

**How to Get Over  
the Asian Currency Crisis:  
A Proposal for an  
East Asian Stable Currency Group**

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## I. Introduction

East Asian economies have continued their 'miraculous growth' for the past decade. Since July 1997, however, a speculative run on the Thai baht has developed into a currency crisis throughout East Asia and stopped rapid growth. Thailand, Indonesia, and Korea, which sought rescue from the IMF, had to resort to severe contractionary policies and have fallen into slow growth. Other economies have responded to the currency crisis by constraining their budget, suspending development plans and reducing their growth rates considerably. The East Asian miracle has disappeared abruptly. China and Hong Kong have maintained their exchange rates, but both suffered from the same severe impact of the currency crisis on their real economies.

Eight months have passed since the currency crisis started in East Asia and many writers have explained why it started, but no clear direction has been shown regarding how to resolve it. Many express their optimistic view that the Asian economies will resume their high growth, not as rapid as 9 to 10% but at least 5 to 6% annual growth, in the mid and long term. However, nobody provides a scenario of how to guide these economies from lingering turmoil to high growth. Current cross exchange rates of Asian currencies have changed drastically from those of eight months ago and the steady expansion of trade and investment will not be restored under the current cross exchange rates. This seems to require that Asian currencies return to a more stable and balanced set of exchange rates. Will this be achieved only through market forces? This paper proposes a means to resolve the current currency crisis in East Asia by achieving a stable set of exchange rates among Asian currencies. The author wishes that Japan would take the initiative in agreeing to this proposal together with other Asian economies. Otherwise Japan will lose its leading role in Asia forever.

## 2. Steady Expansion of Trade and Investment under US Dollar Peg

Fig. 1 shows changes in the nominal exchange rates of East Asian currencies against the US dollar since the first quarter of 1995 (1995I). They are indicated in an index form with the base year of 1995I. Quarterly averages are taken for 1995 and 1996, monthly averages are taken throughout 1997, and exchange rates on specific dates are taken for January and February 1998. They are denominated in individual currencies per US dollar, so that an upward movement indicates depreciation in the Asian currencies, while downward movement indicates their appreciation against the US dollar.

For the first two and a half years, Asian currencies were pegged with the US dollar and were stable. To be exact, the Asian economies determined their exchange rates with currency baskets composed of the US dollar, the Japanese yen, the German mark and other European currencies, but the weight of the US dollar was so dominating that they were often called a de-facto dollar standard, that is pegged with the US dollar. The exchange rate indexes of Asian currencies were almost flat at 100 and stable until July 1997. There were only two exceptions. The Chinese RMB was devalued by 49% a year before, in January 1994, and the Japanese yen floated against the US dollar all through the period - fluctuating widely from 5% appreciation (up to 84 yen per dollar) in 1995II to 30% depreciation (down to 121 yen per dollar) in February-April 1997.

However, inflation continued in those Asian economies under stable exchange rates. Fig. 2 shows, in the same index form, changes in general prices within the individual economies relative to those in the United States. Relative prices in China, the Philippines, Indonesia, Thailand, and Hong Kong increased by 5 to 10% for the first two and a half years. Korean, Malaysian, and Taiwanese prices were almost flat, while Singaporean and Japanese prices

decreased by 3 to 5% for the same period. The currencies with increased relative prices were depreciated in real terms even if the nominal rates were unchanged. Fig. 3 shows changes in real exchange rates in the same index form. As a matter of fact, Chinese prices increased by 25% throughout 1994, after the January devaluation of 49%, so that the RMB's real exchange rate appreciated by 25%, thus leaving only a 24% devaluation in the real exchange rate. Chinese inflation stabilized throughout 1996 leaving around 10 % devaluation in the real exchange rates altogether since 1994I. However, trade and investment expanded steadily during this period and nobody predicted a sudden stop in the high growth of East Asia.

East Asian growth was interrupted abruptly. Let us follow the changes in Asian exchange rates after July 1997 in Fig. 1. During the run on the baht on July 2nd, the Thai government abandoned its peg with the US dollar and moved to a floating rate. The baht depreciated in the market by 20% within a month and depreciated further by 40% until November. A similar run took place on the Indonesian rupiah, Philippine peso, Malaysian ringgit, and Singapore dollar and they depreciated by 60%, 40%, 30%, and 10% respectively until November. The Taiwan dollar and Korean won were also affected in October and November. In December and January, another round of currency runs attacked the rupiah, baht, and won so that the rupiah depreciated by 567%, the baht and won by 120%, and the Peso and Ringgit by 75% in seven months. By the middle of February, all Asian currencies bounced back by 20 to 40% so that many observed that the currency crisis has passed its peak.

