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

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1. Foreword

The concept of "East Asian Community" began to be discussed around the time of the Asian financial crisis among academics and think-tanks. At that time, conceptual exercise would invariably end with the conclusion that the intellectual community had reached a consensus on the issue as to its necessity and had a keen interest in bringing about such a community, and that the only missing factor was the political will. In other words, all debates were conducted without the participation of politicians and the intellectuals would conclude their responsibility by throwing the ball to the politicians.

In Europe, on the other hand, regional integration has been intensified over the last decades. Countries in North and South America are also groping for ways to cooperate regionally. In both Europe and the Americas, there are constant and diverse developments, such as the increase of member countries and the possible creation of smaller groups within the integrated area. Whatever the developments, there seems to be no doubt that there is no turning back from strengthening cooperation among countries in a region. These developments in Europe and in the Americas leave Asia as the one region lacking in more concrete regional cooperation, a fact which should have an impact on the political establishment in Asia. Intellectual circles are observing the situation with some expectation that the environment for regional cooperation in Asia may finally be changing.

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The debate on East Asian Community at the political level has moved from the stage of the leaders acknowledging the issue to dialogues among politicians at various forums. Throughout these exchanges, the discussions seem to have focused on the most political of the aspects, i.e. membership --- whom to include, or more significantly, whom to exclude. Needless to say, if integration should mean political integration and/or the creation of a single currency, it would extensively limit the sovereignty of individual members, and membership could be the determining factor for the success or failure of the organization.

Creating East Asian Community is not regarded as an urgent or inevitable issue. Regional cooperation does exist, such as on health and safety issues concerning SARS and bird flu, and there are numerous free trade agreements (FTAs) that cover the region like a spider's web. The cooperating countries on the health and safety issues should not necessarily be the same as the countries that may eventually cooperate in something like a customs union that may emerge from the FTAs. The reality on the ground is that practical cooperation is developing in various areas and the countries participating, and depends on the issue concerned and whether or not countries see it in their interest to do so. Such an approach is sensible and realistic for the region.

The region had a devastating experience during the financial crisis, but thanks to the bullish US economy and growing Chinese economy, many of the affected countries were able to return to a growth cycle. Their foreign exchange reserves have increased and so has capital flow without much ado. However, as regards regional financial cooperation, there is no shortage of debates but there is no telling when they may produce some concrete consensus. There were heated discussions on foreign exchange rate policies in the immediate post-crisis period, since they were acknowledged as shared problems for the region. Partly due to the relatively stable situation of the currencies of the developed countries, such discussions seem to have evaporated as a thing of the past. This paper is an effort to revive such debates, arguing the significance of the foreign exchange issue and how it is in the interest of the whole region to share an understanding of the problem.

2. The Pros and Cons of Pegging to the US dollar

One policy that no one, whether in or outside of the region, supports after the Asian financial crisis is the "dollar-peg" arrangement of the currency. This is because the dollar-peg was seen as one cause of the crisis. On the other hand, a simple reflection will reveal that the same policy also helped realize the sustained growth of the region from the second half of the 80s to the financial crisis. Before contemplating the suitable foreign exchange policy for the region, it is useful to review the role that the dollar-peg policy had played, as foreign exchange rate policy does affect various domestic policies as well, although it is reflected in the foreign exchange rates in a straightforward manner and may seem to be a technical issue.

Even the countries that had adopted a dollar-peg policy were reluctant to admit this crucial fact when the financial crisis occurred. They explained that their foreign exchange rate policy was based on a basket of currencies, which was floated on the basis of periodic calculation. Assuming that the explanation was right, the next question would be “which currencies are in the basket”? The governments of those countries would decline to give the answer saying that the revelation of the components could start unnecessary speculations in the market. They would also explain that the currencies and their weight were determined by the payments and receivables of trade, current account and capital transactions. This meant that the content of the basket would have accurately reflected the foreign currency and foreign exchange policies of these countries.

An academicians’ group in Japan calculated the components of these baskets using statistical methods and concluded that currencies that had a relatively stable foreign exchange rate against the US dollar since the mid-80s, such as Thai baht and Malaysian ringgit, must be managed with the basket of currencies where 80-85% of the weight was the US dollar. The other currencies and their ratios do not seem to matter seriously when one particular currency weighs so heavily. Their baskets, in effect, reflect a dollar-pegged foreign exchange rate.

