

Special Feature A

Asian Monetary Policy Forum 2019¹

Introduction

The 6th Asian Monetary Policy Forum (AMPF) was held on 31 May 2019 in Singapore. As in past years, it was convened under the auspices of the Asian Bureau of Finance and Economic Research (ABFER), and co-organised by the University of Chicago Booth School of Business, the National University of Singapore (NUS) Business School and the Monetary Authority of Singapore (MAS). The Forum brought together central bankers, academics and private sector analysts to share

perspectives on the current monetary policy challenges facing central banks, especially in Asia.

This year's deliberations revolved around several themes: (i) the challenges posed by a low interest rate environment for central banks and governments; (ii) the dominant role of the US dollar in the global economy and its implications for policymakers in Asia; and (iii) the policy issues arising from the advent of digital currencies.

Opening Remarks and Keynote Address

The MAS Deputy Managing Director and Chief Economist opened the AMPF 2019 with a review of the global economic conjuncture. He noted that the synchronised expansion of 2017–18 had waned and a significant step-down in activity had become apparent by late 2018, with the weakness persisting into Q1 2019. In a global environment characterised by a “tyranny of suspended risks”—including but not limited to unresolved trade tensions—business cycles appear to have shortened and the path of monetary policy normalisation has become more unpredictable.

Over the past five years, the Forum had engaged in international monetary and financial issues that came to the fore after the GFC, revolving around concerns with capital flows and domestic monetary policy autonomy. For instance, the commissioned paper at the inaugural AMPF in 2014, by Maurice Obstfeld, was on policy trilemmas and trade-offs, with the key takeaway being that globalisation places some limits on monetary policy autonomy, even with flexible

exchange rates (Obstfeld, 2014). Following this, Olivier Blanchard at AMPF 2016 concluded that, if constraints on fiscal policy are binding, and room for international policy coordination limited, then a judicious use of capital flow management measures can improve welfare (Blanchard, 2016). In 2017, Jeffrey Frankel argued that central banks can intervene effectively in foreign exchange markets to dampen fluctuations in the real exchange rate caused by external shocks by way of “systematic managed floating” (Frankel, 2017).

The authors of past AMPF commissioned papers have also devoted attention to financial market development in Asia: Barry Eichengreen at AMPF 2015 noted that governments can help develop the securities markets, especially bond markets, which would allow their economies to reap efficiency gains from cross-border market integration (Eichengreen, 2015). In 2018, Hyun Song Shin examined the changing circuitry of cross-border capital flows, including the build-up of vulnerabilities associated with the

¹ This article provides an overview of the AMPF 2019 discussions, based on the full documentation of proceedings by Chia Wai Mun, Associate Professor, Division of Economics, Nanyang Technological University (NTU). It has benefitted from comments and inputs by Professor Bernard Yeung, President of the Asian Bureau of Finance and Economic Research and Stephen Riady Distinguished Professor at the NUS Business School. The views in this article should not be attributed to MAS, NTU or NUS.

procyclicality of banks' balance sheets (Avdjiev *et al.*, 2018).

In his keynote address at this year's Forum, Philipp Hildebrand, Vice Chairman of BlackRock, shared his views on the challenges facing monetary policymakers in a low interest rate environment. First, central banks and governments currently may not have a robust framework to deal with the next recession. Doing "more of the same"—including unconventional monetary policies undertaken in the aftermath of the GFC—may not be sufficient, given that long-term interest rates are already very low or negative. Current policy proposals centred around price-level or inflation targeting would not be effective, as they continue to work via forward guidance, which has not lifted inflation rates.

Second, future countercyclical policy measures are likely to blur the distinction between monetary and fiscal policy. In a low interest rate and low inflation environment, a more

aggressive form of quantitative easing that works through directly channelling resources to real spending and investment may be required. "Helicopter money" is a possibility, but it would blur the line between monetary and fiscal policy and raise challenging questions about governance and central bank independence. Another option would be to address the current deficiency of aggregate demand through expansionary fiscal policy. This will not undermine debt sustainability as long as the interest rate is lower than the economy's growth rate. However, central banks might then be pressured to ensure that the interest rate stays low, resulting in financial repression.

Third, central banks cannot remain insulated from political influence. They have to pay more attention to the distributional impact of policy choices and explain their policies more clearly to the public. Such enhanced communications would be even more imperative if any form of helicopter money were to be contemplated.

