

Commentary: How Should Monetary Policymakers Respond to the New Challenges of Global Economic Integration?

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There are, of course, many aspects of global economic integration that have quite direct and immediate implications for the way in which central banks go about their work. Four issues in particular stand out.

First, economies are becoming increasingly integrated through trade, particularly at a regional level. As our conception of “the economy” takes on less and less of a national dimension and more and more of a regional dimension—whether it be the EU, NAFTA, or ASEAN—it is not surprising that parallel questions arise about whether currency arrangements should move in a similar direction, that is, toward enlarged common currency areas. We have already seen the advent of a common currency in much of western Europe. There has been increasingly widespread discussion about the pros and cons of dollarization in the Americas. And there has even been some discussion of a common currency for East Asia. In my own country, there appears to be quite strong support within the business community for forming a common currency with Australia, and some support also for dollarization.

Secondly, questions have also arisen about whether the increasing openness of economies is resulting in the world becoming less prone to inflation. Does the exposure to global competition help to suppress inflation pressures. And is this one of the factors behind the

so-called “new paradigm,” in which the United States in particular appears able to enjoy non-inflationary growth at rates previously thought impossible?

Thirdly, we are seeing an accelerating trend toward genuinely global financial institutions, including enormous entities, such as Citicorp, HSBC, Deutsche Bank, and UBS. This is raising some issues, including, for example, whether the transmission of monetary policy in national banking systems dominated by foreign-owned banks is somehow different from where banks are predominantly local in ownership, and whether the regulatory framework is appropriate to dealing with these global behemoths.

Fourthly, in today’s globalized markets, capital moves in amounts and at speeds that complicate the management of monetary policy directed to achieving internal macro objectives. Most now accept that where there are no restrictions on capital flows, it is not possible, at least not beyond quite narrow limits, to simultaneously direct monetary policy to an internal objective (such as an inflation target) and an external objective (such as an exchange rate target).

In my few minutes, I will focus mainly on the fourth of these issues, as it has been the most challenging issue facing us in New Zealand. Having said that, it will also be evident that the issues I have listed overlap and interact to some degree.

Substantial current account imbalances and associated capital flows have always been a feature of the economic landscape of course. However, with the liberalization of private capital flows and increased trading in marketable securities, gross private capital flows during the last decade or so have been larger, faster, and perhaps more “concerted,” than in the preceding decades (and probably at any time in the history of modern central banking). I don’t think there is any need at this point in proceeding to try to support that proposition with data. But let me just quote a few numbers to illustrate the point in the case of New Zealand.

In 1990, the government’s net foreign-currency debt was equiva-

lent to 22 percent of GDP. By 1998, that net foreign-currency debt had fallen to zero.

On the other hand, during the same period, non-resident holdings of New Zealand government New Zealand dollar bonds rose from 14 percent of the total on issue to 65 percent of the total on issue.

During the same period, outstanding euro-kiwi issues (issues of New Zealand dollar bonds by foreign corporations and governments) rose from 8 percent of New Zealand's GDP to 18 percent.

During the same period, foreign ownership of the New Zealand equity market rose from 23 percent of market capitalization to 55 percent.

And foreign ownership of the banking system, measured as a percentage of the total assets of the system, went from an already high 62 percent in 1990 to 99 percent in 1998.

Note that during a decade in which New Zealand consistently ran a current account deficit—a deficit which never fell below about 2 percent of GDP and ended the decade at 8 percent of GDP—the New Zealand government entirely eliminated its exposure to foreign currency debt, and there was a very large increase in the exposure of non-residents to the New Zealand dollar (increased foreign holdings of New Zealand dollar government bonds, increased issuance of euro-kiwi bonds, increased investment in the New Zealand equity market, and increased foreign direct investment, of which the increased foreign ownership of the banking system is a good example).

