

# Contemporary exchange rate regimes

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# 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

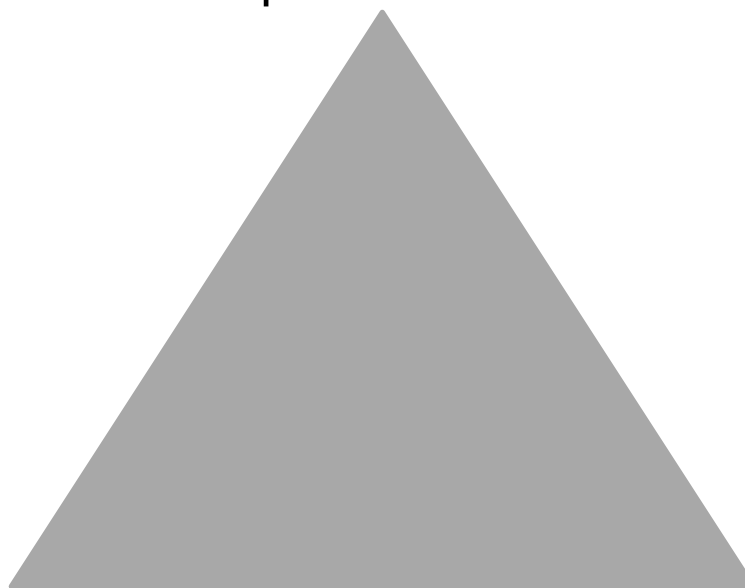
- The monetary policy ‘trilemma’
- Is the trilemma a constraint?
- Is there a best choice?
- International experience
- Lessons for New Zealand



# The monetary policy 'trilemma'

*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



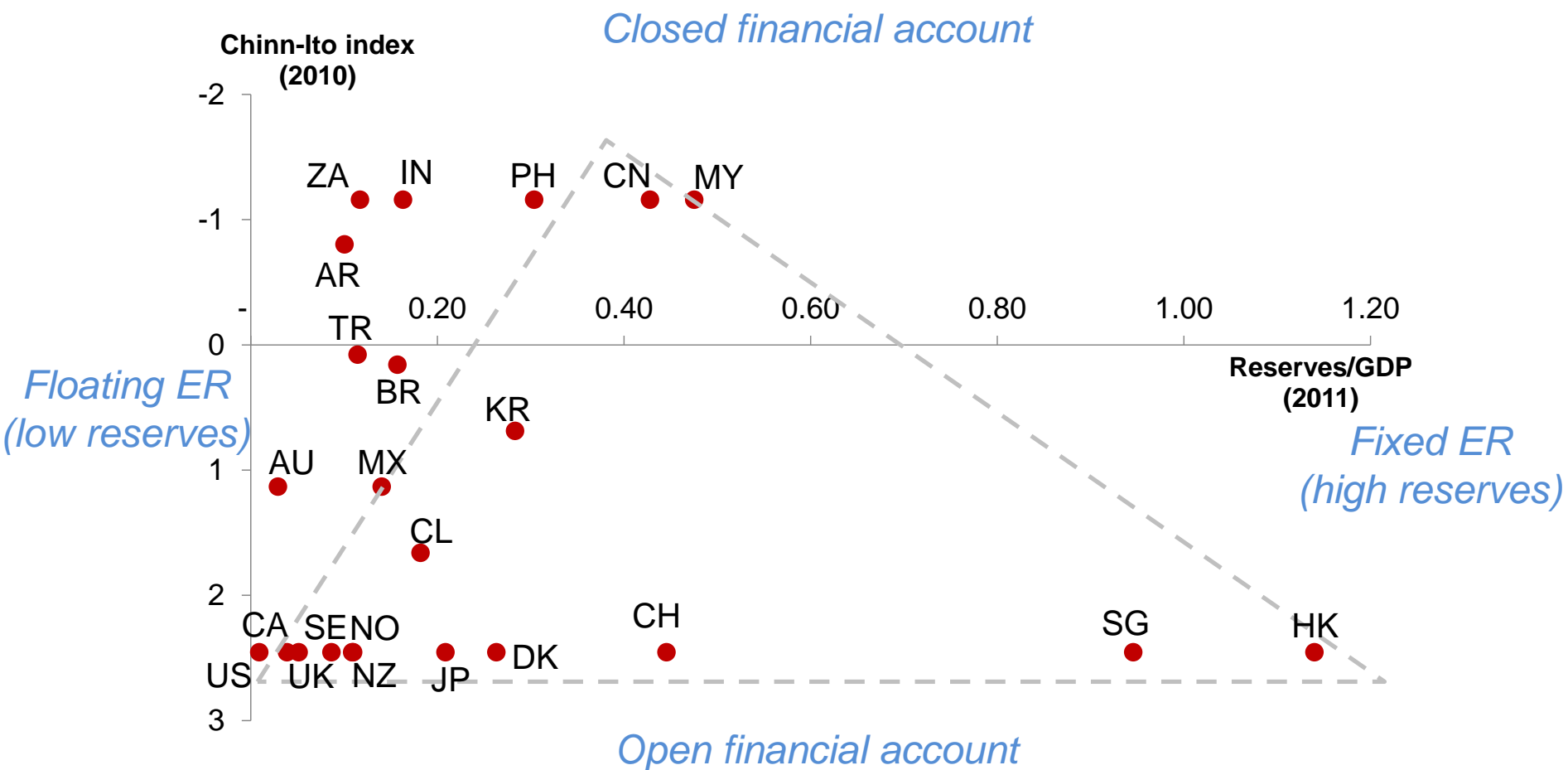
# Is there a best choice?

- 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





# 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 → tighten policy through a higher nominal exchange rate
  - For NZ, similar effects: tighten through interest rates → 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