

The Role of Asian Currencies in the International Monetary System

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1. Introduction: Key Issues

- East Asia has become increasingly interdependent through market-driven trade, FDI and finance.
- What are the roles of the U.S. dollar, euro and yen?
- Is it desirable for an integrated East Asia to create its own currency? Does East Asia—or a group of economies in the region—satisfy OCA criteria?
- If so, how? What are the practical steps towards regional monetary and exchange rate policy coordination?
- Which currency should assume a nominal anchor role in East Asia—the yen, the yuan, the US dollar, or a currency basket?

2. International Roles of the US Dollar, Euro, and Yen

Foreign exchange market trading and foreign exchange reserve holding

- The US dollar by far the most dominant currency in foreign exchange market turnover, although its share has declined (from 90% in 2001 to 86% in 2007).
- The euro is the next at 37-38%, followed by the yen at 17% (a decline from 23% in 2001). The yuan is 0.5%.
- The US dollar is the most dominant reserve currency, rising from 50% in 1990 to 64% in 2007.
- The euro follows with 27% in 2007, up from 18%.
- The yen's share has been declining from a peak of 9% to a mere 3% in 2007.

2. International Roles of the US Dollar, Euro, and Yen

Nominal anchor currency role of the dollar, euro and yen

- Calculation based on Kawai-Akiyama (1998)
- Measured by GDP, the US dollar area is the largest at 45% in 2005-2007 (although it declined from 53% in the early 1970s). The euro area has expanded from 22% to 36%. The yen area remains at 11% (though it reached 17% in the 90s).
- Measured by trade, the dollar area expanded from 34% to 39%. The euro area also expanded from 36% to 46%. The yen area stagnant at 10% in the early 70s to 7% in 2005-2007.

2. International Roles of the US Dollar, Euro, and Yen

Limits to the yen's international currency role

- Japan's trade structure
- Tokyo's financial market
- Historical context
- Japan's lost decade

3. OCA and Convergence Criteria

Is East Asia an OCA?

- Asia's market-driven economic integration.
- Past studies suggest that, despite rising regional economic interdependence, East Asia as a whole is not a strong candidate for a single currency area at least for now.
- But subsets of East Asian economies appear to begin satisfying some key OCA criteria, such as symmetry of supply shocks. These subsets may include: Japan and Korea; Singapore, Malaysia and Brunei.
- Hong Kong may be better off by switching to a RMB peg and eventually adopting the yuan

3. OCA and Convergence Criteria

Macroeconomic convergence

- East Asia has not achieved macroeconomic convergence—inflation, interest rates, fiscal deficits and fiscal debt (Maastricht convergence criteria)
- Macroeconomic (and structural) convergence is not part of OCA criteria. It is not required for a single currency area, particularly in the case of unilateral pegging—such as Italy vs. Germany under EMS.
- However, macroeconomic convergence is critical once countries try to form a single currency area as equal (or symmetric) partners.
- For many economies, the first priority is to pursue macroeconomic institutional reforms to strengthen macroeconomic policy-making to achieve good macro performance

3. OCA Criteria and Convergence

Structural convergence

- East Asia has not achieved structural convergence—such as per-capita incomes, industrial structures, financial sector development, capital account openness, institutional and policy frameworks, and market infrastructure
- Structural convergence is not part of OCA criteria, and a country with weak institutions can unilaterally peg its currency to the currency of a country with high degrees of institutional quality.
- For many Asian economies, the first priority is to pursue structural reforms to strengthen domestic economic and structural fundamentals for structural and macroeconomic convergence.

4. East Asia's Exchange Rate Regimes

Lack of exchange rate policy coordination

- Despite close interdependence of East Asian economies through trade, investment and finance, there has been no exchange rate coordination yet
- Asian exchange rate regimes are very diverse and in serious disarray, with Japan adopting a pure float and China a tightly managed regime targeted at the USD
- Japan has not been able to play an anchor currency role for Asia's monetary policymaking
- China's RMB revaluation in July 2005 and its shift to a managed float (followed by Malaysia's similar shift to a managed float) suggest the beginning of such coordination

4. East Asia's Exchange Rate Regimes

Global financial crisis & capital inflows

- East Asia, like any other emerging market, is vulnerable to sudden stops, or even reversals, of capital inflows due to the global financial crisis
- But, once the US financial system stabilizes, East Asia can again attract large capital inflows, given the region's robust economic prospect.
- To reduce domestic financial and macroeconomic risks (overheating, inflation, and asset price bubbles) due to surges in capital inflows, each economy needs to supervise the domestic financial sector and manage macroeconomic policy in a prudent way, including allowing currency appreciation.

