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International Monetary Developments in Asia: Consequences for the Global Monetary Regime
Intervention of Francesco Papadia[1]

Introduction

It is often said that financial markets have a limited attention span, both in the time and in the variable dimensions, i.e. that they cannot keep too many variables under control at any given point in time and thus focus on a changing and relatively small subset of all potentially relevant variables. This seems to be a problem also for economic observers. Their attention has been focussed for some time on the US and the euro area, while Asia has not been highly visible in their radar screen since it underwent its own crisis at the end of the nineties. In addition, the amount of attention that markets and observers are capable of devoting to Asia is mostly dedicated to issues other than monetary policy, thus the topic of this session is not one on which a lot is written these days. I have checked in the last World Economic Outlook of the International Monetary Fund and found only a few sentences dedicated to this issue.

There is one very good reason for this limited attention, summarized as follows by Filardo and Genberg (2010): *"Judged by the average inflation rate in the post-Asian crisis period, central banks in the Asia and Pacific region have performed very well both on an absolute level and relative to a comparison group consisting of economies whose inflation performance is regarded as exemplary."*
Filardo (2012) further generalizes this, discussing the repercussions in Asia of the crisis that started in 2007 and that is now commonly referred to as the Great Recession: "*One important question to consider is the role domestic monetary policy played in Asia during this period. This paper attempts to assess this role, arguing that, on the whole, monetary frameworks adopted prior to the crisis served the region well."*

One of the reasons of the good performance of monetary policy in Asia, also during the Great Recession, is that the lessons of the Asian crisis at the end of the nineties were well learnt: Asians did not waste their crisis! Indeed many countries in the area, alas with the exception of the two biggest ones, China and India (Filardo and Genberg (2010)), reformed their monetary policy frameworks, enhancing the independence of their central banks, emphasising price stability as their predominant target and moving towards more transparency, thus building on the model used since long in the region by Australia and New Zealand. I cannot help saying that I am convinced that also Europeans are not wasting their own crisis and learning their lesson, but of course this is the issue of another session.

My comments so far would seem to lead either to the conclusion that the organizers of this conference could have spared the time devoted to this session or to the milder one that it will be difficult for the three speakers and the two discussants to say something interesting and that the audience could indulge without excessive sense of guilt in a physiological, post-prandial through of attention, not to mention a refreshing nap to harness forces for sexier topics. I will try in my

[1] Comments from Jean Pisani-Ferry and assistance from Erkki Vihriälä are gratefully acknowledged.

intervention to show that neither the harder nor the softer conclusion is warranted and that there is indeed something interesting to be said about: *International Monetary Developments in Asia: Consequences for the Global Monetary Regime*, as the title of our session goes.

In order to do this I will concentrate on structural, long term issues, not cyclical ones, and I will mostly consider the two largest economies: Japan and China. This is justified, in my view, not only because of the economic size and global relevance of these two economies but also because they act, in different ways and size, as monetary and economic leaders in Asia at large.

Small and large country assumption

My basic question is whether monetary policy in these two countries sufficiently recognizes that the small country paradigm is totally inappropriate for them. While you may suspect that my question is, at least partially, a rhetoric one and that my answer to it is a tentative no, I count on the superior knowledge about Asia of the other panellists and the discussants to provide a more comprehensive, possibly contradictory, answer. Lest any misunderstanding arises, let me clarify at the outset that my definition of monetary policy is a broad one, which encompasses foreign exchange policy; indeed I do not think that it is in any sensible way possible to separate foreign exchange policy from overall monetary policy, while recognising that the exchange rate is also influenced by non-monetary factors.

Let me start by recollecting the definition of a small open economy: this is (according to Deardorffs' Glossary of International Economics) *"An economy that is small enough compared to the world markets in which it participates that (as a good approximation) its policies do not alter world prices or incomes. The country is thus a price taker in world markets. The term is normally applied to a country as a whole, although it is sometimes used in the context of only a single product."*

One can establish a rank of countries according to their inconsistency with the small countries assumption as in the following table

Table 1: Ten largest economies in the world by GDP (current US $) in 2011.

