**Asia's Experience with Exchange Rate Regimes: Lessons for the Future**

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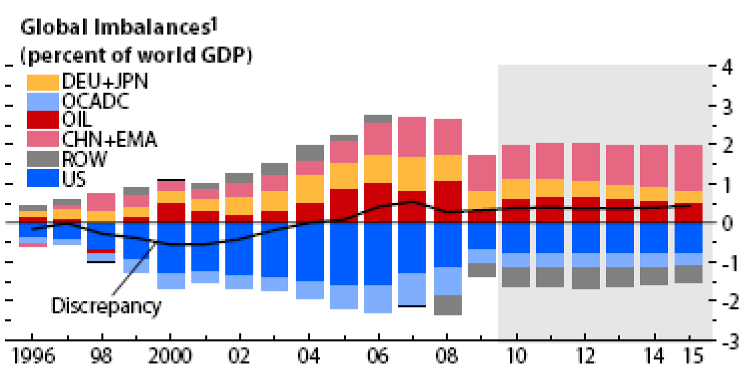
At the November 11-12 Seoul summit Asia will be in the spotlight as the popular focus on the G20 shifts to its core task of changing the composition of global demand that is needed to ensure sustainable long term growth. In Europe and the United States the shift requires fiscal consolidation, shrinking domestic demand and more reliance on external demand. In Asia, which has become a significant growth pole demand needs to shift from heavy reliance on external demand to greater reliance on domestic demand. The shift depends on an agenda of challenging policy changes: structural and institutional changes to encourage domestic demand, financial regulatory reforms and the successful conclusion of the global trade talks to restore market confidence.

The Toronto summit formalized commitments to medium fiscal consolidation strategies, the G20's most important challenge in exiting from the extraordinary public sector stimulus that averted a global depression in 2008-09. While those strategies must still be turned into credible actions, the focus at Seoul is to deliver on commitments on structural policies and changes in exchange rate regimes that are central to the medium-term imperative of more balanced global growth.

**Addressing Global Imbalances**

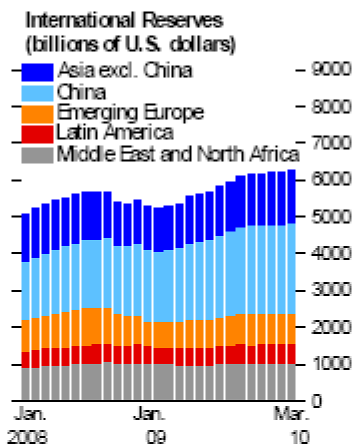
Global current account imbalances peaked in 2006 but the IMF expects them to rise again, as surpluses rise in East Asia with the restoration of global trade and financing flows (top segment of each bar in Figure 1). To prevent their recurrence, countries with external surpluses should rely more on domestic demand and imports while those with external deficits should rely more on exports. Flexible exchange rates would help cushion the necessary adjustments.

**Figure 1. Global Imbalances (IMF, April 2010)**



Rebalancing will be both a technical challenge and the G20's biggest political challenge. Surplus countries in Asia resist flexible exchange rates and continue to build their foreign exchange reserves (top two segments in each bar in Figure 2). One of the lessons to draw from the disruptive market adjustments as imbalances declined in 2009 is that the process could have been smoother with flexible exchange rates. In the absence of flexible exchange rates more of the burden of adjustment must be borne by structural policies that may not be popular at home as they impact consumer and trade interests vested in the unsustainable status quo. Yet with the US consumer no longer the engine of growth a determined effort to rebalance is essential to take up the slack.

**Figure 2. International Reserves (IMF WEO Update July 2010)**




The IMF in cooperation with the OECD and other international organizations has shown the benefits of collective action to reduce imbalances and the risks of continuing the status quo.

