

Newsletter



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Policy Steps towards a Regional Currency Basket ¹

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1. Forward

There is a broad recognition that this is the tenth anniversary of the beginning of the Asian financial crisis of 1997, and various events in relation to the crisis are being held throughout the year. For example, the Annual Meeting of the Asian Development Bank to be held during the Golden Week (end of April to beginning of May) in Kyoto will focus on the decade since the crisis. These events seem to share the objective of defining what Asian countries have learnt from the crisis, what concrete progress they have made as a result and the strategic plans for the coming decade based on such analyses. This paper will follow the same principle and, to some extent, deliberately associate developments in the surveillance system and the progress towards a regional currency basket.

Of the various steps, both large and small, that were taken, let me review a number of concrete developments that were achieved in the decade that have strategic implications for the future.

The first development that is especially worth noting is that the concept of an East Asian Community has been established. Although membership is still fluid, some suggesting India, Australia and New Zealand, it is now accepted that the ASEAN plus 3 (APT) will be the core of this regional concept. The dialogue among the APT has developed to an extent that would have been unimaginable before the crisis both in the areas it covers and the level at which the

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issues are discussed, especially since the turn of the century. A major achievement of this dialogue is the number of Free Trade Agreements (FTAs) or Economic Partnership Agreements (EPAs) that are being signed among the economies of the region. Since there was nothing beyond friendly agreements among the ASEAN countries before the crisis, the signing of FTAs and EPAs is a considerable step forward in regional cooperation. These agreements aim to stimulate the movement of goods and capital, and they have contributed to the expansion of intra-regional trade, which now exceeds half of the total trade volume of the region.

The Asian crisis, which engulfed the regional financial markets, is widely accepted as a 21st century or an Asian type of crisis, having been caused through capital accounts transactions unlike the more traditional current account crises of Latin America and other countries. In the case of such current account crises, many countries try to stabilize their domestic financial markets by tightening their foreign exchange control law to temporarily halt financial market liberalization that had been carried out too rapidly, regulate the flow of short-term foreign capital and de-internationalize their home currency. The speed and timing at which the law is relaxed, what was called the sequencing of liberalization at the time of the crisis, would differ from country to country but are expected to be the topic of discussion in the not-too-distant future.

2. Development of various measures

Tightening of the foreign exchange control law and the de-internationalization of the home currency are measures that can be taken by individual countries in the light of their respective situations, and have been carried out in that manner. However, it is difficult for individual countries to carry out mutual surveillance as a preventative measure or deal with a near-crisis situation by themselves. This became evident in the discussions at the conference on financial support to Thailand held in Tokyo in 1997. But the crisis suddenly made international cooperation that was not thought possible before a reality. Let us review the three areas of cooperation under discussion.

(a) Measures to deal with a crisis

A crisis brought about through capital accounts is a situation where a whole country can be said to be experiencing a run and is short of reserve requirement. A crisis or near-crisis can be avoided if liquidity supply can be provided instantly. With this in mind, the APT countries came to an important decision as early as the finance ministers' meeting at Chiang Mai in May 2000. The arrangement, which is now called the Chiang Mai Initiative (CMI), basically aims

to create a network, like a spider's web, by having the member countries sign as many bilateral swap agreements as possible. The total amount of agreements now comes to 75 billion dollars. Various efforts have been made for the initiative to be applied as easily as possible so that it is now possible to expect it to be effective in a crisis or near crisis. The finance ministers' meeting at Hyderabad last May praised the progress made so far and decided to take further measures such as to establish various special teams to oversee post-CMI developments such as multilateralization of the CMI. It can be said that enough progress has been made in the establishment of a multilateral system to deal with a crisis. The medium term goal now is the establishment of an Asian Monetary Fund (AMF, a provisional name), which has been shelved since 1997. I am sure that the debate will resume along with the discussions on further expansion and the effective use of the CMI.

(b) Foreign exchange rate policy

For a relatively extended period, from the 80s until the crisis, East Asian economies had enjoyed continuous growth in a stable economic environment. There is no doubt that one of the pillars of that success was the dollar-peg system and the dollar-centric foreign currency policy. But once the crisis occurred, the countries that had pursued the policy were criticized for that very policy. However, the real culprit was the wrong sequencing of the various liberalization measures of the domestic financial markets and the rampant free-ride on foreign exchange risks by misusing the dollar-peg system rather than the dollar-peg policy itself. The validity of this argument can be seen in the fact that the dollar-peg system was central to the measures taken by Malaysia in September 1998. Such a policy had to include a tightening of the foreign exchange control law and the de-internationalization of the home currency.

The regional economies explained to the domestic and foreign audience that they will anyway be rid of the dollar-peg foreign exchange policy. They also made it clear that they intend to "create a currency basket and manage the exchange rate of their home currency by carefully evaluating its value to the basket." This was, in effect, explaining a shift to a managed float system. The composition of the basket has not been announced for the reason that the revelation "could trigger unnecessary speculation." There was a wide range of reaction in international financial circles. Some comments were quite irresponsible, such as suggesting that "the value of a currency should be stabilized by creating a basket", as if to imply that once there was a basket, stability of a currency was assured. Other opinions included increasing the weight of the US dollar, the currency of a trading partner, and of the renminbi, the currency of a trade competitor. Advocates of such a course seemed not to realize that increasing the weight of the renminbi, which until recently was fixed against the dollar, would mean, in effect,

increasing the weight of the dollar and would deviate from the value of having a basket.

