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Currency Policy to Enhance Regional Cooperation (Part 4)[1]

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Let me start by sharing an experience I had at the end of last year. Just as I was thinking that the year 2007 would be ten years since the Asian financial crisis, Bangkok was hit by another financial tremor. The Bank of Thailand introduced a new restriction on capital transactions and, foreign capital reacted negatively, withdrawing from the stock market where it had been invested. As a result, the stock market plunged by 15% compared to the day before and foreign exchange rate by 2%. An excited journalist phoned me and said, “This is a dangerous situation, isn’t it? Could it be the beginning of another financial crisis in Asia? Shouldn’t the swap agreement of the Chiang Mai Initiative be activated?”

With the purpose of putting his mind to rest, I provided the following explanation. “The Asian financial crisis, which began in Thailand ten years ago, was caused by the draining of foreign capital liquidity. We can say that the whole country experienced a run. This time, in contrast, short-term capital had been flowing in with the expectation that the Thai currency, the baht, would be revalued. After being exchanged into the baht, the money mostly went into the stock market. As a result, the currency had gained by nearly 15% in one year and the stock market had overheated. The government intervened by selling the baht and buying the dollar from time to time. But judging that such form of intervention did not have much impact and that further appreciation of the baht would disrupt the real economy, the authorities decided to implement a regulation on capital inflow. They could use the dollars that they had bought in the previous operations, so the new regulation would in no way lead directly to a liquidity crisis. This means that there is no role for the swaps to play.” The enthusiasm of the journalist was deflated quickly.

After having provided that rationale, I went over my arguments in some detail. As the journalist

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said, the combination of restrictions on capital flow, foreign currency outflow, drop in the stock market and foreign exchange rate is very similar to that of the last crisis. The capital restriction was put in place this time as almost a desperate cry to stop the inflow of capital because the markets could not absorb any more. So the markets should calm down in a short time as the writer predicted. The government, shocked by the market reaction, did withdraw some of the restrictions the following day. The stock market also seemed to have regained two thirds of the loss the following day. However, the stock market was still unstable over the new year holidays as it reflected the various conjectures of the participants. Also, not all of the foreign capital that came in hopeful of a baht revaluation, would have left the Thai markets. So if an unexpected development occurred, like the credit fear of non banks, which triggered the last crisis, it is possible that a huge run would start.

Part of the reason behind the short-term speculative buy of the baht was the situation surrounding the Chinese renminbi. Many investors wanted to buy the renminbi but because of various restrictions and more recently predictions that the revaluation of the currency would be slower than first expected, they invested in the baht instead. If that were the case, the amount of foreign currency that went into the markets would be within the possible bounds of control. Also, looking at the current account balance and the trade balance of Thailand in the last few years, it is difficult to see that the country would plunge into a sudden shortage of foreign exchanges . On the other hand, the journalist was not far from the target. The current phenomenon is very close to the situation we saw before the financial crisis.

It has been ten years since the shattering experience of the Asian financial crisis. How much progress have the countries made in creating a system of financial cooperation in the region to avoid another such crisis?

It is pertinent that we review the various premises and objectives, and to have consistent rationale for regional cooperation.

This paper is the fourth in the series. As readers already have seen, the issue behind the series is to illustrate “the foreign exchange policy that enhances regional cooperation”. This paper will lay out the goals of this policy.

1. Reaffirming the Policy Goals

Looking at the ten years since the financial crisis, the regional economies have generally achieved smooth growth and increased their foreign exchange reserves. They were supported by the continuing positive business conditions in the United States and the growing dynamism in China, especially since the beginning of this century. So a tightening of foreign currency liquidity, such as the one that triggered the last crisis, is unlikely to happen easily. However, regional cooperation, as a critical means to avoid another crisis, has not advanced much, although it was often talked about during and immediately after the crisis. It is precisely when we have a relatively stable environment like as now that we should seriously consider foreign exchange and foreign exchange rate policies, which would not only avoid another crisis but also help maintain the stability in the value of regional currencies. Such policies are, of course, meaningful even if a single country adopts them. But the consequences and benefits would be much more significant if the regional economies pursue them together. That would be something that we could truly call regional cooperation.

First, I would like to describe what the goals are for these policies. I believe there are two.

(1) Breaking off from the dollar centered foreign exchange policy

Just as in the rest of the world, the foreign exchange policy of the regional economies has been centered on the dollar and various aspects of the economy and trade have been managed in accordance with this policy. Trade transactions and settlements as well as non-trade acceptances and payments, trade finance, and current capital account transactions (trade on a long-term deferred payment basis and direct investment), etc., and foreign exchange reserves as a total balance of all such transactions, and their management operations have all been conducted in dollars. We can say that almost all transactions that involved foreign currencies were dollar denominated. Hence, the “dollar-peg” foreign exchange rate policy, which was a logical outcome of the situation, has an economic rationale. This was enhanced by the sentiment after the financial crisis in Latin America in the 80s that “the currency that can maintain stability is the best currency.” We can say that since there was an economic rationale to the arrangement, the so-called “East Asian miracle” of continued high growth was made possible.