Such a policy also leads to a natural conclusion that 80-85% of their foreign currency policy decisions were related to the US dollar. This is not at all a surprise, but rather within reasonable assumptions since it reflects the fact that current account transactions including trade and capital transactions were mostly conducted in the US dollar. Foreign exchange reserves, which provide an overall picture of the foreign exchange rate policy, should reveal an even higher ratio of the US dollar.

A dollar-pegged policy is logical for these countries for the following reasons. (1) avoiding foreign exchange risks. This applies to all foreign exchange risks of individual countries, including their foreign exchange reserves in terms of managing excess capital. (2) Foreign exchange rate stability brings stable domestic economic management. The stability of export and import prices in the home currency contributes strongly to the expansion of domestic economic activities. (3) It is to the benefit of countries to demonstrate that their currencies are stable against the US dollar since the international markets closely watch their exchange rates against the US dollar. This reflects the message sent by international organizations and markets in developed countries after the Latin American crisis of the ’80s that “a good currency is the one that can maintain a stable exchange rate." (4) Exchange rates between the currencies of the countries that are pursuing a similar dollar-peg policy, such as Thailand and Malaysia, stabilize as a result of adopting such a policy, which encourages closer economic and trade relations.

As is evident from the above, the foreign exchange rate does not only affect international travellers individually but also such basic economic activities as a whole as depicted above.

I will now review why this dollar-peg policy, which had been an important factor that brought about the "Asian miracle", was then quickly assailed once the financial crisis occurred.

I think the dollar-peg policy provided two of the factors, larger and smaller. that caused the Asian financial crisis. First, the smaller factor was the effect on current account transactions. I have already mentioned that more than 80% of current account transactions were conducted in the US dollar and that this phenomenon was the logical result of the dollar-peg policy. The problem was that even though trade and settlements were conducted in the US dollar, the trading partners were not necessarily the United States nor other countries that adopted the dollar-peg policy. A good case in point is Japan. Let me take Thai baht as an example: It had floated around 25 baht per the US dollar for a long time. In 1995, the US dollar dropped to around 80 yen and baht was worth 3.2 yen. Three years later, the US dollar appreciated to 147 yen per the US dollar, which meant 5.9 yen to baht. It is obvious that such a huge fluctuation in just three years has had a considerable impact on Thailand's trade with Japan. The rise of the US dollar in this period was not just against yen but also against various European currencies, which implied that trade with Europe was affected in the same way. Such consequences are evident in the trade statistics between '95 and '97. The reason why I gave this dollar-peg a smaller factor is because Thailand had been suffering from a foreign exchange liquidity crisis as a result of current account imbalance long before it was hit by the Latin American style of capital crisis. However, it is true that because baht was pegged to the US dollar, it became a victim of a selfish US foreign exchange rate policy, and it would have been forced to revalue even without the other factor.

Following is the second, more major impact of the dollar-peg. A dollar-peg policy means that the value of the home currency baht has been fixed or semi-fixed to the US dollar for a relatively long time, thus minimizing the foreign exchange risk between baht and the US dollar. It was natural that the opening of the markets (liberalization of capital transactions through off-shore accounts called BIBF) and the related deregulations increased cross border capital transactions because of the differentials between domestic and foreign interest rates. For most countries, measures that are also taken in such cases to avoid foreign exchange risks will absorb the interest rate differentials. However, in the case of Thailand, because baht was pegged to the US dollar, foreign exchange risk was neutralized by the dollar-peg policy, resulting in increased short-term capital transactions in what I call a "capital transaction with a free ride on foreign exchange risk." Inflows of the foreign currencies (mainly the US dollar) through such short-term capital transactions were exchanged for baht at spot transactions, and the US dollar caused the foreign exchange reserves to increase rapidly while baht maintaining firm stability against the US dollar. All these factors provided strong support for maintaining the dollar-peg policy. The tragedy was that those capitals flowed into the domestic market created over-liquidity and a bubble. The bubble affected domestic businesses and serious questions began to be asked about their profit abilities and fund availability. The situation spiralled down to a point where there was a sudden run on foreign capitals that had entered the markets as short-term capital, and the country was hit with a severe foreign currency liquidity crisis. It would not be a mistake to say that the dollar-peg policy was the main reason of the crisis by creating the impression among market participants that foreign exchange risks could be disregarded.