Rank	Country	GDP (bn $)	Trade (X+M)/GDP
1	United States	14991	31.7
2	Euro area	13080	86.6
3	China	7318	58.7
4	Japan	5867	31.4
5	Brazil	2477	24.5
6	United Kingdom	2445	66.6
7	Russia	1858	53.3
8	India	1848	54.5
9	Canada	1736	63.6
10	Australia	1379	41.1

Note: Euro area is treated as a single country and individual euro area countries are therefore omitted from the list.
Source: World Bank & IMF World Economic Outlook

Not surprisingly in the first positions one finds the US and the euro area but also China and Japan. Obviously the small country assumption does not apply to the two largest economies of Asia. This is reinforced, for the case of China, by the fact that this country has become a trade and financial leader in its region, as shown by Subramanian and Kessler, which document the existence of a Renminbi bloc in Asia, supplanting to a large extent the dollar bloc.

The topic of this session is Asia and it would be out of place to start a discussion on whether all the countries in the first positions in the table above fully stand up to their responsibility to act as a country with a material effect on the global economy. Let me just recall the conclusions that Darvas and Pisani-Ferry (2010) reached for the European Parliament, according to whom "currency war" issues could derive from: "*1) the inflexible pegs of undervalued currencies; 2) attempts by floating exchange-rate countries to resist currency appreciation; 3) quantitative easing.*" And conclude that: *"Europe should primarily be concerned about the first issue, which relates to the renewed debate about the international monetary system. The attempts of floating exchange-rate countries to resist currency appreciation are generally justified while China retains a peg. Quantitative easing cannot be deemed a 'beggar-thy-neighbour' policy as long as the Fed's policy is geared towards price stability. Current US inflationary expectations are at historically low levels."* If, as European looking at the responsibility of other regions in fully playing their "large country" role, I have to say, out of fairness, something critical about the euro area, this is that the European Central Bank was somewhat hesitant, during the Great Recession, in playing its monetary leadership role beyond the border of the euro area, particularly by limiting the extension of its swap arrangements with countries outside of the euro area. The FED was clearly more forthcoming in this respect.

There is a clear element of fairness in recognizing the responsibilities of a country to act while taking into account the effects of its action on the global economy. In this panel, however, I am more interested, in self-interest issues than in moral ones. What happens if a large country behaves like a small open one? What are the consequences for itself and for the globe? Let me give you what I think are the most important examples in this respect.

Consequences from a large country behaving like a small one

The first, and foremost, issue is the contribution that monetary policies belittling their global impact gave to the origin of the Great Recession. The jury is still out to adjudicate the sharing of responsibilities for the Great Recession, between different factors that, following Truman (2009), can be classified as follows:

- "*macroeconomic failures, which have three subcategories: monetary and fiscal policies, global imbalances, and housing booms;*
- *failures of financial-sector supervision and regulatory policies and practices, which have innumerable subcategories;*
- *excesses of poorly understood innovations in financial engineering, which have several subcategories: subprime mortgages, credit default swaps, and new forms of securitization to name a few;*
- *excesses, or imprudence, on the part of large private financial institutions, in particular those with a global reach."*

There is, however, a broad consensus that unwise macroeconomic policies played a significant role in generating the crisis, in particular giving rise and sustaining large global imbalances, mainly between the United States and China. Among the macroeconomic policies that contributed to global imbalances I would definitely put, again following Darvas and Pisani-Ferry (2010), the over rigid monetary-foreign exchange policy of countries defending unbalanced pegs, to which I will return in a while.

Overlapping but distinguished from the contribution of monetary policies to the development of global imbalances are the "beggar thy neighbour" policies implicit in currency undervaluation. While it is not clear that the United States were the innocent victim of mercantilist policies of countries "stealing demand" by pursuing currency undervaluation, as the too low national saving in that country as well as pitfalls in financial regulation more generally were a necessary factor in generating and sustaining global imbalances, it is obvious that trade flows were distorted at global level by exchange rates not being allowed, through forceful intervention, to move to their equilibrium level. And it required the patience of other global players to avoid moving into really fought "currency wars". This patience was definitely one of the reasons that spared the word from a repeat of the Great Depression as the Great Recession definitely had a similar destructive potential.

