

Challenging Times for Central Bank Governors 挑戰中央銀行總裁的時代

Lawrence J. Lau 劉遵義

Ralph and Claire Landau Professor of Economics, The Chinese University of Hong Kong
and

Kwoh-Ting Li Professor in Economic Development, Emeritus, Stanford University

Conference in Memory of the late Professor LIANG Kuo-Shu

「梁國樹教授逝世20週年紀念會」

Taipei, 26 September 2015

Tel: +852 3943 1611; Fax: +852 2603 5230

Email: lawrence@lawrencejlau.hk; WebPages: www.igef.cuhk.edu.hk/ljl

*All opinions expressed herein are the author's own and do not necessarily reflect the views of any of the organisations with which the author is affiliated.

Introduction

- ◆ The responsibilities of a Central Bank
 - ◆ Monetary stability—a low rate of inflation; a low but positive real rate of interest (taking away the punch bowl when the party gets going);
 - ◆ Financial stability—stability of the banking system; the soundness of banks; reserve requirements; loan to deposit ratios; maintenance of a safe degree of leverage economy-wide; prevention of asset price bubbles;
 - ◆ Exchange rate stability—enabling the real economy to grow and prosper;
 - ◆ Full employment.
- ◆ The objective is to enable the real economy to operate smoothly, efficiently (efficiently means that resources, including labor, are fully utilized) and stably.
- ◆ Today the Central Bank faces new challenges on all fronts.
- ◆ Are there enough instruments at the disposal of a central bank to discharge all of the above responsibilities?

Introduction:

The Challenges Faced by the Central Bank

- ◆ Monetary stability—quantitative easings pursued by the central banks of the United States (since 2009), Japan (since 2010) and the Euro Zone (since 2013), as well as their expected endings; large pools of speculative short-term capital seeking yields around the World first entering and then leaving other economies.
- ◆ Financial stability—shadow banking, asset price bubbles, excess leverage and new financial derivative products; financial institutions too big to fail (Systemically Important Financial Institutions (SIFIs)).
- ◆ Exchange rate stability—volatility caused by alternately massive short-term capital inflows and outflows disrupting the real economy.
- ◆ Full employment—the lack of supportive complementary fiscal policies. Monetary policy is ineffective in the presence of a "liquidity trap."

Monetary Stability:

The Ineffectiveness of Monetary Policy

- ◆ While the “Quantitative Easings (QEs)” undertaken by the United States, Japan and the Euro Zone have brought down their rates of interest, they have not significantly enhanced the performance of their respective real economies. Their experiences demonstrate the limits to monetary policy by itself alone.
- ◆ Yet the QEs, by keeping the rates of interest near zero (and negative in real terms) worldwide have also driven up the relative exchange rates of other economies as well as their asset (stocks and real estate) prices.
- ◆ For example, the U.S. QEs drove the exchange rate of the Japanese Yen to as high as 75 Yen per U.S. Dollar (as well as the exchange rates of many other economies); the Japanese counter-QE, sometimes referred to as QQE, brought the exchange rate of the Japanese Yen down to almost 125 Yen per U.S. Dollar.

Financial Stability

- ◆ Macro-prudential policies can be used to control leverage in the economy and to try to prevent asset price bubbles (stocks and real estate) from becoming too large, e.g., by changing the margin requirement of stock purchases or the down payment requirement of residential real estate loans.
- ◆ Shadow banking must be regulated as it accounts for an increasingly large proportion of deposits and loans.

Financial Stability:

Internet Finance

- ◆ The revolution in “Information and Communication Technology (ICT)” revolution and the rise of the internet have also created new platforms for deposit-taking and loan-making.
- ◆ Internet finance is a form of shadow banking. It should be regulated just like all other forms of finance. The objective is to protect the public.
- ◆ The use of “Big Data” and protection of the privacy of individuals.
- ◆ Prohibition and/or regulation of “Bitcoin” and other similar internet “currencies”. Again, the objective is to protect the public.

Exchange Rate Stability

- ◆ Volatility of the exchange rate is bad for the exporters and the importers, bad for long-term direct investors (both outbound and inbound)—it is bad for the real economy.
- ◆ An open foreign exchange market, without any capital controls, can be subject to predatory speculation. For example, consider the successful attack of the British Pound by George Soros in the early 1990s.
- ◆ The question for a central bank is: To intervene or not to intervene? The exchange rate is too important a price to be left to the currency speculators to determine. A responsible central bank must monitor the exchange rate of its currency carefully.

Exchange Rate Stability: Short-Term Capital Flows

- ◆ The volatility of the exchange rates discourages international trade flows in goods and services and long-term direct and portfolio investment flows. The key to the reduction of volatility of the exchange rate is the reduction of short-term purely speculative capital flows, both inbound and outbound.
- ◆ Economic theory tells us that free international trade flows are beneficial to trading partner countries. Long-term capital flows in the form of direct investment or long-term portfolio investment are also known to benefit both the investor and the investee countries. However, there is no theory to support the hypothesis that short-term capital flows are beneficial to either the economy of origin or the economy of destination.
- ◆ International trade flows are relatively stable. Foreign direct investment flows, both inbound and outbound, are basically long-term in nature and hence also relatively stable on the whole. The same is true of long-term portfolio investment flows.

Exchange Rate Stability: Short-Term Capital Flows

- ◆ However, short-term cross-currency international capital flows are susceptible to abrupt changes in magnitude and direction (e.g., hot money) that can greatly de-stabilise the financial markets of a country, including its foreign exchange market, credit market and capital market, impacting the real economy negatively.
- ◆ But the most compelling argument against such short-term cross-currency international capital flows is that, with the exception of short-term trade-related financing, they are not socially productive.

