Asian currencies and the dollar

Stuck in the middle
Oct 30th 2003
From The Economist print edition

The wobbling won and baht

WHEN the yen-dollar exchange rate goes through one of its occasional gyrations, smaller Asian currencies wobble too. Since the G7 rich countries called for greater exchange-rate flexibility in September, the yen and the dollar have parted company, ending more than a year of trading between ¥115 and ¥125 to the dollar. At first, the South Korean won and the Thai baht followed the yen up. Now both, coaxed by their monetary authorities, have veered closer to the dollar.

Six years ago the baht, which had been pegged to the dollar, collapsed under speculative attack. Now, speculative inflows of capital from “big, foreign institutions” have pushed the baht up too far, too fast, according to the Thai authorities. On September 30th, for the first time in over three years, a dollar cost less than 40 baht. On October 14th the Bank of Thailand took steps to inoculate the financial system against unwanted capital inflows. It ruled that foreigners could hold no more than 300m baht in their current accounts and would receive no interest on those sums. Only deposits on at least six months' notice would earn interest. Foreign capital has ebbed slowly out of the country and the baht has lost some of its vigour.

The rise of the won was snuffed out more quickly. Shortly after the G7 communiqué, the South Korean currency reached its highest against the dollar for nearly three years, despite a faltering economy. Alarmed, Kim Jin-pyo, South Korea's finance minister, gave warning of “excessive fluctuations triggered by speculative forces”. The government, he said, was prepared to undertake “smoothing operations” to stabilise the currency markets. The won has since returned to its summer lows against the dollar.

Why should either country worry so much about tracking the dollar? Unlike Canada, most of whose trade is with the United States (see article), Thailand and South Korea sell only about a fifth of their exports to America. But if America is not the dominant economic power in the region, the dollar is nonetheless the hegemonic currency. East Asia's trading nations price most of their goods in dollars, even when they are selling to each other. South Korea, for example, invoices over 80% of its exports in dollars. So when the dollar falls against the won, South Korea's exporters earn less.

One way to fix this problem is to peg your currency to the greenback, as Malaysia, Hong Kong and China do. South Korea and Thailand cannot afford to lose competitiveness against their neighbours, but they
nonetheless abjure the hard pegs that got them into trouble in the past. Research by Ronald McKinnon of Stanford University and Gunther Schnabl of Tübingen University* suggests that they maintain “soft pegs” to the dollar, stabilising exchange rates daily or weekly.

The authors contend that such small, open economies, bobbing on flows of foreign capital, want a link to the dollar to help stabilise prices at home and dampen the currency risk of borrowing abroad. No wonder that the Thais and South Koreans do not want to see that link severed.