Chapter 2

2.00 Literature Review

This chapter will begin by examining the range of exchange rate regimes that are in used by the economies of the world. The advantages and disadvantages of each regime are discussed. Finally, the recent literature regarding the possible re-pegging of Ringgit or Yuan will be elaborated.

2.10 Foreign Exchange Regimes in General

There are a number of possible exchange rate regimes. The spectrum of exchange rate is bounded at the one end by a perfectly free-floating exchange rate and on the other end by a completely fixed exchange rate (Scheibe 2002). Totally fixed exchange rate is where the government takes whatever measures necessary to maintain the exchange rate at some stated level (Sloman 1997). Countries using a totally fixed exchange rate regime are the European Monetary Union (EMU), countries in francophone West and Central Africa whom are fixed against Euro (classifications used by Frenkel 1999; Edward and Savatano 1999; and IMF 1999). Sloman also defines freely floating exchange rate is where the exchange rate is determined entirely by the forces of demand and supply in the foreign exchange market with no government intervention whatsoever. Countries using a totally free-floating exchange rate regime are Japan, US, and Switzerland (classifications used by Frenkel 1999; Edward and Savatano 1999; and IMF 1999). Other variants in between the two extremes of exchange rate regimes can

be broken down to currency boards, adjustable pegs, crawling pegs, crawling bands, basket pegs, target zones where central parities are anchored on nominal or real terms, and managed floats.

The choice between fixed, floating, or a combination of both depends on the examination of five key issues.

Firstly, different types of economic shocks have different effects, depending on which exchange rate policy is chosen. If a country believes that it is mainly hit with internal shocks, it would favour a fixed rate; if a country believes that it is mainly hit with external shocks, it would favour a floating rate.

Secondly, monetary policy is less effective as an independent policy influence on the domestic economy with a fixed exchange rate. A country that desires to use monetary policy to influence its domestic objectives such as employment or inflation targets will fare best with a floating exchange rate.

Thirdly, countries adopting a fixed exchange rate regime must have a consistent macroeconomic policy. Only when policies are consistent that defending of a fixed rate will be successful. Otherwise, a free-floating regime will be appropriate for the policy discrepancies be reflected on the exchange rates. Flood & Jeanne 2000 found that increasing domestic-currency interest rates makes domestic assets more attractive according to an asset substitution effect, but weakens the domestic currency by increasing the government's fiscal liabilities. Under the context of a weak fiscal policy that sparked speculations, raising interest rates further widens the fiscal fragility (example of inconsistency). Notwithstanding the

findings from Flood & Jeanne, Furman and Stiglitz (1998)'s empirically findings found, in a small set of episodes of crises in nine emerging markets, that interest rate hikes are associated with exchange rate depreciation.

Fourthly, the choice of exchange rate regime depends on the inflation rates of the country and its major trading partners. For countries with a less than solid history of inflation and economic discipline, fixing the exchange rate to a currency with desirable track record of inflation and growth facilitates the 'import' of favourable foreign monetary policy (Scheibe 2002). The reverse is true if the country being pegged upon experiences high inflation, such inflation will also be imported 'home'.

Fifth, a floating exchange rate creates high volatility. Such volatility may affect a country's international trade. Scheibe argued that a country like Singapore, which is confined geographically, high number of urban dwellers, developed infrastructure and education systems, per capita income GDP in 1996 equalled 90% of US income per head, thrives very well on their government's decision to manage exchange rate volatility via a currency board.

2.11 Advantages of a Fixed Exchange Regime

Fixed exchanges regime cultivates a level of certainty in international trade. Changes to the regime will disrupt the perceived certainty enjoyed similarly seen in the Malaysia's case of Ringgit repeg. Economists argues that it would not be

prudent not to change Malaysia's stance given the uncertainties to the potential economic slowdown in the region.

