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Helmut Reisen and Axel van Trotsenburg\*

## Should the Asian NICs Peg to the Yen?

*Recently, the calls for closer monetary co-operation between the Asian NICs and Japan have been becoming louder. The following article discusses the pros and cons of pegging to the yen and compares them with those of a basket peg.*

The search for a solution to global current account imbalances and, in particular, to the US trade problem has led to the discovery of the East Asian NICs (Newly Industrialising Countries) – Hong Kong, Korea, Singapore, Taiwan – about two years ago.<sup>1</sup> First, the discussion has centered on currency *misalignments* following requests from the US Treasury that the NICs appreciate their exchange rates.<sup>2</sup> Now, the discussion is taking a more sophisticated direction with a new focus on the appropriate exchange rate *regimes*.

The discussion on exchange rate regimes takes a rather longer-term view of possible developments within the international monetary system. This also was at the heart of recent statements by the President of the Deutsche Bundesbank when he stated with respect to the NICs and Japan, "The Pacific Basin should perhaps follow the monetary policy example set by Europe. It is for instance conceivable that Japan and a number of NICs, once they have moved rather closer together in their trade and economic policies, could one day launch a kind of Asian Monetary System on the pattern of the EMS (European Monetary System). In this way, so to speak, a tripolar global monetary system might come into being, with a dollar area, a Pacific zone and a European Economic and Monetary Union".<sup>3</sup>

It is within this context that we will attempt to evaluate the scope for a closer monetary co-operation between Japan and the NICs. We will try to find a partial answer based on economic considerations received from the optimum currency area approach and the literature on exchange rate regimes in developing countries. We will leave aside political considerations although we do not ignore how essential they are for the economic integration of sovereign nations.

The exchange rate management of all four NICs has generally been applauded for supporting the export-led

development these countries initiated at the end of the 1950's and beginning of the 1960's. But they adopted quite different financial and exchange regimes. Table 1 conveys that Korea and Taiwan maintained tight exchange controls and strictly regulated their domestic financial markets (which they only recently started to relax a bit). By contrast, the common characteristics of restricted financial markets are absent in Hong Kong and Singapore as well as Japan.

During the first half of the 1980's the Asian NICs' exchange rate policy has been characterised by a strong orientation towards the US dollar and by keeping the variation in the trade-weighted and inflation-adjusted (real effective) exchange rate to a minimum. As long as the NICs met this target with success between 1980 and 1985 when their currencies moved in line with the yen in real effective terms, their exchange rate policy did not stir much criticism. However, 1985 marked the turning point.

As Figure 1 shows, beginning in the first half of 1985 and reinforced after the Plaza Agreement there has been a growing discrepancy between the movement of the real exchange rates of the NICs and Japan. This was caused by the sharp depreciation of the US dollar vis-à-vis key currencies (e.g. yen, D-mark) since 1985. On the other hand, NICs maintained either a de-facto peg to the US dollar or appreciated significantly less vis-à-vis the US dollar than the yen did, leading to a depreciation of NICs' currencies in real effective terms. This has enhanced their competitive position internationally and helped to boost exports and increase trade surpluses. Korea and Taiwan have even moved into major overall

<sup>1</sup> Hobart Rowen: U.S. to ask Taiwan, South Korea to Allow Currencies to Rise, in: The Washington Post, July 30, 1986.

<sup>2</sup> See, e.g., Bela Balassa and John Williamson: Adjusting to Success: Balance of Payments Policy in the East Asian NICs, Institute for International Economics, Washington D.C. 1987; Rudiger Dornbusch and Yung Chul Park: Korean Growth Policy, Brookings Papers on Economic Activity, Vol. 2, 1987, pp. 389-454; Morgan Guaranty: World Financial Markets, January 1987 and March 1988.

<sup>3</sup> "Herr Pöhl reviews recent monetary and economic trends with particular reference to East Asia", in: BIS Review, 18th March 1988, p. 2.

