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East Asia's Foreign Exchange Rate Policies

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Summary

Monetary authorities in East Asia have adopted a variety of foreign exchange rate policies, varying 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 currency to fluctuate within a limited range over time as part of a larger economic policy. A "crawling peg" is a special type of managed float in which a nation allows its currency to gradually appreciate or depreciate over time. China adopted a "crawling peg" policy from July 2005 to July 2008, and again from June 2010 to the present.

U.S. policy has generally supported the adoption of "free float" exchange rate policies. Legislation has been introduced during past Congresses designed to pressure nations seen as "currency manipulators" to allow their currencies to appreciate against the U.S. dollar. However, most East Asian monetary authorities consider a "managed float" exchange rate policy more conducive to their economic goals and objectives. A "managed float" can reduce exchange rate risks, which can stimulate international trade, foster domestic economic growth, and lower inflationary pressures. It can also lead to serious macroeconomic imbalances if the currency is, or becomes, severely overvalued or undervalued. A managed float usually means that the nation has to impose restrictions on the flow of financial capital or lose some autonomy in its monetary policy.

Over the last 10 years, the governments of East Asia have differed in their response to the fluctuations in the value of the U.S. dollar. Some, such as China, have allowed their 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, including Japan and South Korea, have seen their currencies depreciate in value relative to the U.S. dollar.

Some Southeast Asia nations—such as Malaysia, the Philippines, Singapore, and Thailand—may have adopted exchange rates regimes to keep their currencies relatively stable with respect to China's renminbi. This supposed "renminbi bloc" has emerged because those nations' economic and trade ties are increasingly with China. In addition, China has been actively promoting the use of its currency for trade settlements.

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 sources of tension with the United States in the past and remain so. Some analysts and Members of Congress maintain that some countries have intentionally kept their currencies undervalued for a period of time 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 of 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."[1]

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 "consider whether countries manipulate the rate of exchange between their currency and the United States dollar for purposes of preventing effective balance of payments adjustments or gaining unfair competitive advantage in international trade."[2] In its semi-annual report to Congress released in October 2014, the U.S. Treasury concluded that:

> no major trading partner of the United States met the standard of manipulating the rate of exchange between their currency and the United States dollar for purposes of preventing effective balance of payments adjustments or gaining unfair competitive advantage in international trade as identified in Section 3004 of the Act [i.e., the Omnibus Trade and Competitiveness Act of 1988] during the period covered in the Report.[3]

Several bills have been introduced during past Congresses concerning the issue of "currency manipulation" or "misalignment" in general. In the 114th Congress, these include the Currency Undervaluation Investigation Act (S. 433) and the Currency Reform for Fair Trade Act (H.R. 820).[4] While these bills address the exchange rate issue in general, congressional concerns were focused on the exchange rate policies of some countries in East Asia, particularly China.

This report examines the de facto foreign exchange rate policies adopted by the monetary authorities of East Asian governments.[5] 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) is required to intervene to keep the exchange rate between 7.75 and 7.85 Hong Kong dollars (HKD) to the U.S. dollar (USD).[6] Such an arrangement is often referred to as a "fixed" or

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[1] The IMF Articles of Agreement are available at https://www.imf.org/external/pubs/ft/aa/. For more background on currency manipulation and exchange rates, see CRS Report R43242, *Current Debates over Exchange Rates: Overview and Issues for Congress*, by (name redacted) and CRS Report IF10049, *Debates over "Currency Manipulation,"* by (name redacted).

[2] 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. The law requires the Treasury to provide an annual report "on or before October 15 of each year," plus "a written update on developments six months after the initial report."

[3] U.S. Treasury, "Report to Congress on International Economic and Exchange Rate Policies," October 15, 2015, http://www.treasury.gov/resource-center/international/exchange-rate-policies/Documents/2014-10-15%20FXR.pdf.

