2006.6.1 (No.2, 2006)

Newsletter

Institute for International Monetary Affairs

(財) 国際通貨研究所

Currency Policy to Enhance Regional Cooperation (Part 2)[1]

Hajime Shinohara

Advisor

Institute for International Monetary Affairs

In my previous paper, I proposed a managed float system pegged to a basket as a basis for a foreign exchange rate policy to enhance regional cooperation. I mentioned some prerequisites for such a system, which are as follows.

First, there is an underlying reality that long-term exchange rate stability cannot be expected among the three major currencies of the developed industries that heavily affect other economies, i.e. the US dollar ($), the Japanese yen (¥) and the euro (€). The foreign exchange market participants will not be assured of a steady movement of the market from now into the future.

On the other hand, the important goal for monetary authorities of individual countries is to assure the stability of the value of their home currency. This may be achieved by simply balancing domestic factors in the case of a country economically secluded from the rest of the world. However, for countries where settlement of trade, of non-trade payment and receivables and of funds for capital transactions has considerable impact on domestic activities, the task of stabilizing the home currency becomes more complicated. Stability of a currency means that the value of a foreign currency (foreign exchange rate) evaluated in the home currency does not fluctuate sharply. Such stability will promote sound economic activities and growth domestically while also serving as an indicator of external stability of the home currency. During the period of what was termed the "East Asian miracle", most governments in the region chose to adopt a de-facto dollar-peg foreign exchange rate policy in order to achieve such the stability. The chosen policy did bear fruit, contributing to an impressive growth. However, it is also an undeniable fact that the same policy precipitated the Asian financial crisis, which began in 1997 by inducing unnecessary and undesirable

[1] This article was published in "International Finance Journal No1165" issued by Institute for Foreign Exchange and Trade Research in June 1, 2006.

capital transactions (i.e. capital transactions with a free-ride on exchange rate risks).

The most significant lesson from this experience is that although the policy of pegging to one currency, such as the US dollar, is beneficial for stabilizing the value of the home currency, it is also the policy that carries too heavy a risk. The monetary authorities of the Asian region had learned the lesson the hard way. Naturally pegging (or linking) to a basket has been suggested as an alternative to this single-currency-pegged policy. Given the lessons learned, such a basket will have to be the one that enables the home currency to stabilize for a long period and should be presented in a way that can be easily accepted domestically by the society and the economy. It is also important that the mechanism of the basket can be easily understood by the international community and even more so by international market participants. This means that the current policy adopted by many of the authorities in the region, which is to create a basket to adopt a managed floating system using this basket as a benchmark but keeping the composition of the basket confidential, is not adequate. Also, if the basket is to be a "mirror" to reflect the value of the home currency, then it will be preferable that the same "mirror" is used by multiple economies in the region.

These are the basic considerations for creating a basket composed of the three equally-weighted major currencies and a foreign exchange rate management of the home currency based on this basket.

1. Composition of the Basket

Creating a basket with the three equally-weighted major currencies is, in effect, simple. Following are how it could be done and what the basic management philosophy based on the basket is.

Let us say that the currency unit of a country X is X. (e.g. Thai baht) When the spot rates of X against the three major currencies are quoted in the foreign exchange market at the base time T0, they can be depicted as follows.

1 \$ = A0X, 1€= B0X, 1¥ = C0X

Rewriting these as the value of X will be:

1 X = (1\$/A0, 1€/B0, 1¥/C0)

Since the three major currencies have equal weights in this basket, the value of 1X against the three currencies can simply be added then divided by three. This means that the value of basket B at the base time can be calculated as follows.

BX = 1/3 x (1\$/A0 + 1€/B0 + 1¥/C0) -----(1)

Such a simple equation calculates the value of the basket at the base time T0.

Now, let us say that at time T1, the exchange rate of the three currencies are A1, B1, C1 respectively. The weight of the basket as shown in (1) can then be calculated as follows.

If the exchange rates of the currencies are

1 \$ = A1X, 1€= B1X, 1¥ = C1X,

then equation (1) becomes

$BX = 1/3 \times (A1X / A0 + B1X / B0 + C1X / C0)$

which can be written as

$BX = 1/3 \times (A1/A0 + B1 / B0 + C1 / C0) \times X$ ----- (2)

Let us use these two equations to review how the basket can actually be utilized.