After the Asian crisis, the dollar centered foreign exchange policy, especially “dollar-peg”, was pointed out as having been a mistake. Such analysis was an indication of a fundamental rethinking of the foreign exchange rate policy. Some countries began applying a managed float system using a basket consisting of various currencies as a mirror to manage their currency. (However, these countries tend to explain that their policies have not changed since before the crisis.) Components of these baskets are usually not revealed but are explained as having been determined by calculating the weighted average based on their use in trade settlements or on the actual foreign currency policy. In other words, a basket is created by reflecting the use of the currencies in markets and the real economy without changing the applied foreign exchange policy itself. Unless the foreign exchange policy itself should change, the dollar would be used 80-90% of the time. Statistics from before the crisis show that if the weight of the dollar is that high in a basket, then the basket itself would not be much different from the dollar itself. The “dollar-peg”, which was understood to have been one of the problems that triggered the Asian crisis seems to remain thriving ten years after the crisis.

The most recent upheaval in Thailand could be seen as a reflection of this situation. The combination of the dollar-peg foreign exchange rate policy and the flexible application of a control system could gain most support. I do not deny the usefulness of such a method to be used in the transition period before a more favorable environment is created. However, one cannot ignore the danger inherent in the situation where the only way of measuring the value of a currency is by reflecting it on the mirror of just one currency, the US dollar. Since the dollar is the currency of the United States, its exchange rate policy will swing to reflect the American domestic situations of the time. This is something we have experienced a number of times in the past. As long as the policies are targeted towards the currencies of the developed countries, the East Asian currencies can be said to be in a safety zone. (They are in the shadow of the US dollar.) But the foreign policies of the United States in the last year or two indicate that there is no guarantee that the East Asian currencies would not be affected by an American policy direction. Therefore, it is not wise to maintain the close association with the dollar and to alternate between hope and despair each time there is a change in American policy nor, in view of the huge affect it has on their domestic markets.

The current account deficit and the increasing amount of foreign debt of the United States, which have attracted global attention in the last few years add to the seriousness and urgency of the problem. The global imbalance problem (The US calls it such but it is fundamentally an American imbalance) is supposed to be solved through discussions at the IMF with a number of countries that are seriously involved in the situation, but I believe that in the end, a substantial depreciation of the dollar is the only answer. Whether there is going to be a soft landing or a crash depends on how long it will take for the revaluation of the dollar to occur. But either way, it will not be possible to change the direction. The currency basket scheme and the adoption of the foreign currency policy that such a basket would demand would decrease the risk that the dollar peg carries and the associated risk it brings to the region to theoretically 1/3 of what it is now. If a basket that encompasses the three key currencies equally is adopted as a mirror or a yardstick that reflects the value of the regional currencies and a foreign currency policy that is associated with such a basket were to be adopted even over some objections, those currencies would be able to distance themselves from the dollar and become more autonomous. There must be some mutual understanding among the regional economies to pursue such a course and the policy has to be supported by the strong political will of those concerned. There could be some skilful means of making use of the long-term weak tendency of the dollar in adopting the policy such as making the payments in the dollar but having the receivables in the yen or the euro so far as possible.

(2) Stability and mutual use of the regional currency

There are many leaders among the currency authorities and those involved in the real economy who share this goal, and there have been innumerable discussions on this issue. But in many cases, the discussions end by pointing out the negatives such as that foreign exchange markets for the regional currencies are not developed, that there exists only arbitrage transactions and this type of exchange would mean paying the margins against the dollar twice and is not economical, that the financial markets of these countries are underdeveloped and trade financing denominated in local currencies has not been established, that settlements cannot be expected to work smoothly because the financial infrastructure is underdeveloped, that there is no way of avoiding the foreign exchange risks in the markets. The list goes on.

However, on the other hand, those in the region who are involved in business and trade know far better than anyone the inconvenience of trade and other transactions within the region being conducted in the dollar. There are problems such as the fact that settlements are delayed for a day. It is also a huge source or irritation that the currency exchange margin has to be paid twice because foreign exchange against the dollar occurs twice, once in payment and one in acceptance. When the history of the how foreign exchange markets were created in different countries is studied, it is clear that the foreign exchange margins are, in the end, against the dollar, which means that they are paid to the United States. It is about time that we cease to be just irritated by having to buy at the higher price and sell at the lower price set by the American banks.