[4] Legislation introduced in previous Congresses, for example, includes: the Currency Reform for Fair Trade Act of 2009 (H.R. 2378 and S. 1027), the Currency Exchange Rate Oversight Reform Act of 2010 (S. 3134), the Currency Reform for Fair Trade Act of 2011 (H.R. 639), and the Currency Exchange Rate Oversight Reform Act of 2013 (S. 1114).

[5] 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.

[6] 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.

"pegged" exchange rate. At the other extreme, Japan, the Philippines, and South Korea have reportedly 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—like the United States—have intervened in international currency markets to influence fluctuations in the exchange rate.[7] Most of East Asia's governments, however, have chosen exchange rate policies between these two extremes in the form of a "managed float."

Types of Exchange Rate Policies

There are a number of different types of exchange rates policies that a nation may adopt, depending on what it perceives to be in its best interest economically and/or politically. At one extreme, a country may decide to allow the value of its currency to fluctuate relative to other major currencies in international foreign exchange (forex) markets—a policy commonly referred to as a "free float." One advantage of a "free float" policy over other exchange rate policies is that permits the nation more autonomy with its domestic monetary policy. However, disadvantages of a "free float" policy include greater exchange rate risk for international transactions, potentially destabilizing balance sheet effects, and possible rapid shifts in capital flows.

At the other extreme, a nation may decide to fix the value of its currency relative to another currency or a bundle of currencies—usually referred to as a "pegged" exchange rate policy. Pegged exchange rate policies can take several forms. The pegged exchange rate may be set by law, without special provisions to defend the value of the currency. Alternatively, a nation may create a "currency board"—a monetary authority that holds sufficient reserves to convert the domestic currency into the designated reserve currency at a predetermined exchange rate. The currency board utilizes those reserves to intervene in international forex markets to maintain the fixed exchange rate. For example, Hong Kong's three designated currency-issuing banks—The Bank of China, HSBC, and Standard Chartered Bank—must deposit with the Hong Kong Monetary Authority sufficient U.S. dollar denominated reserves to cover their issuance of Hong Kong dollars at the designated exchange rate of HKD 7.80 = USD 1.00. Some economies that are heavily dependent on trade—such as Hong Kong and Singapore—perceive extensive currency volatility as a burden to trading enterprises, and manage their currencies to avoid it. An advantage of a pegged exchange rate is that it virtually eliminates exchange rate risk. Disadvantages are the loss of autonomy in domestic monetary policy, potentially rapid changes in domestic prices (including fixed asset values), and exposure to speculative attacks on the pegged exchange rate.

A third common exchange rate policy is a "managed float." A nation that adopts a "managed float" allows the value of its domestic currency to fluctuate in international forex markets until certain designated economic indicators reach critical levels. In some cases, the country may designate a band around a determined exchange rate, and intervene in international forex markets if its currency hits the upper or lower value limits.[8]

[7] 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.

[8] This is frequently done by using a "trade-weighted basket" of currencies, in which the relative importance of each currency is based on the volume of bilateral trade with the nation. The rise of Asia's bilateral trade flows with China is likely a contributing factor to the emergence of a "renminbi bloc."

One special form of a managed float is a "crawling peg," in which the nation allows its currency gradually to appreciate or depreciate in value against one or more other currencies over time. China initiated a "crawling peg" policy on July 21, 2005, which it maintained until the summer of 2008, a period in which the renminbi appreciated 21% against the U.S. dollar.[9] Other forms of managed float policies do not rely on the exchange rate, but other economic factors such as the trade balance, current account balance, inflation, and overall economic growth.

Contemporary economic theory asserts that a nation cannot simultaneously maintain a fixed exchange rate, free capital movement, and an independent monetary policy. If a nation wishes to peg its currency and allow free capital movement (for example, Hong Kong) it must tie its monetary policy to that of the reserve currency nation (for Hong Kong, the United States). Many nations with pegged exchange rates choose to restrict the movement of capital to allow them greater autonomy in their monetary policies (such as anti-inflation measures, interest rate adjustments, or regulating the money supply).

