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Monetary Policy Regimes in the Pacific Region

PEO/Structure Project 2013

PACIFIC ECONOMIC OUTLOOK

Structure Project

Monetary Policy Regimes in the Pacific Region

Japan Committee for Pacific Economic Outlook

ISBN 978-4-87769-349-7

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PECC, Pacific Economic Outlook Structure Project
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PREFACE

This report on *"Monetary Policy Regimes in the Pacific Region"* is the 14th report in a series of studies conducted by the Pacific Economic Outlook (PEO) Structure Task Force. PEO/Structure is one of the task forces under the Pacific Economic Cooperation Council (PECC) and deals with longer-term structural issues of macroeconomics in the Pacific region.

Following the previous topic of Macrofinancial Linkages and Financial Deepening, this project is to scrutinize monetary policy regimes, particularly how they affect macroeconomic performance in advanced and emerging economies in the Pacific region. Facing the current global turmoil, the macroeconomic policy trilemma among the three policy goals, i.e. exchange rate stability, free capital mobility and monetary autonomy has been reexamined.

The above observations lead us to discuss the following questions: While the current crisis has seriously affected domestic financial systems and macroeconomic developments in the region, how has the policy authorities coped with this and how can we assess their efforts so far? Then, does the above examination suggest us to change the framework of monetary policy management or monetary policy regimes in terms of monetary policy independence, exchange rate stability and capital mobility? If they do, how and if they don't, why?

Reviewing our diverse experiences in the region, we confirmed diverse monetary policy regimes and developments in the monetary policy framework, but then we identified a few common facets to learn for more robust monetary policy regimes for the future.

This report is a summary of studies conducted by the PEO/Structure Task Force under the coordination of Dr. Akira Kohsaka.[1] The first section of the report provides an overview, prepared by Dr. Kohsaka, on macro-financial linkages and financial deepening. The second section consists of executive summaries of individual countries/regions that were submitted by specialists from each PECC member economy.

The PEO/Structure Project held two International Specialists Meetings in March and September 2012 in Osaka, Japan. These meetings were hosted by the Japan Committee for Pacific Economic Outlook which has been housed in and staffed by the Asia Pacific Institute of Research (APIR).[2] The Committee has been sponsored by the Ministry of Foreign Affairs of Japan and by regional business communities, the relevant organizations of which are the Pacific Resource Exchange Center (PREX) and the Kansai Economic Federation (KEF).

Ambassador Yoshiji Nogami, Chairman of Japan National Committee for PECC (JANCPEC), serves as Chairman of the Japan Committee for Pacific Economic Outlook. Mr. Yoshinobu Iwaki, Executive Director, Mr. Mamoru Yamada, Deputy Executive Director, and Directors Ms. Chitose Nakada and Ms. Machiko Omori (maiden name, Fujita) coordinated the management of the PEO/Structure Project. Dr. Janis Y.F. Kea provided editorial support to the PEO/Structure Project.

The PEO/Structure Project presents its reports to the meetings of PECC and the Asia Pacific Economic Cooperation (APEC), forums of government officials and individuals in business, government and academic sectors who are interested in economic issues of the Asia-Pacific region.

For more information on the PEO/Structure Project, contact the Secretariat at the Japan Committee for Pacific Economic Outlook.

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[2] The Asia Pacific Institute of Research (APIR) is a nonprofit organization in Kansai (the region centered in Osaka, Kobe and Kyoto) that has as one of its objectives contribution to the development of the national and regional economies through academic advances. APIR promotes research projects under the cooperation of academia and local business community with the aid of governmental support. For more detail, see the information provided.

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Note:The positions and affiliations of the authors are as of September 2012, registered for the final Specialists Meeting of this study.

OVERVIEW

OVERVIEW:
MONETARY POLICY REGIMES IN THE PACIFIC REGION

BY AKIRA KOHSAKA*

Introduction and Summary

Following up on the previous topic of *Macrofinancial Linkages and Financial Deepening*, the purpose of this project is to scrutinize how monetary policy regimes affect macroeconomic performance in advanced and emerging economies in the Pacific region. Under the previous topic, we discussed increased *financial deepening* (accumulation and diversification of financial assets) and expanded *financial globalization* (increases in cross-border assets and liabilities), as backgrounds for macroeconomic management issues such as how to deal with financial business cycles.

We examine, under this new project, how we can more effectively set macroeconomic policy instruments, and in what kinds of institutional settings. In the context of advanced economies, rule-based monetary policies represented by *inflation targeting* have been pursued. But they failed to prevent the bubble-bursts of the global asset market. Many emerging and developing economies abandoned the *virtual dollar peg* system of exchange rates and adopted, as another nominal anchor, inflation targeting with flexible exchange rates and freer capital movement. But they are now confronted with volatile international financial flows and exchange rate risks, which may impact their long-term growth paths to a significant degree.

In advanced economies, there is much debate on discretionary vs. inflation targeting monetary policies in terms of *monetary stability*. In the Pacific context, Japan and the U.S. are in the former league, while Australia and New Zealand are in the latter. Recently, however, we are more concerned with not only monetary stability (control of inflation and output gap), but also *financial stability* (stability of the national financial system) as advocated in *macro-prudential policy* arguments.

In emerging markets, China/Hong Kong being an exception, many have claimed to have abandoned virtual fixed exchange rates and some have actually adopted inflation targeting In either of the two monetary policy regimes, however, their track records to date have demonstrated, on average, superior macroeconomic outcomes in terms of monetary stability and fiscal and external balances compared with those of emerging markets in other regions.

In light of the current global turmoil, the *macroeconomic policy trilemma* among the three policy goals, i.e. exchange rate stability, free capital mobility and monetary autonomy, has been reexamined. Recently, even the IMF admitted, albeit reluctantly, that capital controls and monetary policy discretion could be useful in some circumstances. We are not sure, however, precisely in what circumstances, to what extent and exactly where in the *trilemma* we should attain a balance among the three goals. As a first step, we review our diverse experiences in the region since the 1990s, and then pursue a new perspective on monetary policy regimes by liberating ourselves from the mantra of "the freer and the more flexible, the better." Again,

* Coordinator, Pacific Economic Outlook

we need to take into account the new realities that we found under the name of *financial deepening and globalization*.

The above observations lead us to discuss the following questions: The current crisis has seriously affected domestic financial systems and macroeconomic developments in the region. How have the policy authorities coped with these and how can we assess their efforts to date? Then, does the above examination suggest that we should change the framework of monetary policy management or monetary policy regimes in terms of monetary policy independence, exchange rate stability and capital mobility? If so, how? If not, why?

Reviewing our diverse experiences in the region, we confirmed the diverse monetary policy regimes and their developments; we also identified a few common facets worthwhile to learn for more robust monetary policy regimes as follows:

1. Policy objectives: Facing with financial globalization, emerging market economies need to cope with increasing volatile foreign capital flows. Meanwhile, prudential policies regarding the financial sector need to be better coordinated with macroeconomic stabilization policy under the name of *macro-prudential policy* in advanced economies. Through the series of financial crises in the 1990s, emerging economies in the Pacific region continued to resort to unorthodox, but traditional instruments, i.e. a combination of foreign exchange market intervention and capital controls. Conventional wisdom, such as the macroeconomic trilemma and/or corner solutions within it, was challenged and the emerging economies settled on non-corner solutions to address the new global economic environment.

2. Policy transmission: The region consists of surplus economies which have expanded their linkages with the global financial market on a "gross" basis; i.e. both hosting foreign investment and investing abroad themselves. Moreover, the composition of capital inflows has been dominated by foreign direct investment, not by restless portfolio and other flows. Nevertheless, domestic financial deepening appears to have stagnated. In the 2000s, the non-financial corporate sector came to rely less and less on financial intermediation (bank credits) and more on self-financing as well as on FDI (*financial internalization*).

3. Assessments of policy outcomes: Emerging economies in the Pacific region have successfully coped with the destructive force of volatile foreign financial flows, using unorthodox policy tools. *This time is very different* from that of 1997. These economies have minimized reliance on foreign financial resources and diversified across categories toward less volatile flows. Remarkably, their private sectors have also done the same through their *financial internalization*. Their domestic financial systems are not as deep as those of advanced economies but neither are they as shallow as those of emerging economies in other regions, thereby enabling their policy mix. Resulting changes in domestic demand may need to be re-examined, though.

4. Sustainability from a global perspective: It is often argued that emerging economies have appeared to be far more resilient during the global financial crisis but that they are far from immune to some new types of risks. Under the prolonged recession in advanced economies, emerging economies may have to confront more destabilizing capital flows in the short run, and trend currency appreciation along with accelerated income convergence in the long run. These risks are inevitable anyway. The real concerns over the long run are macroeconomic rebalancing in domestic demand and financial development in these economies. Significant trenddeclines in domestic investment, persistently high savings, and persistently low household consumption are notable. Whether or not they are sustainable and appropriate for long-run growth remains to be seen.

1. POLICY OBJECTIVES: CHALLENGES TO CONVENTIONAL WISDOM

Policymakers in an open economy must confront a *trilemma* in choosing their monetary regimes, where they cannot attain more than two goals among the following three, i.e. exchange rate stability, independent monetary policy , and free movement of international capital flows. In fact, the collapse of the Bretton Woods system of international finance in 1973 means that all advanced economies decided to give up the first goal of exchange rate stability for the other two goals opting for floating exchange rates.

Many developing economies have long been left behind, wondering whether to stick to the old fixed exchange rate regime or to follow the lead of advanced economies. In practice, emerging markets compromised by more or less liberalizing capital accounts under stable exchange rates. The series of currency crises in emerging market economies in the 1980s and the 1990s were often characterized by huge foreign capital inflows and resulting currency overvaluation in advance of the crises.

Observing the crises, some economists advocated "corner solutions" among the three trilemma goals; i.e., completely abandoning one of the goals, sticking to a clean fixed exchange rate or a completely open capital account, or both (then, inevitably, monetary independence foregone). Actually, in the Pacific region, Hong Kong has chosen the third course since 1983 while China chose the first course until 2008.

