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Currency Policy to Enhance Regional Cooperation (Part 3)[1]

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My past two articles in this publication were on foreign exchange rate arrangement and foreign exchange rate policy that should be pursued by the regional economies in order to enhance the future cooperation based on a wide-ranging but ballpark view of the East Asian region. I argued the case for the implementation of a foreign exchange rate policy for their home currencies as part of their domestic policy so that future regional cooperation would be founded on an effective and meaningful currency policy.

As I mentioned in my first article, the foreign exchange rate arrangement adopted by most regional economies before the Asian financial crisis was "de facto dollar pegged". Although the currency authorities explained that they had "created a basket and adopted a managed float system using the basket as a reference", it seemed evidently dollar pegged policy in the eyes of those watching foreign exchange rate movement for any extended period. Such a policy did have a certain economic rational. The US dollar was used for most of the settlement of trade, of non-trade payments and receivables and of funds that are appropriated in capital accounts. The foreign currency reserves as a balance of those accounts were also mostly in the US dollar. This meant that the de-facto dollar pegged policy was logical for a country that wanted to reduce the foreign exchange risk for its economy. There is no denying that this policy did play a role in the remarkable economic development of those countries from the late 1980s right up to the eruption of the Asian crisis. Nevertheless, one of the reasons why the dollar peg policy was severely criticized was because stability against the US dollar had been

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taken for granted and led to rampant capital transactions, which enjoyed a free ride on foreign exchange risks. Such a reaction is also clear evidence that despite the pre-crisis comments of the currency authorities, the markets have regarded the managed float system as de facto dollar pegged. The Asian crisis illustrated that high concentration on one currency could invite an international liquidity crisis in an unexpected way. The most significant lesson learnt by the Asian economies as a result of the huge sacrifices and heavy burden they suffered in the ensuing years is that they should not adopt a dollar pegged foreign exchange rate policy.

A number of years have passed since the crisis and those economies seem to be back on the growth track. Looking at their foreign exchange behavior, many of them have returned to concentrating their efforts on stabilizing their currency against the US dollar in greater or lesser degrees, though only a few countries are adopting an evident dollar pegged policy. This is perhaps inevitable. For most of these economies, which yearn, above all, to resist the upward pressure on their currency and to accumulate foreign reserves, the only benchmark is the exchange rate against the US dollar. However, meekly acknowledging the current situation does not solve any problem, so let me move on to discuss foreign exchange rate policy in a mid to longer term perspective.

Let me first touch on the issue of “global imbalance”. This is not some exceptional situation that arose recently, but rather, a trend that has existed for about two decades. There is only one way to deal with current account imbalances, and that is to achieve a domestic balance. The United State, which is the most significant player in this debate, should be well aware of this reasoning. More than 30 years ago, when the United States boasted a huge current account surplus, they inflicted the theory on countries with deficits that sought bilateral cooperation with the United States that the only possible way to recover from continuing current account deficit is to achieve a domestic balance. Such reasoning by the United States must still be remembered by many of my readers. The twist in the current situation is that the current account deficit is accumulated by the country that runs the key currency. This means that the deficit is being financed by its own currency, the US dollar, and it resulted in boosting the other countries’ foreign currency reserves. These countries (all countries except the United States) are also responsible for this situation since they viewed the circumstances without providing any means to avoid it. A serious disappointment is the lack of a second key currency to complement the US dollar including the fact that the SDR of the IMF was never developed to a satisfactory degree.

There is now another possibility, which is the euro. There are views that the conditions to create a single currency were not met satisfactorily according to the analysis of the most suitable currency area theory. Since the conditions may not have been adequately met, further adjustments may need to be made. But the important fact is that a single currency has been created and is being used backed by a huge economic area, and a more active use of this currency should be contemplated. The United States may now apply the logic of "surplus country responsibility", and conduct a diplomacy as if to say that it does not hurt the United States when the value of the US dollar drops but only those countries holding the US dollar as their foreign reserve currency. It is highly possible that at future multilateral negotiations at the IMF, there would be discussions on balancing the basic savings and investment ratio (and balancing of other domestic figures) in the United States while showing a degree of understanding to the demands by the United States to revalue the exchange rates of the surplus countries. (The discussions are likely to progress at a snail's pace.) A solution would be sought slowly with a heavy emphasis on the sacrifices to be made by the Asian economies by revaluating their currencies against the US dollar. (I am intentionally leaving other countries, such as those from the Middle East, outside of this argument.)

It is vital for the East Asian countries to put their heads together to discuss this issue. Logically, one of the key agreements that should be achieved is the means to reduce the use of the US dollar. (This agreement may be overt or covert depending on the time and situations.) Currencies have various roles to play but in purely functional terms there is no significant difficulty for the yen or the euro to play some of the roles that the US dollar is used in trade and non-trade payment and receivables, or in which borrowing and lending accounts are settled. The yen does not seem to be an ideal currency as the investment management currency since there is no immediate prospect that the low interest rate environment would change any time soon. However, it may still be the currency of choice if one takes into account the fact that investment asset denominated in the US dollar are likely to drop below the principal. That is the devaluation of the US dollar.) There is of course the possibility that the yen and/or the euro will devalue, but as long as the global imbalance continues to be the underlying issue, it is unlikely that these currencies will drop more than the US dollar and show the overall weaknesses. I pointed out in the first of these articles that there is no foreign exchange regime that assures exchange rate stability among the three key currencies, and that significant fluctuations among them must be expected as a consequence. The undercurrent of such fluctuations is the gradual devaluation of the US dollar as a means to cope with the global imbalances.

