THE INTERNATIONAL ECONOMY
THE MAGAZINE OF
INTERNATIONAL ECONOMIC POLICY
888 16th Street, N.W.
Suite 740
Washington, D.C. 20006
Phone: 202-861-0791
Fax: 202-861-0790
www.international-economy.com
editor@international-economy.com

# Has Dollar Pegging *Paid Off* For Asia?

*Mention Asia and currencies, and most people think of China. But setting China aside for a moment, has dollar pegging paid off for the rest of Asia? Since 1997–98, most emerging Asian market economies have run a de facto or explicit peg against the U.S. dollar. Many U.S. commentators view this as an expensive form of insurance against currency speculators, an approach with significant costs to domestic Asian households and business purchasing power. Other Asian observers believe that this strategy is in keeping with the long-term bias toward savings and export-oriented growth. As international pressure mounts for the dollar to adjust downward against Asian currencies, have the last six years of this policy on the whole been a success for the Asian markets?*

**Three top experts offer their views.**

**TADASHI NAKAMAE**
***President, Nakamae International Economic Research***

**The Asian economies will soon face a body blow.**

Eight years ago, at the height of the Asian currency crisis, the fundamental objective for the economies of Asia (excluding China and Japan) was to curb over-investment and to increase domestic consumption. In fact, as the capital investment bubble subsided, Asian consumption increased only marginally, whereas exports grew massively. Now therefore, with pressure mounting on the United States to save more and spend less on imports, the export-dependent economies of Asia look increasingly vulnerable.

Dollar pegging was a necessary expedient to stabilize the markets. By keeping Asian currencies undervalued, it was partly to blame for Asia's shift to an economic structure that is overly dependent on exports. But I lay greater blame at the door of the U.S. Federal Reserve. The Fed's unduly expansionary monetary easing, first in response to the Asian, LTCM, and Russian crises, then with redoubled intensity following the September 11 attacks, created successive demand bubbles in the United States which lured Asia off course.

Take Thailand, for example, where the Asian currency crisis began. *Continued on page 50*

---

**YONGHAO PU**
***Chief Regional Economist and Head of Asia Regional Research, UBS Wealth Management***

First of all, I need to clarify the question. Apart from China, Malaysia, and Hong Kong, the rest of the Asian currencies do have some degrees of flexibility against the U.S. dollar. Since January 2003, when the dollar depreciated about 27 percent against the euro, most of the Asian currencies have been appreciating against the dollar as well, ranging from 6 percent by the Singapore dollar, to 10 percent by the Thai baht and 12 percent by the Korean won. Admittedly, Asian central banks have been intervening in the foreign exchange market to prevent strengthening of their currencies, thus running some kind of soft peg against the U.S. dollar, which in my view has been a successful strategy since 1997–98. Why?

**I see nothing wrong with an approach biased toward savings and export-oriented growth.**

I agree that this approach has a long-term bias toward savings and export-oriented growth, but a more important point to remember is that *Continued on page 50*

**ADAM S. POSEN**
***Senior Fellow, Institute for International Economics, and an executive editor of* The International Economy**

Since the 1997–98 Asian currency crisis, most emerging Asian market economies have run a de facto or explicit peg against the U.S. dollar, and have tended to maintain undervalued currencies (especially of late). Outside of Japan and China, the motivation for dollar reserve accumulation is self-insurance. The region's governments are still extremely concerned about the possibility of another speculative attack their currencies.

This concern stems from fears of what happened to the region's regimes and elected officials during the crisis, as well as the widespread but not entirely justified feeling that these countries were left in the lurch by the West and in particular by the International Monetary Fund. The hope is that a large enough war chest of dollars and other reserves will deter speculation against their currencies, or allow the governments to fight off any attack using exchange rate intervention. *Continued on page 51*

**The governments of emerging Asia have made a bad insurance deal with their dollar pegs.**

**Nakamae**, *continued from page 49*

Fixed capital formation in Thailand subsided from 41 percent of GDP in 1996 to 24 percent in 2003, a decline of 17 percentage points. The GDP share of personal consumption increased by only around 3 percentage points over the period. Net exports, meanwhile, registered a 13 percentage point increase from minus 6 percent in 1996 to 7 percent of GDP in 2003. Gross exports rose from 39 percent to 66 percent of Thai GDP.

True, most of the increase in Thai exports has been in exports to China, not to the United States. But how much Chinese demand would there be for Thai products without sustained U.S. demand for Chinese products? I fear the day is coming when we will find out.

Ironically, the operations of Asian central bankers have hastened the advent of that day. Central bank intervention to maintain the dollar peg caused the accumulated foreign exchange reserves of the Asian economies to rise from $543 billion at the end of 2000 to $917 billion as of September 2004, a total increase of $374 billion. By comparison, Japan's reserves as of September 2004 were $811 billion, and China's were $515 billion. Unlike the Bank of Japan, the Asian central banks—and lately the Chinese central bank also—have felt the need to avoid currency risk by diversifying their foreign exchange portfolios. Thus in the four years during which dollar-buying by the central banks saw their reserves rise by $374 billion, Asian purchases of U.S. Treasury and agency bonds amounted to only $151 billion—and this total includes private investment. Financially it was prudent for Asian central banks to protect against dollar weakness, but the unintended effect of their portfolio diversification—especially after the People's Bank of China followed suit—was to ensure that the dollar did weaken against the euro and the yen, thereby exerting upward pressure on U.S. interest rates, with likely dire consequences for Asia's real economy.

The rising of U.S. interest rates, quite independently of the will of the Fed, sends a clear signal that it is time for the United States to reduce its current account deficit. There is not sufficient capacity in U.S. manufacturing for the trade deficit to be cut through increased exports, even under a weaker dollar, and so the United States must adjust primarily by reducing imports.

