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Monetary and Exchange Rate Policies in Cambodia, Laos
and Vietnam: The Scope for Regional Cooperation

Enhancing Monetary Stability in CLV

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Outline

- Introduction
- Defining monetary stability
- Fundamental regime options under the policy trilemma
- Implications of the multiple currency phenomenon
- A set of criteria for policy design
- Potential scenarios for CLV policy-making
- Conclusion: Sketching a road map for CLV cooperation in enhancing monetary stability

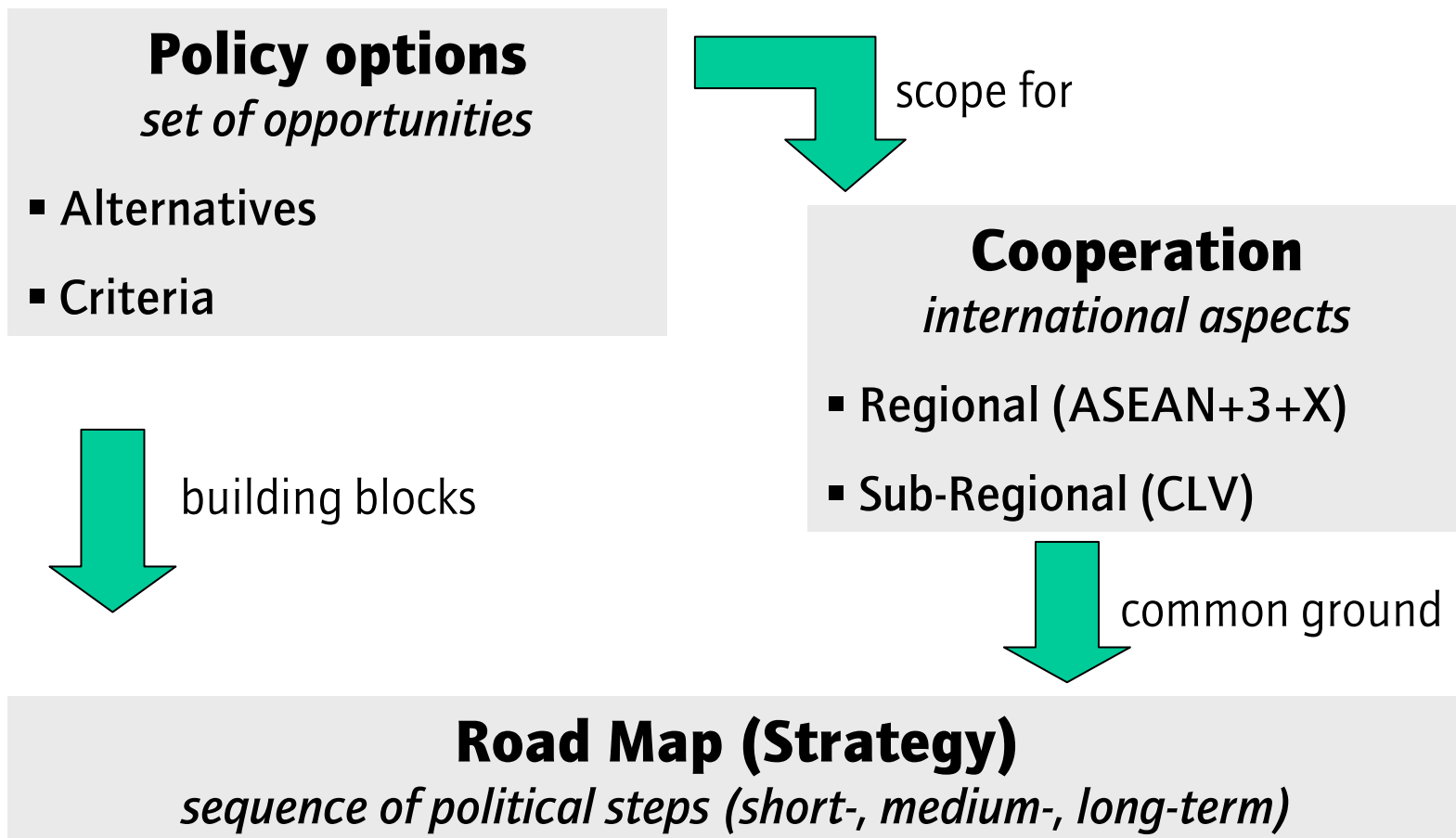
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Stylized facts

