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Management of exchange rate regimes in emerging Asia☆,☆☆

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Abstract

This paper revisits the issue of exchange rate regimes in emerging Asia over the decade 1999–2009. It finds that while Asia is home to a wide array of exchange rate regimes, there are signs of gradual movement toward somewhat greater exchange rate flexibility in many of the regional countries. There appears to be evidence of an apparent "fear of appreciation" which is manifested in asymmetric exchange rate intervention—i.e., a willingness to allow depreciations but reluctance to allow appreciations. This policy of effective exchange rate undervaluation is rather unorthodox from a neoclassical sense, but is consistent with a development policy centered on suppressing the price of non-tradable goods relative to tradables (i.e., real exchange rate undervaluation).

JEL classification: F31; F40; F41

Keywords: Emerging Asia; Exchange rate regimes; Fear of appreciation; Fear of floating; Foreign exchange intervention; Global imbalances; Real exchange rates

1. Introduction

Maintaining a stable and "competitive" exchange rate has been one of the cornerstones of Asian industrialization strategies starting with Japan in its high-growth period from 1950 to 1973, and largely emulated by the Republic of Korea (Korea hereafter) and some of the other newly industrializing economies (NIEs) in the 1970s and 1980s. The "near NIEs" in Southeast Asia—Malaysia, Indonesia, and Thailand, which had effectively pegged their currencies to the US dollar—benefitted significantly from a revaluation of the Japanese yen following the Plaza Accord of 1984–1985 as Japanese foreign direct investment (FDI) moved offshore to maintain export competitiveness. This flood of Japanese FDI helped kick-start growth in the region, which continued until the Asian crisis in 1997. More recently, the People's Republic of China's (hereafter, PRC) devaluation of the yuan in January 1994, and its continued peg to the US dollar until recently, has, it has been argued, helped transform the country into the world's factory and export powerhouse.

This paper revisits the issue of exchange rate regimes in emerging Asia.[1] The paper is divided into two main parts. The first part of the paper (Sections 2 and 3) compares the de jure and de facto exchange rate regimes in selected emerging Asian economies. An enduring question in the literature on exchange rate regimes is: how do official classifications compare with de facto regimes? The paper facilitates this comparison by presenting an analysis of the degree of de facto exchange rate flexibility in the exchange rate regimes for emerging Asian economies. To

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[1] We limit ourselves to a subset of Asian currencies for which comparable data are more easily available: Bangladesh, PRC, India, Indonesia, Korea, Malaysia, Pakistan, the Philippines, Singapore, Sri Lanka, Thailand, and Viet Nam.

preview the main conclusion, it is evident that Asia is home to a wide array of exchange rate regimes, though there are signs of a gradual movement toward somewhat greater exchange rate flexibility in many of the regional countries. Nonetheless, the propensity for foreign exchange intervention and exchange rate management among regional central banks remains fairly high in many instances, particularly in terms of managing against a currency basket (i.e., maintaining a stable nominal effective exchange rate, or NEER).

However, beyond a general reluctance of many Asian economies to allow for a "benign neglect" of their currencies both in terms of managing volatility as well as in terms of "leaning against the wind," the sustained stockpiling of reserves in developing and emerging Asian economies since 2000 (interrupted only briefly by the global financial crisis) suggests that they are more sensitive to exchange rate appreciations than to depreciations. This is the focus of the second part of the paper (Sections 4 and 5). Section 4 empirically explores the particular issue of this asymmetry in exchange rate intervention in developing and emerging Asia. We find there to be evidence of an evolution of Asian exchange rate policy towards an apparent "fear of floating in reverse" or "fear of appreciation" (Levy-Yeyati and Sturzenegger, 2007). This policy of exchange rate undervaluation is rather unorthodox, and at odds with most neoclassical/mainstream wisdom, which likely would recommend that policymakers aim to keep the real exchange rate (RER) as close as possible to its equilibrium level, as any sort of misalignment could in theory create macroeconomic disruptions. Specifically, according to conventional wisdom, RER overvaluation stifles economic growth and export competitiveness while persistent undervaluation leads to inflationary concerns. Section 5 reconsiders the PRC's and East Asia's unorthodox development, which has been centered on suppressing the price of non-tradable goods relative to tradables (RER undervaluation). The final section concludes with a few observations on Asian currency management in light of the global financial crisis and concerns about global imbalances.

2. Exchange rate regimes in developing and emerging Asia[2]

2.1. De jure classifications

Until 1998 it was fairly easy to obtain de jure exchange rate classifications, as this data was compiled from national sources by the IMF. Specifically, between 1975 and 1998, the IMF's *Annual Report on Exchange Arrangements and Exchange Restrictions* was based on self-reporting of national policies by various governments, with revisions in 1977 and 1982. Since 1998—and in response to criticisms that there can be significant divergences between de facto and de jure policies—the IMF's exchange rate classification methodology has shifted to compiling unofficial policies of countries as determined by the Fund staff.[3] While the change in IMF exchange rate coding is welcome for many reasons (including the fact that the new set of categories is more detailed than the older one), the IMF no longer compiles a list of the de jure regimes. The only way this can be done is by referring to the website of each central bank or other national sources individually, and wading through relevant materials. The results are summarized in Table 1.[4]

As is apparent, the de jure exchange rate regimes in Asia span a wide spectrum. Many smaller Asian economies appear to prefer some form of single currency pegs. This is true of Hong Kong, China (whose currency board arrangement is pegged to the US dollar), as well as others like Brunei (pegged to the Singapore dollar) and Bhutan and Nepal (pegged to the Indian rupee) and Myanmar (pegged to Special Drawing Rights, or SDR). In contrast, Bangladesh and Sri Lanka in South Asia and the East and Southeast Asian economies of Indonesia, Korea, and the Philippines officially operate flexible exchange rate regimes. The flexible exchange rates in the three East Asian countries are accompanied by inflation-targeting frameworks. Thailand too operates an inflation targeting arrangement, though it defines itself officially as a managed floater. Table 2 summarizes some key components of the inflation targeters in Asia.[5]

A number of other Asian countries have adopted a variety of intermediate regimes (currency baskets, crawling bands, adjustable pegs, etc.). For instance, according to the Reserve Bank of India (RBI), India "monitors and manages the exchange rates with flexibility without a fixed target or a pre-announced target or a band, coupled with the ability to intervene if and when necessary."[6] Viet Nam officially maintains a crawling peg and band around the US dollar. Singapore officially manages its currency against a basket of currencies, with the trade-weighted exchange rate used as an intermediate target to ensure that the inflation target is attained.[7] While Singapore's currency basket regime follows a more strategic orientation, both PRC and Malaysia in July 2005 officially shifted to what may be best referred to as a more mechanical version of a currency basket regime (i.e., keeping the trade-weighted exchange rate within a certain band as a goal in and of itself). Pakistan seems to operate rather ad hoc adjustable pegs. Overall, therefore, it is readily apparent that "one size does not necessarily fit all" when it comes to the choice of exchange rate regimes in Asia.

[2] This section is based on Rajan (2010).

[3] The data has since been applied retroactively to 1990.

[4] The descriptions in Table 1 are mostly direct quotes from official sources and not paraphrased by the author.

[5] Roger (2009) offers a useful overview of the achievements and challenges faced by countries that have adopted inflation targeting frameworks over the last two decades.

[6] See Cavoli and Rajan (2009, Chapter 4) for an analysis of India's exchange rate regime.

[7] See Cavoli and Rajan (2009, Chapter 5) for an analysis of Singapore's exchange rate regime.