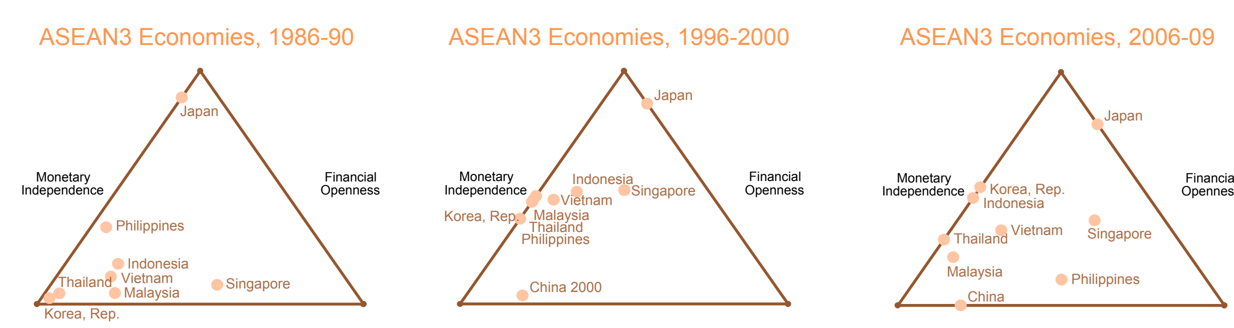
Many other emerging economies, however, have behaved differently from what they officially claim to have flexible exchange rates and free capital movements. In practice, they are more or less away from the corners in terms of exchange rate stability and free capital mobility. Emerging economies in the Pacific region are no exception. Figure 1 shows one example estimate where the policy combination of flexible exchange rate and free capital mobility, as in Japan, is in the top corner and that of fixed exchange rate and capital controls, as in China, is in the bottom-left corner[1]. While we see some shifts of positions during the 1990s, the Figure demonstrates that, even in the late 2000s, Indonesia, Korea, Malaysia and Thailand were remote from the top corner of free float and free capital mobility.

An increasing number of countries have been adopting inflation targeting (IT) as monetary policy. Under IT, flexible exchange rates are presumed because inflation rates are regarded as a substitute for fixed exchange rates as a nominal anchor for macroeconomic stabilization. Some emerging economies have become inflation targeters, including the above four economies in the Pacific region. As Figure 2 shows, however, the resulting exchange rates in East Asia (*Other Asia*) appear relatively stable compared to those of other regions such as *LAC* (Latin America and the Caribbeans) along with an accelerated pace of foreign exchange reserves.

In fact, there is evidence that not only inflation and output gap, as in the *Taylor rule*[2], but also exchange rate stability has been pursued by the policy authorities in emerging inflation targeters. Specifically, there is reasonable conjecture that some authorities have sought to maintain some desirable exchange rate levels, when at least part of the accumulated foreign exchange reserves was unintended. This observation seems to be consistent with apparent non-corner solutions in the triangle of the monetary policy trilemma in emerging economies in the Pacific region.

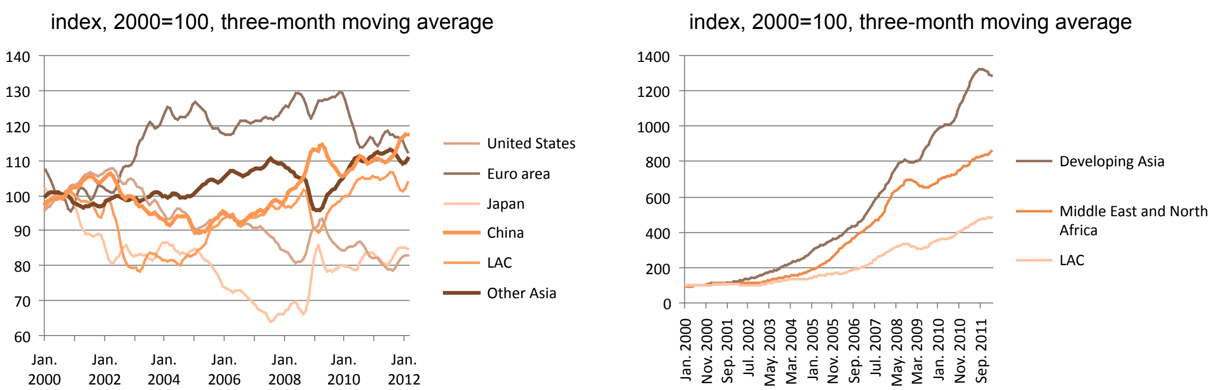
For example, estimating monetary policy responses of these inflation targeters in emerging economies, Ostry et al. (2012) found that they are concerned with not only inflation and output gap, as in the *Taylor rule*, but also (real effective) exchange rate stability. For this additional policy target, they seem to be equipped with an additional policy tool; i.e.

Figure 1. Macroeconomic Policy Trilemma: ASEAN+3 Economies



Source: Ito and Kawai (2011).

Figure 2. Exchange Rates and International Reserves.



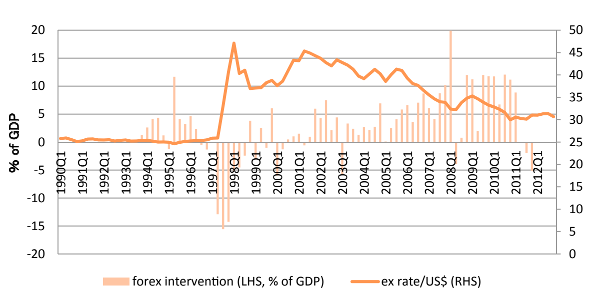
Source: IMF, *World Economic Outlook*, April 2012.

foreign exchange market intervention. Indeed, it is well known that emerging market economies, particularly those in the Pacific region, have accumulated foreign exchange reserves against huge foreign capital inflows so as to prevent currency appreciation through intervention in the foreign exchange market. Their interventions are asymmetrical; i.e. mostly against currency appreciation except for some occasional capital reversals.

Figure 3 illustrates the case of Thailand. After a desperate currency defense in 1997, foreign exchange market intervention has been almost exclusively on the side of dollar purchasing; i.e. against currency appreciation. The same holds true for other emerging economies such as Indonesia, Korea and Malaysia, not reported here.

The ultimate goals of macroeconomic policy have been both internal and external balances in the short

Figure 3. Exchange Rate and Foreign Exchange Market Intervention: Thailand



run. The former includes price stability and full capacity utilization (minimized GDP gap), and the latter some sustainable current account balance. The macroeconomic policy trilemma is about the combination of policy arrangements in order to attain these ultimate goals. Even under flexible exchange rates, external balance remains valid because markets, especially the international capital market, do not always adjust and stabilize it automatically.

In sum, under financial globalization, emerging market economies need to be equipped with more safety policy measures in order to cope with increasing volatile foreign capital flows. Their initial conditions are relatively shallow domestic financial markets, including credit markets and foreign exchange markets and almost negligible securities markets. Meanwhile, in advanced economies with relatively deeper financial systems, prudential policies on the financial sector need to be better coordinated with macroeconomic stabilization policy under the name of *macro-prudential policy*. Through the series of financial crises and capital reversals in the 1990s, emerging economies in the Pacific region continued resorting to unorthodox but traditional instruments; i.e. a combination of foreign exchange market intervention and capital controls, under whatever names they applied. Conventional wisdom, such as the macroeconomic trilemma and/or corner solutions within it, was challenged and settled through non-corner solutions to address the new global economic environment.

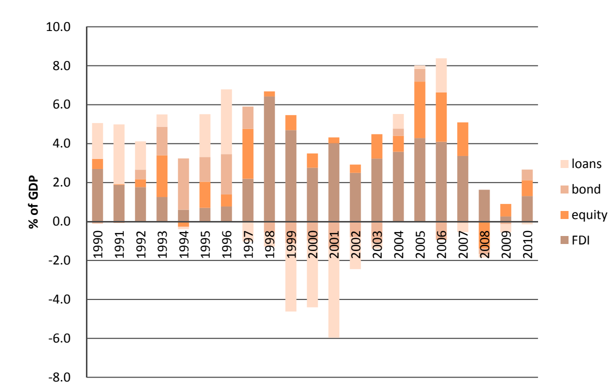
2. POLICY TRANSMISSION: GLOBAL FINANCIAL LINKAGES AND DOMESTIC FINANCIAL DEEPENING

Financial linkages of emerging economies in the Pacific region to the international capital market have experienced two large waves - in the 1990s up to 1997, and in the 2000s up to 2008 - as demonstrated in Figure 4, using the case of Thailand as an example. At each end of these waves, we witnessed reversals of foreign capital inflows, although the reversals in the 1990s were larger and longer-lasting than those in the 2000s. By contrast, it is notable that, for the first time since World War II, the same kind of capital reversal occurred in advanced economies in the late 2000s; i.e. the Global Financial Crisis.

The scale of foreign capital inflows as a percentage of GDP was significantly expanded in the two waves. For example, in Thailand, inflows peaked at 6% of GDP in the 1990s and increased to 8% in the 2000s, while averaging 6% and 10% respectively across emerging economies in the Pacific region. Meanwhile, the composition of capital flows has changed dramatically during the past two decades. Most stable FDI became dominant, followed by portfolio flows, and most volatile other flows, including loans, became less dominant. After 2008, even FDI shrank.

These developments of capital inflows in emerging economies in the region were documented in our previous report (2011). We should note, moreover,

Figure 4. Capital inflows: Thailand



Source: Author's calculation from World Bank, *World Development Indicators* 2012.

that we need to watch not only inflows but also outflows of these economies in order to understand their financial linkages to the international capital market. On average across the region, outflows peaked at 10% of GDP in 2007, excluding foreign exchange market interventions, and exceeded 20% including interventions.

In discussing the financial linkages of these emerging economies, we need to do so not on a net basis but on a gross basis, just as in the case of advanced economies. Note that we are not suggesting that they are at the stage of advanced economies in terms of financial development, as we will discuss later. This is important because we need to be careful on how these financial linkages relate to their monetary policy regimes with non-corner solutions.