4. East Asia's Exchange Rate Regimes

A case for collective currency appreciation

- In the face of persistent capital inflows, many East Asian emerging economies used to intervene to prevent currency appreciation for fear of loss of price competitiveness, thereby accumulating large reserves and injecting domestic liquidity.
- This sterilization policy cannot be sustained for a long time.
- They need to work together for collective currency appreciation vis-à-vis the US dollar while keeping relative currency stability within the region, so that financial and macroeconomic stability is maintained and loss of price competitiveness minimized
- This requires exchange rate policy coordination

4. East Asia's Exchange Rate Regimes

Dollar, yen or yuan as an anchor for East Asia?

- Relying solely on the dollar is not desirable due to the lesson learned from the 1997-98 currency crisis.
- The yen (failed internationalization, declining size) or the yuan (inconvertible, weak prudential supervision, non-independent central bank) alone cannot assume a nominal anchor currency role
- The yen, the yuan and other important currencies can share the nominal anchor role for East Asia.

Currency basket system

- G3-plus currency basket (dollar, euro, and ACU): Singaporean model
- ACU system: complex and hard to establish internal anchor for now, but a very useful starting point

5. Steps for Asian Exchange Rate Policy Coordination

Step 1: informal coordination (regime choice)

- Greater exchange rate flexibility vis-à-vis the dollar, based on a basket of G3-plus currencies (dollar, euro, and ACU [= yen plus emerging Asian currencies])
- Stabilization of exchange rates against G3-plus does not require macroeconomic or structural convergence
- Emerging East Asian economies can pursue structural and policy/institutional reforms to achieve convergence
- Strengthening of CMI and effective surveillance with finance ministers & central bank governors