In preparation for the Toronto summit the IMF prepared a base line scenario of growth and output in 2014 based on countries' own forecasts and adjustment packages. These were then adjusted for consistency and subjected to alternative assumptions reflecting upside possibilities of collective action and downside risks of no action. Significantly the model assumes exchange rate flexibility. The differences in outcomes under the two scenarios are startling. Collective action yields large benefits: world output would be higher by US$ 1.6 trillion and global growth over the next five years would be 2 1/2 percent higher than the baseline. Over 13 million jobs would be created in emerging Asia (Table 1A.)

**Table 1A: Upside Scenario: Employment and Output Gains by region (IMF Mutual Assessment, June 2010)**

| | Employment | Unemployment 1/ | Real GDP | |
|---|---|---|---|---|
| | (Millions) | (Percentage points) | (2009 USD billion) | (Percent) |
| United States | 3.1 | -2.0 | 426 | 3.0 |
| Euro area 2/ | 4.6 | -2.8 | 563 | 4.5 |
| of which Germany | 1.6 | -3.8 | 174 | 5.2 |
| Japan | 0.5 | -0.8 | 126 | 2.5 |
| Emerging Asia | 13.2 | -0.7 | 128 | 1.4 |
| Rest of the world | 8.2 | -1.1 | 370 | 2.1 |
| World | 29.5 | -1.4 | 1614 | 2.5 |

**Table 1B: Downside Scenario: Employment and Output Losses**

| | Employment | Unemployment 1/ | Real GDP | |
|---|---|---|---|---|
| | (Millions) | (Percentage points) | (2009 USD billion) | (Percent) |
| United States | 1.6 | 1.0 | 765 | 5.4 |
| Euro area 2/ | 2.1 | 1.3 | 705 | 5.6 |
| of which Germany | 0.7 | 1.6 | 192 | 5.7 |
| Japan | 1.0 | 1.5 | 244 | 4.8 |
| Emerging Asia | 11.3 | 0.6 | 109 | 1.2 |
| Rest of the world | 6.6 | 0.9 | 301 | 1.7 |
| World | 22.7 | 0.9 | 2124 | 3.1 |

Notes: 1/ Unemployment for emerging Asia and rest of the world is calculated using the respective output responses and assuming the maximum estimated unemployment response in the other regions. 2/ Based on PPP-weighted average of Germany and the other euro members; employment and real GDP level is a sum of Germany and the other euro area members.

Risks in the downside scenario compared to the baseline (Table 1B) imply large losses in output and employment – 23 million jobs lost of which more than 11 million are in emerging Asia and a million in Japan —and an estimated 60 million people fall into poverty. World output will be 3.1 percent lower and unemployment nearly 1 percent higher than the baseline.

Comparison of the downside and upside scenarios provides a dramatic estimate of the global benefits of collective action. Global output in 2014 would be 5.6 percentage points *higher* with policy actions (comparing Tables 1A and 1B fourth columns, bottom lines) than if the risks were to materialize. Unemployment would decline rather than rise (even in emerging Asia unemployment rises in the downside scenario).

*Asian Exchange Rate Regimes*

These scenarios assume exchange rate flexibility and emphasize two kinds of structural reforms: those that strengthen domestic demand in countries with external surpluses (and replace the US consumer) and those that enhance productive potential in countries with external deficits.

*Strengthening domestic demand in Asia:* Countries with external surpluses are assumed to take up some of the slack in global demand by strengthening domestic demand with such measures as strengthened social safety nets with pension and health insurance programs, enhanced physical infrastructure that reduces supply bottlenecks, reformed corporate governance and more-developed financial markets that can extend credit to small and medium-sized enterprises. Household demand is assumed to expand as wage rises are permitted, restrictions loosened on labor mobility and households provided with capital income-generating opportunities. Of course the structure and timing of such reforms will depend on each country's economic circumstances and institutions.

In emerging Asia the Mutual Assessment exercise found that raising public investment in emerging Asia by 2 percent of GDP over three years increases domestic demand relative to the base case through investment projects and stronger safety nets that provide targeted transfers to the poor of around 2 percent of GDP. These expenditures are financed with higher deficits and higher consumption taxes.