One further point by way of background: Although we have never totally ruled out the possibility of intervention in the foreign exchange market, there has, in fact, been no intervention in the market for the New Zealand dollar since it was floated in March 1985. I suspect that we may be the only central bank in the world that can claim never to have intervened directly in the market for its currency for more than 15 years. (A few years ago, we even looked seriously at eliminating our foreign exchange reserves, on the grounds that the

best way of convincing the market that we will not intervene is to have no capacity to intervene.)

What have been the challenges?

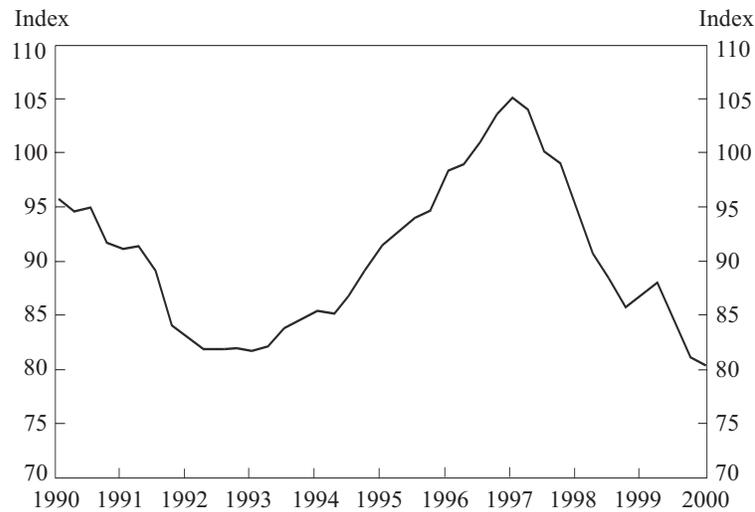
We have thought about the challenges arising from the openness of our economy to capital flows under two related headings.

First, we have been concerned about the responsiveness of capital flows to changes in monetary policy settings, as evidenced by the amplitude of the exchange rate cycle over the monetary policy cycle (see Chart 1). This has resulted in monetary policy having a very uneven effect on the economy, as between the tradable and non-tradable sectors. When monetary policy was tight in the mid-1990s—as it needed to be to contain rapid domestic demand expansion—our unusually high real interest rates attracted demand for New Zealand dollar assets. And the exchange rate appreciated in real terms, on a trade-weighted basis, by 29 percent (from the trough in early 1993 to the peak in early 1997). And then, in the face of the negative shock to demand generated by the Asian crisis, when monetary policy needed to be eased, the exchange rate fell, initially back to about where it had been in the early 1993 trough, and then somewhat further.

We also experienced a similar cycle in the exchange rate in the period 1985 to 1992—a substantial appreciation as monetary policy was tightened, only to be followed by an equally substantial depreciation as policy was eased.

There is little doubt that firms in the tradables sector of the economy find these cycles very difficult to cope with. Some exporters tell us that they are now wary about expanding production, even though the currency is currently at a very competitive level because of concerns about running into financial stress when the currency swings up again. In other countries, the lightning rod may be domestic firms that face increased competition from imports as the exchange rate appreciates, and argue the need for tariff protection. Therein lies the challenge: how to keep the tradables sector of the economy growing and protectionism at bay in the face of large cycles in the exchange rate.

Chart 1
Real Effective Exchange Rate



Second, we worry about the potential for these exchange rate cycles to end up in tears—in other words, in substantial disruption to the macro-economy. A background factor here is that New Zealand probably has the highest ratio of net external financial obligations to GDP in the developed world. What would be the economic and social cost if, perhaps in response to some initially fairly trivial loss of confidence, the exchange rate was to fall abruptly and interest rates rise equally abruptly?

