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G20 agenda on Currency exchange and APEC[1]

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Heated discussions regarding currency issues continue. G20 also discusses the international monetary system. Economic recoveries of developed economies are sluggish, and the political foundations of current administrations are weak. Developing economies are expected to function as a growth center of the global economy. It is a consensus that the recovery of the US economy is extremely important within APEC's regional economic growth. Continuous monetary easing by the United States weakens the dollar, a policy criticized by some emerging economies as "currency wars" or "beggar-thy-neighbor policy".

A currency has three basic functions: 1) unit of account, 2) means of settlement, and 3) store of value. An international currency is defined as a currency which has these functions globally. In the APEC region, the US dollar dominates the market as an international currency which is used for calculations, exchanges and settlements. The US dollar is a reasonable and efficient choice in light of the supply chain of companies in the region whose final destination is the US. From a business point of view, the crucial point is to decrease the following three obstacles with regard to currency: transaction cost in currency exchange; fluctuation of foreign exchange rate; a currency crisis brought on by the sudden outflow of capital.

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[1] This paper is the script of a speech delivered at the 1st ABAC Meeting on February 17th, 2011 in Guangzhou. The last 2 paragraphs are added after the G20 meeting in Paris (February 18-19).

In order to decrease the obstacles regarding currency, macroeconomic policy cooperation is key

A) Decreasing transaction costs in currency exchange

Transaction costs should be minimized in currency exchange as much as possible. In the EU, the introduction of the Euro as a single currency had significant positive economic impacts on the trade within the region by diminishing transaction costs. The trade within the region expands very rapidly as the supply chain develops across the APEC region.

On the other hand, US dollar dominates the market as a settlement currency. Thus, every time intermediary goods and capital goods are procured, transaction costs are generated between US dollar and local currencies. Currency fluctuations in the region significantly affect trade transactions.

In order to decrease the transaction costs, local foreign exchange markets need to run more efficiently. There are many economies whose transaction costs are not low due to underdeveloped foreign exchange market. More fundamentally, however, a single currency or a currency with less fluctuation is necessary. While currencies should be flexible in the long run, a currency with short-term low volatility is also needed.

B) Removal of uncertainty derived from fluctuation of foreign exchange rate

Excessive volatility of foreign exchange is an enemy for trade, and thus uncertainty should be removed. Since it is impossible to maintain the economic fundamentals of all economies at the same level, currencies should move flexibly in the medium and long term, reflecting difference in production, change of demographics, etc. Nonetheless, short term excessive volatility of exchange rates can be diminished by policy cooperation, particularly among large developed economies. Such cooperation can contribute substantially to diminishing uncertainty.

Differences in the growth ratio reflect various factors such as development stage, policies to raise productivity, and relative difficulty of undertaking structural reforms. Thus, the growth ratio of each economy differs. Developing economies should implement policies to catch up with developed economies, which should in turn support these policies financially and technically.

C) Avoidance of a currency crisis brought by sudden capital flows

Currently, there are differences in the economic growths of developed and emerging economies, in which the former recover slowly while the latter maintain stable growth. Global liquidity expands through monetary easing of developed economies, and capital inflows rapidly increase to emerging economies. Some emerging economies have already regulated capital inflow due to concerns of inflation and bubble brought on by rapid capital inflows.

In order to stabilize foreign exchange market, regulations on capital inflows are accepted to certain extent, but capital outflows should not be regulated. Regulations, if applied without sufficient consideration, would hinder smooth capital transfer. Thus, abusive regulations should be avoided and certain standards should be introduced.

A mechanism should be implemented and strengthened in order to avoid rapid capital inflows/outflows. CMIM (Chiang Mai Initiative Multilateralization) is a framework in the east Asian region that supports liquidity in the crisis, and its function should be strengthened. A mechanism is needed to control excessive liquidity, by monitoring the liquidity globally.

The ultimate solution for the above three points would be the introduction of a single currency. Under the current circumstances, however, such an introduction to the APEC region is considered almost impossible. In contrast to the EU, APEC has a diversity of economic development, regulatory frameworks, and politics. For APEC, a single currency is not realistic nor desirable. On the contrary, depriving freedom of monetary policies through introduction of a single currency would harm APEC.

