

'Emerging economies cautious about capital account convertibility'

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Chennai, Feb. 5

When does monetary sterilisation become relevant? Monetary sterilisation makes good sense when the balances of payment pressures are considered to be temporary, says Mr Ramkishan S. Rajan, Associate Professor in International Economics at the School of Public Policy, George Mason University (www.gmu.edu) in Virginia, US, during a recent interaction with Business Line. "However, when these pressures are sustained, the carry costs of this reserve accumulation can become fairly high, as they have in a number of countries," he adds.

Asymmetry

It would appear though that there is an asymmetry in the way that many Asian central banks treat exchange rate movements, comments Mr Rajan. What's that? "Specifically, they have not always altered interest rates in response to upward (buying) pressure on their currencies, preferring to intervene in the foreign exchange market, but they are more willing to hike interest rates in the midst of downward (selling) pressure on their currencies."

"Of course, the pressure on the balance of payments and thus the exchange rate can always be reduced to some extent by allowing interest rates to decline, though this would compromise the domestic inflationary objective.

Thus, a bone fide inflation targeting central bank should appropriately respond by allowing the currencies to appreciate vis-à-vis major currencies including the US dollar to lessen the pressures on reserve build-up."

The examples he cites are of the policy that the Australian and New Zealand central banks generally adopt. Any among the Asian economies? Korea and Thailand, says Mr Rajan. "

The Korean won appreciated from 1040 per dollar in July 2005 to about 920 won per dollar by early December 2006, while the Thai baht appreciated vis-à-vis 42 baht per dollar in July 2005 to almost 35 baht in early December 2006.

But dramatic changes happened in Thailand, not long ago. "On December 19 the Bank of Thailand attempted to impose Chilean type of controls so as to curb capital inflows," recounts Mr Rajan.

"While the policy was quickly reversed in the face of massive sell-off of the Thai equity and currency markets, the action betrayed an unwillingness of the Bank of Thailand to fully commit to its new monetary framework."

Alternative route

What can be an alternative route to alleviate the pressure on the currency?

"Easing any remaining restrictions on capital outflows and effectively allowing domestic residents to hold more foreign assets (rather than the central bank having to do so via foreign exchange intervention)," postulates Mr Rajan.

"China and India have been doing exactly this, albeit gradually. However, even since the Asian financial crisis, emerging economies have rightly been cautious about wholesale acceptance of complete capital account convertibility," comments Mr Rajan.