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The Global Financial Crisis, 
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Note
In this publication, the term East Asia is used to refer collectively to the countries of East and Southeast Asia.
Forward

Duck-koo Chung
Chairman
The NEAR Foundation

In 2007, the U.S. sub-prime mortgage crisis drove investment banks and commercial banks into insolvency and ultimately sparked the biggest global financial crisis since the Great Depression. One of the biggest lessons from the crisis is that the market can be both an angel and a demon, and that government may be both a savior and a tyrant. We also learned that the U.S. or the E.U., which now make up less than 30% of the world economy, do not command the global economy on their own. Most of all, the diminishing faith in the financial industry has led to the failure of the internal balancing mechanisms of the world’s economies, which in turn has triggered the fall of financial capitalism.

Meanwhile, the countries such as Great Britain, Japan and others that are closely attached to U.S.-led financial capitalism faced most damage whereas countries such as China that are not closely attached to U.S.-led financial capitalism mitigated the financial crisis relatively well during the crisis. Also, the countries with largely depending on imports and exports or foreign capital, the countries with low birth rates and aging populations and the countries with excessive debt have also been among the hardest hit during the crisis.

In addition, the financial crisis has also shaken up the nature of international economic competition, providing an opportunity for a radical shift in the dynamics between the traditional growth engines such as the U.S., the E.U., China, and Japan, and other newly developing countries.

With a tremendous effort and collaboration, the world economy could extricate itself from the steeper fall and get back on the track. However, the uncertainties surrounding the world economy still looms because we all failed to precisely predict the course and magnitude of potential risk, and the international financial organizations, on the bottom, no longer have sufficient capacity to address tough issues such as global imbalances, excessive financial capitalism, or even moral hazard.

These uncertainties are followed by structured and extensive problems, and these problems range from the financial and monitoring system issues to the moral hazard issues in the market economy. However, we believe that we can provide fundamental solutions to these problems when the recession and financial distress mostly become alleviated in few years.

Many of these problems are associated with the key currency system (U.S.
Dollar), and there are a number of disputes whether a new international financial system should be in place. At the center of these problems, there are many lingering questions for diminishing U.S Dollar standard; Will the dollar continue to play the dominant role in the future? SDR as a reserve currency, IMF bonds in Chinese FX reserves? Will the dollar remain strong in the future? and the future of the Euro? Is there a chance for Chinese yuan or Japanese yen to be a key currency? The countries with a large amount of the U.S Dollar-based assets are anxious because the United States monetary authorities have yet to assure them with clear answers.

Since most East Asian countries use currencies that are not freely convertible, their currencies are closely linked to the U.S Dollar. China, for example, is a country which is largely sensitive to the changes in the value of U.S Dollar because of its massive investment in US dollar denominated assets. Therefore, Chinese government is trying to avoid potential risk, and, as a way of avoiding potential risk, the RMB internationalization is considered as an alternative measure. However, the real barrier is the fragile financial system, and this barrier should be removed most urgently.

The NEAR–ADBI Conference 2009, under the title The Global Financial Crisis, Future of the Dollar, and the Choice of Asia, aims to propose answers to the aforementioned uncertainties and problems. In this conference we are especially interested in Asia’s response to the changing international monetary and financial order. I believe the conference will provide a forum for proposing valuable suggestions from both academic and practical perspectives.

I extend my deepest gratitude to our co-host, the dean of the Asian Development Bank Institute, Masahiro Kawai, and to the Ministry of Strategy and Finance, the Korea Institute of Finance, the Kookmin Bank, and many other organizations for their full support.
Opening Address
Masahiro Kawai
Dean
Asian Development Bank Institute

Mr. Duck-Koo Chung, chair of the NEAR Foundation and former minister of industry and energy, distinguished guests, ladies and gentlemen, good morning.

Let me express my gratitude to all of you for taking time off from your busy schedules to participate in the conference on the Global Financial Crisis, Future of the Dollar, and the Choice for Asia, jointly organized by the NEAR Foundation and the Asian Development Bank Institute (ADBI). Actually, this is the second conference organized jointly by the NEAR Foundation and ADBI. In August 2008, at ADBI in Tokyo, we held the first conference to discuss the then emerging subprime mortgage crisis, capital flows, and the Asian economy. The subprime crisis has now evolved into a full-blown global financial and economic crisis, the worst since the Great Depression in the 1930s.

This crisis is different from other financial crises we have observed over the last several decades, not only in its breadth and magnitude but also in its origin. The crisis is global, affecting almost all countries in the world, not just a few, and its impact is devastating. The epicenter of this crisis is not a peripheral country but the United States (US), which is the largest and most central economy in the world, and home to the most dominant global key currency—the dollar—and the world’s most sophisticated and developed financial system.

So it is not surprising to see that the crisis has generated many important debates and posed several major challenges for the world economy and Asia. Let me point out five of these.

First, this crisis has raised the questions of whether the United States will be able to remain the central economic power in the post-crisis period, and whether emerging Asia—with the People’s Republic of China, India, and ASEAN\(^1\) at its core—will play a much bigger role in the world economy. It appears that Europe will not be able to replace the US as the most powerful economy, at least in the foreseeable future, as many European countries are also suffering, perhaps more severely than the US, from the ongoing global financial and economic crisis. The world seems headed toward a truly multi-polar world, where not only the US and Europe but also Asia will increasingly influence the development of the world economy and finance, and will increasingly share responsibility for global economic and financial management. In this sense, the recent shift of the global focus away from the G-7 and G-8 to the G-20 is a natural and healthy

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\(^1\) Association of Southeast Asian Nations.
Second, the crisis has cast doubt on the future role of the US dollar as the most dominant key currency. Despite the fact that the global financial crisis originated in the US, the value of the dollar is high because of the high global demand for dollar liquidity due to the presence of counterparty risk, repatriation of the dollar back home following the “deleveraging” by US financial institutions, the increased need for dollar liquidity globally on the part of both financial institutions and nonfinancial firms conducting international business, and “safe haven” demand for dollars. However, the large public spending in the US for fiscal stimulus, finance sector support, and the bail out of automobile and other firms will eventually bear on the country’s ability to service debt, and this may put the future of the dollar into uncertain territory.

The recent suggestion made by Governor Zhou Xiaochuan of the People’s Bank of China that the US dollar should be replaced by the special drawing right (SDR) as the global reserve currency may make good sense, at least in theory, although in reality the reserve currency role of the dollar will not go away anytime soon. The reason is that the key currency role of the dollar has been supported by its network externality; incumbency inertia; and, more fundamentally, the deep, wide, and liquid financial markets for dollar-denominated instruments. In contrast, the SDR has been used only by the International Monetary Fund (IMF) and its member authorities largely for accounting purposes and not in the private markets. Nonetheless, the role of the dollar may decline so it is useful to consider the future shape of the international monetary system. Will the euro regain its strength and credibility? Will the renminbi rise to become the third international key currency, after the dollar and the euro and surpassing the role of the yen? Even though the yen is a fully convertible currency, it has not become an international key currency. Although the PRC has recently embarked on initiatives to internationalize the renminbi for trade settlement through the banking system, it would take a long time for the renminbi to become a fully convertible currency—i.e., a currency to be used and traded freely and globally for both current account and capital account purposes. This suggests that, as Asia is rising to become the world’s largest economic bloc, the region needs to seriously explore the possibility of developing its own currency or currency basket.

Third, the crisis has raised the question of whether the US consumption decline is a permanent or a temporary phenomenon. The ongoing crisis is forcing adjustment of current account imbalances in both the US and Asia due to the reduction in US consumption. If this is a permanent or semipermanent process, it has significant implications for growth in Asia. Asian countries can no longer rely on US consumers being their growth engine and must find their own sources of
growth by changing their development path from an excessively export-dependent one to a domestic and regional demand-led model. Essentially, Asia must permanently increase consumption and investment, and transform the supply side of the economy from tradable toward nontradable activity. Sustained expansion of consumption requires structural reforms to strengthen social sector protection (health, education, pension systems, and unemployment insurance), reduce urban-rural income disparity, and improve efficiency of financial intermediation for consumers. Infrastructure investment as well as improvement in the investment climate is needed to stimulate investment in countries where this has has been inadequate or stagnant. Productivity of the services sector needs to be upgraded, as this sector is the major component of nontradable activity and has been relatively weak in Asia—except in India. Regional market integration is essential as it stimulates more regional trade in goods and services, creates new business opportunities, and facilitates mobilization of regional savings for regional investment.

Fourth, the crisis has raised the question of whether emerging Asia should rely on the IMF or a regional reserve-pooling arrangement for crisis prevention and resolution. The G-20 meeting in London agreed to increase the financial resources of the IMF from $250 billion to $750 billion, and the IMF introduced a new financial instrument, the Flexible Credit Line. Looking at its recent interventions in Europe, the IMF appears to have become more flexible, focused, and effective than during the Asian financial crisis in 1997-1998, but many emerging Asian economies have doubts about the value of the IMF for them. Many Asians seem skeptical of whether significant IMF governance reform will take place, as Europeans are unlikely to give up substantial voting powers to Asia, and the US may not give up the only veto power; they expect only marginal changes.

A few advanced countries in the region, such as the Republic of Korea and Singapore, have been able to secure international liquidity from the US Federal Reserve (without going to the IMF and without any conditionality), but other middle-income countries have not had that privilege and hence are more vulnerable to capital flow reversals. The recent agreement to multilateralize the Chiang Mai Initiative (CMI) and create a surveillance unit is a significant step forward, as this implies that ASEAN+3 countries are now heading towards the creation of a de facto Asian monetary fund. However, most emerging Asian economies may not wish to use the CMI, as its use—beyond 20%—is constrained by its link with IMF programs. To make middle-income countries more secure financially, significant progress is needed for the CMI to further reduce IMF links (eventually to zero), and it can do this by raising the effectiveness of its regional surveillance. For the time being, however, in this emergency period, middle-

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2 ASEAN+3 refers to the 10 ASEAN countries plus the People’s Republic of China, Japan and the Republic of Korea.
income countries need to be protected by making CMI operations more flexible in a way comparable to the IMF’s Flexible Credit Line.

Finally, the US dollar may not be strong forever. Asia needs to be prepared for eventual dollar depreciation, beginning with a serious discussion about regional exchange rate policy coordination. Asian countries need to discuss how Asian cross rates can remain relatively stable in the event of a sharp and rapid depreciation of the US dollar against Asian currencies. From the perspectives of both preserving macroeconomic and finance sector stability and securing international price competitiveness, coordinated currency appreciation is highly desirable. Collective currency appreciation in Asia can also facilitate the region’s growth shift away from excessive export dependence on the US market towards growth led by regional demand and the nontradables sector. The introduction of an Asian currency unit, consisting of the ASEAN+3 currencies and the Hong Kong dollar, will be useful in strengthening the region’s policy dialogue for greater exchange rate policy coordination.

I believe that all of these important issues will be discussed and debated here in the conference. Hopefully, these discussions and debates can identify key policy measures to be taken by Asian governments to achieve stable and sustainable economic growth for all.
Section I

The Global Financial Crisis and the Role of the G-20

Shinji Takagi

A. Introduction

By highlighting the limitations of the existing international financial architecture, the global financial crisis has brought the Group of Twenty (G-20) nations into the limelight as a new forum for discussing world economic issues at the highest political level. In turn, the G-20 summits of heads of state or government in November 2008 (Washington, DC) and April 2009 (London) called for reform of the International Monetary Fund (IMF), including the immediate reform of its lending policies and the medium-term reform of its surveillance and governance. Will the G-20 permanently replace the Group of Seven (G-7) and the Group of Ten (G-10) entirely in the post-crisis international financial architecture? Will endorsement by the G-20 leaders be strong enough to push the needed reforms of the IMF forward? These are the issues I will address in this paper.

B. The Future of the G-20

Given its severity and global scale, the ongoing economic crisis has highlighted the limitations of the G-7 and G-10 processes that have enjoyed dominant presence in the international financial architecture over the past 30 or more years. The G-7 (consisting of Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States) has been holding regular meetings of finance ministers and central bank governors since the 1970s; contacts at the deputies level have been closer and more frequent. The G-10 (11 countries consisting of the G-7 countries plus Belgium, Sweden, Switzerland, and the Netherlands), organized initially as a group of countries subscribing to the General Arrangements to Borrow (GAB) within the IMF in the 1960s, has, since 1974, assumed a standard-setting role among central banks through the work of various Basel committees. Among them, the most important is the Basel Committee on Banking Supervision, which also includes representations from bank supervisors (subsequently, Luxembourg and Spain joined the G-10 group).

As the global crisis unfolded, the world was made to recognize that, given the emergence of Brazil, the People’s Republic of China (PRC), India, the Republic

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1 This is a revised version of the paper presented at the NEAR–ADBI conference held in Seoul on 1 June 2009

2 The G-20 consists of 19 countries—the G-7 countries plus Argentina, Australia, Brazil, the People’s Republic of China, India, Indonesia, the Republic of Korea, Mexico, Russia, Saudi Arabia, South Africa, and Turkey—and the European Union.
of Korea (henceforth Korea), and other countries as new economic powers, the G-7 and the G-10 were no longer adequate to deal with economic and financial issues of global dimensions. Instead, the G-20, which had been established at the G-7 finance ministers meeting in September 1999, took center stage with a November 2008 summit in Washington, DC. Then, in 2009, the Basel Committee invited all non-Basel members of the G-20 (plus Singapore and Hong Kong, China) to join, thus making the total membership 27. The G-7 continues to exist, though with diminished influence, while the G-10 has virtually ceased to exist except as a nominal body of countries participating in the GAB.

Do these developments mean that the G-20 (or its expanded version, with the addition of several financially important economies) will be at the center of the new emerging international financial architecture?

The emergence of various alphanumeric groups (such as the G-7 and the G-10) in the international financial architecture is an outcome of the ineffectiveness of supranational organizations (such as the IMF) as decision-making bodies. Although supranational organizations enjoy representation and legitimacy, they are limited in their ability to make decisions quickly (or make any decisions at all) given the size and diversity of their membership. Though limited in representation and legitimacy, smaller intergovernment groups can act more quickly under certain conditions. Usually, these conditions include a sufficiently small membership, and one that is relatively homogeneous in terms of level of development and philosophy.

The G-20 is not likely to take the place of the G-7 or G-10 because it does not meet either of these criteria of effectiveness—it is too large and not sufficiently homogeneous. A group of 19 or 27 sovereign countries is too large to be effective or efficient as a mechanism of decision making; a body that includes the United States on the one hand and the PRC or India on the other is too diverse to be responsive and flexible on divisive issues. Despite the outward demonstration of solidarity and responsiveness shown by the G-20 leaders on the last two occasions, a close examination shows that the G-20 process has so far produced little of substance.

Even in terms of showmanship, we cannot use the extraordinary circumstance of the past several months as the guide for predicting how the G-20 process may work in the future. For example, when the interests of the G-7 countries and those of the PRC and India differ substantially on critical issues—as is likely on many issues—how will the G-20 resolve the differences? Once the global crisis is over, the sense of cohesion that appears to exist now may well be lost. The current troika form of leadership, in which the responsibility for agenda setting is rotated from year to year, may be a nice device for ceremonial performance but it is a
recipe for ineffectiveness and irrelevance where substance matters. The greatest weakness of such a system is that the involvement of the most important countries in the agenda-setting process is not assured.

The G-20 as an entity probably will not cease to exist any time soon, but the role it plays will likely be largely ceremonial. Important decisions will likely be made in a smaller grouping of countries—perhaps different groups will emerge for different sets of issues. In fact, this is exactly what happened in L’Aquila, Italy in July 2009. Following the Group of Eight (G-8) summit, two separate groups of countries were invited to join the G-8 countries to discuss two separate sets of issues. Brazil, the PRC, India, Mexico, and South Africa were first invited to a discussion on global economic issues, including the reform of international financial institutions; Australia, Indonesia, and Korea then joined to form a major economies forum to discuss global energy and climate issues. A similar pattern is likely to be repeated in the coming years, with the G-20 acting as something of an umbrella group to give strategic direction or to endorse big decisions.

C. International Monetary Fund Lending Reform

The recent G-20 summits proposed two areas in which the IMF should be reformed. One relates to the immediate need to augment IMF resources to meet the financing needs of countries hit by the global crisis, and to develop new instruments and lending procedures to better meet the needs of the membership. The second relates to the medium-term need to improve the effectiveness of IMF surveillance in order to prevent future crises, and to reform the governance of the institution in order to increase the voice and representation of new economic powers. I will consider the first set of reforms in this section, leaving the discussion of surveillance and governance reforms to the subsequent two sections.

Two things should be noted in connection with IMF lending. First, the IMF has successfully augmented its resources in recent months by securing credit lines from a number of countries, including Japan ($100.0 billion), the European Union (also about $100.0 billion), Canada ($10.0 billion), Switzerland ($10.0 billion), and Norway (about $4.5 billion); the membership in July 2009 also agreed on a new allocation of special drawing rights (SDRs) amounting to about $250 billion. In addition, the IMF is in the process of setting up an arrangement whereby member countries can purchase notes it issues. The PRC (up to $50 billion), Brazil and Russia (up to $10 billion each), and others have expressed interest in participating in such a scheme when it becomes operational. Second, parallel to these developments has been what the IMF managing director has called a “modernization” of conditionality, designed to remove the “stigma” attached to IMF borrowing.
Conditionality has always been a controversial aspect of IMF lending, but especially since the Asian crisis of 1997-1998 when the IMF was discredited for what many considered to be inappropriate terms of macroeconomic and structural conditionality. Especially in Indonesia, but also in Korea, the IMF crisis management programs called not only for tight fiscal and monetary policies, as customary, but also for structural reforms in areas that some thought were not fundamental to resolving the crises (Independent Evaluation Office [IEO] 2003). At that time, many countries, especially in Asia, vowed never to borrow from the IMF and began to accumulate foreign exchange reserves as an insurance against a sudden flight of capital. Coupled with the plentiful supply of international liquidity in the early to mid-2000s, the IMF lost its customers and found itself in serious financial difficulty. As recently as early 2008 it launched the process of cutting the size of its staff by some 500 people and sought to find a different business model to sustain itself.

Although the global financial crisis brought some lending business back, the IMF decided to make its lending facilities even more attractive to crisis borrowers. The newly established Flexible Credit Line (FCL), for prequalified “strong performing” economies, has done away with conditionality as we know it. The FCL replaced the earlier Short-Term Liquidity Facility (SLF), established in late 2008 to respond to the global crisis, by eliminating features undesirable to potential borrowers—the SLF’s capped access and short repayment period, as well as the inability to use it on a precautionary basis. The FCL has already attracted Colombia, Mexico, and Poland as customers, in sharp contrast to the previous Contingent Credit Line (CCL) that failed to attract a single borrower.

Conditionality was also modernized for other existing lending facilities. In a policy approved by the executive board in March 2009, the IMF now relies less on “hard” conditionality for its lending; instead, it relies “more on pre-set qualification criteria (ex-ante conditionality) rather than on traditional (ex post) conditionality.” Structural reforms are monitored in the context of program reviews, and the use of structural performance criteria was discontinued in all arrangements, including those with low-income countries. The IMF would have liked to go even further to eliminate quantitative performance criteria for macroeconomic policy variables, but no consensus was reached to make the change.

These developments pose some questions. For example, should the international community welcome the modernization of conditionality as a step reflective of the new economic reality—crises are less homegrown and the world is so interconnected that an international lender of last resort would benefit not just the borrower but also everyone else? Or should we think of these developments as a dangerous move that would lead to an even bigger moral hazard for both
governments and international investors? From the point of view of Asia, are these changes sufficient to remove the stigma attached to IMF borrowing and make it less compelling to have a regional financing facility in the form of the multilateralized Chiang Mai Initiative?

D. International Monetary Fund Surveillance Reform

Strengthening IMF surveillance has been a constant theme, at least since the Mexican crisis of 1994-1995. A number of initiatives have been taken over the intervening years, including the establishment of the General Data Dissemination System in 1997, the Special Data Dissemination Standard in 1996, the Financial Sector Assessment Program in 1999, and the efforts within the IMF to increase its financial market expertise. The repeated mantra, at least since the Crow Report (Crow, Arriazu, and Thygesen 1999), has been “improve financial surveillance,” followed by “integrate financial with macroeconomic surveillance.” In this respect, the G-20 call for strengthening IMF surveillance is not very helpful because it gives no specifics of how to do it.

Because much has already been done—successfully and unsuccessfully—to strengthen IMF surveillance, it is difficult to think of additional measures. Those at the IMF must know that there is not much more they can do, at least with the tools they have. They have not objected to the G-20 admonition only for strategic reasons (it is a bad idea to disagree with the G-20, especially at this time), and the IMF, an institution that had once been thought irrelevant, is now being asked to do more! It is advantageous to be thought of as inadequate at this time because, in such circumstances, the IMF may be given greater resources and be able to increase the size of its staff again. In any case, before further concrete action can be taken to strengthen IMF surveillance, we must first determine what went wrong in the IMF’s failure to identify the vulnerabilities that eventually contributed to the current crisis.

Fundamentally, making further progress is difficult precisely because financial surveillance is difficult, especially for an international organization. If financial surveillance is difficult, integrating it with macroeconomic surveillance is even more difficult. An international organization simply does not have the tools that the national governments have to examine the books of financial institutions and other market participants. By their very nature, data related to financial transactions—including the quality of assets, market expectations, the creditworthiness of borrowers, and the complexity of derivative positions—are private to those who actually engage in the transactions. National authorities, albeit with some time lag, may be able to uncover some of the information through legal means; international organizations are far too removed to obtain relevant information in a timely manner. One should not expect too much from
international organizations in the area of financial surveillance (unless of course they are fully and expeditiously supplied with all relevant information by national authorities).

There is, however, an area in which international organizations, such as the IMF, can add value in financial surveillance: to see how national markets are connected with each other and to uncover vulnerabilities that result from cross-border spillovers. The IMF can perform this task only in cooperation with national authorities that are willing to provide timely data. Moreover, the IMF is handicapped by the lack of legal mandate or jurisdiction over cross-border capital (or international financial) transactions. To give the IMF jurisdiction over international financial transactions would require an amendment of the IMF Articles of Agreement. The G-20 summits made some reference to the need to review the mandate of international financial institutions. Given the diversity of opinion on the role of the IMF in the international financial architecture, however, how quickly the deficiency in the IMF’s toolkit will be addressed in the context of amending the Articles of Agreement remains uncertain.

E. International Monetary Fund Governance Reform

The G-20 summits stressed the need to increase the voice and representation of new economic powers in the governance of the IMF. In this context, what has been achieved in the 2006 and 2008 quota reforms is disappointing: the weight of EU-15 has declined only by about 0.6%, while that of Asia and the Pacific has risen by about 1.5%. The G-20 summits called for the next round of quota reform to be completed by 2011 but, given the resistance of countries that are set to lose voice, the pace of reform can only be expected to be incremental. We saw a glimpse of the extent of the likely resistance in the April 2009 meeting of the International Monetary and Financial Committee, a ministerial advisory body to the IMF, where IMF governance reform was initially not put on the agenda, even though the meeting immediately followed the G-20 summit and was timed with the release of the Manuel Report (Manuel et al. 2009).

Representation reform is important to maintain (or restore) the legitimacy of the IMF, but it cannot by itself be expected to improve its effectiveness or relevance. More often than not, the IMF is managed through consensus; rarely does the IMF executive board take a formal vote in its decisions. For this reason, the 2008 report of the IMF Independent Evaluation Office (IEO) on governance (IEO 2008) argued that a reform of the decision-making mechanism would be far more important than a reshuffling of voting shares in terms of increasing the effectiveness and relevance of the institution. The committee of eminent persons, which the IMF managing director established with Trevor Manuel as chair to follow up on the IEO report, also appears to have accepted the IEO assessment on
this point.

The IEO report (endorsed by the Manuel Report) argues that the IMF executive board is far too removed from the actual decision makers in the member countries. Executive directors are usually mid-level bureaucrats from central banks, or finance ministries who have little direct access to the governors or ministers, not to mention the prime ministers and presidents. Because the directors are not given decision-making power, it takes the IMF a long time to make any substantive decision, if a decision is made at all. The ministers and governors of more important countries pay more attention to the G-7, the G-10, and now, increasingly, the G-20. If the IMF is to become more effective and relevant, it will require greater involvement from senior policy makers.

To make it happen, the Manuel Report has accepted the IEO proposal of activating the “Council” envisioned in the Articles of Agreement: “The Fund shall have a Council if the Board of Governors decides, by an eighty-five percent majority of the total voting power” (Article XII). The articles further specify that, should a council be activated, a member “shall be a Governor, Minister in the government of a member, or person of comparable rank.” The G-20 summit of April 2009 accepted the idea in principle but remained more general about the precise modality of increasing ministerial involvement by simply endorsing the idea of giving “consideration” to “greater involvement of the Fund’s Governors in providing strategic direction to the IMF and increasing its accountability.”

Greater ministerial involvement may well increase the effectiveness of the IMF as a decision-making body and, hence, its relevance. However, the coexistence of informal intergovernmental groups with formal supranational institutions that now characterizes the international financial architecture will only cease if the composition of the council (or a reconstructed International Monetary and Financial Committee, with explicit supervisory authority) coincides with the composition of the G-20 (or some other body that replaces the G-7 or the G-10). This is unlikely to happen, however, as long as Europe continues to enjoy disproportionate representation and virtually no African country is a member of the G-20.

**F. Conclusion**

The recent global financial crisis has brought the G-20 into the limelight, and highlighted the need for IMF reforms in the areas of surveillance and governance. While the influence of the G-7 has diminished and the G-10 has virtually ceased to exist, the place the G-20 is likely to occupy in the new international financial architecture will not be a replica of the G-7 or the G-10 in the old regime—the G-20 is too large and too diversified a group to be an effective decision maker. I
have argued that, in the emerging international financial architecture, different groups of countries are likely to be formed to discuss different sets of issues, perhaps with the G-20 acting as an umbrella.

The need to strengthen IMF surveillance has been a constant theme since the Mexican crisis. With the many initiatives that have already been taken over the intervening years, it is not clear what should be done next. Financial surveillance is a difficult task for an international organization, and the IMF is also handicapped by the lack of jurisdiction over cross-border capital transactions. To strengthen IMF surveillance in this area would require an amendment of the Articles of Agreement. Though the G-20 summit appears to have endorsed the idea of amending the articles, given the diverse opinion that exists among the membership, reaching agreement will not be easy.

Equally difficult to push forward would be the reform of IMF governance. The voice reform, involving the realignment of votes to reflect the new economic reality, is a zero-sum game and therefore can only be a slow process. Another aspect of the IMF governance reform is to increase the involvement of senior policy makers in the institution, an idea the G-20 summit broadly endorsed. Here, too, there is a diversity of opinion, with some countries not so keen on giving the IMF any more authority than it already has. If nothing substantial happens at the IMF over the coming months, the prestige of the G-20 may suffer. What does it mean for a group of counties that constitute some 85% of world gross domestic product to have little impact on the working of an international organization of 186 members? It means that the G-20 and the IMF will continue to be ineffective and, ultimately, irrelevant.

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The global financial crisis that started in 2007 heavily influenced the world economy. The Korean economy was not an exception, and the won depreciated by 80% almost immediately. This is not unfamiliar to the Republic of Korea (henceforth Korea), as it was in a similar situation 10 years ago.

There are a number of differences between the current crisis and the previous one, however, the most significant one being that the source of the current crisis is external. While a number of causes of the crisis are pointed out, the most obvious cause is the bad subprime mortgage loans in the United States (US). The finance sector in Korea was much healthier than in the US, and much healthier than in Korea 10 years ago.

Why then did Korea suffer such a severe drop in the value of its currency? This was mainly attributable to foreign banks’ massive withdrawals from banks in the country. During the 4 months of September-December 2008, Korea experienced record high loan withdrawals of $46.5 billion. The average rollover rate of bank loans plummeted to close to 30% and, as a result, concerns about Korea grew and the CDS premium surged.

While there were some reasons to view the Korean economy with suspicion, with hindsight it can be seen that these worries were exaggerated. In fact, the main banks in trouble with the rollover problem were local branches of foreign banks. As the parent companies were hit by a liquidity crunch, the local branches, which had been in a much better position in borrowing from abroad, were no longer able to extend their loans.

There is not much that emerging economies such as Korea can do to prevent this kind of global crisis. Its foreign reserves of $260 billion were not at all helpful in preventing the sharp depreciation of the won. At the peak of the crisis, the authorities were reluctant to use foreign reserves actively because they feared that, if foreign reserves were lowered below $200 billion, it would spark a speculative currency attack. In the worst scenario, if a country is susceptible to a crisis, foreign investors may not only sell stocks but also dump even long-term securities, and domestic residents may also want to convert their local currency deposits into foreign currencies.

To prevent this kind of crisis, the most effective approach is to establish a global lender of last resort. The International Monetary Fund (IMF) is supposed to
play this role but has been proven not to be effective. In fact, the sharp depreciation of the won was stopped when the US Federal Reserve agreed to a swap contract of $3 billion with the Bank of Korea in October 2008. In the current international financial system, the only institution that has full capability of channeling global liquidity—in most cases in US dollars—where it is needed is the US Federal Reserve. However, its main purpose is to execute US monetary policy and to play the role of a lender of last resort for the national economy, not for the global economy. This ad hoc scheme of relying on a national central bank as a global lender of last resort is, for practical as well as political reasons, not desirable over the longer term, because the US Federal Reserve has no supervisory power over foreign institutions (Obstfeld 2009).

What other options do emerging economies such Korea have? The first possibility is to accumulate more foreign reserves. However, this has a cost, especially in Korea’s case where purchases of foreign reserves are financed by selling won-denominated bonds. Costs accrue as long as there is an interest rate difference between dollar-denominated bonds and won-denominated bonds. Holding more reserves is also risky as the international value of the reserve currency varies over time. Secondly, Korea may try to internationalize its currency. Once the currency is internationalized, Korea may hope that its external financing is obtained through won-denominated assets so that it does not have to suffer from a currency mismatch problem. However, internationalization of a currency is hardly achieved through policy enforcements, and its success is mainly associated with market fundamentals, which are not likely to be satisfied in the short term.

Finally, Asian countries may seek to form a new international institution that can replace or at least complement the IMF in Asia. The current global crisis renews interest in monetary cooperation among Asian countries. As pointed out by Park and Shin (2009), reserve currency countries such as the US enjoy substantial privileges as suppliers of global liquidity. Currently none of the Asian currencies qualify as a key international currency, but if Asian countries pool the foreign reserves they hold, or if they succeed in creating a common Asian currency, it is expected that they will also be able to set up a proper institution that can provide international liquidity in an appropriate way.

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3 See Park and Shin (2009) for the pros and cons of the recent attempts made by Asian countries as well as Korea to internationalize their currencies.
THE GLOBAL FINANCIAL CRISIS AND THE ROLE OF THE G-20

Tae-Joon Kim

1. How long and how deep will the global financial crisis be?

After showing jitters in February and early March 2009 from a potential crisis in Eastern Europe and potential further losses at global financial institutions, global financial markets have been stabilizing since mid-March. However, there remain concerns that a vicious circle will result from the ongoing stagnation in the real economy. The persisting stagnation has been gradually spreading to other financial products and financial institutions, as seen in the spike in the delinquency ratio of formerly sound commercial mortgage-backed securities and in the deterioration in the earnings of life insurers. Another financial crisis is thus a possibility.

Further, amid a continued slump in the United States (US) housing sector that induced the crisis, a rise in unemployment due to economic stagnation is also gradually expanding foreclosures on prime mortgages. In addition, Britain’s credit rating outlook was recently downgraded to “negative”, as concerns have risen that there could be a financial crisis sparked by the United Kingdom (UK). Due to the heavy toll of capital injections for financial institutions, reduced tax revenues following the economic downturn, and the cost of economic stimulus packages, the fiscal deficit of the Government of the UK is forecast to top 10% of gross domestic product (GDP), the highest among G-20 nations in 2009.

Thanks to the aggressive measures of national governments, however, the chances of another 2008-type financial crisis are judged to be very slight. Nevertheless, several potential destabilizing factors remain, and it is expected to take considerable time for global financial markets to fully get back to normal.

2. What are the main achievements and limits of the G-20 summit in London, and what are the prospects for the summit?

The biggest significance of the summit is viewed as its having gone beyond mere rhetoric and actually achieving agreement on tangible deliverables for easing the economic crisis and upgrading the financial system. These deliverables include aggressively undertaking the necessary fiscal measures for a return to global growth and for achieving recovery in employment, and putting in place effective and practical systems to counter protectionist obstacles. Moreover, members also agreed to increase support for emerging and developing economies by expanding funding for international financial organizations. Finally, members resolved to improve financial regulations to regain trust in the financial markets, and to
reform the governance structures and expand the functions of international financial organizations.

