Threat of currency volatility

Policy-makers unlikely to target exchange rates

Linda Yueh, Advisory Board

For decades under inflation-targeting, currencies were hardly mentioned for fear of disrupting the foreign exchange market. Along with the change in monetary policy regimes to include macroprudential regulation, currencies are no longer taboo, though such discussion still occurs only occasionally as central bankers are rightly concerned about igniting a currency war.

Exchange rate volatility, or even the possibility of a currency crisis, has risen to the forefront of macroeconomic policy concerns. As with all such risks, whether a sufficient policy response exists matters a great deal. Policy-makers face a set of challenges.

Market for renminbi still faces barriers

At the top of the list is China. Until recently, when the ceiling on the benchmark deposit rate and the floor of the lending rate were lifted, there was no market-clearing interest rate. The gap between the two may have helped the net interest margin that raises revenue for the mostly state-owned commercial banks, but it prevented the accurate pricing of risk and the efficient allocation of capital. And it made it difficult, if not impossible, to determine the long-run value of the exchange rate since currency movements are linked to the real interest rate.

Now that the interest rate has been liberalised, the renminbi is beginning to find its footing, helped by a stabilising current account balance, even though global prices provide a challenge. More fundamentally, China's central bank hasn't relied on the interest rate to set monetary policy as a result, so its gradual shift will bear watching.

Meanwhile, offshore currency traders are being wrong-footed during this volatile period. Nearly $600m worth of bets on the renminbi weakening past Rmb6.6 against the dollar – its low point during last year's surprise devaluation – have expired and become worthless.

Divergent monetary policies

The other major global currencies are also being tugged and pulled by divergent monetary policies. Stimulus policies by the European Central Bank and Bank of Japan are juxtaposed against the normalisation of US monetary policy by the Federal Reserve. The resulting weakening and strengthening of their respective currencies, the most traded in the world, are presenting challenges for the rest of the economy.

Most emerging markets have pegged their currencies to the dollar and also to the euro. Some Asian economies, owing to the dominance of regional supply chains, keep a close eye on the renminbi as well as the yen. Yet the Fed is considering raising rates while the ECB has just unleashed a slew of loosening policies, including more cash injections or quantitative easing.

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In Asia, China is cutting interest rates now but it still is sufficiently above the zero bound, while Japanese rates remain in negative territory. Such divergences among the dominant currencies add to global volatility because they lead to variation among the economies that are pegged to them. So, some emerging economies are seeing their currencies rise while others are experiencing devaluation.

For those central banks, the main monetary policy aim is targeting the exchange rate. This has become more challenging. It is especially the case for commodity exporters, which tend to be pegged to the dollar as the currency in which commodities are priced, and are seeing their exchange rate appreciate alongside the dollar when they could use a weaker currency.

Lack of tools a key concern

It is even more difficult for major economies with free floating currencies. After all, the notion of a fully flexible exchange rate is that there is no need to manage it. But one of the members of the reserve currency club is now the renminbi. There are those who worry about the Chinese currency's volatility even though the tools to manage this remain limited.

For a variety of reasons central banks rightly remain reluctant to target currencies explicitly. Markets should expect that, at a time of divergent monetary conditions and given the continued uncertainties of Chinese reforms, currencies will remain volatile. ■

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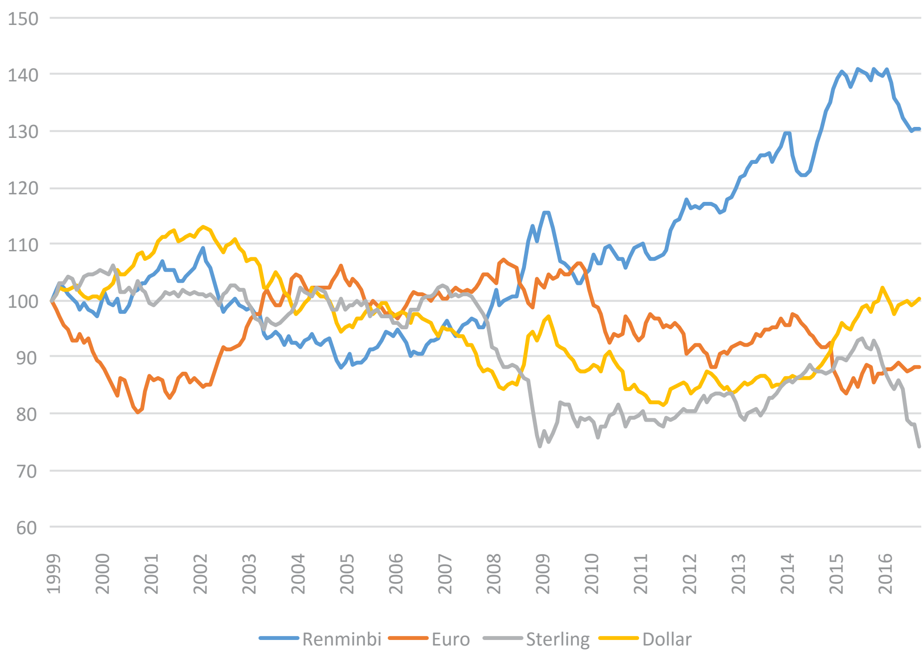
Renminbi depreciates following years of strengthening

Real effective exchange rates, Jan 1999=100 (increases are an appreciation)



Source: Bank for International Settlements, OMFIF analysis