In light of the financial linkages of East Asian emerging economies to the international capital market, we should note, in addition to foreign financial flows, the movements of official foreign exchange reserves. There has been much debate on the huge accumulation of these reserves by East Asian emerging economies. While many emerging economies have accumulated reserves since the late 1990s, East Asia is distinguished from other regions by being both the earliest and the fastest. Moreover, various combinations of economies concluded foreign exchange swap agreements in East Asia, which shows that they paid meticulous attention to liquidity in foreign exchanges.

The changes in the financial linkages of East Asian emerging economies to the international capital market since the Asian crisis can be summarized as follows.

1. With respect to foreign capital inflows, non-debt FDI has become dominant in composition, and intra-regional investors have played more important roles. This probably reflects financial account liberalization policies and robust industrialization in the region.
2. Debt capital inflows such as loans and bonds are sensitive to capital market sentiments and their volatile movements tend to magnify rather than dampen business cycles. This suggests the presence of imperfections inherent in capital markets, which are likely to be lessened by the increasing presence

of intra-regional investments.

3. The accumulation of official foreign exchange reserves, which themselves might be by-products of stabilizing exchange rates, is particularly remarkable in emerging economies in the Pacific region. These reserves have played the role of buffers against capital market stresses. Whether they are in excess or not remains to be seen, however.

In other words, parallel with the case of trade flows, we have witnessed increasing intra-regional dependence in capital flows. In the case of FDI, as well as equity investment, old emerging economies such as Hong Kong, Korea, Singapore and Chinese Taipei have become important investors in new emerging economies such as ASEAN4 and China. These are rational behaviors that compensate for capital market flaws in information asymmetry and would moderate the volatile effects of investment flows from old advanced economies. These new developments suggest that it is no longer sufficient to look only at capital flows from North (advanced economies) to South (developing economies).

Now, we turn to the interaction between these foreign financial flows and domestic financial systems. How are these foreign capital inflows linked to domestic finance?

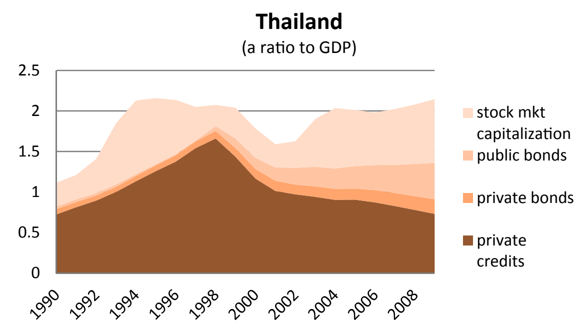
Our previous report (2011) summarized the linkages to the international capital market and the contrast between emerging economies in the Pacific region and those in other regions, as follows:

1. Reliance on foreign capital flows in emerging economies is significantly lower than in other developing countries.

2. The scale of financial intermediation is not only far larger than those of other regions, but has expanded in a sustained manner; hence, more financial deepening.

These observations may not necessarily imply that the financial systems in emerging economies in the region are now sufficiently resilient to cope with a headwind coming from globalized financial flows. Figure 5 illustrates the degree of financial intermediation in the private sector in Thailand. Apparently, domestic credits to the private sector did not recover to the previous peak level relative to GDP and this decline was not compensated for by substituting

Figure 5. Financial Disintermediation: Thailand



Source: World Bank, A New Database on Financial Development and Structure (updated November 2010)

growth of private bond markets, resulting in continued overall financial disintermediation in the private sector since 1997. Note that Thailand is not an exception but is atypical among the crisis-hit economies in the Pacific region.

Our assessment of the domestic financial systems in emerging economies in the region is as follows:

1. Recovery of domestic financial systems in the wake of the Asian crisis is far from complete. In fact, these economies have not attained pre-crisis levels yet, in contrast to the recovery and dynamism of their real economies.

2. Particularly notable are the retrenchment of private credits on one hand and the slow growth of private bond markets on the other.

3. Probably because of the above, the growth of the real economies appears to be underpinned less by external financing through the domestic financial system and more by FDI (foreign savings) and own finance (corporate savings), both of which can be regarded as internal financing.

In sum, in the Pacific region, global financial linkages are no longer on a "net" basis. In fact, emerging markets in the region have expanded their linkages with the global financial market on a "gross" basis; i.e. both hosting foreign investment and investing abroad themselves. Moreover, the composition of capital flows has been dominated by foreign direct investment, not by restless portfolio and other flows.

Nevertheless, domestic financial deepening appears to have stagnated. The non-financial corporate sector has relied less and less on financial intermediation (bank credits), which is far from compensated for by the development of private bond markets. In other words, the corporate sector has financed through its own resources as well as through FDI in the 2000s. We are concerned with whether this trend of *financial internalization* is temporary and/or sustainable for the future. The final outcome remains to be seen.

3. ASSESSMENTS OF POLICY OUTCOMES: THIS TIME IS VERY DIFFERENT

To date, the macroeconomic performances of emerging markets in the Pacific region have generally been superior to those of emerging markets in other regions. Relatively low inflation, high income growth, stable exchange rates and current account surpluses have been attained. Their fiscal balances are in relatively good shape and their interest rates are very positive. Hence, no one can argue that the resulting non-corner solutions of monetary regimes in the regions are unsuccessful.

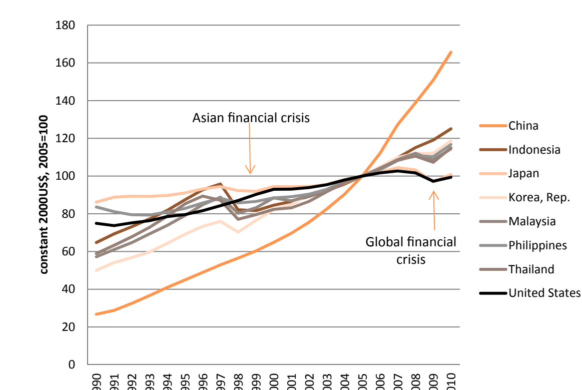
However, if we compare situations before and after the two crises, we can note some important differences in macroeconomic performance. On one hand, for several years before the Asian crisis in 1997, the emerging economies in the region enjoyed steady and strong growth with current account deficits due to historically high investments, while their inflation rates were controlled at around +-5%. On the other hand, in the 2000s prior to the global financial crisis in 2008, they slowed down slightly but still enjoyed strong growth under controlled inflation. In addition, they had current account surpluses rather than deficits due to stagnated domestic investment.

Moreover, when we turn to recovery processes after the crises, while the recovery from the Asian crisis was quicker than expected, the crisis hit them more harshly than this time around, with deeper recessions, so that it took more time to exceed previous peak income levels. For example, it took Indonesia 7 years, Korea 3 years, Malaysia 5 years, the Philippines 3 years, and Thailand 7 years. Figure 6 shows developments of their per capita GDPs in constant 2005 US$, illustrating how they witnessed sharp downturns during the Asian crisis. In contrast, the recession following the global financial crisis was relatively shallow and it took only one year this time for those economies to regain their previous income peak levels, in stark contrast to Japan and the U.S..

Referring back to the observations on policy management in Section 1, their experiences, in fact, appear to suggest that what matter are, 1) stable exchange rates rather than freely flexible rates; 2) adequately controlled capital flows rather than laissez-faire capital flows; and 3) well-informed domestic saving rather than ill-informed external saving. Modestly put, this unorthodox policy mix turned out to be not that bad. Rather, their approach is worthwhile to examine further in pursuit of optimal monetary regimes for emerging markets under financial globalization.

Emerging economies in the Pacific region learned a lot from their painful experiences of the Asian currency and economic crisis during 1997-98. First, they learned and felt to their bones that unconditional global financial integration or capital account liberalization is very risky. Indeed, they did realize 15 years ago that these global financial linkages could be "a destructive force, increasing volatility and setting off devastating crises rather than promoting growth or helping diversify risk by increasing investment opportunities" (Prasad (2011)). Second, there is no reliable international safety net when rescue is acutely in need. International organizations and their supporters (international bankers) could have helped, but they some-

Figure 6. GDP per capita



Source: Author's calculation from World Bank, *World Development Indicators* 2012.

times do not know or care much about Asia, imposing ready-made tight policy prescriptions designed for some lax, stereotypical emerging economies, which was far from the reality in East Asia (or elsewhere).

Since the Asian crisis, emerging economies in the Pacific region have formally converted to inflation targeters under flexible exchange rates, opening up financial accounts and strengthening prudential controls. In practice, however, they have continued to pursue exchange rate stability through foreign exchange market intervention and sterilization on one hand and control capital flows with various, deliberate prudential measures on the other. Policy goals are stability and growth under monetary independence, for which complete financial openness is not a practical intermediate target. And, they were right. Emerging economies in general, and particularly those in the Pacific region, have recovered quickly from the global financial crisis as against advanced economies. Furthermore, they look more resilient to ever more volatile international financial flows in the following years.

In sum, emerging economies in the Pacific region have successfully coped with the destructive force of volatile foreign financial flows, using foreign exchange market intervention and capital controls as additional policy tools. They have minimized reliance on foreign financial resources and diversified them across categories toward less volatile flows. Remarkably, their private sectors have also done the same through *financial internalization*. Their domestic financial systems are not so deep as in advanced economies but not so shallow as in emerging economies in other regions. Resulting changes in domestic demand may need to be re-examined, though. Significant trend declines in domestic investment, persistently high savings, and persistently low household consumption are notable. Whether or not they are sustainable and appropriate for growth in the long run remains to be seen.

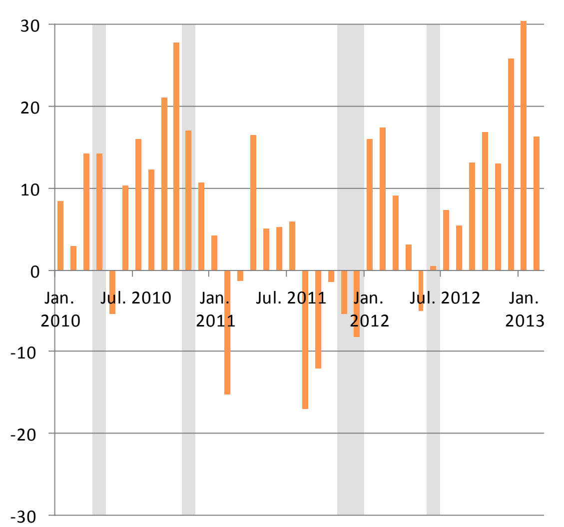
4. SUSTAINABILITY FROM A GLOBAL PERSPECTIVE

For emerging economies in the Pacific region, the days of heavy reliance on foreign capital inflows and *fear of float* have long gone since the Asian crisis. Today, they live with somewhat flexible exchange rates and somewhat open financial accounts, using large foreign exchange reserves as buffers or insurance against the volatility inherent in the international capital market. They could still be exposed to some new types of risks, however.

