By tying their currencies to the dollar, Asian governments are creating global economic strains

AFTER sinking since the start of the year, the dollar has come up for air, gaining 4% against the euro in recent weeks. But it is quite likely to plunge again, pulled under by America's huge current-account deficit. So far the dollar's descent has been uneven. It has fallen by around a quarter against the euro since the start of 2002. But it has lost only 10% or less against the yen and many other Asian currencies, and it is unchanged against the Chinese yuan, although most of the Asian economies have large balance-of-payments surpluses.

America's biggest bilateral trade deficit is with China ($103 billion in 2002). Asia as a whole accounts for half of America's total deficit. If these currencies cling to the dollar, then others such as the euro will have to rise disproportionally if America's deficit is to be trimmed.

And cling they do. The Chinese yuan and the Malaysian ringgit are pegged to the dollar and protected by capital controls. The Hong Kong dollar is also tied to the greenback through a currency board. Officially, other Asian currencies float, but central banks have been intervening on a grand scale in the foreign-exchange market to hold down their currencies as the dollar has weakened. The exception is the Indonesian rupiah, which has gained 27% against the dollar in the past 18 months (see chart).

Whereas intervention to support a currency often fails, intervention to push one down can be more effective, because in theory a central bank can print unlimited amounts of its own currency with which to buy dollars. As a result of central banks' heavy buying, Asia's foreign-exchange reserves have swollen from less than $800 billion at the start of 1999 to over $1.5 trillion now, almost two-thirds of the global total. Japan bought over $30
billion-worth in May alone; it now has almost $550 billion in its coffers. The world's seven biggest holders of foreign-exchange reserves are all in Asia (see chart).

The Asian countries’ reluctance to allow their currencies to rise against the dollar is coming in for increasing criticism. At a meeting in Bali last weekend of Asian and European finance ministers, the Europeans urged the Asians to let their currencies rise. John Snow, America’s treasury secretary, the International Monetary Fund and the Bank for International Settlements have all called for a stronger yuan.

Asian governments worry that appreciating currencies might hurt their exports. Yet many of their currencies are supercompetitive. As the dollar slides, their trade-weighted values against a basket of currencies is falling. According to The Economist’s Big Mac index, China has the most undervalued currency in the world. Using more sophisticated methods, UBS, a Swiss bank, reckons that the yuan is now more than 20% undervalued against the dollar.

UBS reckons that there are two tell-tale signs that a currency is undervalued. The first is rapidly rising official reserves. China, Japan, Taiwan and India have seen the biggest increases in reserves over the past 18 months. On the other hand, in Hong Kong, Singapore, Malaysia and the Philippines, reserves have been fairly flat.

A second test is the size of a country’s basic balance (the sum of its current-account balance and net inflows of long-term capital, such as foreign direct investment). In 2002 China’s current-account surplus was 2.2% of GDP; adding in foreign direct investment gave a basic balance of 6% of GDP. This year the current-account surplus has shrunk, but the overall basic balance remains well in surplus.

UBS reckons that all the Asian currencies, except Indonesia’s, are undervalued against the dollar on the basis of these two measures. The most undervalued are the yuan, the yen, the Indian rupee and the Taiwan and Singapore dollars; the least undervalued are the ringgit, the Hong Kong dollar and the South Korean won.

In a free market, China’s currency would surely rise. But demands from foreigners are likely to fall on deaf ears. The Chinese government is worried about rising unemployment as jobs are lost in unprofitable state companies, and deflation remains an issue. Moreover, until banks are reformed and non-performing loans tackled, it would be dangerous to liberalise the capital account. It would be safer to peg the yuan at a higher rate. But most economists reckon that, at best, the yuan’s band will be widened slightly over the next year, without allowing room for any significant appreciation. And, so long as the yuan is pegged to the dollar, other Asian countries will have a big reason to resist appreciation too.

In the wake of the Asian crisis of 1997, it is understandable that governments like to have bigger reserves to defend their currencies against future attack. But stuffing reserves under the mattress is not without cost. The return on American Treasury bonds is much less than could be had from investing the money more productively at home. Large inflows of foreign exchange can also bring too much liquidity into the economy, which can then cause asset-price bubbles. Asian central banks have tried to “sterilise” their intervention,
selling bonds to mop up extra liquidity, but this will become harder as reserves grow.

China is considering various policies to stem the rise in reserves and fend off pressure for a revaluation. One option would be to allow firms to retain more foreign-exchange earnings; at present most have to be sold to the People’s Bank of China. Another option is to relax restrictions on residents and firms wanting to buy foreign currency. The government already plans, later this year, to allow Chinese firms to buy foreign bonds. In June, 11 Asian countries set up a $1 billion Asian Bond Fund that will invest in local bonds. The aim is to develop local bond markets and so keep more Asian capital at home rather than see it invested abroad.

Fred Bergsten, of the Institute for International Economics in Washington, DC, criticises Asian countries’ exchange-rate policies. He complains that they are not playing their role in the global adjustment process that is needed to reduce America’s external deficit. As a result, as the dollar slides, the euro is likely to become seriously overvalued, while Asia’s cheap currencies may provoke protectionism.

The complaints from Europe are likely to be louder than those from America. American pressure on China may be limited because the United States needs China’s help in resolving tensions with North Korea. Another reason for America to pull its punches is that China and other Asian countries hold their reserves largely in American government securities. If Asians lost their appetite for dollar assets, the greenback would fall even faster, and American bond yields would rise.

Indeed, from this point of view, the Asian economies are supporting America’s profligate habits. By buying American government securities they help finance America’s large external deficit, hold down interest rates, and so sustain the boom in consumer spending and mortgage borrowing. This may benefit America in the short term, but it allows even bigger imbalances, in the shape of consumer debt and foreign liabilities, to continue to build. The eventual consequences for America—and the world economy—could be more painful.