- PPPPP: poorly performing purchasing power parity (nominal and real exchange rates highly correlated)
- CLV: small and very open economies
- highly integrated with ASEAN+3
- so far very low intra-CLV integration

Policy Options, Cooperation and Road Map



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Monetary and Exchange Stability

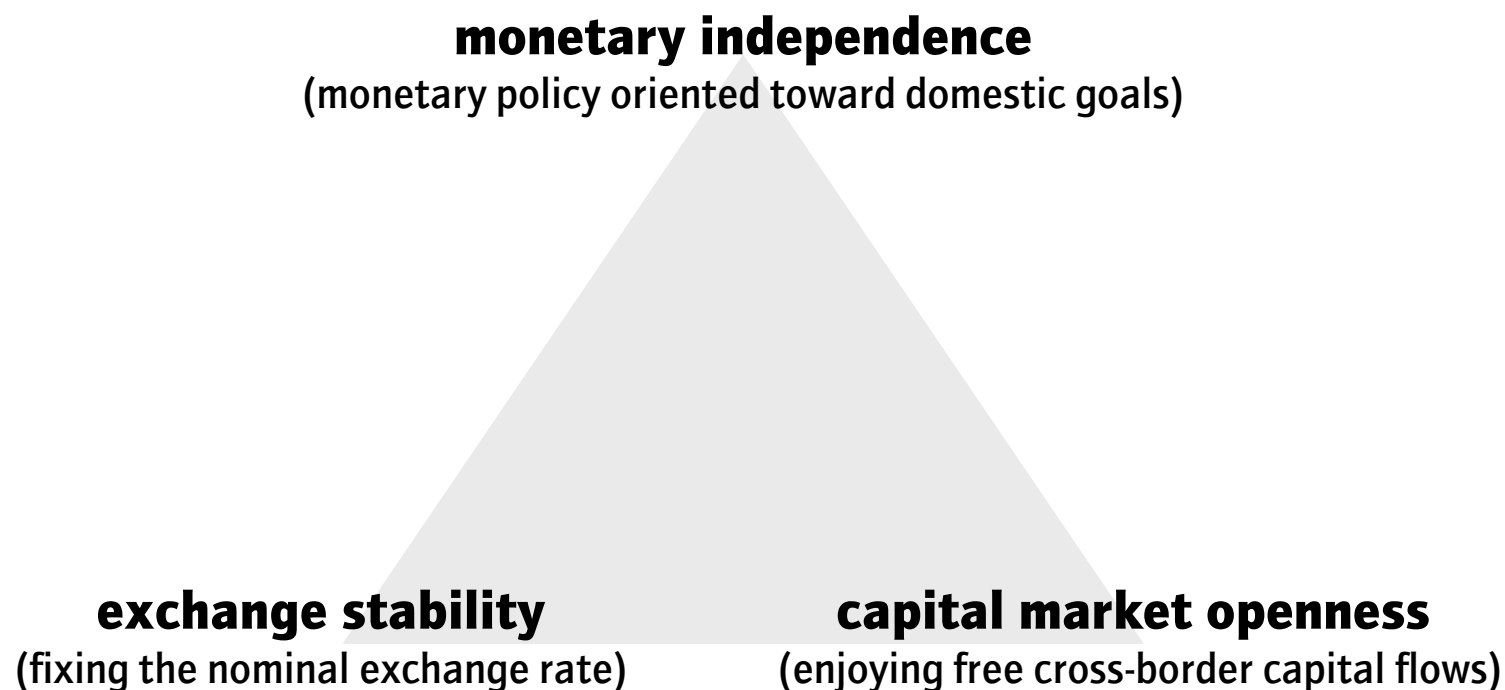
- Monetary stability
 - reliable means of payment (inflation control)
 - workable financial sector
- Exchange stability
 - exchange stability \neq constant nominal exchange rates
 - absorption of external shocks
 - no dysfunctional alignments (disturbances)
 - workable interface to ROW

