Exchange Rates and Financial Globalization

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Introduction

Two contradictory recent views of monetary autonomy in small open economies:

–The open economy is qualitatively no different from the closed economy, provided the nominal exchange rate is flexible.

–Small economies have no monetary autonomy, regardless of the exchange rate regime, due to the effect of financial cross-border flows. Large countries' monetary and financial shocks dominate the global monetary environment.

"Taper tantrums" of 2013 highlighted role of volatile capital flows for EMEs.

The Classic Monetary Trilemma

The following three are not all mutually compatible:

1. Fixed exchange rate.
2. Unimpeded cross-border financial flows.
3. Monetary autonomy.

Bretton Woods made US exceptional.

Floating was supposed to bring symmetry, "insulate" economies, and free monetary policy (Milton Friedman, Harry Johnson).

But Life Turned out to Be Complicated

- Charles Kindleberger summarized well in his 1970 response to Johnson at the Boston Fed's Cape Cod conference:
- "Along with one more instrument – the exchange rate – there is one more target – the exchange rate."
- And don't even mention financial stability (FS)!
- Given current realities – does it follow that floating rates confer no monetary autonomy?

So, How Does Monetary Policy Work?

Not infrequently we hear central bankers say something like: "We have only one instrument, money growth (or the interest rate), and so we can have only one target, inflation." This view may be based on the targets and instruments approach of Tinbergen, of over fifty years ago, the general result of which was that you need as many instruments as targets. That view is correct if you have to hit the target exactly.

But it is not correct if the problem is set up as is typical in microeconomics, where the goal is to maximize a utility function subject to constraints, in a situation where for whatever reason it is not possible to hit all the targets precisely and all the time. Among the reasons we may not be able to hit our targets precisely and all the time is that there may be more targets than instruments, for instance when the central bank's maximand is a function of output and growth. In that case we have to find marginal conditions for a maximum, and to talk about tradeoffs in explaining the optimum.

Stanley Fischer, "Myths of Monetary Policy," *Israel Economic Review*, 2010.

