The Other Side April 14, 2016

"The Global Monetary Non-System" - II

In the last week's article, I had summarised the views of the Reserve Bank Governor on how the unconventional monetary policies (UMPs) are aimed at using "*exchange rate* (as)… *the primary channel of transmission"* to the global economy. He therefore feels the need for an organisation like the International Monetary Fund to monitor such policies. The missing link is that the transmission to exchange rates takes place through cross-border capital flows. The IMF has made some changes in its "institutional view" on capital controls and exchange rates recently, but these are mostly cosmetic.

The bigger issue is whether monetary policy can determine or influence in a consistent fashion the external value of the domestic currency, in an era of liberal capital flows. The pioneering attempt to analyse the issue was made by Rudiger Dornbusch (1976). To quote Kenneth Rogoff (2002), former Economic Counsellor and Director of IMF's Research Department:

*"Dornbusch's 1976 paper became an instant classic because it seemed to make sense of the chaotic new world of flexible exchange rates…. In Dornbusch's view, excessive exchange rate volatility was the inevitable result of the chaotic monetary policies. If domestic monetary policies are unpredictable, then so, too, will be domestic inflation differentials. Ergo, the exchange rate must be volatile because, in the very long run, there has to be a tight link between national inflation differential and exchange rates…".*However, *"Whereas the over-shooting model is a landmark theoretical achievement, it is an empirical bust, at least as far as it concerns exchange rates among the United States, Japan, and Europe (known as the Group of Three, or G-3). The most obvious observation is that monetary policy in the G-3 is far more stable today than it was in the mid-1970s after the first oil crisis…Yet the volatility of G-3 exchange rates has dropped only marginally since the 1970s.... Where is the windfall that we were supposed to reap by restoring global monetary stability? .... there is some tendency for a country's real exchange rate (the nominal exchange rate adjusted for differences in relative national price levels) to return to its historical value. But* ***the adjustment is very slow indeed. All empirical evidence suggests that one must think in terms of several years, not several months, for the pull of purchasing power parity to kick in."***

The situation has not changed since 2002, with the yen appreciating from JPY 135 to two-digit level before the financial crisis, when Japanese interest rates were much lower than in the US. More recently, after the December 2015 rise in USD interest rates, and negative rates in Japan, the yen reached a 17 month high earlier this month! The euro appreciated against the dollar after the European Central Bank announced a more aggressive monetary easing last month – no wonder the dollar index is down 10 points this year. Surely there are an equal number of instances of changes in the opposite direction. But the point is that the impact of domestic monetary policy and inflation on exchange rates is unpredictable at least in the short run, or even "for several years" (Rogoff) – and, in the long run, all of us are dead anyway. International monitoring of domestic monetary policies will not alter this.

In my view, what is needed is

⇒ Managed exchange rates through intervention in the market by the central bank; and/or

⇒ Controls on movement of capital.

China's policymakers "*have opted not to follow the conventional Western approach of using flexible exchange rates as the main shock absorber for volatile capital flows"* (*Plan B for the Global Economy* by Andrew Sheng and Xiao Geng, Business Standard, April 5, 2016), and spent $ 700 bn of reserves to stabilise its currency. Much earlier, in 1985, under the Plaza Declaration, German and Japanese central banks threatened to intervene in the markets to appreciate their respective currencies against the grossly overvalued dollar. More recently, the Swiss National Bank kept a ceiling on the CHF/EUR rate by intervention but gave up when money supply increased to uncomfortable levels. The central bank of Sweden recently took powers to intervene in the market to protect the krona.

It is intervention, sterilised or otherwise, that influences exchange rates, not so much monetary policies, conventional or otherwise. And, what needs to be targeted is the level, not just volatility. It is difficult to see any other alternative to "The Global Monetary Non-System".

Would the G 20, now under Chinese presidency, alter the thinking on the subject?

A.V.Rajwade (avrajwade@gmail.com)