As long as advanced economies remain in deep and prolonged recessions, emerging economies in the region could be good targets for international investors seeking promising investment opportunities and/or for flights to quality. Emerging economies' huge foreign exchange reserves could be exposed to major currency realignments and capital losses . Or, it could be argued that the resilience and/or savings gluts of those emerging markets are the ultimate cause of the global financial crisis and the prolonged global recessions.

It is indeed possible that a surge of capital inflows ignites domestic credit booms and asset bubbles, currency appreciation and/or domestic inflation in emerging economies, damaging their export-led industrialization, which eventually leads to a series of boom/bust cycles, *sudden stops* of capital inflows/capital reversals and then long and deep recessions. In fact, we can ascertain a series of ins and outs of foreign capital flows to and from emerging economies since the global financial crisis, as shown in Figure 7. We can find at least four

Figure 7. Net Capital Flows to Emerging Economies



Note: billions of US dollars, monthly flows.
Source: IMF, *World Economic Outlook*, April 2013.

capital flow reversals during the years of 2010-12. But, it seems that, at least thus far, they have fared well, one way or another, successfully avoiding the above-mentioned traps. No substantial currency appreciation, nor uncontrollable domestic inflation resulted.

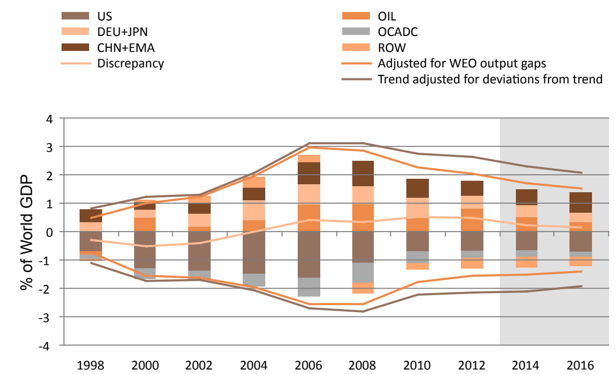
Also, it is possible that, as long as the U.S. and other advanced economies continue current low productivity growth due to public debt burdens, emerging economies with higher productivity growth cannot avoid currency appreciation in the medium term, which implies significant wealth transfer to advanced economies. But, again, it is inevitable,, with or without the Great Recession, when we expect long-run income convergence between emerging economies and advanced economies. The previous Figure 5 appears to suggest that this could happen for at least a few more years. Income convergence with advanced economies is, without doubt, a blessing, not a doom.

Rather than worrying about these new risks, which are inevitable anyway, we may need to consider the long-term issues of macroeconomic rebalancing and financial development in these emerging economies, even beyond the current recession.

Figure 8, from IMF (2013), shows that global imbalances in current accounts have significantly narrowed because external deficit economies cut back their domestic demand during the Great Recession. Emerging economies in the Pacific region (CHN+EMA in Figure 8), as external *surplus* economies, have not contributed much in this process, however. Crisis-hit economies witnessed significant trend declines in their investment-to-GDP ratios during the Asian crisis and have never recovered pre-crisis[3] levels, while they have more or less maintained their national savings-to-GDP ratios throughout the post-crisis period. The resulting gaps between savings and investment are equivalent to current account balances. Moreover, China is well known in that her very high investment has been more than financed by higher national savings, consisting of ample saving by households, corporate and incorporated firms and the public sector.

These investment slowdowns in emerging economies in the Pacific region do not mean that their

Figure 8. Global Imbalances



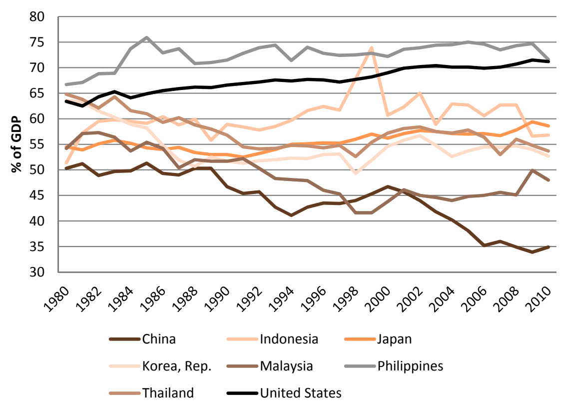
Source: IMF, *World Economci Outlook*, April 2013.

investment levels are lower than those in other regions. In fact, they have stayed significantly higher than those of Latin America and European emerging economies throughout the past couple of decades. We are not certain, therefore, whether or not the current investment levels are to be corrected upward. Note that these investments have been internally financed, as pointed out earlier, rather than through financial intermediation and/or capital markets. Since there is no evidence that their investments have been constrained by fund availability, these financial internalization trends have little to do with the investment slowdowns.

Rather, high savings–to-GDP ratios may have room for reduction. It is also well-known that both domestic financial liberalization and strengthened social security will help reduce these high private savings or low private consumption. While emerging economies in the Pacific region are high-savers and low-consumers relative to those in other regions, we still have seen further declining trends in household consumption-to-GDP in China, Singapore and even Thailand (Figure 9). Given these circumstances, it is easy to see that both financial deregulation in consumer finance and improvements in social security would help rebalance saving-investment gaps and then upgrade investment opportunities.

Financial development would help emerging economies, including those in the Pacific region, by enabling better management of capital inflows and

Figure 9. Household Consumption



Source: Author's calculation from World Bank, *World Development Indicators* 2012.

of their volatility over the long run. But, this cannot be achieved overnight, or without strong financing needs. Information on borrowers is vital in capital markets. The current trend of financial internalization may be one way to help reduce imperfections due to information asymmetries but may not contribute much to rapid development of securities markets in such emerging economies in the region. Furthermore, the demand for these markets should come ahead of construction of institutional arrangements.

The same holds true for capital controls. They sometimes tend to distort capital inflows and outflows. But, we know that capital markets themselves sometimes add economic distortions, particularly when absorptive capacities are lacking in recipient economies. We have learned that an oversupply of financial resources could be worse than nothing, and that it could also distort exchange rates if they are left freely floating, destabilizing the aggregate economy.

Markets are effective institutions, but not panaceas. Advanced economies have just recently proved this. Market imperfections are generally thought to be higher in both developing and emerging economies than in advanced economies. Market imperfections are particularly serious in capital markets, as has also been shown by recent events. Bond markets can help in mobilizing financial resources and channeling them to higher-risk-but-higher-return investment opportunities than can banks, *if* everything else goes well. But, if they don't, emerging economies have every reason to be cautious about resorting to full-fledged liberalization of capital markets and capital (financial) accounts.

With internal and external financial liberalization as well as freely flexible exchange rates, emerging economies could possibly invest more among themselves rather than financing debt buildups in advanced economies. If they see that it is in their interests, they should do so. In fact, until recently, advanced economies found it in their interests to borrow heavily from whomever abroad, while emerging economies found it in their interests to lean against capital inflows through exchange rate manipulation, or equivalently, to unintentionally lend to whomever abroad through foreign exchange reserve accumulation. Now that advanced economies realize that their *Great Moderation* is unsustainable, they have no choice but to behave themselves. What about emerging economies? They know what they should do. Fortunately, they have choices as to how fast to go.

Endnotes

[1] Quoted from Ito and Kawai (2011). Note that the degrees of exchange rate stability (ES), financial openness (FO), and monetary independence (MI) depend on definitions, and alternative measures produce varying and/or diverse results in trends, movements and levels of these variables. Also note that the trilemma between MI, ES and FO does exist, but the trio are not goals, rather intermediate targets used to attain some other goals such as short-run macroeconomic stability and long-run growth. We cannot suggest the optimal mix of the three elements without discussing how they are related to policy goals.

[2] The rule proposed by John B. Taylor (1993) is a formula for how to control the policy interest rate in order to minimize some combination of gaps from two policy targets; i.e. the GDP gap from the natural unemployment level and the gap from the inflation target.

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EXECUTIVE SUMMARIES ON INDIVIDUAL ECONOMIES

AUSTRALIA

BY ALEX ROBSON
ANTHONY MAKIN

The main aim of monetary policy in Australia is to keep inflation low. In practice, this means that the Reserve Bank of Australia (RBA) targets inflation within a range of 2-3 per cent on average over the business cycle. Australia's inflation targeting regime, formalized in an agreement between the Australian Government and the RBA in 1993 following a major recession in the early 1990s, has successfully achieved its stated objective since inception.

Inflation targeting became the modus operandi of monetary policy after it was recognised that high inflation imposes numerous costs. These costs include the inconvenience and real cost to business of having to mark prices up frequently and the inefficiencies that arise in the economy because the price system no longer clearly signals which *relative* prices are changing when all prices are rising. As a result, resources can be misallocated, thereby reducing overall productivity and economic growth. When inflation is high, it tends to be more variable, introducing further uncertainty for business and complicating long-term planning decisions. If unanticipated, high inflation also causes arbitrary redistribution of wealth between borrowers and lenders in the economy.

Australia is among a group of advanced economies that have adopted inflation target ranges as the centrepieces of their monetary policies. The others include New Zealand, the United Kingdom Canada, Sweden, Finland and Spain. Countries which have adopted inflation targeting usually also have floating exchange rates as these make it easier for central banks to control domestic liquidity and short term interest rates for the purpose of controlling domestic inflation.

