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An Observation for Closer Financial Cooperation in East Asia[1]

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(1) Introduction

An elaborate and positive vision for an East Asian community was discussed at the First East Asia Congress held in Kuala Lumpur in August 2003, which I reported in an article for this magazine. (Vol. No. 1125 of May 1, 2004) Since then, there have been steady developments towards this goal in various areas. A good example is the ASEAN-Japan Summit Conference held in Tokyo in December 2003, where the participants expressed their "political will" to create such a community. I believe this conference will be long remembered as an occasion where such determination was expressed explicitly within the region as well as to others. I have also heard that at the Second East Asia Congress, which was held in Kuala Lumpur in the summer of 2004, there was further, even livelier debate on the subject. Then there are increased number of the bilateral free trade agreements, which have been concluded or negotiated throughout the region, creating a network of FTAs within East Asia. This too, is an important contribution towards regional economic integration.

On the other hand, looking at the monetary side, linking the home currency to the dollar seems to have revived as the favored foreign exchange rate policy of the regional economies, although such a policy was criticized severely for a while. This u-turn is due to the fact that the real economies of the region have stabilized and that the dollar rate against the major currencies has been steady in the last few years. As I have repeatedly pointed out, it is hard to expect exchange rates between major currencies to stabilize for the time being, which means that there is always the danger of volatile exchange rate fluctuation. This again points to the danger that a

[1] This article is an adaptation of an article written for the "AFA Papers" of October 2004, published by the Asia Friendship Foundation. And then it was published in "International Finance Journal No1139" issued by Institute for Foreign Exchange and Trade Research in February 1, 2005.

dollar-centered foreign currency policy or a dollar-pegged foreign exchange rate policy may lead to the next crisis.

Various recommendations focusing on these aspects are part of the debate on international monetary structure for the region. The proposal to use regional currencies for regional trade is such an example. This debate has a long history and proposals have come and gone. Progress seems slow, but once it gets started, there is no doubt that an outcome to the debate would have a huge impact on the real economy and could serve as a powerful engine for reform. That is why this proposal to use regional currencies crops up repeatedly. Then why does it disappearrepeatedly?

It has faded away because the idea does not seem realistic where there is a negative spiral created by "things that do not exist." First, the foreign exchange market for the regional currencies has not developed sufficiently. Hence, foreign exchange rates vis-à-vis the dollar have to be the basis of foreign exchange for regional currencies. So there are no direct exchange rates but only arbitrated exchange rates to be calculated indirectly by using exchange rate against the dollar. In calculating the arbitrated exchange rates, the margin between the buying and the selling rates against the dollar has to be paid twice, which means that the rate is not economical. Financial markets have not developed adequately in the region so there is no established way to carry out trade financing in the regional currency. Because the financial markets and monetary infrastructure are not adequately developed, settlement in the regional currencies cannot be expected to be carried out smoothly. The movement of the exchange rates between the regional currencies cannot be discerned easily because such rates have to be calculated indirectly by using the exchange rates of those currencies to the dollar. So the foreign exchange risk for those who are forced to trade in the trading partner's currency cannot be said to be small. There are many more such shortcomings.

Such an environment of negative factors must be changed. I have made various policy suggestions with the aim of contributing to bring about some change. For example, I proposed an "Asian Currency Central Settlement System" (Newsletter No. 1, 1999, International Monetary Affairs) in order to enable settlements between regional currencies in a smooth and highly reliable manner. As a way to change the negative environment, I would like to make a medium-term proposal on international monetary and foreign currency policies of the region in order to encourage the use of regional currencies in intra-regional transactions, which in turn may encourage various reforms in the region. This paper is written with such objectives.

(2) Basket Peg Regime

After the Asian currency crisis, the dollar–pegged exchange rate policy was explained as its causes. This was because the dollar-pegged foreign exchange policy created a dollar-centered foreign exchange policy and this policy, coupled with the dollar-pegged exchange rate (i.e. stable rates against the dollar) formed the basis for capital transactions devoid of foreign exchange risks and allowed the uncontrolled movement of short term capital.

Out of this reflection, the basket peg theory became fashionable and various proposals were made. One proposal even suggested including the Chinese renminbi along with the dollar. The future may bring different scenario, but for the time being there is no reason why the Chinese renminbi, which is fixed to the dollar, should be included along with the dollar. There is still a considerable amount of confusion, including arguments for the sake of arguing, but the critical and long-term aspect that is lacking in all these debates is what aims and strategies the currency basket should have. As an exchange rate policy has complex and multi-faceted aspects and forms the basis of long-term domestic economic management, it is all too clear that there must be a distinct strategy behind the policy.