Fixed exchange rate regime is said to render currency speculation pointless. This is only true to the extent that the domestic policies are consistent with the existing fixed rate implemented. Inconsistency in policies will attract speculation to correct the imbalances as evidenced in 1992 when United Kingdom was forced leave the EMU (Sloman 1997). Krugman reinforces this statement when he commented that it would still be technically quite possible for a country to drop out of EMU... even after EMU supposedly has gone into effect (Krugman 1998).

Edward and Savano (2000) compared the performance of fixed and floating regimes and find that fixed regimes have higher output volatility, fixed and floating regimes lead to equal output growth, and floaters experience higher inflation. Devereux (1999) however, argues that the effects of the exchange rate regime depended upon both the stance of monetary policy and the way in which the exchange rate is pegged. He further added that with a passive monetary policy, a cooperative pegged exchange rate regime has no implications for macroeconomic volatility, relative to a floating regime, but implies a higher mean level of employment, capital stock, and real GDP. If under an optimal monetary policy stance, fixed regimes leads to higher employment volatility and a lower mean level of employment and real GDP.

Fixed exchange regime also has the advantage of correcting monetary errors. When a government expands the monetary base too fast, result in fueling extra

demand and lower interest rates will force the current account to run into deficit. This will be a sign for the government to reduce the money base via forex intervention to buy foreign currencies or raise interest rates to counter the deficit. Cordel (1993) and later Scheibe (2002) stated that the commitment required to sustain an exchange rate peg imposes the 'much needed' discipline. The peg gives a nominal anchor to policy and it makes policy objective transparent and (its) success easily measurable. In a similar tone, fixed exchange rate also discourages a government from implementing irresponsible macroeconomic policies. Inconsistent policies would stick out like a sore thumb.

Herrendorf 2002 argued that inflation is uncontrollable due to stochastic disturbances, the authority's actions cannot be monitored perfectly when the exchange rate floats, thus implying that reputational forces may become ineffective. In contrast, pegging the nominal exchange rate to a low inflation currency allows perfect monitoring, because the exchange rate is, in principal, controllable (Herrendorf 2002).

Kasa & Huh 2003 argued that there exists a competitive devaluation that provides an explanation to the contagious currency crises. When a group of countries relies on exports to a common foreign market, pressures for competitive devaluations arise. In response, competing exporters peg their exchange rates to the currency of their export market. Maintaining the arrangement requires a collective devaluation that reduces the unilateral incentive to devalue (Kasa & Huh 2003).

Frankel 2000 argued that free-floats, currency boards, rigid pegs, money targeting, CPI targeting, and gold standards were all but not without their weaknesses. Frankel proposed a new regime called Peg the Export Price (PEP) when a country is specialized in the production of a certain mineral or agricultural product. PEP proposes to fix the price of that commodity in terms of domestic currency. Frankel 2000 argued that PEP simultaneously delivers automatic accommodation to terms of trade shocks, as floating exchange rates are supposed to do, while retaining the credibility-enhancing advantages of a nominal anchor, as dollar pegs are supposed to do.

Echoing Frankel 2000's study, Devereux and Engel 2003 found that there appears to be a large degree of local-currency pricing (LCP) in industrial countries. Optimal monetary policy leads to a fixed exchange rate, even in the presence of country-specific shocks.

Lyrio & Dewatchter 2004 found that they was no evidence to prove that Brazil's crawling peg collapse was due to self-fulfilling speculations. Brazil's exchange regime collapsed due to deteriorating fundamentals of the economy.

Hamada 2003 evaluated the economic consequences of pegging to the Dollar in a multicurrency world. Hamada studied a three-country world where two large countries are engaged in floating exchange rates with each other, and a small country is pegged to one of these large countries. Three countries possess an endogenous wage determination process, so that the choices of exchange rate regimes have real consequences. Hamada found that the best solution will be for

all three countries to be completely floated or alternatively, the small country floats while the other two large countries go on a currency basket pegging.

