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“Monetary and Currency Policy Management in Asia” by M. Kawai, P.J. Morgan and S. Takaji [book review]

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Book Review of “Monetary and Currency Management in Asia” by Masahiro Kawai, Peter J. Morgan and Shinji Takagi

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This book edited by Kawai, Morgan and Takagi addresses important issues on monetary policy making and currency management that are related to the global financial crisis and recent monetary developments in the global economies. It has five parts namely, monetary policy issues; exchange rate policy and reserve management issues; recommendations related to the “impossible trinity”; impacts on Asia of the global financial crisis and policy responses; and regional cooperation issues. Relevant theoretical framework and empirical methodology are employed in the chapters to analyze and evaluate these wide-ranging issues that have a direct impact on monetary policy strategies in the region. This review focuses in turn on the applicability of unconventional monetary policies; the inclusion of financial stability objective; the degree of monetary policy autonomy; and policy trilemma configurations which bring in exchange rate stability as well as reserves accumulation issues.

First, we consider the effectiveness of unconventional monetary policies and their applicability to the region. Constrained by zero interest rates or the existence of a credit crunch, monetary authorities of the advanced economies had to be creative in coming up with unconventional monetary policies such as commitment effect, quantitative easing and credit easing. Chapter 2 spells out the workings of the three types of unconventional monetary policies and draws upon recent research done in this area to assess the effectiveness of such policies. The authors conclude that (i) commitment has a larger impact on shorter-term interest rates; (ii) the influence of quantitative easing is secondary to that of commitment; and (iii) the effect of credit easing is limited to specific markets. In any case, the application of such policies to emerging economies where financial markets are less well-developed may be hampered by various factors including insufficient credibility on inflation fighting and vulnerability to capital outflows.

What monetary policy strategies should the region then adopt going forward? To answer this question, Chapter 3 first evaluates the performance of monetary policy regimes in the Asia and Pacific region by examining the evolution of various indicators on central bank governance and independence. Since the late 1990s, central banks in the region have gained greater legal and/or political independence and improvements in various aspects of governance that enhance their ability to control inflation. Nonetheless, one of the lessons of the global financial crisis is the need for monetary policy to pay more attention to financial imbalances and asset price misalignments. While financial stability is advocated to be an objective for public policy, the authors highlight various difficulties with its inclusion as an additional target for monetary policy particularly in relation to the limited policy tools at the central bank’s disposal. More studies are needed before a more conclusive assessment can be made on the extent to which monetary authorities ought to take charge of the financial stability objective.

Chapter 4 examines a more fundamental question of how much monetary policy autonomy central banks in the region really have. To this end, the authors investigate the impact of a US monetary policy shock on interest rates and exchange rates in the East Asia economies by applying a block-exogenous structural Vector Autoregression model to each country for the inter-crisis period. The authors show that the conventional exchange rate channel seems to play a role only in Japan which has the most flexible exchange rate and least restrictive capital account. At the other extreme, interest rates in China and Malaysia are insulated from a US interest rate hike through the imposition of capital controls. Adjustments to the shock take place in the foreign reserves of these countries. By comparison, most East Asian economies which do have some degree of capital account openness choose to accept a lower level of monetary autonomy by adjusting domestic interest rates to offset the US interest rate change. As the authors explain on page 113, "fear of floating may have prevented these countries from securing monetary autonomy".

The findings in Chapter 4 suggest that stabilizing domestic exchange rates reduces the capacity of monetary independence in the Asian economies that have relatively open capital accounts. The policy trilemma is defined in Chapter 6 on page 143 as "a country simultaneously may choose any two but not all of the following three goals: monetary independence, exchange rate stability and financial integration." To better understand how monetary authorities deal with this policy trilemma, the authors use trilemma indexes to quantify the extent to which each policy goal is achieved and trace the trilemma configurations across country groups. They show through "diamond charts" that Asian emerging market economies have opted for a balanced combination of the three policy goals by retaining moderate levels of monetary independence, financial openness and exchange rate stability.

A closer tracking of the more recent evolution in trilemma configurations in the region can be found in Chapters 4 and 7. Chapter 4 gives a characterization of the exchange rate regimes in East Asia which reveals generally greater flexibility in both de jure and de facto classifications after the Asian crisis. This concurs with evidence provided in Chapter 7 which uses R-squares in the Frankel–Wei regressions to show that exchange rate flexibility in Asia has been gradually increasing since 2002. With regard to financial openness, Chapter 4 uses the Chinn-Ito index to show the Asian economies have varying levels of capital restrictions with China, Malaysia, Indonesia, the Philippines, Thailand and Korea having more restricted current accounts compared to Singapore and Japan. Meanwhile, the study in Chapter 7 provides evidence in the form of capital flows to GDP ratios that point to increasing de facto capital account openness over time. In sum, the evidence point to reduced exchange rate fixity and greater financial openness in Asia for the period up to the global financial crisis. An interesting question that is not addressed in these chapters (probably due to the unavailability of data at the point when the research was conducted) is the impact of the global financial crisis on Asia's policy trilemma configuration.

The ability to achieve a balanced combination of the three policy goals is aided by having large international reserve accumulation. Regression analysis results in Chapter 6 suggest that an emerging market economy that pursues greater exchange rate stability by accepting a lower level of monetary independence can achieve lower real exchange rate stability. At the same time, they can offset the increase in investment volatility by holding higher levels of international reserves. The reason is while greater monetary independence tends to dampen investment volatility, at high levels of international reserves — say above 15% to 23% of GDP — greater monetary independence enhances investment volatility by providing too much liquidity. (As an aside, Chapter 5 uses both theoretical and empirical analysis to investigate the impact of foreign reserves on macroeconomic variables.) Furthermore, greater financial openness is found to lower real exchange rate volatility. Taken together, the findings help to explain why as economies in the region embark on financial liberalization, they prefer to pursue greater exchange rate stability and lower monetary independence while holding huge amount of reserves.

Another advantage of maintaining exchange rate stability relates to its effect on output underperformance in crisis countries. Chapter 6 applies regression analysis to show that economies tend to come out of a crisis with a smaller output loss, if they had entered the crisis with more stable exchange rates. However, Chapter 7 warns of inconsistent monetary policy frameworks with implications for China. The authors point out that keeping a rigid exchange rate regime when increasing capital account openness will distort the policy rate and lead to pro-cyclical monetary policies. An important issue is the robustness of the financial system to absorb external financial shocks. Hence, they argue that currency flexibility should be sequenced before capital account liberalization. It could perhaps be emphasized that all three dimensions of liberalization namely domestic financial sector development, exchange rate flexibility and capital account openness do not necessarily follow sequentially but have to be determined together as a single holistic set of interrelated policy decisions.

To what extent will exchange rate flexibility help to bring about global rebalancing? Chapter 8 investigates this issue using a model-based dynamic analysis and concludes that exchange rate flexibility in Asia alone is insufficient to bring about a correction to the current account imbalances. Rather, structural changes to boost demand in the region and policy actions on the part of current account deficit economies are necessary as well. Finally, Chapter 9 proposes how exchange rate cooperation can be carried out in the region by tracking deviations of Asian currencies from the Asian Currency Unit rate.

Overall, this book is an excellent contribution to the field as it provides research-based assessments on a rich array of inter-related policy issues that are pertinent to monetary and currency management in the region. I highly recommend it to both academics and practitioners who wish to deepen their understanding of the implications of recent global monetary developments on policy options facing the region.

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