Additional risks created by monetary policies not fully recognizing the impact they have on the rest of the world are those relating to financial stability. If a country does not take into account that its loose monetary policy could induce other countries to follow suit, the consequence may be too loose global economic conditions, including excessive credit expansion. And Kindleberger and Aliber (2011) in a narrative fashion and Reinhart and Rogoff (2009) in a quantitative one have demonstrated beyond doubt that financial crisis breed on excessive credit expansion. Caruana (2012) makes the point very clearly; after having noted that very loose monetary policies have prevailed during the last few years he adds: *"But well beyond policy frameworks, on a global level, low average policy rates also result from policy interactions. After all, global outcomes reflect decisions of groups of policymakers in individual economies who take the decisions of policymakers in other economies as inputs to their decisions. Thus, we can think of monetary policy as a dense web of interactions, with both global and important regional strands."* Given these interactions, the loose policies in one globally relevant country tend to lead to similar conditions in other countries and, eventually, in the entire world.

Of course, since a few years there is a hope that a new class of measures, evocatively called "macro prudential" can take care of financial stability issues, thus freeing monetary policy from the burden of having to also target financial stability. And, as Filardo (2012) reports, *"Asia has been relying on macroprudential tools to control credit growth, credit quality and economic activity for a while now. From a macroprudential perspective, this is sensible. But over time, as long as real lending rates are low, the financial system may find it easier and easier to evade some of these administered measures. This suggests that monetary authorities will eventually have to rely more on policy interest rates – and allowing currency appreciation – to prevent macroeconomic imbalances from growing. Letting regional policy interest rates track those in the West, especially in the case of future rounds of QE, may become a more risky strategy going forward. Macroprudential policies cannot effectively substitute for macroeconomic rigour."* I feel like generalizing this statement beyond the Asian borders: macro prudential policy is, in my view, just a hope for the time being: the tools are untested, the frameworks in their infancy, calibration uncertain.

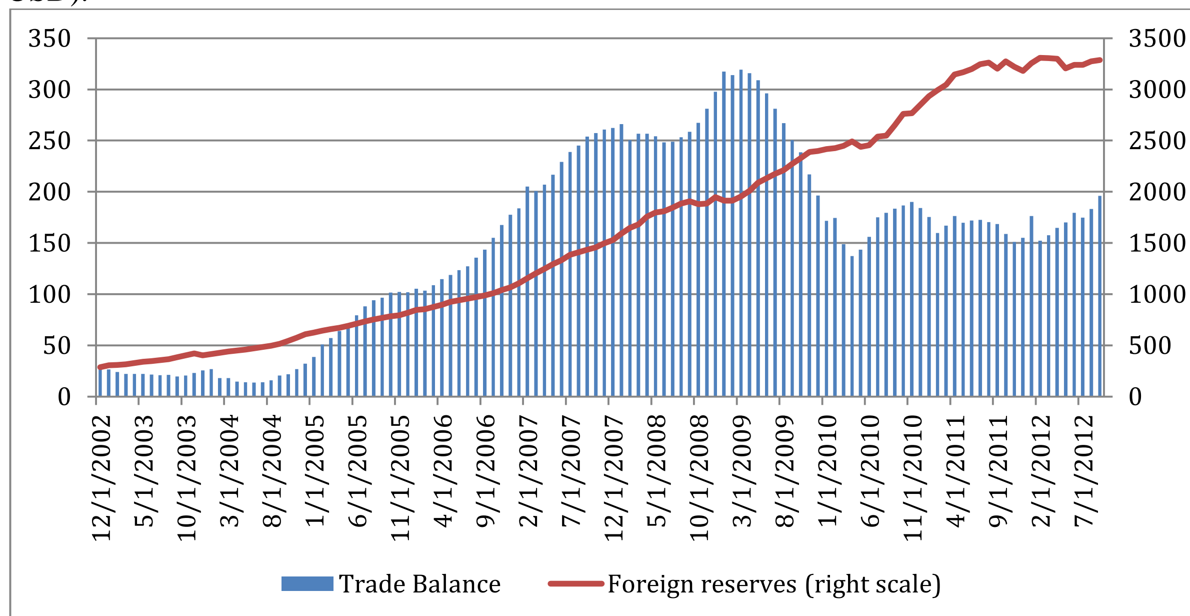
One last possible effect from national monetary policies not sufficiently recognizing their global impact is, still drawing on Filardo (2012), the potential effect on commodities markets. Here basically the issue is one of distinguishing between supply and demand shocks. A demand shock would clearly require a tightening of monetary policies, while a supply shock implies a much more ambiguous policy response, and a "see through the shock" approach is probably the least damaging. A globally relevant country, especially one which covers a leading role, may contribute to a demand shock in the commodities market and still take the increase in commodity prices as caused by a supply shock and choose, as a consequence, the wrong monetary policy approach, with the consequent inflationary consequences.

