Lessons Learned from Countries that Experienced Difficulties in the Transition from Fixed to Float

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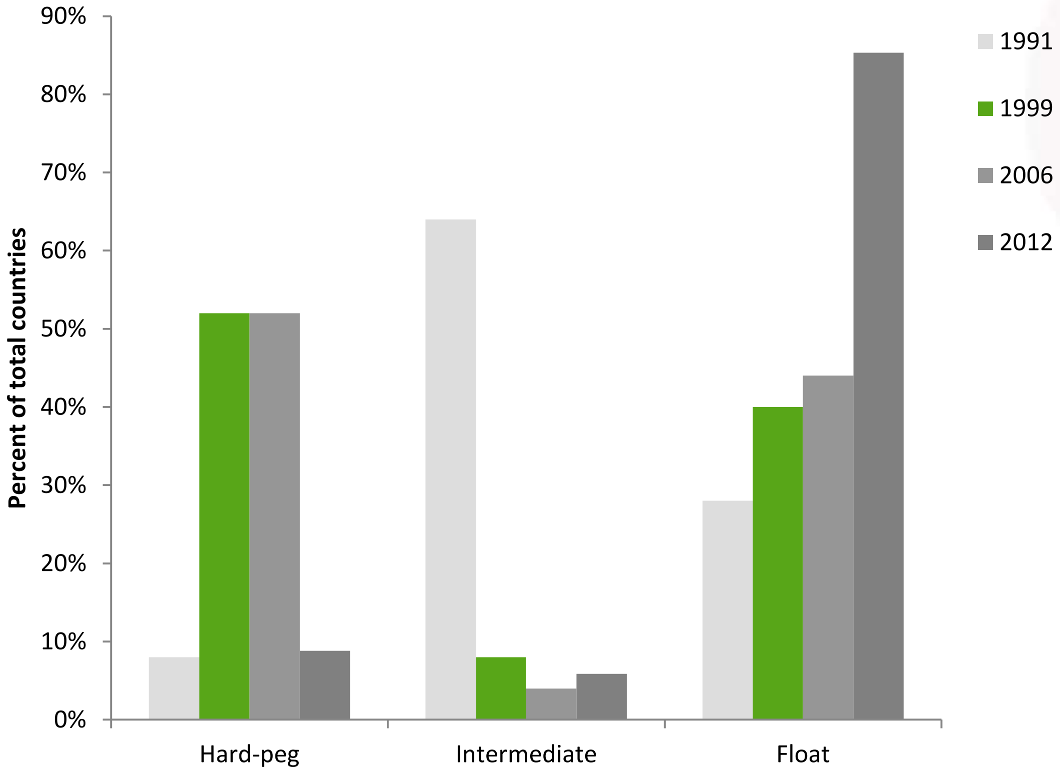
Main Themes

- Most countries exit from pegs under stress and is therefore better to be prepared
- Successful transitions require
  - a deep and liquid foreign exchange market
  - a coherent intervention policy
  - an appropriate alternative nominal anchor, e.g. Inflation under Inflation Targeting
  - adequate systems to review and manage public and private sector exchange rate risk
- The room for effective capital flow regulation gradually evaporates after the float
  - deepen the financial markets
  - strengthen financial system supervision and regulation
  - strengthen macroeconomic policy management

OVERVIEW OF MAIN ISSUES

Flexibility is gaining ground among developed economies

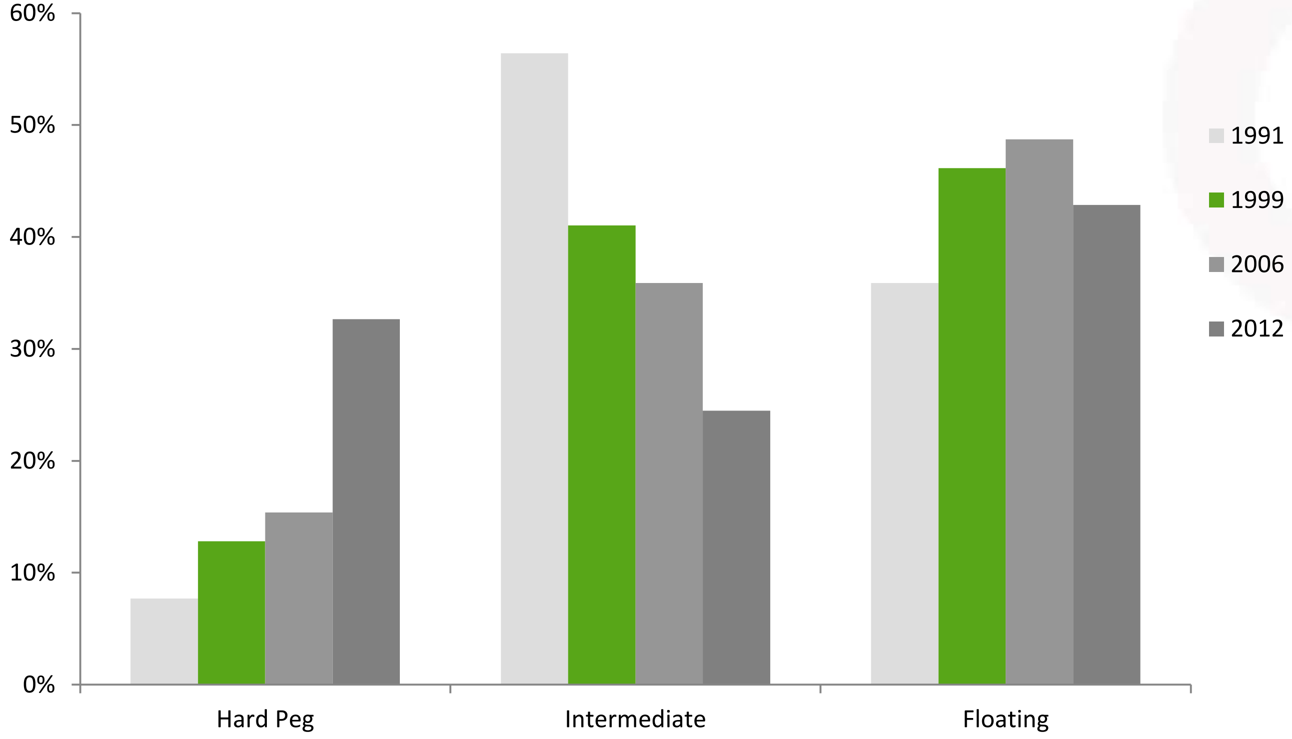
- *Advanced* Countries: Exchange Rate Regimes, 1991, 1999, 2006 (Fischer, 2008) , and 2012



Source: 2012 advance countries list is from *World Economic Outlook*, April 2013

… while EMEs increasingly face only two options: float or peg

- *Emerging Mar*ket Countries: Exchange Rate Regimes, 1991, 1999, 2006, and 2012



Source: Emerging markets is SPR department official list

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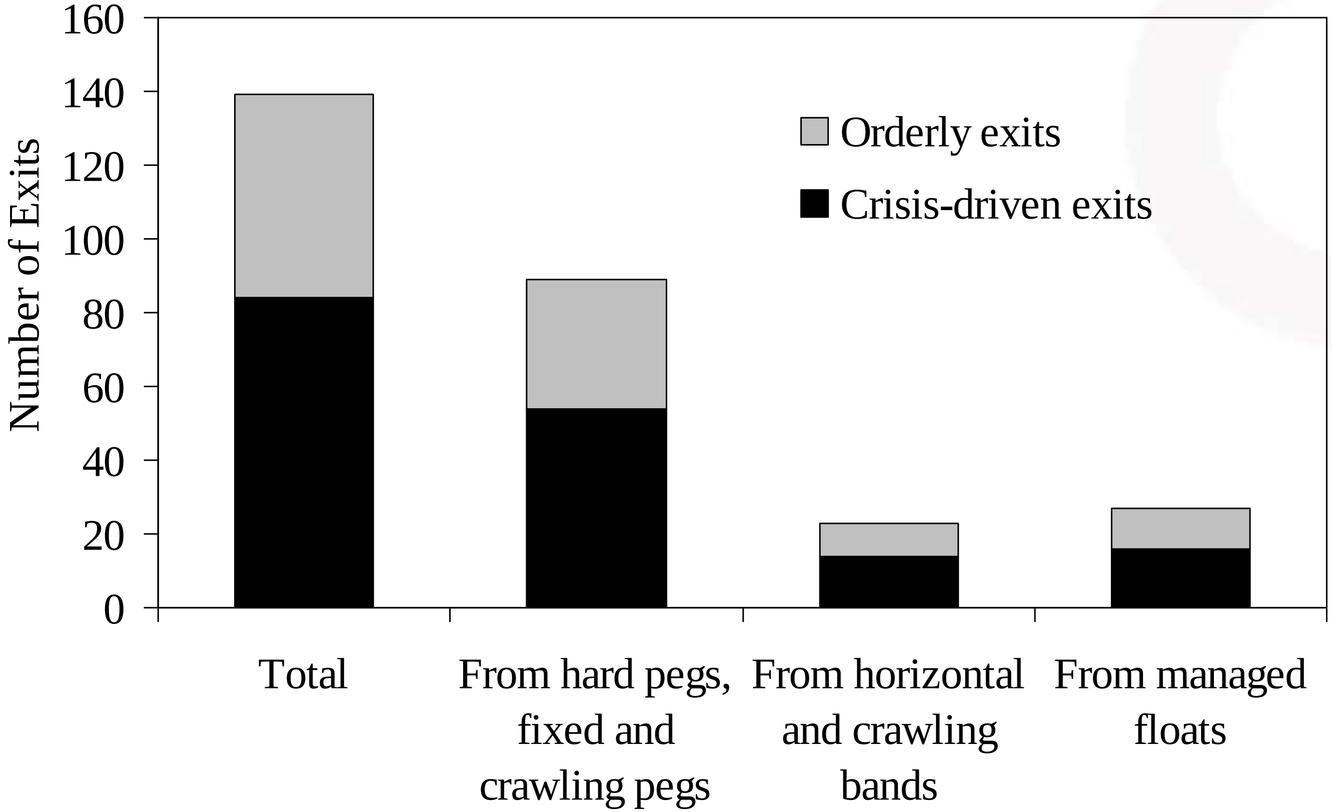
Yet exits are often disorderly