These changes would both enhance and provide more balanced growth through time. Current account deficits will decline as currencies depreciate, savings rise in advanced deficit countries and external demand for their products increases while in advanced surplus countries product and labor market reforms will enhance both investment and consumption. In emerging surplus countries reduced precautionary saving and higher infrastructure spending will boost domestic demand and imports which, with currency appreciation, help reduce current account surpluses.

But not all exchange rates in East Asia are market-determined. Since the Asian crisis more than a decade ago, fixed-but-adjustable exchange rate pegs that were common to a number of economies have been replaced. Among the larger economies, fixed exchange rates are now found only in Hong Kong and (at times) China (Table 2). Significantly, China's nominal

**Table 2. Exchange rate regimes in East Asia**

| Economy | 1997 | 2010 | Notes |
|---|---|---|---|
| China | Peg | Managed currency basket specified range | Moved in June 2010 from defacto US$ peg adopted in September 2008<br>Capital controls |
| Hong Kong | Peg | Peg | Currency board |
| Japan | Float | Float | Recent intervention to slow appreciation |
| Indonesia | Intermediate | Managed float | |
| Malaysia | Intermediate | Managed float | Partial capital controls since 1997 |
| Philippines | Intermediate | Float | |
| Singapore | Intermediate | Managed float | |
| South Korea | Intermediate | Managed float | Inflation targeting since 1998 |
| Thailand | Intermediate | Managed float | Inflation targeting since 2000 |
| Taiwan | Intermediate | Managed float | |

*Source*: IMF *Exchange arrangements and exchange restrictions;* various years.

exchange rate has been allowed to appreciate against the US dollar since June 2010 in response to growing US political pressures.

Even so, most governments are reluctant to allow exchange rates to float freely, reflecting fears that real and nominal exchange rate volatility will undermine their export-led growth goals. Managed floating has been successful in both Singapore and Taiwan, but for good reason. These economies have large stocks of foreign reserves, disciplined macroeconomic policies, and well-developed, sophisticated and liquid financial systems. In the former crisis economies, immature financial systems, structural problems and debt overhangs make managed floating very risky. Such a practice easily turns into a soft peg, with the associated liability that, by inviting speculation in times of adversity, the risks of crisis are magnified.

Other intermediate exchange rate alternatives, such as basket pegs and regional currency units, have been suggested to provide authorities with more modest combinations of exchange rate stability and monetary policy independence despite capital mobility. But in practical terms, such alternatives are complicated. Finding optimal weights for currency baskets is a major technical challenge. Another challenge is to satisfy market participants' demands for transparency. Loose arrangements with wide bands are worth examining, but with open capital markets, these bands are likely to be tested by the markets.

The intermediate option is relevant to China. US politicians and a number of economists have become increasingly insistent that the yuan is undervalued by between 15-40 per cent. Without evaluating the merits of the respective arguments in this debate, China's case illustrates a basic principle. The choice to fix or heavily manage the yuan's nominal value has major implications for China's monetary and financial policies. Monetary policy must focus on maintaining yuan stability by administering interest rates, sterilization and reforming capital markets to reduce pressures on the yuan. In effect two key prices in the economy, the exchange rate and interest rates, are stabilized which provides certainty for exporters but constrains the alternative monetary framework choices available to the Chinese authorities, and distorts price signals. Fixing these prices also impacts the bank-dominated financial system which depends for much of its profitability on the generous spreads between relatively fixed deposit rates and higher lending rates. This contributes to risk-averse behaviour by banks; China lacks a modern commercial banking system that efficiently intermediates savings into viable credits. How long can the increasingly complex Chinese economy be managed in this way? It would seem that it is reaching a stage where greater exchange rate flexibility would be in its own long-term interest; thus gradual moves to an intermediate option would seem to be the most advisable route to take.

In the more advanced economies, such as Singapore, Taiwan and South Korea, which have legacies of low inflation and moderate inflation expectations, inflation targeting and a more flexible exchange rate provides yet another alternative monetary framework. Such a framework requires central bank independence and a low target for inflation (in the 1–3 per cent range). The central bank cannot target the exchange rate, but must allow it to float relatively freely. Such a framework must include explicit identification of, and commitment to, inflation targets as well.

