East Asia's Foreign Exchange Rate Policies

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July 16, 2009

Congressional Research Service
7-5700
www.crs.gov
RS22860

CRS Report for Congress
Prepared for Members and Committees of Congress

Summary

Financial authorities in East Asia have adopted a variety of foreign exchange rate policies, ranging from Hong Kong's currency board system which links the Hong Kong dollar to the U.S. dollar, to the "independently floating" exchange rates of Japan, the Philippines, and South Korea. Most Asian monetary authorities have adopted "managed floats" that allow their local currency to fluctuate within a limited range over time as part of a larger economic policy.

Over the last few years, the value of the U.S. dollar has generally declined against most major currencies, although the U.S. dollar has rebounded against some currencies in recent months. The various economies of East Asia have responded differently to the fluctuation in the value of the U.S. dollar. Some have allowed their local currency to appreciate against the U.S. dollar; others have held the value of their currency against the U.S. dollar relatively unchanged. A few have seen their currencies depreciate in value relative to the U.S. dollar. While there is some evidence of competitive adjustments among some of the exchange rates, it is unclear if these adjustments have had much impact on exports to the United States.

While U.S. policy has generally supported the adoption of "free float" exchange rate policies, most of East Asia considers a "managed float" exchange rate policy more conducive to their economic goals and objectives. In addition, it is uncertain if the adoption of "free float" exchange rate policies across East Asia would necessarily lead to a major decline in the U.S. trade deficit with East Asia. It is possible that U.S. complaints of "currency manipulation" and pressure on one East Asian government to alter its exchange rate policy may foster resistance from other East Asia governments that have adopted similar exchange rate policies. This report will be updated as events warrant.

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The exchange rate policies of some East Asian nations—in particular, China Japan, and South Korea—have been a source of trade tension with the United States. Some analysts and Members of Congress maintain that these countries have intentionally kept their currencies undervalued in order to keep their exports price competitive in global markets. Some argue that these exchange rate policies constitute "currency manipulation" and violate Article IV, Section 1(iii) of the *Articles of Agreement the International Monetary Fund*, that stipulate that "each member shall avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members."

Under U.S. law, the Secretary of the Treasury is required to conduct a biannual analysis of the exchange rate policies of foreign countries and determine if they violate Article IV, Section 1.[1] In its report to Congress released in April 2009, the U.S. Treasury "concluded that no major trading partner of the United States met the standards identified in Section 3004 of the Act during the reporting period" (i.e. none was manipulating its exchange rate).[2]

Several bills have been introduced during the 111th Congress concerning the issue of "currency manipulation" or "misalignment" in general. These include the Currency Exchange Rate Oversight Reform Act of 2009 (S. 1254), the Currency Reform for Fair Trade Act of 2009 (H.R. 2378 and S. 1027), the End the Trade Deficit Act (H.R. 1875), and the Trade Reform, Accountability, Development, and Employment (TRADE) Act of 2009 (H.R. 3012). While these bills address the exchange rate issue in general, it is widely understood that the main targets are in East Asia, particularly China.

This report examines the de facto foreign exchange rate policies adopted by the monetary authorities of East Asia. In some cases, there is a perceived discrepancy between the official (de jure) exchange rate policy and the observed de facto exchange rate policy. This report will focus primarily on the de facto exchange rate policies At one extreme, Hong Kong has maintained a "linked" exchange rate with the U.S. dollar since 1983, under which the Hong Kong Monetary Authority (HKMA) intervenes to keep the exchange rate between 7.75 and 7.85 Hong Kong dollars (HKD) to the U.S. dollar.[3] Such an arrangement is often referred to as a "fixed" or "pegged" exchange rate. At the other extreme, Japan, the Philippines, and South Korea have usually allowed their currencies to float freely in foreign exchange (forex) markets over the last few years—an exchange rate arrangement often referred to as a "free float." However, all three nations—much like the United States—have intervened in international currency markets if fluctuations in the exchange rate are considered too volatile and pose a risk to the nation's economic well-being.[4] Most of East Asia's governments, however, have chosen exchange rate policies between these two extremes in the form of a "managed float."

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[1] Section 3004 of the Omnibus Trade and Competitiveness Act of 1988 (P.L. 100-418), codified into U.S. Code Chapter 22, Sections 5304-5306.