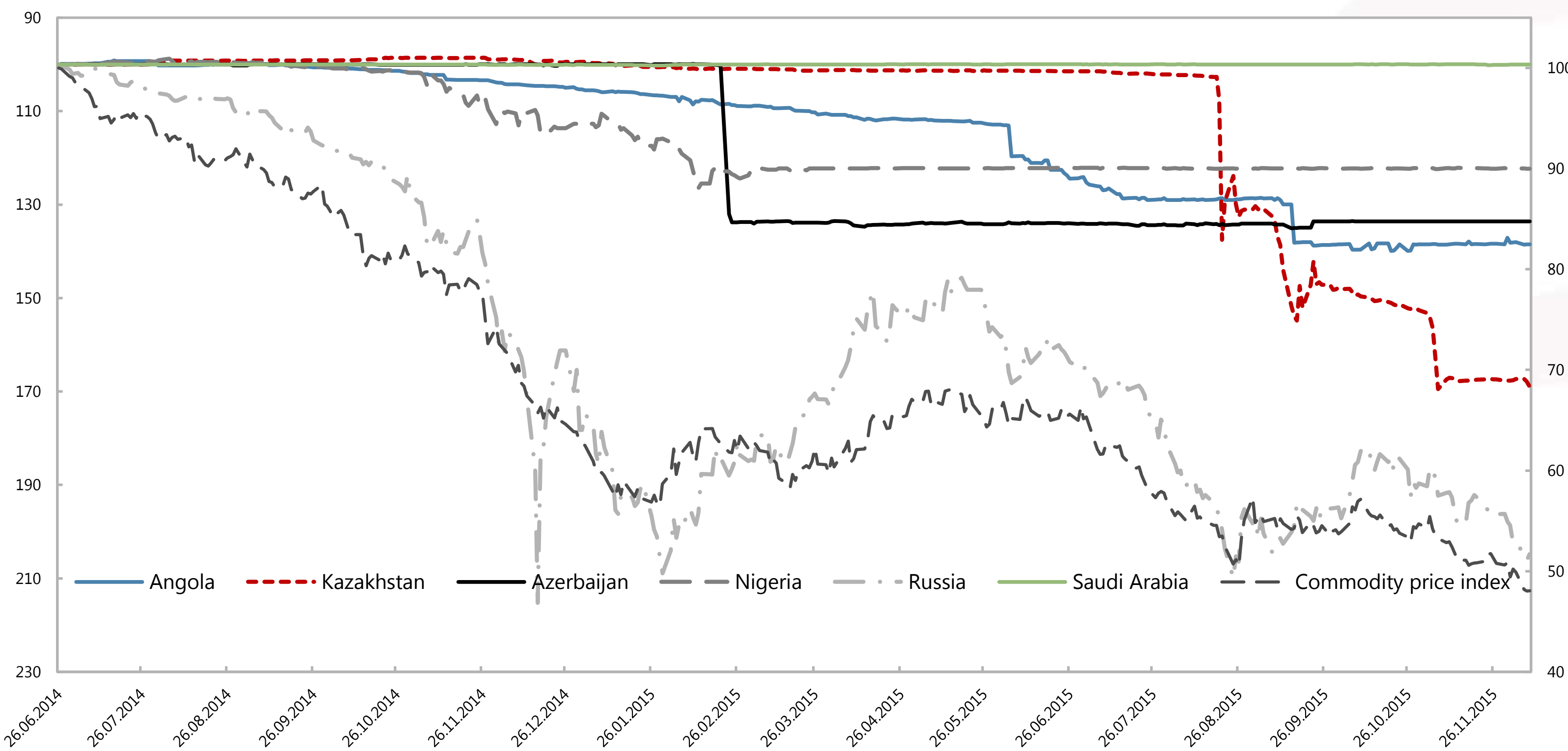
Figure 2. Exits by Exchange Rate Regime, 1990–2002



Source: IMF

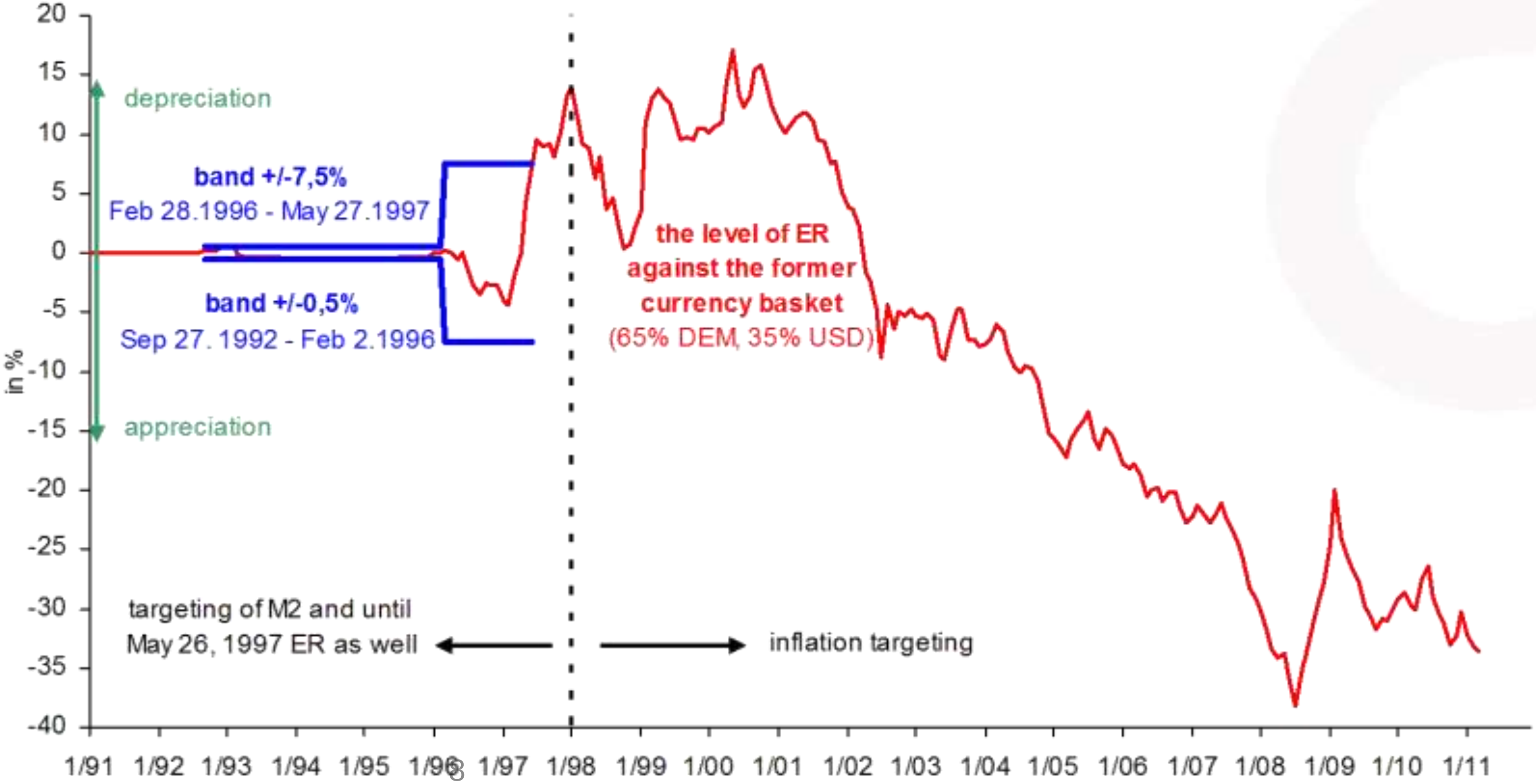
… mostly triggered by external forces

Figure 3. Exchange Rates Against the US$



Sources: Bloomberg, Datastream and IMF staff calculations.

… aggravated by domestic macroeconomic imbalances



Source: CNB

Fixed exchange rate regimes

- Easy to operationalize and manage in the short-term
- Long-term costs in terms of
  - Higher macroeconomic volatility
  - Higher dollarization and financial sector vulnerability to FX risks
  - Lower stabilizing power of domestic central bank as the LOLR and MMOLR
  - Risk of disorderly adjustments and high interest rates