Since 1997 South Korea has made much of its transition to this regime. The central bank is independent; an inflation target is the nominal anchor; the target and the plan for achieving it, as well as the conduct of policy are transparent; the bank is accountable to the National Assembly; and the exchange rate is relatively flexible.

Still, as Figure 3 indicates, beyond the volatility experienced during the Asian crisis there has been little variability in nominal exchange rates in Hong Kong, China, Malaysia and Singapore.

Indeed, as Table 3 shows, the significant build up of foreign exchange reserves in China, Korea, India, Thailand and Malaysia indicates central bank intervention in foreign exchange markets to moderate exchange rate appreciation. Reserves of these magnitudes exceed what is prudently required to cover import bills should there be balance of payment problems, and is an unproductive use of capital.

**Table 3. International Reserves, selected countries, August 2010**

| Country | Reserves (US$ billions) | Reserves/ monthly imports | Reserves/GDP (2009) |
|---|---|---|---|
| China | 2,454 | 26.1 | 49.4 |
| Russia | 475 | 20.8 | 35.7 |
| South Korea | 286 | 8.2 | 32.4 |
| India | 274 | 10.2 | 22.2 |
| Brazil | 261 | 16.4 | 15.2 |
| Switzerland | 250 | 7.1 | 27.3 |
| Thailand | 151 | 10.6 | 52.5 |
| Malaysia | 95 | 8.0 | 50.5 |
| United States | 129 | Na | na |

Sources: IMF, National Statistical Agencies, Bank of Canada

Why do exchange rates matter in the adjustment programs in East Asia? Because flexible exchange rates allow key price signals to fluctuate causing knock-on relative price changes in the economy in a relatively smooth manner; an appreciation reduces the price competitiveness of exports to foreigners and reduces the relative cost of imports. Otherwise these structural changes must be accomplished through interventionist policies.

Perhaps of greater significance are the implications for the international monetary system (IMS). The IMS consists of exchange rate arrangements, capital flows, and governance through institutions, rules and conventions. The IMF was envisaged at Bretton Woods as the best approximation of a world central bank to which governments could agree without significantly compromising national sovereignty. Today, the IMF *Articles of Agreement* which constitute the rules of the system are no longer observed, nor does the IMF have any power to enforce them. The G7 provided informal governance in the post-war period. It has now been pre-empted by the G20 – but only for as long as the G20 is a credible forum where members take their responsibilities seriously. This is why action on global rebalancing is so central – not only to sustainable global growth after recovery has taken hold – but to G20 credibility and longevity.

The global crisis has underlined two major changes in the global economy: one is how liquidity concentrates in a few markets and into one currency (seen as safe) in times of crisis; the other is the multi-polar structure of the world economy with emerging markets accounting for rising shares of commodities, trade and global growth.

In times of major structural change as we are now experiencing, fixed exchange rate systems present problems in that, as has been evident historically, wages and price resist downward adjustment and adjustment is asymmetrical. In surplus countries, it is convenient and less costly politically to maintain nominal values of exchange rates. Yet deficit countries cannot sustain their deficits; they are forced to run down their reserves or depreciate their currencies, as Thailand experienced in 1997.

Today this situation if it continues will undermine the stability of the international monetary system. The alternative is international cooperation in making the necessary adjustments. Unfortunately the inertia in existing governance structures means that it does not provide good incentives to cooperate. Membership clout needs to more accurately reflect economic size and clout of countries; as well contingent financing mechanisms need to be available to members with balance of payments problems that they feel they can reliably access. G20 leaders intend to change this, but more cooperation is also required at the regional and economy levels.

