

Virtuous Harmony:
Asia's Responsibilities and Interests in Currency Liberalization

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Abstract

Many export-dependent Asian economies rely on central bank interventions to sustain cheap currencies, to the extent that Asian exchange rate policy has almost become synonymous with 'currency interventions'. Although such policies create market distortions that pose significant risks to the stability and health of the global economy, the IMF appears reticent to take action. This essay argues that Asia can take on greater responsibilities commensurate with its growing economic weight by liberalizing its exchange rate regimes, not by relying on external inducements from international financial institutions but by appealing to its self-interest. Asia's exchange rate regimes limit its own prospects for development, due to (1) inflation costs and limitations on monetary policy, (2) efficiency costs and limitations on long-term growth, and (3) strategic vulnerabilities. Liberalization, by abandoning exchange rate manipulation for cheap exports, will allow market forces a greater role in balancing currencies and capital flows – achieving a 'virtuous harmony' that will allow Asian nations to grow stronger while also discharging their responsibilities to the international financial system, better enabling Asia to take on a greater role in the global economy.

Introduction

为无为，则无不治。

- 老子，「道德经」第三章

[The Sage rules] through non-intervention, and all is in *harmony*.

- Lao-tzu, Tao Te Ching chapter 3

子曰：为政以德，譬如北辰，居其所而众星共之。

- 孔子，「论语」卷一为政第二

To rule with *virtue*, be as the unmoving North Star, around which all stars revolve.

- Confucius, Analects 2:1

As Asia plays a greater role in the global economy and the international financial system, perhaps it might find wisdom in its own philosophies on governance: some scholars identify elements of classical liberal economic thought in ancient Taoist, Confucian, and Zen Buddhist philosophy¹. However, contemporary Asia's involvement in the global economy often runs against the tenets of market liberalism, most visibly in the success of the 'East Asian Economic Model' or 'East Asian Development Model' (Lian 2001, Richter 2000).

The 'East Asian Development Model' is that of the 'High Performing Asian Economies' (HPAEs), beginning with Japan and then shifting to the 'East Asian Tigers' of Hong Kong, Singapore, Taiwan and South Korea, then the newly industrialized Southeast Asian countries of Indonesia, Malaysia and Thailand, and most recently China. While

¹ Boaz (1997) identifies Laozi as the "first known libertarian". Rothbard (1995) claims "The Taoists were the world's first libertarians, who believed in virtually no interference by the state in economy or society". Long (2002) identifies precursors of free-market and civil libertarian thought among the ancient Chinese schools of philosophy, with particular focus on early Confucian thinkers. Donner (1997) identifies libertarian themes in Eastern mysticism, including Hindu and Zen Buddhist thought, and posits a "Mahayana Libertarian".

specific development strategies among HPAEs have differed on a range of areas, all of them have pursued export-driven models of development (World Bank 1993) that relied on, among other policies, sustained currency intervention. Currency regimes to keep exchange rates artificially low make exports cheap and imports dear, supporting exporting industries and protecting domestic ones from foreign competition.

Though official IMF classifications describe most Asian exchange rate regimes as 'managed floats', scholars have attempted to distinguish *de facto* from *de jure* regimes, some noting that most are really adjustable pegs, and that those that claim to float have intervened repeatedly – a “fear of floating” (Benassy-Quere 1996, Frankel 2003, Calvo and Reinhart 2002). As few Asian central banks openly admit to currency intervention, the accumulation of massive foreign exchange reserves in US dollars is often treated as circumstantial evidence of manipulation (Goldstein 2004).

Perhaps of greatest interest to the international financial system is China's exchange rate regime, in which the renminbi has been estimated by some to be undervalued up to 35 percent, though opinions differ widely on the range of variance, and whether it is undervalued at all². China has more than 800 billion USD in foreign exchange reserves³, 200 billion of which were acquired in 2005 alone. Roughly three quarters of its reserves are invested in US Treasury bills and dollar-denominated assets⁴.