Devaluation of the Hong Kong dollar and RMB were anticipated in the market following other Asian currency depreciations in October and November, but both governments tried hard to keep their exchange rates unchanged. The yen was depreciated for the seven month and was at a 30% depreciated level in February. Of course, this reflects the strong position of the US

economy and US dollar. The European currency (ECU) also depreciated (by 15%), as did the German mark (by 22%) for the same period.

### 3. Impacts of Big Depreciation on Trade and Investment.

Big fluctuations in exchange rates never leave trade and investment unaffected. In Thailand and Korea, export prices decreased abruptly and boosted manufactured exports. Exports of primary products were boosted in Malaysia and Indonesia. Exports have increased in other Asian countries as well. It goes without saying that their export prices have not decreased fully as much as the exchange rate depreciation. Manufacturing production in the Asian economies depends highly on imported parts and materials whose prices increased under the depreciation. Exchange rate depreciation has tended to increase the imported prices of industrial materials, and foodstuffs in case of Indonesia, and tended to raise domestic prices and impede export increases. Furthermore, a depressed domestic economy has dampened imports and a trade deficit has changed to surplus in many economies. On the other hand, exports from China and Hong Kong, which have sustained exchanged rates and export prices, have been depressed so that exporters cry for rescue from their governments. The impact of big depreciations has a strong element of 'beggar thy neighbor' and inevitably tends to aggravate conflicts among Asian exporters and between Asian exporters and their main market, the United States.

What about the impact on foreign investment in these economies? Big depreciations tend to decrease the acquisition price of assets in depreciated countries and encourage foreign investment. However, only Mr. Soros and a few American and European investors are reported to be seeking profitable investments. Japanese and other Asian investors have become so defensive, they intend to delay their investment until stable exchange rates are restored. Without

returning to a stable set of exchange rates, steady expansion of trade and investment will not resume in the Asia Pacific.

#### 4. Will Stable Exchange Rates be Restored only by the Market?

Here, the stable exchange rate must be defined clearly. Considering that Asian trade and investment expanded steadily under unchanged exchange rates pegged to the US dollar from 1995I to June 1997, it will be safe to assume that the production conditions of individual economies were reflected in their exchange rates. This is confined only to the currency transactions based on trade and direct investment. Nowadays, portfolio investment and short-term capital flows dominate the foreign exchange market and determine equilibrium rates in the market. The current currency crisis itself was caused by the abrupt outflow of these funds from Asian economies.

Do the current exchange rates of individual Asian economies, departed so much from their rates eight months ago, reflect correctly the stable exchange rates which would support a steady expansion of trade and investment? Their current rates resulted from volatile flows of foreign funds and do not reflect correctly the actual production cost in the individual Asian economies. Many people observe that big depreciations in the rupiah, baht, and won have all been overshoot by market forces. Of course, market forces will correct the overshoot currencies. Indeed, Asian currencies appreciated by 10 to 30% from January to February. The rupiah rose by 240%. However, adjustment in these overshoot currencies by market forces seems to be proceeding too slowly to restore stable exchange rates in time. The currency crisis has caused financial crises in many Asian economies, where reported big losses among major commercial

banks continued to cause runs on some currencies in foreign exchange markets.

We must be prepared for it to take a longer period of time to correct the exchange rates of overshot currencies in the market. However, if this big under-valuation continues in the market, it will lead to two serious situations. First, undervalued currencies will accelerate inflation in domestic markets and cause ill effects on income distribution and social unrest. Second, China may not be able to endure its overvalued currency and may devalue the RMB, which will cause another competitive devaluation among other Asian currencies, further departing from the stable set of exchange rates.

With only market forces at work, we will achieve stabilization of cross-exchange rates among Asian currencies only after much trial and error, and we will not get them corrected in a timely fashion. Therefore, I propose that East Asian governments jointly conduct a multiple currency realignment ala the Plaza agreement of 1985 or the Smithsonian agreement of 1971 and restore stable exchange rates in East Asia.

##### 5. Proposal of East Asian Stable Currency Group

My proposal consists of the following two elements. First, East Asian governments should undertake jointly a realignment of their exchange rates ala the Plaza Agreement (1985) or Smithsonian Agreement (1971) with their stable exchange rates pegged to the US dollar (suggested below). This will result in an East Asian Stable Currency Group including the Japanese yen and US dollar in which member governments jointly intervene in foreign exchange markets to sustain the stable exchange rates within a 15% wide band.

Second, they will introduce a minimum coordination of macro-economic policies. That

is, they will introduce a set of maximum ratios of their government debt, balance of payment deficit, external debt to their GDP and their inflation rate and sustain these target ratios through mutual surveillance and early warning in order to avoid the recurrence of big macro-economic disturbances. It is important to make the East Asian Stable Currency Group so that the market will believe in its continuance for some length of time.