The kind of currency basket that I recommend for East Asia is as follows.

---The basket must be composed of three currencies: the dollar, the euro and the yen, and their component ratio should be one third each.

---The composition of the basket, its value vis-à-vis the home currency on the standard date, in other words, its exchange rate versus the basket on the standard date, and the acceptable fluctuation margin as an operation target for the time being should be made public.

---The difference between the daily exchange rate of the home currency against the basket, which is traded in the domestic foreign exchange market, and that of the standard date, i.e. the difference caused by fluctuation, should be announced according to a prearranged rule.

---East Asian countries should adopt the above currency basket as well as the same arrangements for making public the various items of information. There may be countries which may want to allow for a broader fluctuation out of domestic considerations and this should be accepted.

This is a straight-forward proposal to adopt a very simple and clear currency basket, and to use it as a shared yardstick of currencies. The simplicity of the system will enable the creation and implementation of foreign exchange rate policies, which are unquestionably necessary for a basket peg regime. A more complex basket will complicate this process and make it impossible to carry out the system. Even if it were architected on a very idealistic concept, a basket system would end up irrelevant, when it has no implication for foreign exchange policy or for domestic economic management, where foreign exchange policy plays an important role.

The next segment will describe the implications of this basket and where it would lead.

(3) The implications of a basket peg regime

I have so far discussed a basket peg regime as a realistic possibility, but would now like to add some new ideas. First, though this is rather intuitive and rough, the component ratio of the yen, the euro and the dollar should be one third each. Second, I am proposing that this ratio and the fluctuation margin as an exchange rate target should be made public. Third, the difference between the current value of home currency against the basket and that of the standard date should always be made public. Fourth, the Asian economies should all peg their currencies to a basket with the same composition.

The logical outcome of pegging the home currency to such a basket is that all three currencies must be used as foreign exchange reserves, as the currencies to be used in trade and settlement and in various foreign /financial transactions starting with trade financing. If a country is adopting the basket peg regime in order to protect itself from a malign intention of one of the developed countries, then that country needs to have the necessary policy targets and to make efforts in related policy areas in order to make the adoption of the system worthwhile. The one-third-each foreign exchange policy is a policy aimed at achieving this goal. Let us now review the implications of a basket peg regime.

First, it will make a drastic change in the notion of "foreign exchange rate stability". When we based our thinking on the premise that "a good currency is a currency that can maintain a long-term stable exchange rate", we all thought of the exchange rate against the dollar, and no other currency really came to mind. (Here I am excluding the few European countries that had pegged their currencies against the Deutsche Mark) If a country adopts a foreign exchange policy of linking its home currency to the kind of basket discussed here, then the currency's rate of exchange would be announced as how many percentage points against the adopted central rate of exchange or against the rate of the standard date it has moved up or down. If this difference is within the policy fluctuation margin (some percentage points above or below the standard rate), the currency is stable even if, for example, it loses drastically against the dollar. (This scenario will occur when the dollar gains single-handedly against the other two basket currencies)

The foreign exchange rate is an exchange ratio, which reflects the relative relationship between the two currencies. It is like looking at oneself in a mirror. So adopting a basket peg would change the notion of foreign exchange stability drastically.

When the relative relationship between the three currencies changes, intervention becomes necessary in order to maintain a link to this basket and that within a fixed fluctuation rate. Also, intervention would be necessary to calm the situation where the currency is targeted in speculation. Intervention can be made against three currencies, but the effect of an intervention against just one currency would be diminished to one third, which means that such intervention would require particularly skilled technique and a well-developed intervention policy. However, long and short-term swap markets already exist between the three currencies and such intervention requirements are possible to meet.

In any case, these issues are likely to become major challenges for a proposed Asian Monetary Fund[2] or an Asian Monetary Fund Institute run by the Fund.

When a currency is linked to a combined value created by three currencies and we try to stabilize it against the basket, it would mean that even when one of the three countries in the basket adopts a selfish foreign exchange policy for its own domestic reason, the resulting fluctuation would not directly affect the linked currency. Adopting such a regime would mean in turn that three currencies could be used in foreign currency policies from foreign exchange reserves to financing, and any unique circumstance of one of the three currencies would no longer have a dominating influence.

Needless to say, the exchange rate of the home currency against the three currencies must result from liquid transactions in the market. It would no longer be the case that even though the foreign exchange rate against the dollar is functioning well, the rates against the other two currencies are calculated based on the rate against the dollar. There would be more direct and various transactions in the market. Fostering markets and making the market functions more vigorous would become major challenges after the adoption of the basket peg regime.