² The IMF Country Report (2004) states that “it is difficult to find persuasive evidence that the renminbi is substantially undervalued” yet “views among academics and market analysts...vary widely, with estimates of the degree of undervaluation ranging from 0 to 35 percent.”

³ *Xinhua English*, “Foreign exchange reserves reach \$818.9 bln” 15 Jan 2006.

⁴ *Washington Post*, “China Set To Reduce Exposure To Dollar” 10 Jan 2006.

Yet this is only one example in a larger trend throughout Asia. Since the collapse of the Bretton Woods system in the 1970s, the Japanese Yen has been heavily undervalued, weakened through interventions despite adopting a floating rate in 1973. Recent interventions to buy foreign exchange have only grown larger, having totaled 20 trillion Yen in 2003⁵. Japan's current reserves are almost 850 billion USD, even larger than China's. In the 1980s, the US Treasury classified South Korea as an exchange rate manipulator, with the IMF sending a 'supplemental consultation' to investigate. Still, South Korea's foreign exchange reserves now amount to more 200 billion USD⁶ while Taiwan's reserves exceed this, standing at 250 billion⁷. Just recently, Indonesian Vice-President Jusuf Kalla said that the government favors a stable rupiah-dollar exchange rate as a "too strong" rupiah would hurt exports⁸.

It is in this climate of Asian exchange rate regimes, that we seek to ascertain the effects of Asian currency manipulation.

I. Theoretical Currency Manipulation Traps

A. Prisoner's Dilemma

The framework of game theory may be useful in illustrating the dynamics of currency interventions⁹. In a simple 'Prisoner's Dilemma' model with two trading countries as 'players', where each may choose to 'cooperate' in the international financial system and compete fairly, or 'defect' by devaluing its currency, each country gains a

⁵ *Asia Times*, "Dollar Slide to Push Euro to New Heights" 7 Jan 2004.

⁶ *Associated Press*, "S. Korea's Foreign Exchange Reserves Surge" 17 Jan 2006.

⁷ Central Bank of China press release, "Foreign Exchange Reserves as at the End of December 2005" Jan 5 2006

⁸ *Jakarta Post*, "Indonesian VP wants U.S. dollar stable at Rp 9500 to Rp 10 000" Jan 13 2006

⁹ A related example is Drezner (2005) which extends the prisoner's dilemma to central bank decision-making.

significant relative advantage from the boost to exports if it is the only one to devalue. However, if both countries devalue their currencies, both will be worse off than if they had mutually cooperated, with no relative advantage gained from the financial instability wrought.

Country A Country B	Non-intervention	Devalue
Non-intervention	R,R	S,T
Devalue	T,S	P,P

Where $T > R > P > S$

The payoff matrix is such that each country will always stand to gain more (or lose less) relatively from devaluing their currency, regardless of what the other does – in the equilibrium the defection strategy strictly dominates the cooperation strategy. The dilemma is that when both countries rationally pursue their own interests, both obtain a worse outcome than if they had cooperated. Ludwig von Mises (1996) describes this trend in the international financial system towards competitive devaluation:

[The effectiveness of exchange devaluations policies] depend on the condition that only one country devalues while the other countries abstain from devaluing their own currencies... If the other countries devalue in the same proportion, no changes in foreign trade appear... If they devalue to a greater extent, all these transitory blessings, whatever they may be, favor them exclusively. A general acceptance of the principles of the flexible standard must therefore result in a race between the nations to

outbid one another. At the end of this competition is the complete destruction of all nations' monetary systems.

To avoid this pareto-suboptimal outcome, the international financial order has formed 'collective action' institutions to enhance cooperation and constrain defection. The IMF Articles of Agreement 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."¹⁰ However, IMF enforcement of this statute is less than assuring and it has only twice in the past 25 years sent a 'supplemental consultation' to investigate an exchange rate problem¹¹.

