

International Capital Markets and Exchange Rates

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Outline

- (1) Capital inflow problem
- (2) Exchange rate movements in East Asia
- (3) Basket currency proposal

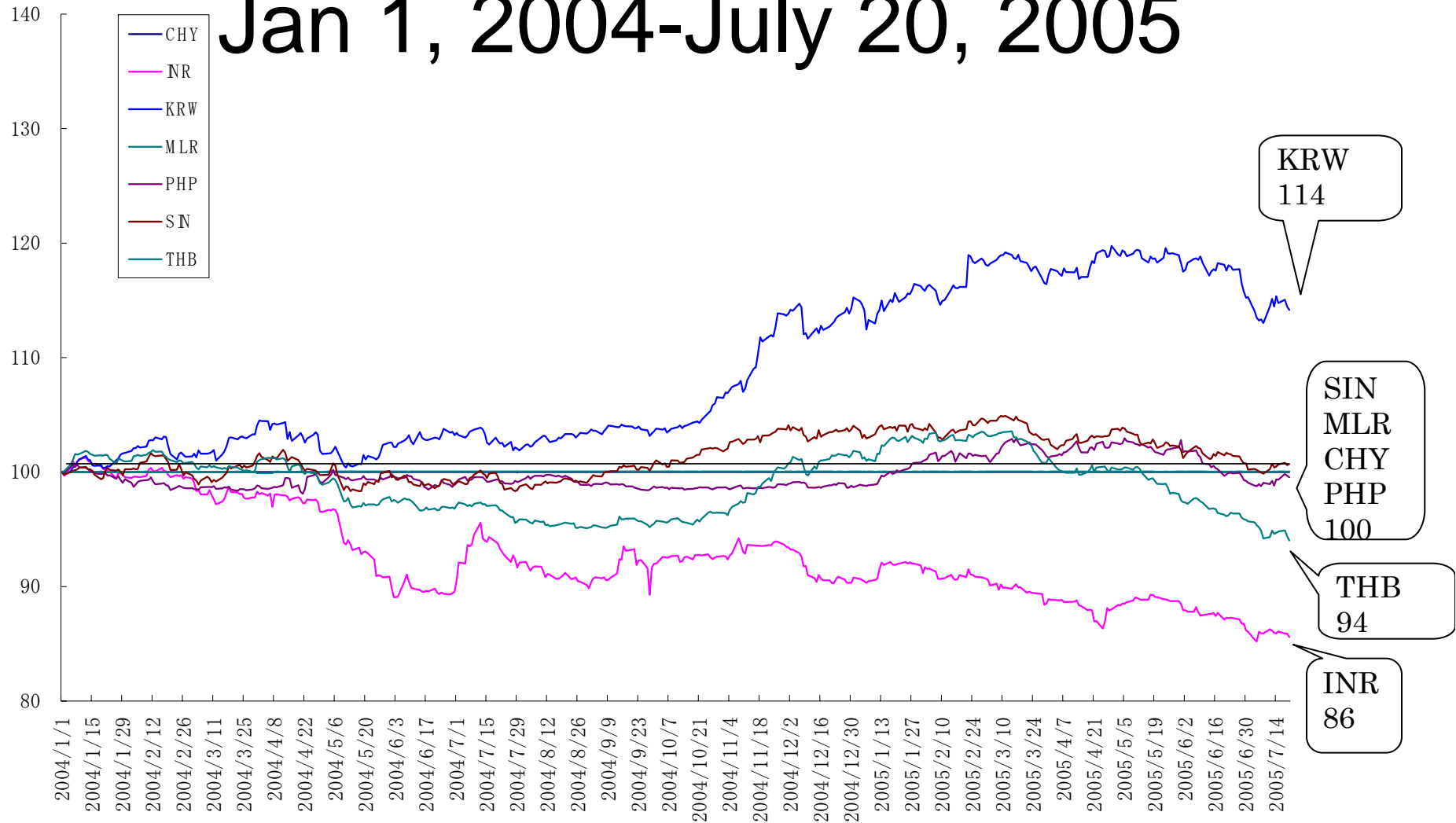
What do you do when capital flows are coming in?

- Examine the nature of capital inflows
 - Do not worry too much in case of equity investment
 - Do not worry if current accounts are in surpluses—allow appreciation
 - Do worry if short-term capital inflows come in to the banking sector and to fixed income securities (They may quickly reverse the flows and take profits out.) Sudden reversal would present difficult choices.

Cont'd

- Counter Measures
 - Fiscal tightening (IMF favorite advice)
 - Lowering interest rate to discourage short-term inflows (May exacerbate over-heating)
 - Allowing exchange rate appreciation (exporters may get hurt)
 - Intervene and sterilize if capital inflows cause too sharp appreciation
 - Prudential measures on bank balance sheets (restrictions on the short-term, foreign currency denominated liabilities)
 - Chilean-type tax on short-term capital inflows
 - Controls on Non-deliverable Forwards (NDF) for defense against speculative attack when the direction is reversed