AMPF Commissioned Paper

This year's commissioned paper by Pierre-Olivier Gourinchas (2019) from the University of California, Berkeley on "The Dollar Hegemon? Evidence and Implications for Policy Makers" explored the policy issues relating to the widespread use of the US dollar and its role as a global reserve currency. Gourinchas began by laying out a number of stylised facts concerning the international role of the US dollar.

First, from the real economy perspective, global trade is substantially invoiced in US dollars. The dollar's share as an invoicing currency is about 4.7 times the global share of US goods imports, and about 3.1 times its share of exports (Gopinath, 2015). Second, on the financial side, a significant portion of cross-border financial flows is denominated in dollars. For example, US dollar-denominated bank loans and debt securities issued by non-residents doubled as a share of global GDP from around 7% in 2000 to about 14% last year. Third, on the policy side, monetary authorities anchor their currencies to the dollar more than any other currency, and their holdings of international reserves are also largely in dollars.

The dominance of the dollar in invoicing and payments, in financing, and as an anchor currency is a mutually reinforcing phenomenon. This can be attributed to important complementarities between the different roles of the dollar as a unit of account, means of payment and store of value. From the real economy perspective, in a world of dollar pricing, a change in the exchange rate *vis-à-vis* the US dollar does not affect the relative prices of imports and exports. However, the price of the consumption basket of residents in local currency is affected. Central banks therefore focus on stabilising the consumption basket's price and aim to reduce volatility in the bilateral exchange rate. This in turn incentivises them to anchor local currencies to the dollar. Conversely, the more central banks anchor to the dollar, the more desirable it is for trade to be invoiced in the dollar. Further, if the private sector's cashflows are denominated in US dollars, borrowing will also be predominantly in dollars to limit the impact of currency fluctuations on firms' balance sheets.

According to standard producer currency pricing (PCP), exports are priced in exporters' currencies and, consequently, changes in bilateral exchange rates affect the relative prices of imports and exports. However, in practice, today's trade is often invoiced in a small number of dominant currencies such as the US dollar. This prevalence of US dollar invoicing has given rise to a new paradigm called dominant currency pricing (DCP), which leads to a number of policy implications.

First, local monetary authorities face a more adverse inflation-output trade-off under DCP than PCP. Under DCP, a nominal depreciation of the bilateral exchange rate between trading partners has no effect on the terms of trade, as it does not affect the home currency prices of either imports or exports, both of which are priced in dollars. Hence, changes in bilateral exchange rates lead to little expenditure switching, which can only take place through a change in the dollar exchange rate. However, a depreciation of the domestic currency against all currencies (including the US dollar) leads to an increase in the price of imports and consumer price inflation.

Second, US monetary policy has a larger impact on global growth and trade under DCP. Intuitively, US monetary policy matters more the larger the portion of trade invoiced in dollars. A contractionary US monetary policy appreciates the dollar, reduces US output and lowers US inflation. Under DCP, when the US dollar appreciates, the home currency prices of imports rise.

To counter the higher inflation, these countries' central banks will tighten monetary policy. If that happens, a contractionary monetary policy in the US triggers a larger reduction in global output and trade than that under PCP.

The third implication concerns the desirability of exchange rate flexibility within the context of the trilemma versus dilemma debate. According to the open economy trilemma, it is impossible for a central bank to have a fixed exchange rate, free capital mobility and an independent monetary policy simultaneously; the central bank has to forgo one of the three. However, an important contribution by Hélène Rey (2013) suggests that the existence of a global financial cycle in capital flows, asset prices and credit growth turns the

classical trilemma into a dilemma. When capital is freely mobile, the global financial cycle restricts monetary policy autonomy regardless of the exchange rate regime, reducing the desirability of flexible exchange rates.

However, Gourinchas argued that in an environment with financial spillovers, flexible exchange rates may become more, not less, desirable. His argument runs as follows. A US monetary tightening and the related dollar appreciation raises the financial burden of a dollar borrower outside of the US, and thus can have potentially contractionary effects in other countries. The impact on any economy will depend on the degree of financial spillovers and the response of local monetary authorities.

When spillovers are limited, a US monetary policy tightening is expansionary for a small open economy due to the latter's currency depreciation against the dollar and expenditure switching effects. However, when the degree of financial spillovers is higher, a US monetary tightening raises the financial burden on a small open economy. In this case, a parallel monetary tightening by the local monetary authority resulting in an appreciation of the domestic currency can relax the financial constraints on the dollar borrowers, thus moderating the contractionary effect. Thus, with greater financial spillovers, exchange rate flexibility is more desirable.