From cross country to China and Japan

So far my considerations have been mostly of cross-country nature, as they tried, not always successfully, to abstract from the experience of any particular country to get to fairly general conclusions. As from now, I would like to concentrate on the two countries that I announced at the beginning of my intervention: China and Japan. Indeed, as I already hinted, I worry that monetary policies in these two countries risk not giving sufficient weight to their global repercussions.

The case of China is clearer. On the one hand, because of its size, its de facto trade and regional financial leadership, its actions clearly have a global relevance and an even stronger regional impact. Over the years China´s monetary policy has compressed the value of the currency by huge purchases of foreign currencies. The large FDI flows and the expectation of a gradual appreciation of the renminbi added capital inflows to the pressure for exchange rate appreciation deriving from large current account surpluses, which interventions repressed. The result was, for many years, a disorderly increase of foreign reserves that forced the People´s Bank of China to mop up the created liquidity by means of issuance of bank bills and the increase of compulsory reserves in the, not consistently successful, attempt to keep inflationary pressure in check. Indeed there has been quite some inflation variability in China, with rates approaching 7 per cent in 2007 and 5 per cent in 2010.

Figure 1: Evolution of Chinese trade balance (12 month cumulative) and foreign reserves (billion USD).



Source: Datastream.

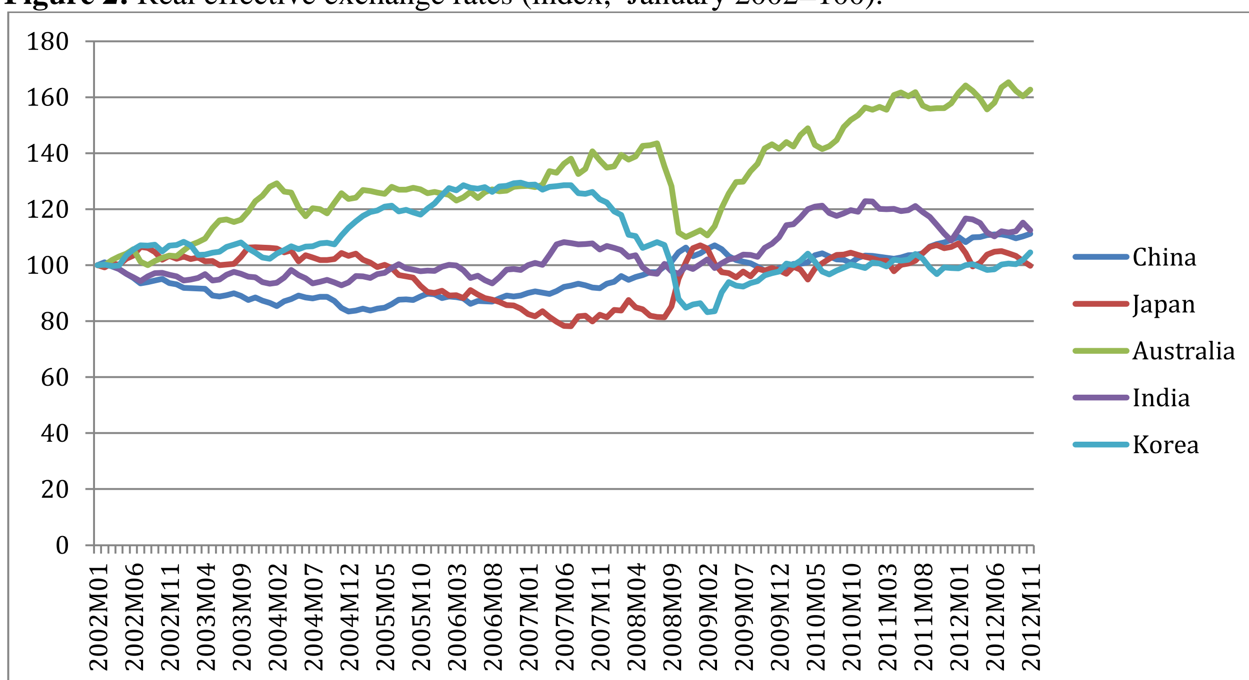
Table 2: Development of China’s current account and total reserves (% of GDP).

