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# Globalisation, pass-through and the optimal policy response to exchange rates<sup>☆</sup>



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### ABSTRACT

In this paper we examine how monetary policy should respond to nominal exchange rates in a New Keynesian open economy model that allows for a non-trivial role for sterilised intervention. The paper develops the argument against the backdrop of the evolving policy-making environment of Asian economies. Sterilised intervention can be a potent tool that offers policymakers an additional degree of freedom in maximising global welfare. We show that the gains to sterilised intervention are greater when goods market integration is low and exchange rate pass-through is high. However, increased financial internationalisation reduces the effectiveness of sterilised intervention, as the international policy trilemma becomes more relevant. Unsterilised intervention may also have a role to play, although the potential welfare gains from this are generally smaller.

Most central banks in Asia have actively used sterilised foreign exchange intervention as a policy tool to smooth exchange rates. But, over time, declining exchange rate pass-through and the increasing international integration of financial and goods markets will tend to reduce the efficacy of sterilised intervention. Given the limited effectiveness of unsterilised intervention, our model implies that the role of exchange rate movements in the optimal setting of monetary policy in Asia is decreasing.

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## 1. Introduction

How should central banks respond to exchange rate changes? Historically, economies in Asia have placed a high weight on nominal exchange rate stability. Moreover, stabilising the external value of the currency appears to have served as an effective nominal anchor for the economies in the region. But, Asian economies have been changing rapidly in terms of their industrial and financial market structure, and the choice of optimal nominal anchor is likely to evolve along with these changes. In this paper, we assess the nature of structural changes in Asian economies, and discuss their implications for the role of the nominal exchange rate in monetary policy.

In the past, goods market integration was relatively low in Asia. Domestic consumption was heavily weighted towards domestically produced goods, and trade was concentrated in raw material imports and finished good exports intended for the so-called advanced economies. The degree of exchange rate pass-through to domestic prices also tended to be high. Any change in the exchange rate was likely to quickly show up as a corresponding change in domestic price levels. Under such conditions, there is a high degree of complementarity between exchange rate stability and inflation stability, and exchange rate changes can play a powerful real role by generating expenditure switching.

Another key characteristic of previous decades was relatively low levels of financial internationalisation. Domestic financial markets were relatively underdeveloped. External investors had little choice of domestic assets that they could purchase, and effective capital controls further limited the scope for international risk sharing. In such an environment, official holdings of foreign exchange reserves may be an effective substitute for private holdings in increasing international risk sharing and improving global welfare.

But, as we document below, these three characteristics have changed. Goods markets have become more integrated in Asia as consumer preferences across different economies have moved closer together. By most metrics, the degree of exchange rate pass-through has fallen. As average inflation rates have come down, prices have tended to become stickier, slowing the rate at which exchange rate shocks are passed on to domestic price levels. Also, regional financial markets are now more integrated with global markets. Clearly there are still large deviations from complete international risk sharing but the combination of developing domestic financial markets in the region, and declining barriers to international capital flows, have seen increased financial globalisation.

We capture these characteristics in a New Keynesian model in the following ways. Increases in the degree of goods market integration are represented by a reduction in the degree of home bias in the consumer's utility function. To allow for variation in the degree of underlying exchange rate pass-through, our model assumes that some portion of imports is priced in local currency, with the remainder priced in the producers' currency. In addition, we have varying degrees of financial integration, from financial autarky to full international risk-sharing.

This paper argues that these trends in exchange rate pass-through and financial market and goods market integration have important implications for the conduct of monetary policy. In particular, the effect of these developments is to reduce the gains to using sterilised intervention to influence exchange rates. In the limit, as financial internationalisation increases, sterilised intervention becomes incapable of influencing exchange rates at all. And if goods market integration were to become complete, we find that there would be no gains in welfare terms from influencing exchange rates using either sterilised or unsterilised intervention.

Although increasing financial integration reduces the usefulness of sterilised intervention, this does not leave policymakers completely without effective tools for influencing exchange rates. In response to both productivity and cost-push shocks, there generally remains a small role for unsterilised intervention to improve global welfare.

While our model is highly stylised along a number of dimensions (for example, we do not include a role for investment, or a mercantilist motive for foreign exchange intervention), we view our model as capturing some of the most salient features of some of the middle- and higher-income economies in Asia, such as Korea, Malaysia and Thailand, who follow an inflation target in addition

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