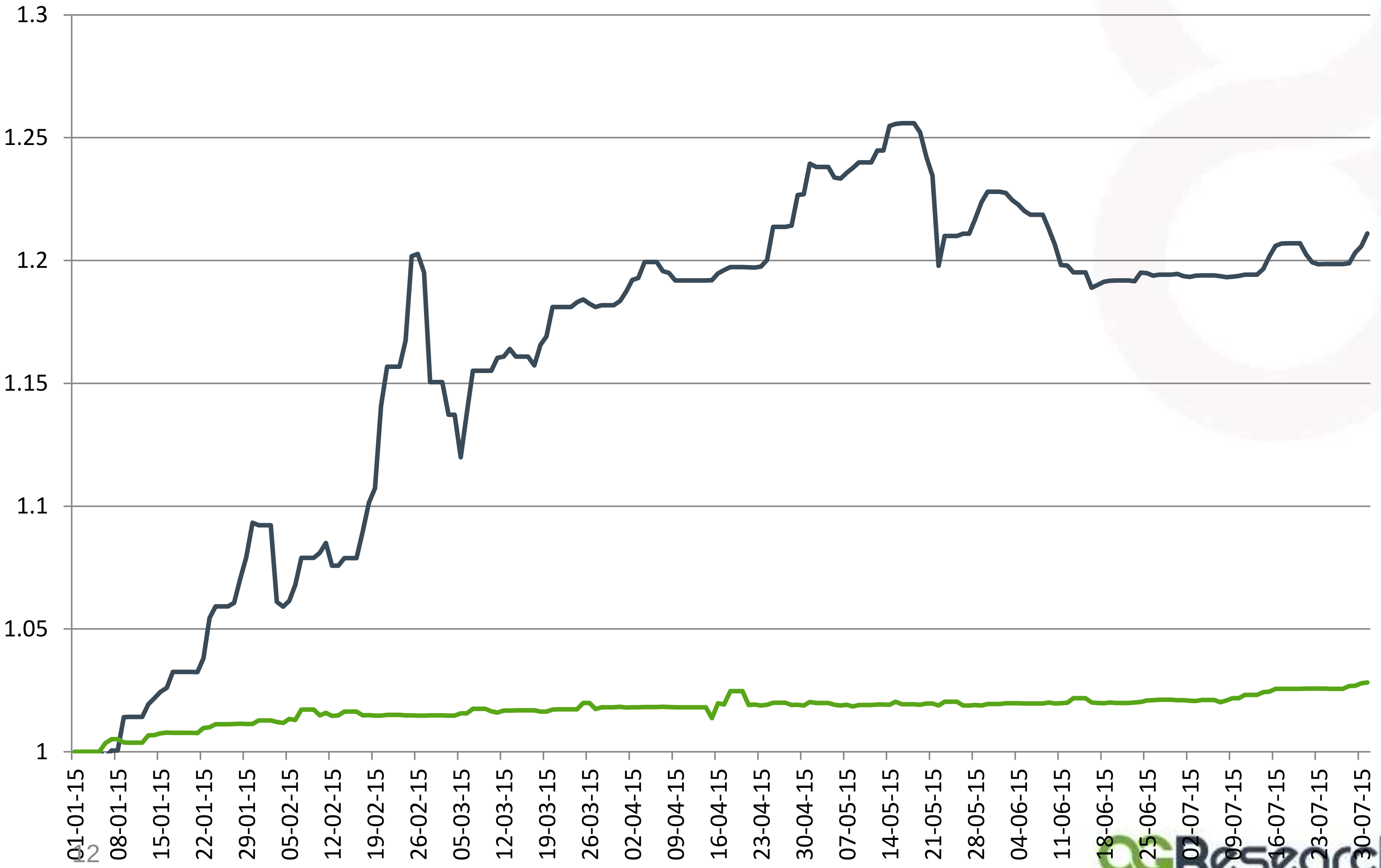
Exchange Rate rate flexibility

- Difficult to implement and manage
- If well managed, then long-term benefits in terms of
  - Lower interest rates
  - Lower macroeconomic volatility
  - Lower dollarization
  - Flexibility and insurance in terms of the LOLR and MMLR

Lesson #1

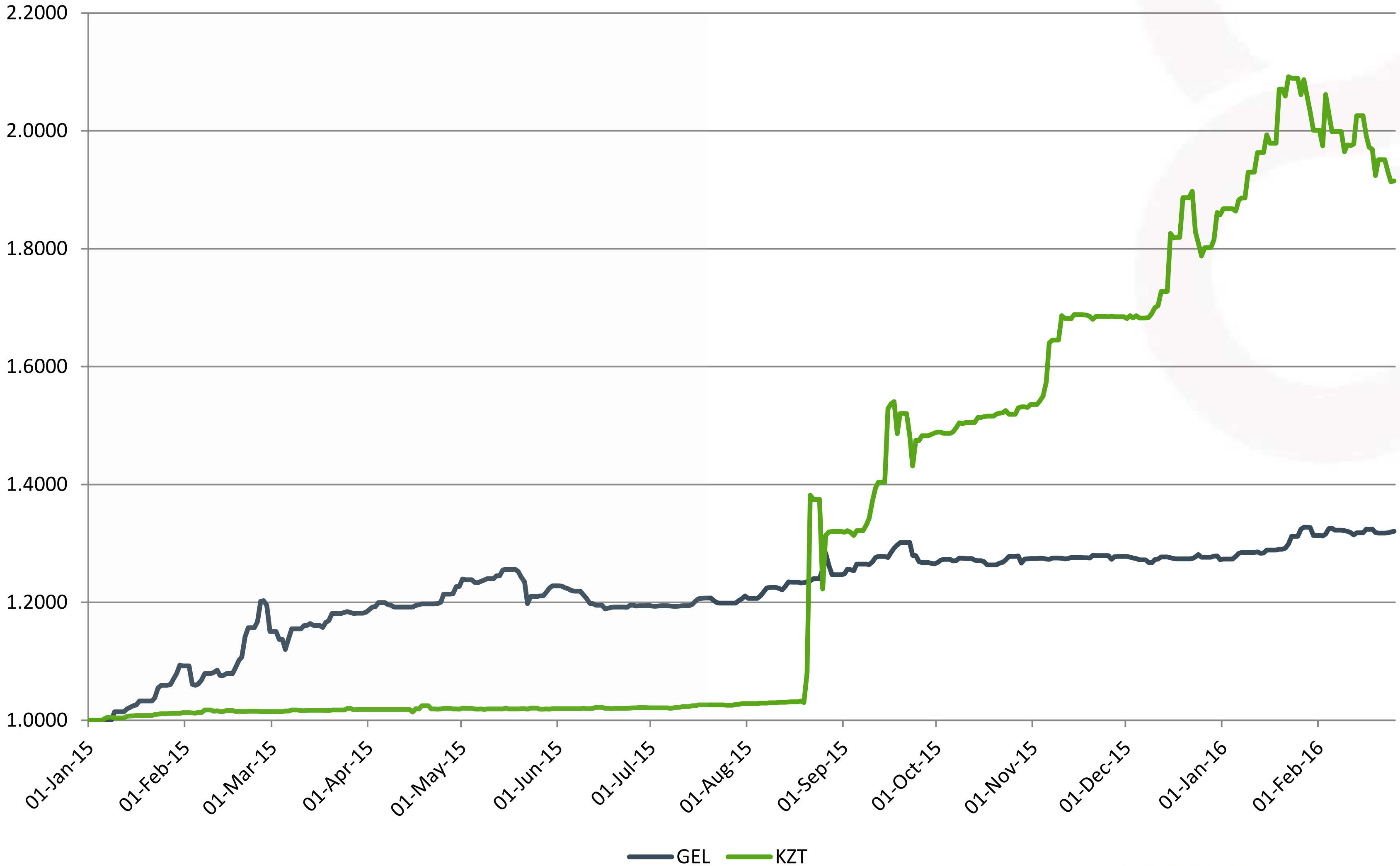
Pegs often lead to higher long-term exchange rate volatility

Stable FX?



Source: NBG

Stable FX?

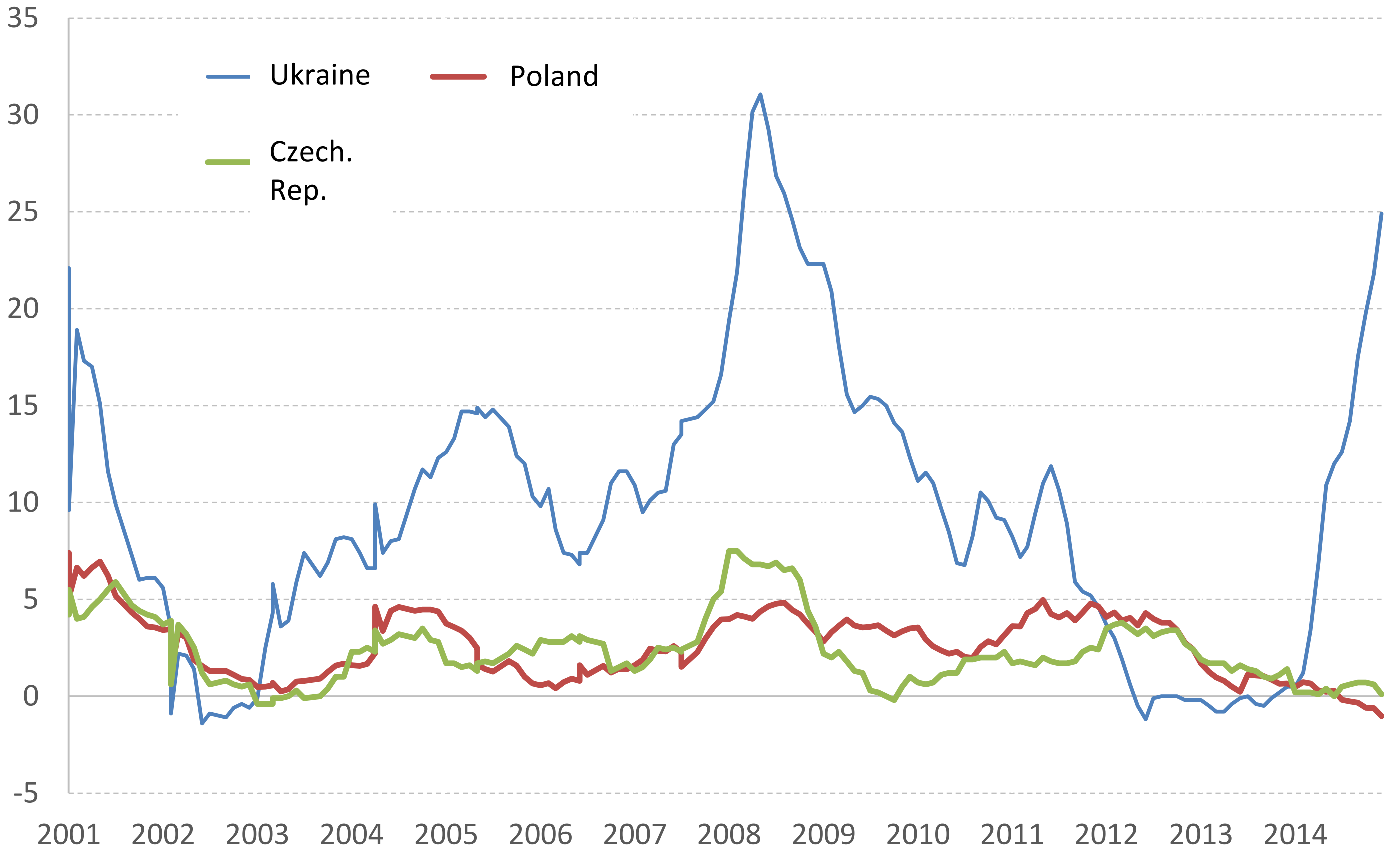


Source: NBG

Lesson #2

Pegs do not guarantee nominal stability

… and similar is true for output growth or financial sector stability



Source: Bloomberg

Lesson #3

Most peg exits are unprepared (and under stress), and well sequenced reforms are needed for success