Therefore, the G-20 has risen to prominence as a high-level group centered on addressing global economic issues. Key current issues, such as the expansive reorganization of the FSF into the FSB and international cooperation for regulations on tax havens and other uncooperative regions, are now decided within the G-20.

The G-20 does, however, have several limitations. First of all, it is unclear how long the G-20 will last. For one thing, unlike the G-7, in which any issue may be brought up and addressed, the G-20 is limited to discussions on specific preselected issues. In this respect, one should add that in this year's meeting there were a great many disputed issues that remained unresolved. Such issues include further fiscal expansion, how to deal with toxic assets, breakdown of trade financing, and expanding International Monetary Fund (IMF) funding.

Opinions are divided on the chances of the G-20 remaining in place after the current financial crisis ends. Those with vested interests, such as European nations, are sticking to their negative view of emerging market economies taking part in the G-20. On the other hand, with the current financial crisis as the impetus, the possibility exists that the G-20 will continue on the condition that it is able to achieve tangible results.

Therefore, the following efforts are needed for the subsequent survival of the G-20. I think it is critical to make sure that the matters agreed upon at this year's summit be thoroughly implemented and that visible results are accomplished. It will also be necessary to continue developing an agenda that is able to incorporate the interests of both advanced and emerging market countries. Such an agenda should encompass several issues, such as the aging population and global economic imbalances.

3. What should be the position of Asian countries in the G-20 process? In particular, what should our opinion be on strengthening financial regulation and the reform of the International Monetary Fund?

Firstly, I believe that Asian nations need to recognize that the G-20 is the most useful structure for voicing the interests of emerging Asian economies. It should also be noted that, in addition to Korea, three other emerging market Asian countries—the People’s Republic of China (PRC), India, and Indonesia—presently take part in the G-20. Further, it is possible for Korea and Indonesia to represent other nations in the region; Korea could play this role for Taipei, China, Singapore, and other developing Asian economies. Similarly, Indonesia could do
the same for the Southeast Asian countries that constitute the Association of Southeast Asian Nations (ASEAN).

This is to say that, in order for Asian nations to be able to pursue mutual benefit through the continuance of the G-20, they need to actively participate in it and build support systems for each other. It is particularly important to devote ourselves through mutual efforts to adjusting the national quotas for the IMF and raising the voice of Asian nations in the IMF and other international organizations. These adjustments should reflect changes in the relative economic strength of the member nations of the IMF and other organizations.

In respect to strengthening financial regulations, we should consider that it was the insufficiency and the failure of financial supervision in advanced nations that hampered the financial stability of emerging market countries. I would thus deem it necessary that Asian nations express our views and actively take part in any discussions in this area.

In particular, Korea should make an active effort to join as a permanent member of the subcommittee and the decision making body of the FSB, which will assume the role of the new international financial supervisory institution. This will also enhance Korea’s role as a representative for Asian emerging market countries. Korea should aggressively take advantage of chairing the G-20 next year by helping to select the items and main agenda in preparing for the summit. Further, we need to aggressively publicize our experience in successfully overcoming a financial crisis in the past and thereby further bolster the Korea’s role.

In essence, Korea needs to favorably look at the fact that, through the coming IMF reform, we should be able to raise Korea's position within the IMF. Let us also keep in mind that, even though the absolute majority of present IMF members is developing countries, the relative minority of advanced countries hold 60% of the voting rights and also make up the majority of the executive directors. There is, thus, quite clearly a lack of democracy and fair representation.

In subsequent IMF reform discussions, we should figure that Korea will be able to raise its role in the IMF by making efforts to reasonably adjust national quotas as early as possible in a way that reflects changes in the relative economic strength of member countries. Efforts must also be made to put in place a rotation scheme of constituent countries, based on objective criteria such as the actual economic size of member nations. At the same time, existing countries should have their constituency examined and justified. Finally, Korea should actively take part in detailed discussions on the procedures for electing the managing director, so as to raise the country’s role in the election process. Moreover, we need to improve the chances of Korean personnel filling senior positions at the
IMF by advocating for appropriate regional distribution of high-level appointments.
1. How long and how deep will the global financial crisis be?

In the course of the 1980s, it became a policy of professional journals such as the Journal of Finance not to accept papers based on the supposition that financial markets were perfectly competitive markets. Their informational deficiencies in particular had become common currency among specialists. Equally, by the end of the 1980s, the United States (US) fiscal and current account deficits had become a serious concern. Incidentally, I worked on both issues at that time (Kamppeter 1988, 1990). I picked up the loose ends of those discussions and came to the conclusion that we were heading for a serious financial and economic crisis. Its causes lay on the one hand in the informational deficiencies, moral hazards, and the solipsism of capital markets and, on the other, in the US double—deficit problem and the corresponding global saving—investment disequilibria. I was convinced that if we did not change course, i.e., reregulate financial markets and reverse the global macroeconomic disequilibria, the world economy was heading for an ever more inscrutable problem.

The Republic of Korea (henceforth Korea) at that time had just won the battle for democracy. After the former dictatorial and developmental governments had controlled the economy rather strictly, the economy experienced a major liberalization drive under its new democratic government. In a sense, after having suffered so much under its authoritarian governments, Korea fell into the trap of considering economic freedom as an equivalent of political freedom and liberalism. As we may have learned from the present crisis, political and economic freedoms are quite different animals. Because economic freedom can be quite destructive and impose a hefty price on the public, even the most liberal democracies need to restrain the freedom of the economic actors. This is precisely the meaning of the primacy of politics. As we know from political science and constitutional law, democratic regimes also need a state able to act effectively to safeguard the public good. Yet, because of bounded rationality, ideology, media democracy, lobbyism, etc., it is not at all easy to draw the proper line between private and public interest1.

Apparently, at that time my views were completely discordant with reality. Instead of moving toward the abyss, as I had expected, the world economy and

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1 Twenty years ago, there was a general perence for more economic freedom (and competition) in Korea. Hence, when I put forward reasons for proper regulation and reregulation of financial markets at a workshop of the Korea Development Institute in 1991, these were not well received.
the financial markets in particular entered a phase of much-praised and seductive buoyancy. Yet, unfortunately, in the end the solipsism of estranged financial markets joined hands with the global macroeconomic disequilibria (which could not have occurred without the liberalization of capital accounts) and produced the most severe crisis since the Great Depression of the 1930s.

I was by far not the only economist to perceive those problems 20 years ago, yet it took more than two decades for the disastrous consequences rooted in these problems to become an undeniable reality. Should one really be surprised if it took another 20 years to sort out the problems created by the present world economic and financial crisis? There are plenty of reasons to believe this may occur:

(i) As most observers agree, this is the most serious crisis since the Great Depression.

(ii) In this emergency, most major economies responded with huge increases in government expenditure and guarantees for financial institutions, yet government debt eventually will become a huge burden for taxpayers and put serious limits on the ability of governments, households, and private enterprises to spend, consume, and invest. Not least, the past and present accumulation of debt will severely restrict the future maneuverability of governments in weathering the present and future crises.

(iii) The extremely loose monetary policies and the huge sums spent to stabilize the financial system could well cause a liquidity-driven asset bubble in financial and commodity markets in the future. Sovereign risk is bound to rise (Roubini 2009).

(iv) Apparently, the political power and influence of financial and other vested interests in the failed neoliberal regime is unbroken.

(v) Even though there have been some swift reactions, it is hard to identify serious efforts to improve the existing system of global institutions. This system is fragmented, incoherent, exclusionary, largely ineffective, unaccountable, and slow (Held and Young 2009).

(vi) As yet, nobody is really sure whether we will get inflation, deflation, stagflation, or a strong recovery, recession, or even depression.

Thus, while this list could easily be expanded, optimism for a quick resolution

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2 This has a direst effect on goverment action: “I think the Obama administration has succumbed to political pressure and scare-mongering by the big banks. As a resule, the administration has confused bailing out the bankers and their shareholders with bailing out the banks...this is a form of ersatz capitalism, in which the losses are socialized and the profits privatized...America has expanded its corporate safety net in unprecedented ways... The rich and powerful turn to the government...while the needy individuals get little social protection.” (Stiglitz 2009). Thus, “corporate welfarism” underrates social welfare. Inthe same vein, John Sweeney (2009) complained at the Organisation for Economic Co-operation and Development (OECD) Council on 24 June 2009 that “the fiscal stimulus packages to date are not sufficiently focused on employment and social protection.”
of the present crisis does not seem to be justified. Furthermore, we should not
forget that we face larger and deeper challenges than the short-term management
of this crisis and the reconstitution of economic governance structures. Just to
mention two of them:

(i) Environmental destruction and the wretched poverty of most human
beings on this planet surely are much more demanding long-term
challenges, and they are bound to become more serious through this
crisis.

(ii) After decades of stimulating economic growth through government
deficits, we have not seen a significant reduction in the levels of
unemployment. Instead, the superfluous population outside the formal
market economy (who would not remember Arthur W. Lewis’ “surplus
labor” concept?) has increased remarkably, nationally as well as
globally. Even in Organisation for Economic Co-operation and
Development (OECD) countries, a steadily increasing number of people,
who are citizens of democratic regimes that rely on notions of social
justice, fill the ranks of the “precariat”, trying to eke out a modest living
on the fringes of the prosperous core of the market economy or relying
on public transfers. We are bound to wonder whether economic growth
can really be the basic rationale or ideology for economic policy making.

Unfortunately, the present economic and financial crisis not only diverts
attention from these deeper problems, but tends to see the only solution in the
ideology of economic growth, varnishing it with newly popular yet old-fashioned
neo-Keynesian growth packages—“bastard Keynesianism” as Joan Robinson
would have said³.

2. The main achievements and limitations of the G-20 summit in London

As I cannot claim to any deeper knowledge about the front-door results and back-
door dealings of that summit, I want to limit myself to one comment: In all
financial crises since the Latin American debt crisis in the early 1980s, short-term
capital movements played a major role. Just think of the Asian financial crisis 10
years ago⁴. Unbelievably, the problematic role of short-term capital movements is
not discussed at all in any one of the documents of the G-20 summit (Eric

³ In the final chapter of his General Theory, Keynes deals with the limits of accumulation and economic
growth and makes proposals on how to maintain full employment under conditions of a saturation of
investment. See also Keynes(1943) 1980

⁴ This disastrous experience did not induce the Korean authorities to hold in check the movement of short-
term capital. At the beginning of the present crisis, short-term debt, in particular through the yen carry
trade, was higher than the considerable reserves of the Korean central bank. Additionally, there was a
huge outflow of portfolio capital because of the liquidity problems of their (mostly US)owners, which were
a result of the crisis itself. The awareness of these problems is growing again. (See, for example, Kim
Kyung-soo’s article in the Korea Herald(Kyung-soo 2008))
Helleiner, pers. comm.).

I recognize the conceptual and practical problems in limiting short-term capital movements, yet I am firmly convinced that they need to be regulated seriously. Some economist might be able to argue convincingly that foreign direct investment offers net benefits for the recipient countries (I do not deny some skepticism). However, referring to an argument frequently made by Jagdish Bhagwati, in contrast to the case of free trade, nobody has yet been able to demonstrate that unrestricted international capital movements lead to higher levels of welfare.

3. Strengthening financial regulation

“Banking is the industry that failed. Banks are meant to allocate capital to businesses and consumers efficiently...Banks are supposed to make money by skillfully managing the risk of transforming short-term debt into long-term loans; instead, they were undone by it. They are supposed to expedite the flow of credit through the economies; instead, they ended up blocking it.” (Economist, 16 May 2009).

Looking at this disaster and its horrible sequels, one cannot avoid becoming normative. There is, after all, a difference between private and public interest. It is the task of laws and regulations to safeguard public interest with regard to private interests and, one might add, to protect the private interests against their own madness.

From a normative point of view, the right of existence of financial intermediaries can only be based on their usefulness for the real economy and of the public interest in general. The financial markets ought to serve dutifully the needs of the real economy (Kamppeter 1993).

For the real economy, financial intermediaries have four basic functions:

(i) mobilization of savings,
(ii) allocation of savings to investment in terms of profitability and risk,
(iii) facilitation of financial transactions between economic actors, and
(iv) intertemporal allocation of liquidity.

In particular, with respect to the first two functions, financial intermediaries have failed dismally. We have learned the hard way that most financial markets are inefficient in allocating future risk, are highly volatile, and are driven by expectations on expectations on expectations, if not by sheer greed and recklessness:

(i) Instead of mobilizing savings, the business of financial intermediaries expanded based on credit and liquidity creation and extremely high
leverage ratios. They did so largely outside the regulated sphere of their businesses and far beyond what their equity positions would be able to bear.

(ii) Instead of mobilizing savings for real investment, financial intermediaries carelessly expanded consumer credit and, in particular in the US, mortgage finance, generating a real estate bubble.

(iii) Even banks, which really should have known better, engaged in excessive maturity transformation (as in conduits and SIVs), which then contributed to the liquidity crash.

(iv) A 25% rate of return benchmark for leading banking institutions implied that there was something seriously wrong—either these institutions engaged in too much risk taking or competition did not work the way it should. There was a frantic search for yield (“yield panic” as Martin Hellwig put it), which contributed to the mania of markets and financial institutions.

(v) Governance was flawed in a variety of ways. System-stabilizing incentives were either absent, wrong, or ineffective. Regulators, central banks, governments, politicians, and international regulating bodies turned a blind eye, to say the least, and, worse, literally did not know what was going on in the markets. For example, for better or worse, Basel II was based on the risk models of the banks and, along with Basel I, encouraged the formation of conduits outside of balance sheets. Basel I and II made it possible for banks to treat assets under certain conditions with a zero-risk weight; this was a recipe for disaster.

(vi) Another flaw pointed out by Charles Goodhart is that, while the good times still roll, it is difficult for the guardians of the financial system to take measures that will reduce economic growth in the short term in the interest of fending off a recession no one thinks will happen (Plender 2009).

(vii) Bankers and managers did not know much better. The parameters of behavior were set by bonuses, peer pressure, carrier concerns, fears of being ostracized, and, alas, the self-fulfilling promises of their deficient models. Internal risk control was not comprehensive, but distorted and weak.

(viii) Rating agencies also did not know better, or they knew but were afraid to hurt their consulting business. Yet, when things became tough, they triggered and accelerated the implosion of markets and the difficulties

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5 One serious defect of these models was that they underestimated tail risks “that with our present knowledge cannot be quantified” (de Grauwe, 2008). Interestingly enough, these models, through their specifications and interactions have a strong if not decisive impact on markets. Schulmeister (1987) has shown that this for the use chart models in foreign exchange trading.
of intermediaries.
(ix) Systemic and procyclical interdependencies and risks were almost completely ignored.
(x) Some pieces of regulation exacerbated the difficulties of financial institutions and thus became an important source of systemic risk. Among them are mark-to-market (fair-value) accounting and capital adequacy regulations (Basel Accord), which in times of difficulties increased the solvency problems of banks. Both pushed financial institutions onto a downward spiral of equity losses and shrinking balance sheets (Hellwig 2008).

4. Challenges of regulation

It has become increasingly clear that effective regulation is not only in the interest of the real economy but also safeguards the stability of the financial system itself, as well as that of the individual financial institutions (Griffith-Jones 2009).

a. Purpose

The finance sector ought to be seen as a means to an end; it should serve the real economy, and thus the needs of households, enterprises, and governments to consume and invest. Finance is an intermediate good that does not produce utility directly (Kamppeter 1992).

The following questions arise:
(i) Which financial intermediaries are minimally necessary to satisfy the needs of the real economy?
(ii) Have the stock company and the stock market outlived their 19th-century purpose of financing large-scale industrial investments?

In most countries, only a fraction of new investment is financed through the emission of new stock. Therefore, stock markets are largely a secondary or secondhand market dealing with stocks that have already served their investment purpose. These markets for secondhand stocks are driven by expectations on expectations on expectations, not to say on euphoria and panic. Therefore, against what one would expect on theoretical grounds, they are much more volatile and unstable than real economic activity. However, because the price movements of the stock market are perceived as an economic barometer or even a divine judgment on firms and governments, they generate a lot of noise and tend to have a destabilizing impact on economic activity and the financial markets themselves.
As has been known for a long time, shareholders are not able to impose transparency and market discipline. Instead, for many decades already, the stock company has served as a camouflage for managerial capitalism. These informational asymmetries were further enhanced by wrong incentives such as stock options and other nice devices—with disastrous consequences as we could see again.

(iii) What contribution do international short-term capital movements, e.g., portfolio investments and the yen carry trade, make to real investment and employment? They have been a major vehicle for transmitting boom and bust across borders. They have produced dramatic exchange rate movements and destabilized real economic activities.

(iv) More generally, if movements in the capital account determine exchange rate movements (as they have for quite a number of years), then exchange rates cannot fulfill their real-economy function as a central price for balancing trade and allocating resources. Hence, free-trade arguments of whatever description become invalid. It certainly is not very far-fetched to argue that free-trade ideology (the only thing left once its theoretical justification loses stringency) has basically served to discipline labor and governments (e.g., through the Washington consensus).

(v) The speed with which financial markets move is excessive and has negative repercussions for the real economy. How can it be, for example, that the exchange rate, which is supposed to reflect the average of myriads of price movements, is one of the most unstable and volatile prices? Surely, there is a need to dampen the speculative mood in these markets through transaction taxes or otherwise.

(vi) Is securitization intended to circumvent statutory regulation, or does it indeed reallocate and provide a better sharing of risks? Does it reduce the risks for real economic actors?

b. Rationale for statutory prudential regulation

(i) Limit the risk implications of strategic choices made by financial intermediaries for their creditors and the financial system as a whole.

(ii) Create a regulatory framework that generates stability even when mistakes are made (Lee Dukhoon, pers. comm.).

(iii) “...the notion that there is a difference between private interests and the public interest in risk management and risk control of banks seems to have been lost.” (Hellwig 2008, 54–5)

c. Decentralized global system
(i) The system ought to be based on general principles and a minimum set of international guidelines. There is a strong presumption in favor of a separation of commercial and investment banking (“narrow” banking).

(ii) The system ought to be comprehensive, in the sense that prudential regulation and control are extended to all major participants in the financial system (micro-prudential regulation), while systemic risks are observed and acted upon (macro-prudential regulation). Comprehensiveness requires that financial institutions be banned from operating in regulation-and law-free offshore financial centers.

(iii) The system ought to be differentiated to account for the differences in the roles and liability structures of financial institutions. The homogenization of market participants reduces the resilience of the financial system (Hellwig 2008, 63).

(iv) The system should locate the responsibility for regulation and supervision at local, national, regional, and international levels. The basic point of reference is the nation-state, which must assume this responsibility within a framework of general rules and guidelines (similar to the Bretton Woods system). This is necessary because

(a) the real world possesses a large variety of capitalist-type economies;

(b) the specific needs of regulation and supervision vary with the level of economic development;

(c) the improvement in living and conditions in the least-developed and developing countries should not be impeded by systems of control and supervision not appropriate to their needs and levels of development;

(d) economic cycles do not coincide among countries;

(e) it cannot be expected that powerful countries in particular will cede sovereignty to international agencies; and

(f) in any case, whatever some experts and technocrats might say, any sort of regulation and control is politics; political decisions need legitimacy, and legitimacy is largely a matter of national constitutions and laws; the present crisis indicates that it might be worthwhile reconsidering the case for independent central banks.

(v) Macro and micro prudential risks and problems can take different shapes between and within countries, and between multinational regions. Functionally there should be a preference for supervision and control at the most appropriate and lowest level (subsidiarity). The concept of subsidiarity is different from the concept of equivalence, which links benefits with costs at the level of jurisdictions. Both principles can be useful in the design of systems of control and supervision:

(a) If the system is developed and put into practice in a top-down manner, the whole system is likely to be a poor and ineffective
compromise and to be poorly enforceable.

(b) The home-country principle (which restricts the supervision of banks to their home country and allows no additional supervision by authorities of other countries in which they are active) needs to be revised. This principle is one of the reasons why today’s big private banks are “global in life but national in death” (Mervyn King, governor, Bank of England), with the burdens of their failure falling onto the countries where they happen to reside.

(vi) The system should allow for capital controls, i.e., limits on capital account transaction. As Jagdish Bhagwati has argued repeatedly, the liberalization of international capital movements has not produced the promised benefits, and in fact very much the contrary. In particular, developing countries have to be able to protect themselves from financial turbulences originating elsewhere (Helleiner 2009, 7).

(vii) There is a need to reduce the pressure to accumulate reserves for future crises (one of the reasons for the present macroeconomic disequilibria and, obviously, an aim impossible for all countries to realize). Therefore it is suggested that
(a) swap agreements among central banks are extended, and
(b) special drawing right (SDR)-type credit facilities are created at the central level (e.g., IMF) and regional level (e.g., an Asian regional monetary fund).

One of the expected benefits from regimes of flexible exchange rates was that the pressure of accumulating reserves of the Bretton Woods system would be eliminated. Nowadays we know how wrong this expectation was, and we also know that systems of flexible exchange rates and unrestricted movements in the capital account are not compatible.

d. Characteristics

(i) Transparency.

(ii) Nobody knew about the systemic risk from conduits and SIVs before July 2007 because these, as well as hedge funds, did not have to provide information about their positions.

(iii) Simplicity. The following measures will be beneficial to the understanding of the public, journalists, and politicians of what is going on in financial markets:
(a) Unbundling of universal banks; separating commercial from investment banking and restricting “casino banking” to potential benefits for the real economy. Not least, such a separation can be expected to significantly reduce maturity problems.
(b) A general preference for national financial intermediaries, as
prudential regulation and supervision can be extremely complicated when they fall under various jurisdictions. The massive injection of government funds in any case has “deglobaled” finance (Wolf 2009).

(c) Prohibition of all off-balance-sheet activities.
(d) Limiting the issuance of complex, customized, often nontradable instruments (Eatwell 2009).
(iv) Limits on size and market shares of financial intermediaries through competition and administrative procedures, lest these intermediaries gain political power and influence, and become too big to fail.
(v) Take proper account of systemic interdependences and risks (Hellwig 2008), and stress test the system as a whole (Eatwell 2009).
(vi) Implement anticyclical regulation, e.g., financial institutions should raise capital reserves in good times and use them as a cushion in bad times.

e. Specific measures

(i) Oblige rating agencies to divest from consulting business (if not create public bodies instead).
(ii) Do not allow higher stages of securitization (such as MBS CDOs, MBS CDO2s).
(iii) Limit total leverage of financial firms.
(iv) Develop comprehensive and properly conceptualized models of private and public risk, taking account of the correlation of risks between markets and market participants.
(v) Develop robust and simple procedures for unwinding positions when a financial institution becomes insolvent (Hellwig 2008, 63).
(vi) Revise capital adequacy regulations. The present regime has a number of drawbacks and disadvantages, which among other things give it a procyclical bias.
(vii) Institutionalize a quota for women traders to dampen the influence of the overzealous, testosterone-driven investment managers on markets and risks.

f. Limitations

There is only so much that can be done through regulation and control. In the final analysis, control can only come from self-restraint and the recognition of the public purpose of our deeds by institutions and the individual actor. Within the limits of the law, behavior can be legal, yet at the same time selfish, irresponsible, and immoral. Surely, there is a need to take consciousness and pride in the public purpose and in public virtue and to give it a central place in society, politics,
We do not only face the challenges of the present financial and economic crisis, which in the face of the (momentary?) self-destruction of neoliberalism has bestowed upon us the “state socialism for the rich and the neoliberalism for the poor” (Beck 2009).

The much more difficult challenges are the ones of the destruction of our own habitat and those of most other living beings; the excessive consumption levels of some 15%-20% of the world’s population; the existence of surplus labor that capitalism and the market economy generates or cannot absorb, along with the enormous levels of inequality and impoverishment both nationally and internationally; the scandalous misallocation of resources through military expenditure and the killing fields that follow in their wake; the rising number of failed states; high population growth in the poorer countries and the challenges of shrinking populations and ageing in the more advanced ones; and the widespread disenchantment with politics and the declining legitimacy of democratic government, as well as the lack of confidence in our economic and political elites and their governance. Potentially, covered only by a thin veneer of crisis management, capitalism and politics suffer a severe crisis of legitimacy.

It is extremely difficult to meet these challenges. It is quite clear that capitalism and the market economy cannot be a panacea for answering any of them. It is more of a cause than a cure, as capitalist modernization contributed mightily to the pathologies we observe today (Habermas 2008). These challenges will require a thorough readjustment of the relationship between state, market, politics, and citizens at the local, national, regional, and global levels.

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Roundtable Discussion:

Moderator: Richard N. Cooper
Panelists: Fan He
          Shinji Takagi
          Deok-Ryong Yoon
          Kwanho Shin
          Tae-Joon Kim
          Woosik Moon
          Jung Sik Kim
          Shin-ichi Fukuda
          Chalongphob Sussangkarn
          Eiji Ogawa
          Werner Kamppeter

Richard N. Cooper: Session one is about the financial crisis and what came out of the G-20 meeting.

We will invite each speaker to speak for 5 minutes, and then we’ll use the remaining time for discussion.

Fan He: My topic is: America’s Crisis and [the People’s Republic of] China’s problem.

The United States (US) first said that the dollar is our currency but your problem, and it is true this time. What we saw is a crisis in the US, but the impact in the People’s Republic of China (PRC) is so significant that it forced the PRC to make some very painful adjustments. Before the American financial crisis, a lot of policy makers in the PRC believed in the so-called decoupling theory, which claimed that, even if the US economy slows down, the PRC could still maintain quite robust economic growth. However, when the American crisis happened, its impact on the economy of the PRC was quite significant. We witnessed a sharp decline in the 4th quarter last year (2008), which we had not experienced in the last 30 years. A lot of people blamed the American financial crisis, but in the PRC’s case I would also like to point out that, while we had a very sudden post-crisis decline, a part of the reason was domestic. If you look at the industries which have suffered most during this financial crisis, they are the industries that have overinvested and gained overcapacity during 2005-2007. So the good news for the PRC is that due to these difficulties I hope some new momentum has been given to economic reform in the PRC.
After the financial crisis the Government of the PRC announced a CNY4 trillion stimulus package, so we are already seeing quick recovery for the PRC economy. I think the first phase of this recovery is the readjustment in the market for overshoot in the last quarter, and then recovery started from the second quarter because the stimulus package started to take effect. So things are good so far but, as I mentioned yesterday, we still face some potential risk from local government fiscal pressure, the amount of loans in commercial banks, and the rising unemployment rate, together with still sluggish external demand. So these remain potential dangers in the PRC.

The more important task for the PRC is seeking a more balanced development strategy. In the international financial system, the PRC has become very interested in taking part in different levels of reform of the system. One multilateral reform may be reform of the International Monetary Fund (IMF), and also increasing the use of the special drawing right (SDR). I think the background of the speech by Governor Zhou is not to replace the US dollar with the SDR. Instead, the real purpose for the PRC is that we want to see more discipline in the US dollar. We will also take part in the regional reform, in the Chiang Mai Initiative, reserve pooling, and also renminbi internationalization. Although we are at a very early stage, as you can see from my slide, there is already some official and private use of the renminbi.

The final remark is on the PRC and the Group of 20 (G-20) countries. The PRC doesn’t share any interest in the G-7 or G-8 because we don’t want to become a member of the rich club. On the other hand, we are very active in participating in all G-20 meetings. I think the G-20 is a good place for consensus building, but because it has so many members it may be an unsuccessful mechanism for collective action.

My suggestion for the future is that we could expand the informal network for lower-level government officials such as deputies or even generals, since they are doing the real work. Another proposal is that we could find a new platform for major developing countries so that they can share their views and exchange their opinions before going to the international arena.

Shinji Takagi

I will concentrate on four points: the G-20, IMF lending reform, surveillance reform, and government reform.

Speaking of the G-20, it is very clear that the G-7 or G-8 no longer
reflect the reality of the real economy. I am not convinced that once the cohesion that is apparent in the current crisis disappears, the G-20 will not last for a long time, because for these informal intergovernment groups to be effective, you have to meet two conditions: One, membership has to be small; and two, membership has to be homogeneous. The G-20 meets neither of these criteria. My guess is that, once the crisis is over, there will be several different groups for different issues—some G-14, some G-12, and so on—but I think that different groups will emerge on different issues that meet the two criteria of small membership and homogeneity.

With respect to IMF reform, there are three aspects to this. One is lending reform. I don’t know how many of you are aware but about a month ago the IMF abolished conditionality. IMF programs therefore no longer have the conditionality that we used to associate with them. While the managing director argues that it was necessary to remove the stigma attached to IMF borrowing, the question we have to raise is whether this is a good thing. One argument is that it is a good thing because countries need to borrow from the fund due to the contagion from the global crisis and not because of problems of their own. Also, the lender of last resort is needed for crises of this nature, and for which conditionality should not be attached. On the other side, however, there is an argument that this may lead to greater hazard on the part of international investors and governments.

My third point is regarding surveillance reform. Each time there is a crisis there is a call for surveillance reform. The IMF has been doing this ever since the Mexican crisis in 1994. What else is to be done? I think it is easy to say that surveillance should be strengthened, but the question is how. My cynical view is that people at the IMF know that there is much to be done but they go along with the criticism because it is likely that the very people who criticize will be the ones to give more funding and more resources. Therefore, to be criticized in the IMF is a good thing. Just 6 months ago the IMF was considered to be irrelevant, and now it is relevant enough to be criticized.

My final point is on governance reform. I happened to visit Washington, DC at the time of the spring meeting. In talking to a number of people in Washington I discovered to my surprise that, despite what was mentioned in the G-20 summit, IMF reform was not on the agenda of the International Monetary and Financial Committee meeting. It is incredible that the world is talking about IMF reform but the IMF is not talking about IMF reform. The reason for this is that
there are countries that will lose if there is IMF reform and these countries control the agenda of the IMF. So, if we think that IMF reform is necessary, we have to really push for it—just because the G-20 said so doesn’t mean that it is going to happen.

Deok-Ryong Yoon We have three issues to discuss in the first session, but I will skip the first issue due to time limits and go directly to the second issue: the main achievements and the limitations of the G-20 summit in London, and the prospects of the G-20 summit.

The main achievement of the G-20 meeting in London can be found firstly from the official community. The main results of the meeting can be classified into five categories: macroeconomic coordination to overcome the economic crisis; strengthening financial supervision and regulation; reforming international financial institutions; rejecting protectionism; and building an inclusive, green, and sustainable recovery.

Let me make some remarks on the main achievements. Having in mind the agreements, we can try to evaluate the G-20 meeting. I think the first contribution of the G-20 meeting was the contribution to overcome the current economic crisis and stabilize the market. Directly after the London summit, the stock market in all countries around the world showed positive responses with big price increases. The G-20 also introduced necessary institutions such as the Financial Stability Board, and reform measures needed for the IMF, World Bank, and other institutions for essential functions of financial markets to recover. The G-20 meeting demonstrated the ability to work together to solve global problems, even though there were many doubts before the meeting. The G-20 also showed there was the ability to manage potential conflict between emerging economies and developed countries, as well as regional interests. There were conflicts of interest and confrontations, as the G-20 constituted a group representing over 85% of the economic world and with the capacity to manage most of the economic issues. The G-20 meeting provided an official opportunity to emerging economies and developed countries to deal with global issues and to set global rules. As you know, the G-20 covers two-thirds of the world’s population and 85% of global gross domestic product (GDP). According to Goldman Sachs, current emerging economies will hold 75% of world GDP in 2050.

But, as we know, there were many limitations to the G-20 summit in London. The G-20 participants disregarded fundamental issues such as
global imbalance and an international anchor currency. For instance, you have probably read the article by Martin Wolf in the Financial Times. He has discounted the contribution of the G-20 meeting because it disregarded the main cause of this financial crisis, which is the global imbalance, even though Professor Cooper has a different idea. The G-20 could not attempt to deal with the issues requiring long-term engagement, such as the idea of a world financial organization, made by Eichengreen. The G-20 did not have enough time to deal with fundamental issues because of the world pressure to solve the current and urgent economic crisis. The G-20 did not have supporting agencies and lacked legal and institutional legitimacy. Because of all this, the G-20 functioned merely as an ad hoc entity for crisis management. Nobody knows if there will be a next G-20 summit or not, and is decided in the meetings. In short, the G-20 meeting in London only paid attention to short-term issues.