Finally, the dollar standard has implications for the stability of the international monetary and financial system. The present scarcity of safe assets is consistent with one of the main macroeconomic phenomena of the past few decades—the secular decline in global real interest rates since the early 1980s. The real safe return fell by about 6% points between 1980 and 2016, and is now close to zero, or negative. Importantly, the scarcity of safe assets mutates once the economy reaches the zero lower bound (ZLB) for interest rates. An acute scarcity of safe assets creates a situation similar to a liquidity trap, which is dubbed a “safety trap”. At the ZLB, the scarcity can have adverse effects: since the equilibrium real interest rate cannot fall any further to equilibrate the market for safe assets, global output becomes the only adjustment variable. Aggregate demand falls below potential

output, and the global economy enters a recession.

In short, when markets cannot clear via prices, they will clear via changes in quantities. In this environment, countries will be tempted to depreciate their currency, and devaluations become “beggar-thy-neighbour” policies as countries gain output and employment only at the expense of others. As a result, currency wars and trade wars are more likely to break out. Any domestically-oriented policy such as fiscal austerity, reserve accumulation or stricter liquidity requirements in the banking sector, which are deemed appropriate at the country level, may be counter-productive globally as they would further increase the demand for safe assets.

In the short to medium term, the factors supporting the global dominance of the dollar are strong and there is little risk of it being displaced. However, in the long run, Gourinchas believes there is a greater chance that the dollar’s pre-eminent position will be eroded. This is because the US share of world output is declining and expected to fall further. According to projections by the IMF, the share of the US economy will fall from 15.5% of world GDP in 2016 to 13.7% in 2024. This decline implies that even though the

dollar hegemony is locally stable, it is not sustainable. The global economy will transit either to another anchor or to a multipolar environment. The most likely outcome is one where the dollar co-exists with one or two other international currencies.

During the discussion of Gourinchas’ paper, a distinction was made between the role of US Treasuries as safe assets and the fact that they are denominated in US dollars. Recent research has shown that it was US Treasuries’ liquidity that led to the violation of uncovered interest rate parity, i.e., it was the greater-than-anticipated demand for US Treasuries that drove the US dollar appreciation (Jiang *et al.*, 2018).

Moreover, foreign demand for a country’s government-issued securities depends on a number of factors, including capital market size, level of economic development and financial openness, and not just on reserve currency status. As governance and institutional standards in emerging economies have improved, monetary policy frameworks strengthened and inflation brought under control, many emerging economy borrowers are now able to issue debt to foreigners in their own domestic currencies, in contrast to the situation a decade or two ago.

Policy Note

The final section of the Forum, the Policy Note, was devoted to the challenges posed by digital currencies to central banks and the existing banking system.² The two presenters were Darrell Duffie from Stanford University and Beatrice Weder di Mauro, President of the Centre for Economic Policy Research (CEPR), and Distinguished Fellow at INSEAD Emerging Market Institute, Singapore. The presenters drew attention to the implications for monetary policy transmission and financial stability resulting from technological advances that have led to a decline in the use of cash, the rise of digital payments, and the creation of private digital currencies.

The advent of digital currencies has opened up opportunities for considerable efficiency gains in global payment systems, particularly in cross-border transactions. Traditionally, banks formed the backbone of payment systems. However, the declining use of cash and rise in electronic payments pose a threat to the traditional payment model. Concurrently, technology has allowed the issuance of multiple private digital currencies. Such currencies not only threaten central banks’ monopoly on currency issuance, but could also be a means for money laundering, illegal transactions and tax evasion. In a decentralised system, monetary authorities will not have the information to regulate these

² Please see also Special Feature A in the April 2019 issue of the *Macroeconomic Review* on the Digital Currency Economics and Policy Workshop jointly organised by ABFER, NUS Business School and MAS in November 2018.

activities which society collectively deems undesirable.

In response to these developments, central banks could consider introducing central bank digital currencies (CBDCs), which would enjoy greater public trust and have a distinct advantage over private digital currencies. In the case of a general CBDC, central banks can provide an account to all residents and transactions would be recorded as changes to individual accounts. Alternatively, residents could receive tokens of cryptocurrencies with a stable value tied to major fiat currencies (such as the US dollar). Payments with tokens would be backed by bank deposits and banks would maintain their key role in handling transactions.