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Current account	2.8	3.6	5.9	8.6	10.1	9.1	5.2	4.0	2.8	2.3	2.5	2.8	3.2	3.8	4.3
Total reserves	25.4	32.2	36.8	39.8	44.3	43.5	49.1	49.1	44.5	-	-	-	-	-	-

Source: World Bank and IMF World Economic Outlook.

As a result of the forceful interventions, the real effective exchange rate of the renminbi recorded only limited appreciation.

Figure 2: Real effective exchange rates (index, January 2002=100).



Source: Bruegel real exchange rate database.

The situation has, partially, changed with the onset of the Great Recession. The most visible change has been the drastic reduction of the current account surplus, which, in relation to GDP, was reduced to less than a third of its level in 2011 with respect to 2008 (from more than 9.0 to less than 3.0 per cent). The IMF forecasts that the surplus will increase again in the next few years, as the more cyclical effects fade out, but still the surplus will remain at around half, in GDP terms, of its level before the crisis. Correspondingly reserve accumulation has levelled off, while the effective exchange rate of the renminbi was allowed to appreciate somewhat over the last 3 years. The IMF notes, however, that a weakness of the on-going correction is that the most dynamic component of domestic demand has been so far investment rather than consumption, whose contribution is necessary for a fundamental rebalancing of the Chinese economy.

Of course, this rebalancing can not be affected only or even predominantly by means of monetary policy moves, and indeed the 12th five year economic plan foresees a comprehensive action to rebalance the Chinese economy away from an excessive reliance on external demand towards more reliance on consumption. The success of this rebalancing remains to be seen and monetary and exchange rate policy will be an important component of it.

In conclusion, to come back to my initial question, Chinese monetary policy did not adequately recognize, for many years, the impact of its actions on the rest of the world. The consequence was a contribution to the build-up of global imbalances, which were, in turn, one factor generating the Great Recession, with its huge macroeconomic and financial stability costs. In addition, monetary policy may have had only mixed success in controlling inflation because of not fully recognizing that it was demand for commodities from China which led, or at least powerfully contributed, to increases in commodities prices, which inevitable had global repercussions. There is now a hope that things may change in the future, but a hope does not constitute evidence and keen attention should remain focussed on this issue.

Let me now consider the more subtle case of Japan. We do not find here patent cases of excessive current account surpluses, also taking into account the aging of Japanese society, nor an unrelenting

foreign exchange intervention activity to keep down the value of the currency and generating a sustained increase of foreign reserves. It is however clear that, among the G3, Japan is the most "trigger happy" when it comes to foreign exchange interventions. Not only actual interventions but also the threat of interventions has been used more frequently than in the euro area or the US to depress the value of the yen. The dominant fixation, in the public opinion and the government, about the nominal bilateral dollar/yen exchange rate, instead of looking at a more comprehensive real effective exchange rate, has contributed, in some occasions, particularly when the dollar itself was weak against other currencies, to put excessive weight on the exchange rate for the performance of the Japanese economy.