What will be the circumstances that would logically arise after the Asian countries accept such a basket system and fully adopt the methods and functions necessary to maintain the system? The first issue to contemplate is to confirm the rates between different Asian currencies. Currently,

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[2] There are debates over the suggested name of the Asian Monetary Fund. Although I have used "Asian Monetary Fund" in this paper only because it is more popularly accepted, I have no reason to insist on the specific title.

the rates are based on a currency's relation with the dollar, so the rates among the Asian currencies can easily be calculated from this basis. What would happen after the adoption of the basket peg regime? Here, my emphasis on "baskets with the same composition" begins to have some relevance. If all currencies could be pegged to a basket with the same components and weights, then the same method of calculation as currently used could also be applied. Fluctuation margins to the basket need not have to be all the same reflecting the different situations of each country. Consequently, fluctuations among the Asian currencies would be more complex than now. But since they are linked to the same basket, they would not be so directly affected by the fluctuations between the three currencies (though they could be as volatile as now). Thus the relations among Asian currencies would be much more stable and it would not be long before the Asian economies mutually confirm this situation.

As I have already mentioned, the intervention operations would possibly be more complex, when they become necessary to maintain the link to the basket. In many cases (if not always because of the different widths of fluctuation margins) Asian countries would all be forced to intervene in the same direction. It is also possible that the countries will make a concerted intervention in such a case. It is expected that the Asian Monetary Fund will have a major role to play in theorizing and establishing practical methods to deal with such circumstances.

When the Asian currencies link to the same basket, they are expected to move in the same direction generally. Of course, under such circumstances as the inflation rises for domestic reasons, the central rate of the band will have to be changed. One possibility for it is to modestly and intermittently adjust the intervening point as Indonesia was doing for some time. However, it will be seen at the same time that the Asian countries would be more aware of the relative strength of their currencies and the need for the efforts to maintain that relationship. This could lead to making efforts to stabilize the relationships between the Asian currencies. Then the following step is the logical outcome.

(4) Currency union as the next step

The next step to consider is a moderate currency union of Asian currencies. The currency union I am thinking of here is like "the snake" that Europe once had. The way that the snake worked was that some of the European currencies created a system whereby the exchange rates among them would be maintained within a fixed band. This arrangement moved along a narrow band within a larger fluctuation among the major currencies and it looked like the movement of a snake.

So my suggestion is a scheme for the Asian currencies to make a similar arrangement and to intentionally stabilize the exchange rates. It is natural to assume that the arrangement would be more stable if the countries that join this union are at a similar stage of economic development, since that would make it easier to maintain the criteria that are agreed upon. However, it would be possible to include countries with varying degree of economic development if their foreign exchange rate policy and foreign exchange management are carried out smoothly and appropriately Though I have mentioned this union as the step after basket peg, it does not necessarily mean that a union could only be established after the basket peg is adopted and the various policies to be imposed for it (e.g. administration of foreign exchange reserves) are applied with reasonable results and effect. Theoretically, creating a currency basket and adopting it as the mirror for the home currency and establishing a currency union to minimize the exchange rate movement are two completely different policies and they can be pursued in parallel.

But one thing can be said. A currency union would lose a major purpose unless a foreign exchange rate policy based on a basket peg was carried out. It is possible to form a union while maintaining the same dollar-centered foreign exchange rate policies as now but it would end up being a foreign exchange union pegged to the dollar. The hard-learned, expensive lesson that the currency crisis of 97-98 was due to the excessively dollar-centered foreign exchange rate policies would not be reflected at all in it. It would mean that Asian currencies would continue to be overly affected by dollar rate fluctuations and the relative value among the currencies would have to be accordingly adjusted even in the union. This would not make a real currency union. As a prerequisite for realizing a long-term stable currency union among the Asian currencies, it is necessary not to be directly affected by the volatile fluctuations that occur between the major currencies, and to be able to carry out Asia’s own foreign exchange rate policies.

The Asian currency union is expected to be a loose one at the start. If the fluctuation margin from a central rate is as narrow as 2% or 3%, then the ceiling would be easily hit. So the margin would have to be as wide as 10% or 15%. However, it is essential that Asian countries should be aware of each other and try to mutually stabilize their currencies against each other. One positive outcome could be that foreign exchange transactions among Asian currencies would increase. Intra-regional trade could be denominated in one of the trading partner’s currencies and current capital movement starting with smaller transfers could also be denominated in a regional currency. Such foreign exchange transactions in the form of direct transactions between Asian currencies could then develop into larger market transactions.

