



# **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

## Bretton Woods System

## Current International Monetary System

	Bretton Woods System	Current International Monetary System
<b>Format</b>	Set of rules	Informal
<b>Exchange Rate Regime</b>	USD/Gold	Major Currencies Float <i>except euro - internally fixed</i> EMEs Pegged <i>'Dollar-Standard' in developing countries</i>
<b>Capital Flows</b>	Restricted	Open for developed countries Semi-restricted for EMEs
<b>International Liquidity</b>	Limited Provision by link to USD/Gold	Liberalisation International Capital Markets and Credit Growth
<b>Adjustment Scheme</b>	Automatic adjustment of external imbalances	Adjustment through prices or quantities <i>(in theory)</i>

# How Will the IMS Look Like?

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

**2011 Mar. 31<sup>st</sup> , 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

## 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<sup>nd</sup> largest economy
- Capital control – *limited convertibility of capital account*
- *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,**

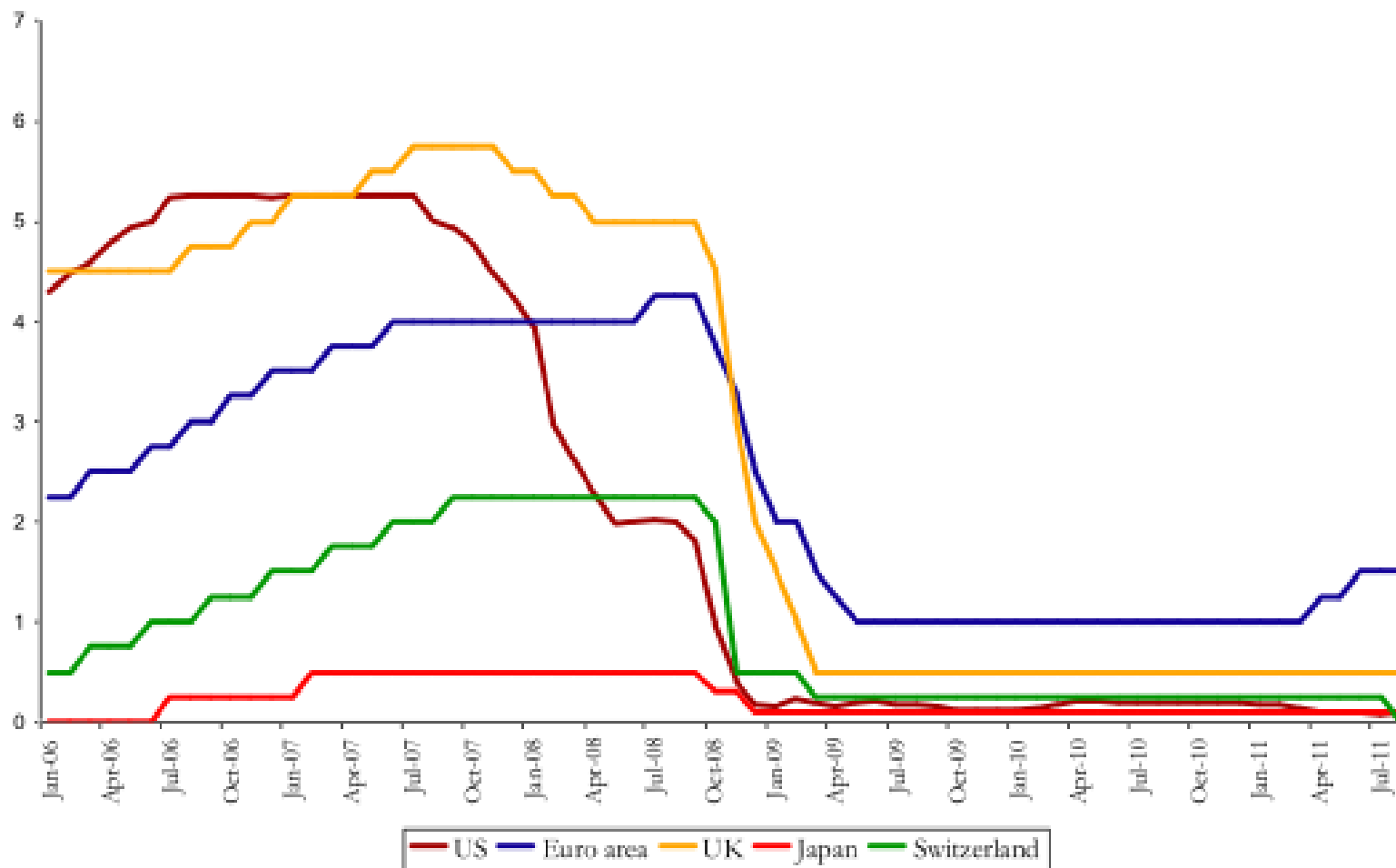
- Low interest rates in the developed world induce 'hot money' flows to EMEs and 'safe havens'
- EMEs: heavy interveners
- A near-zero interest rate liquidity trap with a weak dollar
- Fiscal sustainability problems