After the trial and error of various ideas, there are now two major basket theories. The first is to compose a basket of the three major currencies, although the ratio of the currencies is still being debated. (The author supports this theory.) The other is a basket composed of the regional currencies. This theory seems to be based on the reasoning that if adopting a currency basket is a step towards creating a common currency, like the Euro, in the future, then it would be circuitous to adopt a basket of three major currencies even if something like a sunset clause was attached. It would be much simpler to go straight to a basket composed of the regional currencies, so the argument goes. A bird's eye view of the issue cannot help but reveal that although ideas abound, they are barking up a wrong tree. There is still a shortage of debate based on strategic objectives such as to deal with American trade deficits or to nurture direct foreign exchange transactions.

(c) Various issues related to surveillance

There was no system or habit of regional surveillance in East Asia before the crisis. There was the IMF's article IV consultation arrangement with member countries, but the failure of this system is evident from the fact that it could not send a warning signal on the financial crisis and from the basic mistakes that were made in the diagnosis when some of the crisis-hit countries approached the IMF. Since the crisis, the regional economies have concentrated their efforts on avoiding the resurgence of the crisis and in creating a way to stop the spread if a crisis or near-crisis should occur in one country.

The CMI is a means of containing a crisis in one country and stopping its spread, and from that perspective it has strengthened the system of cooperation to supplement the liquidity of regional countries. On the other hand, the focus of a regional surveillance system is to avoid the resurgence of a crisis and, if it fails, to stop its spread. In October 1998, while still in the midst of the crisis, the ASEAN finance ministers agreed at a conference to create the ASEAN Surveillance Process (ASP). This could have been motivated partly by a shared sense of urgency which was aroused by the criticisms from the developed countries depicting Prime Minister Mahathir as "having become autistic" when Malaysia's emergency measures were announced a month before.

The principal means of surveillance in the ASP are exchanges of information on the economic and financial trends of the member countries, monitoring of the global economic and financial trends and the understanding that, when a joint measure becomes necessary, the members would

consider taking action as a group. This framework was introduced to the APT in May 2000 and was agreed on and systemized at the Yangon conference in April 2002. The APT surveillance system is called the Economic Review and Policy Dialogue (ERPD). The ERPD comprises a wide range of items on which there would be information exchange, and the details of those items are being coordinated. The ADB has been extending invaluable help in this endeavour. The ERPD includes not only exchanges of information on various issues and monitoring and sharing of the information on global economic and financial trends, but also includes peer review, which is strict scrutinizing by other members, and even peer pressure. This shows that a regional surveillance system is gradually being structured.

The next key step is the formation of a permanent, high-quality secretariat to operate such surveillance. This secretariat may employ logic and categorize statistics in a way reminiscent of the “Asian values and Asian methods” of years past that would appreciate the Mahathir package of 1998 as well as the de-internationalization of a home currency as “a necessary step in the sequencing of internationalization”. Then an organic association with the CMI must be probed. Currently only 20% of the agreed swap total can be initiated by the regional countries, and coordination with the IMF is necessary to use the remaining 80%. There are those who argue for dissociating from the IMF in order to expand the CMI and to improve its utility. I suspect that many in the political leadership would agree with such a development “if possible” with a right of reserve. If there is a high-quality, permanent secretariat that is responsible for surveillance and there is a CMI mechanism that can be initiated by that secretariat, this could only be, to all intents and purposes, the AMF that was mentioned previously.

3. The road to a regional currency basket

As mentioned in the above section on the foreign exchange rate policy, the supporting argument for a basket of regional currencies seems to be progressing without a sense of reality. The argument goes something like this: Create an Asian currency basket composed of regional currencies quickly. The foreign exchange rates of the participating regional currencies would be maintained and managed by pegging them to the basket. Bonds denominated in this basket of currencies would be issued and circulated in the region. This would fit in well with the Asian Bond Markets Initiative (ABMI). The important factor would be the initiative and the efforts of the private sector. The key to success would be the effective utilization of the vitality of the private sector. In Europe, the ECU was first used for bond issuance, then expanded to other areas, and finally led to the creation of a common currency. In this development, the key to success was the use of the ECU by the private sector.

As for the lessons that the experience of Europe can bring to Asia, there is a detailed study by Professor Tetsuji Murase of Kyoto University. But overall, the arguments for a basket composed of Asian currencies have a lot of holes. Let me give an example. When bonds denominated in the Asian currency basket (let us call it an Asia Monetary Basket, AMB) reaches maturity, the issuer will prepare enough funds for redemption in the issuer's home currency. If, for some reason, the issuer must make the repayment in the currencies in the basket, the issuer must sell the home currency to acquire necessary amounts of other regional currencies. However, this would not be possible if the currencies were not convertible. And the only currency of the APT that is fully convertible is the yen. Under such conditions, there is not much initiative that the private sector can take even if its vitality is highly regarded.