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current account surpluses which, in the case of Taiwan, reached beyond the 20 per cent of GNP in 1987. Since the NICs' export increase to the United States since 1985 represents a considerable proportion of the total increase of US imports over the period, the NICs have been blamed with preventing the global adjustment process towards financeable trade balances, reaping windfall profits behind the shield of the yen appreciation, and exercising exchange rate protection.

These criticisms, however, can hardly be substantiated, except for Taiwan. Exchange rate protection is characterised by the preferential treatment the tradable sector receives vis-à-vis the non-tradable sector through maintaining an undervalued exchange rate or effectively preventing its appreciation. If the subsequent shift towards the tradable sector is accompanied by a decrease in absorption in order to balance supply and demand in the non-tradable sector, a current account surplus and higher stocks of foreign reserves will be the logical consequence.<sup>4</sup> Table 2 reveals, however, that Korea's foreign reserves remained remarkably stable in terms of imports throughout the 1980's. Since 1986, it has been using its current account surplus to pay off part of its massive foreign debt, benefitting from favourable external conditions such as lower interest rates and raw material prices. Neither Korea nor Hong Kong and Singapore are traditional surplus countries. The current accounts of Hong Kong and Singapore have fluctuated between -1.5 billion and +2 billion dollars during the 1980's.

Taiwan, by contrast, recorded increasing foreign exchange reserves, culminating in 77 billion dollars at the end of 1987, which represented the world's third largest reserves. Translated into terms of months of imports, the country's foreign exchange holdings jumped from a 1980-84 average of 4.3 to 21.2 in 1987 (Table 2). However, excessive reserves entail considerable economic cost. First, they provide a low yield as compared to alternative allocation possibilities for export earnings, be it in foreign and domestic investment, be it in improved social welfare for Taiwan's current population. Second, unless Taiwan fully sterilises its interventions on the foreign exchange market, the build-up of foreign reserves will affect the money supply and eventually fuel domestic inflation. If this is the case, sooner or later the real exchange rate will move to bring about a new equilibrium under both fixed and flexible rate policies. The exchange rate will then appreciate in real terms due to a growing inflation differential between Taiwan and its trade partners. Third, although economic growth has not yet been adversely affected by the sterilisation efforts, the risks are inherent. The sterilisation policy, together with heavy regulation of the banking and housing sectors, has depressed domestic investment, down from 30 percent of GDP in the early 1980's to a mere 18 percent during 1985-87. This could jeopardise the country's competitive position and its growth prospects, if it fails to

<sup>4</sup> W. Max Corden: Protection, Growth and Trade, Oxford 1985, Chapters 17 and 18.

Table 1  
Exchange System and Exchange Controls

	Hong Kong	Korea	Singapore	Taiwan	Japan
<b>I. Exchange Arrangement</b> separate exchange rates(s) for capital and/or trade transactions	No	No	No	No	No
<b>II. Payment Restrictions</b>					
1. Restrictions concerning current transactions	No	Yes <sup>1</sup>	No	No	No
2. Restrictions concerning capital transactions	No	Yes <sup>2</sup>	No	Yes <sup>6</sup>	No
<b>III. Cost-Related Import Restrictions</b>					
1. Import surcharges	No	Yes <sup>3</sup>	No	Yes <sup>7</sup>	No
2. Import deposits	No	Yes <sup>4</sup>	No	Yes <sup>8</sup>	No
<b>IV. Surrender Requirement for Export Proceeds</b>	No	Yes <sup>5</sup>	No	No	No

Notes:

<sup>1</sup> For remittances over US\$ 20,000 authorization from the Bank of Korea is required.

<sup>2</sup> All foreign investments and loans by residents to non-residents require approval. Foreign direct investment in Korea is allowed in all areas which do not appear on a "negative" list. Foreign borrowing needs authorization.

