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East Asia's Foreign Exchange Rate Policies

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Summary

The economies of 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 of the economies of Asia 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 declined against most major currencies. The various economies of East Asia have responded differently to the fall in the value of the dollar. Some have allowed their local currency to appreciate against the U.S. dollars; others have held the value of their currency against the U.S. dollar relatively unchanged. 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 the economies of East Asia consider 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 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 counter arguments from other East Asia governments that have adopted similar exchange rate policies. This report will be updated as events warrant.

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 for several years. Some analysts and Members of Congress maintain that these countries are intentionally keeping their domestic 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 December 2007, the U.S. Treasury "concluded that neither China nor any other major trading partner of the United States met the requirements for designation under Section 3004 of the Act during the period"(i.e. none was manipulating its exchange rate).[2]

Several bills have been introduced during the 110th Congress concerning the issue of "currency manipulation" in East Asia. These include the Currency Harmonization Initiative Through Neutralizing Action Act of 2005 (H.R. 321), the Fair Currency Act of 2007 (H.R. 782 and S. 796), the Japan Currency Manipulation Act (H.R. 2886 and S. 1021), and the Currency Reform and Financial Markets Access Act of 2007 (S. 1677).

The economies of Asia have de facto adopted a variety of foreign exchange rate policies.[3] 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.[4] Such an arrangement is often referred to as a "fixed" or "pegged" exchange rate. At the other extreme, Japan, the Philippines, and South Korea (up until mid-March) have 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.[5]

Most of the Asian economies have adopted a variety of exchange rate policies commonly referred to as "managed floats." 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, some nations, such as China and Vietnam, have adopted a type of managed float known as a "crawling peg" — that typically includes either the gradual appreciation or depreciation of the currency

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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," December 2007, available online at [http://www.ustreas.gov/offices/international-affairs/economic-exchange-rates/pdf/Dec2007-Report.pdf].

[3] In some cases, there is a perceived discrepancy between the official (de jure) exchange rate policy of an economy and the observed de facto exchange rate policy. This report will focus primarily on the de facto exchange rate policies.

[4] 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].

[5] 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].

over time against one or more currencies.[6] **Table 1** lists the current *de facto* exchange rate policies of East Asia according to four general categories: 1. Pegged; 2. Crawling Peg; 3. Managed Float; and 4. Free Float.

Categorization of a government's exchange rate policy can be complicated if there is an intervention on forex markets. For example, it has been 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.[7] There are also reports that Korea sold more dollars for won in early April.[8] Some forex analysts claim that the new South Korean government has adopted a goal of holding the exchange rate between the won and the U.S. dollar at 975-1,000 to 1.[9] However, according to South Korea's central bank, the Bank of Korea, the nation's exchange rate policy has been a "free floating system since December 1997.[10] Based on Korea's past pattern, it is uncertain at this time if the recent actions are temporary interventions to stabilize markets, or indications of a categorical shift in Korea's exchange rate policy.[11]

Table 1. De Facto Exchange Rates Policies of East Asia

Economy	Exchange Rate Policy
Cambodia	Managed Float
China	Crawling Peg
Hong Kong	Pegged
Indonesia	Managed Float
Japan	Free Float
Laos	Managed Float
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/2006/eng/0706.htm].
*Note: reflects policy change subsequent to release of the IMF report.

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[6] For more information about China's exchange rate policies, see CRS Report RL32165, *China's Currency: Economic Issues and Options for U.S. Trade Policy*, by Wayne M. Morrison and Marc Labonte.

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

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

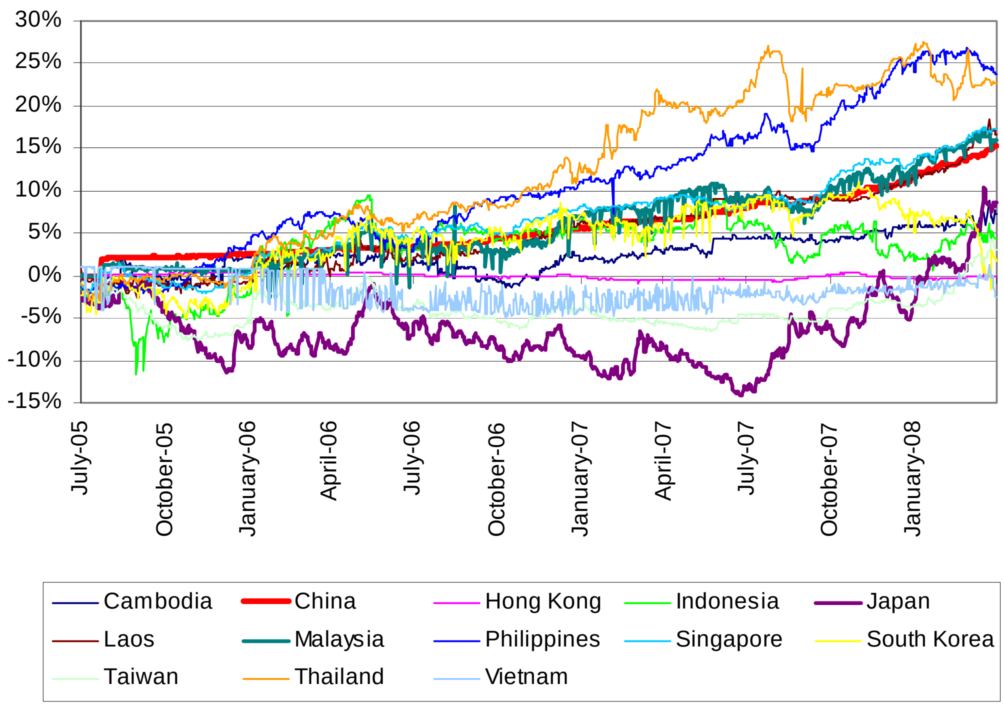
[9] Yoo Choonsik, "S. Korea Won Hit by New Policy, Consumption at Risk," *Reuters*, April 7, 2008.