At the regional level, the Asian crisis crystallized awareness that much of the region's savings were intermediated in the world's financial centers rather than in the region. In response, local currency bond markets are being developed and a regional emergency financing mechanism, the multilateralized Chiang Mai Initative (CMIM), has been created with access to $120 billion in currency swaps of which 80 percent has been contributed by China, Japan and Korea. In 2011 a surveillance mechanism, the ASEAN +3 Macroeconomic Research Office, will be in place to support macroeconomic cooperation and could conceivably provide support to members with rebalancing.

Finally, it is also worth noting that adjustment will occur eventually. It can come through real exchange rate adjustment, with higher inflation (Figure 4) or higher factor input prices. It can come through cooperative changes in nominal exchange rates. Or it will be forced by markets, with more severe and unpredictable consequences. A Bank of Canada study released in June 2010 shows the "hit" to global output by 2015 if markets, rather than policy cooperation, bring about adjustment (Figure 5). Global output is estimated to be $7 trillion lower in the absence of cooperative policy changes.

*Lessons*

There a number of lessons for East Asia. In the G20 setting goals and evaluating alternative scenarios are a first step, as has been done with technical assistance from the global institutions. The Seoul summit will be expected to show evidence of action. Such action will depend on individual countries, particularly the largest economies. But pan-Pacific institutions such as APEC could coordinate with G20 decisions to include other countries beyond the G20 in policy cooperation.

Greater nominal exchange rate flexibility is desirable for the reasons argued earlier. But it should not 'crowd out' the need for structural reforms that are also needed in a number of economies in both market and non-market institutions such as social safety nets.

**The United States:** cannot be ignored because of its role at the epicenter of the crisis. A credible medium-term plan of fiscal consolidation is required. This is unlikely until after the

November 2010 mid-term elections, however, when the bipartisan National Commission on Fiscal Responsibility's reports. All options should be on the table, including a broad-based consumption or carbon tax as well as spending cuts. Policy initiatives to increase US exports in the next five years should be consistent with the global trade liberalization agenda.

**China:** As a major surplus country China's relatively fixed exchange rate implies that much of the burden of rebalancing must be carried by domestic policy changes. Domestic policy changes should include reforms in the services industries to allow more competition and raise productivity. Further fiscal reform are desirable to extend education services, infrastructure, public pensions and health insurance to the rural areas, along with labor market reforms that raise wages will help reduce high household saving rates. Raising artificially low input prices is a priority to change incentives for industrial production. Input prices for energy, land, the environment and capital are all under-priced. Allowing exchange rate appreciation will facilitate these shifts, either *real* appreciation through higher domestic inflation or nominal appreciation.

**Other Asians:** Asian economies need to build confidence in macroeconomic stability through closer policy cooperation that encourages greater exchange rate flexibility and reliance on CMIM, rather than further building their own reserves, to provide liquidity if they run into balance of payment problems. Surplus East Asian economies could contribute more to global demand by reducing export incentives, increasing domestic demand through infrastructure projects and raising productivity in services industries by encouraging competition. They could make labor and product markets more flexible and encourage household consumption by creating social safety nets and developing domestic financial markets in ways that reduce credit constraints on households and small businesses.

