

DIW Berlin

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

Policy Options

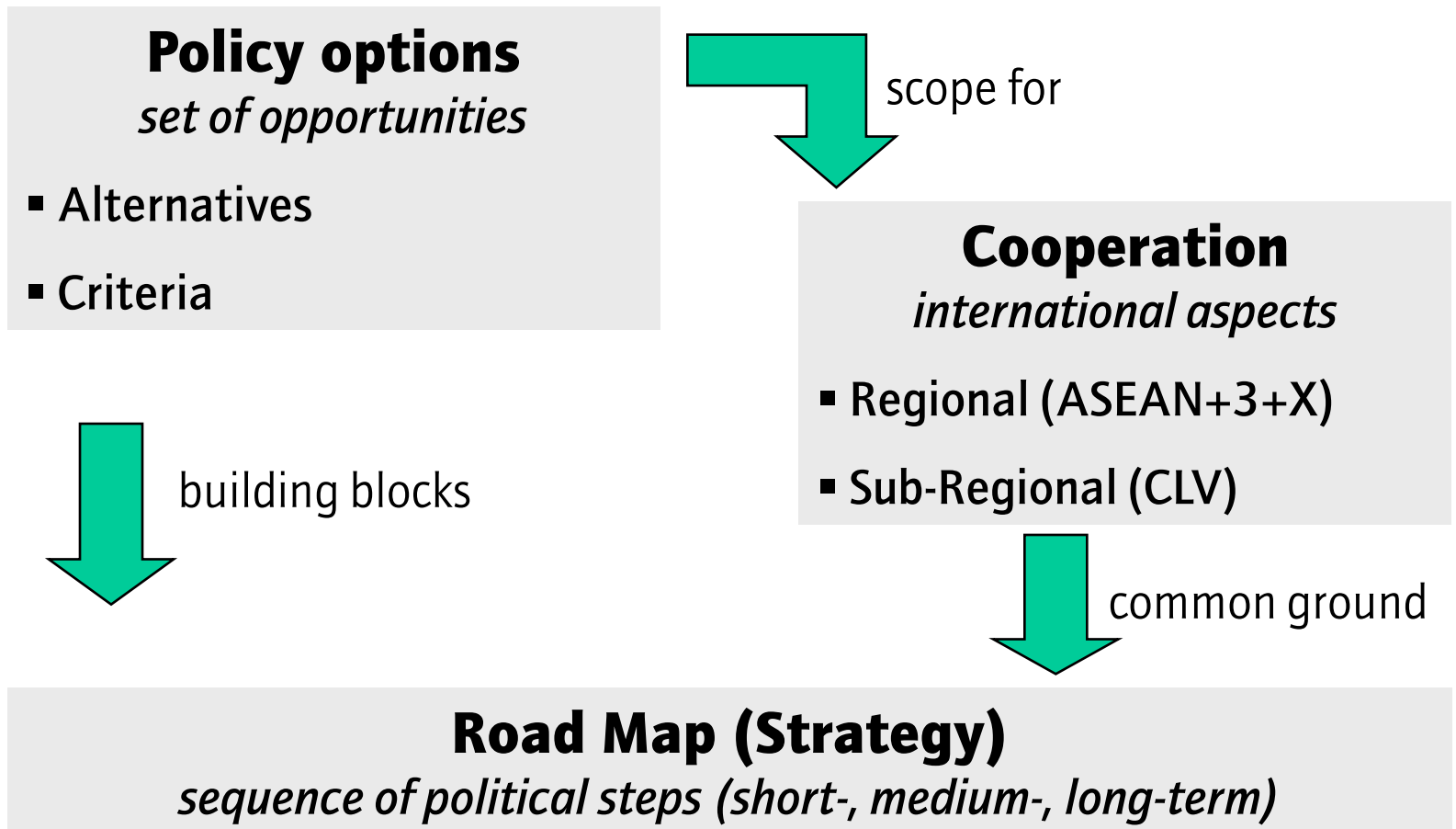
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Outline

- Introduction
- Monetary fundamentals
- Building blocks of currency regimes
- Criteria for Policy Design
- Selected Options