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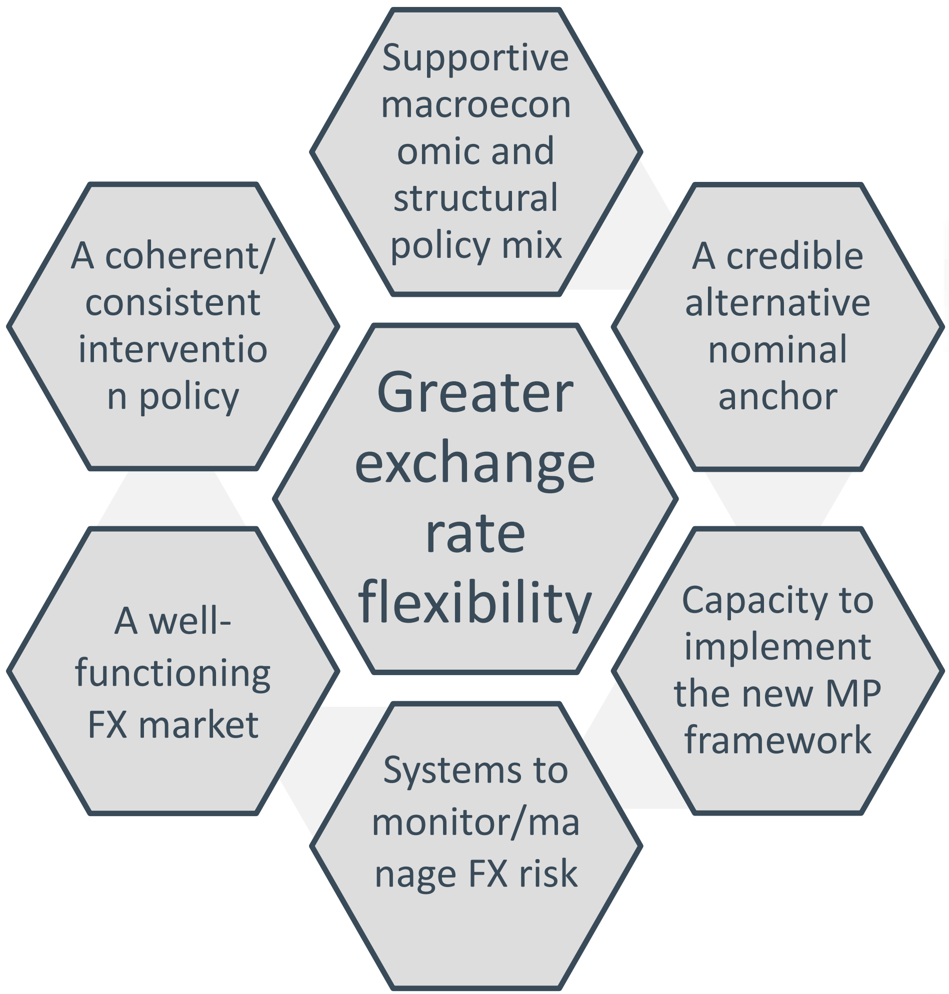
Key ingredients of a successful move to flexibility



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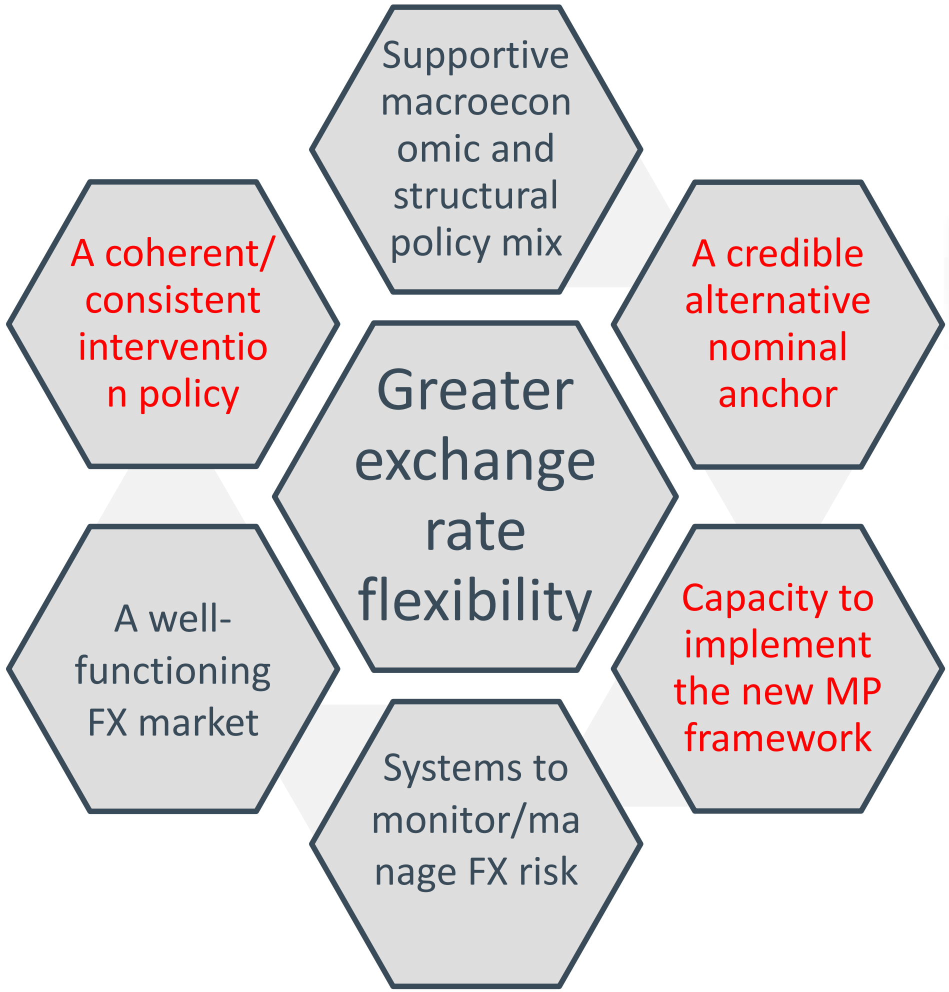
Key ingredients of a successful move to flexibility



Lesson #4

Alternative monetary policy regime with inflation as the new nominal anchor

Principles of Effective Monetary Policy*

- Price stability as the overriding objective
- Medium-term inflation objective as the basis for policy actions and communication
- Operational independence, mandate and accountability towards the objective
- Clear and effective operational framework aligning market conditions with the policy stance
- Transparent forward-looking monetary policy strategy that
  - reflects the monetary transmission mechanism.
  - bases policy actions on an assessment of implications for the economy and financial stability
- Transparent communication about policy objectives and actions

* Evolving Monetary Policy Frameworks in Low-Income and Other Developing Countries; IMF Policy Paper; October 23, 2015

Inflation Targeting Regimes as a particularly successful example

- Price stability as the overriding objective
- Medium-term inflation objective as the basis for policy actions and communication
- Operational independence, mandate and accountability towards the objective
- Clear and effective operational framework aligning market interest rates with the policy stance and a flexible ex rate
- Transparent forward-looking monetary policy strategy that
  - reflects the monetary transmission mechanism.
  - bases policy actions on an assessment of implications for the economy and financial stability
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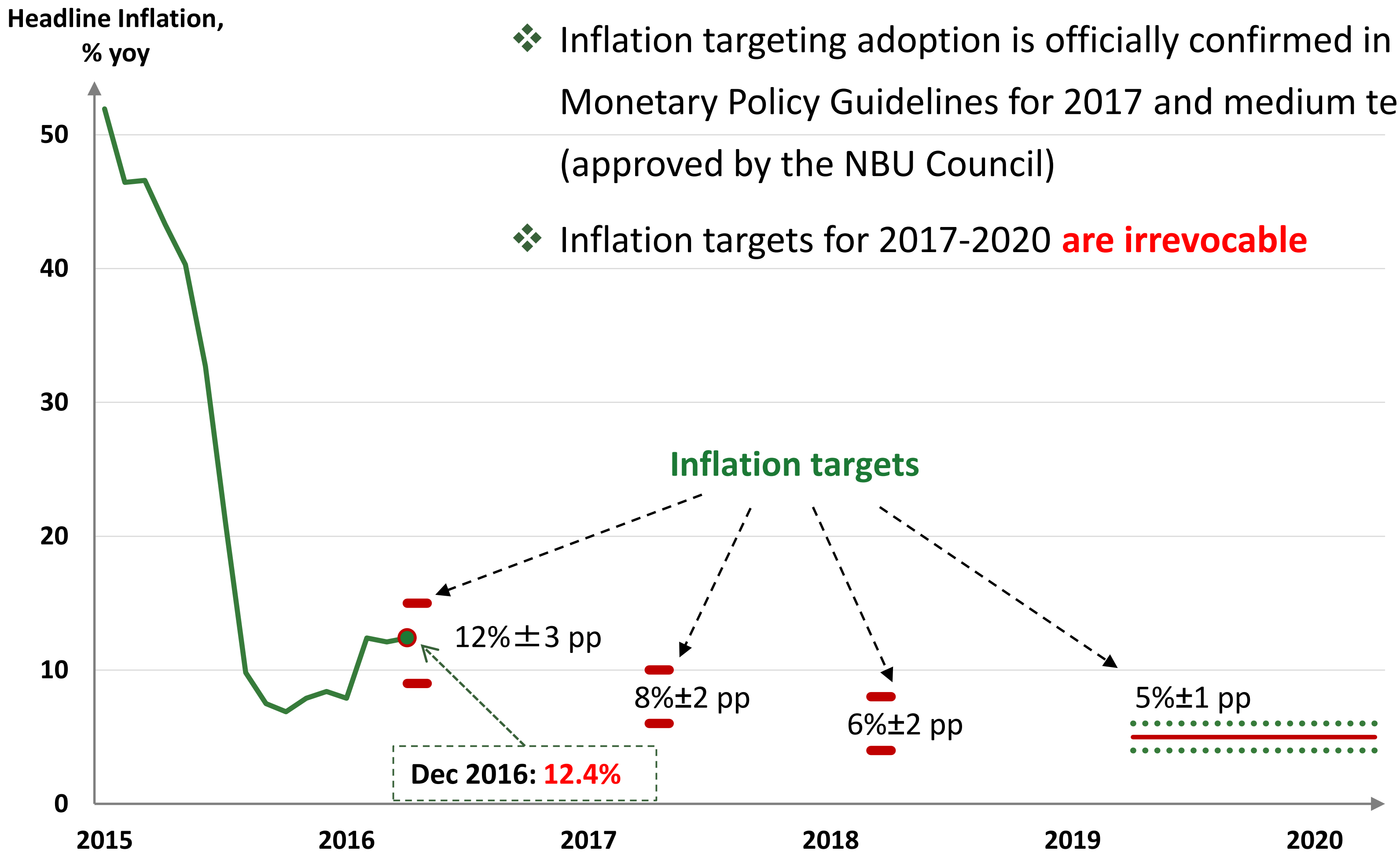
* Evolving Monetary Policy Frameworks in Low-Income and Other Developing Countries; IMF Policy Paper; October 23, 2015