The RBA uses a short-term interest rate as its operating instrument for implementing monetary policy. In Australia's case, the official interest rate is the short-term cash rate, whose movements are strongly correlated to other key interest rate series. Controlling the official short-term interest rate varies real interest rates across the spectrum, which then alters real investment spending by changing the cost of capital, as well as real consumption spending (to the extent that it is interest-rate sensitive). Interest rate changes also influence asset prices, particularly the prices of equities and real estate, thus reinforcing the impact on investment and on consumption via the household wealth effect.

The link between interest rates and the exchange rate provides another key transmission channel since higher domestic interest rates induce foreign capital inflow, which strengthens the nominal exchange rate. In turn, again assuming sticky prices, this translates to a real exchange rate appreciation which worsens the economy's competitiveness in relation to those of its trading partners, resulting in lower export volumes and higher import volumes. Hence, the net exports component of aggregate demand is also affected. High pass-through of exchange rate changes to the domestic currency prices of tradable goods and services also directly influences the tradables component of the CPI.

The key rationale for inflation targeting is that it provides a consistent and transparent anchor for monetary policy. The Reserve Bank's credibility ultimately depends on whether or not it manages to successfully keep inflation within the stipulated target range. Having a simple, single monetary policy target as an objective of monetary policy is also a tacit admission that achieving low and stable inflation over the medium to longer term is all that monetary policy can usefully achieve.

Whether monetary policy should also target asset prices in addition to normal inflation is an issue that is frequently raised in the Australian policy debate. To date, however, asset prices have not been explicitly targeted as this would distract attention from the main goal of minimizing price rises for goods and services.

CHINA

BY DONGMIN LIU

In line with China's economic reforms and the opening up of its markets, the People's Bank of China (PBOC) initiated its own reforms. To date, PBOC has undergone five evolutionary stages: exploration stage (1978-1992), development stage (1992-1997), reform stage (1998-2001), relatively mature stage (2001-2009), and reform deepening stage (2009-present). Many Chinese economists consider the third stage (1998-2001) and the latest stage (2009-present) as the key periods. It is interesting that both stages closely followed serious financial crises, suggesting that existence of crisis conditions might be regarded as the most important spur for reform to be undertaken in China.

Multi-target decision-making has been the typical model for China's monetary policy regime since a true central bank function was created in the form of PBOC, in 1984. PBOC will continue to follow the multi-target decision model, going forward. In fact, following the global financial crisis, the responsibilities of China's monetary policy could be generalized into four key items: economic growth, inflation control, financial stability and internationalization of the RMB. The fourth target is a new one; last, but not least. Some observers see stability of the exchange rate as the key target for China's central bank. This view is correct but the PBOC's real concern with respect to the exchange rate is economic growth. In addition to the four targets mentioned above, PBOC actually has a very important mission: financial reform and opening up of the financial system. Over the last three decades, China succeeded in reforming and opening up its real economy. But, in the financial market area, there is still a lot of work to be done. Recently, interest rate liberalization, entry of private capital to the finance industry and capital account opening have begun to accelerate. So, in the author's view, PBOC's most important goal is to firmly implement comprehensive financial marketization reform and opening, which is merely a way of guaranteeing sustainable economic development. In other words, reform targeting should be a priority for PBOC.

Today, with financial deepening and globalization, monetary policy transmission mechanisms are becoming more effective and available in China. Open market operation, deposit reserve ratios, rediscounting, the RMB counterpart of foreign exchange reserves, interest rates and PBOC's policy suggestions constitute the main transmission mechanism in China. Since there are still some interest rate controls in effect, the most effective method for adjusting the money supply in China is open market operation and deposit reserve ratios. PBOC policy suggestions are also an effective tool for implementation of China's monetary policy. It is due to a PBOC suggestion that Chinese commercial banks are actively engaged in the business of cross-border RMB trade settlement, which is making a significant contribution to rapid development of internationalization of the RMB. Another PBOC suggestion has prompted all commercial banks to set loan quotas for small and very small companies, thereby significantly promoting provision of loans to such companies in 2011 and 2012.

Generally, China's money policy has performed relatively well over the last two decades, spurring economic growth, successfully dealing with the Asian financial crisis and the global financial crisis, controlling inflation and house prices, and facilitating internationalization of the RMB. Of course, PBOC still faces some big challenges. With respect to the macroeconomic policy trilemma, China's government has chosen a combination of independent monetary policy, a fixed exchange rate system (the "crawling peg" applied since 2005 was similar to a fixed exchange rate), and controls on capital accounts, thereby resulting in over-accumulation of official foreign reserves and, to some extent, impairing the independence of China's monetary policy. Moreover, in the context of RMB internationalization, capital controls also made the RMB less attractive to foreign investors. In short, it is imperative to step up the opening of capital accounts. In fact, one of the main reasons for PBOC dedicating itself to promotion of RMB internationalization is to force capital account opening, which would also stimulate simultaneous liberalization of the exchange rate and the interest rate. It is a form of political wisdom called 'reversed transmission mechanism,' which has been successfully employed in one instance - China's pursuit of WTO membership.

COLOMBIA

BY JORGE HERNAN TORO CORDOBA

As the world financial crisis clearly showed, price stability is not sufficient to bring about financial stability. In this context, the traditional Inflation Targeting scheme needs to be widened so that monetary policy reacts not only to deviations from inflation forecast targets but also to factors that may compromise financial stability. Accordingly, the task of monetary authorities goes beyond achieving price stability to include realization of financial stability and crisis prevention. This requires that central banks play important macro-prudential roles, which entails (i) striving toward a stable financial system with the ability to accomplish its basic functions in an efficient manner; (ii) having the central bank focus on the macroeconomic aspects of financial stability, and particularly on occurrences of systemic risks, in order to complement the surveillance responsibility of supervisory agencies; and (iii) adopting prudential measures aimed at avoiding excessive risk-taking by financial institutions while inducing them to accumulate assets during boom periods that may be useful in withstanding crisis periods. This requires the central bank to work to prevent asset price bubbles; monitor the dynamics of credit and monetary aggregates; assess the output gaps and debt burdens of households and firms; survey capital inflow and its effects on the local economy, etc.

The Colombian monetary policy is a good example of this extended inflation targeting framework. Key lessons drawn from domestic and world financial crises helped in shaping the new policy framework. Among the main lessons worthy of mention: (i) excessive credit growth and asset price bubbles may have negative effects on financial stability, inflation and output growth; (ii) large currency mismatches compromise financial stability in the event of a correction of the exchange rate; (iii) the financial system has an inherent procyclical character and self-regulation is clearly difficult; (iv) exchange rates are very volatile and attempts to reduce this volatility could substantially increase volatility in inflation and output; (v) when credit or asset price dynamics take hold, additional instruments should be used by central banks to supplement use of the interest rate, rather than it being the only instrument.

Through the putting into practice of these lessons, monetary policy in Colombia has played a timely counter-cyclical role according to changing conditions. For instance, between 2006 and 2008, when the economy attained a rapid rate of growth and a high expansion of credit that threatened to become unsustainable, monetary authorities progressively raised interest rates from 6% to 10%. In addition, they imposed a marginal reserve ratio of 27% on current account and savings account deposits (about three times the average reserve ratio of around 9%). This requirement was complemented by the imposition of capital controls through a compulsory deposit equivalent to 40% of any foreign debt disbursement or portfolio inflow, to be held for six months by the central bank with no remuneration. This policy helped to contain credit expansion in 2007 and thus was useful in limiting excessive exposure to risk for both households and financial institutions. In hindsight, these decisions proved to be very useful as prudential policies that were crucial in protecting the economy against the effects of the international financial crisis.

Colombia has also used a battery of instruments to manage capital inflows. For instance, the Colombian central bank decided to intervene in the foreign exchange (FX) market in order to build up international reserves that could serve as a buffer against external shocks. Through this intervention, a large stock of reserves has been accumulated; this is deemed to be necessary to minimize contagion risk and reduce the probability of speculative attacks against the local currency. Other kinds of instruments for managing capital flows include restrictions on currency and foreign exchange maturity mismatches of financial intermediaries and an unremunerated Reserve Requirement to limit leverage and external liquidity risk. These policies has been supported by a sound fiscal policy aimed at increasing domestic saving in order to moderate the pressure of capital inflows on appreciation of the real exchange rate.

These measures are always decided within a cost/ benefit analysis framework in which the policy objectives are clearly stated. However, assessment of the cost/ benefit balance is not always easy and the instruments that are used do not always prove to be the instruments of last resort. Depending on the size and speed of capital inflows or other shocks that may be occurring at the same time, there could be a role for simultaneous use of macroeconomic and macro-prudential policy measures, including foreign exchange regulations.

INDONESIA

BY SOLIKIN M. JUHRO
MIRANDA S. GOELTOM

The monetary policy regime in Indonesia has been significantly affected by rapid changes in the macroeconomic environment, structural adjustments, and a dynamic political atmosphere over the last four decades. As is well-known, Indonesia has undergone a number of far-reaching structural adjustments in all economic sectors since the early 1970s. The adjustments which were fostered by accelerated globalization and two major financial crises in 1997/98 and 2008/09, have had major implications for monetary management. In this regard, despite substantial progress made following the process of recovery from the Asian financial crisis of 1997/98, the economy was still burdened by various constraints and problems. The main challenges confronting the Indonesian economy were to maintain stability in a time of growing global uncertainty and to accelerate growth. In the second half of the 2000s, amid the struggle to reinforce macroeconomic performance, monetary management was confronted with fundamental challenges associated with occurrence of the global financial crisis of 2008/09 (GFC). In a context of high global uncertainty, the GFC significantly affected not only domestic financial systems and macroeconomic developments in the region but also the ways in which monetary policy was implemented.

Related to the above context, one important policy issue that needs to be addressed is the Impossible Trinity (monetary policy trilemma). In the case of Indonesia, orientation of monetary policy in the midst of high global uncertainty is tactically directed not only toward controlling inflation but also at managing the exchange rate in a specified range in line with macroeconomic fundamentals through quite active interventions in the foreign exchange market. In addition, it simultaneously manages international reserves at a safe level. This condition has a logical consequence in that the exchange rate dynamic will not be completely influenced by market forces but is also strongly influenced by domestic monetary policy. The above facts provide strong evidence that there is a tendency for monetary policy strategy to move away from that hypothesized in the monetary policy trilemma.