For the Asian economies that will be a body blow. Appreciation of their currencies against the dollar may cushion the blow, but it will not negate the shock of the structural adjustment that Asia still needs to make. The fundamental task for each Asian economy is the same now as it was before the last Asian crisis: to nurture growth of domestic demand so as to become less vulnerable to external shocks. ◆

---

**Pu**, *continued from page 49*

the strategy has also bought some time for Asian countries to restructure their banking system, which was in a terrible state and largely contributed to the financial crisis in 1997. It is very clear that whatever exchange rate regime a country pursues, long-term success depends on a commitment to sound economic fundamentals and a strong banking sector. In the past years, Asian countries have made efforts to clean up their banking sectors, improve corporate governance and transparency, and so on under a favorable cyclical environment including relatively stable exchange rates. To me, these are much more important things to do than opening up the currency regime prematurely.

Macroeconomics textbooks teach that fixing the exchange rate without imposing capital account controls causes loss of control over monetary policy and inflation. However, the reality is more complex. Inflation in Asia ex-Japan has not been runaway; while it is slowly bottoming out, it still hovers around 3 percent on the back of achieving 6 percent real growth, indicating Asian currencies are not too far away from their fair values. Fundamentally, for an emerging economy, I see nothing wrong with an approach biased toward savings and export-oriented growth. Many Asian countries—including China, Hong Kong, the Philippines, and Indonesia—are still suffering from very high unemployment, and high savings rates could support local investment and create jobs. And most importantly, Asian savings have been able to finance U.S. current account deficits and act as a stabilizer for the global financial system.

More interestingly, Asian authorities have started to be a bit flexible as well. With improved domestic demand (which has not been dented by their undervalued currencies) and less-than-expected deceleration in exports, Asian central banks are showing increasing willingness to tolerate gradual U.S. dollar weakening and associated Asian currency strength. In summary, I support the idea of Asian countries gradually liberalizing their currency regimes, but not before a sound financial sector is in place. ◆

**Posen,** *continued from page 49*

Not every insurance policy is worth the price, however. The governments of emerging Asia have made a bad insurance deal with their dollar pegs. Their policies cost too much for the limited amount of protection offered, and the policyholders—Asian central banks and finance ministries—are devoting more resources than are justified to worrying about the risks they face from foreign exchange markets.

Tying up several percent of GDP annually in dollar assets is expensive, aside from the risk of capital losses on those holdings if the dollar declines. It deprives households of the purchasing power that their productivity should earn them in two ways. First, national savings are being lent at very low interest rates to the U.S. government rather than being invested productively; second, access to and consumption of imported goods are repressed. In addition, an undervalued currency makes many industrial inputs, from advanced technology to dollar-priced commodities, more expensive for domestic businesses who want to compete on points other than cheap labor.

From this perspective, it is no surprise that South Korea has been the first and most obvious to start backing off the dollar peg—despite the trauma of 1997–98. South Korea has one of the most vital democracies in emerging Asia, with by far the strongest politically active middle class, and they suffer most directly from the government tying up savings in U.S. Treasuries and from having their purchasing power constrained. Meanwhile, Korean businesses are far more advanced in their markets and competitive advantages than most in Asia, with more to lose from elevated input costs.

**If the United States and European Union really need Asian currency appreciation as part of global adjustment, they may have to offer an overdue reallocation from Europe to Asia of quotas and voting shares in the IMF.**

The insurance policy that dollar peggers have written themselves also overestimates the likelihood of the policy paying off in full. If a minor currency (say the Thai baht again) were to come under attack, either the markets believe the government has enough credibility and commitment to fend off the speculators (which a fraction of the current reserve levels should be enough to demonstrate, if the market cares), or the markets view the currency as fundamentally unsustainable, in which case no realistic amount of reserves is large enough to fend off the attack.

The dollar peggers also overestimate the risks from currency markets, and therefore the need for such insurance. Given the departures from adjustable fixed pegs by the majority of these countries, they are not as vulnerable as before. It does make a difference whether a government's rate commitment is explicit or informal and can be altered without announcement or clear change of target. The informal currency stabilizers are subject to far less volatility than the formal peggers.

Also, though the officials involved are loathe to admit it, the Asian currency crisis was not entirely driven by speculation and panic. Some weak fundamentals in the region's financial systems were also at play—and those have improved, markedly in some cases, whether through market pressure, IMF conditionality, or well-designed reform. This further reduces the need for self-insurance through reserve accumulation.

Thus, mercantilist motivations are secondary as a source of these countries' exchange rate policies, and concerns about the damage to central bank balance sheets are tertiary (who marks those to market in the region anyway?). Sure, these countries are concerned about China and other competitors undercutting them if they allow their currencies to appreciate. That though is an exit strategy issue requiring some coordination, which is likely to be attainable if sought, not a fundamental motivation for the policies pursued. In any event, the mercantilist advantages from undervalued exchange rates are really overblown once these economies get past a certain size and level of development.

Still, given the lingering mercantilist mindset (and interests) of some pressure groups and civil servants in emerging Asia, as well as these elites' unwillingness to recognize that the Asian currency declines of 1997–98 had some justification, their self-insurance policies will persist—despite being a bad deal for the economies involved. Only where democracy empowers the rising middle classes and value-added producers, as seems to be happening in Korea, can we expect domestically driven change of these undervalued dollar pegs in the near term.

Thus, if the United States and European Union really need Asian currency appreciation as part of global adjustment, they may have to offer an overdue reallocation from Europe to Asia of quotas and voting shares in the IMF. A visible institutional increase in Asian voices on global financial issues would, in addition to its other merits, probably be accepted in trade for the ending of self-insurance dollar peg policies in emerging Asia. ◆