Here let me introduce an interesting example. When one visits Asian cities, one notices that there are a huge number of moneychangers. Many of them are run by traders of Indian descent, who have enormous influence. For tourists who exchange from the dollar or the yen to the local currency to get some pocket money the exchange rate is not that big a problem. Some of us even exchange at hotels just because it is convenient even though we are aware that we are subjected to an unfavorable rate. When we need to exchange a more substantial amount, the network of moneychangers sometimes provides a much better rate than we expect. When I was working at a Singapore branch of a Japanese bank, there was a mom and pop store that also served as a moneychanger among the row of shops in the basement of the building. I am not sure if he knew I was Japanese but he used to boast that whether it was the ringgit, the baht or the rupiah, he would exchange any amount and that the exchange rates would be better than those advertised at the Japanese bank upstairs. I used the moneychanger to exchange a substantial amount of the Singapore dollars and the ringgit a few times and sure enough, sometimes he would come up with a rate, which the dealers at our bank had no way of offering. There was, of course, the unique feature of the deals, that they were cash. But still, it proves obviously, that where there is demand, there is a market.

In other words, it only takes demand to turn negative notions into positive. Since demand does not just happen, there must be a deliberate attempt to create it. The amount of intra-regional trade is increasing, and much of trade is conducted by the network of foreign investors in these countries including manufacturers from Japan. For them, it is not necessarily convenient to conduct transactions in their home currency, nor in the local currencies because of the kind of global network they have. However, not all trade transactions are conducted by foreign investors. If there is a will, the amount of transactions in local currencies is likely to increase.

There are other goals for foreign exchange policies. For example, the creation of a centralized settlement organization for the local currencies and the establishment of an Asian Monetary Fund are major goals for the region. However, the goals that each country must pursue in order to maintain the stability of the value of its home currency can be summarized in the two that I have illustrated above.

2. The Currency Policy to Meet the Goals

The policy that should be adopted to meet the goals is the currency basket and the sharing of the basket. Since I have explained the currency basket in detail in the previous papers, I will note only the outline here.

(1) Creation of the basket and its adoption

The dollar is the only currency that has been used to weigh the value of the current and present value of each currency and reflect the relationship between various currencies. The first policy goal is to break away from this dollar centered policy. This means that it is illogical to end up adopting a basket system that reverts to the dollar-peg system. On the contrary, it is almost necessary to adopt means to minimize the impact of the dollar. So the basket should be created as follows.

- The basket should include the three major currencies (the dollar, the yen and the euro) equally.
- The composition of the basket and the proportion of the currencies should be announced.
- The difference between the weight of the basket on the basis date and the weight that is calculated daily should be made public.
- The extent to which the value is allowed to deviate from the basis weight, in other words how far the weight of the basket will be controlled, should be made public.
- The East Asian countries will adopt the same basket as far as possible, but the deviation

range should reflect the individual circumstances of each country.

- Each country should diversify the foreign currency they utilize (or more specifically into the three currencies) as a national policy, and push their society and economy directly and indirectly to use the three currencies.

These are the aspects that can be pointed out as pure currency policy. Let us now see how they influence the goals.

(2) Consistency with policy goals

Let us see the effect of breaking off from the dollar centered policy. If the foreign exchange rate is pegged to the basket constituted of the three equally weighted currencies, while the foreign currency policy continues to be centered around the dollar, then it is easy to see that the foreign exchange risk associated with dollar transactions would increase. There would be consistency and economic rationale if most of the foreign currency transactions are in the dollar and the foreign exchange policy is a dollar peg system (or a managed float against the dollar). However, this cannot be a system to be continued for long considering the danger inherent in the dollar concentrated system and the lack of flexibility to develop into other arrangements when circumstances change. That is why diversification of foreign currency utilization was included in the policy goal. If the equally weighted, the three major currencies are included in the basket that reflects the value of the home currency, then the user of the basket would be compelled to diversify the foreign currency of use. This is easy to say but most likely many hurdles will have to be overcome before diversification is realized. Both the public and the private sectors will have to work together. Foreign exchange reserves must be diversified into the three currencies and efforts must be made to extend the swap arrangements of the Chiang Mai Initiative to include both the yen and the euro even further. Since there is a counterpart to all transactions, the wish to switch the employed currency will not be met each time. Three way diversification of foreign currency usage is likely to meet some serious objections and will need an unpredictable amount of time to realize. Furthermore, if one country tries to pursue this policy by itself, it may meet some resistance from the United States. The best way to ensure that there is the highest possibility of realization and to maximize the effect is for the countries in the region to adopt the policy at about the same time and in close consort.