The announced policies of the new government in Japan could rekindle the risk of a monetary policy not sufficiently aware, in its foreign exchange component, of its global repercussions.

I see two, interrelated, risks in the new government policy:

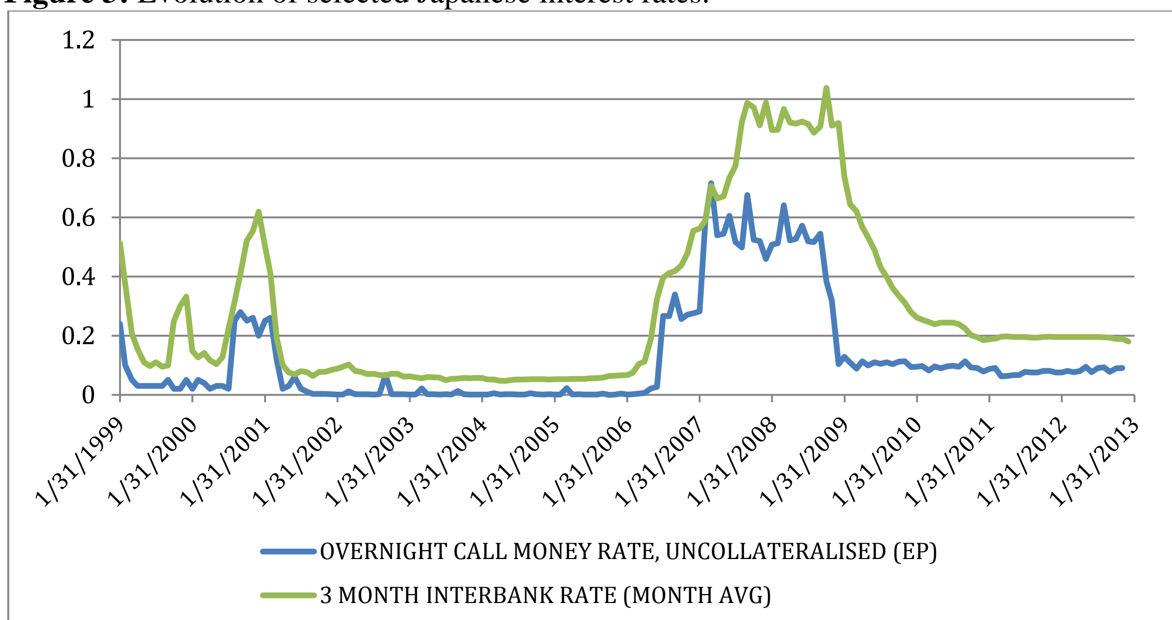
1. An analytical risk, in thinking that the problems of the Japanese economy resides mostly in the monetary sphere,
2. An operational risk, in assessing that the Bank of Japan can do much more than it has done so far to bring the Japanese economy to a more vibrant state.

This is no place to enter into a discussion about the structural problems of the Japanese economy nor into a detailed analysis of Japanese monetary policy. Let me just give tentative evidence that the main issue in Japan is not monetary policy and that there is not an obvious lot more that the Bank of Japan could do.

We have learnt in the Great Recession that interest rates are not a sufficient indicator of the monetary policy stance and that also the size of the balance sheet of the central bank, beyond its effects on interest rates, has to be taken into account. On both account there is no obvious evidence that the Bank of Japan has been timid over the last 15 years.

Policy interest rates have been kept very close to zero between 1999 and well into 2006 and between the last part of 2008 and now. In the entire period they have only occasionally been higher than 0.5 per cent.

