Introduction

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It is perhaps too glib to record that the 1997–1998 financial crisis represented a watershed for the economies of east Asia. But it is certainly clear that many of the economic policies in the region, which had been viewed in a favourable light in the long years of spectacular economic growth, were reassessed in the light of the crisis.

A critical part of this reassessment involved monetary policy and, its close cousin in an open economy, exchange-rate policy. Before the crisis, a de facto currency peg against the United States dollar formed the centrepiece of the monetary policy regimes of many of the countries in the region. But the crisis convinced almost everyone, if they had not been convinced by earlier crises, that such softly pegged exchange rates eventually prove unsustainable in a world of high capital mobility.

Just how far this argument should be taken, however, remains a matter of controversy. For some, the logic of high capital mobility requires that countries must choose one end or the other on the spectrum of exchange-rate flexibility. According to this view, the choice is between a hard fix (monetary union, currency board or dollarisation) and a freely floating exchange rate. But this is by no means a universally held view. In principle as well as in practice, a country's range of exchange-rate choices is not limited exclusively to these two extremes. While softly pegged exchange rates are not an attractive policy option (at least if the capital account remains open), a range of possible arrangements at the flexible end of the spectrum remains on the menu of possible exchange-rate choices.[2]

And so these and many other questions remain open in the debate about which monetary and exchange-rate arrangements are appropriate for east Asia. If individual countries choose flexible exchange rates, should inflation targeting be their preferred monetary policy framework? And if so, to what extent is this framework compatible with exchange-rate coordination between countries? Alternatively, is monetary union within east Asia an appropriate goal, even if it seems a long way off at present? And if this alternative vision is a realistic one, what lessons can be learned from the European journey to monetary union? The papers in this volume were commissioned by the Reserve Bank to address these questions.

Background

In setting the scene for the more detailed discussions to follow, Robert McCauley provides an interesting perspective on a range of the issues. He notes that inflation

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1. In writing these comments, I have benefited from the remarks made by Glenn Stevens at the final session of the conference.

2. Statements about exchange-rate regimes commanding universal support are rare birds indeed. Charles Wyplosz, in his contribution to this volume, has a few kind words to say about softly pegged exchange rates.

targeting has become more prominent after the Asian crisis – as also happened in Europe in the aftermath of the exchange-rate crisis in the early 1990s. He further notes, however, that the idea of a single mandate for monetary policy, with the focus on price stability, which is quite common in other regions, is not that common in Asia. He notes another interesting and subtle difference in thinking about monetary policy in Asia, namely the different degree of emphasis on formal central bank independence. In Europe, the western hemisphere and countries such as Australia and New Zealand, it has come to be widely accepted that a strong degree of independence in the setting of monetary policy is a necessary condition for a good system. It appears that in Asia, while a measure of independence is seen as important, it does not rate as highly as elsewhere.

There may be a good reason for this. The simple association that researchers have found between proxies for legal independence and inflation performance (usually, it should be noted, using countries' experience before the 1990s) appears to have much less power once a group of Asian countries are introduced into the sample. The Asian countries offer a richer experience than that embodied in regressions for the OECD countries. Perhaps what matters more, ultimately, is the degree of credibility and legitimacy central banks have, which is earned in the eyes of public opinion and financial markets over time by performance, rather than created *ex nihilo* by legislation.

It is also interesting to observe how quickly discussions about east Asian monetary policy evolve into discussions about the exchange rate. Were a similar volume to be written on future monetary policy directions in the major OECD economies of the United States, continental Europe or Japan, there would undoubtedly be much less focus on exchange rates.[3] The difference arises, of course, because of the openness of the east Asian economies to both trade and capital flows. Capital flows, both when they are sustained and when they change rapidly, have the potential to blow policies and economies seriously off course. While capital market disturbances in the major economies have sometimes had international dimensions – with the 1998 Russian crisis and the ensuing difficulties of Long-Term Capital Management being a prominent example – the monetary authorities are usually in a position to respond without worrying too much about the effect on the exchange rate. Smaller, more open, economies are denied this luxury.

So the focus on exchange rates is an understandable one. An implication is that monetary policy arrangements for the future will have to find a way either of managing exchange rates, or of coping better with their movement. The former will require a good deal of cooperative behaviour; the latter, in some cases at least, some improvements to the structure of economies and financial systems.