<sup>3</sup> A 2.5 per cent defence surcharge applies to most imported goods.

<sup>4</sup> A 15 per cent advance deposit is required when opening usance (deferred payment) or sight letters of credit.

<sup>5</sup> Surrender of export proceeds to a foreign exchange bank at its posted customer rate or be deposited in foreign exchange accounts in banks.

<sup>6</sup> Foreign borrowing requires prior approval.

<sup>7</sup> In 1984, Taiwan has agreed to gradually eliminate the 10 per cent import surcharge.

<sup>8</sup> A 10-15 per cent performance deposit is required for imports.

Sources: IMF: Exchange Arrangements & Exchange Restrictions, Annual Report 1987; International Currency Analysis: 1985 World Currency Yearbook Brooklyn, N.Y. 1986.

upgrade its industries and to improve its infrastructure in the longer run.

Taiwan's current account imbalance cannot be redressed as long as the country does not encourage new investment and reduce saving in favour of increased domestic consumption. With respect to the other NICs, only Korea's savings-investment balance has markedly changed during the 1980's and moved into surplus since 1986. While investment was maintained at around 30 percent of GDP, the savings ratio has significantly increased (thanks mainly to the public budget improvement). This has enabled the repayment of foreign debt in a growth-oriented way. However, Korea's and Taiwan's current account surpluses reflect not only the internal but also the external saving-investment imbalance, and in this case particularly that of the USA. Global current account imbalances are likely to persist as long as the USA fails to raise its savings ratio and to resolve its twin deficits.<sup>5</sup> Seen from that perspective, the monetary focus on exchange rates provides only little explanation of the present East Asian surpluses.

Nevertheless, the growing trade and production integration among the Asian NICs and Japan still warrants the discussion about their implications for the choice of an appropriate exchange regime. The options for the NICs are freely floating exchange rates, pegging to a single currency (or membership in a monetary system), and pegging to a basket of different currencies.

A free float is generally ruled out in the literature as a realistic option for developing countries. It is argued that limited capital markets, restrictions on capital flows, thin foreign exchange markets, and a prevalence of real shocks would increase the volatility of exchange rates under independent floating.<sup>6</sup> The pros and cons of a free float in developing countries still lack serious empirical evidence for recent years. Anyway, the polar case of fixed versus flexible exchange rates is not a relevant comparison in the present situation. Our concern is more with the choice of the peg, i.e. whether Asian NICs should peg to the yen or to a basket of currencies. We will first make the case for a greater role of the yen in

setting the NICs' nominal exchange rates. But then we will discuss the present impediments to an early peg to the yen or a premature monetary system among the five economies along the lines of the EMS.

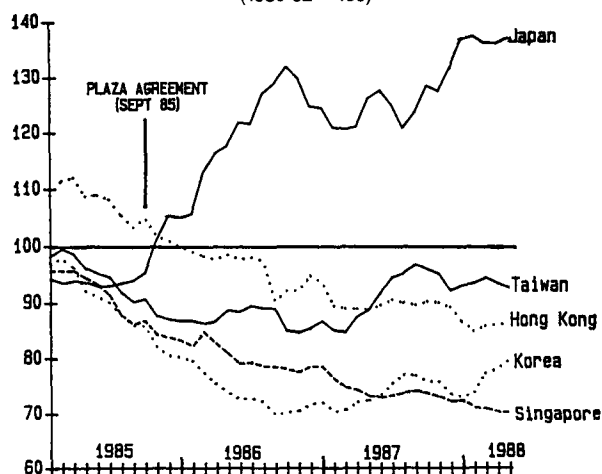
### The Case For More Integration

What makes countries better or worse candidates for monetary integration? Tower and Willett conclude in their celebrated survey on optimum currency areas, "Perhaps the most important condition for a successful currency area is that there be a reasonable degree of compatibility between the member countries' attitudes towards inflation, growth, and unemployment and their abilities to 'trade off' between these objectives".<sup>7</sup> While inflation differentials among Japan and the four NICs have been quite important during the 1970's, they have narrowed significantly in the 1980's and especially after 1985 (Table 2). Inflation differentials among the five Asian countries are much smaller than is the case for the EMS countries.

