Exchange Rates, Interest Rates and the Coordination Problem for the International Monetary System

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Outline

• Coordination needs to be defined
  - different situations
  - long-term solution vs short-term dynamics
  - resulting equilibrium? which ‘game’?

• IMS: example of coordination game

• Preliminary results from work in progress
**IMS: the ‘official’ definition**

A set of rules and conventions framed by institutional arrangements that maintains orderly exchange rate arrangements and provides a multilateral system of payments, while maintaining macroeconomic stability.

**IMF Article IV, Section 1:**

“The essential purpose of the International Monetary System (IMS) is to provide a framework that facilitates the exchange of goods, services and capital among countries”
## Comparison of IMS: Past & Present

<table>
<thead>
<tr>
<th></th>
<th>Bretton Woods System</th>
<th>Current International Monetary System</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Format</strong></td>
<td>Set of rules</td>
<td>Informal</td>
</tr>
<tr>
<td><strong>Exchange Rate Regime</strong></td>
<td>USD/Gold</td>
<td>Major Currencies Float except euro - internally fixed EMEs Pegged ‘Dollar-Standard’ in developing countries</td>
</tr>
<tr>
<td><strong>Capital Flows</strong></td>
<td>Restricted</td>
<td>Open for developed countries Semi-restricted for EMEs</td>
</tr>
<tr>
<td><strong>International Liquidity</strong></td>
<td>Limited Provision by link to USD/Gold</td>
<td>Liberalisation International Capital Markets and Credit Growth</td>
</tr>
<tr>
<td><strong>Adjustment Scheme</strong></td>
<td>Automatic adjustment of external imbalances</td>
<td>Adjustment through prices or quantities (in theory)</td>
</tr>
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</table>
How Will the IMS Look Like?

• Almost consensus on multicurrency system with three reserve currencies: USD, EUR and RMB

2011 Mar. 31st, G20 Finance conference, Nanjing, China

“The SDR basket should also include the RMB.”
- Nicolas Sarkozy, French President

“Global monetary reform was a ‘long and complex process’ that could only be explored and implemented gradually.”
- Wang Qishan, Chinese Vice-Premier

“Currencies should only be included in the SDR basket if their countries had flexible exchange rates, independent central banks and allowed free movement of capital flows.”
- Tim Geithner, US Treasury Secretary
United States & Euro-Zone

**US Today**
- World’s largest economy
- Issuer of the key reserve currency
- Dollar as ‘safe haven’
- Developed and open capital markets
- ‘Strong Dollar’ vs ‘Benign Neglect’
- Monetary policy target: price stability and growth

**Implications**
- Unconstrained stimuli to domestic demand
- Borrowing from RoW

**Implications**

**Eurozone Today**
- World’s 2nd largest regional economy
- Euro as the second major reserve currency since inception
- Sovereign debt crisis, unbalanced economic development within the EU zone.
- Monetary policy target: price stability

**Implications**
- Fixed and float needs some managing
- Common monetary policy, independent fiscal policy
- Governance issues
Emerging Currency: Chinese Yuan

China Today

- World’s 2\textsuperscript{nd} largest economy
- Capital control – \textit{limited convertibility of capital account}
- \textit{de facto} exchange rate target
- Booming economic growth yet with an immature capital markets
- Excess savings and domestic rebalancing

Implications

- Large current account surplus, but narrowing
- Unconstrained accumulation of FX reserves
- Limited debt issuance
- Mismatch on international balance sheet
- Inflationary pressures
- Constrained monetary policy
In the Meantime, however,

- Low interest rates in the developed world induce ‘hot money’ flows to EMEs and ‘safe havens’

- EMEs: heavy interveners

- A near-zero interest rate liquidity trap with a weak dollar

- Fiscal sustainability problems

**Implications**

- Welfare loss
- Race-to-the-bottom
- Unstable equilibrium (non-Nash)
Policy Interest Rates – Major Advanced Economies

Source: Various Central Banks  *US – Fed funds rate (effective)
**G20 Currencies and Capital Account Openness**

**Over/under valuation of G20 currencies**
JP Morgan real broad exchange rate indices, valuation against long-term (1990-2010) average (%)

<table>
<thead>
<tr>
<th>Country</th>
<th>Pre-crisis</th>
<th>Latest</th>
</tr>
</thead>
<tbody>
<tr>
<td>Brazil</td>
<td>-10</td>
<td>-15</td>
</tr>
<tr>
<td>Indonesia</td>
<td>3</td>
<td>5</td>
</tr>
<tr>
<td>Russia</td>
<td>5</td>
<td>3</td>
</tr>
<tr>
<td>Australia</td>
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<td>1</td>
</tr>
<tr>
<td>China</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>South Africa</td>
<td>-2</td>
<td>-3</td>
</tr>
<tr>
<td>Turkey</td>
<td>-4</td>
<td>-5</td>
</tr>
<tr>
<td>Mexico</td>
<td>-6</td>
<td>-8</td>
</tr>
<tr>
<td>Saudi Arabia</td>
<td>-8</td>
<td>-10</td>
</tr>
<tr>
<td>Euro</td>
<td>-10</td>
<td>-12</td>
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<tr>
<td>Japan</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>India</td>
<td>2</td>
<td>3</td>
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<tr>
<td>Canada</td>
<td>5</td>
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<tr>
<td>US</td>
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<tr>
<td>UK</td>
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<td>3</td>
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<tr>
<td>S Korea</td>
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<td>Argentina</td>
<td>5</td>
<td>7</td>
</tr>
</tbody>
</table>

**Measurement of degree of capital account openness**
2008, index

- UK: 2.5
- Japan: 2.0
- US: 2.0
- Mexico: 1.5
- Indonesia: 1.0
- Brazil: 1.0
- Turkey: 0.5
- Russia: 0.5
- Argentina: 0.0
- China: 0.0
- India: 0.0

Source: Financial Times, 10th November 2011
China’s Policy Response

Current Issues:
• The ‘dollar-standard’
• Concentrated supply of liquidity
• Unbalanced intermediation opportunities
• Excessive savings
• Excessive FX reserve accumulation

Responses:
• Further development of domestic capital markets
• Internationalisation of RMB
• Rebalancing growth
• Gradual opening of the capital account, yet depending on China’s domestic economic development
• Multi-currency system, enhanced role of SDR in IMS
Emerging Currency: Chinese Yuan

• Increasing RMB Usage for Cross-border Trade Settlement

• RMB Off-shore Market
  Hong Kong, the first and largest RMB offshore market
  Introduction of R-QFII Scheme in 2011 Q4
    • RMB-QFII scheme: to allow foreign investors to buy mainland stocks and bonds using yuan raised offshore
    • Only HK local institutional investors are permitted to use the quota to invest yuan raised through the local capital market in mainland stocks and bonds.
    • During the experimental stage, 80% of the 20 billion RMB-QFII quotas will be allowed to conduct investment in the mainland Singapore, Taipei, and London in the future
Increasing RMB Usage for Cross-border Trade Settlement

Spurred from 1% to 7% of the total international trade settlement within 12 months

Sources: PBoC, 2011.July
Conclusions (provisional)

• Debate on IMS should focus on transition and adjustment

• Policy attention to interest rates as well as to exchange rates

• Coordination problems: trap of non-Nash equilibrium
  - Trade-off between output target and the objective of exchange rate stability
    • Financial Stability Risks
    • Political Costs

• Pre-commitment arrangements to maintain coordinated equilibrium
Thank You

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