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Merits of currency basket arrangements

In a world of generalised flexible exchange rates among the major currencies, pegging to a basket of currencies is a feasible and attractive choice

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FOLLOWING the International Monetary Fund's (IMF) latest consultation with Malaysia, the institution's executive directors acknowledged the overall good macroeconomic performance of the country since emerging from the 1997-98 Asian financial crisis.

As in previous years, they also noted there were no pressing reasons for Malaysia to forsake its rigid US dollar peg (that is, the ringgit did not appear obviously misaligned), but went on to suggest that the Malaysian authorities may want to think about introducing greater exchange rate flexibility at some stage in the future.

According to the IMF, 'such flexibility would help to manage risks associated with capital flows, alleviate the burden of adjustment on fiscal policy to deal with shocks, and facilitate adjustment to structural changes in the economy'.

Why is there still such a fixation with US dollar pegs in Malaysia and elsewhere? There are two obvious reasons.

One is the transparency or simplicity of such a regime. Everyone knows that the Malaysian ringgit is fixed at 3.80 to the US dollar, the Chinese renminbi is pegged at 8.28 per US\$, and the Hong Kong dollar is set at 7.80 per US\$ (unlike the other two, the Hong Kong dollar is backed by a currency board arrangement).

There is no ambiguity about any of this, and private agents - exporters, importers, financial market participants and foreign direct investors - can go about their respective activities accordingly. The need for stability to promote international trade and foreign direct investment (FDI) is something that is repeatedly emphasised by Asian policy makers.

Two, many developing countries have historically been unable or unwilling to borrow overseas in their domestic currencies, leading them to accumulate foreign currency debt liabilities that are primarily dollar-denominated and unhedged. In such countries, large depreciations magnify the domestic currency value of their external debt and hence sharply reduce the net worth of individuals, corporations and the overall domestic financial system.

This 'balance sheet' effect could lead to massive bankruptcies, as it did in Mexico in 1994-95 and East Asia in 1997-98. This, along with concerns about the inflationary consequences of currency depreciations (due to the high import content of domestic production) is further explanation for the 'fear of floating' exhibited by many developing countries.

Risk management

While there may be some validity in both the above points, they do not automatically suggest that a peg to the US dollar is the best option. Why? With regard to the balance sheet effects, the maintenance of a fixed US dollar peg may be self-fulfilling in that it blunts the incentives for agents to undertake appropriate risk management to hedge against exchange rate movements.

Conversely, the introduction of some transaction costs and exchange rate risk by permitting a degree of currency variability may also help moderate the extent of capital inflows, consequently dampening the intensity of boom-and-bust cycles that have plagued so many developing countries in Asia and elsewhere.

The idea that pegs confer stability can also be contested. If anything, the East Asian financial crisis demonstrated the deficiencies of pegging to a single reference unit such as the US dollar. Thus, if a country like Thailand had given greater weight to the yen in its currency management pre-crisis, there would not have been as large a real exchange rate overvaluation of the baht following the sharp nominal appreciation of the US dollar relative to the yen between June 1995 and April 1997 (from 85 to 125 yen/US\$).

Pegging against the US dollar was, in hindsight, clearly a mistake, whereas pegging against a more diversified composite basket of currencies would have enabled the regional countries to better deal with the so-called 'third currency phenomenon' (that is, yen-US\$ and euro-US\$ fluctuations) which contributed in part to the crisis.

Fixed regime viability

While China, Hong Kong and Malaysia may be benefiting currently because of the decline of the greenback against major currencies in the last two years, one should not forget that just a couple of years ago (in early 2002) when the yen/US\$ rate hit a three-year high of almost 135 per yen and the euro/US\$ rate hovered around 1.15, the market was concerned about the viability of these fixed regimes in Asia.

There were genuine concerns that continued weakening of the yen against the US dollar would pose a serious threat to the ringgit peg in particular. These fears receded once the US dollar started weakening and has continued to do so since, with current concerns being about the extent of undervaluation of some Asian currencies and the inflationary consequences thereof (particularly in China).

Despite the foregoing arguments, many developing countries maintain a genuine aversion towards a flexible exchange rate regime. There is a belief that the exchange rate is too important to be allowed to move 'too freely'.