[2] U.S. Treasury, "Report to Congress on International Economic and Exchange Rate Policies," April 15, 2009, available online at http://www.ustreas.gov/press/releases/reports/fxreportfinalfor%20webapril152009.pdf.

[3] For more information about Hong Kong's exchange rate policy, see the HKMA's web page: http://www.info.gov.hk/hkma/eng/currency/link_ex/index.htm.

[4] According to the Federal Reserve Bank in New York, the United States intervened in foreign exchange markets twice between August 1995 and December 2006, for more information see http://www.newyorkfed.org/aboutthefed/fedpoint/fed44.html.

East Asia's Exchange Rate Policies

Much of East Asia has adopted an exchange rate policy commonly referred to as a "managed float." Cambodia, China, Indonesia, Malaysia, Singapore, Taiwan, Thailand, and Vietnam allow their currency to adjust in value in forex markets so long as the fluctuations in value do not violate some other economic policy goal (such as inflation limits or money supply constraints). In addition, China and Vietnam have officially adopted a type of managed float known as a "crawling peg"—that typically includes either the gradual appreciation or depreciation of the currency over time against one or more currencies. **Table 1** lists the current *de facto* exchange rate policies of East Asia according to the International Monetary Fund (IMF) as of April 30, 2008, divided into four general categories: 1. Pegged; 2. Crawling Peg; 3. Managed Float; and 4. Free Float.

Table 1. De Facto Exchange Rates Policies of East Asia (as of April 30, 2008)

Economy	Exchange Rate Policy
Cambodia	Managed Float
China	Crawling Peg*
Hong Kong	Pegged
Indonesia	Managed Float
Japan	Free Float
Laos	Managed Float
Macau	Pegged
Malaysia	Managed Float
Philippines	Free Float
Singapore	Managed Float
South Korea	Free Float
Taiwan	Managed Float
Thailand	Managed Float
Vietnam	Crawling Peg*

Source: International Monetary Fund, *De Facto Classification of Exchange Rate Regimes and Monetary Policy Framework*, http://www.imf.org/external/np/mfd/er/2008/eng/0408.htm.

***Note:** Status of exchange rate policies of China and Vietnam subject to debate; some analysts think both nations have recently adopted a managed float.

Categorization of a government's exchange rate policy can be complicated. For example, according to South Korea's central bank, the Bank of Korea, the nation's official exchange rate policy has been a "free floating system since December 1997."[5] However, it was reported that the South Korean government sold about $1 billion for won on March 18, 2008, to stop a "disorderly decline" in the value of Korea's currency.[6] There were also reports that Korea sold more dollars for won in early April 2008.[7] At the time, some forex analysts claimed that the new South Korean government had de facto adopted a pegged exchange rate policy of holding the exchange rate between the won and the U.S. dollar at 975-1,000 to 1.[8] Since the summer of 2008, the won had sharply declined in value against the U.S. dollar, hitting a low of 1,569.61 won to the dollar in March 2009.

[5] See the Bank of Korea's webpage for a description of its exchange rate policy: http://www.bok.or.kr/template/eng/html/index.jsp?tbl=tbl_FM0000000066_CA0000001186.

[6] Yoo Choonsik and Cheon Jong-woo, "S. Korea Sold Dollars to Calm Markets-Dealers," *Reuters*, March 18, 2008.

[7] "Intervention Detected as S. Korea Won Pares Gains," *Reuters*, April 4, 2008.

[8] Yoo Choonsik, "S. Korea Won Hit by New Policy, Consumption at Risk," Reuters, April 7, 2008.

Another source of complication arises when there is a seeming discrepancy between the official exchange rate policy and observed forex market trends. For example, both China and Vietnam officially are maintaining a crawling peg policy that allows their currencies—the renminbi and the dong, respectively—to adjust in value with respect to an undisclosed bundle of currencies within a specified range each day. In theory, this allows the renminbi and dong to appreciate or depreciate in value gradually over time, depending on market forces.

However, in recent months, both the renminbi and the dong have been comparatively stable in value relative to the U.S. dollar. This has led some analysts to assert that China and Vietnam have abandoned the crawling peg in favor of either a pegged exchange rate or a managed float. Other analysts maintain that the stability of the value of the currencies with respect to the U.S. dollar is an artifact of the bundle of currencies being used by China and Vietnam. Because some major currencies have strengthened against the U.S. dollar while others have weakened, the weighted average used by China and Vietnam in determining the band for the crawling peg has resulted in a relatively unchanged value when compared to the U.S. dollar.