“Wholesale” CBDCs offer a more limited approach whereby tokens are issued only for wholesale purposes, for example in interbank money markets. In a 2018 survey of 80 central banks, 69% said they were, or will soon be, conducting work related to CBDCs.³

The establishment of a CBDC will lead to major changes in the effectiveness of monetary policy. First, moving from fiat money to a CBDC will expand central banks’ policy room, in the sense that monetary policy can easily go beyond the ZLB; that is, negative interest rate policy may become more effective when cash is eliminated. Alternatively, if fast payment systems are introduced and combined with open banking (i.e., the use of open source application program interfaces (API) in banking), then monetary policy transmission will be much more immediate—when the central bank raises the policy rate, deposit rates will adjust very quickly; otherwise, consumers will move their deposits to a bank that offers a higher return. This will lead to an increase in the pass-through from the policy rate to market rates. While this will be beneficial to central

banks, traditional commercial bank models could be disrupted.

There are also financial stability concerns with the introduction of a CBDC. Since virtually all deposits will be kept with the central bank, its balance sheet will be much larger than it is today. Moreover, CBDC transactions processed by central banks will eliminate financial institutions’ payment intermediation role. With CBDC accounts, banks will have to offer competitive savings deposit rates benchmarked tightly to CBDC deposit returns. This could lower the profitability of banks and weaken their financial position, forcing them to take fewer risks. Given the interconnected nature of credit creation, significant stress in some banks could have large adverse spillovers onto other banks and threaten the banking system as a whole. Accordingly, there may be a need for increased liquidity coverage requirements or other ways to protect the weaker banks and strengthen their financial position. There could also be unforeseen operational risks if central banks were to run an entirely new payment system.

Regardless of whether central banks adopt CBDCs, existing payment systems are likely to be superseded by faster alternatives. Currently, payment rails operate in most countries during business hours on a five-days-a-week basis. However, a number of countries such as Korea have introduced fast payment systems that run around the clock. By using cryptocurrencies and open source APIs, the next generation of payment systems will be an improvement over current fast payment systems in Asia, Europe and the US, including in cross-border payments.⁴ Technology platforms in China such as Alibaba’s Alipay and Tencent’s WeChat have already dramatically changed the country’s payment system. Firms in other countries may do the same. An efficient and convenient payment

³ This figure was from a survey conducted by the BIS Committee on Payments and Market Infrastructure (CPMI) referenced in the welcome remarks by Benoît Cœuré, Chair of the CPMI, at the Economics of Payments IX Conference on 15 November 2018.

⁴ When an individual wants to make a payment, he or she will use the API to make a cryptocurrency transfer. The payment is effected instantly using two ledgers—one for the individual to transfer the funds out of his or her bank account ledger and the other for the bank to move the funds across the interbank ledger. While this may appear to be just a traditional money transfer within or across borders, technological advancement gives everyone with a smartphone easy access to the system.

system expands depositors' freedom of choice and raises the competition for deposits.

In sum, substantial financial changes are expected to take place in the next ten years in the developed markets. Fast payment systems will be the norm, whether payments are processed through banks' payment rails, a CBDC or a private stablecoin. The payment systems that are most likely to prevail are those which continue to utilise current bank payment rails, but operate with faster and more efficient technology. Irrespective of how this will transpire, traditional bank

models will be disrupted on both the payment and deposit sides. On their part, central banks will encourage the development of fast payment systems that are safe and effective, while ensuring financial stability and keeping operational risks to a minimum. If this outcome is not assured, then it is likely that they will step in and issue their own CBDCs.

Conclusion

The juxtaposition of a slowdown in the global economy, rising protectionism and a potential fragmentation of the international monetary system pose significant risks to global economic and trade activity over the medium term. Meanwhile, with policy rates constrained by the ZLB, some have argued that future countercyclical policy measures would increasingly blur the distinction between monetary policy and fiscal policy, posing risks to central bank independence.

At the same time, recent research highlighting the international dominance of the US dollar across the trade, financial and monetary spheres holds significant implications for monetary policy. Dominant currency pricing suggests that changes in the exchange rate will have asymmetrical effects on inflation and exports in many

economies. In addition, policymakers may have to contend with the financial channel of exchange rate movements, further complicating the calibration of monetary and exchange rate policies in response to shifts in capital flows.

Over the longer term, while the adoption of digital currencies could enhance payment efficiency and overcome the ZLB constraint, it could also raise financial stability risks. Central banks would need to be well-prepared to meet the challenges of operating in these uncharted waters. These issues and challenges will remain into the foreseeable future. While the discussions at AMPF 2019 did not arrive at definitive conclusions, the engaging debates and lively exchange of views gave policymakers much to ponder and explore at future AMPFs.

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