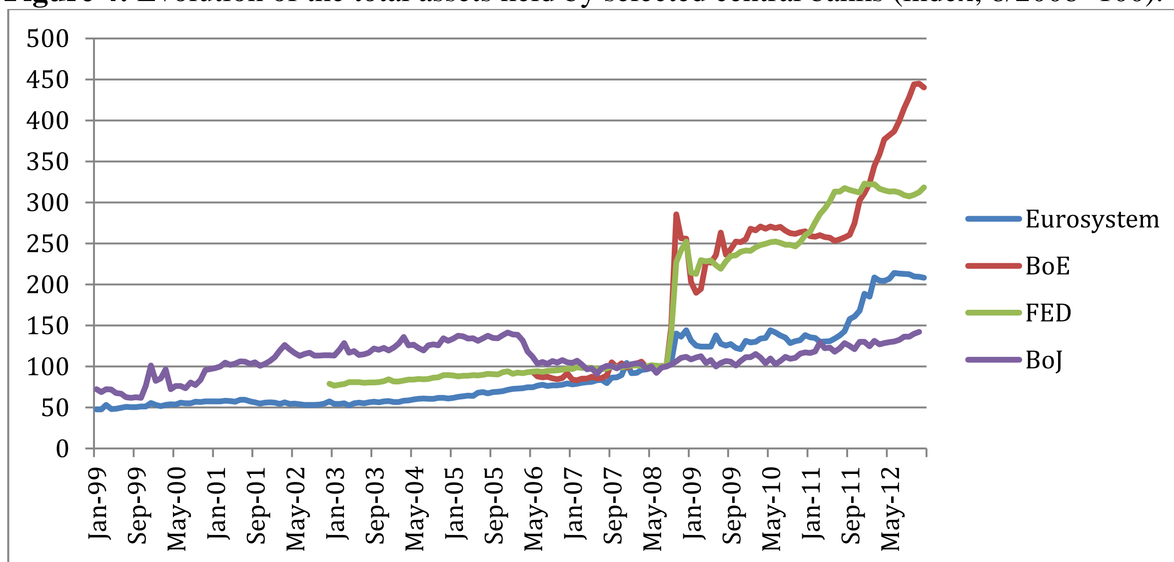
Figure 3: Evolution of selected Japanese interest rates.



Source: Datastream.

The expansion of the balance sheet of the Bank of Japan looks limited in relation to the pantagruelic increases of the balance sheets of the FED, the European Central Bank and the Bank of England during the Great Recession (figure 4). The total size of the balance sheet of the Bank of Japan about doubled during its period of quantitative easing, indeed the Bank of Japan was the first central bank to try and use its balance sheet in parallel to the interest rate as a monetary policy tool. The balance sheet of the Bank of Japan then decreased by some 20 per cent when the quantitative easing period ended but has grown again by some 30 per cent since.

Figure 4: Evolution of the total assets held by selected central banks (index, 8/2008=100).



Source: National central banks.

Of course, my considerations are much too rough to exclude that the Bank of Japan could do more to help the Japanese economy. Indeed, I have no argument to contest the assessment of the IMF that: *"In Japan, further monetary easing may be needed to boost growth and exit deflation. With inflation pressures likely remaining subdued over the next two to three years, the Bank of Japan may need to undertake additional asset purchases to bring inflation closer to the price stability goal in the medium to long term, which is set at 1 per cent for the time being."*

My point is only that it is doubtful that the answer to the problems of the Japanese economy can be found predominantly in the monetary sphere and that the Bank of Japan can do a lot more to revitalise the economy. The risk is that, once the effects of additional domestic monetary stimulus will have shown their limits, the recurrent temptation to look for growth in an artificially depressed exchange rate will get stronger. Given the size and the global relevance of the Japanese economy, this could rekindle the fear of "currency wars" that would be so damaging for the world economy.

Conclusions

In conclusion, it is my belief that monetary policies in large economies cannot pretend, for their own and the globe´s well being, to be irrelevant for the rest of the world. More specifically about China, I would conclude that there is the hope that the awareness that China is a large economy will feature much more prominently in the future in that country´s policies, including in the monetary area. For Japan, the hope is that it will not have recourse, when the mileage to be extracted from a more expansionary domestic monetary policy will have been shown to be limited, to foreign exchange policies not consistent with the global relevance of that country.

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