Contemporary exchange rate regimes

Willy Chetwin and Anella Munro
Reserve Bank of New Zealand

Presentation to the Exchange rate policy forum: issues and policy implications, 26 March 2013

The views expressed are those of the authors and should not be represented as the views of the Treasury or Reserve Bank
Motivation

• To consider the choice of exchange rate regime
• We challenge the current position of a floating exchange rate, asking:
  - could we pursue greater control over the exchange rate?
  - how would that affect other policies?
Lessons for NZ

• For open economies, trade-off between:
  - managing the exchange rate; and
  - controlling interest rates

• Seeking more ER stability implies:
  - less control over interest rates and/or less access to international capital;
  - willingness to buy FX reserves;
  - more adjustment through wages and prices
Overview

• The monetary policy ‘trilemma’
• Is the trilemma a constraint?
• Is there a best choice?
• International experience
• Lessons for New Zealand
Financial market arbitrage means can have two of these three:

- Access to international capital markets
- Control of domestic interest rates
- Control of the exchange rate
Arbitrage and the trilemma

- With an open financial account, arbitrage is active between foreign returns, domestic returns and exchange rates:
  - control the interest rate: markets set ER to equalise returns
  - control ER: markets set the exchange rate to equalise returns
- Close financial account: break the link
  - (but lose access to international capital markets)
Is the trilemma a constraint?

- An important constraint, across countries and a range of periods

- Can we have a bit of three objectives rather than two of the three?
  - Some scope to trade-off ER stability and controlling interest rates
  - But intermediate exchange rate regimes historically not very robust
Is there a best choice?

• Literature:
  - Advanced economies tend towards floating currency and interest rate instrument for inflation control (euro exception)
    • NZ regime looks robust
  - In standard model, NZ regime is optimal; that result being challenged when goods priced in local currency or UIP failure.

• Multiple objectives can mean complexity
International positions

Floating ER (low reserves)

Closed financial account

Fixed ER (high reserves)

Open financial account

Chinn-Ito index (2010)

Reserves/GDP (2011)
Hong Kong: Fixed exchange rate

- Peg to USD, within a band
- Open financial account
- FX reserves about 115% GDP
- Benefits of ER stability: high trade share
- Painful downward adjustment in wages and prices to restore competitiveness
  - For NZ, exchange rate can depreciate instead: less painful
Singapore: Managed exchange rate

- Managed ER (price stability objective)
- Relatively open financial account
- FX reserves about 90% GDP
- Low and stable inflation; strong growth; low short-term ER volatility
- Inflation pressure $\rightarrow$ tighten policy through a higher nominal exchange rate
  - For NZ, similar effects: tighten through interest rates $\rightarrow$ higher ER
Switzerland

• Normally: floating exchange rate; inflation targeting; open financial account (like NZ)

• Recently, exceptional circumstances:
  - deflation risks and interest rates at zero
  - safe-haven inflows

• Intervention meant FX reserves rose from 10% to 70% GDP
  - For NZ, fiscal cost would be high, based on historical costs
Lessons for NZ

• For more ER stability, are we willing to:
  - accept less control over interest rates (so inflation) and/or less access to funding?
  - buy a lot of FX reserves (fiscal cost)?
  - accept greater wage and price adjustment?

• Existing regime looks sensible and robust
  - ER can be an important shock absorber

• Monetary tightening means ER appreciation regardless of regime