While this is a highly simplistic model of exchange rate dynamics (a more realistic model would be multi-player and iterated), its fundamental mechanics reflect the real world impacts of exchange rate manipulation in a global economy.

B. Globalization, the Unholy Trinity, and the Tinbergen Principle

Goodman and Pauly (1995) argue that transformations in the structure of global production and international financial markets have made it both possible and desirable for firms to successfully evade government controls. This has made government attempts to control capital movements more costly and less effective. Edwards (1999) finds that "Legal controls on capital mobility are not always translated into actual restrictions on these movements. In country after country the private sector has found

¹⁰ IMF Articles of Agreement, Article IV Section 1, paragraph iii

¹¹ The two incidents were Sweden in 1982 and Korea in 1987.

ways of getting around controls”, such as through “overinvoicing of imports, the underinvoicing of exports, and the mislabeling of the nature of the capital movement.”

This has implications for the capacity of governments to manage the balance of payments. A basic principle of macroeconomics is that no country can simultaneously have capital mobility, a fixed exchange rate, and an independent monetary policy. With capital mobility, interest rates cannot vary between countries, and monetary policy operates primarily via the exchange rate – money growth leads to depreciation. This leads to a tradeoff between exchange rate control and monetary independence. Cohen (1995) coined the term ‘Unholy Trinity’ in describing this principle:

In an environment of formally or informally pegged rates and effective integration of financial markets, any attempt to pursue independent monetary objectives is almost certain, sooner or later, to result in significant balance-of-payments disequilibrium, and hence provoke potentially destabilizing flows of speculative capital. To preserve exchange-rate stability, governments will then be compelled to limit either the movement of capital (via restrictions or taxes) or their own policy autonomy (via some form of multilateral surveillance or joint decision-making). If they are unwilling or unable to sacrifice either one, then the objective of exchange-rate stability itself may eventually have to be compromised... The problem, from their point of view, is that capital mobility is notoriously difficult to control... In practice, therefore, this means that in most instances the Unholy Trinity reduces to a direct trade-off between exchange-rate stability and policy autonomy.

Yet government policy is also affected by another macroeconomic principle. The Nobel prize-winning economist Jan Tinbergen (1952) explains that to attain a given number of independent targets there must be at least an equal number of policy instruments – and in pursuing multiple macroeconomic objectives consistent with the Tinbergen principle, some combinations of policies can come into conflict with the fundamental exclusivity of policy instruments in the Unholy Trinity: In a globalized economy, efforts to control exchange rates and direct monetary policy simultaneously must result in balance-of-payments crises. This is best illustrated by the Asian Financial Crisis of 1997, when the exchange rate regimes of Asia came under speculative attacks and created contagion effects on the international system.

II. Global Risks from Currency Manipulation

Although the causes of the Asian Financial Crisis are varied, some economists suggest that interventionist currency regimes played a role. Hanke (1998) explains that interventions to simultaneously control exchange rates and avoid inflation led to balance-of-payments crises, just as the Unholy Trinity predicts:

Pegged rates, such as those that were employed throughout most of Asia... invariably result in conflicts between exchange-rate and monetary policies. Balance-of-payments crises erupt as a monetary authority begins to offset more and more of the reduction in the foreign component of the monetary base with domestically created base money. When this occurs, it is only a matter of time before currency speculators spot the

contradictions between exchange-rate and monetary policies and force a devaluation. [Whereas without intervention] ...there cannot be conflicts between exchange-rate and monetary policies, and balance-of-payment crises cannot rear their ugly heads...market forces act to automatically rebalance financial flows and avert balance-of-payments crises.