Table 1. De Facto Exchange Rates Policies of East Asia (as of April 30, 2014)

Economy	Exchange Rate Policy
Cambodia	Managed Float
China	Crawling Peg
Hong Kong	Pegged
Indonesia	Managed Float
Japan	Free Float
Laos	Crawling Peg
Macau	Pegged
Malaysia	Managed Float
Mongolia	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*, April 30, 2014.

East Asia's Exchange Rate Policies

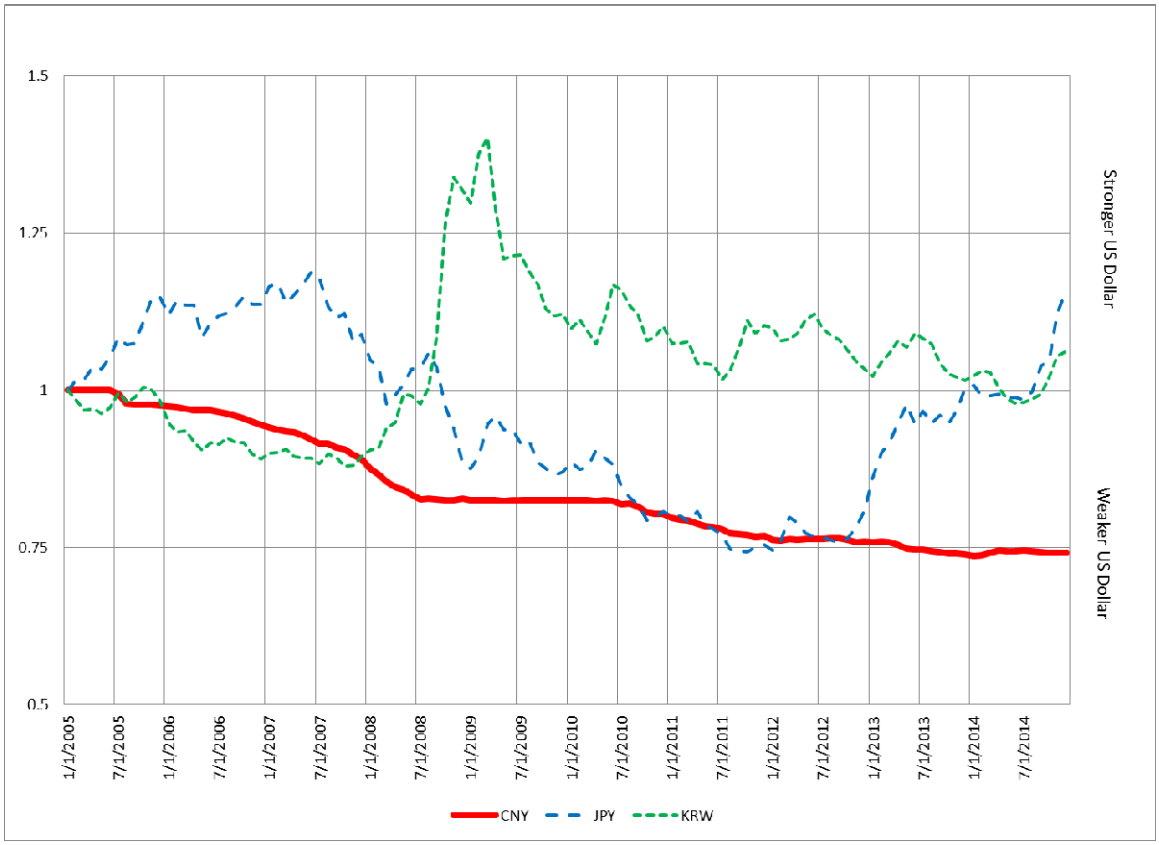
Many East Asian governments have adopted "managed float" exchange rate policies. **Table 1** lists the current *de facto* exchange rate policies of East Asia according to the International Monetary Fund (IMF) as of April 30, 2014, divided into four general categories: (1) Pegged; (2) Crawling Peg; (3) Managed Float; and (4) Free Float. Cambodia, China, Indonesia, Malaysia, Singapore, Taiwan, Thailand, and Vietnam allow their currencies 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. Hong

[9] For more information on China's exchange rate policies, see CRS Report RS21625, *China's Currency Policy: An Analysis of the Economic Issues*, by (name redacted) and (name redacted), and CRS Report IF10139, *China's Currency Policy*, by (name redacted).