I have reviewed the current environment and have gone over its effect in order to continue my line of argument in the previous two articles.

1. Mid to Long Term Policy Objectives and their Development

Mid to long term policy objectives with regard to the regional cooperation in East Asia can be defined as "maintaining the foreign exchange stability among the regional currencies." There is no doubt that the economic activities of the region will be knitted together more closely as the integration proceeds. Beginning with the free trade agreements which enhance the flow of goods, the regional integration will move on to the liberalization of trade in services and to the free movement of human resources in the region. Such developments have come to a point where there is no way of going back. When the integration of the real economies proceeds as it is now, the financial stability, especially in terms of the foreign exchange transactions, is critical for the further development of the real economies. In international financial terms, the challenge is "to achieve foreign exchange rate stability among the regional currencies". Once achieved, the stability will contribute to the sustained growth of the regional economies and to an even closer cooperation within the region, as mentioned before, as well as to avoiding another financial crisis. Although extensive debates have been conducted on this issue, it led to why certain things could not be done because certain conditions did not exist. There were even those who proudly pointed out the lacking conditions to demonstrate their intellectual powers. But as everyone knows, heaven only helps those who help themselves.

Let me review how the points I made in the previous articles could affect the mid to longer term objective of "foreign exchange rate stability among the regional currencies."

Following are the proposals I have made.

1) The regional economies should create a basket comprised of equally weighted three major currencies as a means to evaluate their own currency, and peg their currency to the basket. This would be a common basket for the regional currencies. The

creation of such a basket, how it would be utilized and the width of the band must be announced, then a formula to calculate the divergence ratio against the standard rate must be created and announced.

2) This basket, comprised of three major currencies, would have a built-in self-stabilization mechanism and the fluctuation among the three currencies would be negated within the basket. The weight of the basket itself would hardly be affected. In case the value of the home currency against the basket seems to be going beyond the pre-determined fluctuation limit, intervention can be used to push it back within the band if the situation looks temporary. If the situation looks more permanent, then the standard rate would be changed. It is possible that a number of countries would be in a position to intervene, so strategies such as the harmonized intervention have to be considered for multiple countries.

3) This basket would be used for other purposes besides being a mirror to evaluate the regional currencies. For example, there is a call for the establishment of an Asian Monetary Fund (AMF) and the basket could become its basic unit of currency. Another possibility is to issue bonds denominated in this basket and to invest in this unit as a means to nurture the Asian Bond Market. It would be necessary not only to determine the composition ratio but also to be able to weigh its absolute value as a calculation unit. Once the value is weighted then the unit could be named an Asia Basket Unit (ABU).

Now let us see how these three steps could affect foreign exchange stability among the regional currencies.

(1) Areas where each country has to make individual domestic adjustments.

There are many areas where each country to has to make its own domestic adjustments. Since all domestic economic activities would either directly or indirectly affect the value of the home currency, adjustments would have to be made in all areas of economic policy. However, this paper will concentrate on the international economic issues that would have a more direct impact.

The first is to change foreign exchange policy. The US dollar has been the core of the foreign exchange policy of East Asian countries but it would now have to utilize the three major currencies. Until now, the US dollar has been used to in trade, settlement, capital transaction, and etc. The use of a single currency led to accumulating foreign exchange risks for individuals, corporations and for countries. Such foreign currency transactions should be dispersed among the three currencies. Needless to say, the same can be said for foreign exchange reserves. Such arrangements would, almost by definition, require to establish the foreign exchange markets where the regional currencies are traded against each of three currencies. The readers will remember that the creation of each foreign exchange market for the three currencies was the necessary condition for the creation of a basket with three equally weighted major currencies. Governments and monetary authorities cannot realize this requirement by demanding such a market be created. It can only be achieved by the intentional business conduct of the domestic economic entities based on a deep understanding of the situation. Roughly speaking, they can begin by using the US dollar for transactions with North and South American companies, the euro with Europe or those countries with a close association with the euro and the yen with Japan or for some transactions within Asia. American multilateral companies would want to use the US dollar for transactions and it would not be easy to determine the currency for international commodities such as energy products. Given this circumstance there must be tackled as a national strategy. I believe it is worth starting even with small steps. If this endeavour were to be started by a single country, the reaction in others would probably be too great. Consequently, what I endorse is for multiple countries in the region to adopt the basket with the same components at about the same time. These countries must consolidate their efforts to move their foreign exchange policy gradually but with a strong determination not to turn around. Such a move by multiple countries could have the effect of killing an over-reaction by others.