Low inflation went along with low unemployment and high income growth during the last three years. To be sure, all five countries have benefitted from depressed raw commodity prices which constitute a large part of their imports. But, which is more important for the long-term price trend, all are characterised now by a low public debt burden and the absence of non-interest budget deficits which would risk being monetised eventually.<sup>8</sup> Hence, low inflation differentials are likely to obviate the need for frequent *nominal* exchange rate adjustments among the five countries.

Similar production structures, considerable supply

**Figure 1**  
**Real Effective Exchange Rates, 1985-88**  
(1980-82 = 100)



Source: Morgan Guaranty: World Financial Markets. A rise of the index denotes appreciation.

<sup>5</sup> See BIS: 58th Annual Report, Basle, June 1988, pp. 55-61.

<sup>6</sup> John Williamson: A Survey of the Literature on the Optimal Peg, in: Journal of Development Economics, Vol. 11 (September 1982), pp. 39-61, reprinted in: Chris Millner (ed.): Political Economy and International Money, Selected Essays of John Williamson, New York 1987, pp. 94-116.

<sup>7</sup> Edward Tower and Thomas D. Willett: The Theory of Optimum Currency Areas and Exchange-Rate Flexibility, Special Papers in International Economics, No. 11, Princeton University 1976, p. 15; another valuable survey on the optimum currency area approach is provided by Yoshihide Ishiyama: The Theory of Optimum Currency Areas: A Survey, in: IMF Staff Papers, Vol. 22.2, July 1975, pp. 344-383.

diversification and proven adjustment flexibility reduce the need for large swings in the *real* exchange rates among the five countries. Japan and the four NICs are all net importers of raw materials and net exporters of manufactured products (although Singapore depends indirectly on her commodity-dependent neighbours). The similar economic structure protects the five countries from divergent swings in real exchange rates in response to commodity booms and slumps.

Kenen argues that, if countries have built up a highly diversified production structure, they are better prepared to adopt a fixed exchange rate regime than less diversified countries.<sup>9</sup> The need for frequent changes in the terms of trade, and therefore for frequent changes in exchange rates, is in fact forestalled by the deepened industrial diversification of the five economies. The same argument applies when countries, such as the Asian NICs, are highly open and

show a quick responsiveness to changes in macroeconomic variables. The proposition that open, diversified and flexible economies need less exchange rate changes to generate foreign exchange worth an extra percent of GDP has recently been confirmed for Korea, in contrast to most Latin American debtor countries, which started with the same debt-GNP ratios but did not escape their debt problems when the 1980's unfolded.<sup>10</sup>

The country characteristics mentioned would imply rather stable exchange rates among the five Asian economies. Exchange rate stability could also be fostered by the emerging regionalisation of the world economy. Given that the USA has become a net debtor and will attempt to cut the current account deficit in the years to come, Japan and the NICs have to seek a market diversification away from the USA. The most promising and dynamic alternative is an increase in intra-regional trade between the five countries. Therefore, more trade integration will be a necessary condition for closer monetary co-operation in the medium run and vice versa. A stable monetary environment will enhance the exchange rate stability which, in turn, is conducive to trade.