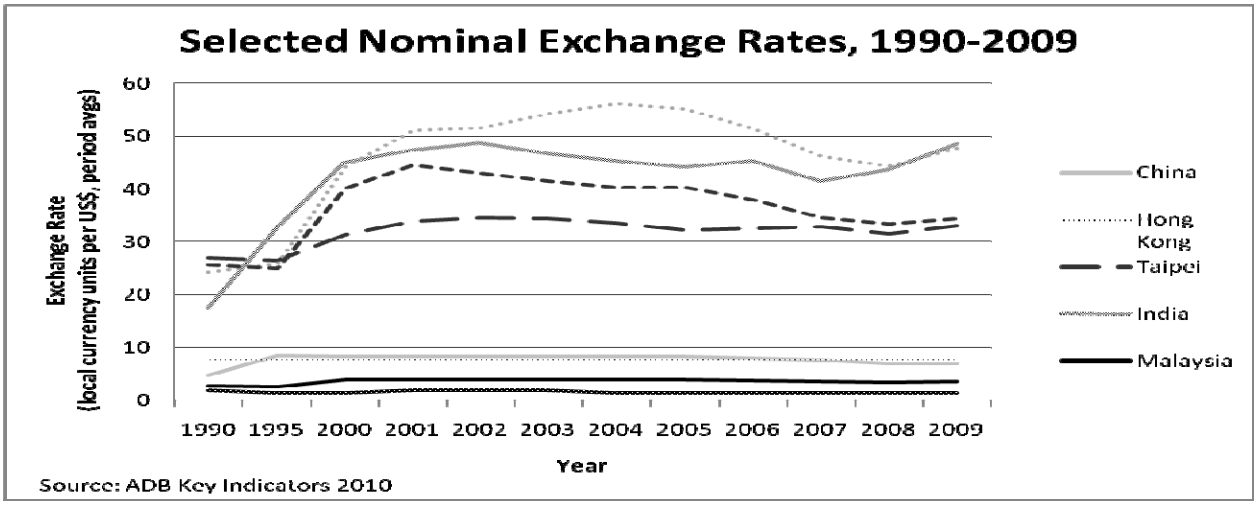
**The Republic of Korea** has successes from which others can learn. Korea is a graduated emerging market economy which introduced major structural reforms and freed up the exchange rate as it recovered from the Asian financial crisis more than a decade ago. Others can learn from Korea's strategy to reduce export dependence through domestic investments in human capital, technology and a "Green Korea" strategy of energy conservation, clean energy R&D and energy efficient transportation.

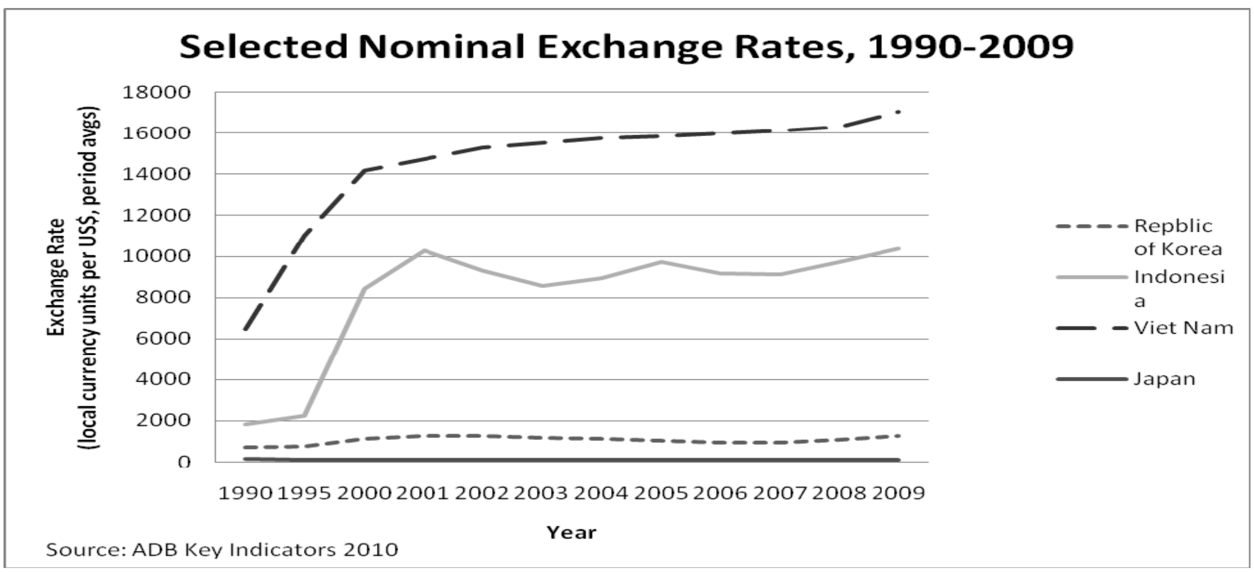
**APEC** also has a role to play. The Yokohama summit on November 13-14 is important to the overall G20 agenda, where both G20 and non-G20 members could agree to strategic goals for the APEC growth strategy that carry forward G20 objectives and follow through with deliverables in 2011 at Honolulu.

