CHALLENGES FOR EXCHANGE RATE POLICY[1]

This paper discusses the adjustment process under different monetary regimes and, in particular, the circumstances in which a fixed exchange rate may be an appropriate monetary anchor. In Hong Kong, the fixed exchange rate has been a cornerstone of monetary stability and a source of confidence. Hong Kong's Currency Board system, a very hard form of fixed regime, operates successfully because the financial system is sound enough to withstand potential swings in interest rates, the economy is flexible enough to deliver internal cost-price adjustments, and the foreign exchange reserves comfortably exceed the theoretical minimum requirement.

The Focus of Monetary Policy

The exchange rate defines a monetary relationship. Thus, exchange rate policy cannot be discussed in isolation from monetary policy as a whole. By general consensus, monetary policy should be directed towards the achievement of monetary stability, which is considered to be the prerequisite for sustainable long-term economic prosperity. However, the definition of monetary stability is open to debate.

Over the past decade or so there has around the world been a marked movement towards the pursuit of inflation targets (usually defined by ranges rather than points) as the principal, or in several cases the sole, definition of monetary stability and hence the objective for monetary policy.

Among the factors which justify such an approach is the purported disproportionately high welfare cost of enduring inflation at a rate outside the set range. Meanwhile, the success of the approach depends in part on the efficiency with which the economy can respond to any policy adjustments, typically via interest rates, which may be judged necessary in order to correct or pre-empt any divergence of inflation from target.

In economies which are smaller or more open than average, the inflation rate may be more heavily affected by external factors, although the sensitivity depends to some extent on the definition of the inflation measure that is being examined. Of course, if the rest of the world is being successful in the pursuit of low and stable inflation, the degree of imported volatility may be unexceptional, but such benign circumstances cannot be counted upon. Depending then on the costs which the economy might have to incur as a result of potentially larger and more frequent interest rate adjustments necessary to meet an inflation target, there may be instances in which an alternative monetary objective to that of internal price stability is preferred.

A Fixed Exchange Rate

One such alternative framework is the fixed exchange rate – in effect, targeting the external value of the currency rather than its internal purchasing power. However, although this relieves policy makers of the necessity to react to imported inflation, it imposes a different set of costs – namely those of defending the exchange rate. Many people would expect these costs to be higher, particularly in cases where there are no exchange controls, since the overall costs must then include the element which may be incurred specifically in responding to speculative activity in the foreign exchange market, although once a regime has established its credibility such speculative activity may die away. In fact, a consensus has emerged that a fixed rate can in certain circumstances serve as a feasible alternative to floating, although some argue that the fixed rate option can only succeed if it is of a particularly "hard" variety, such as a currency board.

1 A paper presented by Tony Latter, Deputy Chief Executive of the HKMA, at a conference jointly organised by the representative offices of Asian central banks in London and the Bank of England's Centre for Central Banking Studies; held at the Bank of England on 12 June 2001.

There are a number of fixed or quasi-fixed rate regimes in operation in the Asian region. Past experience suggests that a fixed rate which necessitates significant intervention, especially on the weak side, or which masks a progressive widening of the gap between internal and external price levels, is unlikely to be sustainable. But fixed rates supported by adequately consistent domestic policies, and sometimes reinforced by effective application of controls designed to minimise short-term speculative capital flows, have proved viable.

In the context of emerging markets, it is also argued that fixed regimes present two practical advantages over floating. First, if the regime is credible and durable, it gives comfort and certainty to businesses at home and abroad in planning their transactions. Such considerations are sometimes dismissed as irrelevant because of the availability of hedging instruments, but hedging is not free and the facility may not anyway be present for a particular currency. Secondly, in cases where the fixed rate functions in conjunction with capital controls, as is not uncommon in emerging markets, the system protects domestic financial institutions and markets, which may be under-developed, from the strains, and even self-inflicted pains, which may arise from premature exposure to external capital flows and exchange rate volatility.