Here is where cooperative efforts by Japan become essential. This scheme aims to conduct transactions in Asia to be denominated in the yen. Such a suggestion has been made a number of times over the years but has never flown because the leaders in Japan’s real economy have continued to react in a negative way. In the Meiji era, there was a belief in long-term planning, looking at a hundred years ahead. Perhaps a hundred years is too long but it is worth thinking of the next thirty years for East Asia. It is quite logical for Japan to put in a serious effort to change the foreign exchange rate arrangement and foreign exchange policies of the region, as Japan would be the top beneficiary of such a change. If other counties want, Japan would have to foster the yen denominated inter-regional transactions, although not with Japan. Such an effort would involve the development of foreign exchange markets between their home currencies and the yen, which would provide business opportunities for Japanese financial institutions.

The next issue is to develop the domestic markets of the East Asian economies. I proposed the establishment of the foreign exchange markets where the regional currencies are traded against each of the three major currencies have equal values. This is necessary to enable the basket pegged system to be effective. The regional currencies that are pegged to this basket would be able to keep some distance from the fluctuations among the three key currencies while measuring its value against the basket. The foreign exchange relationships between the regional currencies would be easier to evaluate and it would not be long before the exchange rates became more stable. The exchange rate between the Thai baht and the Malaysian ringgit were quite stable before the crisis because both were pegged to the US dollar. The new arrangement would peg such currencies to the same basket composed of the three major currencies. If the three currencies in the basket are equally weighted, the regional currencies against the basket would be more stable than the rate against the US dollar and the currency because of the automatic stabilization mechanism built into the basket. It is logical to expect that the regional currencies would be pegged to the basket, would move in a stable manner.

As part of dispersing some of the current roles of the US dollar to the other two currencies, I suggested that transactions within the region could be conducted in the yen. However, there is no reason why they should not be tried in one of the home currencies of the trading partners. They could choose either the yen or one of the home currencies. In order to increase transactions in local currencies, foreign exchange markets must be established in each country. The aim is to move away from the current situation where all foreign exchange trading are against the US dollar, and trading against the yen, the euro and between regional currencies use arbitrage rates calculated from the US dollar exchange rate. Admittedly, it is a challenge for the currency authorities to operate multiple foreign exchange markets simultaneously, but it is a step that must be taken. If the regional countries continue to concentrate on foreign exchange trading against the US dollar, they would continue to be affected with every little turn of the US dollar rate movement just as before the Asian financial crisis. This is because the exchange rate of their currencies against the US dollar would automatically be unstable since each currency would be swayed individually against the US dollar as the global imbalance is adjusted (through revaluation of the US dollar).

(2) Areas where the regional economies should make joint efforts.

For the countries that have decided to adopt the basket composed of equally weighted three major currencies as a mirror to reflect the value of their own currency, and have taken the necessary measures as top domestic policy priority, it would not be difficult to cooperate with other similar countries. This new foreign exchange rate arrangement would be an antithesis to developed countries that failed to produce any meaningful or productive foreign exchange regime since the adoption of the full float system in 1973. As there is a danger that a country that adopts the new arrangement would be harshly reprimanded by developed countries, a number of countries should join forces and adopt it simultaneously. It is also important that once adopting it, these countries stick to the policy with solid determination. These are the ways in which regional countries could cooperate effectively.

There are also a number of technical issues such as the creation of a settlement system for regional currencies and of a securities depository system, and liberalization of intra-regional capital account transactions that must be solved. However, such issues would emerge naturally as part of the debate once the direction of the argument is determined. Most technical questions have technical answers and are probably not difficult to solve. Other issues such as the expansion of the Cheng Mai Initiative (which theoretically would have to include the three major currencies), and as its prerequisite, the improvement of the surveillance system in terms of accuracy and extent must continue to be pursued. As the readers will understand, the development of these two systems theoretically leads to an Asian Monetary Fund (AMF).

2. Issues for the Future

I had intended to focus this article on the developments after the common basket composed of the three equally weighted major currencies are adopted. But looking at where these countries stand after the crisis and at the fact that the global imbalance is attracting attention as if it were a new problem, I decided to write on the role of the basket that I am endorsing in view of these problems. One important factor to note is that although these countries are claiming that they will not go back to a dollar pegged system, the reality is that they only have a foreign exchange market against the US dollar and only conduct foreign exchange transactions against the US dollar. Such reality means that foreign exchange problem is nothing but a US dollar foreign exchange problem for all the countries, and in terms of the system and in the minds of the market participants, these countries have, in practical terms, a dollar-pegged system. While no effective measures are taken to change this situation, the global imbalance has again become a huge issue with the US dollar foreign exchange problem on the other side of the same coin. I am not predicting that this situation will lead to a financial crisis in the region, but I am concerned that the regional economies could be asked to make a huge sacrifice as part of the effort to defend the US dollar.

I believe that the basket scheme I am advocating could decrease the burden associated with solving the global imbalance if the Asian economies would choose the policy of pegging their currency to the basket and take the domestic measures that are theoretically compatible with this system. The argument on this aspect has taken up more space than I had anticipated leaving no room to carry the discussion any further.

In the next paper, I would like to discuss further developments including a currency union and the creation of a calculating unit based on the regional currencies.

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