We are sometimes consoled by the fact that the amplitude of the exchange rate cycles that we have been through during the last two decades is no greater than that experienced by many other countries. The United Kingdom, for example, has experienced in recent years a trough-to-peak real appreciation of somewhat more than the appreciation that we experienced. The United States has experienced an appreciation of broadly similar magnitude. And during the nineties Japan experienced a larger trough-to-peak appreciation on two occasions. But at least in the U.S. and Japan, the ratio of international

trade to GDP is very much lower than it is in New Zealand, so that big swings in the real exchange rate may well cause relatively fewer stresses and strains than they do in a small economy like New Zealand.

What has been our response?

First, we have taken some things as given:

We accept the impossibility of trying to maintain all three of an independent monetary policy (an inflation target), a fixed exchange rate, and an open capital account.

We take the view that maintaining an open capital account is desirable insofar as there are gains from trade in capital just as there are gains from trade in goods and services. Being open to capital flows has enabled New Zealanders to spend more freely than would otherwise have been possible, and to take advantage of investment opportunities beyond what could be financed from our own (low) level of domestic saving. Just as important, foreign direct investment has been a very important channel for technology and skill transfer, not least in the banking sector itself.

Even if that was not the case, we accept that attempting to close the capital account would probably be largely futile. This may not be entirely the case for a country without developed financial markets or one that still has capital controls. But in today's world of globalized markets and sophisticated financial and information technology, trying to wind back the clock seems bound to involve costs that would outweigh any likely benefits. It is hard to put the genie back in the bottle!

Thus, the choice for New Zealand has been between directing monetary policy to a domestic (price stability) objective, or to an external (exchange rate) objective, not between having an open or closed capital account. Our long-established position has been that maintaining a floating exchange rate, with an inflation target as nominal anchor, best serves our interests.

But this view is not shared universally in New Zealand. Recently, there has been an active public debate about whether currency union with a major trading partner might be preferable. This debate has been sparked, at least in part, by concerns, especially in the export sector, about the magnitude of the cycles in the New Zealand dollar to which I have referred. Given the strong appreciation of sterling against the euro in recent years, it is hardly surprising that many British exporters have a strong interest in the United Kingdom entering the European Monetary Union.

So what do we think are the lessons?

First, we have learned that the early expectations of what floating exchange rates could deliver were overstated. Certainly, we have learned that a floating exchange rate, combined with fiscal prudence, does not equal current account balance. Despite running fiscal surpluses since 1994 and maintaining a clean float since 1985, our current account has been persistently in deficit and is currently large, at 8 percent of GDP, as I have mentioned.

Secondly, we have learned that the monetary policy independence that comes with floating does not mean that “shocks,” whether external or domestic, go away. Rather, the adoption of a floating exchange rate has meant that shocks are transmitted to the economy in a different way. But they still have to be coped with.

Let me illustrate. Hong Kong has a very fixed nominal exchange rate, but its real exchange rate appreciated between the middle of 1995 and the middle of 1998 by 27 percent, very similar indeed to the trough-to-peak appreciation of the New Zealand dollar from early 1993 to early 1997. This real appreciation stemmed, in part, from the fact that the Hong Kong dollar was pegged to the U.S. dollar at a time when the U.S. dollar was appreciating against most other currencies, including those of Hong Kong’s other trading partners, and, in part, from the fact that Hong Kong’s inflation rate was higher than that of its trading partners. Since then, the real value of the Hong Kong dollar has fallen (by around 17 percent), at least in part because the shock of the Asian crisis resulted in deflation in Hong Kong. There

are lessons in this when thinking about the implications of pegging irrevocably to a single trading partner, as in the case of a currency union. Currency union would not make the *real* exchange rate appreciations and depreciations go away, certainly not completely, and maybe not at all.

Thirdly, we have learned that since choosing one currency arrangement (fixing) over another (floating) does not, of itself, make shocks go away, then the central issue concerns what institutional structures provide the best framework for managing the adjustment to those shocks. Put in this way, it seems to us that the key policy prerequisites in a world of mobile capital are much the same whether the exchange rate is fixed or floating.