Asian monetary integration would strengthen the yen as an international currency, which could help to counter inflationary pressures on Japan and the NICs, if they were to emerge again from the United States. In this

Table 2  
Key Country Characteristics

	Period	Japan	Hong Kong	Korea	Singapore	Taiwan
<b>GDP per capita</b> (PPP at 1975 dollar prices)	1985	6.920	4.880	2.678	5.355	3.160
<b>Consumer prices</b> (% change)	1975-79	7.3	6.7	16.8	2.7	6.1
	1980-84	3.9	10.8	10.5	3.8	6.5
	1985-87	0.9	4.0	2.7	-0.2	0.5
<b>Unemployment (in %)</b>	1975-79	2.0	3.3	3.8	4.0	1.8
	1980-84	2.3	3.9	4.4	3.7	2.0
	1985-87	2.7	2.4	3.6	4.7	2.5
<b>Productivity</b> <b>in manufacturing</b>	1975-79	5.8	7.9	6.2	4.0	11.5
	1980-85	3.2	7.2	5.6	3.0	4.0
<b>Share in NICs exports (in %)</b>	1980-86					
USA		—	30.3	33.4	17.5	43.9
EEC		—	18.2	12.6	10.6	11.6
Japan		—	4.5	15.6	9.4	10.8
<b>Share in NICs imports (in %)</b>	1980-86					
USA		—	10.3	22.5	14.2	23.1
EEC		—	11.7	8.8	10.8	11.1
Japan		—	22.5	26.0	18.3	28.6
<b>Current Account/GNP</b>	1980-85	1.5	-0.9	-4.1	-6.2	6.6
	1986	4.3	4.1	4.9	2.9	22.1
	1987	3.6	2.6	8.2	-0.5	21.7
<b>Foreign reserves</b> (in months of imports)	1980-84	2.2	n.a.	2.8	4.6	4.3
	1985	2.5	n.a.	2.9	7.6	10.4
	1986	4.0	n.a.	2.7	7.9	18.7
	1987	6.5	n.a.	2.6	6.5	21.2

Sources: Hong Kong Monthly Digest of Statistics, various issues; Economic Planning Board: Major Statistics of Korean Economy; Yearbook of Statistics Singapore 1985/86; Ministry of Trade and Industry: Economic Survey of Singapore; Council of Economic Planning and Development: Taiwan Statistical Data Book 1987; IMF: Direction of Trade Statistics Yearbook, 1980-86; IMF: World Economic Outlook, 1988; OECD Economic Surveys: Japan, various issues.

way, the Asian region could restore the independence of collective monetary control by surrendering individual national monetary sovereignty. The problem, of course, is that monetary policy would no longer be decided in the NICs, but essentially in Tokyo.

Loss of monetary authority, however, sounds more dramatic than it is in reality in the case of the Asian NICs. Only a free float permits monetary authorities to determine independently the domestic money supply. In fact, all four NICs have maintained a sort of peg to the US dollar. Thus, monetary independence, in spite of extensive foreign exchange controls in Korea and Taiwan, has not been enjoyed by any of the four NICs. Moreover, they all now dispose over sufficient foreign exchange reserves<sup>11</sup> which allow for some autonomy in the conduct of short-term monetary policy.

### The Case against Pegging to the Yen

Although we advocate a greater role for the yen in Asian NICs' exchange rate policies, the establishment of an Asian Monetary System is premature even if it remains a longer-term option. Basically, two obstacles stand in the way of the realisation of such a system in the short to medium run. First, in a world of floating key currencies, and given the low degree of trade integration among the five countries, the NICs would suffer from increased macroeconomic instability. Second, the role of the yen in the world economy and the difference in stages of economic development between Japan and the NICs provide a strong argument for trend flexibility in exchange rates. Third, as in the EMS a genuine monetary integration requires the abolition of existing foreign exchange controls which are still widespread in the Asian region.

Assume that with four small middle-income countries and a large industrial (reserve-currency) country any exchange rate arrangement is bound to become asymmetrical.<sup>12</sup> Japan would keep monetary independence and the four NICs would peg their currencies to the yen. By pegging to a single currency, floating rates among key currencies destabilise the effective exchange rates and increase the macroeconomic effects of external shocks for the Asian NICs, as theoretical and empirical evidence on the optimal peg has abundantly shown.<sup>13</sup> With a peg to the

yen, the NICs would find themselves forced to revalue their currencies against non-yen currencies if the yen appreciated sharply in the foreign exchange market. By pegging to a trade-weighted basket instead, the NICs can reduce the effect on their international trade of large swings in the values of the individual currencies in the basket.