If the use of the other foreign currencies increases in frequency and in amount, the foreign exchange markets for the home currency against the yen and/or the euro can be expected to develop just as in the anecdote of the foreign exchange dealer in Singapore. In fact, the effective operation of such foreign exchange markets is the condition for the successful application of the foreign exchange rate policy based on the basket of equally weighted three major currencies. Since these East Asian countries only have dollar markets, it may sound logical to create a basket of three currencies after the yen and the euro markets are developed. But that could take forever. It is much more realistic to change the fundamental foreign exchange rate policy and to implement the three way diversification which the policy requires.

Let us now see the relationship between the policy and the second goal of maintaining stable exchange rates and enhancing mutual use of the regional currencies? Thailand and Malaysia, which had maintained a very tight dollar-peg policy for about ten years prior to the crisis are telling examples of the phenomenon. Both countries had placed the utmost importance on maintaining the stability of the foreign exchange rate against the dollar, and as a result the exchange rate between the ringgit and the baht had been steady. However, it is unfortunately not at all clear whether the mutual use of the baht and the ringgit for current and other transactions increased significantly between the two countries. Generally speaking, the use of currencies does not increase automatically even if the exchange rate is stable, and in this case it was partly inhibited by technical restrictions, which include issues that persist among the regional countries. The factors related to infrastructure are expected to improve gradually without too much time having to be spent on there.

What will the pegging of national currencies to the basket of three equally weighted currencies bring? The first benefit is that it would be much simpler to calculate the exchange rates between the local currencies. Since all the currencies would be pegged to the same basket, the value relationship between them could be gained with one simple division. It is true that even in the current system of having only the exchange rates against the dollar, the exchange rates between local currencies can be obtained with one division. However, since the basis of the exchange rates (i.e. the relationship between the currency and the dollar) is different from currency to currency, it is more complicated to figure out how the current relationship might change the next day or how to read the trend using the numbers from the past. Such endeavors would be much simpler if the currencies are all pegged to the same basket. Once the foreign exchange market of the individual local currency and the three major currencies start to function efficiently, would the intermediary currency for arbitrary trading to calculate the exchange rate between the local currencies be the US dollar? Since that is the easiest way for the time being, the rates are likely to continue to be calculated by using the dollar as the intermediary. However, once the foreign exchange markets for the three currencies begin to function, the intermediary role could also be played by the yen or the euro. For the time being, the dollar is used because that is the only way to conduct arbitrary trading. But once there are three ways to conduct arbitrary transactions, which means that any of the three currencies could be used, then the use of the yen could increase for transactions in Asia since Japan is in the Asian time zone. Furthermore, when the environment develops to this stage, a situation could be created where the home currency would be traded in the foreign currency market with another East Asian currency. Moving away from the dollar is likely to encourage the mutual use of the regional currencies, and as a result, direct trading between the local currencies.

Though it is necessary to outline the theoretical details further, because of the limited space in this paper, I would now like to sum up by considering the measures that should be taken by Japan.

The reasons for the East Asian countries to take the course that has been outlined here are primarily for their currencies to be more independent and to maintain a stable value in the long run. It would be beneficial for the financial stability of the whole region if the member countries pursue this course as a shared policy. Furthermore, it would have huge benefits for Japan as well and the country should go out of its way to cooperate in this endeavor.

Expansion of the Chiang Mai Initiative and further use of the yen in the scheme is an example. There will be times when intervention is necessary once the basket of the three currencies is used. In some cases, the intervention in the yen could be carried out as much as in the dollar, in which case, there must be an established way of securing the necessary yen funds. Procedures regarding intervention do require confidentiality, but the first step should be to further evolve the Chiang Mai Initiative both in quantity and quality.

The next issue that must be considered is to include the regional currencies among the Japanese foreign currency reserve. Such a step would have a number of benefits but most of all, it would be an indication to other Asian countries that Japan is, so to speak, on the same ship. Including the currency of the country that has added the yen in its swap agreements in the Japanese foreign currency reserve is not only a show of courtesy but is likely to contribute in many ways to make market intervention by that country more efficient. Surplus savings in Japan would also find a more proficient way of investment in the region.

Such policy procedures are to be carried out by the currency authorities. But there are ways in which the participants in the real economy could contribute. First, a policy of denominating trade transactions in yen should be adopted as a long-term, national commitment and should be carried out with determination. It is especially relevant to switch the import side of trade to yen denomination. (i.e. receivables for our trade partners) Of course, it is necessary to do the same on the export side. Transactions that are denominated in the dollar out of habit should be reviewed comprehensively and every effort should be made to switch to yen denomination as far as possible. This will lead to an increase not only in the demand for yen purchase (payment for Japanese exports) in the region but also for yen sales (receivables for Japan's trading partners). Such a drive to provide the opportunities for yen transactions should be promoted for a long time. As a result, the foreign exchange market between the local currencies and the yen will develop naturally. The creation and the nurturing of these currency exchange markets against the yen is the most significant task for the

Japanese financial institutions.

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