The characteristics of this new currency regime become clear when it is compared with the currency regime existing before July 1997. Under this regime, individual member governments pegged their currencies with the US dollar independently and adjusted their rates according to their own judgment. They conducted cautious macro-economic policies without any coordination among themselves. They responded to the currency crisis individually, but all became involved in this currency turbulence. It is very necessary for them to cooperate and coordinate their efforts so that no currency crisis is repeated in this region.

We may have to wait for the Indonesian situation to be resolved. The minimal coordination of macro-economic policies suggested above is consistent with the Manila framework agreed upon by the Deputy Finance Ministers of the Asia Pacific region in November 1997. The author wishes that Japan would take the initiative to make this proposal and coordinate between the East Asian economies and the United States so that the East Asian Stable Currency group is formed in short order.

The East Asian currencies were floated because their dollar peg was not sustained and depreciated against US dollar. Is there any rationale for returning to the dollar peg now? The



Asian currencies became overvalued under their dollar peg, which indeed triggered the currency crisis. However, should we attribute all fault to the dollar peg and give up its merit of stable currency values to traders and investors? Should we ignore their wish for a return to stable currencies?

Asian currencies became overvalued under their dollar peg for two reasons. One is the appreciation of their real exchange rates against US dollar because their domestic prices increased faster than those in the United States. The other is their appreciation together with the US dollar against the yen and European currencies by 15 - 30 % over the past few years. These changes can be absorbed within the wide band of 15% if they are of short-term nature, while they can be adjusted via a crawling peg if they are of a medium or long-term nature. Either will be decided after we get back to the stable exchange rates of our proposal.

We should compare both advantages and disadvantages of our stable exchange rate regime with those of the current floating rates in which the volatile flow of short-term capital dominates the market and traders and investors always incur a big risk of currency fluctuation. Little cooperation and coordination in currency and financial matters has been attempted in the Asia Pacific, although interdependence has intensified greatly through trade and investment in the past several decades. Is this not the true cause of the currency crisis?

## 6. Calculation of Stable Exchange Rates

The currency realignment requires a specific set of exchange rates of individual

currencies with the US dollar, which will be illustrated as follows. The textbook theory of determining exchange rates is Purchasing Power Parity (PPP). Its naive application tells us to keep PPP or real exchange rates unchanged at the level of a bench mark year. The real exchange rates are derived by deflating nominal exchange rates (Fig. 1) by relative price changes (Fig. 2) and are depicted in the same index form (1995I=100) in Fig.3. These cover only up to November 1997, when relative price indexes are available.

Real exchange rates of Asian currencies tended to be short of 100 appreciation against the US dollar until July 1997, but rapidly depreciated by 40-60% afterward. It would not be practical to return to the original level of 100, although some currencies apparently overshoot. Instead, I suggest that their real exchange rates be depreciated by 20-40% taking into consideration the Asian economies' competitiveness having weakened against the United States: the baht and won by 40%, peso and ringgit by 30%, the Singapore dollar, Taiwan dollar and Japanese yen by 20%. The rupiah has departed from its original level so much that its real exchange rate is depreciated by 100%. Incidentally European currencies have depreciated by 15-20% against the US dollar for the same period (ECU by 15% and German mark by 22%).

Table 1 shows our calculation of stable exchange rates for March 1998 (Column 4), based on a new set of real exchange rates depreciated along the formula outlined above. Relative price changes until February 1998 (in Column 3, including our estimates) are added to changes in real exchange rates and multiplied by nominal exchange rates in 1995I so as to get the stable rates (Column 5). Compared with actual nominal exchange rates on March 3, 1998 (Column 6), the gap is found to be filled by the currency realignment.

This is only a numerical illustration and I would not claim these figures as an economic

rationale. Rather, they should be regarded as showing how substantial an adjustment in real exchange rates will be needed. Two remarks should be made regarding this calculation. First, figures in parentheses for RMG are calculated based on the RMB 's nominal rate against the US dollar before its devaluation of 49% in January 1994, and show that its real exchange rate was depreciated by 15% until now, which is comparable with the depreciation formula described previously. Second, the yen's stable exchange rate of 110 yen per US dollar may appear a difficult target to many Japanese business people, considering the yen rates for the past two years. However, it is most likely throughout this year that Japan's trade surplus with the United States will increase under its current cheaper rate and the US-Japan conflict will become aggravated. Furthermore, the 100 yen level itself is depreciated by 20% from the level of 1995I. This is in line with a stable set of exchange rates for East Asian economies and Japan will have to accept it.