In maintaining their exchange rates, reserves reached critical levels in Thailand and Korea. Speculative attacks forced sudden readjustments which precipitated the crisis - readjustments that were exacerbated by the market distortions of interventionist currency regimes. Market participants interpreted the pegged exchange rate policies in Asia as an implicit government guarantee (assumed to be backed by their foreign reserves) against volatility, which created the tendency not to hedge foreign currency borrowing, reducing perceived risks and thus the cost of foreign credit (Dooley 1997). As Milton Friedman (1999) notes, the large capital flows encouraged by these policies partly masked the weaknesses of the financial sectors of several Asian economies, leading to over-borrowing and excessive capital inflows with respect to the risks involved:

The fact that Thailand had a pegged exchange rate with respect to the United States and the fact that the IMF was around there encouraging it to have a pegged exchange rate at that time meant that lenders elsewhere underrated the exchange-rate risk. Three factors — IMF, pegged exchange rate, and discretionary central bank — set the stage for investments that were not economically justified.

Both the balance-of-payment and distortionary effects of the Asian currency regimes suggest currency manipulation tends to increase the volatility of financial markets and the risk of crisis¹². As international capital flows grow larger, these risks can only increase. With the spillover contagion effects of currency crises brought about by economic interdependence (Glick and Rose 1998), these risks threaten not only the interventionist regimes but all nations.

Yet a survey of the currency landscape in Asia today would lead one to assume that most Asian policy-makers have not learned from the crisis. The interventionist currency regimes of export-oriented Asian economies are as costly and unsustainable as they were before¹³. Asia cannot continue funding such expenditures indefinitely.

Neither can it continue running up massive trade surpluses with Western economies. Asian currency regimes are often cited as a cause of persistent current account deficits with developed and mostly Western countries. In 2005, the US international deficit in goods and services increased to \$725.8 billion from \$617.6 billion in 2004¹⁴. Although devalued Asian currencies are not the only causes of the US deficit¹⁵, they are still significant for their direct and indirect effects. Directly, they suppress the prices of Asian exports and deter imports from the US. Indirectly, they prolong the duration and size of the deficit, as Asian interventionism typically involves buying dollar-denominated

¹² Fischer (2001) notes that every major international economic crisis of the past 15 years has been rooted in rigid exchange rate regimes. Nitithanprapas, Rongala, and Willett's (2002) study of the Asian crisis finds "some support for the conventional wisdom that substantial government management of exchange rates makes countries more crisis-prone." Razin and Rubinstein's (2005) study accounts for the "crisis-prone state of the economy" under rigid exchange rate regimes. Lahiri and Vegh (2005) argue that central banks, in raising short-term interest rates to defend currency pegs, create 'large negative output effects' which could 'bring forward a crisis'.

¹³ The *Korean Herald* (19 Jan 2006) reported that stabilization bonds floated by the Bank of Korea to curb appreciation of Korean won resulted in a record net loss of US\$1.4-US\$1.5 billion in 2005. A total of US\$6.1 billion in interest was also paid to bondholders in 2005.

¹⁴ US Census Bureau 'Goods and services deficit increases in 2005' 10 Feb 2006

¹⁵ Bhaskaran (2005) argues that the roots of the US deficit are complex and cited US monetary and fiscal policies as being among causes.

securities, thus funding American deficit spending. When the inevitable correction occurs, the worst scenario would be a hard landing and possible recession for the global economy as America reins in its spending.

Despite this, the international financial institutions have yet to act, and given their history of enforcing the statute on exchange rate manipulation, they are not likely to. Whether due to structural (institutional deadlock, bureaucratic inertia etc) or other barriers (political concerns) to collective action, external inducements have thus far not been successful in encouraging Asia to discharge its responsibilities to the international financial system in ameliorating such systemic risks.

III. Currency Liberalization in Asia's Self-interest

As Adam Smith put it, "it is not from the benevolence of the butcher, the brewer, or the baker, that we can expect our dinner, but from their regard to their own interest." Where the external compulsion of international financial institutions has failed, self-interest might prevail – and it is in the interests of Asian nations themselves to cease their interventionist currency regimes.