⇒ Stability = system sustainability (adequacy)

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The Monetary Policy Trilemma



Currency Regimes: Fundamental Options

- Exchange rate system
 - Flexible exchange rate
 - Fixed exchange rate
 - currency board
 - no currency board
 - No national currency
- Reserve/reference currency
 - Basket
 - transparent weights
 - disclosed weights
 - Single currency
- Capital mobility
 - Unrestricted
 - Segmented
 - Strict controls
- Parallel currency
 - official (legal tender status)
 - informal

Exchange Rate System

- Flexible exchange rate

- free floating
- managed floating

- Fixed exchange rate

- crawling peg
- adjustable
- strictly pegged
- currency board

+
*choice of
intervention
band width*

- No national currency

- official dollarization
- monetary union

strengthening network effects

Fixed Exchange Rates: Choosing the Peg

- **Single currency (national peg)**
 - rules of the game imply that pegging country has to adopt monetary policy of the anchor currency's central bank
 - implicit exchange rate regimes vis-à-vis third countries
 - requires "obvious" dominant anchor currency
 - **Currency basket (composite peg)**
 - should reflect not only bilateral trade but also main competitors on world markets
 - less exposed to possibly strong variations of single currency
 - regional basket as starting point for future currency union
- ⇒ Irrespective of the peg, same peg for CLV implies fixed CLV exchange rate system
- ⇒ Strict peg can be relaxed by larger, country-specific intervention bands

The Case for Capital Controls

- **Reasons for capital controls**
 - traditional view:
making money supply less endogenous in a fixed exchange regime (more independence for domestic monetary policy)
 - more important here:
supporting the stability of the domestic financial system
 - efficiency losses are relatively small in the absence of a fully developed financial system (including capital markets)
⇒ complete elimination of capital controls not advisable
- **Streamlining capital controls (better regulation)**
 - replacing non-tariff barriers by taxes or reserve deposits on capital inflows/outflows (more transparency + accuracy)
 - future adjustments (gradual phasing out) in line with market developments and improved supervision

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- **Implications of the multiple currency phenomenon**
 - The multiple currency phenomenon in the CLV countries: causes and policy implications
 - Seigniorage in multiple currency economies
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MCP: Causes and policy implications

- **Main causes of the MCP**
 - macroeconomic instability
 - political uncertainty
 - underdeveloped financial and monetary system
- **Example of Viet Nam**
- **Negative policy implications of the MCP**
 - monetary autonomy restricted
 - central bank's lender-of-last-resort capacity limited
- **Positive policy implications**
 - stability/credibility import
 - disciplines governments (limited inflation taxation)

Dealing with Dollarization

- De-Dollarization not an end in itself
 - De-Dollarization via regulation
 - refusing legal protection for domestic contracts denominated in foreign currencies
 - risk of evasive responses, strengthening shadow market activities
 - De-Dollarization via economic incentives
 - currency competition: making the domestic currency relatively more attractive (= provoking upward pressure)
 - exchange rate target dominated by de-dollarization objective (loss of one degree of freedom)
- ⇒ national currencies unlikely to compensate for loss of network effects
- ⇒ (sub-) regional currency more competitive

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Criteria for Policy Design

- **Economic efficiency criteria**
 - Effectiveness (acceptance of official currency)
 - Monetary stability
 - Allocative efficiency
(transaction costs, trade and FDI effects)
 - Shock absorption (real/monetary)
 - Exposure to liquidity risks (currency crises)
 - Monetary autonomy
 - Seigniorage
- **Politico-economic criteria**
 - Scope for international cooperation
 - Compatibility with future regional currency area

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Scenarios

- **Non-cooperative scenarios**
 - Status quo: No monetary cooperation, but individual country reforms
 - Official dollarization
 - Individual currency board arrangements
- **Cooperative scenarios**
 - **Implicit CLV exchange rate system**
 - similar peg in each country vis-à-vis the US-Dollar
 - implicitly pegged cross-rates between CLV countries
 - **CLV currency area (ACU-based)**
 - identical currency basket (ACU) for all three countries (different intervention band widths may apply)
 - implicitly pegged cross-rates between CLV countries
 - option to switch from national currencies to single currency