An alternative like a flexible or soft inflation targeting arrangement is not a very attractive option to a country currently operating a rigid US dollar peg.

Indeed, even an early inflation targeter like New Zealand - which has been held up as the poster-child of the feasibility of a flexible exchange rate regime for small and open economies - has recently taken steps to bolster its central bank's capacity to

intervene in the foreign exchange market to influence the level of the NZ\$ in certain circumstances.

Therefore, in a world of generalised flexible exchange rates among the major currencies, pegging to a basket of currencies - as done by Singapore and India - appears to be a feasible and attractive choice.

By managing exchange rate changes against a composite bundle of currencies (that is, stabilising the 'effective' exchange rate), countries may be able to buffer themselves against outside exchange rate shocks (such as G-3 currency variations) and neutralise this source of instability.

But how does one determine the optimal weights of the currency basket? There are a number of issues that need to be considered. Should one use export shares, import shares, or an average of the two? Each of these can lead to quite different weights.

For instance, the US tends in general to be a major export market for many developing Asian countries but is relatively less significant as a source of imports, while the opposite is true for Japan.

There are also questions about whether one should use country trade shares or the currency denomination of trade; if the latter is used, the US dollar would have a very high weight since most of the transactions in Asia are invoiced in US dollars.

Others have suggested that rather than attempt careful computations of optimal exchange rate pegs, countries like China may want to consider an equally weighted share between the US dollar, Japanese yen and the euro (one third each).

Apart from how to calculate the optimal weights for the currency basket, there remain other outstanding questions, including whether there should be a crawl, either upwards or downwards (and, if so, how rapid), and a band around the peg (and, if so, how wide).

The reasons for an upward crawl (that is, allowing the currency to strengthen over time) might be to help keep inflation in check; as a means of promoting constant restructuring to higher value-added sectors and activities; and to spur higher productivity bias in the tradeable goods sector.

Gradual downward crawl

This was the policy maintained by Singapore during its high-growth era pre-1997/98. Alternatively, countries which are faced with higher inflation than their trading partners may want to allow for a gradual downward crawl, so as to keep their real exchange rate competitive.

Apart from the crawl, there are other important issues that need to be sorted out such as whether there should be a band around the peg (possible size of the bandwidth range between plus/minus 2.5 and 10 per cent); whether the bands should be 'soft', such that the central bank may or may not intervene if the currency threatens to fall outside the pre-determined band (that is, no absolute commitment); whether the

government should make explicit the values of the bands or whether this should be left more ambiguous, as in the case of Singapore. In general, more flexibility (that is, wider and relatively soft bands) is preferable to less. Irrevocably fixing a composite peg may lead to problems in just the same way as would fixing a single currency peg. More flexible exchange rates act as a safety valve by providing a less costly mechanism for relative prices to adjust in response to shocks, as opposed to the slow and often costly reductions that occur under fixed rates through deflation and productivity increases vis-a-vis trade partners.

Move towards wider pegs

Nonetheless, it could well be that a country that is initially concerned about exchange rate variability may want to start by shifting from a US dollar peg to a fairly rigid and transparent peg consisting of a composite basket of currencies.

However, once the country's monetary authority becomes more comfortable with the basket regime and builds up credibility in managing the new currency arrangement and agents get used to the exchange rate variability and realise the need to buy cover against currency fluctuations, there could be a movement towards wider pegs that allow for more policy discretion a la Singapore.

The preceding suggestion of a 'band-basket-crawl' or BBC arrangement may not only be an attractive regime for US dollar 'fixers' in Asia like China, Hong Kong and Malaysia to consider, but also a country like Indonesia, which appears to have had difficulties with implementing an inflation targeting regime.

While such an arrangement is no panacea against unsustainable macroeconomic policies and extreme external shocks, it may be a way of trading off the disciplinary and credibility benefits of a pegged regime with the flexibility of a floating one.

A tangential positive spin-off of Asia moving towards BBC arrangements is that if there is a convergence in basket weights and bands over time among the regional economies, the region could even think about pegging to a common regional basket or create a synthetic currency (Asian Currency Unit or ACU) and use that as a reference point.

This in turn may reduce concerns about competitive devaluations and be an important step towards promoting regional monetary integration. But this is something to be considered only over the longer term.