3. The new economy, asset prices and financial stability would presumably be discussed more prominently in such a volume.

The Options

Inflation targeting

Both McCauley and Gordon de Brouwer point out that many east Asian countries – apart from the strict-peg regimes – have accepted considerably more exchange-rate variability, relative to interest-rate variability, in the aftermath of the crisis. In a few cases, this has gone against the expected relationship between openness and desired stability of the exchange rate. For countries that choose flexible exchange rates, inflation targeting is a promising monetary policy framework. Guy Debelle argues in his paper that while there are many practical difficulties involved in setting up a successful inflation-targeting regime, they should not be regarded as insurmountable.

Successful inflation targeting requires a capacity to forecast future inflation outcomes. It also requires an understanding of the link between monetary policy actions and the final objectives of policy. In both these respects, inflation targeting is likely to be more difficult to implement in developing economies than in developed economies. For one thing, inflation is likely to be more volatile in developing countries, particularly since food items, which are inherently more volatile, make up a larger fraction of consumption baskets in developing countries. For another, there may be more uncertainty about the size and timing of the transmission channels of monetary policy when financial systems are less developed and when the economy is undergoing rapid structural change. These influences make inflation targeting difficult. But a more volatile economy with more uncertainty about the monetary transmission mechanism will present difficulties for any monetary regime.

The advantages of inflation targeting, as Debelle argues, are in terms of the coherent framework it provides. The central bank can explain its actions in terms of the inflation target, and can be assessed in these terms by the public and financial markets. To the extent that a numerical target for inflation – that the central bank is committed to achieving in the medium term – helps to focus private-sector inflation expectations, there is an additional benefit from the framework.

The exchange rate: to manage or not to manage?

If countries choose inflation targeting, what scope is there for them to also manage their exchange rates? Both Debelle and John Williamson argue in their papers in the volume that there is considerable scope for exchange-rate management. Inflation-targeting central banks should be concerned about deviations of both inflation from target and economic output from potential. But there is nothing, in principle, preventing central banks in very open economies from also being concerned about deviations of the exchange rate from (some estimate of) its equilibrium rate.

In practice, however, conflicts may sometimes arise between the inflation target and the desire to stabilise the exchange rate, and it is then difficult to know how best to respond. Debelle argues that the inflation target must take precedence in such situations, in order to maintain the credibility of the regime. But a counter-argument is put by Alejandro Werner, who reasons on the basis of Chile's experience during the Asian crisis, that when an exchange rate is under pressure it is not the best time to down-play its importance, so that concern about the exchange rate will instead take precedence at such times.

In his contribution to this debate, Williamson provides a nice motivation for the co-existence of an inflation target and an exchange rate objective by appealing to the 'Australian analysis' of Salter and Swan, which distinguishes between internal and external balance. The allocation of monetary policy to internal balance – the inflation target – in the short to medium term and exchange-rate policy to external balance in the longer term fits squarely into the traditional inflation-targeting model. But where that model, in its canonical form at least, assumes that a floating exchange rate will address external balance considerations pretty much automatically, Williamson retains a role for management or guidance of the exchange rate.

In support of this position, he cites the by now overwhelming evidence that floating exchange rates are often subject to fads and bubbles, rather than being predominantly driven by economic fundamentals. In Williamson's view, this exchange rate behaviour has significant real costs, especially for countries that are very open to trade and capital flows.

Williamson discusses three options for helping to manage a flexible exchange rate – monetary policy, sterilised foreign exchange intervention and capital controls – and argues that each option has a role to play. He reads the recent evidence as supportive of a potential role for sterilised intervention. This point is echoed by Takatoshi Ito, who draws on recently released data to argue that Japanese foreign exchange intervention has been stabilising over the past decade. Williamson's view on capital controls is somewhat similar to his view on foreign exchange intervention; recent evidence in his view suggests that, while capital controls cannot be made 'leak-proof', they can influence both the volume and nature of capital flows and hence the exchange rate. Both Ito and Charles Wyplosz, in their contributions to this volume, also express sympathy for this view.

