



## Currency Regimes in Asia Revisited

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Since the Asian financial debacle of 1997-98, four of the five crisis-hit countries -- Korea, Indonesia, Thailand and the Philippines -- have instituted monetary policy arrangements fashioned around an inflation objective. Each of these countries has passed legal and institutional legislations supporting their respective inflation targeting arrangements. Important features of an inflation target arrangement include the definition of what type of inflation is being targeted, the inflation target range, the use of exclusion clauses or caveats (i.e. under what circumstances the central bank is able to overshoot its target), and the target horizon.

Inflation targeting is conducted in conjunction with a monetary policy rule (MPR). In general, the MPR is one element of a strategy employed by the central bank as part of its overall monetary policy. The MPR specifies how the instrument of monetary policy is to be changed given the characteristics of the macro economy and the policy objectives of the central bank. The MPR implicitly assumes that the instrument of monetary policy will always react strongly to inflation (or some forecast of future inflation). MPRs and inflation targets are different elements of a general monetary policy strategy. The MPR provides a guide to the policymaker as to how to manipulate the instrument of monetary policy, while the inflation target simply makes a statement of what the instrument is ultimately employed for.

Conventionally, an inflation targeting arrangement ought to be accompanied by a flexible exchange rate, with the interest rate used as the monetary policy instrument. It is however recognised that for small and open economies in Asia and elsewhere, fluctuations in the exchange rate can and do have significant and direct impacts on the domestic economy. Consequently, many Asian inflation-targeting central banks do take into account exchange rate movements in their monetary policy frameworks. It would appear though that there is an asymmetry in the manner in which many Asian central banks deal with exchange rate movements.

Specifically, they have not always altered interest rates in response to upward (buying) pressure on their currencies, preferring to intervene in the foreign exchange market, but they are more willing to hike interest rates in the midst of downward (selling) pressure on their currencies. This in turn inevitably has led to a rapid stockpiling of international reserves which has had to be "sterilised" or mopped up so as to prevent a domestic monetary overhang and, including the creation of asset bubbles in the housing and equity markets.

Monetary sterilization makes good sense when the balance of payment pressures are considered to be temporary. However, when these pressures are sustained, the costs of this reserve accumulation can become fairly high, as they have been in a number of countries. There are also questions about the success of such sustained (as opposed to temporary) sterilization efforts. Of course, the pressure on the balance of payments and thus the exchange rate can always be reduced to some extent by allowing interest rates to decline, though this would compromise the domestic inflationary objective.

Thus, a *bona fide* inflation targeting central bank should appropriately respond by allowing the currencies to appreciate viz. major currencies including the US dollar to lessen the pressures on reserve build-up. This is the policy Australian and New Zealand central banks generally adopt (both being credible inflation targeters with flexible exchange rates). Among the Asian economies, Korea and Thailand stand out as having done just that. The Korean won appreciated from 1040 per US\$ in July 2005 to about 920 won per US\$ by early December 2006, while the Thai baht appreciated from 42 baht per US\$ in July 2005 to almost 35 baht in early December 2006. This trend appreciation despite some valid concerns of its potential negative repercussions on the exportables sector seemed to underscore the commitment of both central banks to their inflation targeting frameworks.

Things changed quite dramatically on 19 December 2006 when the Bank of Thailand attempted to impose selective taxes and controls to curb capital inflows. While the policy was quickly reversed in the face of a massive sell-off on the Thai equity and currency markets, the action betrayed an unwillingness of the Bank of Thailand to fully commit to its new monetary framework. Of course, an alternative route to alleviate the pressure on the currency might have been to ease any remaining restrictions on capital outflows and effectively allow domestic residents to hold more foreign assets (rather than the central bank having to do so via foreign exchange intervention). China and India have been doing exactly this, albeit gradually. However, ever since the Asian financial crisis, emerging economies have rightly been cautious about wholesale acceptance of complete capital account convertibility.

The extreme export-oriented nature of most Asian economies -- especially those in East Asia -- has given rise to a collective action problem (the so-called "prisoner's dilemma") whereby the fear of losing competitiveness leads each of them to heavily manage their respective currencies, particularly in view of the continued limited flexibility of the Chinese currency. This in turn has led to growing internal imbalances within these economies, while also contributing to the global macroeconomic imbalances. This prisoner's dilemma with regard to exchange rate policies in Asia in turn implies that there may be potential benefits from pursuing a more coordinated approach to dealing with monetary and exchange rate policies in the region. But in the absence of greater regional coordination, formal adoption of a currency basket regime with explicit recognition of the important role of the exchange rate may be the best way forward.

A well-known practitioner of such a regime is the Monetary Authority of Singapore (MAS), which has managed the Singapore dollar (SGD) as a flexible Band-Basket-Crawl (BBC). Officially, the Monetary Authority of Singapore (MAS) has been managing the Singapore dollar against an undisclosed basket of currencies (major trading partners) since 1981. The MAS allows the Singapore dollar to vary within an undisclosed "band" around the central parity as a means of ensuring greater exchange rate flexibility in the face of external shocks and other uncertainties. The MAS explicitly states, "the exchange rate policy band is periodically reviewed to ensure that it remains consistent with the underlying fundamentals of the economy". While the trade weights are not disclosed by the MAS, simple empirical analysis suggests the US dollar emerges as the single most significant currency influencing the Singapore dollar (about 65 percent), though there are some signs of a slight decline in the greenback's influence post-1998.

This corresponds to an offsetting increase in the influence of the *yen* and might suggest an adjustment of weights in Singapore's currency basket post crisis. This could also be consistent with the hypothesis that post-crisis, some of Singapore's trading partners such as Korea moved away from strong USD peg and have been influenced relatively more by the *yen*. As regional currencies such as the Chinese *yuan* and the Malaysian *ringgit* become increasingly flexible, one would expect their independent weights to increase in Singapore's currency basket with a corresponding decline in the share of the US dollar.

The manner in which Singapore operates its exchange rate regime is of international interest at a time when a number of other countries in the region, including China and Malaysia, are gradually introducing greater exchange rate flexibility by adopting currency basket regimes. Many observers have also enthusiastically advocated a "Singapore-style" exchange rate regime for many other developing countries in Asia and elsewhere. Such managed flexibility might work well for many other emerging Asian economies as well.

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