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## Prisoner's dilemma in Asian exchange rate policies

*The extreme export-oriented nature of most Asian economies has given rise to a collective action problem where the fear of losing competitiveness leads each of them to heavily manage their respective currencies. — MR RAMKISHEN S. RAJAN, ASSOCIATE PROFESSOR IN INTERNATIONAL ECONOMICS AT THE SCHOOL OF PUBLIC POLICY, GEORGE MASON UNIVERSITY*



*Thailand continues to be on the radar of currency-watchers. And the country's report card is not all that good. For instance, Standard & Poor's commented adversely, only weeks ago, about Thailand's investment climate taking a beating from political instability and sudden shifts in capital control policies, as towards the end of 2006.*

*To know more about the international monetary scene, Business Line interacted with **Mr Ramkishan S. Rajan, Associate Professor in International Economics at the School of Public Policy, George Mason University** (<http://mason.gmu.edu>) in Virginia, US. He has previously been on the faculty at the University of Adelaide, Claremont McKenna College and National University of Singapore. Professor Rajan specialises in International Economic Policy with particular reference to the developing Asia-Pacific region and has published extensively in his field.*

### Excerpts from the interview:

**Recent developments in Thailand remind experts of the Asian financial crisis of the late 1990s. Why? What were the lessons of that crisis?**

The Thai crisis ignited some fears of a possible repetition of the 1997 Asian crisis for three main

reasons. One, as in 1997, the trigger or the first country to be impacted was in fact Thailand. The crisis spread rapidly from Thailand to Indonesia, Malaysia, Korea and other regional economies (so-called contagion).

Two, some still hold the view - not grounded in any solid theory or empirical evidence - that booms and bust in the macro economy and financial markets occur in regular cycles. Thus, the 10-year gap between the first crisis and the recent uncertainties in Thailand fuelled concerns of a repetition of a financial crisis in the region.

Three, the Asian region today shares three common characteristics with the last decade — sharp inflows of foreign capital, asset price reflation (that is, the intentional reversal of deflation through a monetary action by a government) and appreciating exchange rates.

This said, while most Asian economies have been booming, their economies are by and large more durable than a decade ago (though of course, not immune to downturns).

### **What precautions did countries adopt to avert a similar crisis? How effective have these measures been?**

The Asian economies have taken a number of steps to strengthen their economies in a number of ways. Domestic financial systems have been restructured and bond markets are being developed to diversify sources of funding.

Exchange rate in many economies have become somewhat more flexible thus inducing agents to protect themselves against adverse exchange rate movements. This, along with general restructuring of corporate balance-sheets, has helped strengthen the corporate sectors in these economies.

Central banks in the region have also accumulated large-scale reserves as a precaution against future balance of payments crises (though this is not without its own costs) and greater attention is being paid to more careful macroeconomic and financial surveillance both at a country level as well as a regional level. Steps are also being taken to enhance regional monetary and financial cooperation by ASEAN (Association of South-East Asian Nations) plus three (Japan, Korea, China) economies.

### **Has inflation targeting been an important component in policy-making? Why?**

As many economies have moved away from strong dollar pegs towards a degree of exchange rate flexibility, there is a need to look for an alternate monetary anchor. Buoyed by the experiences of many industrial countries as well as encouraged by the IMF (International Monetary Fund), Korea, Thailand, the Philippines and Indonesia have officially adopted inflation targeting frameworks. Each of these countries has passed legal and institutional legislations supporting their respective inflation targeting arrangements.

Important features of an inflation target arrangement include the definition of what type of inflation is being targeted, the inflation target range, the use of exclusion clauses or caveats (i.e. under what circumstances the central bank is able to overshoot its target), and the target horizon. All of this information needs to be publicly available and fully transparent.