Operationalizing the inflation objective under IT



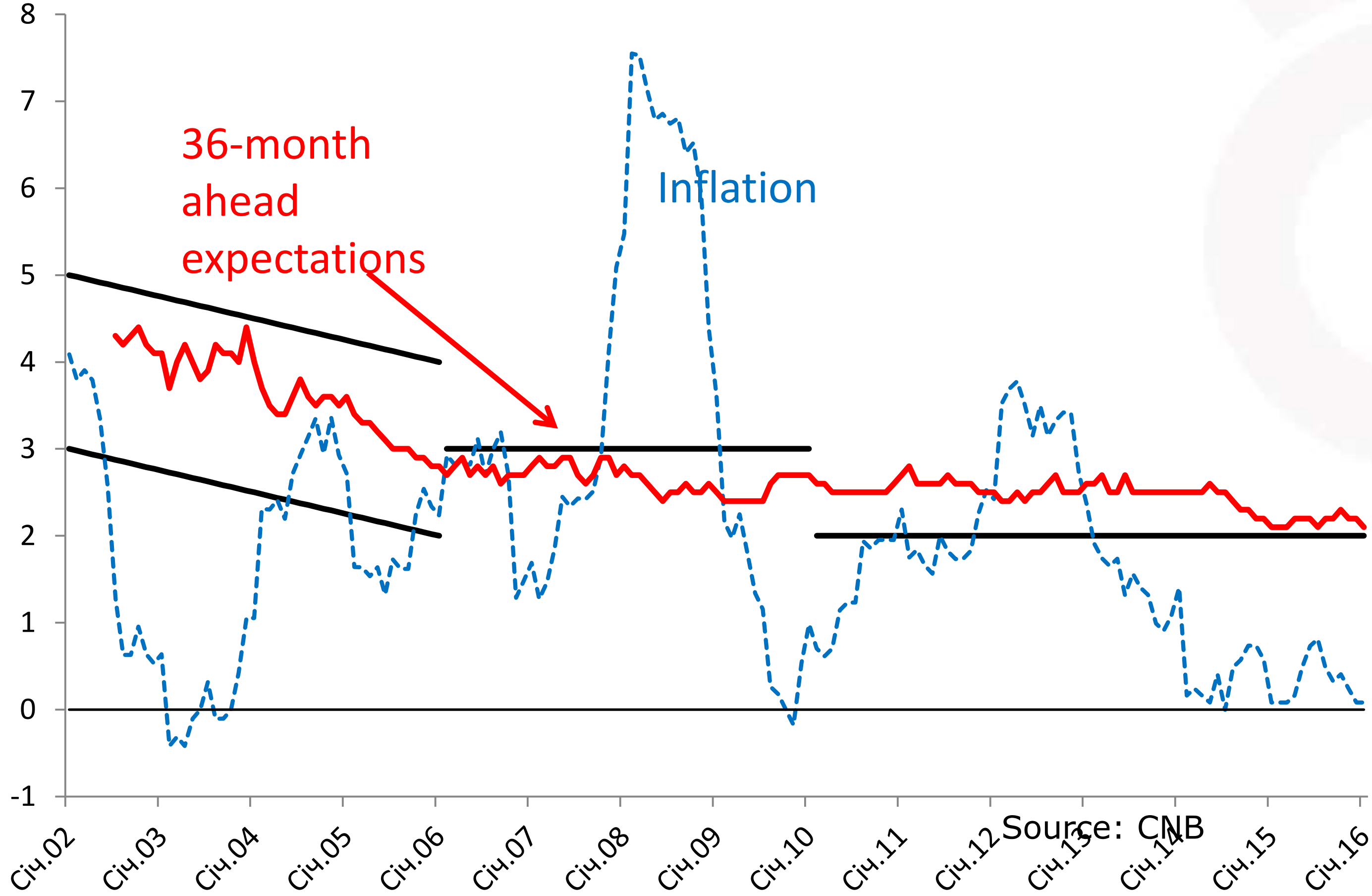
- Inflation targeting adoption is officially confirmed in the Monetary Policy Guidelines for 2017 and medium term (approved by the NBU Council)
- Inflation targets for 2017-2020 **are irrevocable**

Source: NBU

Lesson #5

Inflation as the new nominal anchor

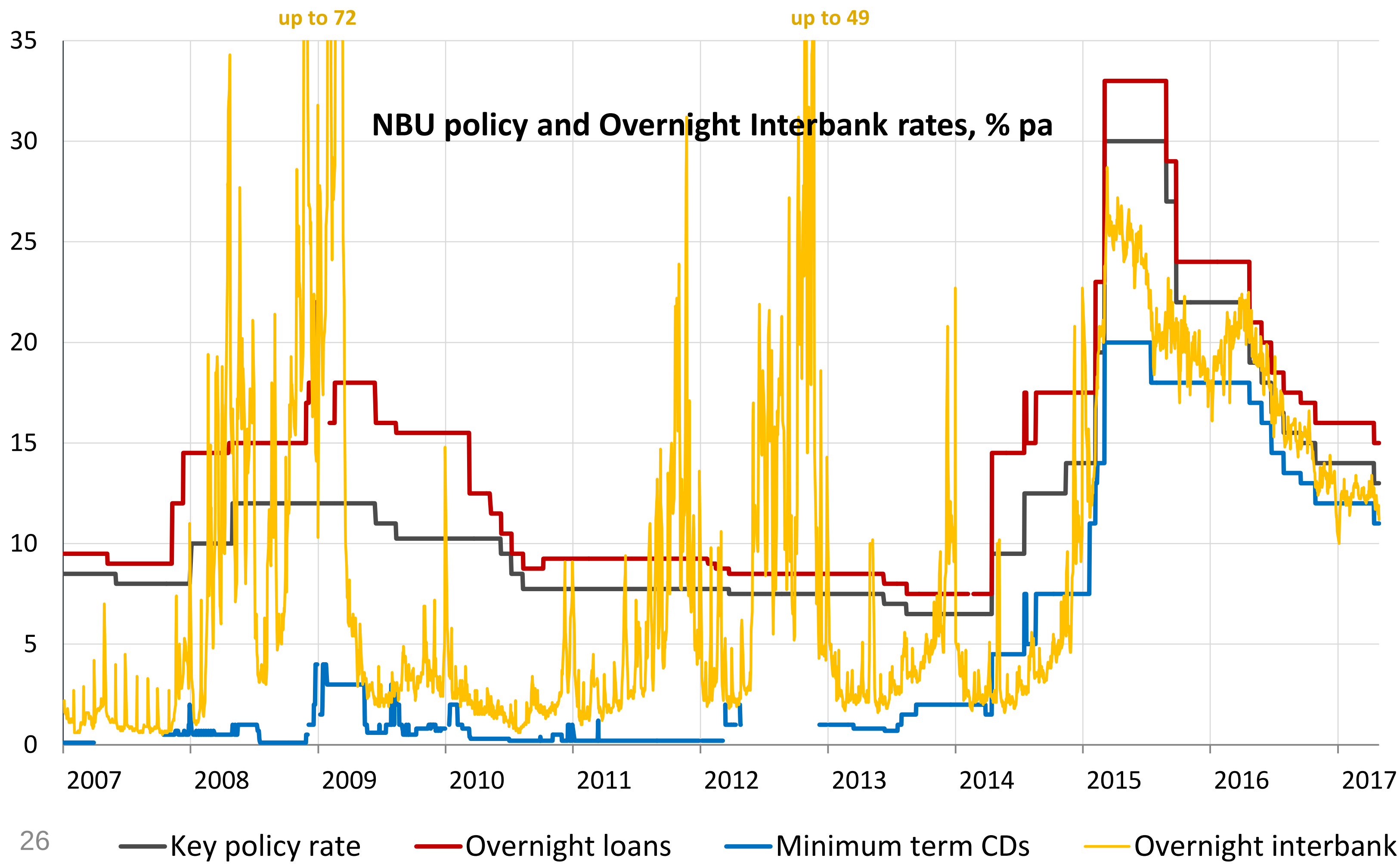
Expectations are effectively anchored on the target



Lesson #6

Interest rate based policy

Predictable movements of less volatile market interest rates



Source: NBU

Lesson #7

Flexible exchange rate with an intervention strategy, consistent with the regime and well communicated

Importance of FX interventions has increased after the crisis, also for ITers

- After the crisis the use of FX interventions has intensified in both developed and emerging markets
  - 20 out of 30 pure inflation targeting regimes regularly intervene on the forex market (and 16 out of 18 countries EME ITers
- FX interventions as a systematic instrument to support a flexible exchange rate is an accepted paradigm now

Tasks

- accumulation of international reserves
- smoothing out the functioning of the FX market
- Supporting the transmission of the key policy rate as the main monetary policy instrument

Forms

- FX auctions
- single-rate interventions
- request for quotations
- targeted interventions