Once a decision is made to use the basket for foreign exchange rate management, the base date, then the coefficients in the equation (1) must be determined by adopting the market rates on the base date. Needless to say, the coefficients can be rounded figures. Once equation (1) is determined, the information must be spread to those involved in markets in and out of the country so that those who need to know the composition of the basket.

Next, the width of managed float band has to be announced to the markets. It means that the limit of divergence from the central rate determined on the base date would be announced as a policy target. The managed fluctuation width must be decided in accordance with the environment and there is no specific percentage of the width deemed universally suitable. Different economies will be in different environments, which means that one country could embrace a different fluctuation rate from another even if they adopted a similar foreign exchange management system.

Once these steps were taken, fluctuations in the foreign exchange market could be reflected in equation (2) and the authorities could confirm that the outcome was within the boundaries of the pre-determined fluctuation rate. The coefficients in equation (2) are the traded value of the three major currencies in the market and unless there is a drastic change in the environment, each component (e.g. A1/A0) is expected to be close to one. The result derived by adding the three components then dividing the result by three is expected to be close to one as well. The composition is such that even if the quoted price of one of the three currencies should fluctuate extensively from that of the base date, the effect would only be reflected on 1/3 of the weight in the calculation of the basket, and would have only a small impact on the value of the basket as a whole. This system would serve as an automatic mechanism to achieve the stability.

The fluctuation of the three currencies amongst themselves, which occurs without any relation to the economies of East Asia, will be reflected in the individual components of the equation. The changes of the value of the three currencies are likely to be offset in the equation since, for example, if the US dollar falls, the euro will rise. Adopting the basket of the three equally-weighted major

currencies is the best way to manage the home currency without being over affected by the fluctuations of the three major currencies. It is also the best way to absorb the impact of the fluctuations among those currencies.

There will, however, be occasions when BX looks likely to move beyond the pre-determined fluctuation limit. This is a situation where the ratio of the weight of the basket (sums of the coefficient part of the equation) as calculated by equation (2) to the weight at the base time appears to exceed the fluctuation limit. There are several ways in which to deal with such a situation.

If the situation seems temporary, then the exchange rate could be pushed back within the band through intervention. This is not far different from market intervention in the case of a dollar-peg system (including an undeclared but essentially dollar-peg system).

If there is a situation which calls for revaluation of the home currency for some reason, it would be necessary to recalculate (1), which would mean constituting a new basket based on the exchange rates of the time, and reassessing the divergence band. This, again, is similar to the case where a country alters the median rate for intervention under the dollar-pegged managed float system.

This paper has so far touched on the creation of a basket composed of the three equally-weighted major currencies and the application of a managed float mechanism based on that basket. The important procedures are to clearly announce the composition ratio in the calculation of (1), and the width of the band within which divergence from the value of the base date as calculated by (2) would be managed. The significance of these procedures will be explained in the subsequent sections.

2. Adoption of the Basket throughout the Region

There are significant advantages to multiple economies in the region using baskets with the same components as a "mirror" to reflect the value of their home currency. Commentators on foreign exchange policies are in agreement on this point. When the most suitable components of a basket are studied in individual countries, it is easily presumed the composition might not be the best for some other country in the region, even if the process were conducted meticulously. The basket composed of the three equally weighted major currencies that this paper endorses would overcome debates on pedantic differences among countries. It would also serve as a trustworthy "mirror" and would have an inherent automatic mechanism for stability. From a wide perspective, such a basket seems the system that could most easily be adopted when multiple countries have similar concerns. Needless to say, it would be more effective if the same base time were adopted with the baskets. However, as long as the components of the basket were the same and they were equally balanced,

any variation caused by different timing of adoption could be adjusted technically. Divergence band could vary from country to country depending on the restrictive conditions placed on foreign currency policy. (The foreign currency policy in this context means an overarching policy deriving from a comprehensive view on the ratio of trade denominated in the home currency, settlement situation of foreign currencies, mid-term outlook on the stability of current accounts, etc.)