Figure 1. Trend of ACU vis-à-vis the USD: January 1995 – April 2008

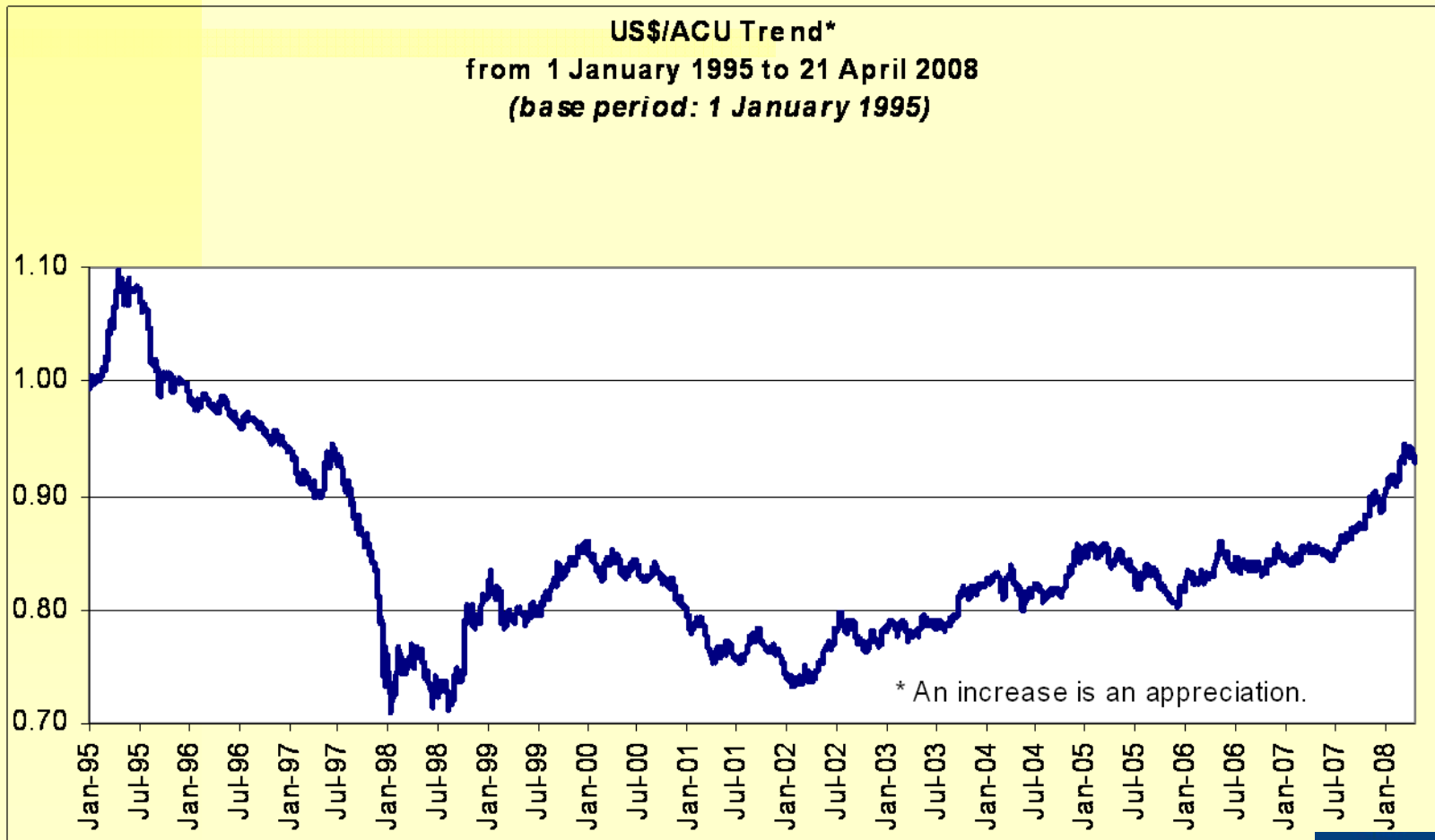


Figure 2. Trend of Main Asian Currencies vis-à-vis the ACU: January 1995 – April 2008

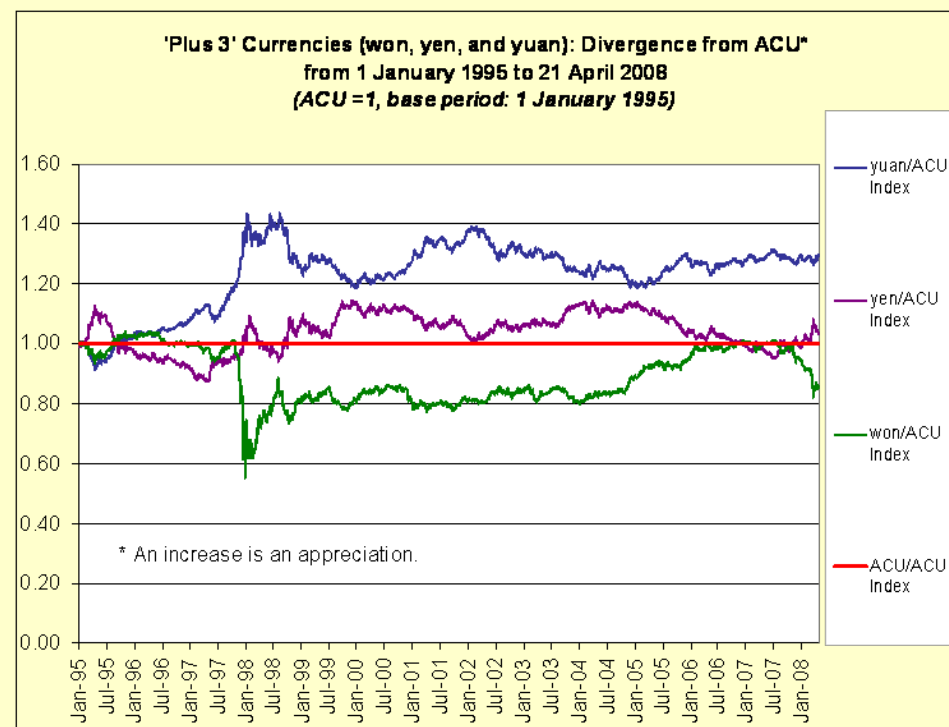
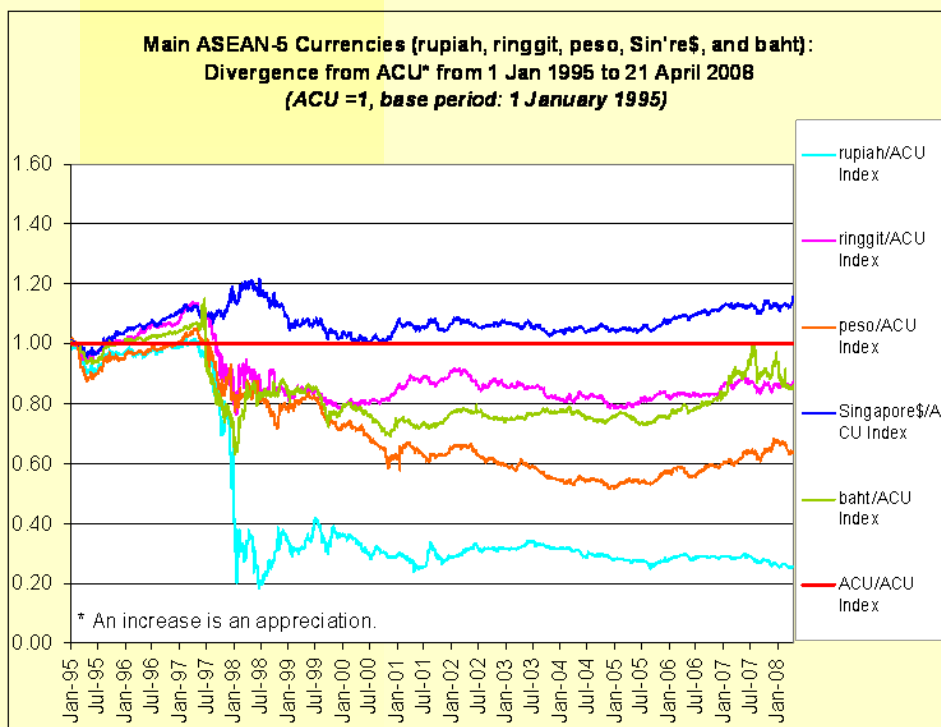
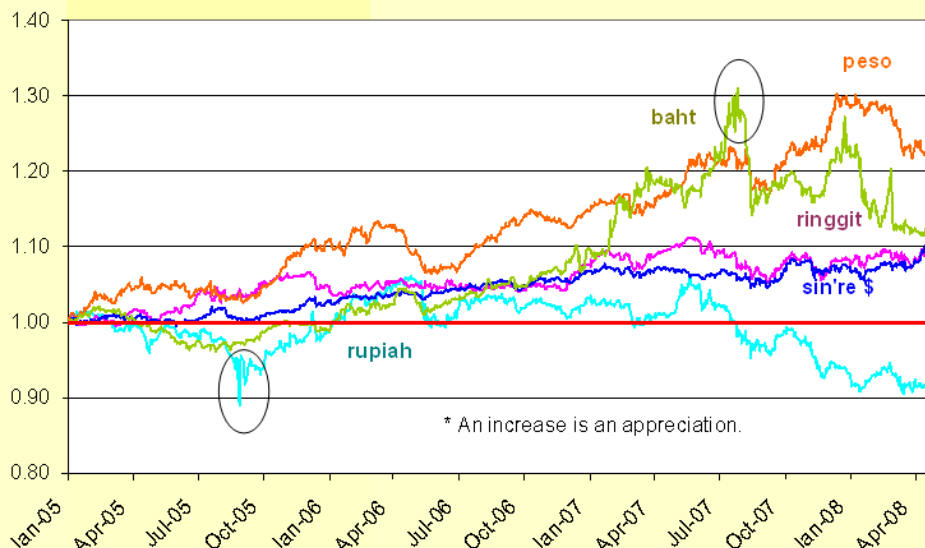