What we have to do would be to stabilize the US dollar as a principle settlement currency within APEC, wouldn’t it? Although a progressive depreciation of US dollar may be accepted, the actual effective exchange rate of US dollar should be stabilized in the APEC region. Thus, policy cooperation towards stabilization of the US dollar is presumed the most realistic scenario.

A package for policy cooperation: combination of macroeconomic policies and growth policies through liberalization of trade and investment

More concretely, policy cooperation is necessary as a package which combines macroeconomic policies (including monetary, currency and international balance) with growth policies through the liberalization of trade and investment and structural reforms of each economy. Each economy should aim to pursue not short term but medium and long term benefit, and global economic stability and growth will be established through this plus-sum relation.

As for rebalancing the external and internal economy, each economy should strive for an improvement of imbalances. More specifically, economies with a positive current balance should expand their domestic demands while economies with a negative balance should increase exports and domestic savings. In addition, each economy should show its own policies and goals depending upon its developmental stage, and mutual monitoring should be strengthened. The policies and numerical targets should be set by each economy, reflecting its own situation. It is advisable that IMF, the mutual appraisal process (MAP) of G20, or AMRO (ASEAN + 3 Macroeconomic Research Office) should advise. These numerical targets are expected to attain through peer pressure.

In order to stabilize currencies, the five conditions should be met, which are determined in introducing Euro: 1) prices, 2) interest rate, 3) fiscal balance, 4) public debts, and 5) currency fluctuation. In addition, a mechanism should be introduced to maintain balances of each economy as macroeconomic policy cooperation.

Liberalization of trade and investment and facilitation of growth strategies through structural reform would need the establishment of a mechanism to minimize short term volatility of foreign exchange markets, while differences in economic growth among economies and change of economic fundamentals, including demographics, should reflect the market and ensure resilience and flexibility. Although capital flows should be regulated to a certain extent, reflecting situation of each economy, "market-oriented exchange rates that reflect underlying economic fundamentals" will contribute to global economic stability, as stated in 17th APEC Finance Ministers' Meeting Joint Ministerial Statement.

Economic surveillance and macroeconomic policy cooperation will effectively minimize short term excessive volatility of currencies. Current IMF/World Bank base system on global currency has fundamental defects. While IMF undertakes surveillance, its advices are not well reflected in policy making processes and remain ineffective. The surveillance systems should be much strengthened.

Concrete measures: let's get started!

Based upon the above, we should get started what the APEC region can do before global system reforms begin.

Currently, the regional monetary cooperation framework has been established, such as European Financial Stability Facility (EFSF) and European Financial Stabilization

Mechanism (EFSM). The Asian region should also establish a framework for the regional monetary cooperation which complements IMF, in which strengthening CMIM is a good example. There is a proposal which recommends that medium and long term stability of currencies in the region be brought by surveillance, by using Asian Monetary Unit (AMU), which has monitoring records in ASEAN + 3 framework. Such an advancement of subregional currency cooperation will be very effective, together with examining and surveying calculated allocation of currency units across the APEC region in the future.

The final target should be substantial convergence of each economy's economic levels in the APEC region, and stability of currencies. Nonetheless, much smaller cooperation might be desirable as the steps to be taken.

Similarly, while it is needless to say that WTO's agreement is preferable to expand and liberalize trade and investment, negotiations in regional frameworks such as TPP should be advanced in light of difficulty of WTO negotiations.

Policy cooperation and coordination of macroeconomic policies, liberalization of trade and investment and structural growth strategies should be advanced as a package in light of their complementary nature.

G20 Communiqué issued at Paris dated February 19, 2011

The G20 Meeting of Finance Ministers and Central Bank Governors was held from February 18 to 19 in Paris where a communiqué was issued. The communiqué stressed the importance of reducing excessive global imbalances by strengthening multilateral cooperation, and that the following indicators will be used for mutual assessment, although they are not targets: 1) public debt and fiscal deficits; and private saving rate and private debt 2) and the external imbalance composed of the trade balance and net investment income flows and transfers, taking due consideration of exchange rate, fiscal, monetary and other policies. G20 also agreed on a work program aimed at strengthening the function of the international monetary system (IMS), including coherent approaches and measures to deal with potentially destabilizing capital flows, management of global liquidity, and discussions on exchange rates issues and on the strengthening of IMF surveillance.

Although all the above points may require various economies to reconcile their differing interests, and although heated discussions may continue, it is important to recognize that G20 has made progress by outlining plans for the future.

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