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**Progress Report: PEO Structure Project**

# Monetary Regimes in the Pacific Region

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## Main Purpose

Following the previous topic of ***Macrofinancial Linkages and Financial Deepening***, this project is to scrutinize monetary policy regimes in the Pacific region. In emerging and developing economies, giving up ***virtual dollar peg*** exchange rate systems, they have been recommended to adopt another nominal anchor (e.g. inflation targeting) with ***flexible exchange rates and freer capital movement***. But they are now confronted by volatile international financial flows and exchange rate risks. In emerging markets, the ***macroeconomic policy trilemma*** among the three policy goals, i.e. exchange rate stability, free capital mobility and monetary autonomy has been reexamined. Recently, even IMF admitted that ***capital controls*** and monetary policy discretion could be useful in some occasion. We are not sure, however, precisely in what occasion and to what extent we should put ourselves exactly where in the *trilemma*.

## Current and Future Directions:

At the second specialist meeting last September, reviewing our diverse experiences in the region, we confirmed diverse monetary policy regimes and developments in the monetary policy framework, and then identified a few common facets to scrutinize further for more robust policy regimes.

**1. Policy objectives**

There are evidences that show not only inflation and output gap, but exchange rate stability has been pursued by the policy authorities in emerging markets. Specifically, there is reasonable conjecture that some authorities have tried to maintain some desirable exchange rate levels, when at least part of accumulated foreign exchange reserves was unintended. This observation seems to be consistent with apparent non-corner solutions in the triangle of the monetary policy trilemma in emerging markets, particularly in the Pacific region.

**2. Policy transmission**: global financial linkages and domestic financial deepening

In the Pacific region, global financial linkages are not on the “net” basis. The region consists of surplus economies or net savors against the rest of the world. Nevertheless, emerging markets in the region have expanded their linkages with the global financial market on the “gross” basis, i.e. both hosting foreign investment and investing abroad themselves. On top of it, the composition of capital flows has been dominated by foreign direct investment, not by restless portfolio and other flows.

Furthermore, domestic financial deepening appears to be stagnated. Non-financial corporate sector has relied less and less on financial intermediation (bank credits), which is far from compensated by the development of private bond markets. Namely, the corporate sector has financed by itself as well as through FDI in the 2000s. We are concerned on whether this trend is temporary and/or sustainable for the future. The final outcome remains to be seen.

**3. Assessments of policy outcomes**: challenges to conventional wisdom

So far, macroeconomic performances of emerging markets in the Pacific region are apparently superior to those in other regions. Relatively low inflation, high income growth and stable exchange rates have been attained. Their fiscal balances are in good shape and their interest rates are very positive. So that nobody can claim that the resulting non-corner solution of monetary regimes in the regions is unsuccessful.

Their experiences, in fact, appear to suggest that what matters are, first, stable exchange rate levels rather than freely flexible rates, second, adequately controlled capital flows rather than laissez-faire capital flows, and, third, well-informed domestic saving rather than ill-informed external saving. These are what we have to scrutinize further in pursuit for optimal monetary regimes in emerging markets under the financial globalization.