A Basket Case

By Ramkishen S. Rajan and Tony Cavoli

Singapore may be tiny, but its influence isn't. Last year, China and Malaysia copied the city-state's exchange rate regime by announcing a move toward currency-basket regimes. A number of other Asian countries have also expressed interest in the idea. The irony is, Singapore's "currency basket" never was as simple as the pundits thought. And its system may not be as easily transferable, either.

> Singapore's regime is hard to copy.

First, some history. Singapore's central bank, the Monetary Authority of Singapore (MAS), established the city-state's exchange-rate regime back in 1981. Since then, Singapore's bankers have let the Singapore dollar's value "float" within a certain band against an undisclosed basket of currencies—primarily those of the country's major trading partners. Simple analysis suggests that the Singapore dollar is most significantly influenced by moves in the U.S. dollar, though there are some signs of a slight decline in the greenback's weight after 1998.

Singapore's set-up has advantages. By keeping the make-up of the basket secret, the MAS can fine-tune the exchange rate. It's also a way of ensuring greater flexibility in the face of external shocks. Nothing's set in stone, however: The MAS "periodically" reviews the policy to "ensure that it remains consistent with the underlying fundamentals of the economy."

The policy worked on several levels. Up until the 1997-98 Asian financial crisis, the MAS deliberately let the Singapore dollar gradually appreciate. This upward crawl kept inflation under check. The so-called "strong Singapore dollar policy" also forced local industry to constantly become more efficient, because as the currency's value rose, Singaporean exports became less price competitive.

The basket proved useful in tougher times, too. After the 1997-98 financial crisis, the Singapore economy lost some of its buoyancy and was faced with a declining export demand. So, the MAS stopped the policy of gradual appreciation of the Singapore dollar, giving its exporters a break in the short term. As business picked up again, the MAS switched once again to a gradual upward crawl while still letting the dollar float in a very narrow band around its basket.

To gauge Singapore's success, just compare it to Hong Kong, where business cycles have been largely similar. Singapore has experienced lower and less volatile inflation. This is principally due to the MAS's strong and pro-active exchange rate response to inflation concerns, unlike Hong Kong, which is bound by its U.S. dollar-based currency board arrangement.

Sound easy? Don't be fooled. When central banks adopt a Singapore-style exchange-rate arrangement, they usually envision a largely mechanical regime, where the central bank tries to keep the trade-weighted nominal exchange rate more or less within a predetermined band. But that's not how it works, in practice—as China and Malaysia are probably learning.

According to our research, as well as others' work, Singapore's monetary policy is used for strategic purposes. Namely, the exchange rate is adjusted to stabilize inflation and economic growth, as well as dampen what the central bank considers excessive exchange-rate volatility. The MAS itself effectively says as much, in its Monetary Policy Statement which has been released on a semiannual basis since February 2001. That document plays a role in economic management, too—by increasing transparency, it is helping promote foreign-exchange market stability.

There appears, too, to be an inconsistency in the way the MAS manages the Singapore dollar. Specifically, the MAS has generally let the exchange rate appreciate to counter any signs of inflationary and overheating pressures. However, it's much more circumspect about using the exchange rate to stimulate the economy during downturns. Why? Because of concerns that the depreciation would create domestic inflation. In other words, there's a definite "fear of inflation."

Many other small and open economies in Asia may also experience this "fear." But they won't have the other set of supply-side tools that Singapore has to manage its economy. In the tiny city-state, the central bank can fine-tune the economy by tinkering with the pension system's payouts, cutting wages and salaries, and changing land and corporate tax rates. Since the Singapore government generally cuts these costs—sometimes quite drastically—during a downturn, the MAS isn't forced to depreciate the Singapore dollar to maintain the city-state's short-term competitiveness.

Singapore's economy has a lot of advantages beyond its exchange rate. It's a productive place, with a fiscally prudent government. But the factors behind its success are quite unique to the city-state. This should give policy makers in other countries reason to pause before attempting to a replicate the Singapore exchange-rate system in its entirety.

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