In order to enable this, the financial infrastructure for individual currencies, especially the settlement system for foreign transactions has to be modernized so as to carry out such settlement automatically and in huge volumes. Though efforts are being made to improve the RTGS payment system in individual countries, settlements must be carried out more effectively. It is also necessary to bridge the individual systems. In doing so, I would again like to suggest creating an Asian Currency Central Settlement System first, and then consider using it for the settlement of international transaction within the region. I have been suggesting the Asian Currency Central Settlement System as part of the Asian Monetary Fund, which should have a huge role to play in creating and maintaining the Asian currency union, including such infrastructure as discussed here.

Theoretically, there is no simple answer to whether or not the yen should join the currency union. If the yen is linked to the basket composed of three currencies with the same ratio as shown above, then theoretically the yen would become the only currency to assure a target zone. On the other hand, there may be Asian economies that would simply peg their currency directly to the yen without adopting such a complicated foreign exchange policy. If there is such a case, it would be for Japan to make a choice whether Japan remains detached or whether it establishes a relationship similar to a currency union with them, helping them to foster their foreign exchange markets for the yen and acknowledging the need to intervene when necessary.

The following scenario must be pursued as desirable and necessary one for Asia, and as having the overall political and economic backing. Asian countries must start linking their currencies to such a basket as mentioned above. When the currencies start switching from the dollar to this basket as a mirror to reflect their value, and using all three currencies in various foreign exchange policies from foreign exchange reserve stocks to current and capital transactions to enable the new foreign exchange rate policies to be effective, then economic entities which have been over-dependent on the dollar would come to use the three currencies equally. This then would drastically increase the use of regional currencies among the Asian countries. Once the situation develops to this stage, the Asian countries may carry out a radical review of the basket and surely urge Japan to be part of the currency union. In other words, the basket composed of the three currencies and the policy of individual countries to link their currency to this basket could be regarded as a policy bridge to the next step. The basket regime has, in effect, the characteristic of a sunset clause.

This developed stage is where there already is a considerable increase in the use of regional currencies for regional transactions including current and capital transactions. The use of the yen among the three currencies will have increased naturally (Though, as I have mentioned, there must be a deliberate effort to realize such a tendency at the outset). There are a number of serious issues that have to be solved before reaching this stage. A good example is how to deal with foreign debt of the United States. Foreign assets of most countries are currently dollar-denominated but there could be a case for changing this situation drastically. This would require that there must be a radical change in the United States' foreign debt situation. Japan, too, must carry out domestic structural reforms such as establishing a central custody and settlement system for various types of securities. Then the currency union including the yen would require the yen to play the role that the Deutsche Mark once played in the European Monetary System.

(5) Conclusion

I have so far gone over the future foreign exchange policy, which includes foreign exchange and foreign exchange rate policies with East Asia in mind. It first reviewed a basket regime and a basket peg as strategies, which would necessarily have to be inclusive of the whole region. Then I have discussed a currency union, including some proposals, as a logical conclusion. If these policies are accepted under a medium-term vision for the region, they are likely to have a huge impact on the real economy in the region. What would the key players of the real sector do if they knew that East Asian countries would jointly accept the same basket composed equally of three major currencies, with a regional currency union contemplated as a medium-term goal? I personally believe that there would be no hesitation in utilizing the three currencies to avoid foreign exchange risks. If the movement among the various regional currencies could be calculated directly and there would be some expectation of stabilization in these relationships, it would not take long before Asian currencies were increasingly used in trade and commerce, beginning with denominating exports in the home currency and in other intra-regional transactions in order to avoid foreign exchange risks as well as out of convenience.

The countries in the region, including Japan, would have to recognize these medium-term policies as critical ones and carry out various domestic reforms. Fostering financial and foreign exchange markets is one of these reforms. Improving the financial infrastructure necessary for such markets is also an important task. Easing various regulations, which would enable diverse arbitrage transactions must be studied. A more important aspect would be to inspect the soundness of the players in the markets so as to avoid failures out of unexpected accidents. Emergency measures must also be thought through in case of such failures. Such domestic requirements would more easily be worked out logically if a firm medium-term policy was established.

Finally, I hope that the establishment of an Asian Monetary Fund (AMF), whose importance was reconfirmed at the First East Asia Congress in 2003, would be recognized as an urgent issue and that there would be a vigorous development. The role of the AMF is varied and hugely important; as the shared policy brain for the region, as the region's IMF, and as the international organization which could watch and advise on the economic management of the regional economies. The earlier it is established, the better it would be. The role of a related research institute, which is also envisioned, is just as important. I have suggested creating such an institute ahead of the Fund, as I believe this issue is of the utmost urgency.

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