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18-06-03

Exchange Rate and Reserve Management in Asia.

Abstract

After the collapse of the SE Asian economies in 1997-98 the idea that developing countries should, or would inevitably, choose between two extreme exchange rate regimes, hard peg or float (corner solutions), has become a conventional wisdom. The US Treasury proposed in 1999 that this be a condition for IMF support. This paper argues that intermediate regimes that stabilize the real effective exchange rate against a currency basket are better than the corners. This would result in a crawling band for the nominal rate. We also argue that this form of management should be used by groups of countries that have similar trade patterns using a common basket. This would spread speculative pressure instead of focusing it on one country at a time.

These ideas are applied to the Asian countries. We see that since the crisis exchange rates in the area have been strongly correlated, whether measured against the US dollar, Yen, or Euro. Thus there seems already to be implicit coordination. This correlation of exchange rates is matched by a positive correlation of monetary policies, as measured by changes in base money. Explicit coordination could spread exchange rate pressures. It would also require some form of reserve sharing, in a possible extension and activation of the Chaing Mai agreement. Ten Asian countries hold more than half the world reserves. Reserve sharing could greatly economise on aggregate reserve holdings.