Regarding the prospects of the G-20, there has been a need for a new international institution which can lead international coordination. If you look at the publications from the Brookings Institution, there are many arguments for a new international institution, and the requirement for the new institution is that it should be efficient, capable, and legitimate. However, if we look at the G-20, the group has failed to meet these conditions so far because the leaders avoided sensitive issues. The G-20 can remain as the new international governance framework as long as the leaders find urgent issues requiring global coordination, but the G-20 will only be able to tackle fundamental and long-term issues after its institutionalization. The leaders may need a few more meetings to confirm the usefulness of the G-20.

I think there is no agreed Asian position yet. Asian countries have more influence as well as responsibility in international society through the G-20. Asian countries will get more voice to reflect Asia’s interest and, with the given opportunity, we are likely to be able to build a regional position in the future.

Asian countries are in favor of strengthening surveillance and regulation of the financial market because we suffered economic damage from the financial crisis, and Asian economies have finance sectors that are relatively undeveloped. As Asian countries have direct relations to the global imbalance, we have a keen interest in finding a solution, and this will be an important issue in the future for the G-20. With regard to IMF reform, as Professor Kawai already mentioned, we
welcome this reform but we think that it is not enough to reflect the regional interest of Asia. I think the IMF reform should go on.

Kwanho Shin

In this presentation, instead of addressing specific issues of the G-20 meeting, I’ll just focus on the Republic of Korea’s (henceforth Korea) perspective on this current crisis and some implications for international financial architecture.

What is the unique feature of the current crisis? First of all, the crisis originated from the US, and because of the size and the status of the US, this crisis has quickly became a global problem, especially a global liquidity problem. There were huge capital outflows from Korea and it is still puzzling as to why this happens, but there was a subsequent sharp slowdown in global trade. This was especially painful for Korea, as it is one of the countries that heavily relies on external demand. There is nothing Korea can do to prevent this kind of crisis; the most it can do is minimize capital outflows. The reality is that we actually suffered from huge capital outflows. Why did this happen? There were three major problems pointed out, and because of these problems, Korea looked suspicious in the eyes of foreign investors. First of all, the current account showed a deficit of $6.4 billion in 2008. Second, the banking sector had large foreign indebtedness. Finally, banks had been losing deposits which were replaced by more costly funding, such as CDs.

This kind of accusation was in a sense very unfair to Korea. Let me especially focus on the current account deficit issue. We actually experienced the deficit in 2008 mainly due to huge increases in the prices of oil and raw materials. In addition, we faced high appreciation of the won. We can see that appreciation started in 2002, and since then we’ve had continuous currency appreciation. Finally, although we had a current account deficit in 2008, in terms of the size of the deficit as a percentage of GDP, we also had relatively high current account deficits prior to the 1997 crisis. After the crisis we had continuous current account surpluses, and then a very small current account deficit in 2008. What actually happened is that we experienced huge currency depreciation, much larger than in similar sized emerging economies. GDP growth in the fourth quarter of 2008 was also much higher than in similar economies.

This raises several important issues. First is the question as to what level of reserve is sufficient to prevent this kind of crisis. One theory is the Greenspan-Guidotti-Fischer rule, which insists that we need to have
reserves covering short-term debt. But this is not appropriate in this case because capital outflows were made mainly from stock market investments. So, we probably need a global lender of last resort because in this crisis reserve currencies could have excessive privileges. Countries could print reserve currencies and rescue their financial institutions but many other countries don’t have that option.

This is a very old issue and I don’t think that it is going to be resolved easily. So what other options do we have? One other option would be internationalization of the won. If we borrow our foreign debt in terms of won, we won’t have to face exchange rate risks. The feasibility of internationalization will depend on economic fundamentals, so this can not be a policy option.

The second option would be forming some sort of Asian financial and monetary cooperation. Maybe we could try to build up an Asian version of lender of last resort by institutionalizing the CMI. Recently we have had extension of the swap line, but they are mainly in local currencies that cannot be effective.

Another possibility is formation of an Asian monetary union. If the common currency created by an Asian monetary union can reach the status of anchor currency or key currency, maybe that platform could be used to give more leverage to rescue countries when they have liquidity problems.

Tae-Joon Kim

I would like to concentrate on the prospects of G-20 and IMF reforms. The G-20 has risen to a prominent position as a high-level group, centered on addressing global economic issues. However, it is unclear how long the G-20 will last. For one thing, unlike the G-7, in which any issue may be brought up and addressed, the G-20 is limited only to discussion of specific and selected issues. In this respect, one should add that in this year’s meeting there were many disputes on issues, and these remain unresolved. Such issues include further fiscal expansion, how to deal with toxic assets, breakdown of trade financing, and expanding IMF funding.

There are some opinions that the economic stimulus was just the announcement of existing agreements. Opinions are divided over the chances of the G-20 remaining in place after the current financial crisis ends. Those with most interest, such as European nations, are sticking to their negative view of emerging market economies taking part in the G-20. On the other hand, with the current financial crisis as the
impetus, the possibility exists that the G-20 will continue, on the condition that it is able to achieve tangible results. Therefore, the following efforts are needed for the survival of the G-20. It is critical to make sure that the matters agreed upon at this year’s summit are thoroughly implemented and accomplished. It is also necessary to continue developing an agenda that is able to incorporate the interests of both advanced and emerging market countries. Such an agenda should encompass issues such as aging populations and global economic imbalances. Asian countries need to recognize that the G-20 is the most useful structure for voicing the interest of emerging Asian economies. For Asian nations to be able to achieve mutual benefit through the continuance of the G-20, they need to actively participate in it and build a support system for each other. It is especially important to devote ourselves through mutual effort to adjusting the national quotas for the IMF, and raising the voices of Asian nations in the IMF and other international organizations. These adjustments should reflect the changes in relative strengths of the member nations of the IMF and other organizations. Korea should aggressively take advantage of chairing the G-20 next year by helping select the items and the main agenda during the process of preparing for the summit. Furthermore, Korea needs to aggressively publicize our experience of successfully overcoming a financial crisis in the past and thereby further increasing our role. In essence, Korea should take encouragement from the fact that, through the coming IMF reform, we should be able to raise the country’s position within the fund.

In future IMF reform discussions, Korea should figure out that it will be able to raise its role in the IMF by making efforts to reasonably adjust national quotas as early as possible in a way that reflects change in the relative economic strengths of member countries. In addition, Korea should actively take part in detailed discussion on procedures for electing the next managing director, and raise the country’s role in the election process. Above all, we need to increase the chances of Korean personnel acquiring senior positions at the fund by advocating appropriate regional distribution of high-level appointments.

Woosik Moon

I would like to focus on three questions.

First, could emerging economies next year be a locomotive for the world economy? Second, could the IMF be an international lender of last resort? And third, what is the desirable architecture of an international monetary system, especially from Asia’s perspective?
Let’s first look at some graphs. This is the foreign exchange market situation Korea faced in 1997, when we had the IMF loan. You can see that, despite the fact that we had an IMF loan of $27 billion, the exchange rate was not stabilized. Meanwhile, when we had the Korea-US currency swap on 29 October 2008, the exchange rate of the won stabilized quite substantially, as you can see. So the first question is whether the IMF is the appropriate lender of last resort. We can see that this is not the case. I do not need to address all the problems related to the IMF emergency loan.

It is also interesting to look at what the IMF did when we had the global crisis. Basically there is very limited financial support provided to emerging economies. The amount of swap agreement from the US Federal Reserve as of the end of 2008 was 10 times larger than the financial support provided by the IMF. Also, countries that received IMF support are developing countries. This is the reality of where we are now. It suggests that the IMF is not well suited to addressing the global liquidity problem and its function as a lender of last resort.

The next question then is, what will be the role of the IMF?

At the recent London summit meeting, the G-20 members decided to establish the new Financial Stability Board (FSB), extending the existing Financial Stability Forum (FSB). As you see now, one of the two most important questions regarding the global financial crisis is, What institution should undertake the role of global supervision and regulation? Basically the FSB is supposed to take this role but it is not clear whether it will do so as it lacks the supporting framework.

So the question is, What will be the division of the FSB and the IMF in the area of global financial supervision and regulation? I think there is more room for the IMF to develop in this area, given that the FSB does not have the necessary infrastructure for the role.

The final question is related to the division of labor between the global lender of last resort and the regional lender of last resort. As emphasized by Professor Kawai and many of my colleagues, there is quite strong support for an Asia monetary institution, but the question is whether once we have it we will have an organization that coincides with the IMF. So, we are wondering whether the IMF will agree, and if an Asia monetary institution is created, what will be the necessary division of labor between it and the IMF. This is the question that I would like to raise.
With regard to the first question, I declare myself to be agnostic. I do not know how deep and how long this crisis will last.

With regard to the second question, on the G-20 summit, I will only mention one point. I think what was lacking was an analysis of short-term capital flows. Short-term capital flows have been a major vehicle for financial crises since the early 1980s and the first crisis that struck in Latin America.

I want to say a bit more about financial market regulation. I think, after all that we have seen, one cannot avoid becoming normative and thinking why we need the finance sector. The finance sector should be seen as a means to an end and it should serve the real economy and thus the needs of households, enterprises, and governments to consume and invest. Finance is an intermediate good that does not produce utility directly, only indirectly. So, if we adopt a normative perspective, the first question we could ask is, What financial intermediaries are minimally necessary to satisfy the needs of the real economy? We could also ask, What contribution do international short-term capital movements really make to real investment and employment?

What is the rationale for some statutory prudential regulation? We have to limit the risks implications of the strategic choices of financial intermediaries for their creditors and the financial systems as a whole. We have to create a regulatory framework which generates stability even when we make mistakes. It has been remarked by Hellwig recently that the notion that there is a difference between private interests and the public interest in risk management and risk control of banks seems to have been lost.

What we need is a decentralized global system. The system ought to be based on general principles and a minimum set of international guidelines. There is a strong presumption in favor of separation of commercial and investment banking. The system ought to be comprehensive in the sense that it covers all major participants in terms of financial intermediaries, which means that it should have an aspect of micro prudential regulation and it should also consider the global risk in terms of macro prudential regulation. The system should be differentiated to account for the differences in roles and liability structures of financial institutions. The system should locate the responsibility for regulation and supervision at local, national, regional, and international levels. Basically, the nation-state is the one that faces
this responsibility within a framework of general rules and guidelines.

This is necessary for the following six reasons: (i) the real world possesses a large variety of capitalist-type economies, (ii) the specific needs of regulation and supervision vary with the level of economic development, (iii) the improvement in living and conditions in the least-developed and developing countries should not be impeded by systems of control and supervision inappropriate to their needs, (iv) economic cycles do not coincide among countries, (v) it cannot be expected that leading countries in particular will cede sovereignty to international agencies, and finally (vi) any system of regulation is politics and politics requires legitimacy and legitimacy can only be given by the laws and constitutions of a country. We do not have international forms of legitimacy.

There should be a preference for supervision and control at the most appropriate and lowest level. In Germany we have a concept of subsidiarity which could be applied to this situation. The system, I think, should allow for capital controls limiting the capital account transaction possibility. There is a need to reduce the pressure to accumulate reserves for future crises. This is the situation that we have for the moment. Of course, not everyone can accumulate reserves. There is a need for transparency and simplicity. There should be simplicity because it is necessary that journalists, the public, and politicians understand what’s going on in those markets, otherwise you cannot create systems that are legitimate. There should be limits on size and market shares and we have to take proper account of systemic interdependences and risks.

I propose a number of specific measures, especially obliging rating agencies to divest themselves of consulting business, and a quota for women in order to dampen the influence of the overzealous testosterone-driven investment managers on markets.

Finally, regarding limitations, I think there is only a certain amount that you can do through regulation. Basically, what any system depends on is that the actors take civic pride, take conscious responsibility for what they do.

And we have the more global challenges. Now we have a problem of state socialism for the rich and neoliberalism for the poor, but that is only one aspect of a much larger global problem. I think these challenges are beyond what capitalism and the market economy can
manage to do and we have to find systems outside the logic of the market and capital accumulation to solve these issues, and priorities have to change.

Richard N. Cooper

In the remaining time, I would like to use my privilege as chair to first address the first question, which the speakers did not talk about, which is the prospects for economic recovery. In the US 10 days ago we had the annual meeting of the national association of business economists, professional economists who are not in academia or in government but in the business world. It is their routine at these meetings to ask the group president what his or her views are on the outlook of the US. I thought the results were interesting and relevant to our discussion: 74% of those present (about 1,000 people) thought that the bottom of the recession would be reached in the 3rd quarter of this year, 19% thought that it would be reached in the 4th quarter of this year, and 7% thought that it would be reached in the 1st quarter of next year. Even 3 months ago that would have been viewed as a relatively optimistic forecast. The big US stimulus package has its major impact.

Now, that’s just one economy, the US. Perhaps Professor He could reinforce or contradict me. Maybe the People’s Republic of China (PRC) will reach the bottom even before then. I think that the PRC may be the first big economy to see some recovery and, if this group is correct, then the US. It is my feeling that both Europe and Japan are both behind the PRC and the US in this regard.

I think that the real issue is not so much when the bottom will come (although the sooner the better) but how vigorous the recovery will be. I think we face an exceptional amount of uncertainty in this recovery because of the damage to the financial system, particularly the banking system in the US and Europe. The big question mark is whether enough repair has been done to the banking system to permit it to participate and play its normal role in economic recoveries, or whether it will still be wounded enough to have a long and rather weak recovery in the US and Europe. So, there is an exceptional amount of uncertainty.

I have to say that the IMF (and I don’t know the inside story) is at the pessimistic end of the forecast. I guess the WEO gets a lot of attention, but if you look at the spectrum of professional forecasters, the IMF is not in the middle but at the pessimistic end. It may be right and it may be wrong but it is an outlier, which is unusual for the IMF. So that’s my first observation.
My second observation is just a historical one. We’ve now had two meetings of the G-20, in November of last year and April of this year. President Obama has called for the third meeting in September. It is worth recalling the origin of the G-7, G-8 which was originally the G-5. It was precisely in a situation similar to this that the French president, who had been a minister of finance in the deep world recession of 1975, felt that there was a need for coordination of action among the major countries. So he invited France and four other countries—the US, Japan, the United Kingdom, and Germany—to what he thought would be a one-off meeting in 1975. At that meeting, the findings were remarkably similar to the one in the G-20 meeting: we must resist protection. It is absolutely essential to resist protection in these difficult times. All of the major countries pledged themselves to that. We had already launched the Tokyo round of trade negotiations at that time, so part of the no-protection pledge was to validate the effort to move the Tokyo round forward. There was no controversy among the participants on this first point. There should be a coordinated expansion of fiscal policy. There was considerable disagreement in that point and Germany in particular, then as now, was resistant to the idea. The British, French, and the Americans were more or less in favor, the Japanese were neutral, and the Germans were skeptical. There were some discussions about exchange rate coordination. As now, there was no specific talk about competitive devaluation but some general talk about the need for exchange rate coordination. Remember, we had just moved to floating rates 2 years before, in 1973, and people were still uncomfortable with floating rates at the time. A major source—not the only source—of this recession was a sharp rise in oil prices, so there was a discussion about the oil sector in particular. In a parallel set of negotiations, what became the International Energy Agency was created, so this group sort of endorsed and blessed that exercise.

So, many similarities, and nothing on financial regulation. Failure of the financial system was not the major problem in 1975. So that’s just the historical parallel.

It was supposed to be a one-off meeting. Four of the five participants, as heads of government, had been ministers of finance, except for the US. But the US liked the idea so much it called for a second meeting in Puerto Rico the year after, and the rest is history. We have had these events annually for the last 30-plus years. The group was extended to seven countries, and then eight with Russia.
The third point I want to make is that it is not as though the financial regulation has not been on the international agenda. There has been annual meetings of bank regulators, focusing on the Basel II regulations, for the past 10 years. National bank regulators have been discussing not the whole financial system but trying to define common risk-based capital requirements for internationally engaged banks. They came out with Basel II, and what this financial debacle has underlined is that they have been on the wrong track. Maybe not on everything, but the outcome was totally unsuited to the problem at the time.

I mention that because there are some issues where there are gaps or omissions in international or domestic regulatory frameworks, but this is not one of them. We actually had intense discussions about banking regulation, so it’s not enough to get together and discuss things, we actually have to get things right, and that’s where the serious arguments begin. What does it mean to get things right, and what’s the actual content of getting things right?

So, I hope that today we will have some discussions about what a perhaps not ideal international system but a feasible international system would actually look like.

Chalongphob
Sussangkarn

I will just give some perspective on these three questions.

First of all, how long will the current crisis last? Remembering the Asian financial crisis in Thailand, we basically hit bottom around 15-18 months after the beginning of the crisis in 1997 and 1998. However, it did not mean that the problem was over, because for us it was 5 years before output returned to the pre-crisis level. So, during the 5 years, there was huge excess capacity in the industries and no investment. For East Asia, we should ask, even if the US hit bottom this year, how long will it take for East Asian exports to get back to pre-crisis levels? It is going to be a very long time; they are not going to bounce back soon. Also, even when we got back to the pre-crisis level, nonperforming loans in the banking sector were still very high; it took 8 years for nonperforming loans to fall below 10%. So, during that time, even if we cleaned up the banks, they could not find good borrowers to lend to. So, there was huge liquidity in the banking system, and what happened is that people invested in government bonds. The government had been forced to issue large amounts of bonds to clean up the mess. So this system did not really function for about 8 years.
Secondly, regarding global meetings such as the G-20, as Professor Cooper just mentioned, we had these meetings for ages, and what did that do? Nothing. We have the IMF, but it is a red herring. IMF reform has little to do with preventing the subprime crisis because the IMF does not have the mandate to perform surveillance on the advanced economy. In fact, what it does is have something called the finance sector assessment program, which it uses for emerging markets and developing countries. When it was suggested a few years ago that the IMF should talk to the US, the US said it was unnecessary. So reform of the IMF is completely irrelevant to the subprime crisis. I think that the global solution might not be so efficient since we are asking the patient to cure itself, and that’s not going to be very effective.

Shin-ichi Fukuda I just want to mention that Asia had a different crisis to that in the US or Europe. For example, in Japan the overall financial system remained somewhat healthy, even during the crisis, so the yen appreciated. However, when you just look at GDP, we had -15% growth. So the issue is not simply the financial institutions.

In Japan the financial system was relatively healthy but still shared a big burden during this crisis. Probably, the G-7 was successful in preventing competitive devaluation but the yen appreciated against the international standard and that caused the decline of the exchange rate. Maybe that’s why Japan had a serious problem. Maybe focusing simply on financial stability is not enough to deal with the current international situation for countries like Japan. Probably economies such as Taipei, China and other East Asian countries face a serious situation, even if their finance sector is healthy and they face negative growth. That’s a point that also needs to be noted.

Richard N. Cooper I think, just as you saw, the G-20 did not just focus on financial issues. It also focused on trade issues and also on macroeconomic issues.

Woosik Moon As emphasized by Professor Kawai in the welcome speech, we need to explore new developments in East Asia because we know that the US will not grow very quickly anyway and Europe will be same. So we understand that East Asian countries and emerging countries will have more potential to grow in the near future.

The problem, especially for emerging countries, is that once we spend more we have to import more. Therefore, we have a fear of international liquidity. For instance, in Korea, we had more than $200
billion in foreign reserves and still we were worried about losing our international reserves, so we could not spend, which prevented us from spending more and contributing to world economic growth. So, regarding this international lender of last resort, the problem should be solved in order for all emerging economies to get onto the right path.

Richard N. Cooper Going back to the question I raised last night, it is a puzzle for foreigners that Korea, with its foreign reserves, allowed its exchange rate to depreciate as it did, although it was partly from the stock market and partly due to the inability of Korean banks to roll over their international loans. Both of those circumstances are exactly the reasons a country maintain the reserves. And if you are not going to use the reserves, why borrow from the IMF?

Eiji Ogawa I have one comment regarding IMF lending reform and also to Professor Shin’s proposal on establishing an Asian version of lender of last resort. IMF lending reform and an Asian version of lender of last resort under the Chiang Mai Initiative (CMI) is both consistent and inconsistent. So I would like to point out the current situation of Korea’s stance against the IMF. Of course the IMF established the FCL without any conditionality for providing liquidity to countries facing a liquidity crisis. But the Government of the Republic of Korea went not to the IMF but to the US Federal Reserve. This is a typical situation not only in Korea but also in other countries.

Professor Kawai mentioned the IMF link and the CMI. We have the IMF link and CMI so that countries facing a currency crisis should go to the IMF to get the support from the CMI. The Government of the Republic of Korea chose not to go to the IMF and implement the CMI. So I have a question for my Korean colleagues, is further IMF lending reform helpful for the Korean economy? I think it is very important to discuss this in the context of regional cooperation.

Woosik Moon Just a few points. One is on the financial crisis in the US. I share some of the views, particularly with Dr. Chalongphob’s observation on Thailand hitting the bottom and then getting back onto a sustainable and perhaps new potential growth path. New growth potential for the US may be lower in terms of the absolute level, and the growth rate may be lower than the pre-crisis level, which was approximately 3%.

So, even if this crisis is over, it may still take a long time for the US economy to get back onto a new growth path because of the banking sector problem and the housing sector problem, and because the real
sector in the US is heavily affected. So, even after recovery (hopefully not a decade), the growth rate may be even lower than in the pre-crisis period. That has a significant implication for Asia and the rest of the world as to how our growth model should be designed.

My second point is about the IMF. I have a question about Governor Zhou’s remark but perhaps we could discuss about it in the next session. Regarding the IMF, swap arrangements, and the CMI, it seems that there are now several arrangements emerging. The traditional IMF is now more flexible, according to Professor Takagi, and is moving away from post-conditionality and providing pre-qualification before the crisis. Also, with the US Federal Reserve facility, no one complained but many welcomed it without conditionality, which I thought was very interesting. No one mentioned the fact that the US Federal Reserve swap arrangement undermines the IMF. I think the reason is that from a more realistic perspective, the US Federal Reserve swap arrangement is very useful. There are also central bank swap arrangements in Asia, such as in Korea and Japan, but the Koreans did not go to the BOJ swap arrangement. Korea could have withdrawn yen liquidity without conditionality without going to the IMF and also outside the CMI restriction, but they chose not to do that. And then we have the CMI, but it is has a strong link with the IMF so at this point it virtually cannot be used by countries.

Regarding the division of labor between the IMF and a future Asian monetary fund, which was raised as an initiative, the relationship could be like that between the IMF and the European Union in the context of Europe addressing the crisis in Eastern European countries. They are working together, putting money on the table, and setting conditionality together. If an Asian monetary fund works with the IMF, maybe jointly, then Asian monetary fund contributing countries can also participate in the IMF program.

Jung Sik Kim

Professor Woosik Moon highlighted a very interesting point in his presentation. While in 1998 the IMF rescue plan could not stabilize the exchange rate in Korea, the US dollar-won swap arrangement could stabilize the market in 2008. So my question is whether the establishment of generalized built in swap arrangements could be an agenda item for the next G-20 meeting, and what would the position of the US authority be about this idea? I would like to raise the question with Professor Cooper.

Deok-Ryong Yoon

I would like to make some comments on the question of why the IMF
is so extraordinarily pessimistic on the prospects for the world economy. Ironically, one of the most powerful beneficiaries of the global crisis this time may be the IMF. How can we link these two facts? The second question is on IMF reform. IMF reform is not constructively feasible without the willingness of the US to reform. At the time of the Asian financial crisis, I was the financial deputy, and proposed the CMI and some ideas for the regional safeguard framework. We handled this very carefully and especially tried to base it on the international financial architecture under the existing leadership of the IMF, but the US Treasury and US-driven IMF staff did not have the willingness to reform at the time. I think it’s not what is true that is important but how we compromise on our conflicting national interests that is the issue. Because the US was the most powerful country, no one could beat that intention. Now the worldwide recession is deep and critical, and at the center is the US economy.

I think it is time to change the general stance. We should understand the difference between leadership of, and partnership in, overall management of the world economy.

Secondly, we have experienced the regional safeguard framework idea. Why do we need the regional safeguard framework? It is mainly due to the inability of the IMF to extinguish the big fire right away. The regional safeguard framework is not contrary to the interests of the IMF. So this is a very compromising point between the IMF reform and the regional safeguard framework.

The most important thing in the market economy is trust. Why do most of the countries have a strong trust in the US dollar? It is because we can read “in god we trust” on the US dollar bill. The reason why the IMF has such weak international leadership is because it has lost international trust since 1985 with the Mexican crisis, the Latin American crisis, and the Asian financial crisis.

I think now there is the opportunity to reform the overall international financial architecture. In 2 or 3 year’s time when the economic recession is easing, the new topic will be reform. In that case, the most important starting point is the willingness of the US to reform.

Professor Kawai remarked on why the Government of the Republic of Korea did not go to the Bank of Japan; it is because we have experienced in the past that, on every urgent occasion, the Bank of Japan has been uncooperative. They always try to shake hands after
some months of recovery. For most developing countries, the issue is
timing of the help; from March 1998, we had many guests from outside
to shake hands with. Thus, developing countries such as Korea need
some institutional background to overcome this kind of problem. That
is why I follow Professor Hee-Yul Chai’s idea that there must be some
built-in currency swap, especially over the next 10 years under the
shrinking US dollar standard. The US should offer to build in the
instrument of the currency swap with some nonconvertible currency
country such as Korea.

Jung Sik Kim

I think the lesson from the global financial crisis is very important.
When I hear the views of the economists about the global financial
crisis, usually the economists from the developed countries are more
concerned about the economic recession or the financial institutions.
The economists from the emerging countries, however, are concerned
more about the shortage of foreign exchange and the instability of the
foreign exchange market. This is because the currencies of developed
countries are convertible currencies and international currencies. They
do not worry about the shortage of foreign exchange. In the case of
emerging countries, there are two solutions. One is controlling capital
flows and the other is having enough foreign exchange. The PRC has
both of these options, so they do not worry about the shortage of
foreign exchange even though the renminbi is not an international
currency and is nonconvertible.

So, in this situation, there may be several solutions to avoid another
financial crisis. There may be measures such as G-20 agreement and
IMF reforms, but it is difficult to reach an agreement, since a solution
could be unilateral.

In the case of Korea, it can either control capital flows or increase
international reserves. But as it is very difficult to reverse capital
liberalizations the country can only choose to increase international
reserves. How do countries increase reserves? Through trade surplus.
So I think that when there is no unanimous global solution, emerging
market economies will depreciate their currency and increase their
trade surplus.

Richard N. Cooper

I just want to say that the question of swaps was raised and why no one
complained that the swap undermined the IMF. I want to remind
everyone that the technical points are actually very important.
Journalists tend to ignore the technical points. There is a high degree of
trust among central banks; it is a worldwide club. They know one another, they trust one another, and they are willing to make short-term unconditional loans. Short term is usually 30 days, but is longer in this case. The IMF lends to governments and governments are not trusted. So I don’t see these things as parallels or substitutes at all; I think they are complementary.

Another thing to be said is that the US Federal Reserve can operate very quickly, while the IMF is a clumsy and slow institution. And so, one of the questions is, can the IMF be made to act more quickly in an emergency? We need to build confidence in the market so that there are enough resources to deal with the emergency at hand. I think of these things as complementary rather than substitutes. Above all, it is important to keep in mind that central banks are the heart of governments. That there is a code of acceptance between central banks is reinforced by the monthly meeting of central bank governors.

We have had an interesting discussion and there are a number of unresolved issues. Capital controls were mentioned. Thailand has had some experience with capital controls, both in 1997 and recently, and I hope that at some point we could ask Chalongphob to talk about Thailand.
Section II

The Future of the US Dollar Standard
PAST, PRESENT, AND FUTURE OF VEHICLE CURRENCY IN EAST ASIA: SOME EVIDENCE FROM JAPAN, THE REPUBLIC OF KOREA, AND THAILAND

Shin-ichi Fukuda

A. Introduction

For over a half century the United States (US) dollar has been the dominant vehicle currency in international trade in East Asia. Except for primary commodities, the role of vehicle currency is relatively limited in international trade among developed countries (McKinnon 1979; Magee and Rao 1980). The US dollar, however, has historically been the dominant vehicle currency in international trade with developing countries. Many developing countries have chosen the US dollar as the vehicle currency even when other developed countries are important trading partners for them.

The purpose of this paper is to investigate the determinants of invoice currency ratios in three East Asian countries: Japan, the Republic of Korea (henceforth Korea), and Thailand. Using the data from these countries is noteworthy because several detailed data sets are available. Long time-series data sets of invoice currency ratios are available in Japan and Korea, invoice currency ratios classified by commodities are available in Japan, and invoice currency ratios classified by trade partner countries are available in Thailand. These data sets thus allow us to see how a vehicle currency evolves over time and varies depending on trade partners.

In explaining why the US dollar has been the dominant vehicle currency, we can point to several reasons. The first is inertia of the previous economic power of the United States. It is well known that once an invoice currency is established, it would need a large change in economic environment to replace it, even if the economic power of that country has declined relatively in world trade (Krugman 1980; Matsuyama, Kiyotaki, and Matsui 1993). Thus, although East Asian economic power has risen in world trade, it will take a long time to replace the US dollar as the key currency in world trade.

The second reason is the relatively small size of the short-term capital markets in East Asia. Although the volume has been increasing recently, the size of the treasury bills market in East Asian countries had been much smaller than in the United States. Since the short-term capital market is important as a place for foreign investors to park funds, its limited size might have reduced the invoice currency ratio of the investors’ own currencies. The choice of the US dollar is particularly important in developing countries where efficient forward markets as
well as other foreign exchange derivatives to hedge the exchange rate risk are missing.

The third reason for the dominance of the US dollar is the role of trading companies which handle the bulk of both exports and imports. Many large manufacturing companies deal with exports and imports at the same time. Since these companies have a relative advantage in avoiding foreign exchange risks, their existence may lead to relatively small use of local currencies to invoice East Asian exports and imports.

East Asian countries have had substantial changes of internal and external environments during the past several decades. They also experienced several events that caused dramatic exchange rate adjustments, such as the Plaza Accord or the Asian financial crisis during the sample period. The Plaza Accord allows us to explore how substantial structural breaks may change the choice of invoice currency; the Asian financial crisis allows us to see whether the invoice currency may change when exchange rates are adjusted dramatically.

East Asian countries have a common feature in that they have a dominant partner in their international trade. The United States has been one of the most important trading partners for a long time, but the role of the other East Asian countries has dramatically increased during the last decade. In particular, the People’s Republic of China (PRC) has increased its role in the 2000s, and is now one of the most important trading partners for many East Asian countries. The trade structure suggests that the de facto pegs to the US dollar may destabilize the real effective exchange rates in East Asian countries. It is important to urgently reconsider what is the desirable vehicle currency in East Asia from the regional cooperation point of view.

**B. Evidence from Japan**

**1. Evidence on exports**

In Japan, the time-series data of invoice currency ratios is available for nearly half a century. During the sample period, Japan experienced a series of institutional and structural changes. The long time-series data is useful for us to see how the invoice currency ratios evolved when the economy underwent institutional and structural changes.

Table 1 reports the time-series data of invoice currency ratios in Japan's exports. The table shows that the yen-invoiced ratio was low in the early 1970s, even though Japan was the second-largest country in the world in terms of gross domestic product (GDP). The US dollar was the dominant invoice currency in
Japan’s exports in those days. This happened because Japanese financial markets were less developed and international capital flow was strictly regulated until the early 1970s.

The Bretton Woods system was over in July 1971, and the yen–dollar exchange rates switched from the fixed-rate system to the flexible rate system in the early 1970s. Japan’s international capital flow had been deregulated gradually until December 1980, when the government decided to allow free international capital flow with a few exceptions. Correspondingly, the yen-invoiced ratio increased steadily throughout the 1970s and had jumped to 40% in the early 1980s. At the same time, the share of the US dollar declined from 90% to 50%. This suggests that financial development and less regulated international capital flow have increased the share of the yen in Japan’s imports and reduced that of the US dollar.

However, the yen-invoiced ratio has remained at around 40%, while the US dollar ratio has fluctuated around 50% since the mid-1980s. This was true even though the yen appreciated dramatically after the Plaza Accord in 1985, and Japan’s large current account surplus has persisted since the early 1980s. There were small declines in the dollar-invoiced ratios and slight increases in the yen-invoiced ratios in the early 1990s, but the ratios in the 2000s have remained very similar to those in the 1980s. In the 2000s the euro became the European common currency but the data suggests that there was no significant rise in euro-invoiced exports in Japan. The results are essentially the same, even with regard to Japan’s exports to East Asian countries.