A. Inflationary costs and limitations on monetary policy

As noted earlier, governments cannot sustain both exchange rate and monetary targets simultaneously. Asian currency regimes thus limit their discretionary powers to target inflation. While Singapore maintains a dirty float with a focus on price stability (Takagi 1996), most Asian countries struggle between containing inflationary pressures and maintaining cheap currencies. Federal Reserve then-Chairman Alan Greenspan (2005)

explains that in printing renminbi to purchase the excess supply of dollars coming into China, “[China’s] support for the RMB could boost the growth of the money stock, with the accompanying risk of triggering upward pressure on inflation”, and that that the immature Chinese financial system will be unable to sustain the sterilization of continuing inflows of speculative funds as they increase with time. Inflation has real costs and damages growth prospects (Bruno 1994), and it can diffuse throughout the regional and global economy¹⁶. Thus, currency manipulation not only limits monetary policy’s effectiveness in targeting inflation, but also directly contributes to inflationary pressures, harming Asia’s growth and limiting its capacity to take on the increased responsibility that comes with increased economic weight.

B. Efficiency costs and limitations on long-term growth

Neglect of fundamentals

The distortionary effects of Asian currency regimes limit their growth potential over the long-term, as relying on cheap currencies to improve export competitiveness masks underlying microeconomic problems. Lack of innovation, poor cost controls, rent-seeking behavior and corporate malfeasance can all be ignored in the short-term by the rosy export figures that currency devaluations provide. Without this information base, policymakers are prevented from taking prompt corrective measures. Such fundamental problems are real, and the longer Asia takes to correct them, the more difficult the inevitable readjustment will be.

Perhaps Asian economies can look at Singapore’s example. Lian (2005) notes that instead of relying on devaluations to improve cost competitiveness, Singapore has

¹⁶ US Treasury “Report to Congress on International Economic and Exchange Rate Policies” (May 2005)

taken real domestic economic adjustments and restructuring measures to improve the quality of its workforce and the innovative capacities of its private sector, with the result that its manufacturing sector's share of GDP increased from 24.3% to 27.1% from 1994 to 2004. Strong fundamentals like innovation and technical expertise matter, and Asian currency regimes have concentrated on cost competition, rather than developing value-adding capacity. In the long-run, to compete in the global economy Asian countries must move up the manufacturing value chain rather than race costs to the bottom.

Inefficient resource allocation

By masking poor fundamentals, Asian exchange rate regimes also distort resource allocation and make markets less efficient. Some have even compared “deliberate intervention” in accumulating reserves and promoting “artificial export-led growth” to Soviet-style central planning¹⁷. As US Treasury Secretary John Snow (2005) explains:

The current system is fueling over-investment and excessive reliance on export-led growth while underemphasizing domestic consumption. Moreover, much of the investment and capital flows into these favored sectors and projects may be going to businesses that do not best reflect China's competitive advantage, which ultimately could lead to another investment hard landing, more nonperforming loans and a weakened banking sector.

¹⁷ Brittan (2005) writes “Just as Soviet five-year plans concentrated on tanks and tractors, Chinese plans concentrate on foreign exchange reserves and the promotion of artificial export-led growth.”

This market distortion results in capital being allocated to firms with poor returns on investment, while potentially successful firms in domestic-oriented industries are left out in the cold. When the inefficient firms inevitably default, weak Asian banking sectors may be unable to absorb the shock.

By artificially depressing currencies, in China's case to pursue higher employment, Asian countries utilize lower technology capital stock through deterring the import of capital goods, largely produced outside of Asia. Capital imports are necessary for raising productivity and such misallocation prevents standards of living from rising. Although employment benefits in the short run, this policy limits long-term competitiveness.

Monetary tools used in currency intervention also result in further capital misallocation. Bonds used to sterilize capital inflows into the economy could prevent the absorption of much-needed capital into the economy. Lal and Bery (2003) estimate that in 1998/1999, India's potential growth rate of 10% was reduced to a real growth of 6.6% due to the non-absorption of capital inflows and the fiscal deficit. Efficient bank lending is also hindered by currency regimes' restraints on monetary policy in setting domestic interest rates¹⁸.