Kong and Macau have effectively pegged their currencies to the U.S. dollar using a currency board system. Japan, the Philippines, and South Korea allow their currencies to free float in forex markets.

Figure 1. Relative Changes in Value of China's Renminbi (CNY), Japanese Yen (JPY), and South Korean Won (KRW) Relative to the U.S. Dollar

2005-2014; base value—January 2005



Source: CRS calculations using data from http://www.oanda.com.

Notes: CNY—China's renminbi; JPY—Japan's yen; KRW—South Korea's won.

Categorizing a government's exchange rate policy can be complicated, particularly during periods of financial turbulence, as was seen, for example, during the global financial crisis of 2008. 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.[10] 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 (see **Figure 1**).[11] There were also reports that Korea sold more dollars for won in early April 2008.[12] At the time, some forex analysts claimed that the new South Korean government had adopted a *de facto* pegged exchange

[10] See the Bank of Korea's webpage for a description of its exchange rate policy: http://www.bok.or.kr/broadcast.action?menuNaviId=678.

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

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

rate policy of holding the exchange rate between the won and the U.S. dollar at 975-1,000 to 1.[13] The value of the won declined further to nearly 1,500 won to the U.S. dollar in the spring of 2009, before gradually recovering over the next four years to about 1,100 won to the U.S dollar.[14]

Another source of complication arises when there is a seeming discrepancy between the official exchange rate policy and observed forex market trends. For example, China officially maintained a crawling peg policy prior to the global financial crisis that allowed its currency—the renminbi—to adjust in value with respect to an undisclosed bundle of currencies within a specified range each day. In theory, this allowed the renminbi to appreciate or depreciate in value gradually over time, depending on market forces.

After the global financial crisis began in 2007, however, the renminbi was comparatively stable in value relative to the U.S. dollar for about two years (see **Figure 1**). Initially, this led some analysts to assert that China had abandoned the crawling peg in favor of a pegged exchange rate. Other analysts maintained that the stability of the renminbi with respect to the U.S. dollar was an artifact of the basket of currencies being used by China. Because some major currencies strengthened against the U.S. dollar while others weakened, the weighted average used by China in determining the band for the crawling peg has resulted in a relatively unchanged value when compared to the U.S. dollar. On June 19, 2010, China's central bank, the People's Bank of China, announced it would "proceed further with reform of the RMB exchange rate regime and to enhance the RMB exchange rate flexibility," implying that it had been intentionally maintaining a stable exchange rate during the global economic downturn.[15] Since the summer of 2010, the RMB has once again gradually strengthened against the U.S. dollar to just over 6 yuan to the U.S. dollar as of February 2015.

Japan's yen has undergone major shifts in value relative to the U.S. dollar over the last 10 years, to a low of 122.6 yen to the U.S. dollar in June 2007, and rising to a high of 76.6 yen to the U.S. dollar in October 2011 (see **Figure 1**). The fluctuations in the value of the yen have also shown some sudden shifts, such as its sharp appreciation in late 2008 or its sharp depreciation starting in the autumn of 2012.

Analysts differ on the causes for the shifting value of the Japanese yen. Financial news reports during that time generally maintained that the fluctuations in the value of the yen reflected market confidence in Japan's economy and the Bank of Japan's monetary policy.[16] According to these accounts, the weakening of the yen is the result of expansionary fiscal and monetary policies, part of the government's program to stimulate economic growth in Japan ("Abenomics"). However, some U.S. business leaders assert that the recent decline in the value of the yen is the result of Japanese government intervention in foreign exchange markets.[17] The Abe government and the Bank of Japan repeatedly denied claims that they were actively attempting to lower the value of

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

[14] In 2014, financial analysts speculated that the Bank of Korea intervened to slow the appreciation of the won, but the reports are unconfirmed. See, for example, Neil Dennis, "Korean Won Falls on Suspected Intervention," *Financial Times*, July 14, 2014.