### **Implications**

- Welfare loss
- Race-to-the-bottom
- Unstable equilibrium (non-Nash)



# Policy Interest Rates – Major Advanced Economies

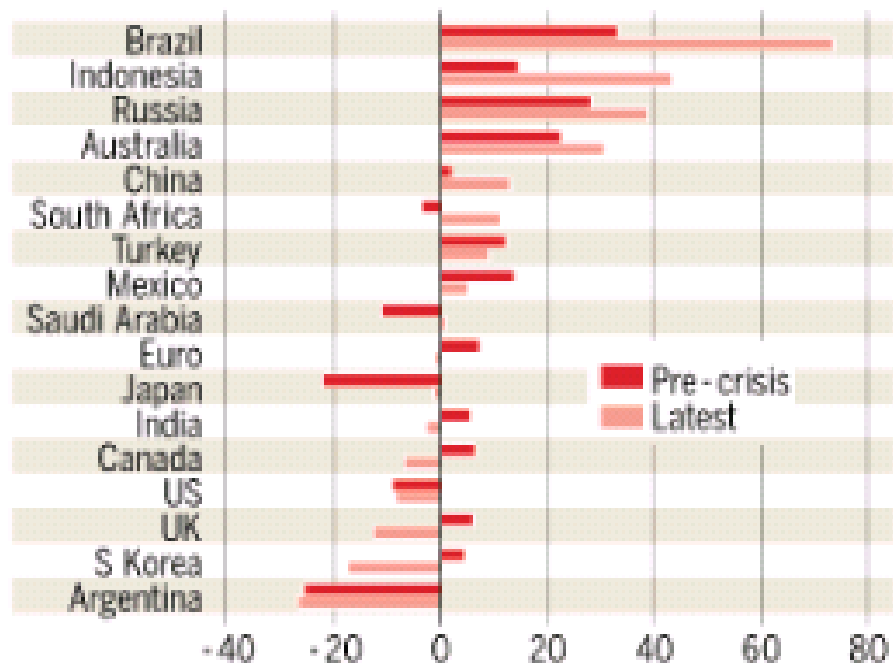


Source: Various Central Banks \*US – Fed funds rate (effective)

# G20 Currencies and Capital Account Openness

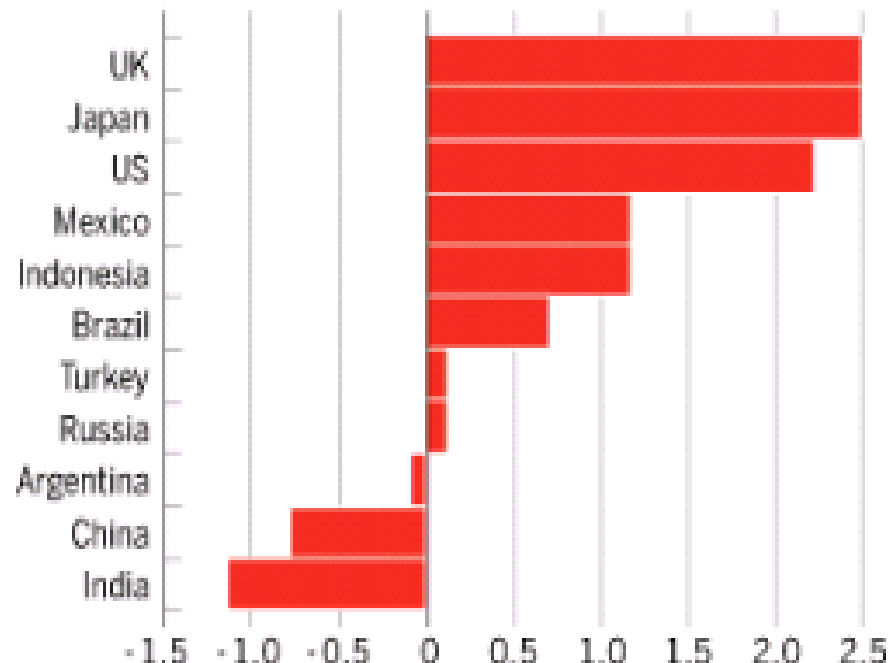
## Over/under valuation of G20 currencies