FX interventions Strategy

Principles

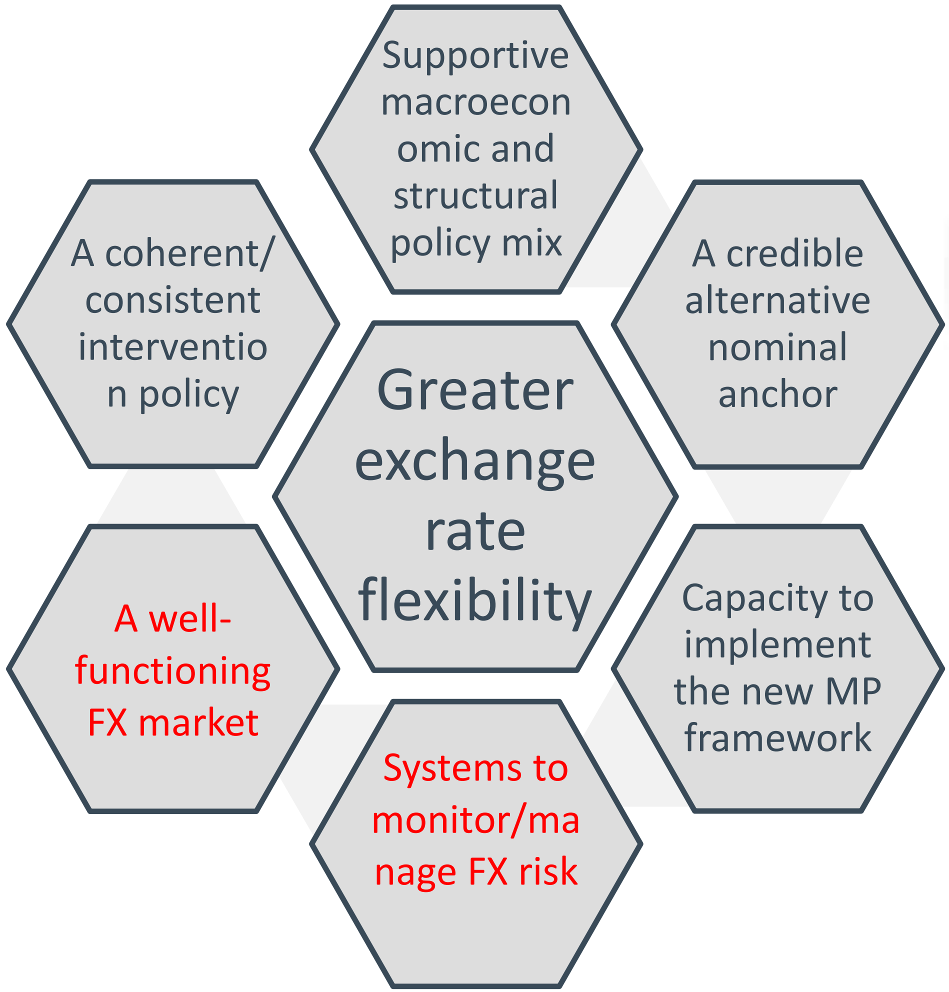
- ✓ FX Strategy is consistent with Inflation targeting and floating ER
- ✓ NBU insists in minimizing the role of FX intervention as policy tool
- ✓ NBU does not counteract fundamental trends, only smooths their effects
- ✓ Criteria of banks’ participation are open and transparent

Communications

the NBU maintains a reasonable level of transparency while disclosing information about its intentions to conduct FX interventions and their outcomes

Source: NBU

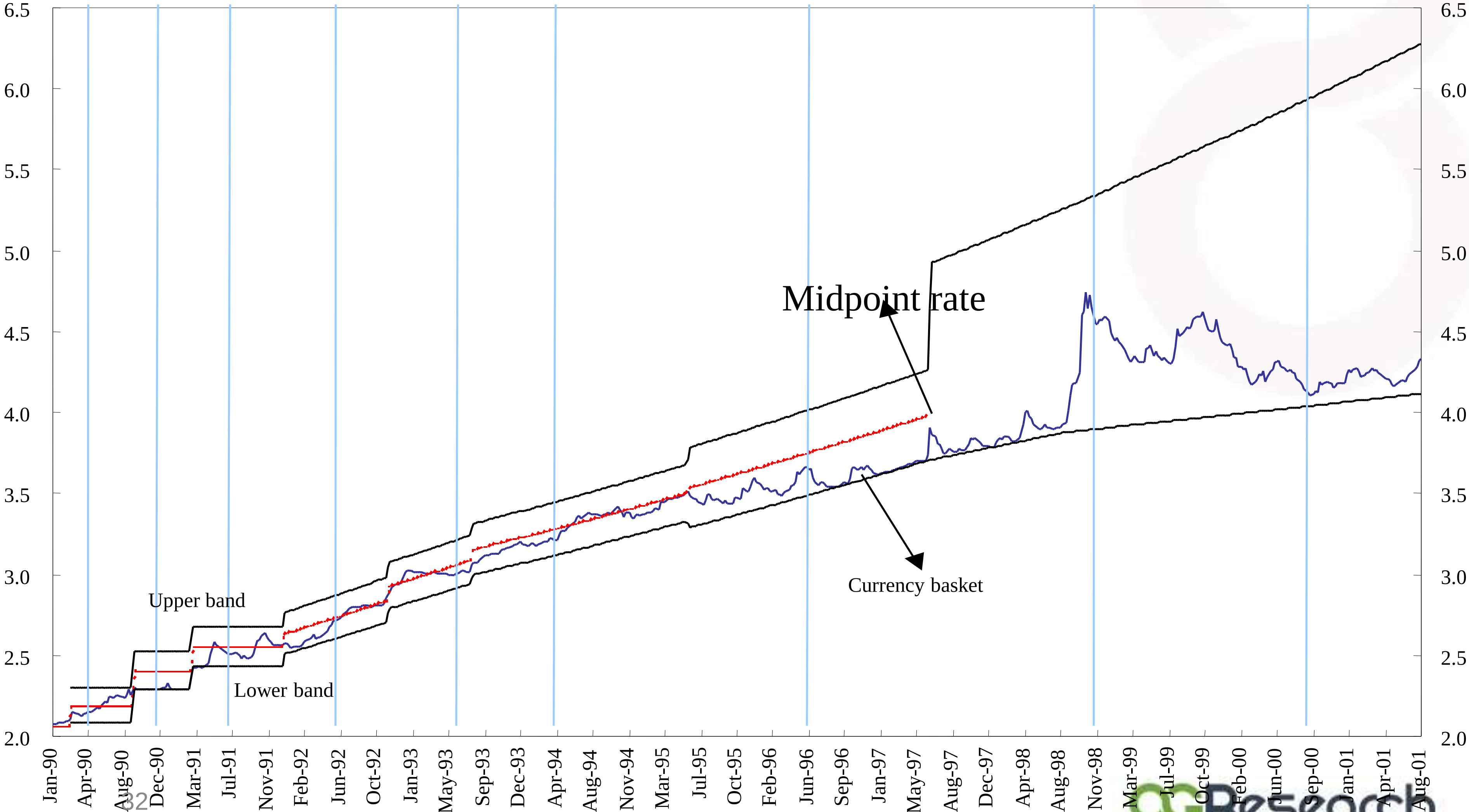
Key ingredients of a successful move to flexibility



Lesson #8

Exchange rate flexibility should come in stages to stimulate the development of the FX market and FX risk management tools

From Fixed Peg to a Float in Israel

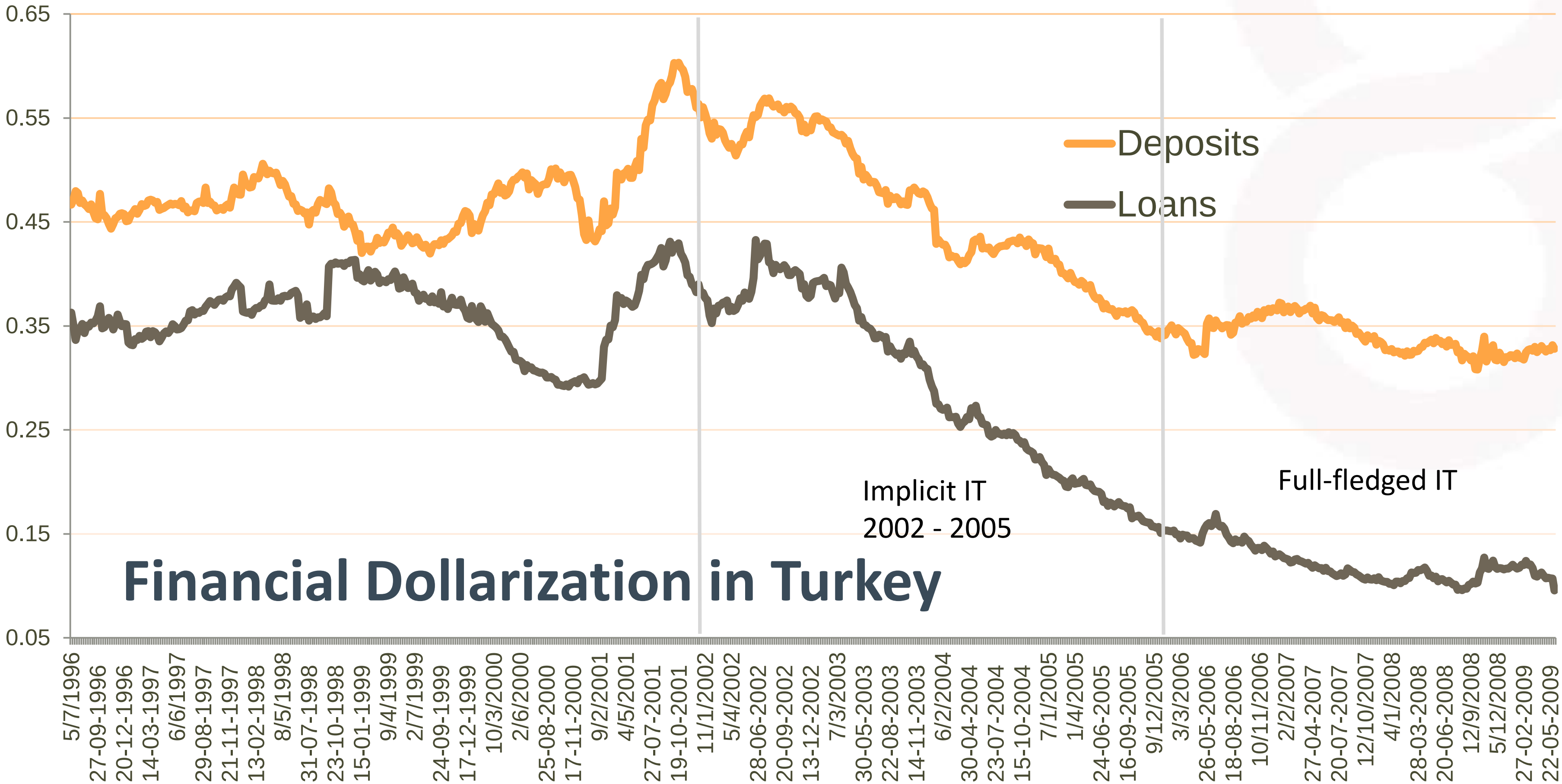


Source: Bank of Israel

Lesson #9

Balanced net open FX positions and developed risk management instruments before significant flexibility