Status Quo

Effectiveness	limited
Monetary stability	mixed results
Allocative efficiency	transaction cost due to parallel currency regime and small network effects
Shock absorption	real shocks more important than monetary shocks
Liquidity risks	unlikely
Monetary autonomy	depending on exchange rate target
Seigniorage	yes, but limited due to dollarization
Sub-regional cooperation	no
Regional cooperation	no

Official Dollarization

Effectiveness	yes
Monetary stability	foreign interest and inflation rates, but no lender of last resort
Allocative efficiency	very low transaction cost, but real exchange rate adjustment via prices/nominal wages alone
Shock absorption	yes (monetary shocks) and no (real shocks)
Liquidity risks	no
Monetary autonomy	no
Seigniorage	no
Sub-regional cooperation	no
Regional cooperation	no

CLV Currency Boards

Effectiveness	more likely, if CLV-wide
Monetary stability	foreign interest and inflation rates, but no lender of last resort
Allocative efficiency	low transaction cost, but real exchange rate adjustment via prices/nominal wages alone
Shock absorption	yes (monetary shocks) and no (real shocks)
Liquidity risks	yes
Monetary autonomy	no
Seigniorage	yes
Sub-regional cooperation	no
Regional cooperation	no

Common Peg – Implicit CLV Exchange Rate System

Effectiveness	depends on nature of the peg
Monetary stability	foreign interest and inflation rates with some latitude via intervention band widths
Allocative efficiency	lowered transaction cost, but: trade patterns vary significantly
Shock absorption	yes (monetary shocks) and limited (real shocks)
Liquidity risks	more likely the stricter the peg
Monetary autonomy	very limited (depending on band widths and capital controls)
Seigniorage	yes
Sub-regional cooperation	yes, CLV-wide monetary coordination is advisable / required
Regional cooperation	useful policy coordination, step toward larger ASEAN currency area

CLV Currency Area (ACI-based)

Effectiveness	tendency to reduce dollarization over time
Monetary stability	mix of ACU-inflation rates latitude via intervention band widths
Allocative efficiency	lower transaction cost within CLV, varying trade patterns less important
Shock absorption	smoother relative to single anchor currency
Liquidity risks	more likely the stricter the peg
Monetary autonomy	limited (depending on band widths and capital controls)
Seigniorage	yes
Sub-regional cooperation	yes, intensive CLV-wide monetary coordination is vital
Regional cooperation	useful policy coordination, possible precursor role for ASEAN-wide monetary union

Cooperation: Options and Implications

- Cooperative options: Peg to an identical anchor (currency or basket) in the short run, move to an ACI-based peg in the medium run
- Potentially substantial early-mover advantages in monetary and exchange rate cooperation
 - institutional and human capacity building at an early stage
 - acquisition of practical experiences with regard to joint exchange rate management
 - opportunity for CLV to secure participation and political influence in process of regional monetary integration

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General Recommendations

- **Foreign exchange policy: focus on ASEAN+3**
 - ACI-basket more suitable than single dollar-peg
 - country specific degrees of pegging via band-widths
- **Capital controls**
 - reasonable while financial sector is not fully developed
 - shift towards more market-oriented capital controls
- **Harmonizing monetary institutional frameworks**
 - regulation: higher cost-efficiency
 - investors: virtually deeper markets (know one, know all)
 - more advanced: building joint financial institutions

A Road Map for CLV Cooperation

Economic integration / convergence



Phase 1: Informal institutional cooperation

- network-building
(decision makers, bureaucrats, researchers)
- consultations and joint training/research groups

Phase 2: Joint institution building

- harmonizing financial market regulatory framework
- loosening intra-CLV capital controls

Phase 3: Common CLV currency policy

- joint pegging (ACI-based)
- gradually reducing band-widths
- creating CLV-wide financial markets

Phase 4: Entering into regional exchange rate system

- ASEAN+3+X exchange rate mechanism
- Asian Monetary Area

Road Map for ASEAN+3 and CLV