Competitive Adjustments?

There are indications that some of the economies of East Asia monitor the region's exchange rates and attempt to keep the relative value of their currencies in line with the value of selected regional currencies. These "competitive" adjustments in exchange rates are allegedly made to maintain the competitiveness of a nation's exports on global markets. For example, one scholar maintains, "Countries that trade with China and compete with China in exports to the third market are keen not to allow too much appreciation of their own currencies vis-à-vis the Chinese RMB [renminbi]."[9] The scholar, Taketoshi Ito, also speculates, "China most likely is more willing to accept RMB appreciation if neighboring countries, in addition [South] Korea and Thailand, allow faster appreciation."[10]

An examination of East Asian exchange rates over the last four years (July 2005 to June 2009) appears to support the supposition that some nations are engaged in competitive exchange rate management (see **Figure 1**). The two pegged currencies—the Hong Kong dollar and the Macau pataca—remained virtually unchanged throughout the time period considered, as would be expected. The two currencies that appreciated the most over the last four years—the Laotian kip and the Chinese renminbi—appear to have followed a very similar path, which is not surprising given Laos' economic ties to China. The Malaysian ringgit and the Singaporean dollar seem to have followed along the same path as the kip and renminbi until May of 2008, when the ringgit and the Singaporean dollar began a period of depreciation against the U.S. dollar.

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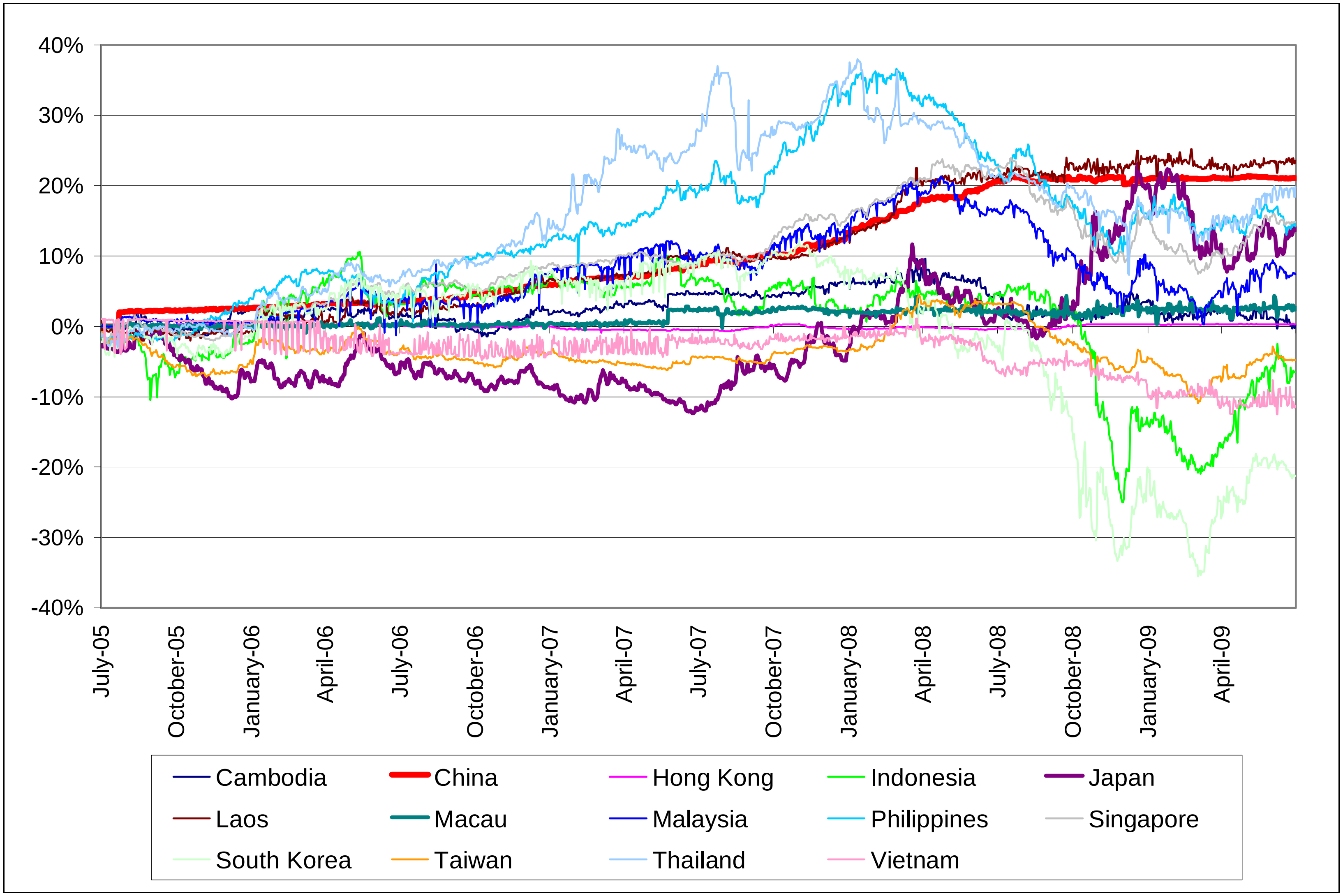
[9] Takatoshi Ito, "The Influence of the RMB on Exchange Rate Policy of Other Economies," paper presented at Peterson Institute for International Economics Conference, October 19, 2007.