One of the significant advantages of adopting the same basket is that the various currencies of the region could utilize the same "language" to explain the condition of its currency and the efforts made to stabilize the home currency to the markets and to the international community. The exchange rate with the US dollar will continue to be the most important for other currencies, but the view of the foreign exchange market as seen from the US dollar (so-to-say the CNN view) could cease to be propagated as the only view of the market.

Thailand and Malaysia adopted and meticulously followed the dollar-peg system after the policy became popular in the second half of the 80s. As a result, the exchange rate between the currencies of these two countries was stable. So adopting the same basket system is also likely to have the benefit of maintaining a stable value (i.e. foreign exchange rate) against the other currencies that adopt the same basket system.

An important mid-term objective of the countries and the currencies in the region is to increase the use of the regional currencies among themselves. Various steps must be taken for this purpose, such as creating a comprehensive settlement system for the regional currencies. (Strengthening of regional cooperation, even if gradually, is quite a positive development from this respect) Another step is to nurture the foreign exchange market for direct transactions among the regional currencies. Currently most transactions are arbitrated using the US dollar as the intermediary and settlements are conducted in a similar way. Theoretically, this means paying the differences twice between the buying and selling quotations to New York. Modifying this situation is beneficial for the national economy of East Asian countries (as well as the regional economy).

There must be deeper understanding among the currencies of the region in order to promote direct foreign exchange transactions between regional currencies. Currently some countries are adopting a managed float based on a basket with undisclosed components. Some economies, in effect, are applying a dollar-peg system with others applying similar but somewhat different policies. Such a situation does not promote an understanding of the foreign exchange rate movements of various currencies, which are calculated arbitrarily.

If these countries take a political decision to adopt the basket with the three equally weighted major currencies, then they should announce the decision to the world and operate a managed float system. The coordinate axis among the currencies would automatically be made clear and foreign exchange calculation would be a great deal simplified. This would also promote understanding among the regional currencies and hence direct foreign exchange transactions.

3. Further Developments

Assuming that the regional economies have adopted the basket with the three equally weighted major currencies and are using this as a benchmark to carry out a foreign exchange policy of a managed float, let us review some of the implications and consequences.

(1) Implications for the Asian Monetary Fund (AMF)

Considerable time has passed since an Asian Monetary Fund (AMF)[2] was first proposed. With the debates over the East Asian Community acquiring more momentum, the understanding of the importance of the AMF has spread gradually and considerations seem to be developing to make it a reality.

This paper will not go into the functions and the rules of the possible AMF, but apparently, the organization would be expected to have a significant role to play in the foreign exchange policy discussed here. For example, let us say a country, which had adopted the managed float based on the basket decides that it is necessary to intervene because of fluctuations in the foreign exchange market. The country would have to decide in which of the three currencies it should intervene, whether to intervene jointly with some other country or countries under the same condition, etc. It would be the first intervention under the policy and the analysis and policies of the AMF will have extensive impact on the decision-making. If the AMF were established before such a basket was adopted, guiding the creation of the basket and having it shared by countries in the region would be some of the ideal issues for the organization to be involved in. Again, I will not touch on these aspects in this paper.

There is a considerable support for creating the AMF but there are not many who would discuss the operations of the organization. For example, what currency would be adopted? Initially, the yen was considered as the currency to be adopted. However, because the scheme was floated

[2] An Asian Monetary Fund was originally floated as an Asia Monetary Organization. After much lobbying at the fringes of the IMF/World Bank annual meeting in Hong Kong in 1997, the organization came to be referred to as the AMF. This paper will use the term AMF as the name is more widely known publicly.

early in the Asian crisis, which seemed to develop into a dollar liquidity crisis, the US dollar automatically was assumed as the currency to be adopted. Counter measures for the US dollar liquidity issue would have to be discussed when the AMF was created. But now that the region has overcome the crisis, does the currency for the AMF have to be the US dollar?