Figure 3. Rupiah Mini Crisis in Aug 2005 and capital controls in Thailand in Dec 2006

Exchange Rates vis-à-vis the ACU: Jan.2005 – Apr.2008

Main ASEAN-5 Currencies (rupiah, ringgit, peso, Sin're\$, and baht):
Divergence from ACU* from 1 Jan 2005 to 21 Apr 2008
(ACU = 1, base period: 1 January 2005)



'Plus 3' Currencies (won, yen, and yuan): Divergence from ACU*
from 1 Jan 2005 to 21 Apr 2008
(ACU = 1, base period: 1 January 2005)



5. Steps for Asian Exchange Rate Policy Coordination

Step 2: formal, loose coordination

- Adoption of a G3-plus currency basket with well-defined rules for intraregional exchange rate stability
- Greater macro and structural convergence required
- Further financial cooperation requires the setting up of an independent secretariat for CMI and ERPD
- Economic surveillance need to strengthen “peer review and peer pressure” elements and will have to introduce “due diligence”
- Real side integration needed through the consolidation of various, overlapping FTAs into a single East Asia-wide FTA

5. Steps for Asian Exchange Rate Policy Coordination

Step 3: tight coordination

- Tightly coordinated intraregional exchange rate stability—a la Asian Snake or ERM using ACU as a reference—requires close monetary policy coordination
- An Asian Monetary Fund (AMF) with sufficient financial and human resources should be in place to issue official ACUs, provide very short-term liquidity finance, and settle balances among the central banks
- East Asian FTA will evolve into a customs union
- Complete exchange rate and monetary policy coordination is feasible, if ever, only in the LR

6. The Way Forward

- East Asia has seen rapid market-driven economic integration through trade, FDI and finance, and an integrated East Asia will need a single currency
- With the global financial crisis & capital inflow risks, it is time to coordinate exchange rate policy to better manage macroeconomic and financial conditions while maintaining intraregional rate stability
- The region may begin with coordination of exchange rate regime choice, based on the dollar, euro & ACU.
- After sufficient convergence and with strong political commitment, East Asia may move to intraregional exchange rate stabilization based on ACU and/or through an Asian Snake or ERM.

Thank you

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