Should exchange rates have a larger role to play in monetary policy frameworks?

Remarks by Hans Genberg at the HKMA-BIS Conference on “Exchange rates and monetary policy frameworks”, 16 October 2018, Hong Kong SAR

The participants in this panel were asked four questions:

1. Should exchange rates have a more explicit and prominent role in monetary policy frameworks?
2. Is there a case for providing central banks with a mandate to lean against persistent FX misalignments?
3. What political economy risks to central bank independence could arise?
4. What trade-offs constrain exchange rate policies? Does the classical trilemma still apply?

In my remarks I will elaborate on the following answers to these questions:

1. The role of the exchange rate in monetary policy frameworks is not and should not be the same in all economies, nor should it necessarily remain the same over time in a single economy.
2. Mandates of central banks should be expressed in terms of final objectives and not in terms of either intermediate targets or instruments?
3. Central bank policies have distributional consequences and may therefore raise political economy risks. Clear communication about the central bank’s objectives and strategies can mitigate these risks.
4. The traditional policy trilemma is alive and well. Financial globalization brings it more clearly out in the open but does not transform it into something else.

1. The role of the exchange rate in monetary policy frameworks.

The first thing to notice is that exchange rates already do play a role in monetary policy frameworks in many economies. Here in Hong Kong it arguably is the monetary policy framework. Similarly, in Singapore the policy of the Monetary Authority of Singapore is carried out with reference to the level and a future path of an exchange rate concept.

While these are only two examples of exchange-rate focused monetary policies, classifications of exchange rate regimes typically find that fixed or managed floating regimes are practised by many central banks, thus indicating that the exchange rate already figures importantly in many policy frameworks. According to the IMF’s 2017 Annual Report on Exchange Arrangements and Exchange Restrictions over 50% of the IMF membership declared that they followed some form of hard or soft exchange rate peg while about 40% had floating exchange rates. In terms of monetary policy frameworks, the same report shows that over 40% of the membership follows an exchange-rate based framework.
But as I will note below, these statistics do not automatically take into account cases where, for example, an inflation-targeting central bank determines the level of its policy interest with an eye on exchange rate developments.

What factors determine the choices of central banks when they consider the role of the exchange rate in their monetary policy frameworks? The short answer is economic structure.

The degree of openness to trade in goods and services and therefore the degree of pass-through of changes in foreign prices and the exchange rate to domestic prices matters. If exchange-rate changes translate rapidly into changes in prices of goods and services in the domestic economy, the central bank may want to limit exchange rate changes brought about by purely financial shocks as these would result in domestic price developments not grounded in underlying real demand and supply developments.

Conversely, economies that are subject to large externally determined terms of trade shocks, producers of commodities traded in global markets for example, would do well in allowing the exchange rate to absorb part of the price adjustments.

Financial structure is also important. The degree of financial integration with global markets will to some extent determine how significant external financial shocks are for domestic macroeconomic and financial stability. An implication of conventional open economy model is that the exchange rate consequences of such shocks should be resisted, at least partially, lest they lead to unwarranted adjustments of relative prices of goods and services.

The extent of such warranted resistance depends on the state of development of domestic financial markets, in particular the availability of instruments to hedge risks associated with exchange rate fluctuations. This in turn points to the likely endogeneity of the development of such instruments. If changes in exchange rates are limited by central bank policy, the incentives in the market to develop hedging facilities will be reduced, giving further motive for the central bank to intervene, a classical chicken and egg problem.

These arguments suggest that taking the exchange rate into account in monetary policy decisions may be justified in certain circumstances. But what form should this take? Or putting it more directly, should it only take the form of adjusting the policy interest rate, or would interventions in the foreign exchange market be considered legitimate? For me the answer is clear: if interventions in the foreign exchange market are effective in modifying the path of the exchange rate, they should be part of the toolkit of the central bank. The analogy with the use of macroprudential policies to deal with financial stability concerns is apt: if they can be used effectively as a complement to interest rate policies then there are good reasons to use them. I would argue that the analogy goes further. If interest-rate changes are believed to be too blunt a tool to deal with financial stability concerns, they may also in certain circumstances be
too blunt to be used to influence the exchange rate. If macroprudential policies and interventions in the foreign exchange market are relatively more effective tools to deal with their respective targets they should be used in conjunction with the interest rate to reach the central bank’s objectives.

Will there be leakages and possible side effects? Quite possibly, and therefore the use of these instruments should be complementary to the use of central bank policy rates and not operate at cross purposes. We must also be cognisant of the possible limits on the effectiveness of different policy instruments implied by the well-known policy trilemma of which I will have more to say below.¹

2. Should central banks’ mandates include leaning against exchange-rate misalignments?

The short answer to this question is no. I believe that central bank mandates should be broadly aligned with the more ultimate goals such as macroeconomic stability and financial stability. How the central bank should achieve these should not be mandated.

Typically, macroeconomic stability is broken down into stability of inflation on the one hand and some mention of economic growth or high employment on the other. How these should be achieved is at the discretion of the central bank. This is what we mean by giving the central bank instrument independence subject to being accountable and transparent in its actions.

The case is similar for financial stability. Which tools are used to achieve this should be left to the discretion of the central bank. Sometimes reference is made to intermediate targets such as credit growth or housing prices, but typically the underlying objective is couched in terms of preserving stability of the financial system.