This paper shows that, in a small open economy like that of Indonesia, the multiple challenges facing monetary policy as a result of capital flow dynamic, amidst inflationary pressures, imply that the monetary authority should apply unconventional wisdom to monetary policy and employ multiple instruments. This suggests that coordinated implementation of a policy instrument mix is a key part of an important strategy for optimally managing the monetary policy trilemma in the current climate, which is blighted by widespread uncertainty.

The paper also shows that a post-GFC monetary policy framework in Indonesia is, in general, characterised by ‘enhanced’ ITF (inflation targeting framework). In ‘enhanced’ ITF, the monetary policy framework continues to adhere to an inflation target as the overriding objective. The main characteristics of ITF remain; namely, that the inflation target is announced publicly and that monetary policy is forward-looking, transparent and clearly accountable. However, ITF is implemented in a more flexible manner in the sense that Bank Indonesia must not only look at the inflation target merely in terms of policy formulation but also consider a number of other factors, including financial sector stability as well as the dynamics of capital flows and the exchange rate. Therefore, under the unconventional wisdom of ‘enhanced’ ITF, managing the monetary stability framework is essentially to manage the monetary policy trilemma; that is, achieving the three intermediate goals of (1) maintaining monetary policy autonomy in achieving price stability by employing a monetary and macroprudential policy (instrument) mix; (2) stabilizing exchange rate movement in line with its fundamentals by employing exchange rate management; and (3) managing capital flow dynamics in supporting macroeconomic stability by implementing capital flow management.

Within the above policy perspective, achievement of macroeconomic stability is not only tied to monetary stability (price stability) but is also interactive with financial system stability. Therefore, the central bank’s policy formulation should evaluate the strategic role of monetary policy and the financial system at the same time. In this regard, under ‘enhanced’ ITF, flexibility in policy implementation can be achieved through, inter alia, additional macroprudential instruments in addition to monetary instruments, which should reinforce each other. While monetary instruments will be utilized to influence monetary variables, such as interest rate, exchange rate, credit, and expectations, macroprudential instruments will be utilized mainly to manage risk potential or perceptions in financial markets.

A change in the framework will have a number of significant implications for the institutional mandate of Bank Indonesia. The paradigm that monetary policy requires the support of macroprudential policy has the consequence of making it impossible to separate monetary policy from macroprudential policy in order to ensure effective implementation. Therefore, strengthening Bank Indonesia and Government policy coordination in maintaining monetary and financial system stability is imperative. Policy coordination can also be implemented from a broader perspective, including in the process of handling a crisis. The lesson is that strengthening of the framework for maintenance of monetary and financial system stability is indeed necessary but that this must be underpinned by a crisis management framework that is clear, expeditious, and capable of providing legal certainty.

KOREA

BY IN HUH

During the 1990s, Korea's monetary system was gradually liberalized. The exchange market was privatized and the interest rate liberalized. International capital flow was also liberalized. However, this period of gradual adjustment ended abruptly with the advent of the 1997-98 currency crisis. Since then, the Korean monetary system has been fully liberalized.

The Bank of Korea (BOK) has targeted inflation since 1998, according to BOK official documents. A law stipulating inflation targeting as the purpose of the Bank of Korea was ratified at the end of 1997. The BOK varied its inflation target annually until 2003, when it changed to triennial targeting as of 2004. Moreover, the targeted inflation index varies between the headline consumer price index (CPI) and core CPI. Up to February 2008, the BOK used the call rate (interest rate for overnight interbank lending) as the policy rate. Now, the BOK uses the 7-day repo rate (7-day loans from BOK to commercial bank) as the policy rate. As promised, the inflation target has generally been met; the BOK has successfully controlled demand pressures thus far but has not been so successful in controlling supply shocks. Frankel's survey (2010) indicates that controlling supply shocks could be harmful for the economy as a whole. Therefore, it might be concluded that the BOK's neglect of inflationary supply shocks during a global financial crisis would be better than a contractionary policy response.

The Korean won generally appreciated up to the point of the global financial crisis due to a foreign portfolio investment increase and an ongoing trade surplus. However, it depreciated drastically during the financial crisis. As the crisis took hold, the Ministry of Strategy and Finance and the BOK supplied dollar liquidities in several forms for the exchange market to make available to the public and thereby prevent a currency crisis. In addition to the dollar liquidity supplies, the BOK entered into a bilateral swap agreement with the Federal Reserve Bank (FRB) on 30-bill dollars. The amount involved in the swap agreement between the BOK and the FRB was not excessively large compared against the more than 200 billion dollars of Korean foreign reserves held during the crisis. This was essentially a symbolic gesture to reassure market participants that the FRB would provide support for Korea. The monetary authorities succeeded in preventing a currency crisis, but it would be a stretch to say that the exchange market was stabilized during the global financial crisis.

Following the Asian currency crisis, the capital market was fully liberalized. Foreign investors' share of the Korean stock market has hovered around 30% of total market value of KOSPI-listed stocks. The most dangerous underlying problem in respect of capital flows is a sudden cessation thereof. As a result of such an event, the Korean economy suffered from devaluation of the won during the global financial crisis. Consequently, the Korean monetary authority implemented three macroprudential measures on capital inflows, namely limits on forward positions, revival of taxing of foreign bond investments, and bank levies on foreign debts. The limit on forward positions was introduced to limit the short-term debts of banks. Revival of taxing of foreign investments in bonds was introduced to reduce capital flows into bonds and stabilize the bond market in order to minimize the negative effects of sudden reversals. The bank levies on foreign debts were designed to discourage short-term debts in favor of long-term debts. Those measures were not effective in reducing volatility in the financial markets; however, they seem to have had some effect on capital flows and lengthening the terms of banks' foreign debts.

THE PHILIPPINES

BY CAYETANO W. PADERANGA, JR.

The Philippines has experienced three discernible economic crises since 1980, starting with the deep recession in 1984-85, followed by the Asian Financial Crisis in 1997 and, eventually, by the Global Financial Crisis in 2007. In each of those three cases, the economy started from a different fundamental economic foundation and responded with different policies. The country has had several macroeconomic and monetary regimes in the past 30 years. Since 1980, it has gone through monetary programming, first using net domestic assets and later monetary supply as the targets. Since 2003, it has formally shifted to an inflation targeting mode. The differing effects on macroeconomic variables provide a lesson as to how (monetary) policy regimes may affect outcomes as policymakers respond to changing economic events and impacts.

In 1980, the Philippines economy was in a relatively weak state as the country had just experienced foreign exchange pressure due to the increasing imported oil bill, partly due to the 1979 oil crisis induced by the fall of the Shah of Iran. The assassination in 1983 of Senator Benigno Aquino, Jr., one of the most popular opposition figures, triggered a political crisis leading to capital flight. The resulting foreign exchange crisis further brought about a moratorium on payment of foreign obligations, in October that year. The consequence of that move was extreme curtailment of external trade and financing. The resulting supply shock increased prices and both actual and expected inflation. In a flustered effort to maintain the existing exchange rate and contain inflation the central bank drastically increased interest rates, at one point raising 91-day t-bill rates to 45% per annum. The net effect was a deep recession whereby gross domestic product decreased by 15% over a two-year period while the inflation rate rose to double digit levels over the next several years. In the rescue package arranged with the International Monetary Fund (IMF), the Philippines Government instituted a rather stringent monetary program to cover the succeeding few years. The agreement with multilateral financial institutions (primarily IMF, World Bank, and Asian Development Bank) also included support for various structural reforms, including fiscal stabilization, industrial reform that included abolition of agricultural monopolies and the restructuring of tariffs and non-tariff trade rules, and depoliticization of basic prices (e.g. wages, rice and oil).

In contrast, during the Asian Financial Crisis of 1997, the government allowed the currency (Philippines peso, Php) to depreciate. Meanwhile, in the lead-up to the crisis, the government had fully liberalized the foreign exchange mechanism in November 1991, allowing exporters and other foreign exchange earners to retain the first 40% and, eventually (in September 1992), 100% of their earnings; the central bank had been reorganized and recapitalized in 1993; and the structural reforms initiated under the previous administration had been continued. The exchange rate adjustment in July-August 1997, indicated by an increase in the Philippines peso:US dollar exchange rate from Php24.6: US$1 to as low as Php38.50:US$1, led to increases in domestic prices. However, after a slight recession (decline of half of 1% of GDP), the economy essentially continued on a generally positive growth track and the initial increase in the inflation rate reverted to a downward trend that has since stayed relatively stable.

Finally, in respect of the Global Financial Crisis, the impact on the economy was muted. The financial conservatism engendered by the experience of the Asian Financial Crisis insulated the financial system

against major exposure to the structured financial instruments. The main impact of the global crisis came through the Philippines' trade exposure to developed economies that suffered more directly and significantly from the global crisis. The government attempted to institute an economic stimulus package. However, this resulted in fiscal uncertainty in the first half-decade of this century. Fortunately, the government was able to recover and reassure observers as to its ability to manage the fiscal deficit.

The global crisis had minimal impact from a monetary point of view, aside from heightened uncertainty over how far the contagion would spread. The financial effect has mainly come through increases in commodity (and ultimately oil) prices as depreciation of the dollar has induced natural resource producers to increase the dollar prices of their products. However, the manufacturing sector has been impacted by a drastic decline in exports, with exports of electronic products having fallen by more than 30%. Otherwise, the inflow of OFW remittances has been maintained, and increasing exports of processed agricultural products and the expanding BPO sector have been beneficial. The net result has been continuation of positive GDP growth as foreign worker remittances have been maintained (even as the growth rate has decelerated), albeit at lower rates in the immediate aftermath of the crisis. However, the economy has recovered quite rapidly, overall.

Choice of policy regimes

The choice of objective or target may pre-condition the available choices for a policy regime. For example, when the government decided that it would keep the exchange rate of the Philippines peso fixed at a specific level, this meant that monetary and price considerations would be secondary to the main objective. Alternative policy regimes are no longer viable programs.