[10] Ibid.

Figure 1. Changes in U.S. Dollar Exchange Rates for East Asian Currencies, July 2005 - June 2009

(base value = June 2005)



Source: CRS calculations based on publicly available data.

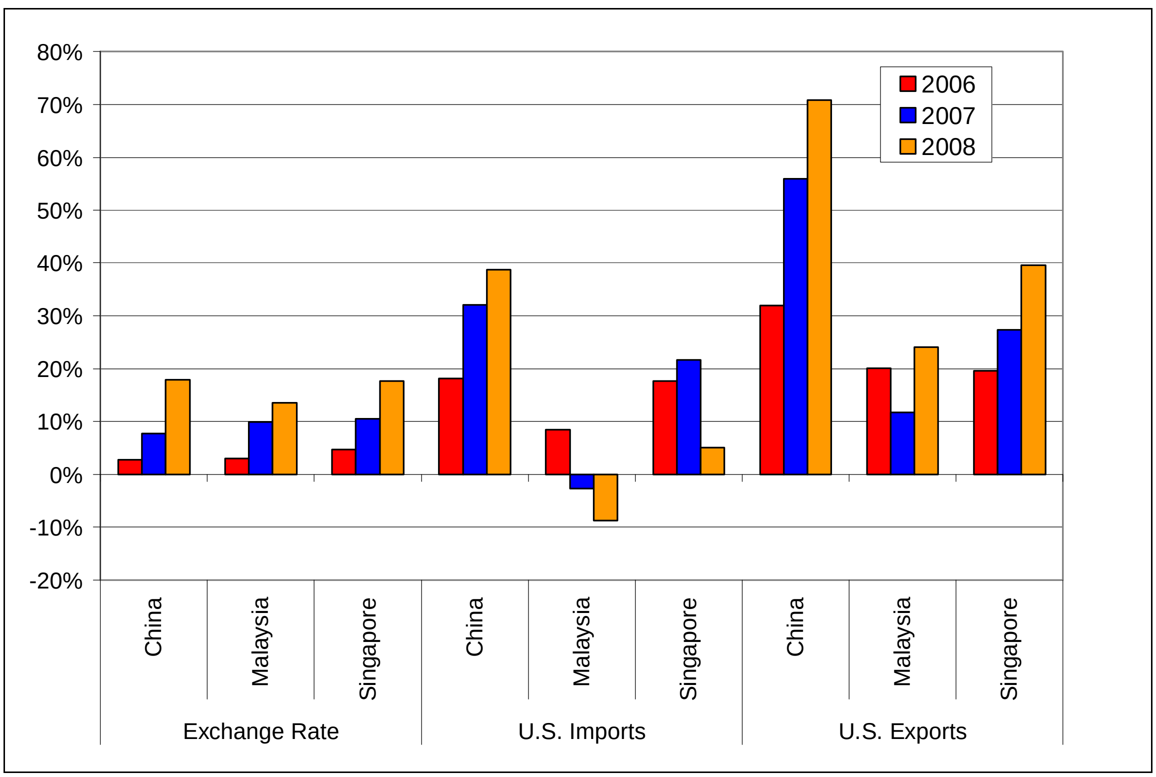
In a similar fashion, the two currencies with the peak level of appreciation against the U.S. dollar over the last four years—the Philippine peso and the Thai baht—also have fluctuated along comparable trend lines since July 2005, possibly indicating that the managed float baht was following the lead of the free floating peso. Another pair of currencies that moved along similar paths since July 2005 were the Indonesian rupiah and the South Korean won; both currencies have depreciated against the U.S. dollar during the last four years, with the won down by over 20%. The reasons for the apparent link between the rupiah and won is unclear.