*Conclusions*

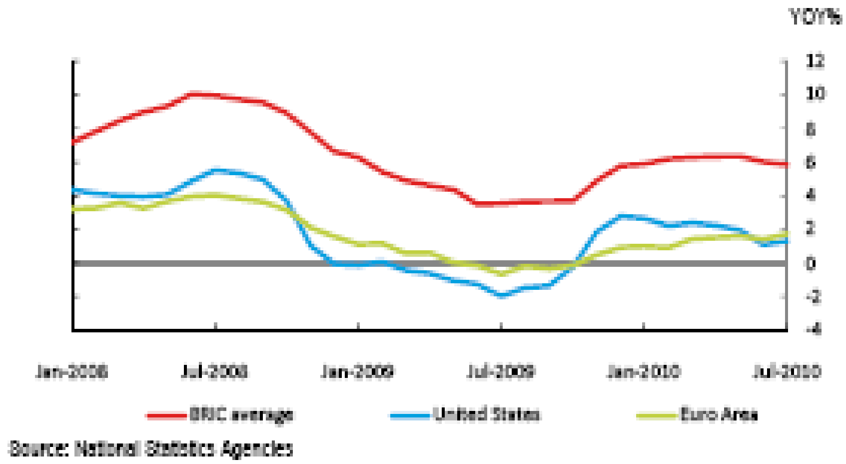
While governments will pursue policies that they believe serve short term domestic interests, continued large external imbalances and disregard for the underlying rules of the existing international monetary system are raising the risks of systemic instability. The G20 has defined the importance of rebalancing; in the surplus countries, the subject of this paper, rebalancing requires both greater exchange rate flexibility and structural changes to rebalance domestic economic growth and increase productive potential as well as to provide safety nets that relieve households of bearing the entire burden of adjustment.

**Figure 3.**

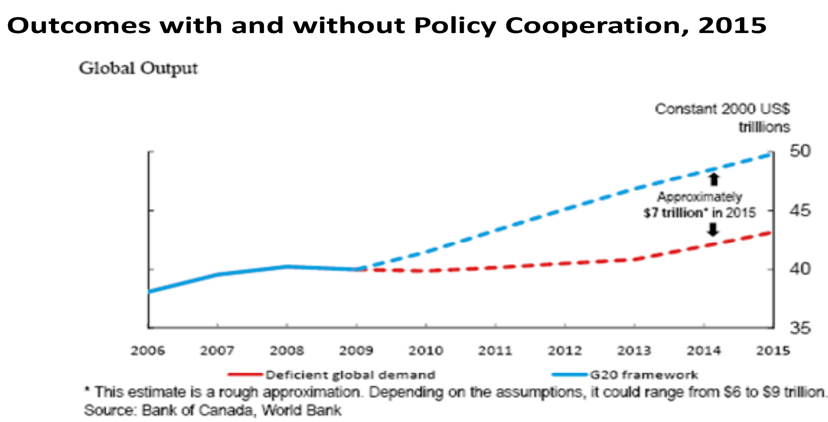

Selected Nominal Exchange Rates, 1990-2009
Exchange Rate
(local currency units per US$, period avgs)
60
50
40
30
20
10
0
1990 1995 2000 2001 2002 2003 2004 2005 2006 2007 2008 2009
Year
China
Hong Kong
Taipei
India
Malaysia
Source: ADB Key Indicators 2010


Selected Nominal Exchange Rates, 1990-2009
Exchange Rate
(local currency units per US$, period avgs)
18000
16000
14000
12000
10000
8000
6000
4000
2000
0
1990 1995 2000 2001 2002 2003 2004 2005 2006 2007 2008 2009
Year
Repblic of Korea
Indonesi a
Viet Nam
Japan
Source: ADB Key Indicators 2010

## Figure 4. BRIC Inflation Rates




## Figure 5.




**Source: Bank of Canada**