[15] The text of the People's Bank of China statement is available online at http://www.pbc.gov.cn/english/detail.asp?col=6400&id=1488.

[16] For example, see Neil Dennis, "Yen Weakens on Japan Growth Concerns," *Financial Times*, November 14, 2013; and Daniel Bases, "Yen Slammed by BoJ Easing, Falls to Near-seven Year Low," *Reuters*, October 31, 2014.

[17] For example, see Keith Naughton, "Ford CFO Says Toyota Gains $10 Billion Advantage on Weak Yen," *Japan Times*, February 2, 2015.

the yen relative to the U.S. dollar, asserting their economic policies are designed to stimulate growth and end price deflation.[18] The last confirmed time Japan intervened in foreign exchange markets was in 2011.

Emerging Renminbi Bloc?

There are indications that some East Asian monetary authorities monitor the region's exchange rates and attempt to keep the relative value of their currencies in line with the value of selected currencies in the region. These "competitive" adjustments in exchange rates are allegedly made to maintain the competitiveness of a nation's exports on global markets.

Some observers have speculated that competitive adjustments are particularly an issue in Southeast Asia, especially countries with closer economic ties to China. For example, one scholar noted in 2007 that, "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]."[19] The scholar, Taketoshi Ito, also speculated, "China most likely is more willing to accept RMB appreciation if neighboring countries, in addition [South] Korea and Thailand, allow faster appreciation."[20]

An examination of selected Southeast Asian exchange rates over the last 10 years provides some support for the idea that a "renminbi bloc" has emerged (see **Figure 2**). Up until the summer of 2013, the currencies of Malaysia, the Philippines, Singapore, and Thailand closely followed fluctuations in the value of China's renminbi, except during the immediate aftermath of the global financial crisis in 2007-2008, and since July 2014. Among the Southeast Asian currencies in **Figure 2**, Indonesia's rupiah is the only exception. The rupiah appears to have followed the U.S. dollar from 2005 to 2012, diverging following the global financial crisis and depreciating relative to the U.S. dollar over the last 2½ years.

In addition to the apparent similar movements in the value of their currencies relative to China's renminbi, there is other anecdotal evidence consistent with the existence of a "renminbi bloc" in Southeast Asia. According to International Monetary Fund trade data, China has emerged as the largest trading partner for many Asian nations, including Indonesia, Malaysia, the Philippines, Singapore, and Thailand. China has also been actively promoting the use of the renminbi to settle trade payments, as well as to arrange currency swap agreements.[21]

[18] For example, "Japan Denies Currency Manipulation Claims Ahead of G20," *Reuters*, January 25, 2013; and Gerard Baker and Jacob M. Schlesinger, "Bank of Japan's Kuroda Signals Impatience With Abe Government," *Wall Street Journal*, May 23, 2014.

