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## Floating Exchange Rates, Self-Oriented Policies, and Limits to Economic Integration

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I will frame my discussion by asking a time-honored question: Are floating exchange rates working? My answer is a qualified yes.

Over the past twenty years, many emerging market economies (EMEs) moved to more flexible exchange rate regimes. These have been widely credited with helping them navigate the 2008–2009 crisis. But the system comes under stress when exchange rates move sharply, especially in a context, such as the period since the summer, when projected turning points in monetary policy and growth drive sudden large exchange-rate readjustments. Those movements are driven by portfolio shifts in international financial markets that have become more extensive and interconnected than ever before in history.

None of this is totally new. The 1980s, for example, featured big swings in the dollar that culminated both in a failed attempt to implement “target zones” for major exchange rates (the Louvre Accord) and the US Omnibus Trade Bill of 1988, from which the annual US Treasury report on foreign exchange is inherited. Past decades also saw multiple episodes of monetary policy transmission, leading to large capital inflows and sometimes to sharp reversals in the form of crises.

When Milton Friedman and Harry Johnson famously argued their cases for floating exchange rates in the 1950s and 1960s, they saw governments’ attempts to maintain disequilibrium fixed parities as sources of official restrictions both on international trade and on international capital movements. To some extent, they initially appeared right, in that floating rates promoted international financial liberalization while allowing a continuing expansion of world trade, as well as greater production efficiency through the development of more finely articulated international supply chains.

But the very success of floating rates in promoting expanded real and especially financial integration has increased the scope for international macroeconomic and financial spillovers, thereby spurring a contrary dynamic in the form of political or economic arguments to reintroduce elements of market segmentation in several dimensions.

In the trade dimension, talk of “currency wars” in the immediate post-crisis years exemplified the political limits of domestic stimulus measures that sharply appreciate foreign countries’ currencies; in some countries the response was to limit capital inflows. Currently the shoe is on the other foot, and the erstwhile alleged currency aggressor, the United States, faces depreciating foreign currencies, including the euro. The result is more serious support for bills in both houses of the US Congress to discipline foreign currency undervaluation or manipulation through automatic sanctions, for example, countervailing duties. Such measures raise the real risk of retaliation by US trading partners and a subsequent disruption of the multilateral global trading system. Unilateral currency sanctions could be open to challenge in the WTO, while WTO decisions reversing national legislative actions could themselves be even more broadly destabilizing.

With the demise of the Bretton Woods system and the adoption of floating exchange rates, countries made a decisive move toward sovereignty over monetary policy. However, the strength of the spillovers from those sovereign policies to other economies was hardly recognized at the time. Countries have been willing to give up some sovereignty through the WTO process because trade policy instruments are comparatively easy to identify and the gains from coordinated agreement to forgo their use are so clear-cut. Countries may also welcome a “commitment mechanism” that helps them withstand political pressure from vested trade interests. This is all less so in the area of monetary policy—countries simply will not commit to constraining their monetary policy tools, even if all other countries make similar commitments, because those tools are too central to macroeconomic stability and growth, and past experience with exchange rate commitments (as under the gold standard) has, on the whole, not been favorable.

At the same time, the potential for competitive currency practices has long been recognized, and avoiding them has been one of the goals of the IMF as well as the G-7 and G-20 processes. Those processes have made

gradual progress, but evidently not rapidly enough to head off domestic political reactions when exchange rates move strongly and abruptly. Are those reactions something the system must simply continue to live with? Or is there any scope for a more robust multilateral approach that would command a widespread perception of legitimacy among domestic electorates? Of course, another goal of the IMF and G-20 is to maintain internationally balanced growth and economically justifiable payments patterns, which themselves would help contain big exchange rate movements. But divergences in national performance are bound to arise despite the best efforts. So, somehow finding ways to strengthen the multilateral approach to exchange rate and macroeconomic surveillance will have to remain high on the agenda.

Another area of serious policy spillovers, not envisaged in the debates of the first two postwar decades, is through interest rates, balance sheets, and capital flows. Long-term nominal interest rates are now tightly linked across major economies, and liquidity conditions in major economies spill over to EMEs through multiple channels.<sup>1</sup> Indeed, some go so far as to argue that this international transmission process must inevitably overwhelm domestic policy measures in EM countries, notwithstanding the nature of the exchange rate regime.<sup>2</sup> There certainly is strong evidence of a global financial cycle—such as the one that drove global credit expansion and housing appreciation in the run-up to the global financial crisis.