However, none of the claimed advantages of a fixed rate can be realised unless there is confidence in the regime itself over the planning horizon. This may mean either, as in Hong Kong, an absolute and credible commitment to the announced rate, or at least adequate assurances as to the robustness of the framework within which any adjustments may be made.

Hong Kong's Currency Board

In Hong Kong, the currency board mechanism requires that the government's Exchange Fund, which is managed by the Monetary Authority, sells US dollars at the rate of HK$7.80 on demand to any bank to the extent that the bank holds sufficient Hong Kong dollar liquidity with the Exchange Fund to settle the deal; and the Monetary Authority has the discretion to purchase US dollars offered to it by a bank at a rate close to 7.80, crediting the Hong Kong dollars to the bank's account with it. These transactions represent unsterilised intervention in the strictest sense, which ensures that money market conditions immediately tighten or ease in response to, respectively, outflows or inflows. Although in Hong Kong interest rates are in practice rarely far out of line from their US counterparts for very long, shifts in interest rates, which are an essential component of the currency board's mechanism, could potentially be sharp and prolonged, and it is for this reason that a currency board may not be suited to an economy where the financial institutions might be unable to withstand such conditions.

The Hong Kong Monetary Authority may also from time to time carry out foreign exchange transactions which are equivalent to sterilised intervention. The most typical example is when the government places surplus budgetary funds with the Exchange Fund which are then invested in foreign assets, or when such assets have to be realised and switched back into local currency in order to cover a budget deficit. Permissible flexibility in the precise timing of such transactions may be exploited to support broader policy objectives. However, such transactions do not in any way compromise the paramount currency board rule, which strictly links changes in the monetary base to flows of foreign currency into or out of the Exchange Fund's currency board account.

Adjustment in Practice

While the financial markets in Hong Kong expediently deliver the adjustments of interest rates and liquidity that are consistent with exchange rate stability, the broader economy has to adjust to the impact of capital flows, or to any changes in competitiveness (which may result from exchange rate movements elsewhere or from differential inflation rates), through shifts in the domestic cost-price structure.

This adjustment process may imply either inflation or deflation, which may be at rates outside the bounds which would typically be set by an economy operating with inflation targeting. For instance, since the mid-1990s Hong Kong's 12-month rate of consumer price inflation has been as high as 10% and as low as minus 6%. Although

this is a much wider range than experienced in the United States, to whose currency Hong Kong's is pegged, the peg itself serves as a sort of insurance against excessive movements – of the nature of hyper-inflation or an intense spiral of deflation – because at some point competitiveness will be sufficiently curtailed or enhanced to halt the process. This contrasts with the type of scenario that is possible under floating regimes where, for example, deflation could lead to a strengthening of the exchange rate in the market, which could in turn precipitate further deflation, and so on, with no guaranteed stabilising mechanism.

Flexibility in Costs and Prices

A key factor in assessing the merits or otherwise of a fixed rate regime for a particular economy is the ability of that economy to deliver the shifts in internal costs and prices which are the necessary substitute for nominal exchange rate movements as a means of restoring the real exchange rate to its equilibrium path after some shock. Typically it is not difficult for costs and prices to adjust upwards in instances where the nominal exchange rate may temporarily have become undervalued; but it is generally much more difficult to achieve downward adjustments in instances of overvaluation, without which reduced output and rising unemployment may persist for longer than the public might tolerate.

One of the main reasons why Hong Kong's currency board has been successful is the internal flexibility of the economy, including this desired downward flexibility in costs and prices. For example, following the initial sharp loss of competitiveness (by about 15%) during the 1997 crisis, caused *inter alia* by the depreciation of several other Asian currencies, it took only about six quarters for that loss to be recovered. This process included steep declines – of up to 50% – in property prices, with consequent feed-through to rentals and other components of the general price level; lower retail margins; and notable reductions in labour costs. The latter were not fully visible in the headline statistics, but reports of reduced bonuses, lowering of starting salaries, recruitment of new staff at lower grades than departing staff, longer hours for the same pay, and so on, indicate that significant overall savings in labour costs were in fact achieved.