In explaining why the US dollar has been the determinant of invoice currencies in Japan’s exports, we can point to heavy reliance of Japan’s exports on the United States. Since only a small fraction (16% in 1991) of Japan’s exports to the United States are invoiced in yen, and since a large fraction of Japan’s exports go to the United States, the structure of Japan’s exports led to relatively low yen-denominated invoice currency ratios in Japan’s total exports until the mid-1990s. However, the United States is no longer the dominant export destination for Japan.

Figure 1 shows Japan’s exports since 1980. The amount of Japan’s monthly total exports, which had been stable at around ¥4 trillion until the end of 2001, started to increase dramatically after 2002. The increases were accompanied by dramatic increases in exports to the PRC¹. The amount of Japan’s monthly

¹ The correlation between total exports and exports to China, which was 0.75 for the sample period from Jan. 1993 to Dec. 2001, rose up to 0.98 for the period from Jan. 2002 to Dec. 2007. This is in marked contrast that the correlation between total exports and exports to the United States was 0.91 for both periods.
exports to the PRC, which was only ¥250 billion in the early 2000s, exceeded ¥1 trillion in 2007. The PRC now almost surpasses the United States as the biggest destination of Japanese exports. The invoiced currency ratios suggest that the rise of the PRC has had no significant impact on the choice of invoice currency in Japan’s exports.

2. Evidence on imports

Table 2 reports the time-series data of invoice currency ratios for Japan’s imports. The table shows that the yen-invoiced ratio was low until the early 1980s; the yen-invoiced ratio, which was 0.3% in 1970, rose only to 3.0% in 1983. Unlike Japan’s exports, Japan’s imports continued to have low yen-invoiced ratios until the early 1980s, even though international capital flow had already been liberalized, with a few exceptions.

The yen-invoiced ratio increased gradually throughout the mid-1980s and rose to 25% in the early 2000s. The dramatic appreciation of the yen after the Plaza Accord increased the yen-invoiced ratios in Japan’s imports. However, the yen-invoiced ratio has remained at around 20%–25%, while the US dollar ratio has fluctuated around 70%–75% since the early 1990s.

As was observed with Japan’s exports, the share of the PRC in Japan’s imports increased dramatically in the 2000s (Figure 2). The amount of monthly imports from the PRC, which was only ¥200 billion in the late 1990s, exceeded ¥1 trillion in 2007. The shares of the US dollar in imports remained significantly large, not only in Japan’s total imports but also in Japan’s trades with East Asian countries. The rise of the PRC did not change the basic features of invoice currency ratios in Japan’s imports.

In the case of Japan’s imports, negligible yen-invoiced ratios in oil and raw material imports are one of the important reasons why the US dollar has been dominant. In particular, crude oil imports have almost always been invoiced in US dollars. The reason is that crude oil and other raw materials are traded in the well-established international markets. Because trades denominated in US dollars are dominant in these international markets, this makes dollar-invoiced ratios dominant in mineral and other raw material imports.

Noting that Japan’s import structure is weighted towards mineral and other raw materials, it is easy to see that these high US dollar-invoiced ratios lead to low yen-invoiced ratios in Japan’s total imports. In fact, if we confine our attention to the imports of manufactured goods, yen-invoiced ratios become significantly higher. In the imports from East Asian countries particularly, more than 30% of manufactured goods on average are invoiced in yen. Part of the low yen-invoiced
ratios might be explained by Japan’s biased import structure.

C. Evidence from the Republic of Korea

1. Evidence on visible trade

Korea is another noteworthy country that provides us with useful information on the determination of vehicle currency for nearly 30 years. The sample size is slightly smaller than that of Japan, but during the sample period, the Korean economy developed remarkably, accompanied by dramatic increases in international trade. The regulations on Korean international capital flow were substantially relaxed during the sample period, but the economy experienced a currency crisis in November 1997. We can thus see how the choice of invoice currency was affected by substantial structural changes and dramatic exchange rate depreciation.

Tables 3a and 3b show which currencies Korean visible exports and imports have been invoiced in since the late 1970s. They show that the invoiced ratios of the US dollar were 95.0% in visible exports and 93.2% in visible imports in 1980. Both of the ratios are higher than the corresponding ratios of Japan’s exports and imports in 1970. The result suggests that, even taking account of the stage of development, the US dollar was a more dominant vehicle currency in Korea than it was in Japan.

The dominant US dollar ratios declined slightly in the 1980s, and the invoiced ratios of the US dollar had dropped to 88.2% in visible exports and 79.1% in visible imports in 1990. However, both of the ratios remained very high, and neither has shown a conspicuous downward trend since 1990. The ratios of the US dollar fluctuated between 83% and 90% in Korean visible exports and between 76% and 85% in visible imports. There were no significant structural changes in the ratios before and after the currency crisis in 1997.

Japan and Western Europe as well as other Asian countries have been the other important trading partners for Korea. In particular, the role of the PRC has dramatically increased in the 2000s. The evidence indicates that the US dollar was chosen as the dominant vehicle currency even when the United States is not the dominant trade partner; Korean exporters and importers choose the US dollar as the vehicle currency even in international trade with other important trading partners.

One may argue that Korea chose the US dollar as the dominant invoice currency because the won was stable against the US dollar. The argument may have been relevant before the Asian financial crisis, when Korea effectively pegged its
currency to the US dollar. However, after the crisis, the country shifted the exchange rate regime from de facto dollar peg to float. As a result, there is no longer a natural reason for Korea to choose the US dollar as the dominant invoice currency to stabilize its export prices in terms of won.

2. Evidence on invisible trade

Korean data provides us not only with invoice currency ratios of visible trade but also with those of invisible trade. In the data set, invisible trade includes foreign travel, transportation, insurance, overseas investment income, government transactions, donations, and miscellaneous services. Putting aside miscellaneous services, transportation has had shares of 20%–30% in both invisible exports and imports throughout the sample period. The share of overseas investment income payments was 45% in 1980 but it dropped to around 18% in the 2000s; the share of overseas investment income receipts was around 10% in 1980 but it rose to 16% in 2000 and 23% in 2005. The share of foreign travel was 6%–7% in 1980 but exceeded 10% in the 2000s in both invisible exports and imports.

Tables 4a and 4b show the currencies that Korean invisible exports and imports have been invoiced in since the late 1970s. They show that the invoiced ratios of the US dollar in invisible trade have been lower than those in visible trade. In the case of invisible exports, the US dollar-invoiced ratios, which were over 80%, declined to below 70% in the early 1990s, while the yen-invoiced ratios exceeded 20% in the first half of the 1990s. In the early 1990s, receipts from transportation increased substantially in Korean invisible exports. It is likely that this increased the shares of the yen in Korean invisible exports. In the case of invisible imports, the US dollar-invoiced ratios declined to below 80%, and the yen-invoiced ratios exceeded 10% in the first half of the 1990s. In the early 1990s, receipts from transportation as well as foreign travel increased substantially in Korean invisible imports. This might have increased the shares of the yen in Korean invisible imports.

However, the US dollar remained the dominant invoice currency in Korean invisible trade even after the mid-1990s. In the case of invisible exports, the US dollar-invoiced ratio has been over 74% since 1996. In contrast, the yen-invoiced ratio, which exceeded 25% in 1990, has been below 15% since 2001. In the case of invisible imports, the US dollar-invoiced ratio has been over 80% since 1996, while the yen-invoiced ratio has been below 6% since 1998. The substantial declines in the yen-invoiced ratios were accompanied by increased euro-invoiced ratios in both invisible exports and imports.

D. Evidence from Thailand
1. Aggregate data

For Thailand, the data set of invoice currencies is available only from 1993, but unlike for Japan and Korea, the data set classified by trade partner countries is available for the invoice currency ratios.

Tables 5a and 5b show the currencies that Thai exports and imports have been invoiced in since 1993. In the case of Thai exports, more than 90% was invoiced in US dollars and only 3%-4% was invoiced in yen in the 1990s. The ratios of the US dollar started to decline in the late 1990s, and had dropped to 80% in 2008. In contrast, the yen increased its share after the Asian financial crisis, while the euro and the baht increased their shares in the 2000s. The changes in external environments had some impacts on the choice of invoice currencies for Thai exporters. However, the impacts were marginal and did not change the dominance of the US dollar.

In the case of Thai imports, the US dollar was less dominant, even in the early 1990s. Throughout the 1990s, 80% of imports were invoiced in US dollars but 10% were invoiced in yen. This reflects the fact that Japanese companies tended to use the yen when exporting to Thailand. However, except for marginal increases in the baht-invoiced ratios, the percentages remained almost stable throughout the 2000s. The changes in external environments in the 2000s had no significant impact on the choice of invoice currencies for Thai importers.

2. Evidence of exports by trade partner countries

Table 6 shows the invoiced ratios of Thai exports classified by major trading partner. The table indicates that the US dollar tends to be the dominant vehicle currency in Thai exports to various countries. When the United States, Canada, and Mexico are destinations, almost all of the exports are invoiced in US dollars. Even when Japan, Europe, and most East Asian countries are destinations, the majority of exports are invoiced in US dollars. The US dollar plays the role of international currency in Thai exports with third countries.

In exports to Japan, the US dollar decreased its share and the yen increased its share after the Asian financial crisis, but even in 2008, more than 60% of exports were invoiced in US dollars and only 33% in yen. Most exports to many European countries—particularly Denmark, Finland, France, Ireland, and the United Kingdom—are invoiced in US dollars. The invoiced ratio in the US dollar has been relatively modest in exports to Germany, although the dollar has increased its share in the 2000s despite the expansion of the euro.

The dominance of the US dollar has also prevailed in exports to most Southeast
Asian countries, and in particular to Malaysia, Singapore, and Viet Nam, where more than 90% of exports are invoiced in US dollars. Except for the exports to the United States, the US dollar is a third currency in Thai exports. This implies that the US dollar tends to be chosen as the dominant vehicle currency in invoicing most intra-Asian international trade.

One may argue that the US dollar is the dominant invoice currency because trading companies are in charge of both exports and imports at the same time. When the amount of exports is equal to the amount of imports, the exchange rate risk can be perfectly spread. Therefore, if trading companies invoice both exports and imports in US dollars, they would partially spread their exchange rate risk. In fact, about 30% of export receipts are deposited in foreign currencies in Thailand. The percentages indicate that Thai exporters may keep some of their foreign exchange receipts for reducing exchange risk in future import payments. However, about 65% of export receipts are exchanged from foreign currencies directly into baht. This implies that more than two-thirds of export receipts in Thailand are still exposed to exchange rate risk.

3. Evidence of imports by trade partner countries

Table 7 shows the invoiced ratios of Thai imports classified by major trade partners. The table indicates that euro shares came to dominate US dollar shares in imports from several European countries. The yen also came to have almost equivalent shares with the US dollar in imports from Japan in the 2000s. Unlike with Thai exports, the US dollar lost its dominant share in Thai imports from many industrial countries in the 2000s.

However, the US dollar remained the dominant vehicle currency in Thai imports not only from North America but also from most East Asian countries. It is not surprising that almost all of the imports from the United States, Canada, and Mexico are invoiced in US dollars, but even in imports from East Asia, the majority is invoiced in US dollars.

E. Thai International Trade with Cambodia, the Lao People’s Democratic Republic, and Myanmar

1. Evidence from Thai exports

In the last section, we showed that the dominance of the US dollar has prevailed in Thai international trade with most other Asian countries. However, the US dollar is not necessarily dominant in Thai international trade with Cambodia, the Lao People’s Democratic Republic (Lao PDR), and Myanmar.
Figures 3a and 3b show the share of the US dollar and the baht in Thai exports to Cambodia, the Lao PDR, and Myanmar. In the exports to these three countries, the baht has been an equally important invoice currency as the US dollar. This happened partly because the Thai economy has had a strong influence on the imports of these three countries. Even in 1999, the import shares of Thailand were 15.7% in Cambodia, 55.6% in the Lao PDR, and 17.2% in Myanmar. Although the shares were not dominant (other than for the Lao PDR), they were significant. The shares of Thailand in their imports has increased throughout the past decade. It is likely that Thai exporters had some market power in Cambodia, the Lao PDR, and Myanmar, so they had a tendency to choose the baht for invoicing their exports.

However, heavy reliance on the Thai economy might not be the only reason why the baht was an equally important invoice currency in imports from Thailand. Another noteworthy common feature in these countries is that their imports have relied little on the United States. The share of the United States in their total imports was less than 1% for most of the periods in all of these countries. This implies that the three countries did not need to save large quantities of US dollars to cover their import payments to the United States.

2. Evidence from Thai imports

Figures 4a and 4b show the shares of the US dollar and the baht in Thai imports from Cambodia, the Lao PDR, and Myanmar. Unlike the case with Thai exports, the US dollar is the dominant invoice currency in Thai imports from the Lao PDR and Myanmar. In contrast, the baht is becoming the dominant invoice currency in Thai imports from Cambodia.

Compared with the imports from Thailand, the percentage of exports to Thailand from Cambodia, the Lao PDR, and Myanmar have been modest. This was true especially in the late 1990s and the early 2000s. In 1999, the percentage share of exports to Thailand in total exports were 1.8% in Cambodia, 11.0% in the Lao PDR, and 7.6% in Myanmar. This suggests that these countries rely heavily on imports from Thailand but not on exports to Thailand. In terms of export destinations, Thailand is somewhat significant for the Lao PDR and Myanmar and not significant for Cambodia.

In contrast, the share of the United States as the export destination is negligible for the Lao PDR and Myanmar but very large for Cambodia. This implies that the accumulation of US dollars might have substantially different impacts on the choice of invoice currencies in Thai imports from Cambodia, the Lao PDR, and Myanmar. That is to say, exports to Thailand are one of the most important sources of US dollars for the Lao PDR and Myanmar, and thus it is important to
use the US dollar as the dominant invoice currency in these countries when exporting to Thailand. However, exports to Thailand are not an important source of dollars for Cambodia, because of the large export volume to the United States that allows Cambodia to accumulate US dollars. This leads to the dominant role of the baht in exports from Cambodia to Thailand.

**F. Conclusion**

In this paper, we have explored the choice of vehicle currency in Japan, Korea, and Thailand. These countries historically had the US dollar as the dominant vehicle currency. To some extent, their financial development and international capital flow reduced the shares of US dollar payments and receipts in their international trade. Despite this, the US dollar remains the dominant vehicle currency in most of their exports and imports, except for some limited intraregional trade.

In the 2000s, East Asia came to face two dramatic changes in external economic environments: the rise of the PRC, and the emergence of the euro, but neither of them changed the essential role of the US dollar as vehicle currency in East Asia. The rise of the PRC dramatically increased the shares of PRC exports and imports in international trade in East Asia in the 2000s. Although this reduced the share of the United States in exports and imports, the US dollar was still used for payments and receipts in international trade. This suggests that the US dollar is chosen as the dominant vehicle currency in international trade with the PRC. The emergence of the euro, in contrast, increased the euro-invoiced ratios in international trade with European countries, especially in imports from European Union countries. However, it did not affect euro-invoiced ratios in international trade with non-European countries.

As has been widely documented, the US dollar has historically been the dominant vehicle currency in developing countries. Regardless of recent remarkable regional economic growth, the US dollar has remained the dominant invoice currency in most East Asian countries. However, after the Asian financial crisis, several East Asian countries started to adopt managed-float exchange rate regimes. The de facto pegs to the US dollar may destabilize the real “effective” exchange rates of these currencies. To avoid another crisis in East Asia, it is vital to urgently reconsider what payment arrangements are desirable in East Asia from the perspective of regional cooperation.

**References**


### Table 1. Invoice Currency Ratios in Japan’s Exports

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1) Unless specified, the data are averaged annually.
2) The data with * show figures for fiscal year.
3) The data with ** show those of September.
4) The data with ## show those of the second half of the year.

### Table 2. Invoice Currency Ratios in Japan’s Imports

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**NOTES**
1) Unless specified, the data are averaged annually.
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3) The data with ** show those of September.
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### Table 3a. The Currency Shares of Korean Visible Exports, 1977–2006

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Notes: Euro data prior to 2001 refer to Deutsche Mark.
Data of 2006 are those of September.

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</tr>
<tr>
<td>1999</td>
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<td>1.5</td>
<td>1.6</td>
</tr>
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<td>84.5</td>
<td>5.5</td>
<td>1.1</td>
<td>1.4</td>
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<td>0.7</td>
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<td>2005</td>
<td>81.9</td>
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<td>4.9</td>
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<td>3.9</td>
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<td>4.0</td>
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</table>

Notes: Euro data prior to 2001 refer to Deutsche mark.
Data of 2006 are those of September.
### Table 5a. Structure of Invoice Currency in Thailand Export Receipts, 1993–2008 (%)

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<tr>
<th></th>
<th>1993</th>
<th>1995</th>
<th>1997</th>
<th>1999</th>
<th>2001</th>
<th>2003</th>
<th>2005</th>
<th>2007</th>
<th>2008</th>
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<tbody>
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<td>92.0</td>
<td>87.6</td>
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<td>84.4</td>
<td>81.6</td>
<td>81.8</td>
<td>80.7</td>
</tr>
<tr>
<td>baht</td>
<td>0.9</td>
<td>2.4</td>
<td>2.1</td>
<td>3.7</td>
<td>4.0</td>
<td>5.0</td>
<td>6.9</td>
<td>6.5</td>
<td>6.9</td>
</tr>
<tr>
<td>Japanese yen</td>
<td>3.9</td>
<td>4.1</td>
<td>3.3</td>
<td>5.2</td>
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<td>5.9</td>
<td>6.4</td>
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<td>5.8</td>
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<tr>
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<td>0.4</td>
<td>1.5</td>
<td>0.8</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Pound sterling</td>
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<td>0.3</td>
<td>0.3</td>
<td>0.3</td>
<td>0.4</td>
<td>0.5</td>
<td>0.5</td>
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<td>0.0</td>
<td>0.0</td>
<td>0.2</td>
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<td>2.6</td>
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<tr>
<td>Singapore dollar</td>
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<td>0.5</td>
<td>0.4</td>
<td>0.3</td>
<td>0.3</td>
<td>0.5</td>
<td>0.5</td>
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<tr>
<td>Others</td>
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<td>1.5</td>
<td>1.2</td>
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<td>1.4</td>
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<tr>
<td>Total</td>
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<td>100.0</td>
<td>100.0</td>
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### Table 5b. Structure of Invoice Currency in Thailand Import Receipts, 1993–2008 (%)

<table>
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<tr>
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<th>1999</th>
<th>2001</th>
<th>2003</th>
<th>2005</th>
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<tr>
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<td>0.6</td>
<td>0.5</td>
<td>1.7</td>
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<td>5.6</td>
<td>4.5</td>
<td>4.3</td>
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<td>Japanese yen</td>
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<tr>
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<td>0.6</td>
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<td>2.0</td>
<td>1.9</td>
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<tr>
<td>Total</td>
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<td>100.0</td>
<td>100.0</td>
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<td>100.0</td>
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<tbody>
<tr>
<td></td>
<td>USD</td>
<td>JPY</td>
<td>THB</td>
<td>USD</td>
</tr>
<tr>
<td>Japan</td>
<td>85.8</td>
<td>12.9</td>
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<td>70.3</td>
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</tr>
<tr>
<td>- Canada</td>
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<tr>
<td>- Mexico</td>
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<td>- Germany</td>
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</tr>
<tr>
<td>- Italy</td>
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<td>0.0</td>
</tr>
<tr>
<td>- Netherlands</td>
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<td>- UK</td>
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<th>2008</th>
</tr>
</thead>
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<td>GBP</td>
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<td>ASEAN - Singapore</td>
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<td>- Indonesia</td>
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<td>- Philippines</td>
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<td>- Malaysia</td>
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<tr>
<td></td>
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Table 7. Structure of Import Payments to Major Trading Partners Classified by Currency in Thailand, 1996-2008

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<tr>
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<td>THB</td>
<td>USD</td>
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<tr>
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<tr>
<td>-Mexico</td>
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<td>0.0</td>
<td>0.1</td>
<td>98.3</td>
</tr>
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<td>2002</td>
<td>2008</td>
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<td></td>
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<td>6.6</td>
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<tr>
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<td>7.1</td>
</tr>
<tr>
<td>-UK</td>
<td>83.2</td>
<td>11.4</td>
<td>0.2</td>
<td>2.8</td>
</tr>
<tr>
<td></td>
<td>2002</td>
<td>2008</td>
<td></td>
<td></td>
</tr>
<tr>
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<td>GBP</td>
<td>THB</td>
<td>SGD</td>
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</tr>
<tr>
<td>-Singapore</td>
<td>86.5</td>
<td>1.8</td>
<td>6.6</td>
<td>3.5</td>
</tr>
<tr>
<td>-Indonesia</td>
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<td>1.8</td>
<td>1.8</td>
<td>1.8</td>
</tr>
<tr>
<td>-Philippines</td>
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<td>6.1</td>
<td>0.1</td>
</tr>
<tr>
<td>-Malaysia</td>
<td>84.0</td>
<td>0.5</td>
<td>4.5</td>
<td>0.2</td>
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Figure 1. Japan's Exports since the Early 1980s

Figure 2. Japan's Imports since the early 1980s
Figure 3. Currency Shares in Thai Exports

Shares of US dollar in Thai Exports

Shares of Baht in Thai Exports
Figure 4. Currency Shares in Thai Imports

Shares of US dollar in Thai Imports

120.0
100.0
80.0
60.0
40.0
20.0
0.0


ASEAN
Cambodia
Laos
Myanmar

Shares of Baht in Thai Imports

120.0
100.0
80.0
60.0
40.0
20.0
0.0


ASEAN
Cambodia
Laos
Myanmar
THE FUTURE OF THE DOLLAR AS A VEHICLE CURRENCY

Jung Sik Kim

A. Introduction

The United States (US) dollar has been a vehicle currency for 65 years. After the euro was adopted in 1999, it became a competitor for the status of a vehicle currency. However, until recently the dollar remained the main vehicle currency in trade invoicing, capital transactions, and official reserve holding.

In 2008, the US-led global financial crisis decreased the authority of the dollar as a vehicle currency, and there has been widespread controversy on the future of the dollar and the reform of the international monetary order. Economists, investors, and policy makers worry about the depreciation of the dollar, because the US Federal Reserve system has expanded the money supply to finance the huge US budget deficits in an effort to overcome the global financial crisis.

Xiaochuan Zhou, the governor of the People’s Bank of China, has proposed a sweeping overhaul of the global monetary system by expanding the use of the special drawing right (SDR) (Zhou 2009). The People’s Republic of China (PRC) has maintained more than $2 trillion in international reserves, most of which are held in dollar-denominated assets. The PRC is concerned about the depreciation of the dollar, as it decreases the value of the PRC’s international reserves. The G-20 has also been apprehensive about reform of the current dollar-dominated international monetary system for future international financial stability.

Will the US dollar maintain its status as the main vehicle currency in the future? Is the euro, renminbi, or SDR a feasible alternative to the dollar? To answer these questions, this paper begins with an overview of the function and major determinants of the vehicle currency. It then examines the role of the dollar, euro, yen, and renminbi as key currencies. Finally, the reshaping of the international monetary system is assessed.

B. Determinants of a Vehicle Currency

International currency is the money used for trade and financial transactions outside its country of issue. To be considered an international currency, the value of the currency should be stable, as its demand outside of the country will decrease when the currency depreciates frequently with high volatility.

International money or a vehicle currency should serve the following three functions in private and official transactions: unit of account, store of values, and medium of exchange.
For private use, the currency serves as a unit of accounts in private international transactions when it is used as an invoicing currency in international trade. It serves as a store of values if international financial assets are dominated by the currency. The currency functions as a medium of exchange when used as an anchor, or vehicle currency, which can substitute for a domestic currency.

For official use, the currency serves as a unit of account when it is used as an exchange rate peg. It functions as a store of value when foreign authorities hold foreign reserves of the currency, and it serves as a medium of exchange when the currency is used to intervene in the foreign exchange market.

Among international currencies, the most reliable and stable currency is selected as the vehicle currency. This vehicle currency, or key currency, is used for official international purposes, such as an international reserve holding, anchor currency, or government intervention in the foreign exchange market. Furthermore, it is used as an invoicing currency in private as well as official international trade and financial contracts.

Why do countries prefer to use the vehicle currency? It is highly related to the benefits of its usage, such as reducing the transaction costs. In international transactions and interventions by authorities in the foreign exchange market, people and the government can reduce more transaction costs by using the vehicle currency than other international or domestic currencies.

Moreover, countries benefit from the stability of a vehicle currency. Government and private sectors can prevent risks from an insecure currency when they hold international reserves and financial assets denominated in the vehicle currency. To further maximize the benefits of the vehicle currency, the following criteria and determinants are to be met:

(i) The size of the economy and the shares in world trade are considered to be significantly influential. As a matter of fact, these are related to the potential uses or demands of the currency in international markets. By circulating the vehicle currency of a large economy, people can reduce the transaction costs and thus increase the size in network externality of the vehicle currency.

(ii) A stable value of the currency and strong fundamentals are important determinants. Whenever a country experiences higher inflation and financial crises, the currency is in less demand internationally due to its instability.

(iii) The financial market of an issuer country of such currency should be fully liberalized and well-structured. Investors prefer financial assets denominated in stable vehicle currencies. Well-developed and
accessible financial markets enable the insurance and transaction of the securities that are also denominated in the vehicle currency.

(iv) The liberalization of foreign exchange markets or convertibility of a country’s currency is another criterion for a vehicle currency, because the regulations on the exchange of one currency for others could limit its international use.

(v) Network externality is one of the important determinants of vehicle currency. Vehicle currencies gain their value when others are using it. Exporters, importers, borrowers, lenders, and currency traders prefer using the widely circulating currencies in their transactions. Once the currency is widely accepted for invoice trades, it is more likely to be utilized in invoicing financial transactions and become the vehicle currency in foreign exchange trading.

(vi) The vehicle currency can serve as the lender of last resort. To accommodate the vehicle currency, the anchor country should be able to supply its currency to countries that are hit by foreign exchange shortages. If the vehicle currency can play the role of a lender of last resort, the demand and credibility of the vehicle will amplify.

C. Determinants of the Dollar as a Vehicle Currency

To be qualified as a vehicle currency, a currency must meet certain conditions. In this section, the future of the US dollar is forecasted by examining the determinants of the vehicle currency.

1. The size and openness of the economy

Size and openness have been the major components that stimulated the international use of the dollar. Table 1 compares the relative sizes of the US, euro zone (or regions where the euro is used), Japanese, and PRC economies in 2008. The US has the largest economy in the world, yet the establishment of economic and monetary union in Europe gave it the second-largest economy. The Japanese economy is one-third the size of that of the US, and the economy of the PRC is slightly smaller.

<table>
<thead>
<tr>
<th>Country or Region</th>
<th>2007</th>
<th>2008</th>
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</thead>
<tbody>
<tr>
<td>United States</td>
<td>14,077</td>
<td>14,441</td>
</tr>
<tr>
<td>euro zone</td>
<td>12,316</td>
<td>13,577</td>
</tr>
<tr>
<td>Japan</td>
<td>4,380</td>
<td>4,911</td>
</tr>
<tr>
<td>PRC</td>
<td>3,382</td>
<td>4,327</td>
</tr>
</tbody>
</table>

PRC = People’s Republic of China
Source: Bank of Korea, database
Table 2 compares the shares by volume in world trade. The euro zone has the largest share at 13.9%, followed by the US, the PRC, and Japan, with just 4.8%.

Table 2: Share of World Trade by Volume, 2008

<table>
<thead>
<tr>
<th>Country or Region</th>
<th>Trade Volume $ billion</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Euro zone</td>
<td>4,440</td>
<td>13.9</td>
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<tr>
<td>United States</td>
<td>3,467</td>
<td>10.8</td>
</tr>
<tr>
<td>PRC</td>
<td>2,559</td>
<td>8.0</td>
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<td>Japan</td>
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<td>World</td>
<td>32,041</td>
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</tbody>
</table>

PRC = People’s Republic of China  
Source: Bank of Korea, database

The size of the individual economies and their shares within world trade demonstrate the magnitude of international demands on vehicle currencies as well as network externality. International demand for the US dollar is still high. The US economy is the largest internationally and its share of trade remains relatively high in proportion to world trade.

International demands for the euro have increased as the euro zone expands. The worldwide demand for the renminbi is currently not high, although it is expected to increase in the near future. The economy of the PRC is growing rapidly and its share of international trade has been increasing significantly.

2. Invoicing currency in international trade

According to Goldberg and Tille (2006) and Kamps (2006), the cross-country evidence on import and export invoicing emphasizes the dollar and its key role as the dominant currency that is being actively invoiced across non-European countries (Table 3). In European countries, exports and imports are extensively invoiced in euros. Nevertheless, a high proportion of exports and imports in Asia, Latin America, and Australia are being invoiced in US dollars. Moreover, the proportion of export invoices accounted in dollars is higher than the proportion of US exports. That is, the dollar is already used as a global vehicle currency in trade, although several firms within the euro zone have switched their invoicing currency to euros.
### Table 3: Dollar Invoicing in Exports and Imports

<table>
<thead>
<tr>
<th>Countries</th>
<th>Date</th>
<th>Dollar share in Export Invoicing (%)</th>
<th>Dollar share in Import Invoicing (%)</th>
<th>U.S. share in Exports (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>United States</td>
<td>2003</td>
<td>99.8</td>
<td>92.8</td>
<td></td>
</tr>
<tr>
<td>Asia</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Japan</td>
<td>2003</td>
<td>48.0</td>
<td>68.7</td>
<td>24.8</td>
</tr>
<tr>
<td>Korea.Rep.of</td>
<td>2004</td>
<td>83.2</td>
<td>79.6</td>
<td>17.0</td>
</tr>
<tr>
<td>Malaysia</td>
<td>2000</td>
<td>90.0</td>
<td>90.0</td>
<td>20.5</td>
</tr>
<tr>
<td>Thailand</td>
<td>2003</td>
<td>84.4</td>
<td>76.0</td>
<td>17.0</td>
</tr>
<tr>
<td>Australia</td>
<td>2004</td>
<td>69.6</td>
<td>50.5</td>
<td>8.1</td>
</tr>
<tr>
<td>U.K.</td>
<td>2002</td>
<td>26.0</td>
<td>37.0</td>
<td>15.5</td>
</tr>
<tr>
<td>Euro zone</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Belgium</td>
<td>2004</td>
<td>29.6</td>
<td>35.1</td>
<td>17.9</td>
</tr>
<tr>
<td>France</td>
<td>2003</td>
<td>33.6</td>
<td>46.9</td>
<td>13.7</td>
</tr>
<tr>
<td>Germany</td>
<td>2004</td>
<td>24.1</td>
<td>35.9</td>
<td>15.6</td>
</tr>
<tr>
<td>Greece</td>
<td>2003</td>
<td>17.5</td>
<td>24.9</td>
<td>15.3</td>
</tr>
<tr>
<td>Italy</td>
<td>2004</td>
<td>51.2</td>
<td>55.3</td>
<td>8.6</td>
</tr>
<tr>
<td>Portugal</td>
<td>2004</td>
<td>27.4</td>
<td>32.6</td>
<td>18.3</td>
</tr>
<tr>
<td>Spain</td>
<td>2004</td>
<td>29.1</td>
<td>35.5</td>
<td>9.9</td>
</tr>
</tbody>
</table>

Note: Invoicing data refer only to trade outside the euro area.