Monetary programming seems to have been too restrictive for the Philippines. As noticed in the early 1990s, an increase in confidence leading to greater demand for finance could not be accommodated under a fixed monetary program. The consequence of adhering to the original program would be higher interest rates and/or unnecessarily lower output. Abandoning the original monetary targets would risk loss of credibility for the monetary authorities. Targeting net domestic assets as a variant of monetary programming was more flexible than monetary programming as it had could accommodate foreign asset inflow. However, the inflow of foreign assets spills over to domestic assets, forcing abandonment of the NDA target; but this may raise the risk of lost credibility.

Inflation targeting appears to be the most flexible option, providing monetary authorities with a wider choice of policy instruments and intermediate targets while providing a concrete anchor upon which expectations can converge. However, in the experience of the Philippines, overall orientation of macroeconomic policy is probably the most important ingredient for a favourable outcome. The flexibility of inflation targeting can fit very well into astute economic policy-making. But, it is still only part of a broader approach and must fit into and is most effective as part of an overall policy program that makes fiscal, monetary, and other policies convergent. Our findings show that inflation targeting fitted very well into an improving macroeconomic picture and probably reinforced it. But, it cannot fully explain the entire phenomenon.

CHINESE TAIPEI

BY SHENG-CHENG HU

Over the last 20 years, Chinese Taipei has undertaken gradual liberalization of its financial system. The most important step was establishment in 1990 of the QFII system, under which qualified foreign institutional investors (QFIIs) were allowed to make portfolio investments in the financial market, subject to some restrictions. Over time, these restrictions were gradually relaxed. By 2003, the QFII system had been abolished and the financial system was close to being completely liberalized, especially in respect of foreign institutional investors.

Opening up of the financial system permits greater efficiency in asset allocation, while increasing the risks associated with capital flows into the economy and affecting the conduct of monetary policy by the Central Bank.

The operational objectives of the Central Bank of Chinese Taipei, as specified in the Act on the Central Bank, are to maintain stability of the price level and value of the Taiwan dollar relative to other currencies, ensure sound banking operations, and foster economic development within the scope of the above objectives.

The goal of sustaining price stability appears to be to hold the (core) inflation rate to below 2%. The Central Bank maintains a managed flexible exchange rate system. It allows the market to determine the exchange rate, intervening only when there is excessive short-term volatility.

To ensure sound banking operations, there is a division of labor between the Central Bank and the Financial Supervisory Commission, the Executive Yuan (Cabinet). The former is responsible for implementing macro-prudential policies while the latter supervises individual institutions.

The Central Bank of Chinese Taipei conducts its monetary policy mainly through changing reserve requirements and the rediscount rate, providing credit to banks, and conducting open market operations. Occasionally, it exercises selective credit controls (especially with respect to local housing bubbles). Because Chinese Taipei's secondary market for government debts is relatively small, the Central Bank conducts open market operations most frequently by issuing and redeeming negotiable certificates of deposit (NCDs) issued by the Bank.

The Central Bank summarizes its policy objectives by way of an intermediate quantitative target; namely the target growth rate for broad money (M2). At the end of each year, the Central Bank provides an analysis of the current economic situation and sets the target range of the monetary growth rate for the coming year. For example, the target range of the M2 growth rate for 2012 was set between 2.5% and 6.5%, with the center rate being 4.5%.

In targeting the M2 growth rate, the Central Bank appears to have followed the McCallum Rule. In addition, the Central Bank has implicitly argued that there are better ways to conduct monetary policy than through inflation targeting. However, as the Central Bank responds to external shocks to the economy and financial markets in an attempt to maintain short-term stability of the exchange rate, its behavior suggest that is has been following the Taylor Rule of inflation targeting.

With the opening up of the financial system, there are increasing cross-border flows of capital, both inward and outward, in the form of portfolio investments. Inward portfolio investment is more volatile than outward portfolio investment. Sometimes, the Central Bank has to deal with large volumes of rapid short-term capital flows, or "hot money". In addition to direct trading in foreign exchange, the Central Bank takes other intervention measures. For example, during the Asian financial crisis, the Central Bank temporarily halted trading in non-deliverable forwards (NDFs), which were considered to be the main source of speculative trading in the foreign exchange market. During the global financial crisis of 2008, the Central Bank closely monitored the trading of some 20 foreign institutional investors who were engaged in large volumes of foreign exchange transactions.

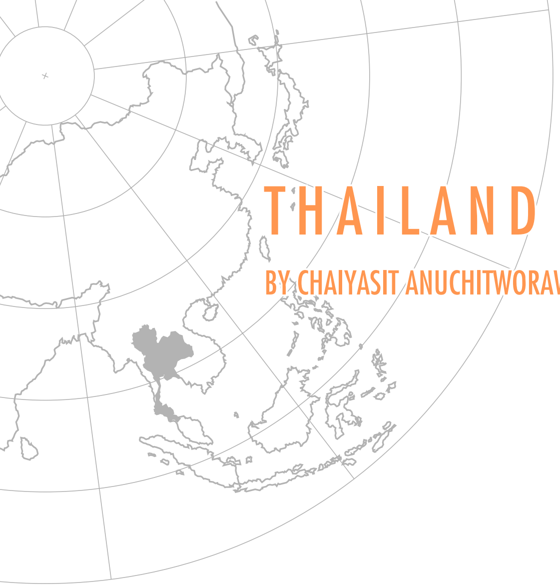
The opening up of the financial system relieves the pressure on the money supply of the economy's rapid accumulation of foreign exchange reserves. The growth rate of M2 has shown a declining trend over the last 20 years, although it is still higher than the growth rate of nominal GDP.

Capital flows have caused increased exchange-rate volatility and forced the Central Bank to frequently intervene in the foreign exchange market. As a result, changes in foreign assets have become an increasingly important factor in explaining the changes in M2. Particularly, the percentage of changes in M2 due to changes in international assets, which had stayed relatively stable, began to fluctuate more widely in the late 1990s.

Although Chinese Taipei was not seriously affected by the Asian financial crisis, it has since encountered a number of external shocks that affected the volatility of the exchange rate and the growth rate of the money supply. However, by and large, Chinese Taipei has been able to maintain a more stable effective exchange rate than its trading partners.

The relationships among movements of interest rates and the inflation rate and the growth rate of the money supply appear to be consistent with theoretical predictions. However, there are times in which inflation appears to be imported (because of the heavy reliance of the economy on imports of natural resources) and cannot be explained solely by the money supply factor.

In summary, Chinese Taipei has pursued gradual opening up of the financial system while maintaining a flexible exchange system. However, in the Central Bank's effort to avoid excessive short-term volatility of the exchange rate, it had to respond to capital flows by changing the monetary growth rate. As a result, it lost monetary-policy autonomy, at least partially.



THAILAND

BY CHAIYASIT ANUCHITWORAWONG

The most recent crises, namely the 2008 global financial crisis and the Eurozone debt crisis, have affected not only developed countries but also many other economies, and they have also posed downside risks to global economic and financial stability. The fallout from the crises suggests that the economic fortunes of various countries are intertwined. However, impacts are relatively country-specific, depending on how tightly particular nations' economies are interconnected through trade and finance with those of the crisis-hit countries. The main objectives of this study are 1) to investigate whether the crises have seriously affected the domestic financial system and macroeconomic developments in Thailand and to describe how the monetary authority has dealt with any impacts; 2) to evaluate the performance of monetary policy; and 3) to discuss ways to improve the effectiveness of monetary policy management.

Following the outbreak of the 1997 financial crisis, Thailand's economy continued to struggle to recover from the effects. During that time, the country suffered significantly due to unstable growth in industrial output. Therefore, the Bank of Thailand explicitly adopted a new monetary policy, namely inflation targeting May 2000 for establishment of a new, formal monetary policy framework for Thailand to replace the monetary policy that had been abandoned following the end of the IMF program. The key purpose was to achieve price stability that would be conducive to sustainable economic growth and to realize increased transparency of monetary policy strategy through communication with both the markets and the general public regarding central bank decision-making. The question is whether or not the current inflation targeting framework performs well during a period of economic turbulence such as the global financial crisis of 2008-2009.

Having become more integrated with world markets through cross-border trade and financial activities, Thailand was also impacted by the global economic crisis. However, the economy was affected through trade rather than financial channels, suggesting that the crisis had a lesser effect on the banking system than it did on real economic sectors. Although the economy was not affected greatly during that period, there were still some concerns about the short-term impacts of the crisis. These concerns focused variously on fluctuation of capital flows, deterioration in the market prices of equities, contraction of investment and capital injection, and a rise in the risk premiums for financial assets.

Overall, the change in monetary policy framework to an inflation-targeting regimen was successful in helping to reduce inflation rate levels and fluctuation thereof, and boosting real output growth during normal circumstances. However, during the global economic crisis, the Bank of Thailand performed quite poorly, as evidenced by eight consecutive months, May through December 2009, in which inflation missed the target range (or 4 consecutive quarters, from the second quarter of 2009 through the first quarter of 2010). The failure to achieve the target ranges for several consecutive periods might indicate that the central bank may have responded too slowly to macroeconomic challenges posed by the global financial and economic crises. Furthermore, the crisis also had a threatening impact on the economy. Coupled with other factors such as political protest and unrest during 2009, the global economic downturn was likely to induce greater variability in output growth. With respect to the effectiveness of monetary transmission mechanisms, the degree of policy rate and exchange rate pass-through is rather incomplete, suggesting that there are weak transmission links which will make the inflation targeting framework less effective in delivering and maintaining lower levels of inflation and in ensuring sustained economic growth.