I should note that there is a very interesting development on this subject in the network of think-tanks that was formed within the APT framework. The study they are carrying out is expected to continue during this fiscal year. I would like to avoid revealing the details of the research and debate so as not to affect them, but let me touch on some of the interesting arguments that are being considered.

- Creation of an AMB to carry out surveillance

There are two key areas of debate in this study. One is on the creation of an AMB composed of all the AMP currencies with a full understanding that there is not much hope of its actual usage. The second is that although an AMB cannot be employed for real commercial purposes, it could be a useful guideline for regional surveillance.

Let us first see how an AMB would be established. The first question is in what ratio the 13 currencies of the APT members should be mixed. Their GDP, volume of trade and other factors would be taken into account and the importance of each item would have to be determined to come up with the appropriate ratio. Politicians and commentators could easily get involved in the process, and it is likely to experience a lot of twisting and turning before a conclusion is reached. Even when there is an agreement on the ratio based on various factors, the figures would have to be reviewed to see if they could actually be applied. If I remember correctly, there was a cap of 30% on one currency for the ECU. On the other hand, for smaller economies, the ratio for their currencies could be minute, so a minimum ratio may have to be pre-determined. Through this process, the weight ratios in the basket would be determined to, let us say, 30% for the yen, 28% for the renminbi, 10% for the bahts, etc. But calculating these figures does not mean much unless the next step is taken, to determine the actual weight of each

currency at a specific time.

Here I would like to draw your attention to the computation I introduced to calculate an Asian basket unit in my article of September last year (“Currency Policy to Enhance Regional Cooperation, Part 3”, *International Finance Journal*, September 1, 2006). The argument was to apply the basket with three equally weighted currencies to reflect the value of a home currency instead of the dollar. There is a huge advantage for Asian countries to use the same basket for home currency evaluation. I pointed out that as a by-product, it is possible to contemplate the use of the unit of calculation by creating, without changing the ratios, a basket at a point in time whose absolute weight (value) is, for example, US\$ 1 and to call this an Asian Basket Unit (ABU). If this calculation is applied, the value of a currency against, for example, the US dollar (how many times or what percentage of the dollar a currency is valued) can be calculated with ease. If the ratio of the currencies against the same Merkmal can be deduced, that would be the absolute weight of that currency at a specific time. Let us call it the benchmark weight of a currency. An AMB can be calculated using these benchmark weights and the average weighted ratio among the currencies. AMB figures can be deduced daily or minute by minute by applying the exchange rate of the member currencies against the three major currencies to the calculation. “A point in time” could be a specific time but the calculation could also be used to deduce the average within a certain period.

What would the characteristics and the trend of this AMB be? The exchange rate among the three major currencies could fluctuate in an unpredictable way for a long time without any relations to the economic situation or environment of East Asia. One of the important areas of debate for the ERPD of APT is the foreign exchange rate movement. For example, if the exchange rate of a currency against the dollar is stable when the dollar-yen rate is not, that would mean the rate between the currency and the yen would be unstable. Under the traditional surveillance mechanism, there was no specific debate on such a situation except to provide impressionistic comments based on the first two trends, such as “the stability of the exchange rate against the dollar is positive but attention should be paid to stabilizing the rate against the yen.” However, if the rates were calculated within an ABU, the effect of instability between the dollar and the yen is likely to be absorbed into the basket.

An AMB which is composed of all the currencies of the APT would have the overall average characteristic of the regional currencies and is most likely to move in such a manner. As I have mentioned, the AMB value as such an average and its trend could be acquired on a daily basis if required. Member countries could monitor the daily movement of the foreign

exchange rates, substitute the rates into the ABU and monitor the daily movement of the ABU as well as the movement of the home currency within the ABU. The difference between the value at the base period and at a later time would be depicted as an index (i.e. so many times or so many percentages compared to the value of the base period. But most often, the figure will be between 1.1 and 0.9). This index would be the divergence ratio of the value of the home currency from that of the base period.

As for an AMB, its value can be calculated at a specific time or as an index compared to the standard time. By dividing the divergence index of individual currencies by the indexed value of an AMB, a figure that can be recognized as the divergence index from the AMB can be obtained. The think tank academics are hoping that this divergence index from the AMB could be used for analysis in surveillance of the APT.

The author of this paper supports this idea and logic. It would be invaluable if the smaller economies of the region support the creation of an ABU as a criterion to reflect the value of their home currencies, to manage their foreign exchange rate by pegging their currencies to the ABU, appreciate the AMB as the average of the total value of the regional currencies and confirm the value of the currencies within the region by consulting the AMB divergence ratio. Most of all, the habit of having a basket where one of the components is one's home currency should be invaluable in the mid-term. Reverting to loosening of capital transactions (roll-back of de-internationalization) could become a topic of mutual interest some time in the future. But even when that occurs, moving to full liberalization at once could not be the choice, though the countries would have to face deregulation at some point. Once an AMB becomes more and more user friendly, it would be a respectable move to internationalize the amount of home currency committed to the AMB.

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