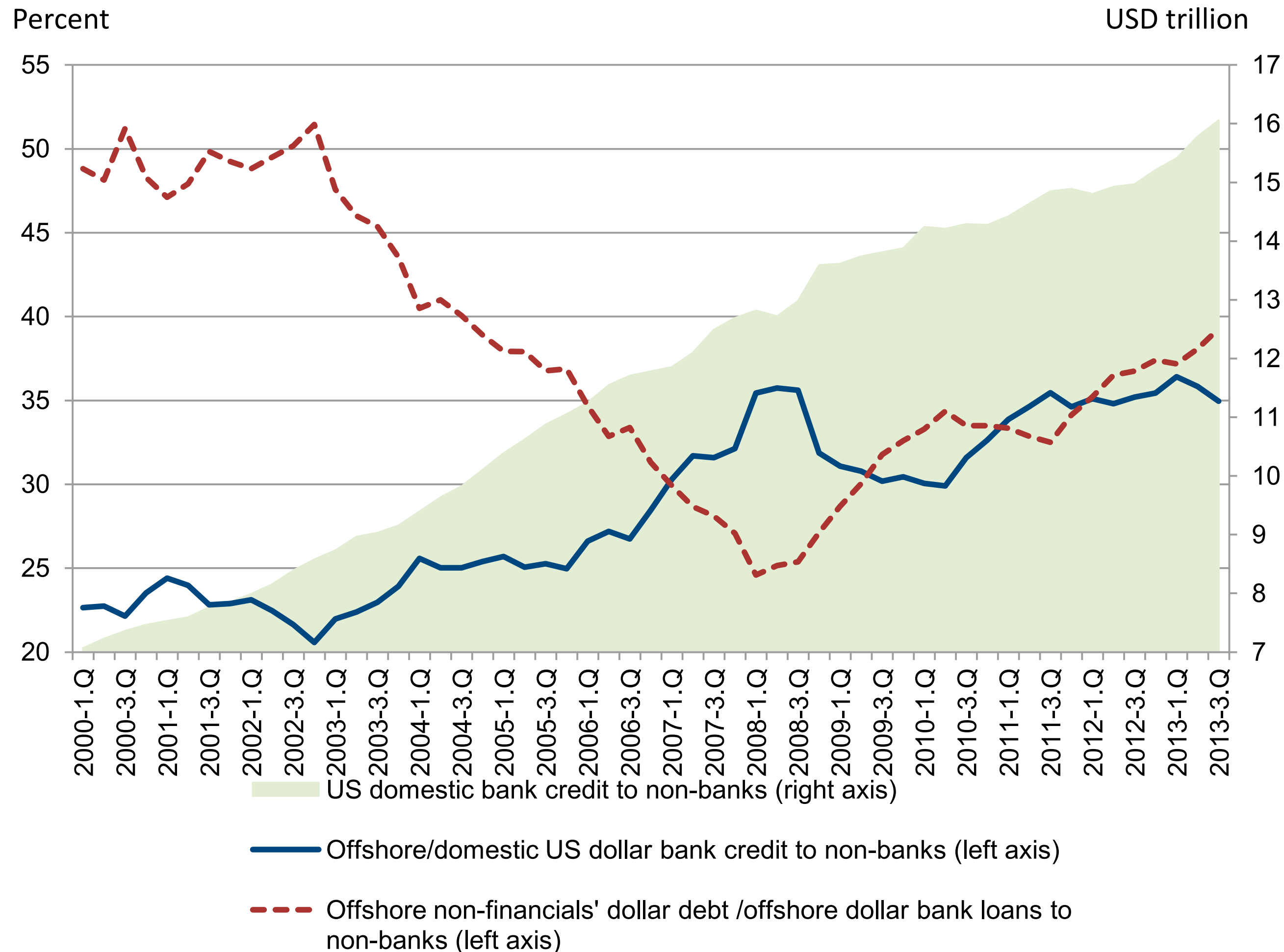
One Monetary Instrument, Many Goals

- With targets > instruments, not all targets will be hit.
- Attained level of "social welfare" depends on position of the short-run equilibrium tradeoff between targets (e.g., a short-run Phillips relationship).
- Economic openness → gains from trade, but also can worsen some policy **tradeoffs**.
- Even optimal exercise of "monetary autonomy" may leave the economy farther from policy bliss point than if more instruments were available.
- But fixed exchange rate "corner solution" is worse.

Recent Concerns Focus on a Broader Range of Transmission Channels - with FS Implications

- Cross-border bank lending can relax quantitative credit constraints, undermine domestic credit control.
- There is a "global financial cycle" (Borio; Rey)
- If agents hedge foreign dollar credits, covered interest parity → same cost as domestic-currency loans.
- But they may choose not to → carry trades.
- Domestic-currency bond markets have developed in EMEs but in many cases remain thin – vulnerable to shifts in foreign demand (Shin 2013), and could conceal off-balance sheet currency mismatches.
- Direct LT interest rate arbitrage.

Offshore Dollar Bank Credit and Debt



Source: BIS, Global Liquidity Indicators

Exchange Rates Don't Cleanly Offset Financial Shocks

- Imagine a portfolio shift toward an EME's assets.
- Even if central bank does not intervene, and currency appreciates, domestic balance sheets may improve.
- Even at a constant current account balance and exchange rate, there can be offsetting *gross* position changes – e.g., corporates borrow and place funds abroad. Implications for FS, resilience.
- Portfolio shifts can show up in other prices along with exchange rate, such as corporate borrowing spreads, which fall with global liquidity/"risk on" conditions.
- We need more/better **general-equilibrium** models.

So Monetary Autonomy *Is* Exercised …

- … but if capital account openness makes the FS problem harder to manage, and if additional prudential policy instruments are unavailable, monetary policy will deviate more from its other targets at an optimum.
- I will argue that **financial openness inevitably challenges prudential tools**.
- So tradeoff for policy is worse … even if monetary policy is potentially effective.

Why is FS Policy Harder in Open Economies? The *Financial* Trilemma is a Useful Framework

The following three are not all mutually compatible (Schoenmaker 2013):

1. Financial stability.
2. Nonintervention in cross-border financial flows.
3. National control over financial supervision and regulation.