The author believes that a measurement unit for the AMF should be devised using the basket discussed in this paper. In other words, a measurement unit that comprised of the three equally weighted major currencies. Just as the IMF created the SDR as its measurement unit, this new unit would be the new unit for the AMF. The absolute value can be $3 worth (the sum of $1 worth of the US dollar, the yen and the euro) or 1/3 of it as long as it is a figure that would stick in the mind.

The new unit would need a new name, but let us use the Asian Basket Unit (ABU) for the time being to reflect the way in which it could be created.

Operations of the AMF, from receiving capital to extending a loan, would be denominated in the ABU. Fundraising could also be in the ABU, from the member countries in the region, directly from foreign exchange reserves or from markets in those countries. There would also be instances of borrowing from the markets of developed countries. If it were yen denominated borrowing from a yen market, then 1/3 of it could be swapped into the euro and the other 1/3 into the US dollar, which would make it possible for the borrowing to be regarded as a debt in the ABU.

The AMF would announce the foreign exchange rate between the ABU and the three currencies, and the compounded interest rate. It should also consider creating a semi-independent settlement organization under its wings to provide a place for foreign exchange transactions and the settlement of capital transactions in the ABU.

Countries using the basket could create assets and liabilities quoted in the basket, which would be linked to the home currency, and this would be an ideal operation to avoid foreign exchange risks. One of the key roles of the AMF is expected to be surveillance of the member countries, and this commitment could be the leverage to conduct a degree of surveillance on the economies of the three major currencies. Using such contacts as an opportune moment to convey the thinking of its members to the authorities of those three currencies would be another important role of the AMF.

(2) Implications for the Asian Bond Market Scheme

Readers will easily suspect the natural flow of this argument. Since one of the causes of the Asian financial crisis was the flaw in the long-term capital market, it is the correct approach to try to develop a bond market by bringing together various ideas from different perspectives. It is also logical that such efforts are materializing in parallel; measures to be taken in international markets

(which were characterized as “euro” market in the past) and the expansion and internationalization of domestic markets.

However, when the discussion comes to the choice of a currency, there is a tendency to turn the tide and go back to dollar denomination. Conducting transactions in dollar-denomination, inviting bond issuers and investors from within the region, and creating the suitable infrastructure are surely the easiest ways to advertise the progress achieved in the region. But would that be the best way to utilize the regional savings that have accumulated massively as seen in the size of foreign reserves?

It is hardly possible to create a regional currency unit in Asia now like the ECU with the regional currencies as its components partly because of technical reasons and partly because of the environment in which these economies are placed. Under such circumstances, an ABU that would serve as a meaningful unit for calculation (an unit that could be used for issuance quotation in bond transactions) should be considered. Transactions denominated in ABU, which would be linked to the home currency to avoid foreign exchange risks, would undoubtedly be welcomed by both the bond issuers and the buyers (investors). If the AMF should provide a venue for settling funds in the ABU, the unit would be an even more convenient one to use. Until such a venue were created, delivery could be made in three separate currencies, which, as some may remember, was the case in carrying out and recalling impact loans denominated in SDR in Japan.

Theoretically speaking, the adoption of the ABU as a unit of calculation in the bond market is possible even before the creation of the AMF and even before a consensus is reached to use a basket with the three equally-weighted major currencies because its realization is achieved by its adoption. This is a viable tactical approach to be considered.

4. In lieu of a Conclusion

This paper has covered areas far beyond the use of a basket as a “mirror” to reflect the value of the home currency. But as explained above, the basket composed of the three equally-weighted major currencies would not only be useful as a “mirror” but would be a present common tool that could be employed with ease. On top of that, it is clear that it could evolve in various practical ways such as developing into a currency unit used by the AMF or be adopted in the Asian bond market.

At the next opportunity, I would like to expand my thoughts on the implications of adopting a basket system on the operation of the domestic economy, then further onto the development of a unit of calculation with the Asian currencies as its components.

Copyright 2006 Institute for International Monetary Affairs（財団法人　国際通貨研究所）
All rights reserved. Except for brief quotations embodied in articles and reviews, no part of this publication may be reproduced in any form or by any means, including photocopy, without permission from the Institute for International Monetary Affairs.
Address: 3-2, Nihonbashi Hongokucho 1-chome, Chuo-ku, Tokyo 103-0021, Japan