At the most basic level, the prerequisites come down to clear, transparent, and credible objectives, and effective risk management.

To elaborate, whether the exchange rate is fixed or floating, there is a need for a credible nominal anchor. In one case, that anchor is the exchange rate itself. In the other, it is nowadays generally an inflation objective or target. In both cases, the nominal anchor needs to be credible. To establish that credibility, transparency helps a great deal (markets being suspicious of what they feel is being withheld from them), as do institutional structures that buttress the regime (perhaps formal inflation targeting structures, or a currency board arrangement). In more generic terms, this is all about ensuring that central banks and other monetary authorities are subject to clear and effective governance arrangements. Clearly assigned responsibilities and accountability structures help give markets an added basis for having confidence that the intended outcomes will be delivered.

Effective governance structures are also at the heart of effective risk management, in the private sector as well as in the public sector. Whether or not a regime is credible depends to a substantial extent on how well the private sector is able to withstand swings in the exchange rate where the exchange rate is the “variable” in the system, and to withstand swings in interest rates where the exchange rate is the anchor. This is, in turn, to a large extent about governance

structures that promote effective risk management in the private sector, and especially in the banking sector.

In practical terms, what this mostly means is ensuring that exchange rate risks, interest rate risks, and credit risks are managed effectively. To a large extent, managing exchange rate risk and interest rate risk is about hedging. And where hedging is not possible—as may well be the case for example, for exporters facing uncertain cash flows, but potentially large medium-term exchange rate swings—strong balance sheets are required. It also calls for a credit culture characterized by rigorous and impartial assessments of borrowers' ability to service the debt and governance structures, in the banking sector, corporate sector, and public sector that promote such a credit culture.

There is another angle to all this, and it relates to crisis management and the vexed issue of moral hazard. We will not get good governance in the face of the challenges of mobile capital if we insist on trying to build response mechanisms to volatility that result in the risk-takers being cushioned from the costs of that volatility. In other words, the economy-wide good governance structures required are not going to emerge if governments persistently absorb the risks inherent in globalization.

This brings me to some concluding comments focused on managing banking system risk in a globalized world. Let me make just two points.

First, I think globalization of the banking industry, far from making banking systems riskier, is probably making them safer—certainly in small countries like New Zealand. For a small country that wants an innovative, competitive, efficient, and safe banking system, there is likely to be little choice other than to be open to a substantial presence by foreign banks. In our own case, all but one of our eighteen registered banks are branches or subsidiaries of foreign banks, including some of the world's most highly rated banks. I have no doubt that we are reaping substantial benefits from that fact.

Second, there are lessons in what I have been saying for bank

supervisors (of which I am one). Bank supervisors need to be as alert as anyone to the tendency for public policy responses to the risks inherent in globalization to result in risk shifting, which invariably means from the private sector to the public sector. Rather than more and better supervision of the actual activities of banks, and endless codes of best practice for that supervision, I would prefer to see more emphasis being given to the need for all parties to understand their own risks, and for responsibility for dealing with those risks to rest where they arise. That is the approach we have adopted, and, again, I have no doubt that it is serving us well.

We place absolutely no restrictions on the extent to which banks operating in New Zealand carry open foreign exchange positions, and no restrictions on the extent to which they finance their operations offshore. In recent years, much of the growth in bank lending has been financed by direct foreign currency borrowing. And yet, we know that the banks carry absolutely minimal open foreign exchange positions. Official statistics released a few weeks ago suggested that, of the total foreign debt outstanding at March 31, 2000—a considerable part of which was owed by banks—97 percent was subject to some kind of exchange rate hedge, roughly one-third by means of some form of natural hedge and roughly two-thirds through the financial markets—which, of course, is where the willingness of foreigners to carry an exposure to the New Zealand dollar has been relevant. We believe that that is an important benefit of continuing to insist that foreign exchange risks are the responsibility of those who enter into foreign exchange contracts.