Here we must consider whether it is possible to have a policy that avoids a free ride on the foreign exchange risk and takes advantage of the dollar-peg policy as well. I believe it is possible. The policy that Malaysia adopted in September 1998 was such a case. Ringgit was fixed (pegged) to the US dollar, and foreign exchange controls were strictly applied, especially on short-term fund transactions. (In the '98 package of reforms, many other changes were made but most of them were temporary and undone in the following two to three years) Besides controlling the flow of foreign capitals, Malaysia was also making the effort to limit the internationalization of its currency (controlling the balance of Malaysian ringgit held by non-residents) in order to dampen foreign exchange speculation. Along with restrictions on capital transactions, this was an effective element of the policy package.

China had been adopting a policy close to Malaysia's and that was most likely the reason why the country was hardly affected by the Asian crisis. The fact that both China, which had been long applying the above policy, and Malaysia, which adopted it after the crisis, came out of the crisis with the least damage provides a meaningful lesson in studying foreign exchange rate policy in the future.

3. Currency Basket as a Constructive Antithesis

The dollar-pegged foreign exchange rate policy supported the sustained economic growth of many Asian countries for a long time after the second half of the 80s, but the same policy also was the cause of the liquidity crisis in Asia from 1997. The contrasting effect showed that if a country tries to maintain its currency's stability against a particular single currency, then the home currency will be unstable against many of the other currencies and the situation could lead to a crisis. Hence, in order to avoid this, the economies in the region should create a basket of currencies and try to maintain stability between the home currency and this basket. This has been the rationale behind a currency basket. There are some extreme proposals that ignore the basic logic and methodologies, and simply suggest creating a currency basket to stabilize the home currency. Those who advocate a currency basket as the antithesis of a dollar-peg seem to hope that a currency basket will be a silver wand, but let us look at its functions analytically.

Before going into the details of currency baskets, it must be reminded that there has never been a sustained exchange stability among the three key international currencies. I am not simply agreeing to the argument that the amount of capitals that the authorities can employ is limited compared to what private speculators can, and therefore the authorities cannot guarantee stability through intervention and other means. On the contrary, I do think it is possible to maneuver foreign exchange rates to where the authorities wish them to be if the three currency authorities agree on the rates and coordinate. This was evidenced by the Plaza Accord of 1985 and several other incidents. Agreements and coordination in this fashion may sometimes be made open, other times covert. The public may look back on exchange rates in the past few years and come to understand where the authorities wanted the exchange rates to be. However, future exchange rates cannot be promised. For once the market finds out what the promised level is (including target rate system or target zone of rates), the market will start moving as close to the target as possible, to the point where there would be a huge speculative move. It would be incredibly difficult to fight against this tendency. The interest rate in Japan has been zero for quite a time. What would happen if future rates could be known? There is no knowing in what kind of magnitude the international capital would move. Whatever arguments are made about exchange rates, the premise is, and therefore, that the stability based on predictable exchange rates arrangements among the key currencies is not on offer for the foreseeable future.

The first possible exchange rate policy in Asia is to peg the home currency to the US dollar or to the foreign currency that plays the key role for the economy of that country. In this case a strict foreign exchange management must be applied and international capital, especially the short-term capital, must be controlled. Various aspects must be taken into account when considering a dollar-peg policy; from a rather technical consideration of foreign exchange management to trade structure and the level of foreign dependency of the economy. If such issues cannot be positively forecast, a dollar-peg policy will not last long.

The second choice is to open the market, deregulate, allow foreign capitals to flow in and out freely and the home currency to float completely. Developed countries, especially the authorities of the three key currencies, apply this policy partly because there is not much choice for them. However, this could be a rocky road to take in the emerging countries in Asia. If taken, such rumors as market is selling certain currency could cause fluctuation in exchange rates. Overshooting, which is an unavoidable symptom in market, or speculation coming out of populist sentiment must be dealt with. These are all difficult challenges for emerging countries. I personally believe that developing countries in Asia should adopt a free-float policy only after an international organization (such as an AMF) in charge of regional currencies and finance is created and well established, so that they will have a dependable guardian, so to speak.