### 3. Development of financial markets

To evaluate a proxy for financial market development, the size of each capital market is shown in Table 4. The size of the US capital market, measured by the sum of bonds, equities, and bank assets allotted in the international financial markets, is comparable to that of the euro zone. In 2008 the euro zone capital market was 28.6% of the worldwide capital market, in the US it was 26.3%, and in Japan it was 11.5%. Table 5 shows foreign exchange derivatives in the global over-the-counter market. The US share is the largest at 42.4%, with the euro zone at 21.1% and Japan at 12.2%. The creation of the euro has prompted this declining trend in the share of the US capital markets within world capital markets. Despite this, and the derivatives market, the US capital market continues to lead the world in both size and liquidity.
Table 4: Capital Market Size

<table>
<thead>
<tr>
<th>Country or Region</th>
<th>(Bond+Equity + Bank Asset)</th>
<th>2007</th>
<th>%</th>
<th>2008</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>United States</td>
<td></td>
<td>60,995.7</td>
<td>26.6</td>
<td>56,391.8</td>
<td>26.3</td>
</tr>
<tr>
<td>Euro zone</td>
<td></td>
<td>63,461.4</td>
<td>27.6</td>
<td>61,288.8</td>
<td>28.6</td>
</tr>
<tr>
<td>Japan</td>
<td></td>
<td>21,720.6</td>
<td>9.5</td>
<td>24,714.4</td>
<td>11.5</td>
</tr>
<tr>
<td>Other</td>
<td></td>
<td>83,534.3</td>
<td>36.3</td>
<td>72,029.0</td>
<td>33.6</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>229,712.0</td>
<td>100.0</td>
<td>214,424.0</td>
<td>100.0</td>
</tr>
</tbody>
</table>


Table 5: Size of Global Over-the-Counter Derivative Markets by Currencies, 2007–2008

<table>
<thead>
<tr>
<th>Item</th>
<th>2007</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$ billion</td>
<td>%</td>
</tr>
<tr>
<td>Foreign Exchange</td>
<td>$ billion</td>
<td>%</td>
</tr>
<tr>
<td>U.S. dollar</td>
<td>46,947</td>
<td>41.7</td>
</tr>
<tr>
<td>euro</td>
<td>21,806</td>
<td>19.4</td>
</tr>
<tr>
<td>yen</td>
<td>12,857</td>
<td>11.5</td>
</tr>
<tr>
<td>pound sterling</td>
<td>7,979</td>
<td>7.1</td>
</tr>
<tr>
<td>other</td>
<td>22,888</td>
<td>20.3</td>
</tr>
<tr>
<td>Total</td>
<td>112,477</td>
<td>100.0</td>
</tr>
<tr>
<td>Interest Rate</td>
<td>$ billion</td>
<td>%</td>
</tr>
<tr>
<td>U.S. dollar</td>
<td>129,756</td>
<td>33.0</td>
</tr>
<tr>
<td>euro</td>
<td>146,082</td>
<td>37.2</td>
</tr>
<tr>
<td>yen</td>
<td>53,099</td>
<td>13.5</td>
</tr>
<tr>
<td>pound sterling</td>
<td>28,390</td>
<td>7.2</td>
</tr>
<tr>
<td>other</td>
<td>35,811</td>
<td>9.1</td>
</tr>
<tr>
<td>Total</td>
<td>393,138</td>
<td>100.0</td>
</tr>
</tbody>
</table>

Note: Counting both currency sides of each foreign exchange transaction means that the currency breakdown sums to twice the aggregate.

4. Holding international reserve

In 2000, the dollar accounted for 71.1% of the official foreign currency reserves that were being held within International Monetary Fund (IMF) member countries (Table 6), the euro accounted for 18.3% and the yen 6.1%. The dollar’s share declined to 64.0% in 2008, whereas the euro rose to 26.5% and the yen fell to 3.3%. IMF member countries diversified their holdings, shifting into euros. The shift in international reserves to the euro from the dollar was caused by the
volatile behavior of the dollar. However, this gradual conversion in the international reserve toward the euro is unlikely to have much effect on the status of the dollar as a vehicle currency.

Table 6: Currency Composition of Foreign Exchange Reserve of International Monetary Fund Countries, 2000-2008 (%)

<table>
<thead>
<tr>
<th>Currency</th>
<th>2000 (A)</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008 (B)</th>
<th>B-A</th>
</tr>
</thead>
<tbody>
<tr>
<td>US dollar</td>
<td>71.1</td>
<td>71.5</td>
<td>67.1</td>
<td>66.8</td>
<td>65.9</td>
<td>66.9</td>
<td>65.5</td>
<td>64.1</td>
<td>64.0</td>
<td>-7.1</td>
</tr>
<tr>
<td>Euro</td>
<td>18.3</td>
<td>19.2</td>
<td>23.8</td>
<td>25.2</td>
<td>24.8</td>
<td>24.1</td>
<td>25.1</td>
<td>26.3</td>
<td>26.5</td>
<td>8.2</td>
</tr>
<tr>
<td>Yen</td>
<td>6.1</td>
<td>5.0</td>
<td>4.4</td>
<td>3.9</td>
<td>3.8</td>
<td>3.6</td>
<td>3.1</td>
<td>2.9</td>
<td>3.3</td>
<td>-2.8</td>
</tr>
<tr>
<td>Pound sterling</td>
<td>2.8</td>
<td>2.7</td>
<td>2.8</td>
<td>2.8</td>
<td>3.4</td>
<td>3.6</td>
<td>4.4</td>
<td>4.7</td>
<td>4.1</td>
<td>1.3</td>
</tr>
<tr>
<td>Other</td>
<td>1.8</td>
<td>1.6</td>
<td>2.0</td>
<td>2.2</td>
<td>2.0</td>
<td>1.9</td>
<td>2.0</td>
<td>2.0</td>
<td>2.1</td>
<td>0.3</td>
</tr>
<tr>
<td>Total</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>-</td>
</tr>
</tbody>
</table>

Note: World average
Source: IMF, Bank of Korea, database

5. Confidence in value of currency

According to the IMF, 64% of the world official foreign exchange reserves are held in dollar-denominated assets. The euro is the second most widely held international reserve currency, followed by pounds sterling and the yen. Many countries worry about depreciation in the value of the dollar that could or will saddle these countries with foreign exchange losses.

Since the global financial crisis in September 2008, the US Federal Reserve has undertaken a $1.2 trillion expansion of its balance sheet. Furthermore, to overcome the crisis, the US ran a huge budget deficit, almost exceeding 6.4% of their GDP in the 2011 fiscal year. The predictions of high inflation and dollar depreciation seem likely. Figure 1 shows the decreasing trend in the value of the dollar against the yen and euro since 2000. Because of the vulnerability and high volatility in values, the dollar’s role as a vehicle currency has been challenged even more since 2008.

*The function of lender of last resort is also important for the vehicle currency. Under the current dollar-dominated system, the IMF, in which the United States works as a leading country, works as a lender of last resort. Since the global financial crisis, the IMF has expanded the Flexible Credit Line for the function of lender of last.*
Reviewing the determinants of a vehicle currency, the dollar’s dominance has been reduced as other economic powers have emerged and the US trade deficit deteriorated.

**D. Prospects of Alternative Currencies**

In recent decades, confidence in the value of the dollar has declined due to the huge US trade deficits in addition to government debt. In 2008, the global financial crisis triggered the debate on the future of the dollar and the search for an alternative vehicle currency.

What would replace the role of the dollar? Some argue for the euro; others say the yen or renminbi. Some require a new international currency, or the SDR. In fact, although the dollar has some problems in maintaining its status as a vehicle currency, finding an alternative vehicle to substitute the dollar at this point is even more challenging, because none of the alternatives is without defects.

**1. Size of economy and trade volume**

As previously mentioned, the GDP of the euro zone is the second largest in the world (Table 1), and the volume of trade in the European Union is much higher than in the US. The euro has gained recognition as a possible alternative vehicle
currency to the dollar due to its economic size. In fact, international consumption of the euro had been increasing rapidly until recently.

The Japanese economy is not yet as big as that of the US or the euro zone. The feasibility of using the yen as a vehicle currency is low, and unlikely in the near future. On the other hand, the PRC economy has been growing rapidly and its share of world trade has increased. The possible use of the renminbi as a vehicle currency depends on the future growth rate in the PRC economy.

2. Confidence in currency value

To meet the criterion for the vehicle currency, the value that the vehicle holds should not show excessive fluctuations. The euro has been relatively stable, for the economic convergence criteria that EMU uses for countries to join the union.

Despite the economies within the euro zone, Japan and the PRC are highly dependent on the US economy. As Table 7 shows, the share of US exports to the euro zone is only approximately 6%, and the PRC and Japan attain 16-18%. Once the US economy sinks into a recession, other countries face high volatility in their currency values. As a matter of fact, during the global financial crisis, the euro seemed to be more volatile and hence was even more undervalued than the dollar.

Thus, the PRC is challenged with possible damage from high inflation and the asset bubbles as it has been accumulating huge international reserves—more than $2 trillion. In this case, the renminbi becomes unstable due to the depreciating value caused by excessive volatility.

### Table 7: US Exports as Share of Total ($ billion)

<table>
<thead>
<tr>
<th>Destination Market</th>
<th>2007</th>
<th>2008</th>
<th>2009*</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>European Union</strong></td>
<td>US export</td>
<td>257.70</td>
<td>246.07</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(6.7%)</td>
<td>(6.1%)</td>
</tr>
<tr>
<td></td>
<td>Total export</td>
<td>3,873.80</td>
<td>4,004.57</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(100.0%)</td>
<td>(100.0%)</td>
</tr>
<tr>
<td><strong>Japan</strong></td>
<td>US export</td>
<td>16.90</td>
<td>14.22</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(20.1%)</td>
<td>(17.5%)</td>
</tr>
<tr>
<td></td>
<td>Total export</td>
<td>83.93</td>
<td>81.05</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(100.0%)</td>
<td>(100.0%)</td>
</tr>
<tr>
<td><strong>PRC</strong></td>
<td>US export</td>
<td>232.76</td>
<td>252.33</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(19.1%)</td>
<td>(17.7%)</td>
</tr>
<tr>
<td></td>
<td>Total export</td>
<td>1,218.16</td>
<td>1,408.87</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(100.0%)</td>
<td>(100.0%)</td>
</tr>
</tbody>
</table>

PRC = People’s republic of China

a 1st quarter

3. Development of financial market

To attain the status of vehicle currency, the capital market as well as the money markets within the anchored country should be highly accessible and well developed. In Table 8, according to our measurement of the financial development in the ratio of capital flows to GDP, the euro zone has more accessibility in its financial markets than does the US or other countries. The PRC and Japan have relatively less accessibility in their markets than exists in the US and euro zone.

Concerning the amount of debt securities outstanding issued by each currency, the share of euro currencies are more than those of the US (Table 9). The share that Japan holds is far less than those of the euro zone and the US. Nevertheless, the euro zone does not have firmly established finance sectors, whereas large financial markets are centered in New York and London. If the United Kingdom joins the European Monetary Union, the euro zone will benefit from the immense potential of financial markets offered in London2. The financial market in the PRC has not been exposed and, indeed, is not concrete.

In short, the euro has gained wide recognition as a vehicle currency, yet still lacks in its role of replacement for the dollar. The circulations of the yen and renminbi are considerably behind the dollar and the euro due to the small and inadequate financial markets associated with the two currencies.

### Table 8: Opening Capital Market, 2007

<table>
<thead>
<tr>
<th>Capital Market</th>
<th>GDP</th>
<th>Inflow (Inflow/GDP)</th>
<th>Outflow (Outflow/GDP)</th>
<th>Total (Inflow+ Outflow)/GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>US</td>
<td>14,077.6</td>
<td>2,129.5 (15.1)</td>
<td>1,472.1 (10.5)</td>
<td>3,601.6 (25.3)</td>
</tr>
<tr>
<td>Euro zone</td>
<td>12,316.0</td>
<td>2,620.9 (21.2)</td>
<td>1,941.9 (15.8)</td>
<td>4,562.8 (37.0)</td>
</tr>
<tr>
<td>Japan</td>
<td>4,380.4</td>
<td>267.6 (6.1)</td>
<td>494.2 (11.3)</td>
<td>761.8 (17.4)</td>
</tr>
<tr>
<td>PRC</td>
<td>3,382.4</td>
<td>241.2 (7.1)</td>
<td>170.8 (5.1)</td>
<td>412.0 (12.2)</td>
</tr>
</tbody>
</table>

GDP = gross domestic product, PRC = People’s Republic of China.
Note: Total net flows are the sum of direct investment, portfolio investment, and other investment flows. Other investment includes bank loans and deposits.

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2 Cooper (2009) and Chinn and Frankel (2008) emphasized the role of the developed financial market in US.
### Table 9: Outstanding Debt Securities by Currency of Issue, 2007-2009

<table>
<thead>
<tr>
<th>Currency</th>
<th>2007</th>
<th>2008</th>
<th>2009a</th>
</tr>
</thead>
<tbody>
<tr>
<td>US dollar</td>
<td>7,535.2 (34.9%)</td>
<td>8,225.5 (36.2%)</td>
<td>8,569.5 (37.5%)</td>
</tr>
<tr>
<td>Euro</td>
<td>10,535.1 (48.8%)</td>
<td>10,875.1 (47.8%)</td>
<td>10,683.6 (46.7%)</td>
</tr>
<tr>
<td>Yen</td>
<td>577.3 (2.7%)</td>
<td>750.2 (3.3%)</td>
<td>682.8 (3.0%)</td>
</tr>
<tr>
<td>Other</td>
<td>2,923.5 (13.6%)</td>
<td>2,881.1 (12.7%)</td>
<td>2,933.5 (12.8%)</td>
</tr>
<tr>
<td>Total</td>
<td>21,571.1 (100.0%)</td>
<td>22,731.9 (100.0%)</td>
<td>22,869.4 (100.0%)</td>
</tr>
</tbody>
</table>

*N 1st quarter


### 4. Network externality

The vehicle currency derives its value when others are using it. Historically, small changes made in the determinants do not result in the same changes in the number of reserve currencies in the short run.

Today, the dollar is being widely circulated in trade invoicing and more comprehensively used in capital transactions. The dollar’s share approximates to 65% of the international reserve holding within IMF member countries; of $3.2 trillion worth of foreign exchange trades in 2007, 86% involved the dollar. This extensive international circulation of the dollar contrives the network externality. In contrast, the impacts of the yen and renminbi on the network are seen to be less beneficial than that of the dollar. Moreover, the composite currency, the SDR, the one Governor Zhou proposed as a possible alternative vehicle currency, cannot accommodate the network externality. Currently the SDR only serves the national monetary authorities and international institutions such as the IMF, World Bank, and BIS. A prerequisite for moving from the dollar to a new vehicle currency such as the SDR or the euro is substantial demand for the new currency. Otherwise, the benefit of replacing the currency would be lost. To retain the advantages of the network externality that the SDR provides, the SDR should also circulate to private firms and individuals.

Despite this, most trades and financial transactions, as well as any form of settlements, specify a single currency because not many sellers want to receive their payments in a bundle of currencies.

Furthermore, it is not convenient to integrate all the components in each currency. Ultimately, participants in international trade and financial transactions will prefer the single convertible currency to a synthetic currency. Governor

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3 Humpage (2009) and Cooper (2009) emphasized the lack of the network externality of the SDR as a vehicle currency.

4 Cooper (2009) also criticized the inconvenience of the SDR as a synthetic currency in the transactions and determination of exchange rate.
E. Conclusion

Since the global financial crisis in 2008, there have been many controversies on the future of the dollar and other potential vehicle currencies, in particular the euro, renminbi, and SDR. Once the euro was adopted in 1999, the dollar’s role as a vehicle currency dwindled and consequently the euro has become the secondary vehicle currency. In this paper, the necessary criteria for the vehicle currency are summarized and the roles of the dollar as well as the feasibility of alternative currencies after the financial crisis are investigated.

It might be difficult to consider the alternatives—which were discussed previously as the euro, renminbi, yen, and SDR—as potential competitors to the dollar, the world-leading international currency, in the approaching future. The US has the largest economy and has retained the highest volume of trade in the world. The dollar has been circulated as a key invoicing currency in trade and capital transactions, with 65% of international reserves being dollar-denominated assets. This tendency in favor of the dollar has been consistent since the 2008 global financial crisis.

The role of the euro as an alternative vehicle currency will keep being emphasized as long as the euro zone continues to expand. Nevertheless, the budget deficits within the euro zone and Japan have deteriorated, with their economies being significantly influenced by the US economic recession. The values of the euro and the yen are uncertain, with excessive volatility led by instability in the value of the dollar.

The role of the renminbi will be heightened as the output of the PRC and its share of world trade increases. The potential role of the renminbi depends on the economic growth rate in the PRC and the establishment of a sound domestic financial system. However, the financial market in the PRC is not yet exposed, and is not yet firmly developed. The economy of the PRC is indeed significantly dependent on the US, as 18% of the PRC’s export are to the US. The renminbi is not a feasible alternative as a future vehicle currency.

The use of the SDR, the currency being proposed by Governor Zhou of the People’s Bank of China, is not possible in the near future because it is to be used in private transactions and hence does not benefit from network externality.

In conclusion, none of the other leading currencies are in a position to replace the US dollar as a vehicle currency in the short term, though there is room for the euro to increase its share in reserve holdings. In the long term, however, more
competitor currencies will emerge, such as the euro and the renminbi and synthetic currencies such as the SDR.

Multiple vehicle currencies will end up competing with each other once the value of the US dollar declines. The international monetary order will possibly undergo reformation, with the current currency system moving from being dollar dominated to having multiple vehicles.

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The United States (US) dollar is not the world’s key currency by policy design, just as English is not the leading global language by policy design; it is the evolutionary outcome of practice and experience. It would take both a major shock and the existence of a viable alternative to the dollar to dislodge it from widespread use. Like a common language, it enjoys “network externalities”—the greater the number of people who use and accept it, the more useful it is to everyone and the more entrenched it becomes. Also, what is not quite the same thing, the dollar enjoys a large market in low-risk and highly liquid securities, most notably US Treasury bills; the liquidity both enhances and is enhanced by the network externalities. Most of the world’s foreign exchange transactions directly involve the US dollar. It is easy to hold and easy to use, even on a large scale. In short, it is highly convenient.

It has a disadvantage as a store of value in that it is not constant in purchasing power (a concept that is itself ambiguous and varies from country to country). It is a disadvantage it shares with all other national currencies, and indeed over the past half century few countries have had a lower rate of inflation than the United States. Moreover, interest rates on securities should, over time, compensate for any persistent decline in purchasing power, especially (in the case of the US dollar) from a US perspective.

A major change in these conditions could in time undermine confidence in the US dollar as a store of value. If its role as a temporary store of value were eroded, this would eventually reduce its role as a currency for transactions, although the two functions need not develop simultaneously.

Are there feasible alternatives to the US dollar as a widely used international currency? Two categories come to mind: another currency in actual use, such as the euro, the yen, the pound sterling, or even (as has recently been suggested by Nouriel Roubini) the renminbi; and a synthetic currency designed for the purpose, of which the special drawing right (SDR) would currently be the leading candidate, as recently hinted by Governor Zhou of the People’s Bank of China. Each will be discussed in turn.

A. Replacement by Another Currency

The euro was created legally in 1999 and began to circulate as currency in 2002. It has now replaced national currencies in 16 countries, and is widely used in some other member countries of the European Union that have not yet formally
adopted the euro but are committed to doing so, and in a number of would-be member countries of the European Union. Debt outstanding in 1998 was converted into euros, and debt issued since that time by participants in the euro zone has been denominated in euros. The euro-based capital market has evolved greatly in the past decade.

Despite great progress, the euro capital market is still quite fragmented, with varying degrees of liquidity depending on the security. Holders of international reserves cannot hold euros; they have to hold euro-denominated securities, and exactly what security it is makes a great deal of difference. The most prevalent euro-denominated government securities are those issued by the Government of Italy, with $1.8 trillion outstanding at the end of September 2008 (Table 1). Many central banks would hesitate to hold such securities, since Italian public debt exceeds gross domestic product (GDP) and the government is not known for budgetary discipline or efficiency. At the end of September 2008 there was $1.4 trillion in Government of Germany debt outstanding, but Germany over the years has had an aversion to short-term debt, so only $266 billion of this had a maturity of less than 1 year. Moreover, German buyers tend to hold to maturity, so the secondary market is much less well developed than it is in the United States or the United Kingdom (UK), and German bonds are correspondingly less liquid. Table 1 also shows the smaller amounts of euro-denominated government debt of France and of Spain, the two next-largest issuers. So, while in total there is much outstanding euro-denominated public debt, the market is more fragmented and much less liquid than the market in US government securities, which in September 2008 totaled $7.3 trillion, including $2.1 trillion of short-term debt.

The secondary market is much better developed in the UK, but at $0.8 trillion, the amount of pound-denominated Government of the United Kingdom debt is significantly smaller than that of the larger euro zone countries. Canada has a somewhat smaller and less well-developed market than the UK.

Japan has extensive government debt, at $7.9 trillion even more than the United States, $2.3 trillion of which is short term. There are three potential problems with Japanese securities as a basis for an international currency. First, the yield has been exceptionally low—below 1% on short-term securities—during most of the past two decades. Second, while Japan has a relatively free market in public debt, Japan has a strong tradition of “guidance” by the Ministry of Finance, and that tradition has not entirely vanished. Foreigners might worry about new guidance that would limit their freedom of action and even discriminate against foreigners in favor of domestic holders. Third, among rich countries Japan has the highest debt-GDP ratio, at well over 100%. This does not pose a financing problem with interest rates as low as they have recently been, but it might do so in the future, particularly in view of the rapid ageing of Japanese society (on which more
With $1.4 trillion, the People’s Republic of China (PRC) has almost as much government debt outstanding as Germany, and over half of it is short term. The PRC fiscal policy has been conservative, and the debt—GDP ratio is moderate at about 50%. However, the capital market in the PRC, including that for government securities, is not well developed; most purchasers hold until maturity. Foreigners at present do not have access to government securities at all, and the PRC currency is not convertible for capital account transactions. Thus, the renminbi is not suitable for being an international currency at present, although all that could change in the next two decades. Indeed, among the many objectives of the Government of the PRC are a much improved capital market and a fully convertible currency. The financial system in the PRC requires much improvement before these objectives can be securely achieved, however, and this is not likely to take place quickly.

I conclude that essentially on technical (market) grounds none of the other leading currencies in the world today are ready to replace the US dollar in its international role. The international role of the euro is likely to increase in the coming decade as non-euro-zone members of the European Union and aspiring candidates increasingly use euros in their transactions with euro zone countries for invoicing, payment, and holding international balances. Other countries closely linked economically to Europe, such as Morocco and Tunisia and perhaps Egypt, are likely to do the same. However, this increasing use of the euro is not likely to displace the dollar at the global level. In a growing world economy, there is room for the euro to increase its share in reserve holdings even while the value of dollar holdings continues to rise.

Moreover, on current benign projections for the world economy, the shares of Europe and of Japan are likely to fall significantly over the next two decades, largely for demographic reasons (Cooper 2008). Both Europe and Japan have low birth rates and rapidly ageing populations. The share of the United States, in contrast, will decline only modestly, due to higher birth rates and continued significant immigration, while those of the PRC and other developing countries grow significantly. Thus the relative importance of Europe and Japan as trading destinations will gradually decline as that of successful developing countries increases, while the United States will continue to be by far the largest national economy, with only a slight decline in share.

For all these reasons, the dollar is not likely to be seriously displaced, assuming the United States continues to manage its monetary and fiscal affairs in a reasonable fashion, and assuming the US capital market remains open.
B. Replacement by a Synthetic Currency

What about the other possibility, that of displacing the US dollar in its international role by a synthetic currency, as a matter of conscious and deliberate collective action? This possibility, quietly suggested by Governor Zhou of the PRC’s central bank in the spring of 2009, could be achieved by substantially augmenting the role of the SDR, a synthetic unit account of the International Monetary Fund (IMF) defined in terms of four currencies: the US dollar, the euro, the yen, and pound sterling. What is not generally known is that such a move has been an official objective of the international community since 1978, as stated in the second (1978) amendment to the IMF’s Articles of Agreement, which states that the SDR should become the center of the international financial system.

The issues here are conceptual, practical, and—if I may say so—aesthetic. The conceptual issues concern the net gains that may be expected to accrue to the world at large from creating a new, artificial international currency, compared with the current nonsystematic practices relying mainly on the US dollar. I will not review these in this brief paper, except to say that they are not completely obvious, and that most of them would not occur without other important changes in how the international financial system functions, including international engagement in the role of national exchange rate policies; changes that would, if anything, be more controversial than achieving wide acceptance of a synthetic international currency.

The aesthetic issue largely concerns the offense that some observers take at having a national currency play the leading international role: it creates an asymmetry in a system which at least formally and legally (as in the United Nations Charter and most other international treaties) treats all nations as equal. It also appears to give special privileges to the nation whose currency is used. More on this issue below.

Most of the issues are practical, in principle soluble, but often with difficulty and with undesirable and perhaps unacceptable side effects. One practical matter concerns the principles that would govern issuance of the synthetic currency, including who exactly would decide. SDR creation under existing IMF arrangements involves a 5-yearly evaluation of whether the world economy needs additional liquidity, and a decision by IMF governors (essentially the finance ministers of the world) by an 85% weighted vote (which gives the US and the European Union taken together effective veto power) concerning when and how much. Only two successful issuances have been decided, in the late 1960s and in the late 1970s, for a total of SDR22 billion (a third, involving distribution to new members such as the PRC and Russia, was decided in principle but has not yet
been implemented). Most transactions in SDRs are in fact between national monetary authorities and the IMF itself. This arrangement is inappropriately cumbersome and time-consuming if the SDR is to become a true international currency.

SDRs as currently constituted can be used only by national monetary authorities, the IMF, and selected designated institutions such as the World Bank and the Bank for International Settlements. Most holdings of US dollars outside the United States are by private parties, and financial markets are operated by and largely for private parties, with governments and central banks taking advantage of them. If the SDR were to become a truly international currency, it would have to be made accessible to private parties or else the modus operandi of international financial relations would have to be radically revised. This applies to holdings of, and payments in, SDRs. There is nothing that prevents transactors in many countries today from using the SDR as a unit of account in their transactions with foreigners. The SDR is priced daily, indeed hourly, in terms of other currencies, so there is no ambiguity about its value at any moment. That it is not used widely suggests either that inertia in human behavior is very high, however irrational that may be, or else that transactors see no compelling reason to shift to SDRs from dollars or whatever currency they may be using.

A third practical issue concerns what is to become of all the US dollars that are held today in both private and official balances if the SDR (or some other synthetic unit) is to replace the US dollar. One approach would be to leave them, and substitute SDRs through incremental growth such that the US dollar (and other national currencies now held abroad) would gradually recede in relative importance, without any formal displacement. Given the amount of foreign balances held today (over $5 trillion in official reserves alone), under such an approach it would take a very long time for the SDR to become the predominant reserve asset, and it would perhaps never become predominant in private balances unless the process was forced in some way.

An alternative approach would involve the creation of a “substitution account” (Kenen 1981), whereby at least official holders and perhaps even private holders of dollars and other currencies would exchange their holdings for an equivalent value of SDRs. The question then arises of what would become of the dollars and other national currencies received in this arrangement, e.g., by the IMF or by a new institution created for the purpose, and would the obligors promise to maintain their SDR value. The latter condition would be unacceptable for the United States, since no Congress would provide an unconditional guarantee of value for assets which, though issued by the US government, were issued in US dollars and voluntarily acquired by foreign parties.
To identify the practical issues that would have to be resolved in creating a synthetic international currency is useful, since it suggests that the gains from such a move would have to be judged to be sufficiently substantial to drive governments to try to solve the practical problems.

But, it may be asked, won’t response to the current financial and economic crisis by the United States result in such large public debt that the viability of the dollar as an international currency, and the willingness to hold it, come into doubt? My answer is that such an outcome is possible but highly unlikely. It is unlikely because, messy as the US decision-making process is, the United States has not over the years been fiscally undisciplined and it is not likely to be in the future. The current borrowing needs are very large, partly to finance a recession-induced budget deficit augmented by a fiscal stimulus package, and partly to finance support for financial institutions whose viability has been impaired by the financial crisis. The financing support of financial institutions involves purchases of financial assets, many of which will have significant value when the government support is unwound, so they will result in a substantial reduction of the budget deficit in future years (although exactly when and by how much is not now known). The public debt relative to GDP will grow, but most other countries are also running substantial budget deficits and will also be adding to their outstanding debt which, relative to GDP, was typically higher than that of the United States. Other rich countries are ageing more rapidly and have problems of unfunded public entitlements that are comparable to, or even worse than, those in the United States. Thus, in relative terms, the financial position of the United States will not worsen significantly.

Some people are concerned about the possibility of much higher inflation in the United States. That is not the problem for the next several years. To be sure, the Federal Reserve has added significantly to its liabilities, so it must have an exit strategy as the economy, and especially financial markets, return to normal. However, developing such a strategy is not a formidable problem, and is being worked on now. Again, in the international context, a comparative perspective must be borne in mind; other countries face similar challenges. The SDR, incidentally, does not address the issue of inflation; since it is a synthetic unit of four currencies, the erosion of the real value of the SDR will correspond to the erosion of the real value of the component currencies, weighted appropriately. Some people have suggested that a new international unit of account and store of value should for this reason not be linked to any currency, and gold has been offered as a candidate. This is not the place to review the compelling disadvantages of the gold standard, both conceptually and in practice (Cooper 1982, 1986). Suffice to say its “disciplines” would be politically unacceptable in today’s world.
Finally, a word should be said about the alleged gains that accrue to the United States as issuer of the national currency that is widely used internationally—what Charles DeGaulle in the Bretton Woods days of fixed exchange rates called an “exorbitant privilege.” I have always thought the net benefits, usually unspecified but as in DeGaulle’s expression implied to be large, were greatly exaggerated.

The gains usually mentioned are three: seigniorage, ease of financing budget (and possibly other) deficits, and employment and profits in the financial market. Seigniorage arises from the difference between the face value of a unit of currency and its cost of production. It is entirely true that the United States benefits from seigniorage on the estimated $380 billion of greenbacks (currency notes) held around the world; Americans receive goods and services or assets for them, and pay no interest on them. But notes are a small part of the international holdings of the dollar; most dollar assets owned abroad pay an interest rate in competition with interest rates on other financial assets, denominated in either dollars or other currencies. The interest rate on Treasury bills is no doubt lower than otherwise because of the high liquidity of those instruments. The high liquidity is due in part, but only in part, to foreign demand for them. Lately some economists have suggested that Americans gain from the equity premium, being able to borrow at low interest rates from foreigners and investing in higher yield equities. It is entirely true that the US earns more on its foreign investments than it pays on its (larger) foreign liabilities, and that this difference in significant measure is explained by the much higher fraction of equity in assets than in liabilities. But anyone who is willing to take risk can benefit from the equity premium, and many individual foreigners (and perhaps sovereign wealth funds) do so. That gain arises from risk taking, not from seigniorage.

Having a larger potential clientele for one’s government securities of course makes it easier to finance government deficits in normal times. It also means, however, that the government has to be concerned with maintaining the confidence of this larger and more diverse clientele, especially in abnormal times.

International use of the dollar undoubtedly brings business to some US financial institutions. But the growth of London as the leading international financial center suggests that financial activity and the national origin of the currencies used are separate issues. London has adapted well to international use of the dollar, as it is increasingly adapting well to growing international use of the euro.

Moreover, against benefits must be set potential costs. Two come to mind. First, international opinion must be taken into account when framing economic policy, especially monetary policy, and international opinion may be more demanding than domestic opinion. (Of course, international opinion must be taken into account these days by any country that relies significantly on foreign capital,
particularly foreign private capital, for its development; this is not a peculiarity of reserve-currency countries.)

Second, to the extent world demand for a country’s currency is raised by its international role, the value of that currency in terms of other currencies is enhanced, and that makes producers in the reserve-currency country less competitive in world markets than they would otherwise be. For this reason alone, many Americans would actually welcome a diminished international role for the dollar.

C. Conclusion

To sum up, the US dollar is likely to remain the dominant international currency for many years—certainly the next decade and probably longer. Given its initial advantage of wide acceptance, no other currency seems likely to overtake it. International use of the euro will grow, perhaps even more rapidly than that of the dollar for some years, but because of limitation on issuers and financial markets, it is not likely to displace the dollar. In a growing world economy, there is room for both.

The dollar could be displaced by a deliberate international decision to create a new international currency, but that task would face formidable practical difficulties. The prospective gains from such a creation would have to be sufficiently great to make governments willing to overcome the practical difficulties, and to adopt the complementary policies (mainly concerning exchange rates) that would be necessary to give a new international currency a compelling advantage over present arrangements.

References


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THE FUTURE OF THE US DOLLAR STANDARD

Peter J. Morgan

1. Will the dollar continue to play the dominant role in the future? Will the dollar remain strong in the future?

In the long-term, the role of the dollar is likely to diminish in line with the United States (US) economy’s share of world economic activity. This is likely to reflect both stronger real economic growth in emerging markets such as the People’s Republic of China (PRC) and India, and long-term currency appreciation in those countries. However, the process is likely to be gradual for a number of reasons.

The main arguments in favor of continuation of the dollar standard are inertia, the lack of a compelling reason to change the standard, the lack of an alternative fixed-income market comparable to that of the US in terms of size and liquidity, and the fixed costs of moving to a new standard. Also, to the extent that Asian countries (which are the biggest holders of foreign exchange reserves) continue to gear their currency policies to the US dollar, they will find it difficult to divest their holdings of US dollar reserves.

