

## EXCHANGE RATES & SOUTHEAST ASIA

**Three approaches** (to the most important price in an economy!)

‘Nominal anchor approach’: link ER to low inflation currencies.

‘Real targets approach’: orthodoxy until 1980s; effects of ERs on real economy.

‘ER stability approach’: focus on ER volatility & its consequences.

**Options** (from fixed to flexible)

	Example	Implications
(a) Hard pegs		
Dollarization	Timor	no mon. policy; suits very small economy; must have cautious fiscal & flex prices; Argentina!
Currency board	HK	‘hard peg’; very similar to dollarization.
(b) ‘Messy middle’		
Fixed	Mal, China	Some variant generally preferred by govts, who want some flexibility but also some control. But danger that govts stick to ‘wrong’ rate; agents don’t hedge.
Fixed but adjustable	most SEA pre-crisis	
(c) Floats		

(2)

'Dirty float'	most SEA	Better insulates an economy from international
	now	volatility; especially for resource exporters. Also,
'Clean float'	Aust (+/-)	check on govts. But volatility has costs; need strong
		financial sector.

### **General points:**

Absence of consensus: prof opinion favours 'corner solutions'; govts skeptical.

Can one blame ER regimes for the Asian crisis? A contributing factor, but not a central one; consider counter-factual if had floating ER pre-crisis. Fixed by adjustable the most risky when have large and volatile ST capital flows. So inter-related issue is whether to place curbs on ST capital flows; and how.

Currency unions? Eg, a 'EMU' for Asia?

Requires macroeconomic coordination (eg, Maastricht requirements re deficits & debts). Major challenge. Also Asian countries face different business cycles (more than EU); therefore may not be suitable. As much politics as economics.

### **Conclusions:**

(3)

Very small economies: go for peg; too risky & expensive to attempt an independent MP; though how small is 'small'.

Large economies (US, Euro, to some extent Japan) generally have less ER options, since have to think of global implications.

Otherwise, float (with smoothing interventions) probably most desirable. Almost always need a floating regime post-crisis; export growth the key to recovery, and ER depreciation boosts competitiveness.

But ER regime won't 'fix' macro policy. Need prudent macro (eg, Argentina, chronic deficits owing to low tax collection); high quality banking system; credible & independent central bank; price (especially labour market) flexibility.

What kind of capital controls work? Best if ex ante cf ex post; market-based not QRs; indirect cf direct (eg, Sing – restrictions on foreigners borrowing in Sing\$); not an alternative to fundamental reform (eg, banking sector).

See Corden, *Too Sensational, ...*