The responsibility of the monetary authority of a country can be consolidated in maintaining the value of the home currency. For countries that insulate themselves financially from the rest of the world, stability in the value of their currency could be pursued through balancing their domestic economic activities. For others the foreign exchange rate becomes the guiding index of the effectiveness of their policy. If it is not advisable to fix the home currency to one foreign currency and maintain stability only against that currency nor permitted to completely allow the market to determine the rate, then there has to be another index. A currency basket can be regarded as that index. As we have seen, if the weight of one particular currency within a basket is too heavy, then the basket becomes identical to that currency. Desirably a basket must wisely reflect the foreign exchange rate policy of the time. It must also be easy for the financial and business circles in the country and market participants to know the components and understand the policies underlying the basket. This logic will lead to the conclusion that the currencies to be included in the basket that reflects the value of the home currency should be the three key currencies, although they will be unstable for the foreseeable future. It would be contradictory to add another currency that is pegged to one of these key currencies (such as renminbi which is pegged to the US dollar), because this would only increase the weight of the pegged currency. It would also be impossible to directly reflect the current foreign exchange rate policy to the basket since this would only result in the US dollar weighing as much as 85% within the basket. The weight of the currencies in a new basket must be decided after a comprehensive analysis of the actual economic conditions and management.

Based on these observations, the author recommends for the Asian economies a basket with yen, the US dollar and euro, each weighing one third. If the composing currencies have the same weight, then the fluctuations among them will be negated most effectively and will least affect the value of the basket. For example, the value of a currency, let us say Thai baht, would not be affected even if yen appreciates 5% against the US dollar because this change would be absorbed within the basket by an equal depreciation of the US dollar. Of course, a basket with the US dollar, yen and euro weighing 4-2-4 can easily be made. But in that case if the yen appreciates 5% against the US dollar, the value of the basket against baht would change unless the exchange rate of baht against yen moves twice as much as that against the US dollar. Thus the best way to avoid the change in the rate between a currency and the basket is to have the three currencies weigh equally within the basket.

Some measures will have to be devised to assure effective use of the basket as an index and a mirror.

a. As a basic environment to create a basket, there must exist foreign exchange markets between the home currency and the three key currencies, and the markets should be operating efficiently. In other words, it is important that the markets provide timely and appropriately the exchange rates between the home currency and the three currencies.
b. A basket will be created using the market rate of the currencies at a determined date and time. That rate must be made public as a parameter of the weight of the individual currencies.
c. Exchange rate of the home currency against the basket must be calculated periodically and the foreign exchange rate policy that determines the band within which the rate should be allowed to fluctuate must be made public. The width of the band will have to be flexible depending on the efficiency of the foreign exchange markets, and the supply and demand of foreign currencies within each country.
d. If this information is provided and if there is a possibility that the exchange rate against the basket may fluctuate beyond the limits of the band, the authorities should intervene in the market to keep it within the band. This is not different from the operations under the dollar-peg system..
e. If this method of pegging to a basket is adopted, then presumably there would not be a free-ride on the foreign exchange risk unlike in the case of pegging to a single currency. Admittedly, there will be no ruling out of the possibility of inviting an unexpected amount of capital transaction depending on market activities and market psychology. Hence, capital movements through capital accounts, especially of short-term capital, must be monitored meticulously. The authorities must also be ready to apply some regulations in an effective manner, if management of such capital movements should become difficult.

The ideal situation would be that the countries within the region with the same policy needs adopt baskets with the same components (of equally weighted three key currencies) to evaluate the value of their home currency. Application of the currency basket policy, including timing of adoption, will be discussed in the next paper.

A basket-pegged (fixed or semi-fixed) foreign exchange rate policy will send the following message to the domestic financial and business circles. Even if the exchange rate of the home currency fluctuates against the US dollar, the exchange rates of the other two currencies against the home currency should move in the opposite direction, which would enable the home currency to be stable against the three currencies as a whole. Adopting this policy would mean for individuals and for businesses that it would be necessary to diversify the currencies of transaction into three. The three currencies should gradually be used equally as the currency for trade, for settlement, for borrowing, for fund management and as foreign exchange reserves. This is the logical outcome of adopting the kind of basket discussed here and of having the home currency stabilized against that basket. However, because of habits coming from past business dealings, it may be difficult for those in the financial and business world to adapt to the new arrangement. But that will have to be done deliberately with the support of political leadership and social acceptance. The biggest lesson of the Asian financial crisis is that foreign exchange policies based on an excessive trust in one currency could provoke unexpected crisis. Asian economies and societies must seriously study the steps to be taken based on this understanding.

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