Inertia means that the current role of the dollar as an international reserve currency is well-entrenched in the global financial system, both in terms of its use as a means of international payments and as a store of value in international reserve holdings.

![Figure 1: United States Savings Rate](source: CEIC)
There is no compelling reason for a change in the dollar standard at this time. The main long-term threat to the dollar’s role as a reserve currency is the perceived risk of a meltdown in the dollar’s value as a result of intolerance of surplus countries for continued large balance of payments imbalances and a steadily rising net debtor position of the US. However, with the US household savings rate now rising significantly, we may see a return to the situation which prevailed before the onset of the Asian financial crisis, where the US ran only modest current account deficits of about 1%–2% of gross domestic product (GDP). If this happens, this level of imbalances would be much more sustainable, and should allay the market’s concerns about a dollar meltdown.

Figure 2: United States Trade Deficit

![Figure 2: United States Trade Deficit](source: CEIC)

To be sure, even if the issue of global imbalances recedes, there still might be concerns about capital losses arising from a downgrade of US government debt from its current AAA rating as a result of the rapid increase in the ratio of government debt to GDP. However, other advanced countries in Europe and Japan face the same problem to greater or lesser degrees, so this development does not necessarily argue in favor of a change in the reserve currency.

Notably, there has been no long-term deterioration in the real effective US dollar exchange rate, although there certainly has been volatility. This does point to the advantage of shifting to some kind of currency basket, such as the special drawing right (SDR), which presumably would have less volatility. However, as I
discuss further below, the SDR is not yet ready for such a role, since it is an artificial currency and is not yet used for settlements.

The euro does now have a scale similar to that of the US dollar, both in terms of the economic size of the euro area and the role of the euro zone in world trade of goods and services. However, from Asia’s perspective, trade with the US is still significantly larger than that with the euro zone, so there is no obvious reason for a switch at this time. Moreover, there is no equivalent in Europe to the US fixed-income market, either in terms of size or liquidity. Moreover, the European Central Bank is not necessarily a buyer of last resort of government bonds of individual European countries. This significantly reduces the attractiveness of the euro as an alternative reserve currency.

*Figure 3: Real Effective US Dollar Rate*

Source: CEIC

2. The People's Republic of China and the Dollar

Although the PRC has recently begun to question the role of the dollar and to propose alternatives, its economic policies are still wedded to the dollar. Specifically, its holdings of dollars are so large in absolute terms that a serious attempt to diversify from US dollar reserves would have a serious disruptive impact, the net effect of which would be to injure the export competitiveness of

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*I thank Chi LO, director investment research, Ping An of China Asset Management (Hong Kong) for the elucidation of many of these points.*
the PRC and thereby undermine the government’s overriding goal of maintaining a high rate of economic growth.

If the PRC were to diversify its foreign exchange reserves away from the US dollar into other currencies (e.g., SDRs) or other asset classes (e.g., gold) rapidly, it would

(i) cause a sell-off in the dollar, create turmoil in international financial markets, and hurt global growth, which would inflict damage on the economy of the PRC;
(ii) undermine the US Treasury market, therefore hitting the value of the PRC’s foreign exchange reserves; and
(iii) disrupt the gold market.

The PRC holds more than 27% of the world’s total foreign exchange reserves. If it reduces the share of the US dollar in its total reserves, other central banks and investors might follow, prompting a crash in the US dollar. This might force the US Federal Reserve to raise interest rates to stem the capital flight, which could damage the US and global economy and financial system.

Other financial markets would be affected as well. Foreign investors, including central banks, are estimated to have held 50% (or $3.2 trillion) of the US Treasury bond market. The PRC is the largest foreign sovereign holder, accounting for 24% of all foreign holdings. The US Treasury market would fall sharply if the PRC and other sovereign holders began selling their holdings. That would force a sharp rise in US interest rates, which could crush the US economy and asset market, sending negative shock waves around the world.

Concern about possible disruptive impacts on world markets means that any shift in reserve holdings is likely to happen slowly. The PRC showed no support for replacing the US dollar with the SDR as the world reserve currency in the G-20 meeting in April, despite an article by People’s Bank of China Governor Zhou Xiaochuan before the meeting supporting this proposal.

3. Potential role of the special drawing right

Governor Zhou’s suggestion on 24 March to replace the US dollar with the IMF’s special drawing right (SDR), which is a unit of a currency basket comprising the US dollar, euro, pound sterling, and yen, as the world reserve currency has merits. In essence, it implies that the PRC would want to shift out of the US dollar into the SDR. However, implementing this would be difficult, even in the medium term.

The main difficulty in implementing the idea of a supersovereign reserve
currency (be it SDRs, some other currency, or a currency basket) stems from the inertia in the global status of the US dollar. Most international trade and financial flows are based on the dollar, and global payments and settlement systems are dominated also by the dollar.

Fundamentally, the SDR is not a medium of exchange in the real world. There are no SDR assets at all, although there could be as the IMF has recently approved a framework to issue SDR-denominated bonds. When the IMF allocates SDRs, the recipient countries exchange them for local currencies at the local central banks. That money is then used to buy goods and services, and invest and trade with other countries.

If the IMF does decide to issue SDR-denominated bonds, these would provide an alternative low-risk (AAA rated) asset for the PRC to invest its foreign exchange reserves in. However, the actual issue amounts would probably be small relative to the size of the PRC’s reserves, even if it bought the entire issuance, which seems unlikely. Therefore, such bonds by themselves would be unlikely to provide a significant degree of reserve diversification.

4. Impacts of buying gold

The PRC could also shift its reserves from US dollars to gold. Currently, the PRC’s central bank has about 1% of its total official reserves held in gold, compared to the world’s major central bank average of 10% (Chart 1). The US, Germany, France, Italy, Switzerland, the Netherlands, and the ECB are the largest gold holders. The US has almost 79% of its official reserves held in gold, amounting to 8,134 tons (or 27% of world total official gold holdings) as of March 2009.

The State Administration of Foreign Exchange announced in late April that the PRC had increased its gold holdings by 76% to 1,054 tons in 2008, from 600 tons in 2003. That revelation sparked a rally in gold prices. Even with that increase in the past 5 years, the share of the PRC’s gold holdings is still very small in its total official asset holdings. So the potential for it to increase gold holdings is big.

However, if the PRC were to increase its gold holdings substantially and rapidly, this could push up world gold prices sharply. This is because world gold supply is pretty much fixed, at around 3,500 tons per year. Gold sales by the other central banks are expected to remain small due to the Central Bank Gold Agreement, which is due for renewal this October, and there are no signs that the signatories to the agreement would want to increase their gold sales.

Assuming an average gold price of $850 per ounce, if the PRC were to use 10%
of its $2 trillion foreign exchange reserves to buy gold, it could buy 6,671 tons of gold, or about 2 years of annual supply. Such a large purchase would have too large an impact on gold prices, and therefore would not be practical.

5. **Will the dollar remain strong in the future?**

The dollar is strong against Asian currencies at the moment, but not against the euro or the yen. Its strength against Asian currencies (other than yen) reflects the continuing shortage of dollars for international trade and finance, while the strength against the euro and yen reflects the extremely low level of US interest rates and the weak US economy. Therefore, as conditions normalize, we may anticipate that the dollar will weaken somewhat against developing economies in Asia and elsewhere, but will strengthen against the yen and the euro. Ultimately, the dollar’s strength at any given time will depend mainly on the relative strength of the US economy and the level of US interest rates.

6. **What do you think of the future of the euro zone? Will there be a widening of the euro zone?**

Prospects for enlargement of the euro zone are fairly limited at this time. Only four countries—Denmark, Estonia, Latvia, and Lithuania—are members of the Exchange Rate Mechanism (ERM) II, which is the official stepping stone to joining the common currency zone. However, the dislocations associated with the current global financial crisis have severely worsened the situation of the Baltic states, presumably delaying their entry. Other European Union countries indicating interest in joining the ERM II include Bulgaria, Czech Republic, Hungary, Romania, and Slovakia. Again, however, current economic and financial conditions will further delay this step. In any case, these countries, with the exception of Denmark, are not very large economically and would not have much influence on the euro zone. Larger countries such as the United Kingdom and Sweden still seem very unlikely to join the euro zone in the medium term.

7. **Is there a chance for the renminbi or yen to be a key currency?**

The yen has already peaked in terms of its global significance, so if it hasn’t become a key currency by now it probably never will. The role of Japan in the global economy is on a long-term downward trend due to the declining trend of Japan’s population. The main problem is that the Tokyo financial market is still too regulated, which limits its development as an international financial center.

The renminbi will no doubt eventually become a key currency simply by virtue of the prospective size of the PRC economy, but this is a very long-term story. Convertibility of the capital account is a major necessary step in this direction, and even the timing of this step seems very unclear. If anything, the impact of the
global financial crisis is more likely to delay rather than accelerate this process.

8. Conclusion

In the long-term, the role of the dollar is likely to diminish in line with the US economy’s share of world economic activity. This is likely to reflect both stronger real economic growth in emerging markets such as the PRC and India, and long-term currency appreciation in those countries. However, the process is likely to be gradual for a number of reasons.

Despite much abuse heaped on the US dollar, the international financial system is still highly geared toward its role as a reserve currency, and this seems unlikely to change dramatically in the near future. For Asian countries, there is still little logic in switching to, say, the euro, as a unit of account, while the logistical difficulties of creating an artificial currency, whether it be SDRs or an Asian currency unit, are still formidable. Moreover, there is no obvious alternative to the US fixed-income market in terms of size or liquidity.

The main long-term threat to the dollar’s role as a reserve currency is the risk of a meltdown in the dollar’s value as a result of intolerance of other countries for continued large balance of payments imbalances and a steadily rising net debtor position of the US. However, with the US household savings rate now rising significantly, we may see a return to a situation of the US running only modest current account deficits of 1%–2% of GDP. If this happens, it should allay the market’s concerns about a dollar meltdown. Concerns about a downgrade of US government debt as a result of the sharp rise in the ratio of government debt to GDP in response to the global financial crisis could also weigh on its role as a reserve currency. However, these concerns also apply to other major currencies, so the net effect is minimal.
IS THE RENMINBI READY TO BE AN INTERNATIONAL CURRENCY?

Seung-Gwan Baek

Recently the Government of the People’s Republic of China (PRC) raised the question of the role of the US dollar as a reserve currency and started taking concrete steps towards the internationalization of the renminbi. However, many researchers such as Cooper (2009) and Morgan (2009) in this roundtable session and Eichengreen (2005) argue that it is too early for the renminbi to be internationally used. The main reason is that capital is tightly controlled and financial markets are not developed. In addition, Eichengreen also points out uncertainty in the security of property rights and low democratic accountability in the PRC.

In this discussion paper, I will present data relevant to the reason that the renminbi cannot get international currency status for a while. I will use data for seven countries (the United States [US], the United Kingdom [UK], Japan, France, Germany, Netherlands, and Switzerland), whose currencies have been internationally used, and for eight East Asian countries (the Republic of Korea [henceforth Korea]; the PRC; Singapore; Hong Kong, China; Indonesia; Malaysia; Philippines; and Thailand), to evaluate whether the renminbi can be a candidate for a regional currency.

A. Economic Size and Confidence in the Value of the Currency

The literature has identified several factors that determine the international currency\(^1\). The first one is that a country should have a large share of international output and trade. Figure 1 compares the shares of gross domestic product (GDP) (measured at purchasing power parity) and export for 15 countries and in the euro area. In 2008, the PRC’s share of global GDP was 10.8%, much smaller than that of the US (21.2%) and the euro area (16.1%) but larger than that of Germany (4.3%) and Japan (6.6%). For exports, the PRC, whose share was 7.2% in 2006, was behind the euro area but very close to the United States and Germany. Therefore, in terms of economic size, the renminbi is competent as an international currency.

The second factor is confidence in the value of the currency, i.e., the value of the currency should be stable. Figure 2 shows the annual inflation rate and monthly change in exchange rate for 2000-2007. During this period, the PRC experienced inflation rates lower than those of major international currency countries such as the United States, the United Kingdom, and those in the euro

\(^{1}\)E.G., see Tavlas(1991), Tavlas and Ozeki(1992), and Chinn and Frankel (2006)
area. In East Asia, only Singapore and Hong Kong, China have inflation rates lower than that in the PRC. Among international currencies, the US dollar and yen depreciated, on average, for this period while the others, including the euro, appreciated; there was virtually no change in the renminbi, however. Inflation volatility and exchange rate volatility for the same period are shown in Figure 3. The PRC’s inflation volatility was the highest except for Indonesia and the Philippines; it was more than twice that of Japan and the euro area. However, the renminbi was the one of the currencies which is most stable. Regarding confidence in currency value, in summary, the renminbi is in a good position to be used as an international currency if inflation volatility is mitigated.

B. Capital Control and Financial Markets

The third factor is associated with financial markets. The country should have financial markets that are large (its size), deep (including secondary markets), broad (a large assortment of financial instruments traded), and open and free of controls. Looking at data on financial markets, we can easily see that the renminbi is not ready to be an international currency, or even a regional currency.

1. The foreign exchange market is small and not developed

Table 1 presents daily foreign exchange turnover in April 2007 for international currency countries and East Asian countries. The PRC’s daily turnover value was $9 billion, and its share of global turnover was only 0.2%. The size of the PRC’s foreign exchange market is very small compared not only to international currency countries but also to Korea; Hong Kong, China; and Singapore. Turnover mostly occurred at the spot exchange market whose share in total turnover was about 90%, which was the highest even among East Asian countries (Table 2).

Table 3 shows daily foreign exchange turnover by currency for 2004 and 2007. The amount of daily trading of the renminbi significantly increased, from $3.6 billion in 2004 to $14.6 billion in 2007, but fell far behind that of international currencies. In addition, the share of offshore trading was 38% in 2007, about 50% of major currency shares. When offshore trading is defined as that between two nonresidents, the renminbi was not internationally used as much as major international currencies.

2. Capital is tightly controlled

Table 4 shows data for capital control from the Annual Report on Exchange

\(^2\)An outlier, Indonesia, is excluded. For Indonesia, inflation volatility is 2.34% and exchange rate volatility is 3.27% for 2000-2007
Arrangement and Exchange Restriction published by the International Monetary Fund (IMF), where financial accounts comprise 11 elements. According to data in 2006, the PRC was the only country where capital control existed in all 11 elements. There was no restriction on capital flows elsewhere, with an exception of one element each for the United Kingdom, Netherlands, and Hong Kong, China. The international currency countries which controlled capital flows most were Japan and Germany, regulating seven out of 11 elements.

Another popular measure of capital control is financial openness measured as the ratio of the sum of private capital outflows and inflows to GDP. Greater financial openness reflects less capital control imposed. As expected, the one country where there was nearly no control in the financial account was the United Kingdom, whose financial openness was 123% in 2005. The Netherlands, Switzerland, Singapore, and Hong Kong, China were also highly open in control of the financial account. However, the PRC’s financial openness was 11%; only Korea and Indonesia were financially less open than the PRC in East Asia.

3. Financial markets are narrow and not developed

Table 5 shows the size and development of financial markets for the countries concerned. The PRC was the biggest holder of foreign reserves, but had relatively small financial markets. In 2006, the GDP ratio of financial assets, defined as the sum of domestic money bank assets, debt securities, and total value of stocks traded, was over 700% for the United Kingdom, Switzerland, and Hong Kong, China. France’s financial market was the smallest (342%) in size among international currency countries, but the PRC’s ratio was only 230%, similar to that of Thailand and even smaller than Malaysia in East Asia.

Financial markets are also undeveloped. Data on the banking and nonbanking sectors are not available for the PRC. Data for stock and bond markets indicate that the PRC was far behind international currency countries in the efficiency of direct financing. The extent of the PRC’s stock and bond market capitalization was very low compared even with that of other East Asian countries.

4. Capital markets are not internationalized

Table 6 shows outstanding debt securities, which consists of domestic and international securities, issued by each country in 2007. The United States issued the largest amount of international debt securities ($5.6 trillion outstanding), followed by Germany ($3.0 trillion) and the United Kingdom ($2.5 trillion). Note that the total amount of international debt securities was more than twice that of domestic securities, indicating that the United States had a highly

---

3 We use data of Beck, Demirguc-Kunt, and Levine(2006), where 2004 is the last year accessible.
internationalized debt securities market, as did the other international currency countries other than Japan and France. The issue of debt securities by the PRC has not only been small in total amount but is also mostly domestic and not international; its international share was only 2.2%.

Table 7 presents the outstanding amount of international short-and long-term debt securities by currency in December 2007. According to the table, international debt securities issued were denominated mostly in euro and US dollars; the yen’s share was less than 3%. For the renminbi, there were no international money market instruments issued. The total balance of international bonds and notes issued in renminbi was $6.4 billion, much smaller than those issued in Singapore dollars and Hong Kong dollars in East Asia. The renminbi share in the world market was only 0.03%.

5. The banking sector is not internationalized

Figure 4 compares each country’s share of global positions in external assets and the liabilities of banks in 2007. The United Kingdom and the United States outstripped the other countries in both assets and liabilities. Japan’s share was about 2%, which was the lowest among international currency countries. The PRC and Korea, whose shares were less than 1% each, fell behind Singapore and Hong Kong, China.

Table 8 presents the total foreign claims of banks, which are defined as the sum of international and local claims of banks, in 2007. As expected, the United States and the United Kingdom had the largest shares of global foreign claims. The PRC had $282 billion of foreign claims of banks, which was smaller than those for Korean banks ($372 billion); the PRC’s share of global foreign claims was only 0.8%.

C. Trade Pattern

Turning to the other determinants of an international currency, the fourth factor is associated with trade patterns. It is known that invoicing in a country’s currency occurs more frequently to the extent that more differentiated manufactures are exported and the country exports more to developing countries. In Figure 5, the shares of differentiated manufactures exports are compared with those of exports to developing countries in 2007. We use data for machinery and transport equipment that represent differentiated manufactures. The figure reveals that all East Asian countries, including the PRC but with the exception of Malaysia, had larger export shares than international currency countries. Note, however, that the PRC’s share of exports to developing countries was the lowest among East Asian countries. Thus, the renminbi is superior to current vehicle currencies but inferior
to East Asian currencies as far as trade patterns are concerned.

**D. Country Risk**

Low country risk is also required for an international currency. Table 9 shows the political risk index from the International Country Risk Guide in December 2007 published by the PRS group, that appraises the political instability of a country. The index comprises 12 subcomponents, and a higher number denotes lower risk. The PRC’s risk number, 70.5, shows that the PRC had a higher political risk than all reserve currency countries and Korea, Singapore, and Hong Kong, China in East Asia. The high risk in the PRC was attributable mainly to corruption, bureaucracy, and democratic accountability.

**E. Trade in East Asia**

For the renminbi to be a regional currency in East Asia, the PRC’s trade share in the region needs to be high. Figure 6 shows data for regional export and import shares of East Asian countries in 2007. We can see that the PRC and Japan have the lowest shares for both export and import among East Asian countries. Figure 7 presents total portfolio investment among East Asian countries in 2006. Notice that the PRC’s holdings for financial assets were zero, but East Asian countries held $126 billion of PRC assets, and their share in total PRC assets was 45%. Singapore, followed by Hong Kong, China, was the largest investor in East Asia. Japan’s asset trade with other East Asian countries was relatively large in absolute terms but its share of global portfolio investment was extremely small, at 1% for assets and 2% for liabilities. Regarding trade in goods and financial assets, in summary, the renminbi and yen do not have an advantage over other East Asian currencies.

**F. Conclusion**

Unless the Government of the PRC cares for financial markets that are tightly controlled, small, and undeveloped, the renminbi cannot be internationally or regionally used in the near future. Institutional quality and democratic accountability must be improved. For a regional currency, the PRC should have more trade in goods and assets with East Asian countries where currency competition is expected to occur among the yen, the Hong Kong dollar, Singapore dollar, and the renminbi.

**References**

Is the renminbi ready to be an international currency?

World Bank. 2007. World Development Indicators.
Figure 1. Share of GDP and Export

Note: GDP share, 2008; Export share, 2006;
US = the United States, GBR=the United Kingdom, FRA=France, DEU=Germany, NLD=Netherlands, CHE=Switzerland, EURO=the Euro area, KOR=Korea, CHN=China, SGP=Singapore, HKG=Hong Kong, IDN=Indonesia, MYS=Malaysia, PHL=Philippines, THA=Thailand.
Source: IMF. 2009. World Economic Outlook Database.

Figure 2. Inflation and Change in Exchange Rate

Note: Inflation is calculated as an annualized percentage change in monthly CPI over the corresponding period of previous year. Change in exchange rate is calculated as log difference of monthly SDR exchange rate, averaged.
Is the renminbi ready to be an international currency?

Figure 3. Volatility

Note: Inflation volatility is defined as the standard deviation of annualized monthly inflation. Exchange rate volatility is calculated as the standard deviation of the log first difference of monthly SDR exchange rate.

Figure 4. External Positions of Reporting Banks for All Sectors, 2007

Figure 5. Trade Pattern: Shares of Total Export, 2007


Figure 6. Trade among East Asian Countries

Is the renminbi ready to be an international currency?

Figure 7. Total Portfolio Investment among East Asian Countries, 2006

Table 1. Foreign Exchange Market Turnover

<table>
<thead>
<tr>
<th>Economy</th>
<th>$ billion</th>
<th>%</th>
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<td>China, People’s Rep. of</td>
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<td>0.2</td>
</tr>
<tr>
<td>France</td>
<td>120</td>
<td>3.0</td>
</tr>
<tr>
<td>Germany</td>
<td>99</td>
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</tr>
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<td>Great Britain</td>
<td>1,359</td>
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</tr>
<tr>
<td>Hong Kong, China</td>
<td>175</td>
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</tr>
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<td>Indonesia</td>
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<tr>
<td>Japan</td>
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<td>6.0</td>
</tr>
<tr>
<td>Korea, Republic of</td>
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<td>0.8</td>
</tr>
<tr>
<td>Malaysia</td>
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<td>0.1</td>
</tr>
<tr>
<td>Netherlands</td>
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<td>Philippines</td>
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</tr>
<tr>
<td>Singapore</td>
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</tr>
<tr>
<td>Switzerland</td>
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<td>6.1</td>
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<td>United States</td>
<td>664</td>
<td>16.6</td>
</tr>
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Notes: Figures are daily averages in April 2007.
Percentage figures denote each country’s percentage share of world foreign exchange daily turnover.
Table 2. Daily Foreign Exchange Turnover by Instrument, April 2007

($ billion, and percent)

<table>
<thead>
<tr>
<th></th>
<th>Total</th>
<th>Spot</th>
<th>Outright forwards</th>
<th>Swap</th>
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<td></td>
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<td>(9.1)</td>
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<td>100.9</td>
<td>25.6</td>
<td>111.9</td>
</tr>
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<td></td>
<td>(100)</td>
<td>(42.3)</td>
<td>(10.8)</td>
<td>(46.9)</td>
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<td>FRA</td>
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<td>(22.9)</td>
<td>(52.3)</td>
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<td>(24.0)</td>
<td>(63.0)</td>
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<td>(44.9)</td>
<td>(7.0)</td>
<td>(48.2)</td>
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<td>KOR</td>
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<td>17.4</td>
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<td></td>
<td>(100)</td>
<td>(52.2)</td>
<td>(15.4)</td>
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<td>CHN</td>
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<td></td>
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<td>HKG</td>
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<td></td>
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<td>(69.9)</td>
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<td></td>
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<td>(59.9)</td>
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<td>1.4</td>
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<td>(40.6)</td>
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<td></td>
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<td>(8.7)</td>
<td>(44.7)</td>
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<td>4.1</td>
</tr>
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<td></td>
<td>(100)</td>
<td>(22.4)</td>
<td>(11.1)</td>
<td>(66.5)</td>
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Note: Numbers in parentheses denote the share of total foreign exchange daily turnover.
Table 3. Daily Foreign Exchange Turnover by Currency

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<tr>
<th>Currency</th>
<th>2004</th>
<th>2007</th>
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<tr>
<td></td>
<td>Global</td>
<td>Domestic</td>
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<td>US dollar</td>
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<td>Euro</td>
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<td>Yen</td>
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<td>Pound sterling</td>
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<td>Swiss franc</td>
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<td>Renminbi</td>
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<td>Hong Kong dollar</td>
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<td>Indonesian rupiah</td>
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<td>Philippines peso</td>
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<td>555</td>
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<td>Singapore dollar</td>
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<tr>
<td>Thai baht</td>
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Table 4. Capital Control, 2006

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<th>Capital market securities</th>
<th>USA</th>
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<th>FRA</th>
<th>DEU</th>
<th>NLD</th>
<th>CHE</th>
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<td>Guarantees, securities, and financial backup facilities</td>
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<tr>
<td>Financial openness(^a) (%)</td>
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<td>16</td>
<td>33</td>
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<td>7</td>
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<td>13</td>
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</table>

Note: 0 = control; x = no control.

\(^a\) 2005

### Table 5. Size and Development of Financial Markets

($ billion, and percent)

<table>
<thead>
<tr>
<th>Size</th>
<th>USA</th>
<th>GBR</th>
<th>JPN</th>
<th>FRA</th>
<th>DEU</th>
<th>NLD</th>
<th>SWI</th>
<th>KOR</th>
<th>CHN</th>
<th>SGP</th>
<th>HKG</th>
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<th>MYS</th>
<th>PHL</th>
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<td>Nominal GDP</td>
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<td>2,402.0</td>
<td>4,377.1</td>
<td>2,252.1</td>
<td>1,575.9</td>
<td>670.9</td>
<td>388.4</td>
<td>1,427.0</td>
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<td>136.6</td>
<td>190.0</td>
<td>364.4</td>
<td>156.1</td>
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<td>40.7</td>
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<td>41.1</td>
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<td>4,273.2</td>
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<td>921.6</td>
<td>174.7</td>
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<td>73.1</td>
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<td>94.6</td>
<td>178.3</td>
<td>77.1</td>
<td>121.9</td>
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<td>4,167</td>
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<td>1,763.2</td>
<td>757.44</td>
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<td>174.7</td>
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<td>1.47</td>
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<td>Private credit(including other)</td>
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<td>1.48</td>
<td>0.99</td>
<td>0.88</td>
<td>1.13</td>
<td>1.6</td>
<td>1.57</td>
<td>1.25</td>
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<td>1.47</td>
<td>0.21</td>
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<td>0.97</td>
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<td>0.56</td>
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<td>4.86</td>
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<td>0.31</td>
<td>0.21</td>
<td>0.19</td>
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<td>0.37</td>
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Table 6. Capital Markets, 2007

($ billion, and percent)

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<th>Country</th>
<th>International debt securities(1+2)</th>
<th>International money market instruments(1)</th>
<th>International bonds and notes(2)</th>
<th>Domestic debt securities</th>
<th>International equities</th>
<th>Stock market total value traded</th>
<th>Stock market total value traded/GDP (%)</th>
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<td>15.8</td>
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<td>4,997.4</td>
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<td>69</td>
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<td>2,629.6</td>
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<td>1,763.2</td>
<td>63</td>
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<td>1,051.9</td>
<td>902</td>
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<td>757.4</td>
<td>121</td>
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<td>94.6</td>
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Note: a 2005.
### Table 7. Outstanding Amount of International Debt Securities by Currency, 2007

($ billion)

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<th>International money market instruments</th>
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<th>International bonds and notes</th>
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<td>Total Share (%)</td>
<td>Total Share (%)</td>
<td>Total Share (%)</td>
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<td>21,576.69 100</td>
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<th>Local claims (2)</th>
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Note: International claims = consolidated cross-border claims in all currencies and local claims of the banking group’s foreign offices in foreign currencies;

Local claims = local claims of the banking group’s foreign offices in local currencies.

Table 9. Political Risk Index, December 2007

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<th>DEU</th>
<th>NLD</th>
<th>SWI</th>
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<th>CHN</th>
<th>SGP</th>
<th>HKG</th>
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1. Will the dollar continue to play the dominant role in the future? Will the dollar remain strong in the future?

The supremacy of the dollar is likely to decline, though it will take time. One reason is that the economic power of the United States (US) will be weaker in the future and it will be reflected in the status of the currency. Another reason is that, regardless of economic power, the implosion of the US financial structure has severely impaired its image as the home of stable institutions and the anchor of the world economy.

Will the dollar remain strong in the future? Relative to what currency? Overall, I bet the dollar will be weaker than now. It may be ironic that the dollar, which had been expected to depreciate for a long time, has been strong until now. The dollar was strong simply because of the need for liquidity during the current turmoil. Once the global crisis abates, however, such need will diminish and the dollar’s strength will evaporate against Asian currencies and the dollar will decline due to the huge current account deficit against Asian countries, among others. Against the euro, it is uncertain if the dollar will be strong or weak.

2. What do you think of the future of the euro zone? Will there be a widening of the euro zone?

The euro will be a key currency in line with the economic power of the European Union (EU) and its importance in international trade and finance. However, it is not likely that the euro will replace the dollar as a dominant currency. There are two obvious reasons why the economy of the EU is not as powerful as that of the US. First, in the past the euro zone had been believed to be relatively independent of the US economy, but the current crisis has proved that the euro zone is also very much linked to the US economy and is vulnerable to fluctuations in it, and they did not believe that the euro could become a new anchor to replace the dollar.

Second, it seems that the EU has many difficulties in resolving its own problems. If the euro zone is to widen, western EU countries should firmly show that they will not let eastern EU countries go under, and that they will do their best to avert such disaster. During the current crisis, when Eastern European countries were on the brink of collapse, Western European taxpayers were worried that easterners were after their hard-earned cash and didn’t believe that Western Europe would rescue Eastern Europe. This hesitation in helping the east,
combined with protectionist instincts, was the doom of any chance of further
enlarging the EU and widening the euro zone.

3. Is there a chance for the renminbi or yen to be a key currency?

Unless the Japanese economy rebounds and finds new strength, the yen will
become weaker in the future, and is unlikely to be a key currency.

The renminbi is likely to be a key currency not only in Asia but also in the
world if the economy continues to grow as it has been doing. However, if the
renminbi is to be a dominant currency by replacing the role of the dollar in Asia,
it should not follow the mistake made by Japan with the yen.

In the 1980s, Japan increasingly became the primary source of capital,
technology, aid, and markets for the regional economy, replacing the US as the
dominant financial power. Even though it has been a major player, however,
Japan has neither played the leadership role in presiding over the
institutionalization of regional monetary cooperation, nor been accepted as the
leader by the rest of East Asia. Japan’s lack of success in converting economic
might into a key currency country is attributed to two features of Japan’s attitude
towards regional (monetary) cooperation: its bewildering Asia-West dual national
identity, and its unwillingness to bear the burden of having a key currency. First,
since the mid-19th century, Japan’s identity has been predicated upon the
perplexing dilemma posed by its often conflicting orientations towards the West
and the East. The Japanese attempt to construct a new sense of national identity
was centered upon reinterpreting Japan’s position between Asia and the West,
and rendered Asia as something to be dissociated from. This Janus’ identity has
left Japan with serious legacies. One of these is that Japan has always wanted the
involvement of Western countries such as the US in regional matters. It may be
because Japan has thought of its main role as a mediator between the West and
Asia, or because it has thought that checking (or overcoming) the dominance of
the People’s republic of China (PRC) in the region would be difficult without the
presence of Western countries, especially the US. Another legacy is that attitudes
such as this have made East Asian countries suspect that Japan is more concerned
with its relations with countries outside the region than with regional members—
when there is conflict between the two, Japan has consistently declined full
involvement in regional initiatives. Second, with the expansion of economic
power, Japan has made efforts to play a more important role in the international
monetary arena but without taking the burden of what a leader is expected to bear.
An example is the effort to internationalize the yen in the 1980s, which failed,
even though the Japanese economy was at its peak at that time. Two main fears
were behind the failure. One is that Japan feared that internationalization of the
yen could lead to domestic monetary policy being influenced by external matters,
a situation that Japan opposed. The other is that internationalization of the yen might require Japan to import more from East Asian countries in order to supply yen to the region, which would reduce the current account surplus on a large scale. Japan was not yet ready to accept this burden as a key currency country.