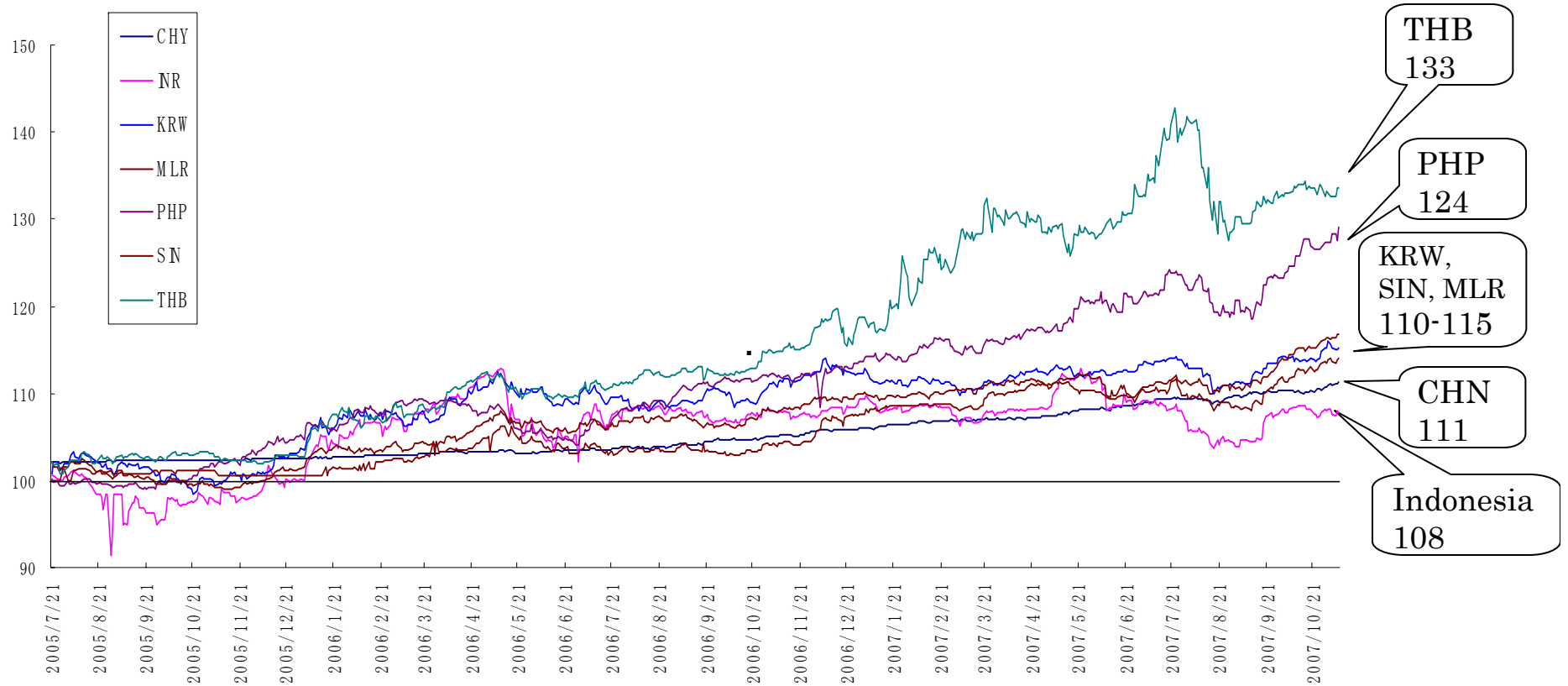
Figure 1: Currency movements: **pre-Reform** Jan 1, 2004-July 20, 2005



PBOC Reform of RMB, July 21, 2005

- “Starting from July 21, 2005, China will reform the exchange rate regime by moving into a managed floating exchange rate regime based on market supply and demand with reference to a basket of currencies.”
 - An immediate 2% appreciation of RMB to 8.11 yuan to a dollar
 - The daily fluctuation of plus/minus 0.3% will be allowed and the closing rate will become the central rate of the following day
 - “The RMB exchange rate will be more flexible based on market condition with reference to a basket of currencies.”
- Has it really moved to a basket regime?

Figure 2: Currency Movements: **Post-Reform** July 21, 2005 – November 7, 2007



Appreciation of the Asian currencies, **post** RMB reform

- All currencies have appreciated vis-à-vis USD in the post-RMB reform (July 21, 2005) period
- Order of the degree of appreciation
 - Thai 33% up (clearly, exceptional appreciation)
 - Philippines 24% up (steadily strengthening)
 - Moving together, some volatility with a appreciation trend, that is slightly above CHY
 - Korea, Singapore, Malaysia, 10-15% up
 - China 11 % up (very little fluctuation over a trend line)
 - Indonesia 8% up (high volatility, occasional dips)
- Chinese Yuan seems to be defining the **floor** of Asian currencies' appreciation

China has not really reformed the RMB regime (still \$ peg)

- Pre- and Post-1, Post-2 produce similar results
- Dollar weight declined only slightly
 - 1.00 in Pre-reform;
 - 0.94 in Post-1, 0.96 in Post-2
- Yen was significant only in Post-1, 0.07.
- Euro did not have any weight
- It is still the *de facto* dollar (crawling) peg

Singaporean Dollar

- All three—USD, YEN, EUR—have significant weights
- Dollar weight, about 0.6, but increased to 0.67 in post-2 period
- Yen weight, about 0.3, but declined to 0.17 in post-2 period
- Euro weight, increased from 0.04 to 0.27, to 0.37

Asian Basket Currency Unit (ACU)

- (definition) ACU is the weighted currency values of Asian currencies
 - E.g., ASEAN+3 ACU has been calculated at RIETI and Hitotsubashi University
- (objective 1) Focus on the relative value vis-à-vis the average of neighboring countries' currencies, NOT vis-à-vis USD
- (objective 2) If all countries in ACU manage their exchange rates relatively stable vis-à-vis ACU, they achieve intra-Asia stability, and joint float against the outside

Conclusion

- Capital flows should be “managed”
 - The exchange rate should be flexible
 - Nature of capital should be monitored
 - Balance sheets of banks
 - Experiences among East Asian countries will be useful
- India will strengthen economic ties with East Asian countries
- When economic integration with East Asia proceeds, the exchange rate management should be in relative to East Asian countries (ACU), as well as USD and EURO