I believe the same principles should apply when we consider basing policy decisions on the exchange rate. We should take it into account to the extent that it will help preserve macroeconomic and financial stability. Misaligned exchange rates can lead to macroeconomic imbalances as resources are shifted to sectors that are favoured by the misalignment. Note the corollary: when relative prices change and resources are shifted because of fundamental changes in underlying demand and supply considerations, there is no real exchange rate misalignment and no case for leaning.

¹ Suffice it here to say that it seems inconsistent to simultaneously hold the view that exchange rate changes are ineffective as tools to influence exchange rates, and the view that interventions in the foreign exchange market must be symmetric with respect to appreciation and depreciation pressures lest any asymmetry would create prolonged misalignments of real exchange rates.
This highlights an obvious difficulty associated with the notion of leaning against misaligned exchange rates, namely the difficulty of identifying misalignments. But this difficulty applies equally to the statement that “we should not fight against exchange rate changes that correspond to changes in ‘fundamentals’”. If we can identify what exchange rate changes correspond to fundamentals, then we will also be able to identify those changes that do not. So, unless we are prepared to argue that all exchange rates movements that are determined by market forces are justified by ‘fundamentals’ there is no alternative but to take a stand on what constitutes a misaligned exchange rate.

Central bankers routinely take a stand on what constitutes fundamental, or equilibrium, values of a host of variables, and implicitly therefore on ‘gaps’ or misalignments. Think of output gaps, credit-to-GDP gaps, and the now in vogue r* to mention just a few. Having a view on an exchange rate gap does not seem fanciful.

But it must be recognized that any estimate of any of these gaps will be imprecise, and that therefore central bank policy should not be focused on closing them rapidly and without watching for signs that the measurement may be erroneous. Care should therefore be taken not to elevate any of them into an automatic rule or reaction function. Hence, I would not want to mandate that the central bank should lean against currency misalignments.

3. Political economy risks.

I will not say much about this topic except to note that monetary policy as typically carried out leads to changes in relative prices and wealth and may therefore be criticised on the grounds that some elements of society are favoured compared to others. Changes in interest rates alter the relative price of present versus future consumption which may be counter to the interest of some members of society. Debtors and creditors are likewise on opposite sides of the winners’ and losers’ corners when interest rates change.

Changes in real exchange rates do not change intertemporal prices (unless they are expected to be reversed in the foreseeable future) but rather the relative price between tradable and non-tradable goods and services. As such they also have distributional consequences as separate members of society are exposed differently to the fortunes of these sectors, and changes in the distribution of income and wealth may have political economy consequences.

I would, however, argue that if the objectives of monetary policy are properly explained the political economy risks can be mitigated. By properly explained I mean that the reasons for the central bank policy - be it a change in the policy rate, a change in a macroprudential instrument, or a policy-induced change in the exchange rate – is couched in terms of the
underlying objectives of preserving macroeconomic and financial stability. Not everyone will be satisfied with the central bank’s arguments, but there is no free lunch when policy instruments are used actively.

4. Is the policy trilemma still relevant?

The Mundellian policy trilemma encapsulates a by now well-known constraint on central bank policy in an open economy. It says that a country can choose at most two of the following policies:

- No restrictions on international capital movements
- A completely fixed exchange rate, and
- The ability to set the domestic risk-free interest rate independently of the foreign risk-free interest rate

It is important to emphasise what the trilemma does not say. It does not imply that if a country adopts a floating exchange rate it will be insulated from foreign financial shocks. As long as international capital markets are linked to some extent there will be financial spill overs across borders. The exact nature of these spill overs will depend on the exchange rate regime, but it has never been the case that a floating exchange rate will prevent them.

But what of the empirical findings that have recently emerged that shows that there is considerable correlation of interest rates across countries even if they operate with floating exchange rates?

Part of this can be attributable to the proposition that with integrated goods and capital markets trends in (risk adjusted) long term real interest rates should be similar across countries. If in addition, central banks have adopted similar targets for inflation, and if they are successful in reaching them, then long term nominal interest rates will also follow similar trends across economies.

Another reason why interest rates are correlated across economies is related to the topic of this panel, the revealed preference of many central banks to pay attention to exchange rate movements when they set policy interest rates. Results of the estimation of policy reaction functions for emerging market central banks indicate that policy rates are sometimes set with an eye on the exchange rate, or alternatively, with an eye on interest rates in global financial markets (read the USA). Such behaviour will lead to some correlation not only of policy rates across economies, also of longer-term interest rates across economies as these are functions of expected future policy rates.
This then brings me full circle. Central banks are mandated to uphold monetary and financial stability. The conventional argument holds that to achieve their mandate, they should use the relevant policy levers at their disposal: a policy interest rate to shift aggregate demand intertemporally with the aim to maintain price stability and macroprudential tools to prevent the build-up of financial imbalances and to render the financial system more resilient. I would argue that exchange-rate induced build-up of sectoral imbalances in the economy with the associated misallocation of resources also constitutes a threat to both macroeconomic and financial stability. Central banks should therefore take exchange movement into account in the monetary policy frameworks and use policy tools, including interventions in the foreign exchange market, to limit this threat. To be sure, these three pillars of policy must work together. Coordinating their use would render each of them more effective.