Adjustment of the Real Economy

During the same period, partly because of the immediate loss of competitiveness but also in line with weaker activity in the region generally, there was an initial sharp drop in gross domestic product – on a quarterly basis by as much as about 7% from peak to trough – which was, however, also quickly reversed in 1999-2000.

Without doubt there is some deadweight loss of output in the adjustment phase under the fixed exchange rate, in comparison to a situation where external competitiveness is preserved through nominal exchange rate depreciation. However, the difference is less marked if account is taken of the fact that depreciation would entail an initial adverse shift in the terms of trade. Moreover, there is evidence from this last cycle in Hong Kong[2] to the effect that the discipline of the adjustment process under the fixed exchange rate forced businesses to focus more intently on efficiency and strategy, in turn delivering a stronger productivity performance than in economies where business would to some extent have been cushioned by currency depreciation. Thus, it is suggested that the Hong Kong economy may have emerged "leaner and fitter" from the cycle.

Deflation – A Novel Experience

It is, however, worth noting that this latest cycle was unprecedented in the degree of deflation which was required. When the present currency board was established in 1983 it was probably not envisaged that global inflation would slow to the extent that it has. The successful targeting of low inflation in some major economies, and the difficulty which an economy as significant as Japan has had in avoiding deflation, make it almost inevitable that others – certainly those on fixed exchange rates – may occasionally be confronted with declining prices. This has for many been a

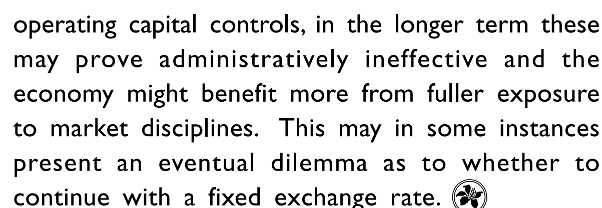
2 See "Corporate restructuring in Hong Kong in the aftermath of the Asian financial crisis", *HKMA Quarterly Bulletin*, May 2001.

novel experience. The wealth effect of falling asset prices, the behaviour of consumers when faced with the prospect of declines in the prices of goods and services, and the impact on the balance sheets of banks and businesses of rising real values of debt, are phenomena which have yet to be fully assimilated. For Hong Kong, adherence to the currency board has precluded the option of trying to inflate one's way out of the situation through domestic monetary expansion.

Conclusions

In summary, a fixed exchange rate may be considered for the role of monetary anchor particularly in an economy where, for one reason or another, alternative anchors, such as inflation targeting or money targeting, would pose more awkward challenges than have arisen in those economies where they appear to have been successfully adopted. Hong Kong's currency board is a very hard form of the fixed regime. It operates successfully because the financial system is sound enough to withstand the swings in interest rates or liquidity that may arise, and because the economy as a whole has a sufficiently flexible nature to deliver the internal cost-price adjustments that must of necessity substitute for nominal exchange rate adjustment. It is also supported, not least psychologically, by the fact that Hong Kong's foreign exchange reserves greatly exceed the minimum theoretical requirement of covering the monetary base. Over the years the fixed rate has become an important symbol of continuing monetary stability and a source of confidence in Hong Kong.

Fixed rate regimes supported by mechanisms other than a currency board – for example by capital restrictions – may be equally viable, provided that such restrictions are sufficiently watertight, but it seems important in such cases that the exchange rate is not allowed to depart too far from what underlying fundamentals would determine, and that, especially if controls insulate the domestic economy too much from the discipline which a fixed exchange rate would otherwise impose, domestic monetary policy should nevertheless be directed towards internal monetary stability. Despite the justification, in terms of protecting an immature financial sector or of sequencing reforms, for


operating capital controls, in the longer term these may prove administratively ineffective and the economy might benefit more from fuller exposure to market disciplines. This may in some instances present an eventual dilemma as to whether to continue with a fixed exchange rate.