Direct and Indirect FX Risks



Source: CBRT

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Source: CBRT

Key ingredients of a successful move to flexibility

Greater exchange rate flexibility

Supportive macroeconomic and structural policy mix

A credible alternative nominal anchor

Capacity to implement the new MP framework

Systems to monitor/manage FX risk

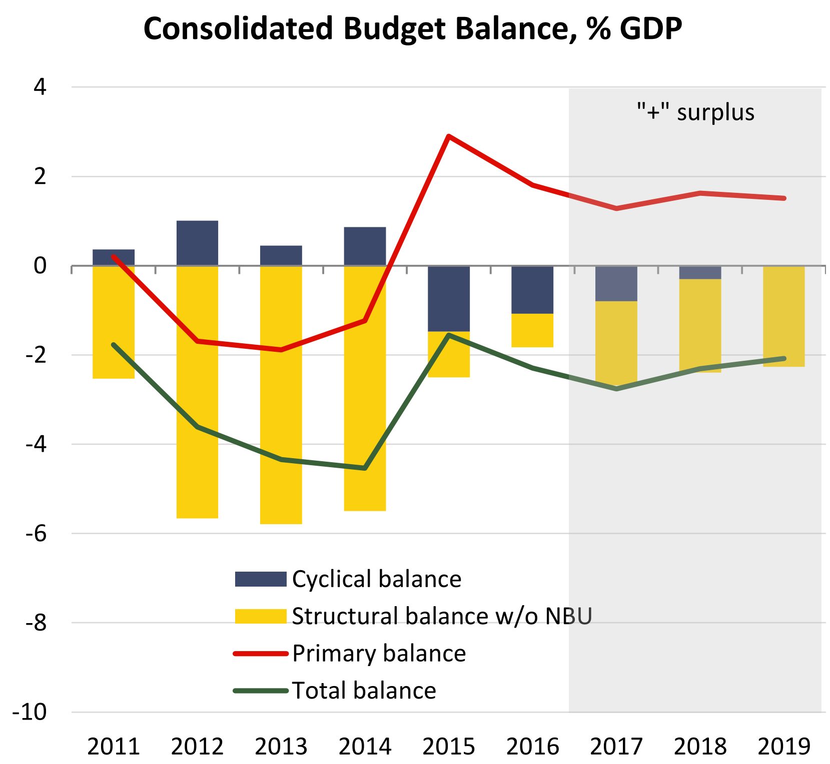
A well-functioning FX market

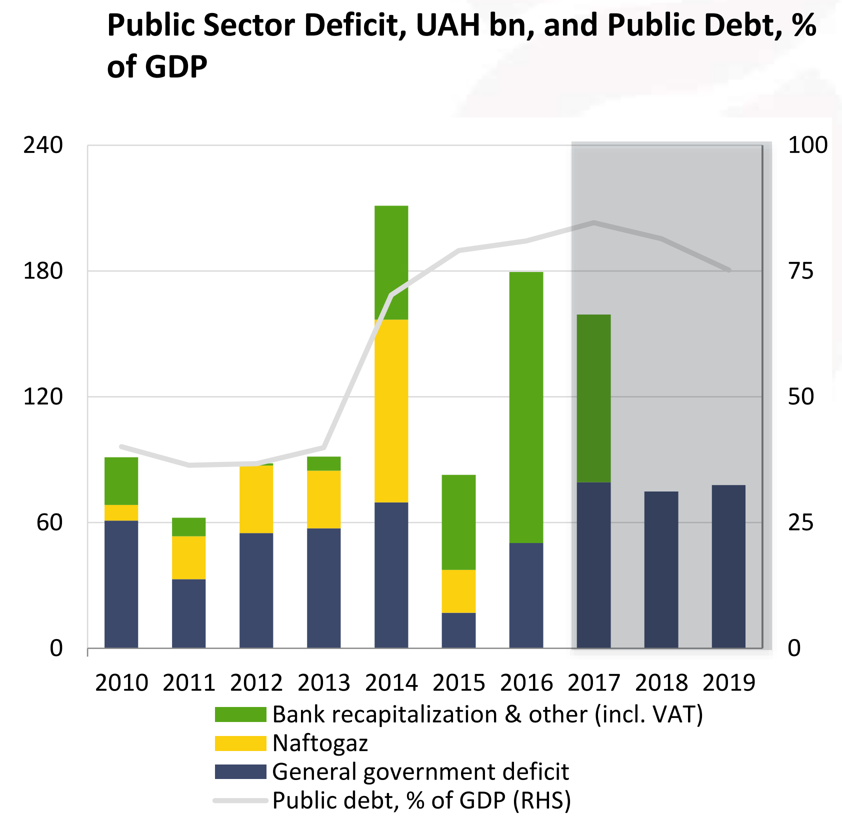
A coherent/ consistent intervention policy

Lesson #10

Better exit from a position of strength and well prepared

Prudent fiscal, willing to resolve systemic banking issues





Source: MFU; NBU staff estimates

Lesson #11

Reforms must be broad and well-sequenced both inside and outside the central bank

Broad reforms inside the bank

Monetary policy

- Shift from over discretionary policy to rule-based policy, from pegged to floating exchange rate.
- The decision-making process and monetary policy implementation are based on the inflation targeting practices.
- Enhanced independence of central bank and avoidance of fiscal dominance.

Banking system rehabilitation

- Diagnostic study (AQR + stress test) for the top 60 banks (over 98% of the sector assets) accomplished, bank recapitalization progress is significant.
- Country's largest bank nationalized (after failing to fulfil capitalization program) to prevent system-wide contagion and secure financial stability.
- Detailed related-party lending diagnostics completed, banks are implementing related-party loan unwinding plans.
- Ultimate beneficiary owners of all Ukrainian banks identified and legalized.

Banking system supervision

- Risk-based supervision concept being implemented.
- Early-warning system put in place to identify bank problems in a timely manner.
- New regulation on credit risk assessment approved, new rules enacted since 2017 after a trial period over Sep-Dec 2016.
- Anti money-laundering policies have been enhanced, about 10 banks closed for money-laundering practices.
- Basel-compliant capital and liquidity rules currently being developed.

NBU transformation

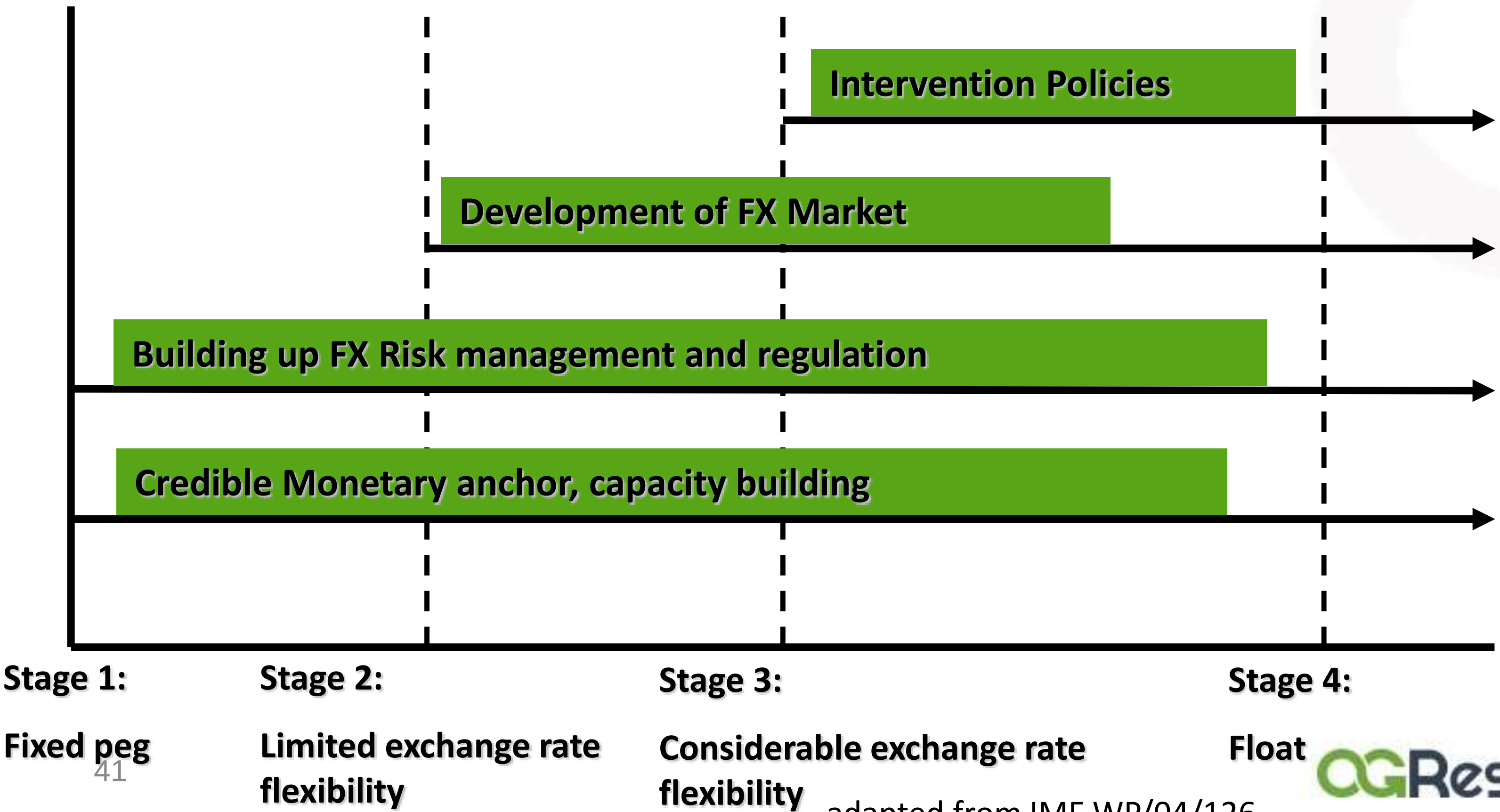
- Overhaul of the organizational structure: strengthening core functions, downsizing non-core functions, optimizing regional presence.
- Roles of internal committees enhanced.