EM countries awash with global credit are advised to let their currencies appreciate, but this can be painful, just as it can be for advanced economies, but probably more so for countries whose firms lack the market power of larger firms in highly developed economies. Moreover, even appreciation does not insulate the financial sector completely, for example, from the easing of quantitative credit constraints and from balance sheet effects. Thus, liquidity conditions abroad may still be transmitted, potentially fueling bubbles and excessive credit growth—and these effects are stronger if the recipient central bank intervenes (as it typically will) to dampen appreciation, and cannot fully sterilize the resulting monetary effects. On the other hand, depreciation in the face of potential financial outflows could be perilous if there are foreign currency liabilities, either onshore or (as the Bank for International Settlements has warned) on the books of offshore corporates.

These dilemmas—and especially the well-founded concern that capital inflows can lead to financial stability problems if the resulting domestic credit is not channeled efficiently—have led to a second-best argument for capital controls: macroprudential policy is preferred in principle, but if it cannot be deployed effectively (and frankly, we have little practical idea how to do that beyond housing market interventions, nor is the evidence on what actually works very strong), capital inflow control may be next best. In the current environment of US interest rates being prepared for liftoff, capital *outflow* controls may next receive more attention, even though they seem much harder to make effective. The hope has been that adequate *inflow* controls may reduce the volume of footloose capital seeking an exit when economic conditions turn, thereby reducing the desire for *outflow* controls. But theoretical justifications for capital controls—for example, the paper by Farhi and Werning given at the IMF’s 2013 Annual Research Conference—tend to ignore enforcement issues and yield symmetric prescriptions about inflow and outflow controls.<sup>3</sup>

A persuasive argument for some form of segmentation between domestic and international capital markets is that national sovereignty over financial stability policy makes macroprudential policy much harder, if not impossible, to execute with fully open capital markets. This is the “financial trilemma” argument that has been elaborated by Schoenmaker (2013). According to the financial trilemma, countries cannot simultaneously enjoy all three of:

1. internationally open financial markets,
2. national sovereignty over financial policy, and
3. financial stability.

For example, nationalistically motivated decisions about supervision or resolution are likely to take inadequate account of repercussions abroad, thereby weakening resilience of the entire interconnected global financial system. Domestic surveillance and regulation stricter than what prevails abroad could draw in foreign intermediaries able to circumvent local rules. These types of problem became painfully obvious in the euro area in the early part of this decade, and have motivated the drive toward banking union in the EU—embodying a sacrifice of national sovereignty in the financial policy sphere—but the general issue extends even to financially linked economies that do not have a common currency.

Therefore, despite floating exchange rates—indeed, coincident with floating and the expanding international capital market that floating encouraged—central bankers in the richer countries recognized the growing importance of financial spillovers and initiated the Basel process of international coordination in 1974. This forum for information exchange and regulatory best practice has grown to encompass many countries and is one of the most shining examples of successful international policy coordination. It recognizes the severe limitations of nationally oriented financial policies in an era of globalized capital markets, but it still does not solve all problems, for example those in the sphere of bank resolution of global systemically important financial institutions, or the possible inability of countries to make macroprudential levers effective when substantial credit originates abroad. This has led regulators in several countries to ring-fence, as exemplified by the US Federal Reserve's requirement that foreign banking organizations with US nonbranch assets above \$50 billion set up holding companies subject to Fed regulation.<sup>4</sup>

Is ring-fencing a capital control or a macroprudential measure? Arguably it is the latter, when there is no discrimination in the treatment of domestic and foreign residents. On the other hand, such rules segment international capital markets—they can impede the free flow of liquidity among components of a banking organization located in multiple jurisdictions—thereby potentially sacrificing some efficiencies and synergies by segmenting the banking firm's internal capital market.<sup>5</sup> Those synergies, however, come partly at the expense of hidden social costs to the financial stability of host, and indeed parent, countries, and some ring-fencing strikes me as a worthwhile price to pay. But it does represent a departure from the state of unfettered mobility of financial resources that would maximize banking profits. I would argue that this is very much in line with Schoenmaker's financial trilemma.

In cases where actual capital controls are needed, perhaps because of nonbank channels of intermediation and a weaker regulatory infrastructure, there probably still need to be international rules of the road on their deployment, to discourage financial protectionism, to limit externalities for other countries, and to prevent the use of controls in currency manipulation. This is yet one more coordination challenge for today's floating exchange rate system. To invoke the old Churchillian cliché, the system certainly has problem areas where reform is needed, but it still appears

to be the best possible arrangement in a world of sovereign actors and largely free global trade in goods and assets.

## Notes

1. For example, see Blanchard, Furceri, and Pescatori (2014) and Obstfeld (2015).
2. See, for example, Rey (2013).
3. See Farhi and Werning (2014).
4. See Tarullo (2014).
5. See Goldberg and Cetorelli (2011).

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