Policy Options, Cooperation and Road Map

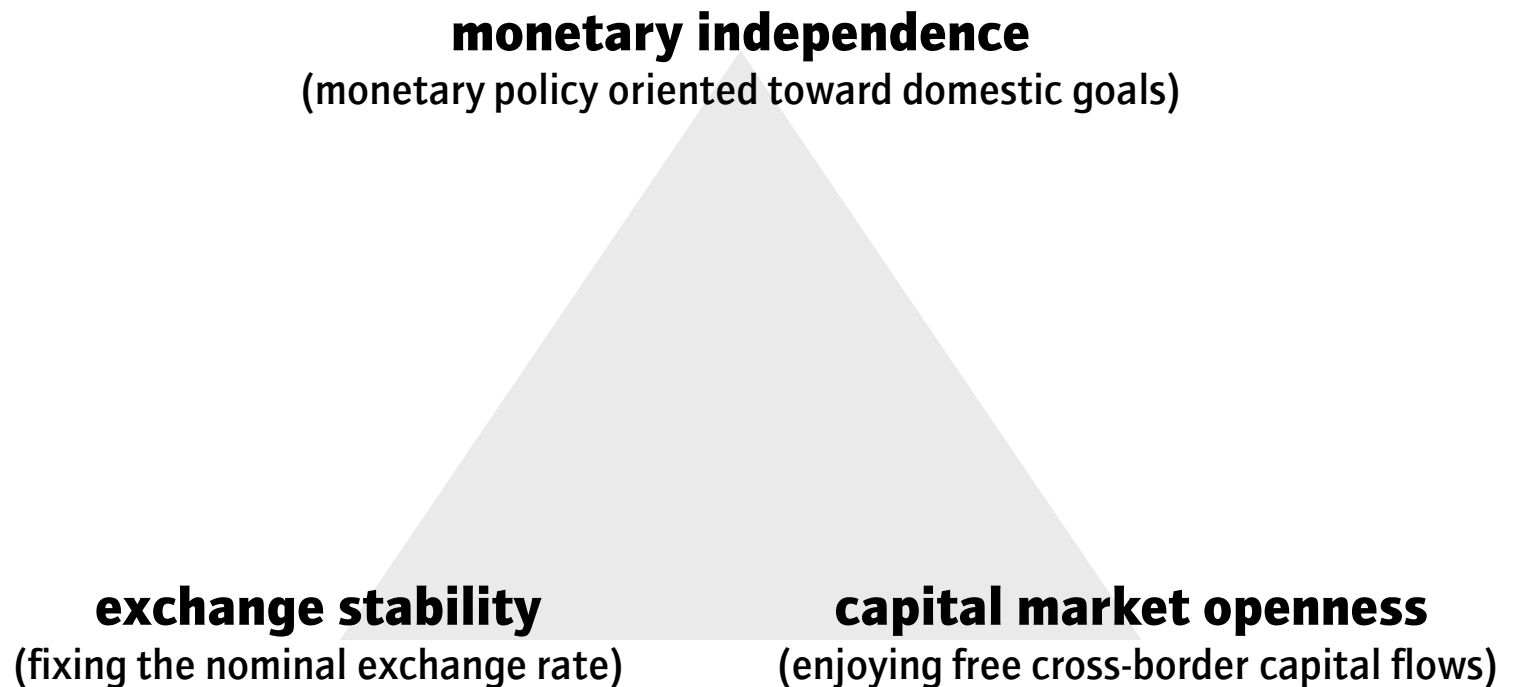


Monetary and Exchange Stability

- **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)**

The Monetary Policy Trilemma



Currency Regimes: Fundamental Options

- Exchange rate system
 - Flexible exchange rate
 - Fixed exchange rate
 - No national currency
- Reserve/reference currency
 - Basket
 - transparent
 - disclosed
 - Single currency
- Capital mobility
 - Unrestricted
 - Segmented
 - Controls
- Parallel currency
 - official (legal tender)
 - 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

- full dollarization
- monetary union

strengthening network effects

Fixed vs. Flexible Exchange Rates

■ Advantages of flexible exchange rates

- allow for monetary autonomy
- more protection against imported inflation
- no political price distortions (but: PPP usually also fails)
- deal better with real shocks (more flexibility if goods prices and or nominal wages are sticky)
- avoid liquidity crises, less prone to speculative pressure

■ Advantages of fixed exchange rates

- anchor to monetary policy (stabilization import, if credible)
but: risk of liquidity crises if rules of the game are ignored
- reduced transaction costs, ease exchange rate forecasts
- avoid non-fundamental exchange rates
(if PPP fails, nominal rates matter!)
- deal better with monetary shocks

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

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

Criteria for Policy Design

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

Scenarios

- **Status quo**
 - independent managed floating
 - **Full dollarization**
 - **CLV currency boards**
 - **CLV-wide currency board**
 - **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
- } non-cooperative

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

Full 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