Swap exchange rate pressure for policy
Stephen Grenville
The Australian Financial Review
13 September 2010
P. 25

Just as China is reluctant to see the renminbi appreciate, so too do most other East Asian countries resist pressure to appreciate their exchange rates.

One of the causes of the 1997-98 Asian crisis was the large capital flows into the region in the preceding years. These flows put upward pressure on exchange rates, enlarged current account deficits and created vulnerability to reversals of these hot money flows. Hence, when the crisis arrived there were huge falls in exchange rates.

After the crisis, the strong international advice (promoted especially by the International Monetary Fund) to these countries was to let their exchange rates float freely. They were warned that the middle ground of a managed exchange rate was not feasible; they must adopt the "corner solutions" view: their exchange rates should either float freely or be fixed immutably.

Ignoring this advice, most of these countries have successfully managed their exchange rates in a flexible but stable way for more than a decade now. Singapore and Malaysia, both running huge current account surpluses, have succeeded in keeping their exchange rate appreciation quite modest, with small volatility. Korea and Indonesia have both intervened substantially to resist fluctuations. Just about all the countries of the region have seen very substantial growth in their foreign reserves, reflecting their resistance to appreciation. The corner-solutions approach didn't find favour, and the infeasible middle ground turned out to be quite feasible, after all.

This strategy of resisting exchange rate appreciation makes some sense. A dynamic export sector has been a central component of the outstanding Asian growth performance. Competing in world markets has forced innovation and productivity. This is the same export-oriented strategy that was pioneered so successfully by Japan, which had a super-competitive exchange rate until the 1970s.

In theory these fast-growing emerging countries should run current account deficits funded by foreign capital inflow. But, still scarred by the 1997 crisis and observing the breakdown of financial markets in 2007, these countries are content to run current account surpluses even if this doesn't maximise growth. The world conjuncture will make this strategy harder to maintain over the next few years. As the United States, Japan and Europe all face the prospect of a lethargic recovery, interest rates in these countries seem likely to stay close to their current near-zero level. Asia, on the other hand, is growing again at close to normal rates: higher interest rates will be needed, which will open up a very substantial interest differential.

Investors in the mature economies will be switching an increasing volume of their funds away from their stagnant domestic economies towards the higher interest rates and better growth prospects in Asia. US, European and Japanese portfolios are huge compared with the still-modest financial markets in East Asia. Redirecting even a small proportion of these funds will represent a large relative inflow for the recipient countries and put substantial pressure on their exchange rates.

Asian central banks can go on resisting appreciation by buying foreign currency, but foreign reserves are already more than adequate. The monetary effects of the reserve build-up can be successfully sterilised but this action is not costless. Even if it is feasible, it may not be good policy because these reserve holdings have to be financed. When this funding amounts to 20 per cent to 30 per cent of gross domestic product (as it does in many countries, even leaving aside China's extreme case) other, more important investment gets crowded out.

Coping with these pressures requires new policies. The key point is that international markets are delivering more foreign capital inflows than these countries can comfortably absorb.

Part of the answer must be to discourage those elements of the inflow that are of least benefit to the recipient countries – generally the short-term flows with their characteristic flightiness.

Until recently, exploring capital controls to limit inflows would have incurred the wrath of the IMF, vigilant defenders of free markets and promoters of unrestricted international capital flows. But, belatedly, the IMF has come to realise that you can have too much of a good thing. Financial markets still regard such measures as anathema (it is in their interests to have as few restrictions as possible), but they will adapt to such measures, just as they have learnt to work with other inconvenient policies.

While countries are looking at ways of discouraging excessive short-term inflows, they might revisit their general tax regimes. In earlier times when countries were desperate to attract foreign capital to fund imports, foreign investors were often given advantageous tax breaks. There is no longer any reason to do this. And where double tax agreements have allowed foreigners to avoid paying tax in the recipient country, this might be reconsidered as well.

Measures along these lines might relieve some of the pressure for excessive structural exchange rate appreciation. The inexorable rise of reserve holdings, a byproduct of the current measures to resist this appreciation, could cease. These countries will still want large foreign exchange reserves because they have seen the damage that volatile capital inflows can do. But instead of a relentless rise, we would see reserves rising and falling, being used to counter the market's fickle waves of optimism and pessimism.

The focus of policy would then be on trying to keep the exchange rate somewhere near its equilibrium level, which will evolve over time. For these high-productivity countries, some appreciation over time represents good policymaking. If these countries are released from the blinkered idea of the corner solutions, and if the legitimacy of a flexibly managed exchange rate was accepted by the IMF and financial markets, then policy could focus on distinguishing structural shifts in the equilibrium exchange rate from the instabilities that characterise free-market exchanges rates.

Stephen Grenville is a visiting fellow at the Lowy Institute for International Policy and a former deputy governor of the Reserve Bank of Australia.