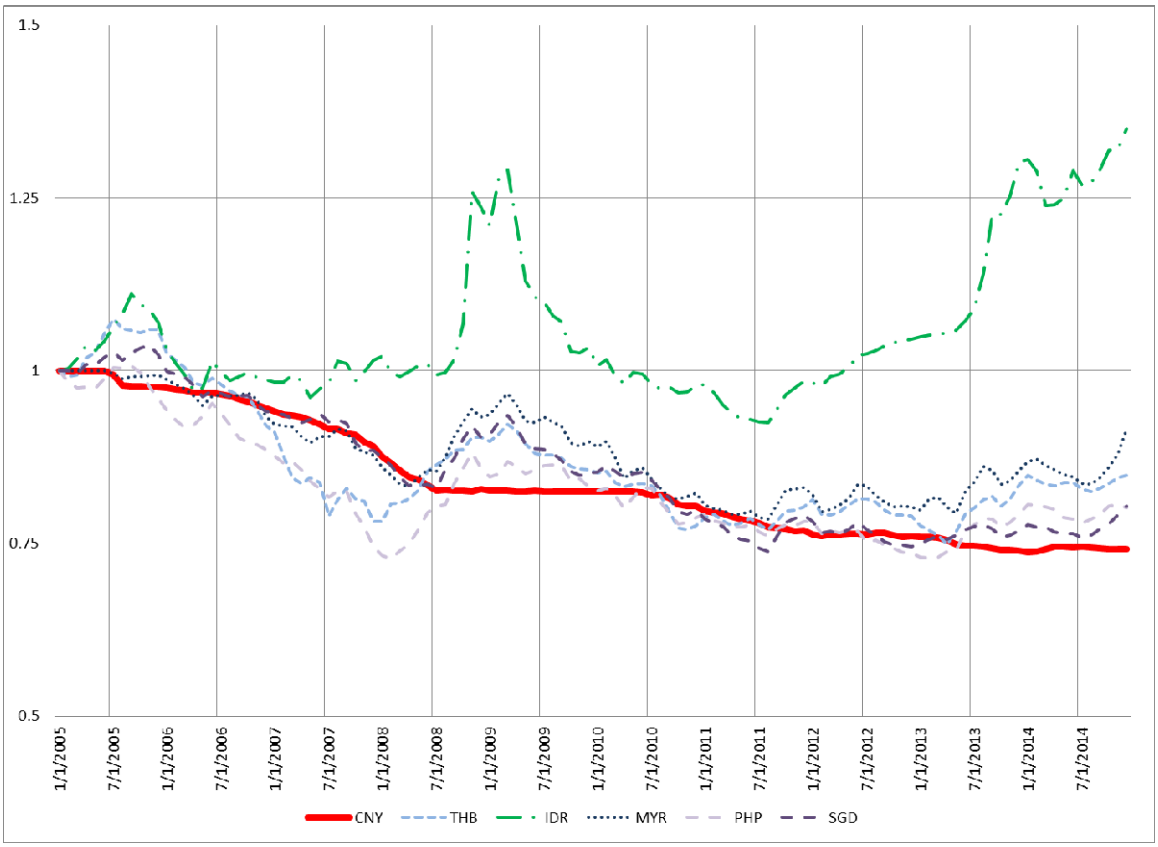
[19] Takatoshi Ito, "The Influence of the RMB on Exchange Rate Policy of Other Economies," paper presented at Peterson Institute for International Economics Conference, October 19, 2007.

[20] Ibid.

[21] For more about the growing use of the renminbi in the region, see Il Houng Lee and Yung Chui Park, *Use of National Currencies for Trade Settlement in East Asia: A Proposal*, Asian Development Bank Institute, ADBI Working Paper Series, Tokyo, Japan, April 2014, http://www.adbi.org/files/2014.04.11.wp474.currencies.trade.east.asia.pdf.

Figure 2. Indices of Selected Southeast Asian Currencies Relative to the U.S. Dollar

2005-2014; base value—January 2005



Source: CRS calculations using data from http://www.oanda.com.

Notes: CNY—China's renminbi; THB—Thailand's baht; IDR—Indonesia's rupiah; MYR—Malaysia's ringgit; PHP—Philippines' peso; SGD—Singapore dollar.

Exchange Rate Policies and Issues for Congress

While U.S. policy has generally supported the adoption of "free float" exchange rate policies, many 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 that moved more forcefully to maintain pegged or managed exchange rates.[22] As a result, there may be skepticism about U.S. recommendations for adoption of "free float" exchange rate policies.

[22] 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. Some analysts, however, have argued that pegged exchange rates and capital controls in some countries were contributing factors to the Asian financial crisis.

In addition, 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.[23] The United States generally runs trade deficits with East Asia. 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.

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[23] 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. However, in a 2010 examination of China's trade with the United States, William Cline of the Peterson Institute for International Economics maintains that a stronger renminbi will significantly reduce the U.S. trade deficit with China (a copy of his policy brief is available at http://www.iie.com/publications/interstitial.cfm?ResearchID=1636).