Exchange Rates and U.S. Trade

There is a widely held notion that if a nation's currency appreciates in value relative to other nations' currencies, its exports will tend to decline and its imports will tend to rise. In practice, there has been little apparent correlation in recent years between the growth of U.S. trade with East Asia and changes in the relative value of East Asian currencies. The example of U.S. trade with China, Malaysia, and Singapore—three significant trading partners in East Asia whose currencies have followed similar paths over much of the last four years—shows that changes in relative exchange rates do not necessarily lead to the anticipated changes in bilateral trade flows.

Figure 2. Currency Appreciation and U.S. Trade Growth with China, Malaysia, and Singapore, 2006 - 2008

(percentage change from 2005)



Source: CRS calculation based on USITC data and publicly available exchange rates

The reasons for the comparative stability of the relative exchange rates of China, Malaysia, and Singapore is a complex issue beyond the scope of this short paper.[11] However, official U.S. trade data appear to indicate that economic forces in addition to relative exchange rates are influencing U.S. trade with these three nations (see **Figure 2**).[12] Although their currencies appreciated against the U.S. dollar in 2006, 2007, and 2008 by similar amounts, U.S. trade with China, Malaysia, and Singapore grew or fell at different rates. U.S. trade with Malaysia showed the anticipated rise in U.S. exports and slowdown or decline in U.S. imports with the appreciation of the ringgit. However, both China and Singapore showed strong—and differing—increases in both U.S. exports and imports despite the strengthening of their currencies relative to the U.S. dollar.

Implications for U.S. Trade Policy in East Asia

While U.S. policy has generally supported the adoption of "free float" exchange rate policies, most East Asian governments consider a "managed float" exchange rate policy more conducive to their overall economic goals and objectives. In part, East Asian governments may be resistant to a "free float" policy because of the commonly held view in Asia that the economies with more liberal exchange rate policies suffered more during the 1997-1998 Asian financial crisis than the economies with pegged or managed exchange rates.[13] As a result, there may be skepticism about U.S. recommendations for adoption of "free float" exchange rate policies.

In addition, as indicated above, it is uncertain if the adoption of "free float" exchange rate policies by more monetary authorities in East Asia would significantly reduce the U.S. trade deficits with countries in the region.[14] Among economists, there is no consensus that the resulting appreciation of East Asian currencies against the U.S. dollar would either significantly increase overall U.S. exports or reduce U.S. imports. However, for some price-sensitive industries where U.S. companies are competitive, the appreciation of a competing nation's currency may stimulate U.S. export growth and/or a decline in U.S. imports.

[11] In particular, this paper does not analyze the possible "J-curve"—an economic theory that the value of a nation's imports may actually rise for a short period of time following the depreciation of its currency because the increase in the price of imports may outweigh the decline in the quantity of imports.

[12] These other forces may include the U.S. federal trade deficit, comparatively low U.S. interest rates , and/or various tariff and non-tariff trade barriers. For more information, see CRS Report RL31032, *The U.S. Trade Deficit: Causes, Consequences, and Cures*, by Craig K. Elwell.

[13] For more about Asian views of the causes of Asian financial crisis of 1997-98, see Pradumna B. Rana, "The East Asian Financial Crisis—Implications for Exchange Rate Management," Asian Development Bank, EDRC Briefing Notes, Number 5, October 1998; and Ramkishen S. Rajan, "Asian Exchange Rate Regimes since the 1997-98 Crisis," Singapore Centre for Applied and Policy Economics, September 2006.

[14] In his abstract of his 2006 study, "The Effect of Exchange Rate Changes on Trade in East Asia," Willem Thorbecke concluded, "The results indicate that exchange rate elasticities for trade between Asia and the U.S. are not large enough to lend confidence that a depreciation of the dollar would improve the U.S. trade balance with Asia." Complete text of paper available at http://www.rieti.go.jp/en/publications/summary/06030003.html.

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