Opportunity cost of excessive reserves

This underinvestment in capital can also be attributed to the opportunity cost of large foreign reserve holdings used to maintain exchange rate regimes, reserves far

¹⁸ US Treasury "Report to Congress on International Economic and Exchange Rate Policies" (Nov 2005)

exceeding the adequacy level of the World Bank's benchmark of 25 percent of annual imports.

Every dollar held in reserves is a dollar of foregone investment in physical or human capital, with far greater potential returns than the typical 1-2 percent on reserve assets. Baker and Walentin's (2001) study finds "the implied cost of reserve holdings could exceed 20 percent of current GDP in East Asia". The opportunity cost of present reserves to future growth from capital investment foregone could exceed this figure. Rodrik (2005) calls this the 'social cost of foreign exchange reserves'.

Lal (2005) suggests that reserves would be better used to finance public pension funds and ease privatization of state-owned enterprises. More broadly, reserves could also finance 'Copenhagen Consensus'-style investments in healthcare, education, infrastructural development, and poverty reduction. The trillions of reserves in Asia should vastly improve the lot of its peoples, yet they do not – and they have their currency regimes to thank for it.

C. Strategic vulnerabilities

Asian export-competitive currency strategies have altered trade patterns and suppressed domestic consumption, making Asia dependent on the import demands of Western trading partners as drivers of economic growth. While Asian economies comprise 53.4 percent of world GDP in 2004¹⁹, only 46.6 percent of its manufactures are exported within Asia²⁰. Hence, Asia becomes more vulnerable to shifts in Western

¹⁹ IMF World Economic Outlook (2005)

²⁰ World Trade Organization International Trade Statistics (2005)

consumption patterns than they would with a more balanced and flexible economy, with diverse demand sources. During the collapse of the technology, media and telecommunications bubble in 2000, US demand for electronics and computers – and thus their components – dropped suddenly, and Asian economies, many heavily dependent on manufacturing and assembling components for export, suffered more than most. Geographic proximity should favor an even greater volume of intra-Asian trade relative to Asia's economic size. Instead, a slowdown in the US economy could easily plunge the region into recession.

Dependence on Western economies limits Asia's capacity to pursue its interests in international trade and financial institutions. It is conceivably easier for a Western country to impose trade sanctions against an Asian country than the other way around. Perhaps this explains why it is possible for the US to pursue extensive preconditions in trade negotiations, such as ceasing Korea's screen quota, while Asian countries are unable to obtain significant concessions on Western agricultural subsidy issues.

Currency manipulation has also led to Asian countries viewing each other more as competitors rather than partners in growth. Research shows that the Won and Ringgit moved closely with the depreciating Yen pre-crisis (Takagi 1996). More recently, we saw Malaysia 'abandon' its greenback-peg shortly after China ceased hers. These suggest that Asian currency decisions are contingent on their effects on competition with other Asian neighbors. Instead of pursuing greater regional trade and development, currency manipulation leads to intense regional rivalry, and fragments pan-Asian solidarity.

IV. Conclusion

The ancient philosophers of Asia knew that to rule virtuously and bring prosperity to the realm, kings must sometimes refrain from interfering with the harmony of the natural balance. Perhaps their lessons are applicable to modern Asia's export-dependent economies and the currency interventions that sustain them - distortionary policies that come with great costs and risks to Asia and the world. To disrupt order is to invite chaos, whether in *fengshui* or financial markets. Liberalization requires abandoning exchange rate manipulation for cheap exports, which constitutes the most extensive and distortionary interventions in its economies. Through abandoning interventionist policies, market forces can play a greater role in balancing currencies and capital flows – achieving a 'virtuous harmony' that will allow Asian nations to grow stronger while also discharging their responsibilities to the international financial system, better enabling Asia to take on a greater role in the global economy.

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