Fluctuations in the value of the currency to which a particular currency is pegged would matter little as long as the bulk of foreign exchange transactions in trade and services (including foreign debt service) is denominated in the pegged currency. That is clearly not the case for the Asian NICs with respect to the yen, nor will it be so in the foreseeable future. To be sure, there has been rapid integration of trade and foreign direct investment recently among the five economies.<sup>14</sup> Japan is shifting assembly and low technology production to the region at a rapid pace. The NICs are narrowing or even reversing their chronic trade deficits with Japan in standardised products such as textiles, steel and TVs. But even if Korea, Taiwan and Japan quickly abolished existing trade restrictions, there would still be a long way to go before intra-regional trade replaced the existing dominance of the US, European and raw commodity producing trade partners (Table 2). Trade integration among the Asian economies is weak even compared with that which existed among European economies when the EEC was founded.

The second case against a monetary union among Japan and the Asian NICs centres on the desirable degree of deviations from purchasing power parities (PPP). The United States is now the world's biggest net foreign debtor, while Japan is the world's biggest creditor. Henceforth, the US dollar will be cheap in terms of PPP in order to avoid the US running into excessive debt, and the yen will be expensive. Japan's net foreign asset position implies a long-run upward pressure on the yen which the NICs would be obliged to follow if they pegged to the yen. In view of the NICs' stage of development, this would be premature. They are still industrialising, and their per capita income (PPP adjusted at 1975 US dollar prices) is only half that of Japan (Table 2).

<sup>11</sup> The level of official reserves is undisclosed for Hong Kong because it does not publish statistics on the balance of payments.

<sup>12</sup> There is widespread agreement that the EMS, even though it consists of a more balanced set of countries than would a monetary system between Japan and the NICs, has been dominated by Germany. See e.g. D. Cohen, J. Melitz and G. Oudiz: *The European Monetary System and the Franco-Mark Asymmetry*, CEPR Discussion Paper No. 245, London, May 1988.

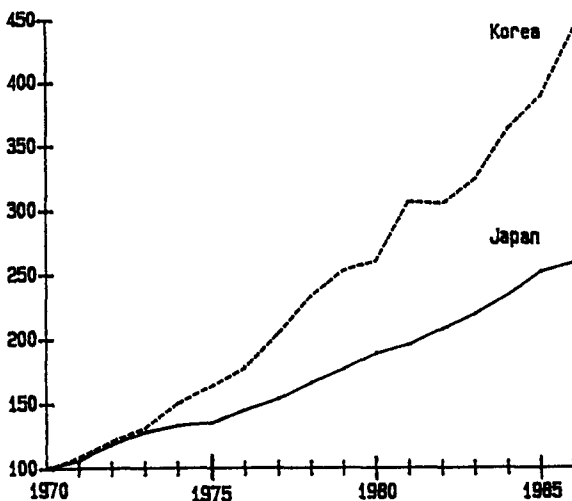
<sup>13</sup> For theory, cf. Stanley W. Black: *Exchange Policies for Less Developed Countries in a World of Floating Rates*, Essays in International Finance, No. 11, Princeton University 1976; and John Williamson, *op. cit.*; for empirical evidence, see Bela Balassa: *The International Monetary System and Exchange Rate Policies in the Developing Countries*, World Bank DRD Discussion Paper No. 294, May 1987.

<sup>14</sup> Whereas Japan's total trade with the NICs still constituted 10.6 percent in the first quarter of 1986, it had increased to 16 percent by the last quarter of 1987. Data Resources, in: *Japanese Review*, 1988, pp. 61-73.

