Economic models show China yuan shift, Malaysia–Singapore reactions, were best options

The People's Republic of China's gradual shift from a currency policy pegged to the US dollar to one that tracks the movements of a range of currencies was the correct choice given the challenges, and neighbors Malaysia and Singapore were best served by reacting in a similar way.

That's the conclusion of research presented in *Global Shocks and the New Global and Regional Financial Architecture, Asian Perspectives*, a new book by the Asian Development Bank Institute.

The vulnerability of the currency regimes used in Asia came into focus after the Asian financial crisis of 1997–1998, when the many Asian countries that had pegged their currencies to the US dollar found they had opened themselves to significant economic and financial risks.

Since the crisis, countries have either chosen to let their currencies trade more freely against the dollar—Indonesia, Thailand, and the Republic of Korea, for example—or shifted to other methods that still retain significant control over the value of their currencies. One of the most popular of these is the basket peg, where the local currency moves in a range against a basket of currencies, rather than being pegged directly to the moves of a single one.

Two countries that kept tight control over their currencies and maintained their pegs to the US dollar after the Asian financial crisis were China and Malaysia. Until 2005, both continued to intervene in currency markets to keep their currencies stable. But in the middle and later part of that year, both shifted their policies to allow more room for their currencies to move in line with market forces.

Naoyuki Yoshino, dean of the Asian Development Bank Institute, and Tamon Asonuma, an economist in the Research Department of the International Monetary Fund, looked at the question of how China could change its currency policy regime for the most positive outcome. They also considered how its neighbors and trading partners, Malaysia and Singapore, should react to any change in China's currency policy. Their research forms a chapter of the ADBI book.

Peter Morgan, co-chair of research for ADBI and one of the book's editors, explains the goals of their research:

> They attempt to answer two main questions: (1) Which would be more beneficial for these economies: a basket peg or a floating regime? and (2) How should a country orchestrate the shift to its chosen regime?

Rather than a shift to a floating regime, where the Chinese yuan would move more freely, the models they used showed that the transition most beneficial for China was to shift from a peg to the US dollar to one that was pegged against a weighted basket of currencies. Moreover, it was optimal for China to shift to that basket peg slowly, to allow time for the economy to adjust. The second-best option was to shift quickly to a basket peg.

> That's exactly what happened. Following the announcement that it was moving to a basket peg from its dollar-focused policy, China slowly allowed more movement in the yuan rate, a transition that continues today.
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> The analysis also showed that the best options for Malaysia and Singapore, when faced with such a shift in China, would be to react in a similar way. Malaysia's best move was to also gradually shift to a basket peg, while Singapore, which already had one, was best served by re-weighting its basket to take into account the Chinese shift.

> Again, the actions of these countries were in line with the best-case scenarios of the economic models. Malaysia announced it was shifting to a currency basket shortly after China's move and, as the yuan appreciated under the new currency regime, so did Malaysia's ringgit. The Singapore dollar also began to rise after the Chinese shift.

That was Peter Morgan, co-chair of research at ADBI.

This episode was based on "Optimal Dynamic Path along the Transition of an Exchange Rate Regime: An Analysis of the People Republic of China, Malaysia, and Singapore," by Naoyuki Yoshino, dean of the Asian Development Bank Institute, and Tamon Asonuma, an economist in the Research Department of the International Monetary Fund. Their research is a chapter in *Global Shocks and the New Global and Regional Financial Architecture, Asian Perspectives*, a new book by the Asian Development Bank Institute. This is part two of a four-part series based on the book.

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