. We should also try to better understand the benefits of using prudential measures to address at least some of those vulnerabilities, particularly in emerging Asian economies.

Following the GFC, Asian emerging market economies (EMEs) have seen large capital inflows and currency appreciation as well as a rapid build-up in leverage and credit. To what extent do these financial imbalances have the effect of loosening domestic financial conditions, for example, through the balance sheets of borrowers with foreign currency liabilities? This would have implications for how far the eventual capital outflows and the associated currency depreciation might amplify the unwinding of leverage and credits in the region.

If large capital outflows eventually lead to volatile exchange rate movements, then is there a role for some form of policy action, be it prudential measures, capital controls or foreign exchange market interventions that could mitigate both the build-up and the unwinding of imbalances? Answers to these questions would carry significant economic and policy implications in the face of current global economic challenges. At this 10th anniversary of the GFC, and with global financial conditions beginning to normalise, this conference provides a timely opportunity for policymakers to think about our understanding of the role of exchange rates as well as the potential policy challenges.

Ladies and gentlemen, I believe we all agree that there are many important and challenging issues to be discussed at this conference. I am sure everyone is looking forward to the presentations and the dialogue during the policy panel session tomorrow. I hope that this conference will contribute useful insights, and wish you all very fruitful discussions in these two days. Thank you.