It now seems that the time when Japan could have seized leadership may have passed, and the PRC is on the rise. Although the PRC economy is sure to keep growing for the time being and its political weight is the strongest among East Asian countries, there are still constraints on the PRC’s leadership role as a key currency country for several reasons. First, the PRC is not yet developed enough to take on the burden of sustaining and providing a stable international economic and monetary order. Second, although the PRC has transformed towards a more market-oriented economy, it is still a highly authoritarian communist regime. It is not certain that the PRC economic system would provide policies that would lead to mutual benefits. For example, the PRC’s avoidance of the Asian financial crisis is attributed to its capital control policy, and it is often suggested that such a policy should be followed to prevent and overcome a crisis. However, capital mobility is now naturally taken as the world’s destiny, and capital control as tight as that of the PRC can put the regional economic integration process in peril. Thus, it is questionable whether following the PRC’s policy would enhance mutual benefits to the countries in the region. Third, although the PRC has taken pains to allay fears of the PRC threat, suspicions of the country’s intentions are growing rather than reducing as it steadily expands its economic and military strength. Perennial resurrection of such conflict may lead East Asian countries to approach outside countries, in particular the US, to resolve internal conflicts.
Richard N. My topic is the future of the dollar and I am just going to go to the bottom line, and the bottom line is that I expect the United States (US) dollar to remain the dominant—not the only, but the dominant—currency for as far ahead as the next 1–2 decades. We’ve learned over the last 20 years how big changes can take place. I think it is a very stable equilibrium and it would take a huge shock to dislodge the dollar from its role as an international currency. And I discuss two possibilities, one of which is alternative existing currencies. While the reasons differ from case to case, I don’t find any feasible alternative to the US dollar among existing national currencies, including the euro, and I put more emphasis than most economists do on the character of financial markets. As the US central bank mentioned years ago, the breadth, depth, and resiliency of the US capital market makes it extremely easy for everyone to deal in dollars. The scale is also important, as we have discovered recently. With the growth of reserves in countries such as Japan, and now especially the People’s Republic of China (PRC), scale is especially important. If you look around the world the only financial market that can handle the scale with high liquidity is the US dollar, and in particular the US Treasury securities. We saw an example of that during last autumn.

So, I don’t see any of the existing currencies providing serious rivalry to the dollar. The euro I think will become more important, but its use will be concentrated in member countries of the European Union (EU), and prospective members of the EU will find it convenient for practical reasons to increasingly use euros. So, I expect the share of the euro in the world’s use of national currencies to rise slowly, but that is
completely consistent with continued growth in the use of the dollar.

There is another alternative, which is the deliberate conscious substitution of a synthetic currency. The obvious candidate, although we can apply our imagination more broadly, is the special drawing right (SDR), and this picks up the theme of Governor Zhou of the People’s Bank of China. What he didn’t mention, and which many of you may not know, is that it is, today, an actually stated internationally agreed policy to move the SDR to the center of the monetary system. It is written in the articles of agreement of the International Monetary Fund (IMF), in the amendment of 1978. It was an agreement of the mid-1970s which has been totally ignored by everyone, but it is, officially, a policy of the world community. I think that it is possible, but to do it would requires a conscious decision by the leading governments of the world and deliberate hard work to make it stick.

A number of serious practical problems have to be solved. The first of these is that the SDR, as currently constituted, can not be used by private parties. It can be used, of course, as a unit of account by anyone at any time, and the fact that it is used so little as a unit of account should tell us something. As a means of payment or a stored value, to make it work we would have to essentially redesign the SDR and allow private parties to use it. Now it is just used as a vehicle among monetary authorities—the IMF and a few other select institutions such as the World Bank and the Bank for International Settlements.

Another practical problem is, if one thinks about literally substituting the SDR for the dollar, what does one do about all the outstanding dollars? This needs to be solved somehow. I assume countries are not going to be willing to write off the obligations of the US. My point is, I think that as a part of monetary reform one could imagine moving consciously to the SDR but a lot of practical problems need to be solved in order to achieve that. Achieving that alone, I am not sure what problem that solves. What problem is solved by substituting the SDR for the dollar? I think we need to discuss that issue. I think that thinking about the SDR as an international currency needs to be thought about only as a part of the package which is a part of a much bigger deal, which involves exchange rate management, macroeconomic policy, and coordination of macroeconomic policies among the major countries. Once we get into the discussion of deep reform of the monetary system, most of the controversies will not surround the creation of the SDR.
So I think we, as economists, need to think about these issues, about what is the problem to which substitution of the SDR for the dollar, by itself, is the solution. Or do we just use that concept as a circuit for a set of much deeper issues involved in reforming the monetary system? I leave you with that question.

Shin-ichi Fukuda

Basically I will talk about the currency issue in terms of the currency used for the transaction of international trade. For over half a century the US dollar has been the dominant vehicle currency, as most of the payment in international trade has been done in US dollars. However, during the last decade, East Asian countries have experienced various dramatic structural changes, such as the currency fluctuation in Japan and other countries. So, looking at the recent issues may give us some hint as to the future of the currency regime for Asian countries. There are several reasons why the US dollar has been the dominant vehicle currency in East Asia.

One reason is the economic power of the US, which has been quite dominant in the world economy since after the World War II, and once an international currency is established it would need a large change in the economic environment to replace it. Asian countries have developed but not enough to overcome this historical issue.

The second factor why the US dollar has been dominant is because of the less-developed nature of the capital markets in East Asia. Although many Asian countries have developed their capital markets recently, the US capital market is still more developed, particularly the short-term capital market which is especially important for currency trade.

The third factor is that the trading companies that dominate international trade do not need to hedge their exchange rates as they are engaged in both exports and imports. Let me briefly look at what happened to Japan’s export during the first decade. In the early 1970s, although Japan had already become the second-largest country in the world in terms of gross domestic product (GDP), almost all exports used the US dollar and more than 90% of transactions were in US dollars. During the 1980s, the Japanese capital market was liberalized and the Japanese economy further developed, after which the use of the US dollar declined dramatically and the use of yen increased. So, in terms of exports, the US dollar is no longer dominant and since the mid-1980s the situation has been quite stable and there has been no dramatic change. Even when we had various structural changes—such as rapid appreciation of the yen, the Asian financial crisis, depreciation
of the yen, and also the change of trade structure due to the rise of the PRC—it did not change the basic feature of the use of the US dollar and yen in international trade. Moving to the Korean case, as with Japan, the US dollar was highly dominant but because of some capital market development the use of the US dollar declined over time. There is a lot of difference between Japan and the Republic of Korea (henceforth Korea); the decline in Japan was much larger than that in Korea. A similar situation is happening with Thailand’s exports, where there is some decline in the share of the US dollar.

In Thailand there are some changes, for example when we focus more on the details of exports and imports. When importing from Japan, the yen is widely used, and because of the rise of euro, that currency is more dominant than the dollar in Thailand’s imports from several European countries. Not surprisingly, for Thailand’s international trade with NAFTA countries, the US dollar is dominant, but what is notable is that the US dollar is still dominant in Thailand’s international trade with several major East Asian countries, e.g., for trade with Singapore 90% of the transactions are in US dollars.

In addition, an important feature of East Asian countries is that no country has a dominant trade partner for international trade—Asian countries have a variety of trade partners; the US is an important trade partner but not a dominant one. Particularly in recent years, other East Asian countries, especially the PRC, have become quite important trade partners. So this trade structure probably suggests that the use of the US dollar may disturb the real expected exchange rate in Asia.

The current structure that is dominated by the US dollar is not necessarily the most efficient regime to stabilize the real exchange rate in Asia. It could be a coordination failure, and in that sense we need to discuss what the desirable currency regime is from the viewpoint of regional cooperation.

Chalongphob The reason why many countries denominate their trade in US dollars is because it is cheaper to use than other currencies.

Jung Sik I would like to summarize the three issues. One, what will be the US dollar’s value in the future? Two, the role of the dollar as the key currency. Three, other currencies taking the role of key currency.

First, there have been few studies about key currencies. Why do countries have demand for a key currency? There are some benefits
and costs of holding and using key currencies, and the benefits are greater than the costs. There are several functions that need to be satisfied to become a key currency. First is the unit of account; another is the function as a lender of the last resort. When a country experiences a crisis, the key currency or the country should be the lender of last resort. To become the key currency, the following conditions should be satisfied: the size of the economy, the role as the invoicing currency in international trade, the openness of the financial market, convertibility, and low inflation.

And the first issue is the dollar’s value, which has been decreasing since the 1960s. When we review it historically, we can see that it has been continuously decreasing in value. What will happen to the dollar’s value in the future? The US trade deficit is currently about 6% of GDP. While the US deficit and debt have increased, it is difficult to solve these problems so we can expect the dollar’s value to decline further in the future. In the short run, by safe-haven hypothesis, the value could be strong, but in the long run I expect the value to decrease. When you see this table, which shows the composition of the US trade deficit, you can see that the US trade deficit in 2008 was about $800 billion, the PRC’s proportion is 33%, Japan’s is 9%, and Korea’s is 1.7%. This means that the relationship between the US and the PRC is very important to reducing the trade deficit. The global imbalance, or the US deficit, is very important in determining the value of the US dollar.

How can the US reduce the trade deficit? There are two options. One is to reduce expenditures, and the other is to adjust the renminbi—dollar exchange rate. However, it is difficult to adjust the exchange rate because the renminbi is not an international currency. In 1995, the US could adjust the renminbi—dollar exchange rate through the Plaza agreement, but the situation is different this time. These are the reasons why I expect the dollar’s value to decrease in the future.

The other is the key currency problem. I think the US dollar will remain as a key currency because its proportion of use as an invoicing currency in international trade is high, with well-developed financial markets and, as Professor Cooper emphasized, the US is a young economy and there could be inflows into the US.

Also, the fact that there is no alternative is another reason. When you look at the international reserves data, the proportion of the dollar is 64%, the euro 7%, and the yen 3%. When you see the International
Monetary Fund (IMF) data, the trend is that the US dollar’s proportion in international reserves of central banks has been decreasing, from 71% to 64%, with an increase in the proportion of the euro, yen, and the pound sterling. So, based on these statistics, you can see that the US dollar remains the key currency but its role is decreasing.

I think the euro’s role is increasing because the euro zone is expanding and more countries will join the euro zone. The euro’s value, I think, is stable because the countries in the euro zone have already prepared the convergence criteria and can maintain a stable exchange rate. The role of the renminbi will increase. The PRC has huge international reserves and trade volumes, and the renminbi could become a regional key currency in Asia, but there are many problems with this: high inflation and the less-developed and not opened financial market, and the convertibility problem. Perhaps it could be a key currency in the future, but not now. The yen could also be one of the key currencies.

So, based on this argument, I think that the international monetary order will move towards a multiple key currency system with three or four currencies, and in this system there could be competition among the key currencies.

Peter J. Morgan

I find that I agree with what Professor Cooper was arguing, but I just want to talk briefly about some of the arguments, both in favor and against the continuation of the dollar’s role as a reserve currency.

In terms of arguments in favor, first is the inertia of the fixed investment in the current system. Second is its continuing dominant role in Asian trade. Third is the issue of the dollar track. Countries such as the PRC have made huge investments in dollar assets. If you look at the real effect of the exchange rate of the US dollar, it has been quite stable. Finally, there is the technical difficulty of shifting to an artificial unit such as the SDR. I think the main argument against the US dollar was put forth by countries such as the PRC, because there is a lot of potential risk from the external balances and concerns about the rise in the US government debt ratio.

I will talk more about the points that Professor Cooper did not mention.

First is the role of the PRC, which is important because it holds 27% of the world’s foreign exchange reserves and 12% of US treasuries. PRC currency policy is still anchored to the dollar and there is therefore a huge problem of trying to exit from that role. If the PRC had tried to
diversify in a meaningful way, it would have basically crashed both the dollar and the US Treasury market. It is interesting, as it seems that even if Governor Zhou put forward the idea of switch to the SDR, the PRC at the G-20 meeting was not particularly in favor of moving in that direction.

Just in terms of the trend of the US dollar, there has been a lot of volatility as a whole over time, but there has not been any trend. So in real terms there is no trend issue but only a volatility issue.

I don’t think it is worth getting into the issue of trade imbalances. There actually has been an amazingly rapid improvement in the imbalances in just the past 6 months. You can see that the US trade balance as a percentage of GDP has gone from -6.0% in 2006 to only about -2.5% as of the most recent data. So, we’ve already seen more than half of the long slide that we saw, particularly in 1997–1998, which by coincidence was the time of the previous Asian financial crisis. So it does suggest that the rebalancing has already happened to a great extent and maybe we shouldn’t worry about it as much as some speakers have suggested.

The reason for that is pretty clear. From the data, you can see that the savings rate of US households has gone from 0% in 2006 to around 4%, which is a huge shift in a short period of time, and is back to the level of 1997–1998.

Talking about the outlook for the euro zone, if you look at the countries that are in the next stage of entering, we currently have four: Denmark, Estonia, Latvia, and Lithuania. Denmark is a medium-sized country but the other three are pretty small. The main point is that the large countries, such as the United Kingdom and Sweden, are unlikely to join. In terms of the outlook for the yen and renminbi, the yen has probably already peaked in its role as a reserve currency. Obviously its economic role is going to decline in line with the aging population, and the Tokyo financial market is still somewhat regulated, so it is unattractive as a financial center. Certainly the role of the renminbi is going to increase, assuming that convertibility is eventually achieved.

Seung-Gwan Baek I read the papers of Professor Cooper and Morgan and agree mostly with what they wrote. I picked out one topic regarding the possibility of the renminbi being an international currency.

Most people, including Eichengreen and Morgan, argue that the
renminbi is not ready to be an international currency. Professor Kim just mentioned the conditions for being international currency, and many people say the PRC’s problem is that financial markets are not developed and capital is tightly controlled. Thus I will concentrate on the financial market.

When you look at data on the PRC’s foreign exchange market, it is very small and not developed. The PRC’s daily foreign exchange turnover is just $9 billion, 0.2% of the world’s share, and around 90% of the turnover occurs on the spot exchange market, which means that the derivative market is not developed. When you see the daily foreign exchange turnover by currency, the renminbi’s offshore trade is only about $5 billion-$6 billion, which is relatively small compared to other countries, and the share of offshore global trading is only around 30%. So the data shows that the renminbi is currently not used as an international currency.

Many people point out that there exists heavy capital control in the PRC. Let me show the data from the Annual Report on Exchange Arrangements and Exchange Restrictions published by the IMF. You can see that there are 11 elements in financial accounts and the PRC is the only country that controls all 11 items.

Table 5 shows the size and degree of development of the financial market. The PRC holds the most international reserves in the world. Other indicators show the size of the PRC’s financial market, such as the financial assets to GDP ratio of 29%, which is relatively small and is similar to the level of Malaysia and Thailand. Regarding the development of financial markets, you can see that the PRC’s stock and bond markets are not developed at all relative to other countries, even among East Asian countries. Capital markets are not developed and not internationalized; the share of international securities out of total securities is only about 0.2%.

Figure 4 and Table 8 show that the PRC’s banking sector is also not at all internationalized. The shares of external assets and liabilities are low, as are the external loans and deposit ratios. The PRC also has very small total foreign claims in banks.

All of these data indicate that the PRC banking sector, financial market, and capital market are not yet developed. It will take a long time before the renminbi can be used as an international currency unless the financial markets are open and more developed.
Yeongseop Rhee

I would like to provide my direct opinions on the three questions I was given.

First is the future of the dollar, which is composed of two smaller questions about the dollar’s role, and whether the dollar will appreciate or depreciate in the near future.

Regarding the dollar’s role, I think that the value of the dollar is likely to diminish in the future. Many scholars have provided various reasons, but one reason is the economic factor. The economic power of the US will be weaker in the future than it is now, and this will be reflected in the status of the dollar. Another reason is that, regardless of the economic power, the current implosion of the US financial market has severely damaged that country’s image as the home of stable institutions and anchor of the world economy.

Regarding the strength of the dollar, overall it will be weaker in the near future. It may be an irony that the dollar, which had been expected to depreciate for a long time, has been strong until now. As Professor Kawai mentioned in his remarks, the dollar was strong simply because of the need for liquidity during the crisis. However, once the global crisis is over, the need will shrink and the dollar will weaken. Against Asian currencies, I think that the dollar will be weaker in the future, but against the euro, I am not quite sure.

The next question is about the future of the euro zone and whether there will be a widening of it. I think that the euro will be a key currency, but I am not sure whether it will replace the role of the dollar because the economy of the European Union (EU) is not as strong as that of the US, although the situation may change in the near future. Another reason for thinking this way is that, in the past, the euro zone was believed to be independent of the US economy while Asia was very much dependent. However, the current crisis has proved that the euro zone is also very much linked to the US economy and is vulnerable because of that. European countries have failed to believe that the euro could become a new anchor.

We could think of another reason for thinking in this way. The EU has a lot of issues in resolving its own problems. If the euro zone is to be widened, western EU countries should show firm belief that they will go together with eastern EU countries. During the current crisis, however, western taxpayers were worried about their money being
spent in the east. So the hesitation in helping the east, combined with protectionist instincts, spelled the doom for any chance of further expanding the EU and further widening the euro zone.

Finally, regarding the question about the renminbi and the yen, the role of the yen will be diminished, not only in the world but also in East Asia, unless there is a rebound in the Japanese economy and Japan sustains its economic position.

Regarding the renminbi, I think that it is likely to be the key currency, not only in East Asia but also in the world, if the economy continues to grow as it has done recently. However, if the renminbi is to be the dominant currency, replacing the role of the dollar in East Asia, the mistakes that were made with the yen in the past should be avoided. In the 1980s, Japan was the primary source of capital, technology, aid, and markets for the East Asian economy, but the yen couldn’t convert to a key currency. It may seem that the Japanese error is fading already and that the renminbi is on the rise, but there are still many constraints on the PRC’s leadership role as a key currency country. For example, the PRC is not yet developed, as Dr. Morgan just pointed out, and although the PRC has transformed to a more market-oriented economy, it is still under a very authoritarian regime.

Finally, many people also worry about the threat the PRC poses.

Antoine Chery
As I agree with most of the remarks already made, I would like to limit my comment to two points.

First, the international role of the euro and the prospect of widening the euro zone. Second, on whether the European experience could be replicated in Asia.

The first point I am going to make, giving a European perspective on this issue, is that Europe has no desire or policy to give a specific international role to the euro. The European Central Bank has stated many times that, as far as Europe is concerned, the international role of the euro should only be a reflection of what market forces think and nothing else. It is more important on our part to limit imbalances in the world monetary system and avoid competitive devaluation between the main currencies. In that regard, Europe has been one of the driving forces behind the G-20. It was said that some people in Europe may have some reservation in giving a leading role to the G-20 and giving more power to emerging countries. There is general consensus in
Europe that there is a need for another body. The G-7 is not enough today to solve the international financial problems, so the G-20 is a solution. For the G-20 to work, however, emerging countries also need to play their part. On that core issue, what we’ve seen during the first G-20 meeting is a bit mixed. The Washington and London meetings have certainly been a success so far, but on the other hand we think we’ve seen that many emerging countries have been very shy when it comes to discussing some issues such as financial stability and regulation. For the G-20 to actually go on, it will be important for emerging countries—and notably for Asian countries—to take a lead in these issues.

Going back to the euro, when we assess the international role of the euro we have to remember that it is a very young currency, only 10 years old. Many people said that the euro would never be created, and many also thought that it would implode, that the major funding countries would leave the euro system. Well, the fact is that after 10 years the euro does exist and is working well, and there is the prospect for it widening. At the present time, 16 countries use the euro and if you count all the countries that either use the euro as their currency or peg formally or informally to the euro, it is a total of about 40-50 countries, which is quite an achievement. It is the leading regional currency in Europe and in Africa and it plays a role that goes well beyond the gross domestic product (GDP) of Europe. The institutional arrangements of the euro have proven to be strong. The euro system also works well because the European Central Bank has proven to be cautious. People said 3–5 years ago that the European Central Bank was too cautious and was not operating a sound monetary policy, but I think the facts have proven that the bank has been right. During the crisis that we experienced, the euro zone not only did not implode but has proven to be a vehicle of stability in the region. Small countries that are not part of the euro zone—such as Iceland, the Baltic countries, and the Eastern European countries—looked to the euro zone for rescue. It is true that Europe sometimes has been reluctant to respond, but nevertheless the European Central Bank has lent a lot of money to Eastern European countries and has rescued Iceland, for example. Therefore, I think Europe has passed the most important test of surviving a big financial crisis. It is my view that within the next 10–30 years the euro zone will grow from 16 members to 20–30 members. Whether the United Kingdom (UK) or Sweden joins is still unclear, but at least talk is now of the expansion of the strength and size of the euro and no one thinks that there is a possibility of the major fund providers leaving the euro zone.
Will the euro replace the US dollar? No, certainly not. It is neither feasible nor desirable in our view. This is not a European policy at all. Having said that, is there a prospect for another currency to grow in another part of the world? There are two regions where you think this may be feasible—Latin America and Asia. I will only talk about Asia for today.

What strikes me, as an observer from outside the region, is that the current dialogue is still very much in its infancy. Finance ministers from the PRC, Japan, and Korea meet maybe once or twice a year, and it is a new thing for the three of them to meet. Most of the time they would only meet at Association of Southeast Asian Nations (ASEAN)+3 meetings. In Europe, finance ministers meet every month for a full day and a half, and their deputies meet beforehand for 2 days per month. There is an element of trust in Europe which does not exist in Asia at the moment between the Asian countries. Asia only exists as a geographical concept, it does not exist as a political concept. And money being about trust, this is a defining criterion. That some things will evolve is a certain thing but, as some speakers have said, the political situation is difficult and the landscape is not as merged in Asia as it is in Europe. That problem needs to be solved before anything concerning Asian monetary integration is discussed.

I think the message of all panelists has been similar, and it is that the US dollar will remain dominant, although the role may decline a little, at least in the short term, and that the potential key currency candidates do not wish to be a key currency. The countries of the euro zone, as we’ve just heard, are reluctant, and Japan is also reluctant to fully internationalize the yen. I think this makes a lot of sense if we ask what the benefits and costs of becoming a key currency are. If the euro or yen wished to become a key currency, the question is whether there is enough liquidity or supply to go around the world. Clearly the answer is no, because they are balanced or have a surplus in their current account.

For the world to be using either of these currencies, the value of the currencies would have to shoot up a lot under current circumstances. The US is different because it runs a deficit, willing to provide liquidity to the world. But there is also another reason. Using any currency involves costs, which is the gap between the buying and the selling

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Sussangkarn

ASEAN+3 is the ASEAN nations plus the PRC, Japan and Korea
rate. In the case of Thailand, the gap between the baht and the dollar, i.e., the difference between buying and selling, is 0.9%. For the yen the gap is 2.2%, 2.5 times bigger, and for the euro it is 1.4%. Why is it that the gaps are so different? The reason, in the case of Thailand, is that there is no direct market between the baht and any other currency except for the US dollar. So, when we go to the bank to buy yen, the banks convert the baht to dollars and then dollars to yen, and vice versa. If you talk to banks about why there are no direct markets between the baht and other currencies, the banks answer that there is no forward market and therefore they are unable to hedge their positions. This is crazy, because if you don’t have a spot market you cannot have a forward market. This is where you need intervention from the authorities. If they want the yen to be used more, the authorities need to subsidize the setting up of these markets. Otherwise it is not going to happen automatically. In Korea, the gaps between the won, dollar, yen, and euro are all about the same, which means there is no problem with a lack of direct markets between various currencies. Interestingly, the gaps are much bigger than the gap in Thailand, where it is about 2%. So, it means that maybe there is less efficiency in the currency market in Korea. In the case of the PRC, the gap between the renminbi and the dollar is 0.4%, i.e., very low, and it may be that the government is controlling this. The gap between the renminbi and yen and the euro is 0.8%, twice the gap between the renminbi and the US dollar. So, if the Government of the PRC wants to eventually make the renminbi an international currency, the most important thing will be to develop the currency market.

Fan He: I think there might be some misunderstanding of the PRC’s position on reforming the international monetary system and internationalizing the renminbi. The reason why Governor Zhou made the remarks regarding the SDR before the G-20 meeting, publishing an article in the Financial Times, advocating reform of the IMF is not because the PRC has any ambition to challenge the US hegemony or replace the US dollar. If we read between the lines of the remarks, the PRC is actually disappointed with the current international monetary system and is also worried about the US dollar.

This disappointment comes from the fact that, during this financial crisis, the IMF remained irrelevant. While there was a very clear signal of a bubble in the current housing market in the US and a potential risk from this situation, the IMF did nothing in the US. On the other hand, they were busy in stating the PRC’s misalignment of the renminbi exchange rate. We are also worried about the purchasing power of the
PRC’s massive foreign reserve, as most of it is still in US dollars, and the externality of US monetary policy—the US is adopting an extremely expansionary monetary policy. Although Professor Cooper mentioned that they are thinking of an exit strategy, we don’t know how. Maybe Professor Cooper could elaborate a bit more to make us confident. Even if the US Federal Reserve has done a wonderful job of managing inflationary pressure in the US, what happens if there is a bubble in other areas in emerging markets even if there is no inflation in the US?

In the current international monetary system, we are in a very embarrassing situation. We cannot vote by hand, there is not enough voting power in the IMF, we cannot tell the Federal Reserve what to do, and we cannot vote by feet. So we are worried about the $2 trillion foreign reserves and there is nothing that we can do. If we dump the US assets there will be free fall in the asset value, but if we continue to hold the US dollar and the bond bubble collapses, there is also a potential risk. This is what the Government of the PRC is worried about, and I think its worry is legitimate.

Eiji Ogawa I have a comment on the key currency system. I would like to focus on governance of national currency policy of the key currency country. We can compare the single key currency system and the multiple key currency system. Under the single key currency system, the key currency is the monopoly. The country has the monopolistic power, and no governance over the national monetary policy. Under the multiple key currency system, there is competition and some governance over the currency.

In terms of efficiency regarding the bid-ask spread, it is better to establish a key currency system, but in terms of governance of the national currency policy I think we should have a multiple key currency system.

I understand that it is difficult for us to establish another key currency other than the US dollar, as there is inertia due to the dollar’s network externality, which is why I think we should have a regional key currency, not only for Europe but also for Asia.

Chalongphob I think it is an important issue that the US dollar needs governance but Asia cannot force the US to improve the governance when there is a problem.

Jung Sik Kim I would like to ask Professor Cooper. You already mentioned the PRC’
s SDR suggestion, but some US economists agree to what the PRC has suggested regarding the SDR. What do you think about that?

Fan He Just one clarification. It is not the PRC’s choice; it is Governor Zhou’s remarks. Governor Zhou is a scholar-like official, so he is always talking about issues such as a carbon trading system and the implication of financial system reform.

So I just want to say that the PRC doesn’t have a very clear plan for SDR reform.

Masahiro Governor Zhou’s proposal may be his own view, but at least three papers were published by the end of March, one on this issue, another on savings, and a third on finance sector supervision. That was just before the London G-20 summit. I thought there was some reason for publishing these papers.

Fan He It is an indirect way of expressing our disappointment.

Masahiro My point is about the substitution account of the IMF, changing the US dollar into SDR through the IMF. In fact, if the IMF issues SDR bonds through the central banks, and not by going to the market, it will have a de facto substitution account effect. In other words, the PRC can reduce the dollar portion of foreign reserves and increase the SDR component so that the currency risk due to US dollar depreciation can be reduced. Peter (Morgan) was right in saying that the amount may be limited. If the PRC agrees to make a contribution to the IMF by putting in $100 billion, as Japan did, and the PRC requests that the IMF issues it SDR bonds, then the PRC is in a better position, at least from a risk currency perspective. I read just a few days ago that Russia made a similar suggestion to the IMF of switching the US dollar to SDR. If the use of SDR expands, then Japan and other Asian countries should also be interested. That may relieve the US, because US Treasury bills can continuously be purchased by foreign authorities, who can then hand over the dollars to the IMF in replacement for the SDRs. I don’t know how far this could go. However, when I heard the remarks of Governor Zhou, I thought that one of his intentions may be the point that I mentioned.

Chalongphob I think it’s the question of what comes first. Before businesspeople are going to be denominating their trade in SDRs, there has to be a very efficient market trading SDRs and all other currencies.

Masahiro This has nothing to do with trading of the SDR. It is just the IMF Roundtable Discussion
central bank arrangement.

Chalongphob The reason they hold the reserve is to back up the current and capital account liabilities. If the capital account liability is in US dollars, they have to hold dollars, they are not going to hold the SDR.

Masahiro The central bank can come up with de facto SDRs through the market. By selling US dollars in the market and getting other currencies, you can have an impact on the dollar’s value. Through the IMF this is an offshore transaction, so there is no need for a trading market.

Richard N. On the last point, it seems to me that what Mr. Kawai is suggesting amounts to the IMF giving an exchange rate guarantee to the countries in question. So it does not eliminate the risk, it just passes it, and then the question is to whom? Does it pass it to the IMF? The IMF actually can’t do that now, without changes in its mode of operations, because the IMF’s accounts are kept in terms of the national currency. So to use an example, if the People’s Bank of China puts dollars into the IMF in exchange for SDRs, the dollar holdings of the IMF go up and eventually will exceed the 75% limit, and the US will have to start paying interest on what it normally pays on that. So where is the incentive in that?

Masahiro There is no SDR market involved.

Richard N. To get on Chalongphob’s point, when Russia or the PRC (depending on which actually wants to use their reserves) can’t use their SDRs, they have to go back to the IMF and exchange SDRs for the currency that they wish to use. So it is just a way of giving an exchange rate guarantee, and then the question is who bears the guarantee? We saw that the IMF, until a year ago, did not have enough income to pay its operating budget, so where is the guarantee going to come from? I know that these are practical issues but they have to be resolved.

On the US view toward the SDR, I found Governor Zhou’s statement unexceptionable. I wrote similar things 25 years ago. What was surprising about it was not the content but the source. I go back to what I said earlier, I do not actually understand what problem is solved by substituting the dollar with the SDR, unless it is a part of the bigger changes in the international monetary system. If we are just going to substitute the SDR for the dollar, although I have no doubt that it could happen, but suppose even if we do all is that, what do we get and are we better off? My own hypothesis is no, it is no better.
SO, I think the notion of substituting the SDR for the dollar either reflects sloppy thinking or actually is a part of a much deeper issue of reform of the international monetary system as a whole, in which, in my view, the key is exchange rate management.

On the question of monopoly, the US does not have a monopoly in the reserve currency at all. This is a completely contested market, and there have always been alternatives, such as the European currencies, yen, pound sterling, and so forth. We mention the term economic power, and that is a term I don’t understand unless it is a political science way of saying economic size. Assuming that it refers to economic size, I think it’s worth mentioning.

I did a project last autumn for a journal that wanted to look 25 years into the future. I used as my base the world energy demand forecast made by the energy information agency of the US. What I am about to say, based on a relatively benign world economy, is that there will be 3% growth from 2005 to 2030. One can ask what is the economic size in 2030 compared with now. The adjustments I made were largely to do with allowing for reappreciation of the currency for developing countries. The results are interesting. The big losers in share are Japan and Europe, largely for demographic reasons; demography plays an important role. The assumption is that productivity growth will continue in both Europe and Japan at possible assumed rates, but we are living through a demographic revolution. We don’t realize it because we can ignore it, but over two decades it accumulates. The big gainers are emerging markets, most notably the PRC. People always link the PRC and India, but in fact the PRC is much bigger than India and is pulling away from India.

The interesting thing is that the US has almost no change in share, just a slight decline. The big changes are basically between Europe and Japan on one hand and the PRC on the other with some contribution from India, Brazil, and a little bit of increase for Russia. So the relative position of the US doesn’t change radically, if one looks ahead a quarter of a century. It has been taken for granted that the dollar will depreciate in the coming years and the reason given is the global imbalances. That is conventional wisdom, but I do not share it.

Chalongphob It is true that the US debt—GDP ratio will rise sharply in the coming years, but since currency issues are relative issues, we need to ask what happens not just in the US but also in other countries. The economic
The future of the US Dollar standard

situation, sadly, will cause the debt—GDP ratio to rise in all countries. The starting point for the rise in the US is actually rather lower than it is for many other major countries.

The only other remark I have is a technical one, on the ratio of currencies in the world reserves, and a slight decline in the proportion of the US dollar in the reserves. I think for analytical purpose one needs to differentiate between quantity changes and price changes. Almost all of the decline in the US dollar share has been due to valuation changes, not to quantity changes. The second technical point is that some countries do not report to the IMF, so it is not a comprehensive survey and one country in particular makes a huge difference, and that is the PRC, which does not report its foreign reserve compositions to the IMF. As the PRC is excluded from the figures, the figures have to be interpreted correctly.