The experiences of the recent crisis suggest that there is some room for improvement that should be carefully considered so as to enhance the effectiveness of monetary policy management in Thailand, especially under the current environment, which sees the country confronted with massive capital inflows as a result of quantitative easing in advanced economies. It should be noted that inflation targeting is not a panacea that can make inflation perfectly predictable or reduce it without economic costs. To improve the effectiveness of monetary policy, there is a need to fine-tune implementation of the inflation targeting framework. The central bank should continue to use a combination of monetary tools in addition to an interest rate policy to tackle inflation and exchange rate pressures. Also required are more effective micro- and macro-prudential regulation and supervision, and better coordination between the two in order to safeguard stability of the financial system. Although monetary policy is important for ensuring sound and durable real economic outcomes, this alone cannot meet the challenges entailed in promoting growth, stability, and sustainability. Uncoordinated monetary and fiscal policies may lead to suboptimal outcomes and be unable to correct structural imbalances in the economy. Therefore, it is imperative to promote greater coordination between monetary and fiscal policies, and between monetary and fiscal authorities. Furthermore, since external shocks and pressures, especially in the form of substantial capital flows, have become more frequent and substantial, the Bank of Thailand should push ahead with a master plan on capital account liberalization in order to make the liberalization process more transparent and systematic, and to prepare for a more volatile economic environment. Last but not least, international cooperation and strong coordination at regional level should be strengthened. However, lessons from the debt crisis in the highly integrated Eurozone financial system raise several important issues that require further discussion toward deeper regional cooperation.

EAST ASIA

BY PETER J. MORGAN

East Asian monetary policy frameworks have evolved substantially over the past two decades, chiefly in response to shocks from the Asian financial crisis of 1997-1998 and the global financial crisis (GFC) of 2007-2009. The Asian financial crisis showed the importance of exchange rate flexibility and credible policy frameworks, leading to increased central bank independence, greater focus on inflation policy and more flexible exchange rates. A key lesson of the 2007–2009 global financial crisis (GFC) was the importance of containing systemic financial risk and the need for a "macro-prudential" approach to surveillance and regulation that can identify system-wide risks and take appropriate actions to maintain financial stability. Emerging economies face particular challenges because of their underdeveloped financial systems and vulnerability to volatile international capital flows, especially "sudden stops" or reversals of capital inflows.

This paper reviews the history of Asian monetary policy frameworks since 1990 describes current monetary policy frameworks, including the issue of price versus financial stability for a central bank and the policies that a central bank can use to manage financial stability; examines the monetary policy transmission mechanism based on financial linkages and financial deepening; and provides assessments of policy outcomes, including inflation targeting and responses to the "Impossible Trinity".

The global financial crisis highlighted the problem that surveillance and regulation of system-wide financial stability was inadequate in many countries in the pre-crisis period, and that central banks may not have focused sufficiently on financial stability risks. The dimensions of systemic risk in both procyclicality of the financial system and interconnectedness of various financial institutions and markets were not adequately appreciated, nor was the need for a macroprudential perspective on such risks. Moreover, when responsibility for financial supervision was divided among central banks and financial supervisors, most countries lacked adequate architecture to ensure coordinated surveillance, analysis, information sharing, and policy actions.

Defining financial stability is not an easy task because it has multiple dimensions and is related to complex financial systems. But, this should not lessen the need to do so. Central banks' overviews of macroeconomic developments and financial system conditions, together with their oversights of payment and settlement systems, give them a unique perspective on system-wide financial stability. There is a strong case for central banks to have an explicit mandate for financial stability. Although there may be short-term conflicts between the traditional central bank objective of price stability and that of financial stability, in the medium and long terms, these objectives should be largely consistent with each other because development of a financial crisis during a period of price stability will eventually lead to deflation and economic downturn.

Central banks have various tools for supporting financial stability, including standard and "unconventional" monetary policy tools, currency market intervention tools and, in some cases, supervisory authority, macroprudential tools and capital flow management tools. These can be used to help prevent crises by dampening the credit cycle and strengthening banks and other financial institutions to ensure that they are adequately capitalized and reserved to be able to ride out systemic shocks. Asian central banks have, in fact, frequently resorted to such tools to safeguard financial stability and reduce the volatility of capital flows. There is no guarantee that macroprudential and capital flow management tools will always be effective, but a multiplicity of tools makes it easier to achieve both price stability and financial stability. This also implies that central bank policy frameworks are more complex than simply being characterized by the presence or absence of explicit inflation targeting.

Monetary policy frameworks in the region have evolved to deal with greater financial openness and depth. The ratio of gross capital inflows to GDP is still showing an upward trend, although that of net capital inflows appears to be stabilizing or declining. Domestic financial markets have also deepened substantially, which should contribute to strengthening the monetary transmission mechanism. Aside from Japan, there is no evidence of major failures of the policy transmission mechanism in the region.

Overall, monetary policy frameworks in the region appear to have worked well in achieving low and stable inflation coupled with economic growth. This mainly reflects three factors: central banks have focused on price stability as the main objective of monetary policy; institutional arrangements have facilitated successful pursuit of this objective; and other economic policies, mainly fiscal policy, have supported this pursuit by reducing concerns about fiscal dominance. We may add to this the availability of a large number of policy tools, including unconventional policies, macroprudential measures and capital flow measures that help to deliver financial and economic stability. East Asian central banks also appear to have coped well with the constraints of the trilemma hypothesis and, for the most part, have gravitated toward an "interior solution" with independent monetary policy, partial financial openness and partly managed currencies. On the whole, this positive experience would suggest that there is no need for any major changes in policy frameworks. Perhaps the most important suggestion at this stage is to give greater weight to financial stability as a policy objective and to strengthen institutions for regional policy coordination, including the Chiang Mai Initiative.

However, the failure of the Bank of Japan to escape from deflation, and the more recent failures of advanced economy central banks in the U,S,A. and Europe to achieve full recoveries, points to problems that may confront other Asian economies in the future as they achieve higher levels of economic and financial development. Therefore, their recent positive experience to some extent reflects luck as well as improved policy frameworks. In that sense, monetary policy frameworks in the region have not yet been adequately tested.

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PACIFIC ECONOMIC COOPERATION COUNCIL

The Pacific Economic Cooperation Council (PECC) was founded in 1980 at the initiative of the Prime Ministers of Japan and Australia, with the aims of serving as a regional forum for cooperation and policy coordination to promote economic development in the Asia-Pacific Region.

PECC is a unique tripartite partnership of senior individuals from business and industry, government, academic and other intellectual circles in 24 Asia-Pacific Economies[1]. All participate in their private capacity and discuss freely on current, practical policy issues in search of broad-based answers to regional economic problems.

PECC advocated the need for a formal, intergovernmental organization in the Pacific from the time of its creation. The regional ministerial process of the Asia Pacific Economic Cooperation (APEC) has realized that goal and now provides PECC with a formal channel by which its practical recommendations can be implemented. PECC is the only non-governmental official observer of APEC since the formation of APEC. PECC has provided information and analytical support to APEC ministerial meetings and working groups.

To promote economic cooperation and the idea of a Pacific Community, the PECC organization's governing body - the Standing Committee[2] - establishes ad hoc task forces to undertake and promote research on issues it has decided need to be addressed by the regional community. For 2008-2009, four signature projects have been established, and PECC's member committees also collaborate on four international projects additionally.

Pacific Economic Outlook (PEO) is among these PECC activities and PEO/Structure, which has dealt with longer-term macro-economic issues in the Pacific region, is the one of the international projects mentioned above.

The groups of PECC activities meet periodically to organize seminars or workshops, conduct studies and publish their research outcomes and recommendations for the benefit of the Pacific community.

PECC member committees and PECC work groups send tripartite delegations to the PECC General Meetings. In the interim, policy matters are handled by a Standing Committee, and day-to-day administrative and coordinating functions are carried out by the International Secretariat based in Singapore.

For more information on PECC, please contact the PECC International Secretariat.

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[1] The PECC Economies include Australia, Brunei Darussalam, Canada, Chile, China, Colombia, Ecuador, Hong Kong China, Indonesia, Japan, Korea, Malaysia, Mexico, Mongolia, New Zealand, Peru, The Philippines, Singapore, Pacific Islands Forum, Chinese Taipei, Thailand, The United States and Viet Nam. France (Pacific Territories) is an Associate Member. The Pacific Basin Economic Council (PBEC) is the regional business organization, and the Pacific Trade and Development Conference (PAFTAD) is the region-wide organization of academic economists, both of which are Institutional Members.

[2] The Standing Committee is PECC's governing body.
It includes the Chairs of PECC Committees in each of the 24 full member economies.PBEC and PAFTAD also have seats on Standing Committee.

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ASIA PACIFIC INSTITUTE OF RESEARCH (APIR)

Background

As the Asia-Pacific region has taken on a more important role in international politics and the global economy, in recent years the world has been watching every move by the countries within this strategic region.
In light of this situation, the Asia Pacific Institute of Research (APIR) was founded 2011, with the aim of supporting sustainable development in the Asia-Pacific region.
Unlike many other institutes, APIR maintains its research activities and organizational operation through financial and operational support from its large number of member firms. As a "neutral think tank" that is not affiliated with government or any specific corporate group, APIR enjoys the freedom to work on whatever research projects capture its attention.

Mission

APIR mission is to make research contributions toward solutions development for issues facing countries in the Asia-Pacific region, thereby vitalizing economies and societies and supporting the sustainable development of countries in the region, including Japan:

- The Asia-Pacific region has increasingly important roles as the global economy undergoes major structural changes.
- In order to successfully address various issues in the diversity-rich Asia-Pacific region, it is necessary to bring together capable human resources, expertise, and information from around the world.
- Focusing our perspective on the Asia-Pacific region, we aim to provide our new platform for sharing "smart ideas" and "information" globally.

Research Areas

<Asia-Pacific Economic Outlook>

* As the global economy becomes increasingly multi-polar, by keeping track of economic activity in the Asia-Pacific region in real time, we develop strategies for further development of public-private partnerships and analyze policy issues to ensure that Japan and its enterprises can establish win-win relationship with their foreign counterparts.

<Innovation>

* With a view to ensuring sustainable development of the Asia-Pacific region, we aim to help the Japanese government and companies to share good practices in applying their advanced solutions to various issues with governments and enterprises in the region. Furthermore, we study innovative ways to take full advantage of the region's powerful growth in order to expand business opportunities for Japanese industries.

<Regional Development Strategies>

* As global competition continues to intensify, the key to economic development is the region's industrial competitiveness and the unique allure that it communicates throughout the world. We take multifaceted approaches to the study of mega-region strategies, which we hope will help Japan to accumulate globally competitive industries and thus consolidate its position as a center of exchange in the Asia-Pacific region.

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APIR is administered by a board of directors, which consists of representatives from major corporations and universities in the Kansai region.

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