JP Morgan real broad exchange rate indices, valuation against long-term (1990-2010) average (%)



## Measurement of degree of capital account openness

2008, index\*



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

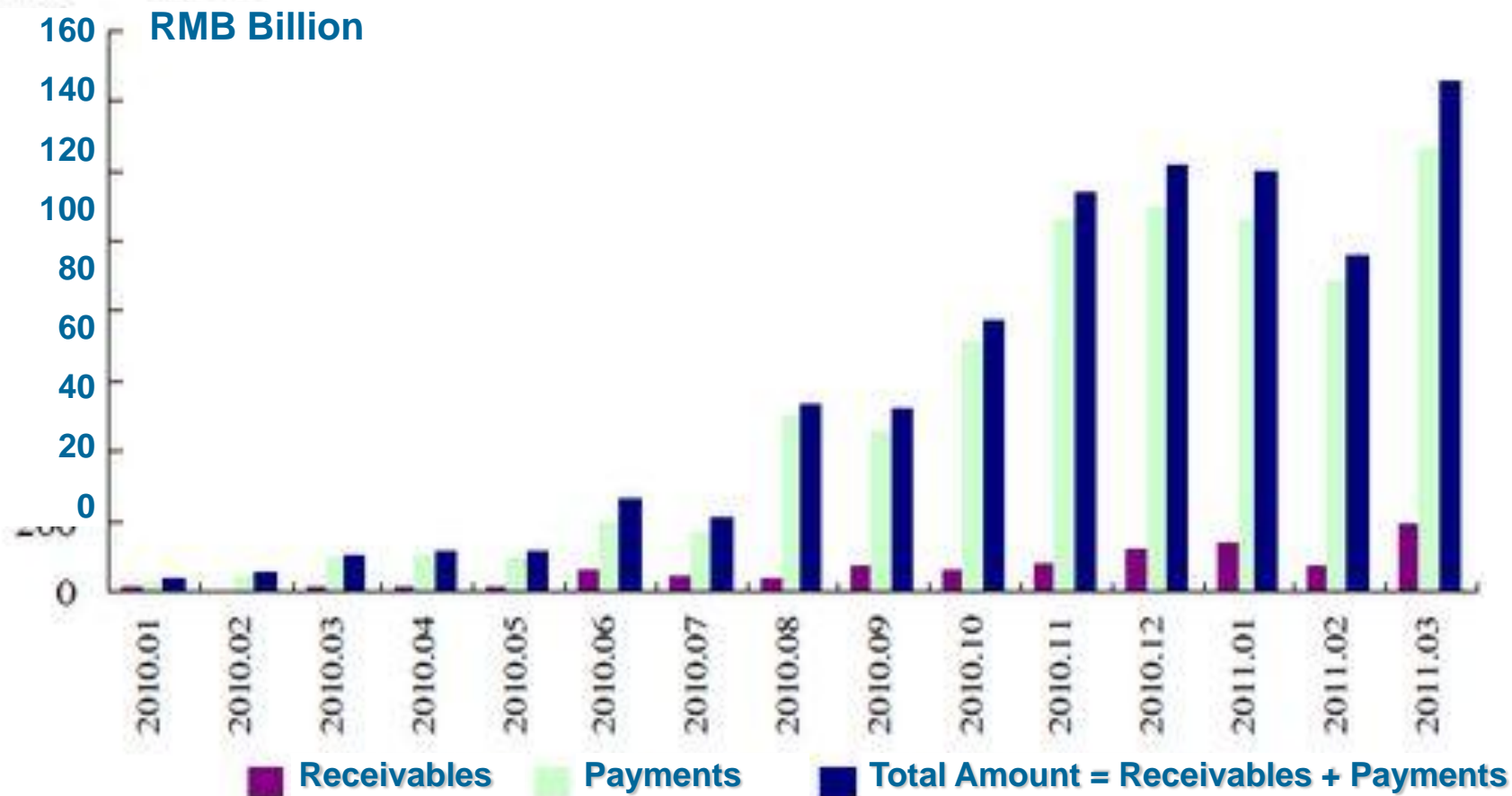
Introduction of R-QFII Scheme in 2011 Q4

- 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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