### **How do countries put in place 'inflation targeting'? Any relevance for India?**

Inflation targeting is conducted in conjunction with a monetary policy rule (MPR). In general

terms, the MPR is one element of a strategy employed by the central bank as part of its overall monetary policy. The MPR specifies how the instrument of monetary policy is to be changed given the characteristics of the macro economy and the policy objectives of the central bank. The MPR implicitly assumes that the instrument of monetary policy will always react strongly to inflation (or some forecast of future inflation).

MPRs and inflation targets are different elements of a general monetary policy strategy. The MPR provides a guide to the policymaker as to how to manipulate the instrument of monetary policy, while the inflation target simply makes a statement of what the instrument is being ultimately used for. Conventionally an inflation targeting arrangement ought to be accompanied by a flexible exchange rate, with the interest rate used as the monetary policy instrument.

Notably in Asia, China still maintains a fairly rigid dollar peg. Singapore operates a quasi inflation target in that its MPR is the trade-weighted exchange rate rather than the interest rate.

Malaysia too appears to be following Singapore in pursuing the objective of managing a trade-weighted exchange rate. India also operates a managed float and has, by and large, done so quite credibly, though the actual monetary and exchange rate framework is rather unclear.

It is apparent that as India has become more open to global economic forces and has paid more attention to its regional and global competitiveness, the policy makers have become more concerned about ensuring the Indian rupee remains relatively stable vis-à-vis other Asian economies. The virtue of inflation targeting is that it forces central banks to be more transparent in the type and operation of monetary and exchange rate policy frameworks.

### **Your view on India's approach to capital account convertibility...**

India's approach to capital account convertibility — which is being undertaken in a graduated and calibrated manner — is to be commended. The debate on this issue has, however, in recent times become rather confused.

People talk about convertibility as though it is a 0 or 1 situation. In actual fact, India and China have both been gradually moving to liberalise capital account transactions. Clearly, as Indian companies look to becoming more global there is a need to allow them greater flexibility to raise funds from overseas markets.

As these and other capital account transactions become more liberal it is incumbent that the RBI (Reserve Bank of India) ensure that it has in place effective surveillance mechanism to keep track of potential concerns (such as over `excessive' short term debt inflows). Tightened prudential regulations are also critical, as made apparent by the innumerable crises in emerging economies.

In addition, it has to be accepted that as India's capital account become more liberal, there is a need for greater flexibility and transparency in India's exchange rate framework. Such flexibility is particularly important if India is to be able to continue effectively to maintain monetary policy autonomy in terms of interest rates.

Given the fact that the Indian economy is far more dependent on domestic demand than its East Asian counterparts, there is particular need to ensure interest rate policy autonomy.

### **Is there a need for better currency management by the Asian economies?**

The extreme export-oriented nature of most Asian economies has given rise to a collective action

problem (the so-called `prisoner's dilemma') whereby the fear of losing competitiveness leads each of them to heavily manage their respective currencies, particularly in view of the continued limited flexibility of the Chinese currency. This, in turn, has led to growing internal imbalances within these economies, while also contributing to the global macroeconomic imbalances.

This prisoner's dilemma with regard to exchange rate policies in Asia, in turn, implies that there may be potential benefits from pursuing a more coordinated approach to dealing with monetary and exchange rate policies in the region. Absent greater regional coordination, formal adoption of a transparent currency basket regime with explicit recognition of the important role of the exchange rate may be a feasible way forward.

### **Examples of cooperative initiatives.**

Indian policymakers need to be more actively involved in regional monetary and financial fora in Asia (as they are in trade and investment fora) and attempt to become part of the Chiang-Mai initiative of the ASEAN Plus Three (APT) economies.

India should also attempt to become a member of the EMEAP (Executives' Meeting of East Asia-Pacific Central Banks), which is a cooperative organisation of central banks and monetary authorities (members include China, Korea, Japan, Hong Kong, Thailand, Philippines, Malaysia, Singapore, Indonesia, Australia and New Zealand).

At the least, these fora facilitate exchange of best practices, help in macroeconomic and financial surveillance, and can also motivate better and deeper research into macroeconomic and financial policies in India (which is in need of further strengthening).

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