Bensaid & Jeanne 2003 developed a model of a fixed exchange rate peg arrangement that showed that the fixed peg is vulnerable to self-fulfilling currency crises in which employment rate increases. They further added that the delegation of monetary policy to an independent central banker does not prevent this type of crises from arising, and can make it even worse (Bensaid & Jeanne 2003). This is clearly another support that in order for a peg regime to work, policy consistency must be present. In wake of the rising unemployment as shown by Bensaid & Jeanne 2003, if policy makers do not attempt to curb unemployment, ironically, their credibility increases.

2.12 Capital Mobility

Capital mobility or the international flows of borrowings and lendings matters for two reasons. Firstly, capital flows will have an effect on the net exports via exchange rates. Secondly, capital flows influence the domestic interest rates and therefore affect the transmission mechanism (Chrystal & Lipsey 1997). Chrystal & Lipsey further explained that perfect capital mobility under a fixed exchange rate regime means that domestic and foreign interest rates on the risk-free assets must be identical. On the other hand, under a floating exchange rate (and perfect capital mobility) the interest rate differential between two currencies is equal (in equilibrium) to the expected rate of change in the exchange rate.

Sloman (1997) argued that the greater the mobility of international capital, the more closely will domestic interest rates be pegged to world rates, and the less effective, therefore, will monetary policy be. In the extreme case of an infinitely elastic money supply curve, monetary policy will be totally ineffective. This in effect meant that under a fixed exchange regime, if a government wished to correct a high inflation and a balance of payment deficit, it would reduce the money and raise interest rates to curb spending (aggregate demand) and correct the deficit. However, the high interest rates will only draw in capital flows. This inflow will increase the money supply and put the situation back to square one.

During the Asian financial crisis, Krugman (1998) argued that the threat of further capital flight (outflows) would prevent Asian economies from simply reflating, that is, increasing public spending and cutting interest rates to get the economies grow again. Krugman advocated a temporary restriction (capital control) on the ability of investors to pull money out of crisis economies...as part of a recovery strategy. Krugman opined that it was his controversial paper amongst others that convinced Tun Dr Mahathir Mohamed to implement the unorthodox capital controls in September 1998. Whichever was the case, as suggested by IMF's Jeffrey Sach in 1998, the Asian financial crisis was more often than not capital flight due to contagion panic rather than weakness in the affected countries underlying fundamentals.

Scheibe commented that initially there was a hypothesis of 'hollowing out' of the middle ground of exchange rate regimes. In essence, most economists initially indicated that middle-way regimes would not work over the long term. The view

of a 'hollowing out' hypothesis for the mid-way regimes was strongly challenged by Williamson. Williamson argues for countries to adopt an exchange regime that comprises of currency baskets, exchange rate bands, and continuous adjustments (crawls), which he called BBC (Williamson 2001). Scheibe reiterated Frankel (1999)'s comment that there is no single currency that is right for all countries or at all times.

2.13 Other Exchange Rate Regimes

2.131 Currency Boards

Oliva, Rivera-Batiz, and Sy 2000 found that currency boards fared better than adjustable pegs or managed floats. Oliva et al 2000 found separating equilibria in which a weak government chooses a currency board as a discipline device while a tough (discipline) government chooses a standard peg for its policy flexibility. Paradoxically, it was found that the weak government could outperform the tough government on average. Currency boards' welfare can exceed pegs' welfare even when unemployment persistency is strong (Oliva et al 2000).

Mirroring Oliva et al 2000's findings, Ghosh, Gulde, & Wolf 2004 noted three major findings: firstly, currency boards had good track records, secondly, currency boards were instituted to gain credibility after a period of hyper-inflation, and thirdly, setting up currency boards were not easy. Once set, it will be an important tool to gain credibility and achieve macro objectives.