Real exchange rates should remain flexible in the long run to accommodate Japan's move to a post-industrial economy and the NICs' further economic development.<sup>15</sup> Rich countries are generally expensive countries because in the course of development productivity in the tradable sector rises more than in the non-traded service sector. The prices of non-tradables (such as housing) therefore rise faster than those of traded goods, reflecting the increasing scarcity of the former. To encourage a smooth shift in optimum location for producing standardised products in the Asian region, the NICs should remain cheaper in terms of PPP than Japan, and they should gradually become less undervalued in the course of catching up on Japan.

A related argument for trend flexibility of exchange rates comes from the fact that countries with divergent rates of productivity growth cannot have the same inflation rate under fixed exchange rates.<sup>16</sup> For example, although productivity growth is still high in Japan, it has been largely exceeded by Korea's productivity trend (Figure 2). Assuming equal inflation of tradables, wages in Korea will therefore rise faster than in Japan. With lower productivity growth in the non-tradable sector in both countries, prices for local goods, and according to their weight in the PPP basket, general prices will rise faster in Korea than in Japan in order to balance the impact of higher money wages on the non-tradable sector. Hence, zero or low inflation in countries with divergent productivity trends will require exchange rate flexibility.

**Figure 2**  
Productivity Growth in Manufacturing, 1970-86  
(1970 = 100)



Sources: B. Balassa and J. Williamson: *Adjusting to Success: Balance of Payments Policy in the East Asian NICs*, 1987; Economic Planning Board: *Monthly Statistics of Korea*, 1987; US Department of Labor: *Monthly Labor Review*, Dec. 1987.

Finally, close monetary co-operation in East Asia cannot work unless Korea and Taiwan liberalise their domestic financial markets and abolish foreign exchange controls. However, the widespread failure of financial liberalisation experiments in Latin America recommends caution.<sup>17</sup> Since the preconditions of a successful liberalisation are macro-economic stabilisation (especially in the fiscal realm) and a liberalised current account, Korea and Taiwan should now be in a position to start opening up the capital account. Both economies have stepped up efforts to liberalise their imports during the 1980's. Keeping in mind the pitfalls of a too rapid opening-up process, gradualism may be the best strategy to adopt. For example, Korea's banking sector has been plagued with a relatively large share of bad loans on its books. It could certainly not sustain an immediate opening up and compete effectively with foreign banks.

### The Choice of the Peg

The economic evaluation of a possible peg by NICs to the yen has identified the pros and cons of such a measure. Clearly, we can rule out a yen peg as a viable short-term option, not only on the grounds of the different stages of development but also because of the small amount of intra-regional (Japan-NICs) trade. At the same time, we found room for closer co-operation and, therefore, we suggest that NICs should move in this direction.

If floating is discarded, the best exchange rate regime for the Asian NICs is to peg to a trade-weighted basket of exchange rates. A basket peg is superior to a single-currency peg for small, open economies with diversified trade partners because it insulates better their ratio of traded to non-traded goods prices from third-country exchange-rate changes. By stabilising the (real) effective exchange rate, a basket peg minimises the terms of trade and real income effects of external shocks, reduces the uncertainty for traders, and limits the extent of over- and undervaluation of the currency. The literature on exchange rate policies in developing countries agrees that the choice of the peg should be mainly guided by the search for internal balance, and not by the current account alone.

<sup>15</sup> Cf. Herbert Giersch: *Real Exchange Rates and Economic Development*, Kiel Working Papers No. 218, November 1984.

<sup>16</sup> Cf. Rudiger Dornbusch: *Doubts About the McKinnon Standard*, in: *Journal of Economic Perspectives*, Vol. 2.1, Winter 1988, pp. 105-112.

<sup>17</sup> Cf. Sebastian Edwards: *The Order of Liberalization of the External Sector in Developing Countries*, Essays in International Finance, No. 156, Princeton University, December 1984.