Source: NBU

Sequencing of pillars of a new monetary policy regime

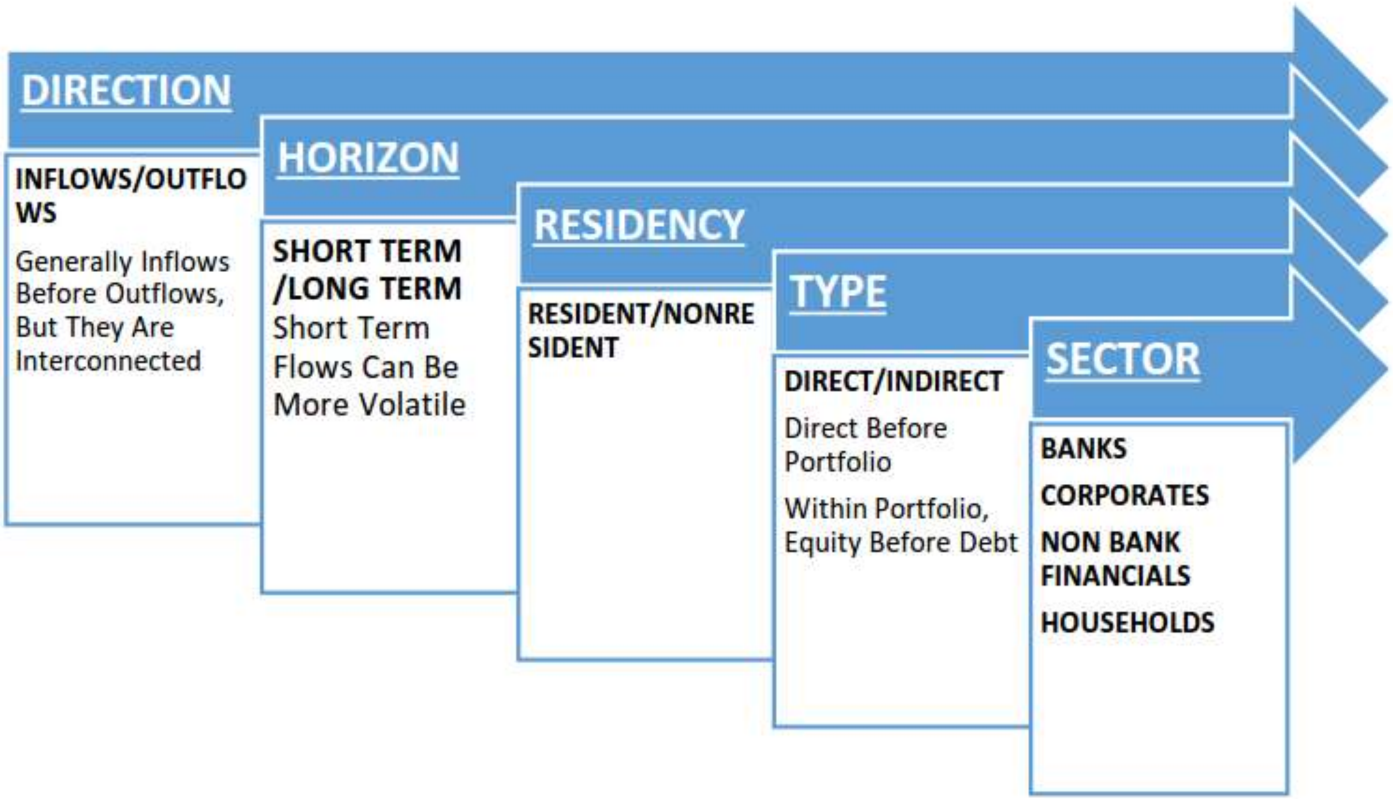
- Effective MP implementation based on interest rate
- Effective market based intervention strategy
- Monetary policy based on strong analytical and forecasting capacities
- Effective communication strategy

Well sequenced with market developments



adapted from IMF WP/04/126

… and with the liberalization of capital flows liberalization



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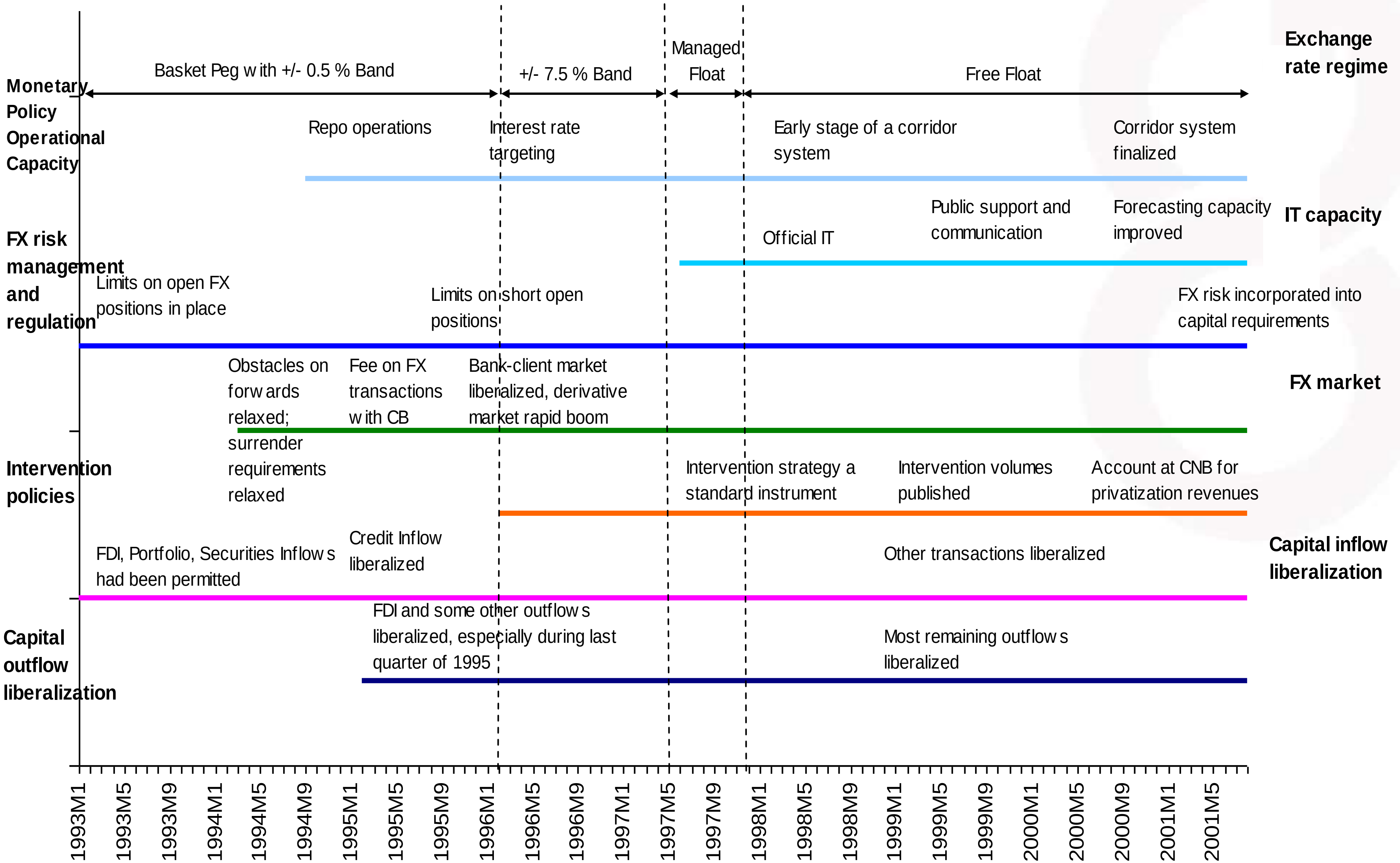
Exchange Rate Flexibility and Capital Account Liberalization

- There are risks to opening the capital account before exchange rate flexibility is allowed
  - Opening capital account may potentially destabilize domestic liquidity conditions, create macro-economic imbalances, precipitate currency attacks
  - Pegged/intermediate regimes found to be more crises prone for countries open to capital flows
- Allowing exchange rate flexibility before eliminating controls on capital flows helps to:
  - Absorb better the real effects of capital flows
  - Avoid short-term speculative capital inflows by reducing perceptions of low FX risks



The Czech Republic

Source: "Operational Aspects of Moving To Greater Exchange Rate Flexibility: Lessons from Detailed Country Experiences", *Occasional Paper*, no. 256

CONCLUSIONS

- Move to flexibility from a position of strength
- The regime change should be part of a comprehensive policy strategy change, including supportive fiscal policies and banking sector reforms
- Gradual transition to float through more flexible pegs allows time to prepare for orderly exits in terms of policy reforms and capacity building
- Preparation can take time, risking being forced out of the peg by markets
- Take advantage of the mutually reinforcing link between flexibility and
  - building inflation-oriented and interest-rate-based policy framework
  - risk management and market development
- Gradually removing asymmetries in the openness of the capital account support FX flexibility

Recommendations

- Since operational capacity takes time to build, preparation should start early
- Some exchange rate flexibility should be allowed at an early stage to reinforce the operational "pillars"
- If already open to capital flows, countries should be prepared for a quick pace of exit
- Exchange rate flexibility should be embraced prior to fully liberalizing the capital account
- It is important not to wait too long and to let the market inflict the exit

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