[10] 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].

[11] For more information on Korea's recent forex market interventions, see CRS Report RL30566,
(continued...)

In addition, 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 so as to maintain the competitiveness of their exports on global commodity 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]."[12] 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."[13]

Figure 1. Changes in U.S. Dollar Exchange Rates for East Asian Currencies, July 2005 - February 2008
(base value = June 2005)



Source: CRS calculations based on publicly available daily exchange rate data.

An examination of East Asian exchange rates over the last couple of years appears to confirm both the general categorization of exchange rate policies, as well as the supposition that some nations are engaged in competitive exchange rate management (see **Figure 1**). The two currencies that appreciated the most — the free-floating Philippino peso and the managed float Thai bhat — both rose about 23% in value between June 2005

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[11] (...continued)
South Korea-U.S. Economic Relations, by Mark E. Manyin.

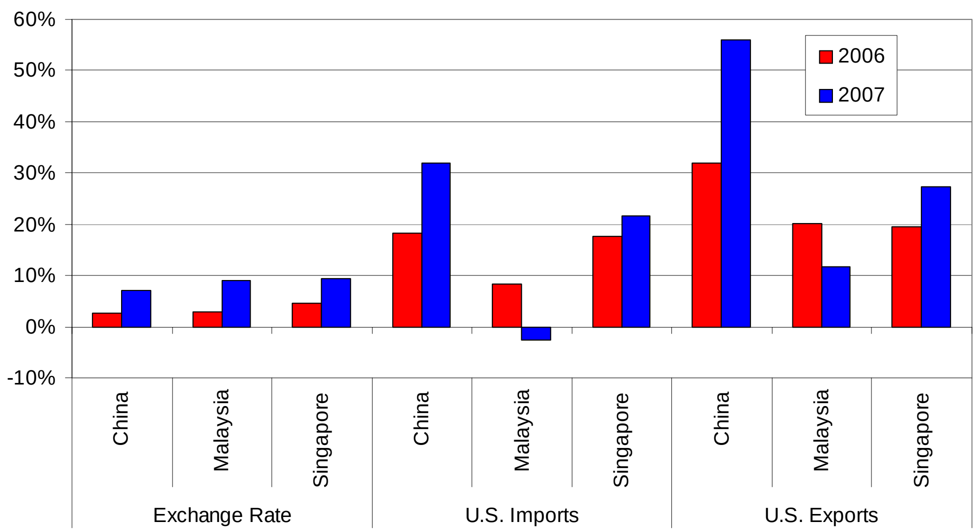
[12] Takatoshi Ito, "The Influence of the RMB on Exchange Rate Policy of Other Economies," paper presented at Peterson Institute for International Economics Conference, October 19, 2007.

[13] Ibid.

and March 2008, but moved somewhat independently throughout the period. A second group consisting of the crawling peg Chinese renminbi and three managed float currencies — the Laotian kip, the Malaysian ringit, and the Singaporean dollar — rose about 15% in value and generally moved as group, especially since January 2007. A third group which included the managed float currencies of Cambodia and Indonesia, and the free-floating Japanese yen — appreciated about 5%, but moved separately. A final group, which ended up relatively unchanged compared to the U.S. dollar, included the Hong Kong dollar, the South Korean won, and the Vietnamese dong.

The pegged Hong Kong dollar remained virtually unchanged throughout the time period considered, as would be expected. The three free-floating currencies — the Japanese yen, the Korean won and the Philippino peso — followed three different but fluctuating paths. In particular, the Japanese yen was the only East Asian currency that significantly depreciated in value for much of the time period under consideration, although it has appreciated significantly since July 2007.[14] The remaining currencies — which followed a managed float or crawling peg exchange rate — either exhibited a fairly smooth rise in value or comparatively limited intertemporal variations. Two possible exceptions are the Indonesian rupiah and the Thai bhat.

Figure 2. Currency Appreciation and U.S. Trade Growth with China, Malaysia, and Singapore, 2006 and 2007
(percentage change from 2005)



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

In general, for the last two years, there has been little apparent correlation between the growth of U.S. trade with East Asia and changes in the relative value of East Asian currencies. The effectiveness of the apparent effort of China, Malaysia, and Singapore to maintain their relative exchange rates unchanged is a complex issue beyond the scope

[14] For more information about Japan's exchange rate policies, see CRS Report RL33178, *Japan's Currency Intervention: Policy Issues*, by Dick K. Nanto.

of this short paper.[15] 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**).[16] Although their currencies appreciated against the U.S. dollar in 2006 and 2007 by roughly 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 exports and slowdown or decline in imports with the appreciation of the ringgit in 2006 and 2007. However, both China and Singapore showed strong — and differing — increases in both exports and imports despite the strengthening of their currencies.

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 of the economies of East Asia 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.[17] As a result, there may be skepticism about U.S. recommendations for adoption of "free float" exchange rate policies.

It is uncertain if the adoption of "free float" exchange rate policies by more economies in East Asia would significantly reduce the U.S. trade deficits with countries in the region.[18] 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 remain competitive, the appreciation of a competing nation's currency may stimulate U.S. export growth and/or a decline in U.S. imports.

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[15] 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.

[16] 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.

[17] 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.

[18] In his abstract of his recent 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].