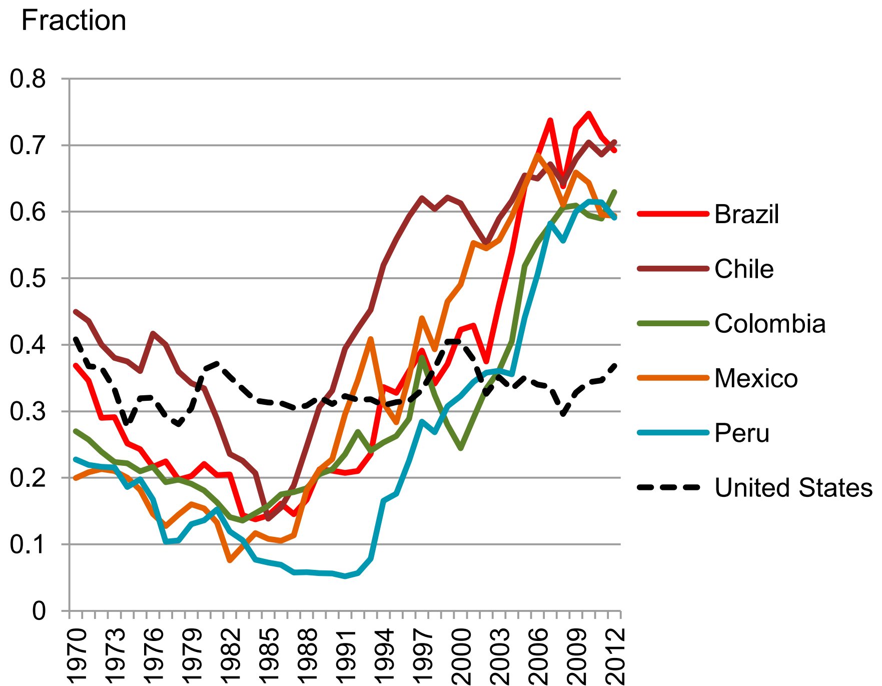
<u>Note</u>: Valid *under any exchange-rate regime*.

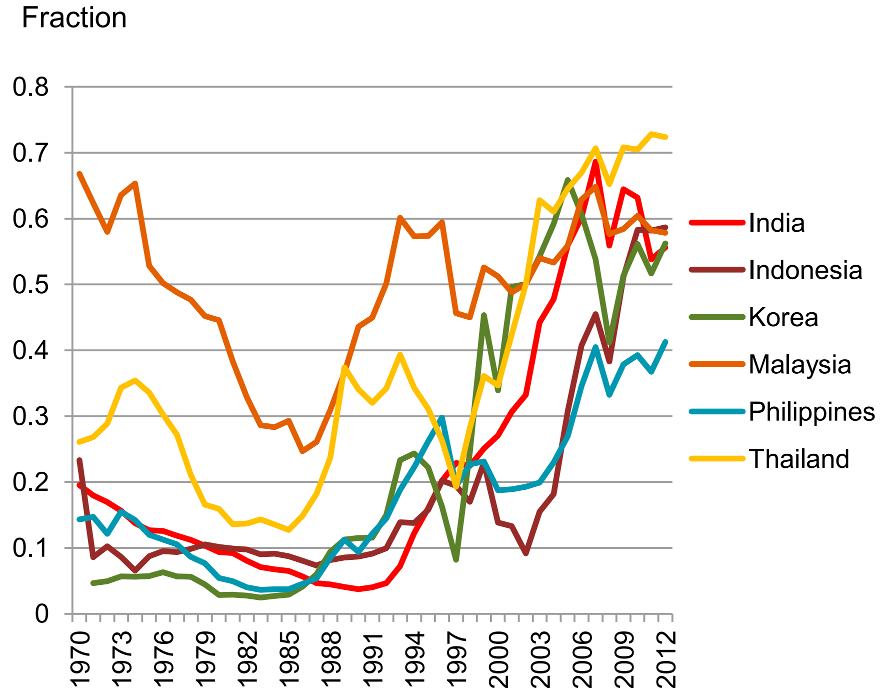
Resolving Trilemmas and Improving Tradeoffs

Ingredients of a more efficient international system:

1. Flexible exchange rates (to resolve monetary trilemma).
2. Sound domestic macroprudential policies (addressing inadequacy of monetary policy alone).
3. More international coordination of regulation/resolution.
4. Including: more reciprocity, as in Basel III CCB rules.
5. Domestic regulatory control over large FBOs, as we have done in US.
6. Since full coordination politically impossible, rules of road for capital controls, if they are at times needed to address nation-specific issues.
7. Enhanced facilities for international liquidity support in key currencies – to counteract downsides of gross reserve accumulation.
8. More equity, less debt – well underway for EMEs.

Remember the Upside of Financial Integration





J-curve of external equity liabilities relative to total external liabilities

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