Williamson favours a basket, band and crawl (BBC) regime for the exchange rates of east Asia. Such a regime can, in principle, be implemented unilaterally by individual countries, and Singapore's monetary policy framework already incorporates the key features of a BBC regime, as Edward Surendran Robinson explains. A BBC regime is undoubtedly easier for a single country to implement, especially at times like the Asian crisis when a decision to change the future trajectory of the desired exchange rate band can be taken unilaterally.

But Williamson favours an approach in which a number of east Asian countries use a *common* basket of the three major world currencies – the US dollar, the yen and the euro – with the aim of significantly reducing real exchange-rate variability both within the region and, in trade-weighted terms, with the rest of the world. As his analysis makes clear, to implement such a system requires considerable coordination between central banks in the region, including the need at times to manage conflicts between the domestic monetary policy requirements of individual economies, and the desire to lean against exchange rate movements that threaten the integrity of the cooperative exchange-rate arrangement. The presumption must be that a strengthening of collective institutions in the region would enhance the prospects for such an exchange-rate arrangement.

Monetary union

If exchange-rate flexibility is judged ultimately to be more trouble than it is worth, a possible alternative is to form a currency union. In an argument with echoes in the contributions by Andrew Coleman, Don Brash and Andrew Rose, Wyplosz points out that it was not so long ago that the idea of a country ceding its monetary policy to another country, or to a supra-national authority, was a curiosity fit only for special cases. But the advent of monetary union in Europe, as well as a re-assessment of the relative merits of floating exchange rates and monetary unions, has seen something of a sea-change in attitudes about the desirability of monetary unions.

Wyplosz uses his paper to draw lessons for Asia from the European journey to monetary union. He makes the interesting point that, given relative sizes and distances between countries, there is much more trade among east Asian countries than among European ones – despite more than forty years of the Common Market in Europe. However, a significantly higher *proportion* of European trade is within the region than is the case for east Asia, and correspondingly, there is proportionately less trade for Europe with the United States than is the case for east Asia. These two observations may pull in opposite directions; the former one suggests that intra-regional exchange rate fluctuations may be more harmful for east Asia than for Europe, while the latter observation suggests that reducing exchange rate fluctuations *vis-à-vis* the US dollar might be more important for east Asia than for Europe.

Wyplosz makes a compelling case for the importance of building collective institutions along the road to monetary union:

> Collective institutions become the advocates of integration. They move the debate from the purely political sphere to the technical level, allowing for professional assessments and avoiding costly mistakes. They provide analyses that would not be carried out otherwise. They can prepare blueprints that can be readily put to use when the occasion arises, often unexpectedly. If the support for collective undertakings is limited, such institutions can start with limited terms of references and be allowed to grow once they have established their credentials.

Europe's message to Asia, as Wyplosz sees it, is that monetary union is a long way down the path of gradually increasing cooperation. In Europe, while there never was a master plan, opportunities were grasped when they arose.

From an economic point of view, the two countries in this region most likely to be able to contemplate a monetary union would be Australia and New Zealand. The two economies share similar monetary policy frameworks, are at a similar stage of development, and the two currencies are highly correlated already. Legal and institutional frameworks are also similar. Coleman's paper contains original discussion on this issue, and uses as a compelling analytical device an economic comparison of the sovereign country of New Zealand with Queensland, a state within the Australian federation and monetary union.

As seems very clear from the European experience, however, the step to monetary union is not just an economic one, it is inherently a political one. While some groups in New Zealand have expressed interest in the possibility of a monetary union with Australia, the idea has hardly registered above the background noise in Australian political discourse. Coleman argues that Australia *should* care – a monetary union with New Zealand should be expected to lead to a big increase in trade between the two countries (perhaps a doubling), which should raise incomes in Australia as well as New Zealand.

To summarise, the monetary policy choices for east Asia are tricky ones, involving trade-offs that are only incompletely understood. In important respects, this is because of the intermediate openness of many of these countries. On the one hand, monetary policy in large, relatively closed economies can focus on domestic price and output stability without taking much notice of the exchange rate. On the other hand, for extremely open economies, like Hong Kong and Singapore, the exchange rate must be at centre-stage, with exchange-rate variability severely curtailed by one means or another. For countries at neither of these extremes, however, there are genuinely difficult questions about where to sit on the spectrum of exchange-rate flexibility, and once the choice has been made, how best to conduct monetary policy. It is to be hoped that the contributions in this volume shed some light on these important but difficult questions.