McKinnon & Schnabi 2004 studied the 1997/98 crises and noted that East Asian economies' soft-peg to dollar made them vulnerable to a depreciating Yen, thereby aggravating the crisis. Amongst others, IMF recommended free-floats. Mckinnon & Schnabi 2004 however, suggested that East Asian countries increase the weight of Yen in their currency baskets. McKinnon & Schnabi also noted that post-crisis, the East Asian countries transformed from a dollar-debtors to dollar creditors. This is where East Asian countries face a 'conflicting virtue' where the pressure to appreciate their currencies could lead to a deflationary spiral as well as a drop in value of their dollar assets held. These countries are trapped into returning to a soft dollar peg as an escape route from currency appreciation.

Gurtner 2005 evaluated Agentina's currency board collapse in November 2000. He found that the inability of the Argentinean economy to grow could be attributed to an overvalued Peso and massive borrowing needs of the government in the context of rapidly rising borrowing costs seriously undermined the credibility of the fixed exchange rate regime. Argentina's currency board failure was due to their rigid labour market, lack of fiscal discipline, and absence of a natural anchor currency (Gurtner 2005).

Bleaney 2002 argued that Argentina's currency board collapse was due to weak fiscal policies, and an overvalued Peso (although real effective exchange rate – REER did not reflect such overvaluation since REER does not capture the effects of a sudden stop in flow of funds to emerging markets). Bleaney 2002 pointed out

that had Argentina floated its currency in 1995, its economy would have gradually adjusted to higher debt to GDP levels without resorting to default.

Rajan 1999 buried the emerging consensus after the Asian financial crises that the frequency with which 'soft-pegs' have been susceptible to speculative attacks in this era of escalating global capital flows has increased pressure for developing countries to adopt 'corner' exchange rate regimes. Rajan 1999 argued in favour of a currency basket instead.

2.132 Monetary Union

Cohen 2004 downplayed the prediction of new monetary unions that are inevitable in many parts of the world. Cohen argued that monetary unions necessarily imply a measure of collective action in the issue and management of money. He further added that an alliance requires allies – other states with similar preferences and a disposition to act cooperatively (Cohen 2004).

Korhonen 2004 studied the correlation of short-term business cycles in the Euro area and the EU accession countries. He found that joining the monetary union could entail reasonably large costs, unless their business cycles converge closer to the euro area cycle. This could be inferred that it is vital for a pegged or fixed regime country to match the business cycle of the country being pegged to (Malaysia-US and China-US).

Based on studies by the European Commission 1990, Baberskii 2001, and Kenan 2001, it was found that the increase of trade intensity leads to higher symmetry of demand shocks while a decrease in exchange rate volatility has positive effect on demand shock convergence. Krugman 1993, however, argued that closer integration implies higher specialization (comparative advantage) and, thus, higher risks of idiosyncratic shocks.

Sentana 2003 rebutted Krugman 1993's argument and found that European Monetary System (EMS) tend to decrease idiosyncratic exchange rate risks while lowers the cost of capital by using a dynamic arbitrage asset pricing theory multi-factor model with time-varying volatility for currency, bond, and stock returns for ten European countries over 1977-1997.

2.14 Crises

Kasa in 2001, found that expectations of devaluation erupt suddenly, without large contemporaneous shocks. Kasa concluded that this was consistent with evidence showing that crises were often poorly anticipated by financial markets.

The question about whether George Soros was capable of forcing Pound Sterling out of the ERM was answered by Corsetti, Dusgupta, Morris, & Shin 1997. Corsetti et al build a model of currency crises where a single large investor and a continuum of small investors independently decide whether to attack a currency based on their private information about fundamentals. They found that signaling

makes the influence of a large trader on small traders' behaviour much stronger. If large trader sells, the small traders will follow suit and vice-versa.

According to Daniel 2002, an exchange rate crises is caused when the fiscal authority lets the present value of primary surpluses, inclusive of seigniorage, deviate from the value of government debt at the pegged exchange rate. In the absence of long-term government bonds, the exchange rate collapse must be instantaneous.