Exchange Rate Stability:

Short-Term Capital Flows

- ◆ Short-term cross-currency capital inflows cannot be usefully deployed in the destination country. When they are used to finance long-term investments in the destination country, they invariably lead to trouble because of the maturity mismatch, and further exacerbated by the currency mismatch. The 1997-1998 East Asian currency crisis is basically the outcome of massive maturity and currency mis-match in the loans taken out by enterprises in the East Asian economies.
- ◆ Moreover, as short-term capital flows in and out of the destination country, they cause the exchange rate and/or the interest rate of the destination country to become excessively volatile, inhibiting not only the flows of its international trade and long-term investment but also the development of the domestic real economy.
- ◆ Thus, it is desirable to be able to differentiate between long-term capital flows, which should be welcomed and encouraged, and short-term capital flows, which should be discouraged.

Exchange Rate Stability:

Short-Term Capital Flows

- ◆ The average daily volume of foreign exchange transactions worldwide in 2013 was approximately US\$5.3 trillion. This is equivalent to approximately US\$1.325 quadrillion per year, on the basis of 250 working days per year. The total annual volume of international trade, including trade among countries and regions that do not require currency conversions such as within the Euro Zone, is approximately US\$45 trillion in 2013, which is only 3.4% of the total volume of foreign exchange transactions.
- ◆ The bulk of foreign exchange transactions consists of short-term speculation, causing unnecessary fluctuations in the currency exchange rates, which generate no benefits to real economies but create large profits for banks handling these transactions. These banks are in effect operating “legal casinos”, so to speak. Moreover, the volatility of the exchange rates caused by such speculation further increases the demand for foreign exchange hedging and hence foreign exchange transactions.
- ◆ However, this volatility actually benefits the U.S. Dollar as the dominant and only safe haven currency.

Exchange Rate Stability:

A Tobin Tax

- ◆ A Tobin tax, suggested by Nobel Laureate economist James Tobin, was originally defined as a tax on all spot conversions of one currency into another. The tax is intended to put a penalty on short-term financial round-trip excursions into another currency.
- ◆ What is proposed here is a Tobin tax on capital account flows but not on current account flows.
- ◆ A Tobin tax allows the differentiation between long-term and short-term capital flows.

Exchange Rate Stability:

A Tobin Tax

- ◆ Such a Tobin Tax is intended to impose a penalty on short-term purely financial round-trip excursions from a foreign currency into the domestic currency or vice versa, and thereby discourage short-term cross-currency capital flows.
- ◆ If every time a foreign currency is converted into a domestic currency or vice versa, a tax of say 0.5% is levied, then a round-trip within a month would amount to an effective cost of more than 12% per annum, whereas for a direct investment with a long time horizon of say 5 years, the tax will amount to only 0.2% per annum, virtually nothing.
- ◆ Thus, a Tobin Tax on capital flows will help to differentiate between short-term and long-term capital flows.
- ◆ Foreign currency transactions related to the exports or imports of goods and services, all current account transactions, will be completely exempted from such a tax.

Exchange Rate Stability:

A Tobin Tax

- ◆ It is in the interests of every economy to encourage and promote long-term capital flows, in both directions (that is, both inbound and outbound direct and long-term portfolio investments), and to discourage and regulate short-term capital flows, which are not only socially unproductive but can actually be disruptive and cause great damages.
- ◆ The central bank can vary the rate of the Tobin tax or Tobin fee as conditions warrant. For example, a 1% rate instead of the 0.5% rate mentioned above can also work well, implying a 24% per annum cost on a one-month round-trip short-term capital flow into China. There is in fact a continuum of rates that can be used--any rate between 0% (completely free capital flows) and infinity (complete capital control) is possible.
- ◆ Moreover, it is not absolutely necessary that the inbound and outbound rates of Tobin tax have to be identical all the time. They can be allowed to be asymmetric under some circumstances.

Exchange Rate Stability:

The Tobin Tax and the Possible Trinity

- ◆ A Tobin Tax can actually make possible simultaneously the “Impossible Trinity”.
- ◆ "The Impossible Trinity" is a trilemma in international economics which states that it is impossible to have all three of the following conditions holding at the same time:
 - ◆ A fixed (stable) exchange rate;
 - ◆ Free capital movement (absence of capital controls);
 - ◆ An independent interest rate policy.
- ◆ A Tobin tax introduces an interest rate differential between domestic capital and international capital, which enables a central bank to have some degree of flexibility in its monetary policy, in particular, in its interest rate policy.

Full Employment

- ◆ The current classic liquidity trap situation means that monetary policy alone will not be effective.
- ◆ The quantitative easings of the U.S., Japan and the Euro Zone have lowered interest rates and raised asset prices around the World but have not been able to increase the aggregate demands in the respective economies significantly.
- ◆ The problem has to do with insufficient private sector aggregate demand itself. There is ample potential supply. Monetary policy alone is ineffective. What is needed is some concrete signal to change public expectations and restore public confidence.
- ◆ These low interest rates have also vastly increased the asset prices and fueled price bubbles in these economies.
- ◆ Moreover, the low interest rate basically redistribute income and wealth from the net savers to the net borrowers, which generally means from the poor to the wealthy, causing the degree of income inequality to rise.

Concluding Remarks

- ◆ The central bank cannot do it alone. Complementary fiscal policies are necessary.
- ◆ The Government must try to change public expectations through its concrete policy announcements and actions.