My conclusion might be that Asia is not going to come up with a regional currency to compete with the US dollar, but the question for Asia is what we talked about after the 1997 Asian financial crisis—whether when we trade among each other we could use more local currencies or synthetic currencies.
A. Origin of the Global Financial Crisis

There are two main views on the causes of the global financial and economic crisis: excess liquidity at the macroeconomic level, and lax prudential regulation at the micro level. The reasons for the development of excess liquidity in the United States (US) and global financial markets are also controversial. Some blame excessively lax monetary policy and insufficient savings in the US, while others argue that excessively high savings rates in the rest of the world contributed to excess liquidity. All these factors seemed to have played a role, although their relative contributions are harder to assess.

1. Lax United States monetary policy

Easy monetary policy over the past decade clearly contributed to the rise in global liquidity. Japan started the zero interest rate policy in the fourth quarter of 1995,
and maintained it (except briefly) until 2006. This gave rise to the so-called “carry trade,” where investors borrowed yen to invest in higher-yielding foreign assets. After the information technology bubble burst in 2000, the US Federal Reserve cut the Fed Funds rate to only 1.0% by 2003, and kept it there until mid-2004, even though the economy was growing robustly by early 2003. The Federal Reserve kept policy considerably easier than would have been indicated by the so-called Taylor Rule for setting monetary policy. Ironically, the Federal Reserve appears to have been concerned about minimizing the risk of deflation of the consumer price index, but this policy instead contributed to rising house prices. Europe also had very low rates between 2003 and 2006.

The ratio of monetary aggregates to gross domestic product (GDP) is commonly used to assess whether liquidity is excessive or not. As shown in Figure 1, the ratio of the broad money supply (M2) to nominal GDP ratio in the US, Western Europe (including the United Kingdom [UK]) and Japan has been increasing since the first quarter of 1999, reflecting this easy monetary stance. This reduced the risk premium and, as a consequence, led investors to invest in risky assets to obtain higher yields, thereby creating asset bubbles in the US, especially in the mortgage market. Housing bubbles also developed in a number of European countries, including Denmark, Ireland, Spain, and the UK.

![Figure 2. Current Account Balance between the United States and Asia](source: International Financial Statistics, IMF)

**2. Global savings glut**

However, even after the Federal Reserve began raising rates in mid-2004, a
conundrum emerged: US long-term interest rates failed to rise significantly. Between mid-2004 and mid-2006, the Fed Funds rate rose 425 basis points, but the 10-year Treasury bond yield actually fell over the first year, and finally rose only about 60 basis points. Since US fixed-rate mortgage interest rates are linked to long-term bond yields, this meant that the effect of the Federal Reserve’s tightening on the housing market was significantly muted.

Federal Reserve chair Bernanke and others suggested that this conundrum could be explained by a global “savings glut” in the rest of the world, especially Asia. It was not clear in advance whether the large current account imbalance between the US and the rest of the world could be attributed primarily to excess demand in the US or excess savings in the rest of the world. However, Bernanke argued that the low level of US interest rates implied the latter rather than the former, since excess demand in the US should lead to higher interest rates there, not lower ones.

This was also suggested by the huge purchases of US Treasury bonds by the People’s Republic of China (PRC) and other Asian economies as a result of their rapid build-up of foreign exchange reserves, which tripled to over $3 trillion between 2002 and 2006. Ironically, this could partly be attributed to a desire to build reserves after the devastating experience of the Asian financial crisis in 1997-1998, but it had unintended consequences. It seems quite plausible that such massive purchases helped to hold down Treasury yields. These large capital outflows were balanced by the US running a large current account deficit and Asia a large current account surplus.

3. Inadequate financial supervision and regulation

Nevertheless, even if a global savings glut contributed to an easy monetary environment, ultimate responsibility for the creation of a financial boom and bust rests with the monetary and regulatory authorities, especially in the US. Historically, such booms and busts have been associated with financial innovation. In this case, the main innovation was securitization of loans, especially mortgage-backed securities associated with the “originate to distribute” model of banks in the US, with a supporting role played by credit default swaps, a kind of insurance against bankruptcy.

In the originate-to-distribute model, the originator of a loan (a bank) packages the loan into a pool and sells it to various third parties. This originally was seen as a way to shrink bank assets to reduce capital requirements stemming from the Basel I and II capital adequacy rules. This already contained the seeds of trouble, since, by separating the originator of a loan from the bearer of its ultimate default risk, the originate-to-distribute model provides banks with an incentive to originate excessively risky loans. In addition, by distancing the borrowers from
the ultimate bearer of default risk, the originate-to-distribute model can weaken the effectiveness of timely monitoring and intervention by banks. In fact, from 2005 to 2007, a massive deterioration of lending standards took place, especially in so-called subprime loans.

A further innovation, which ultimately was to prove so toxic, was the move to “slice and dice” loan pools into various risk tranches. Based on historical loss rates, the lowest risk tranches could qualify for a AAA rating from the rating agencies, making them hugely marketable worldwide since they offered higher yields than normal AAA securities. However, the huge deterioration of lending standards and the collapse of housing prices meant that losses were likely to be far higher than the ratings had allowed for.

The next bad idea was that, too often, rather than selling the securitized assets, banks held on to them in unregulated off-balance-sheet vehicles, which meant they had less capital but still the same risk. The final nail in the coffin was the “wholesale bank” model, where banks funded their illiquid assets with short-term paper rather than deposits, i.e., borrowing short and lending long. Once the magnitude of the potential losses became apparent, the complexity of the securities made them impossible to value and the size of the potential losses endangered the solvency of the banks, leading to a breakdown in trust in the market and making it impossible for them to roll over their short-term debt.

All these developments combined to worsen the impact of the crisis. However, they were ignored by regulators, who seemed mesmerized by the idea that markets were self-regulating and that banks would act in enlightened self-interest. What is most remarkable is that even though banks are one of the most heavily regulated finance sectors, the problems still originated in this sector. The credit rating agencies also failed to recognize the riskiness of the assets they rated so highly and macro-prudential regulation failed as well.

B. Asian Bond Market Initiatives and Asian Capital Markets

Since the Asian financial crisis of 1997, local currency bond markets in Asia have significant attentions to policy makers and academia in order to reduce the currency and maturity mismatches in emerging Asian economies a priori, and to resolve the currency and financial crisis. Later in early 2000s, the development of Asian bond markets focused on the issues of capital flows between Asia and developed countries, especially the US. Capital flows in Asia since the crisis have shown that Asians have been investing largely in low-yielding dollar-denominated assets and investors in developed countries have been investing in higher-yielding assets in Asia. This is the so-called Lucas paradox. Also, capital flows in Asia have been alleged to be one of the root causes of global imbalances
Against these backgrounds, Asia perceived a need for deeper and more liquid local bond markets; the Asian Bond Market Initiative (ABMI) started from this recognition in Asia. ASEAN+3 developed the ABMI, and it has achieved some of its early goals that were set up to address a broad range of issues related to local bond markets in Asia.

However, the development of an Asian bond market itself is not an easy task. Several impediments exist in Asia to developing a deep and efficient local bond market by attracting more foreign investors into local bond markets: market size and liquidity matter, taxes on interest rate incomes and withholding taxes differ from country to country, poor governance and investor protections are also of concern, consistent and stable monetary and exchange rate policy is not guaranteed, real financial and technical infrastructure is problematic, regulations on cross-border transactions and exchange controls are relatively stringent, and an insufficient foreign exchange hedging market is also a stumbling block for a liquid local bond market.

The fundamental question relevant to the development of the Asian financial markets lies in why equity markets appear to flourish in the region while bond markets flounder, even with weak financial infrastructure. Part of the answer is inherent in the difference between debt and equity contracts. Also, equity investors are not engaged in hedging instruments but bond investors are, so the lack of enough hedging instruments matters to bond investors but not to equity investors.

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1 ASEAN+3 refers to the Association of Southeast Asian Nations countries, plus the People’s Republic of China, Japan, and the Republic of Korea.
Figure 3: Performance and Liquidity of Equity Markets

![Graph showing performance and liquidity of equity markets across developed and developing countries.](image)

Note: Turnover ratio is plotted on the right-hand scale; Sharpe ratio is plotted on the left-hand scale.

Figure 4: Performance and Liquidity of Bond Markets

![Graph showing performance and liquidity of bond markets across developed and developing countries.](image)

Note: Turnover ratio is plotted on the right-hand scale; Sharpe ratio is plotted on the left-hand scale.
The ABMI has been focused on the primary market in some senses. We should also consider how to foster the secondary markets which will create more liquid and resilient markets.

Related to capital market development in Asia, we should also consider deep and efficient money markets in Asia. Without them it is not easy to develop deep and breathed foreign exchange markets. Moreover, bonds markets and money markets are quietly dependent on each other.

The key way in which authorities in Asia sought to entice Asians to invest in each other’s markets instead of outside Asia was through the development of local financial markets. For example, the ABMI “aims to develop efficient and liquid bond markets in Asia, which would enable better utilization of Asian savings for Asian investments.” (ASEAN+3 2003). The immediate aim of the ABMI and similar initiatives in Asia is to create deep and liquid markets, not to reduce market frictions; identifying and reducing frictions are means of achieving the goal of greater liquidity. Furthermore, without deep and liquid capital markets in Asia, global imbalances can’t be rebalanced in the long run.

C. Post-Chiang Mai Initiative and Monetary Cooperation

If a scheme for regional monetary and financial cooperation is effective, it will mitigate the risks of recurrent financial crises. No one can deny the desirability of regional financial arrangements; however, various institutions have different memberships and goals for regional financial cooperation. Thus, it is not easy to build an effective regional financial arrangement.

The current regional financial arrangement represented by ASEAN+3 faces a critical moment after the multilateralization of the Chiang Mai Initiative (CMI). One of the main factors in the relative success (if you can call it that) of the ASEAN+3 framework has been the non-interference principle for the last decade. As multilateralization has been achieved, there will be no more non-interfering for member economies. This is a serious challenge for regional financial cooperation.

The current global financial and economic crisis is accelerating and will reinforce the motives and imperatives for regional financial cooperation. The international financial architecture lead by the G-20 group has been initiated to cope with the global financial crisis; this is a big opportunity for a regional financial arrangement and cooperation.

The pooling of bilateral swap is a great step toward the effective regional line of defense needed to prevent and resolve the recurrent currency crises in emerging
Asian economies. However, there remain several issues regarding activation of the multilateralization of swap arrangement in Asia. The first issue is size: is $120 billion enough to calm down the future financial crisis in the region? The $120 billion of the new multilateralization fund will not effectively provide timely liquidity support in Asian emerging economies, since the fund is linked to the IMF program in a way that only 20% of the regional fund can be activated without the IMF program.

The second issue is a surveillance unit. Even though ASEAN+3 agreed to establish the surveillance unit of the multilateralization of the CMI, it takes time to build an effective surveillance unit in the region. ASEAN+3 cannot reach consensus on the location of the surveillance unit or the governance and finance scheme for the new institutions. The independent and effective surveillance unit is a key factor for successful reserve pooling, as well as development of monetary policy cooperation at a later stage.

The third issue is the relationship between any regional financial arrangement and the global financial architecture. Complementarity between regional liquidity support and global liquidity support is an important factor in identifying the appropriateness of regional reserve pooling.

The last issue is enlarging the CMI. Several countries that are not members of ASEAN+3 have expressed their interest in joining the initiative, and ASEAN+3.

The core pillars of the regional financial arrangements can be liquidity support, monitoring and surveillance, and macro-policy cooperation. The late multilateralization of the CMI has achieved the first pillar; however, ASEAN+3 has been lagging on the last two pillars. Achieving a more effective regional financial arrangement depends on the successful establishment of the current reserve pooling. If the current discussions and proposals on the reserve pooling process can be smoothly carried out, this could serve as an institutional base for further monetary and financial cooperation, including building an independent and effective surveillance unit, further monetary policy coordination, and monetary and financial integration in the long run.
GLOBAL IMBALANCES, ASIAN CAPITAL MARKETS, AND FOREIGN RESERVE POOLING

Inchul Kim

A. Introduction

The title of Roundtable III is Global Imbalances, Asian Capital Markets, and Foreign Reserve Pooling. Each topic in the title deserves a lengthy discussion and the three topics are all interrelated. To overcome the adverse effects of global imbalances and to avoid the repeat of a regional financial crisis, Asian countries need to make combined efforts to develop Asian capital markets and to achieve foreign reserve pooling. In this short note, I will make a brief remark on each topic.

B. Global Imbalances

It appears that the definition of global imbalances is somewhat ambiguous. It refers to global imbalances in trade accounts and it also refers to global imbalances in capital accounts. There are two opposing views about global imbalances. One is the overconsumption view, which states that global imbalances cause regional or global crises. The other is the market adjustment view, stating that global imbalances are the result of market adjustments on a global basis.

According to the overconsumption view, all major countries are to blame. First of all, the excessive use of energy by the world and excessive consumption by the United States (US) caused continuous accumulation of huge trade surpluses by the People’s Republic of China (PRC) and oil exporting countries. This in turn caused massive amounts of capital funds to flow from these surplus countries back to the US, thereby causing the bubbles in the prices of real estate, stocks, and bonds. Naturally, the US economy experienced a severe credit crisis when the bubbles in the asset prices burst. Based on this view, global imbalances are to blame for the current global financial and economic crisis.

However, those with the market adjustment view argue that countries may end up with net savings or net foreign borrowings as a result of allocating resources between the present and the future. According to this view, it is no longer clear whether or not global imbalances should be blamed for regional or global crises.

It seems to me that global imbalances can be a cause and/or a result. It may take a while or it may not be possible to eliminate global imbalances. Perhaps it may not even be desirable to eliminate them completely. What seems to be true at this
point is that global imbalances are impediments to restoring the global economy quickly and smoothly.

C. Asian Capital Market Development

The Chiang Mai Initiative (CMI) was agreed upon in May 2000. The 13 ASEAN+3 countries agreed to systemically develop the Asian bond markets\(^2\). The leaders of the 13 countries wanted to eliminate the double mismatches—maturity and currency—and stabilize capital movements within Asia. They had a strong belief that the developed bond market would provide long-term funds for both sovereign and corporate firms.

To remedy the maturity and currency mismatches, the CMI leaders wanted to develop the market in Asia for local-currency-denominated bonds. If the bonds are issued in local currency, the issuers would not worry about maturity risk or exchange rate risk. Then the real question is, what incentive would be given to the investors? Foreign investors would not welcome the exchange rate risks either, unless they are fully compensated for.

The necessity of developing the Asian bond market is well understood. However, appropriate institutions and instruments have not yet been prepared. Most of all, measures attracting much of the attention of investors need to be developed. So far, a handful of Asian bond funds for investment purposes exist but their performance has not been satisfactory. Sovereign as well as corporate investors are concerned about the severity of the fiscal deficits of the issuer countries and about their exchange rate risk.

It has been suggested that not only should the primary market for local currency bonds be developed but also the secondary market be equally developed. Again, this would not help much to eliminate exchange rate risk. The outlook for exchange rate risk in the Asian bond market is gloomy. The exchange rate volatility for Asian currencies will even increase because the US dollar is expected to fluctuate more in the future.

The world’s preference for the US dollar for transactions will be maintained but the preference for the dollar for value storing will be weakened. The euro has emerged as a strong rival in international foreign exchange markets. Furthermore, substitutions between the dollar and the euro in foreign reserve holdings of many countries will be made more frequently. Therefore, it is very likely that exchange rate risk for many currencies in Asia will increase. Due to potential increases in the currency risk, the prospect for the development of the Asian capital market,

\(^2\) ASEAN+3 refers to the Association of Southeast Asian Nations countries, plus the People’s Republic of China, Japan, and the Republic of Korea.
including the local-currency bond market, is not promising at this point.

**D. Foreign Reserve Pooling**

In May 2000 the CMI countries agreed on the idea of pooling foreign reserves for the 13 ASEAN+3 countries. They also expanded the existing ASEAN swap arrangements which originally included five ASEAN member countries (Indonesia, Malaysia, the Philippines, Singapore, and Thailand); now it includes all the ASEAN member countries augmented with a network of bilateral swap arrangements among the 13 ASEAN+3 countries.

As of July 2007, 16 bilateral swap arrangements with a total value of $83 billion were finalized. Japan played a leading role in terms of both number and volume, and concluded seven agreements, and the PRC and the Republic of Korea (henceforth Korea) each concluded five.

An important step has been made recently. Member countries have moved from a series of swap agreements to a foreign reserve pooling system. On 3 May 2009 the 13 ASEAN+3 finance ministers reached agreement on forming a multilateral Asian reserve fund of $120 billion dollars. Eighty percent of the fund ($96 billion) is to be contributed by the three biggest countries ($19.2 billion by Korea and $38.4 billion each by the PRC and Japan).

It has been alleged that the main purpose of foreign reserve pooling is to utilize the pooled reserves when a member country faces a critical liquidity shortage. Through this system, member countries can avoid a liquidity crisis which would cause them irreversible damage.

However, member countries should be able to do more than this. They could enlarge the size of the fund and establish an Asian monetary fund so that it plays an extended role as is done by the IMF. Not only could it create the Asian special drawing right but also it could be utilized as the basis for creating a regional currency and even for forming a currency union for Asian countries. The idea of an Asian monetary fund was shelved when it was proposed 11 years ago because the fund would become an impediment to the IMF. However, things have now changed a lot. The US subprime problem has put numerous countries in trouble and global cooperation is required to restore the US economy as well as the global economy. Under these circumstances, an Asian monetary fund could work together with the IMF and their synergy effect is well perceived.
THE SUBPRIME CRISIS AND EAST ASIAN FINANCIAL COOPERATION

Chalongphob Sussangkarn

The 1997 Asian financial crisis provided important impetus for financial cooperation within Asia. Prior to the crisis, East Asia as a whole was financially strong, with a combined current account surplus (saving surplus) of about $100 billion-$150 billion per year and combined foreign reserves of about $600 billion. However, most of the surplus was invested outside the region, and deficit countries within the region—such as Indonesia, the Republic of Korea (henceforth Korea), and Thailand—had to rely on short-term foreign borrowing. The ratio of short-term foreign debt to official reserves in these countries reached more than 100% prior to the crisis. This was the fundamental reason that precipitated the crisis, particularly after Thailand used up almost its entire foreign reserves in a futile attempt to defend the currency, ending up in an insolvency situation with almost no foreign reserves left to meet foreign currency obligations. Thailand, Indonesia, and Korea had to rely on International Monetary Fund (IMF) assistance, and implement harsh and controversial policies under IMF conditionality.

Given the region’s pre-crisis overall financial strength, countries in the region felt that with better financial cooperation the crisis could have been avoided. This led to the formation of the ASEAN+3 group, a group that was hard to envisage prior to the crisis because of historical tensions between some countries within it. The Chiang Mai Initiative (CMI) was the first concrete financial cooperation initiative arising from the ASEAN+3 group. It consisted of a series of bilateral foreign reserve swap agreements designed to assist countries that may run into foreign currency liquidity problems in the future. Financial cooperation extended to the development of the region’s bond market, with the rationale that this may contribute to the recycling of the region’s saving surplus within the region.

While significant progress has been made in both the above areas of financial cooperation, it has been somewhat slow. The urgency for progress in these areas declined once countries in the region began to experience export booms, current account surpluses, and accumulation of foreign reserves as a result of the depreciation of the region’s currencies resulting from the crisis.

Now that we are in the midst of the subprime crisis, and East Asia is facing
severe indirect impacts through the trade channel, the question is whether the various financial cooperation initiatives that have been carried out in response to the 1997–1998 crisis are still relevant. It is true that the current crisis is a global crisis, and ultimately the solution will involve reforms at the global level. Nevertheless, I believe that it is still extremely important for East Asian economies to push ahead with financial cooperation measures initiated in response to the 1997–1998 crisis, as well as initiate other cooperation measures in direct response to the current subprime crisis. These will help the ability of countries in the region to shore up their economies in the short term, shift their growth path to be less dependent on exports as the main growth engine in the medium term, and strengthen the region’s economic and financial resiliency and protect itself from future crises in the medium to long term.

It is now clear that the indirect impacts of the subprime crisis on the region through the trade channel will be very severe. Exports have declined sharply for most economies in the region, large-scale layoffs can be expected, and the crisis may trigger a social crisis bigger than that experienced in the aftermath of the 1997–1998 crisis. During the Asian financial crisis in 1997–1998 the affected countries could export their way out of the crisis, aided by depreciated currencies; in the current global crisis, this is not a feasible option. In the short term, governments have been vigorously using the fiscal pump, and have also pursued rapid monetary easing. However, many financial cooperation measures at the regional level are needed to supplement country-specific measures.

First, all countries must avoid protectionism, otherwise global fiscal stimulus efforts will be less effective in generating global multipliers to boost individual stimulus efforts. In the context of export-dependent economies, it is also very important to avoid competitive depreciation, as this will not benefit anyone and will make structural adjustments of the economy toward reduced reliance on exports more difficult. Investment projects that will be needed to move toward a more balanced growth path will also become more expensive.

In the short term, fiscal expenditures to counteract the downturn and provide social safety nets for the poor are needed. For countries starting from strong fiscal positions, domestic financing of these expenditures should be sufficient. However, many countries face fiscal constraints or will be facing them, given the stimulus measures that have already been committed. For these countries, the role of external financing is very important. Both multilateral and bilateral sources should be made available to countries in need, and the ability to quickly disburse these funds will be essential. After 1997, Thailand found that it was very difficult to disburse loans from multilateral agencies to cushion the social impacts quickly because of various rules and regulations of the lenders. We were very grateful that the Government of Japan came forward with the so-called Miyazawa Initiative,
providing financial assistance in a way that could be disbursed very quickly. Currently, Japan has scaled up Official Development Assistance loans to Asian countries in response to the subprime crisis, which is very helpful. Other donor countries should follow, even though their own fiscal positions have been harmed by the crisis.

In the medium term, countries need to increase domestic sources of growth. Public infrastructure investment can be an important growth driver over the next 3–5 years. However, given liquidity constraints in the global financial system, or lack of fiscal space for further fiscal expenditures, many countries may need new regional or global assistance to facilitate the financing of public investment. For Asia, the already approved capital increases for the Asian Development Bank should be very helpful. Initiatives to set up an infrastructure fund have been under discussion in East Asia for a couple of years. The 2007 ASEAN finance ministers meeting in Chiang Mai, which I chaired, agreed to explore the setting up of an infrastructure financing mechanism for ASEAN. No concrete agreement has been reached yet but it is timely now to seriously explore this at the East Asia level. Given the savings surplus and large foreign reserves in East Asia, recycling investment funds within the region can also help countries with financing constraints. Further development of the Asian bond markets (through the Asian Bond Markets Initiatives and the Asian Bond Fund) can provide important support to countries seeking to increase fiscal stimulus for growth.

East Asia also needs to strengthen its regional financial architecture to supplement the global financial architecture. The current global architecture has proven inadequate time and again for preventing financial crises, whether in emerging market economies or in advanced economies. Important reforms of the global financial architecture have been put forward following previous crises, particularly the need to regulate highly leveraged institutions and scrutinize the role of credit rating agencies. Nothing substantive was done. These institutions are again at the very heart of the current subprime crisis.

An important step in strengthening the regional financial architecture is a quick conclusion of the multilateral CMI, moving from a series of bilateral swap agreements to a reserve pooling mechanism. This was already agreed to in principle at the 2007 ASEAN+3 finance ministers meeting in Kyoto, which I co-chaired with my Chinese counterpart. It has now been 2 years. There are a number of steps to be taken. First, countries need to agree on the size of contributions. The total amount is $120 billion, with 80% from the “+3” countries (the People’s Republic of China, Japan, and Korea) and 20% from ASEAN countries. Because countries tend to think of their contributions as quota (or voting power) in the new mechanism, agreement has been rather slow. However, agreement was finally reached at the 12th ASEAN+3 finance ministers meeting in

The next step is to develop the implementing mechanism, particularly how countries can make use of the pool. Particularly contentious at present is the need to link to an IMF program if a country utilizes more than 20% of its quota. Given experiences with the IMF during the 1997-1998 crisis, no government of any country that went through an IMF program at that time can survive if it takes the country into another IMF program. The CMI should be delinked from the IMF. To make the pooling mechanism more effective, it should be possible for the pool to be leveraged by bilateral contributions from countries in the region so that the resources available are sufficient for the needs of countries. The way the reserve pool (and bilateral supplements) can be used should also be extended to providing swap facilities (along the lines that the Federal Reserve has with a number of countries and also bilateral swap agreements among some central banks in the region) in addition to direct lending.

Another important step needed to implement the mechanism is to set up a monetary organization for the region to coordinate the scheme. I am sure that there will be some who will raise the issue of so-called “moral hazard,” as was done when the idea of an Asian monetary fund was suggested a decade or so ago. However, in the current context, this would be ludicrous. Given that one hardly hears any strong protests about the huge moral hazards being created in various US bailout programs and moral hazard was raised so often during the 1997-1998 crisis, it would indeed be doubly hypocritical for those in the West or in the IMF to use this argument to try to block the setting up of such an organization again.

In my view, an Asian monetary organization will be an essential part of a new global financial architecture that can provide better regional and global surveillance to prevent future crises and provide more balanced crisis resolution mechanisms. East Asia, as one of the largest creditor regions, needs to play a much more proactive role in global surveillance, particularly surveillance of the largest debtor countries (where the creditor nations have invested their assets) to protect their investments. The current global financial architecture lacks adequate institutions and mechanisms for effective surveillance when problems from advanced economies arise, such as in the current crisis. Apart from its regional role, an Asian monetary organization can also contribute to filling this gap at the global level.
GLOBAL IMBALANCES, ASIAN CAPITAL MARKETS, AND FOREIGN RESERVE POOLING

Kyungsoo Kim

Since the Asian financial crisis in 1997–1998, Asian countries have made continuous efforts to promote financial cooperation, with a focus on developing bond markets in the region. Bond market development has been initiated by governments and central banks in Asia through diverse financial forums such as the ASEAN+3\(^1\) and Executives’ Meeting of East Asia—Pacific Central Banks (EMEAP), the Asian Bond Markets Initiative (ABMI), two Asian Bond Funds (ABFs), the Chiang Mai Initiative, the Asia—Pacific Economic Cooperation (APEC) Regional Bond Market Initiative, the Asian Cooperation Dialogue Asian Bond Market Initiative, and the Economic Review and Policy Dialogue.

The aim of the ABMI is to develop efficient and liquid bond markets in Asia in order to promote increased circulation of massive Asian savings within the region. The ABMI focuses mainly on facilitating access to bond markets for a wider variety of issuers, and building and enhancing the market infrastructure necessary to foster bond markets in the region.

The EMEAP, a forum of 11 central banks in East Asia and the Pacific, launched the $1 billion ABF. The fund invests in a basket of United States (US) dollar-denominated bonds issued by sovereign and quasi-sovereign Asian issuers in EMEAP economies (other than Australia, Japan, and New Zealand). The Bank for International Settlements manages the ABF in a passive style in accordance with a specific benchmark. With the launch of the second ABF in December 2004, the EMEAP extended the ABF concept. Implemented in April 2005, the second fund invests in local currency bonds issued by sovereign and quasi-sovereign issuers in EMEAP economies.

Through such initiatives, as well as the efforts of individual countries, Asian capital markets have been steadily developed. However, progress is too slow. The institutional settings are inadequate and the policy frameworks are too weak to catalyze well-functioning markets. Although some local currency bond markets have grown significantly at the regional level (e.g., the Korean won treasury bond market), Asian bond markets are small, fragmented, and illiquid.

Lack of an efficient regional mechanism for circulating the abundant savings and resources of Asian countries without channeling them through financial

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\(^1\) ASEAN+3 refers to the Association of Southeast Asian Nations (ASEAN) countries, plus the People’s Republic of China, Japan, and the Republic of Korea
markets outside the region hinders reinforcing high and stable economic growth in the region. As a matter of fact, if Asian capital markets were active, emerging market economies in this region would not have been so severely affected by deleverage during the global credit crisis. Absence of regional financial markets apparently exacerbates capital inflow problems associated with boom and bust to small open economies, and, therefore, even strengthens procyclicality of capital flows. Nevertheless, there are few countercyclical policy measures available.

The global credit crisis originating in north Atlantic countries makes the need clear for developing well-functioning capital markets in this region. Considering that few Asian currencies are convertible, well-organized and well-functioning Asian capital markets are vital, not only for recycling the huge volume of Asian savings but for managing the risk of double mismatches in maturity and currency. Again, the impact of unprecedented deleverage last year after the collapse of Lehman Brothers could have been much milder.

Well-organized and well-functioning Asian capital markets fostering investment in this region will contribute to the easing of global imbalances. To that extent, Asian monetary authorities don’t have to amass foreign reserves. With the growing balance sheet of the central banks and increasing international capital mobility, it becomes more difficult than ever to conduct effective monetary policy. Furthermore, rising quasi-fiscal deficits from holding large amounts of foreign reserves potentially distorts the future path of monetary policy.

Interregional trade has increased tremendously and such trade usually involves considerable elements of a purely financial nature, such as trade financing and hedging exchange risk. Therefore, it is puzzling that the cross-border financial market in Asia is not active.

In fact, there are a number of constraints and factors that impede the development of Asian capital markets. These include a diverse institutional and regulatory framework, which is likely to depend on country-specific factors, such as the health and efficiency of the domestic financial system, the sophistication of legal and regulatory institutions, and the size of the economy.

Some countries have inadequate institutional and regulatory market frameworks. As for an Asian bond market, for example, a limited supply of and demand for bonds, the lack of benchmark yield curves, narrow investor bases, and inadequate market infrastructure are identified as direct impediments.

The lack of a common market (such as the European Union), different levels of economic growth among Asian countries, and heavy reliance on bank loans have left a legacy of fragmented financial markets in this region. Moreover,
unfavorable macroeconomic environments, such as unstable macroeconomic policies, are not conducive to market development.

Therefore, given current conditions and limitations, well-functioning domestic financial markets are a precondition for further development of cross-border Asian capital markets. Furthermore, free movement of capital across borders should follow. Eventually at least partial currency internationalization may be needed so that a country can issue debt denominated in its own currency.

Considering all the facts, fully developing Asian capital markets appears to be a long-term objective, but creating an Asian offshore market may be a viable option. Offshore markets do not require convergence of institutional and regulatory frameworks or compliance with specific country rules among Asian countries. They do, however, need a standardized single platform.

In the meantime, Asian governments should provide strong leadership and political commitment to develop domestic and regional financial markets. In line with active promotion of ongoing initiatives, more substantive and detailed guidelines for efficient financial market development in each nation and the region should be prepared.

To create deep and liquid Asian capital markets, more active roles should be played by the People’s Republic of China, Japan, and the Republic of Korea in the various initiatives including the ABMI and the ABFs. Also, to expand local currency transactions in Asia between the won, renminbi, and yen, residual regulation of foreign exchange transactions should be eased to a similar level. The deregulation of foreign capital transactions facilitating the adoption of local currencies in line with the scale of external transactions of each country will build the liquidity of the regional foreign exchange market, and naturally the financial link will be strengthened.

The framework of new financial regulations led mainly by the G-20 can be the future direction and strategies for developing Asian financial markets. These regulations are introducing and heightening the supervision of macroeconomic soundness, scope regulation, removing regulatory arbitrage, strengthening buffer flexibility of financial firms, reforming financial infrastructure, improving account rules, enforcing rules and regulations, and overseeing credit rating agencies, among other things. With a new regulatory framework, Asian governments could pursue and converge to well-functioning financial markets domestically and regionally.
WHY DO EAST ASIAN COUNTRIES NEED REGIONAL MONETARY COOPERATION?

Changkyu Choi

Even if the United States (US) is now being afflicted with financial crisis, the US is not likely to have a currency crisis insofar as the US dollar remains a key currency. However, other countries whose currencies are not key currencies are always worried about the possibility of both financial crisis and currency crisis under a global financial crisis. When the financial crunch in the US deepens, most small open countries are likely to face sudden capital outflows to the US, threatening their foreign exchange markets. The possibility of currency crisis will decrease if neighboring countries have a common currency. Some euro member countries would have been attacked if they had not adopted the euro.

Since the Asian financial crisis in 1997, East Asian economies have felt the need to have a regional monetary cooperation mechanism, such as an Asian monetary fund. Instead of such a fund they could have a very primitive form of monetary cooperation—bilateral swap agreements among central banks in the region. In June 2009, the Chiang Mai Initiative, which started in May 2000 with a combined scale of $39.5 billion, evolved to the $120.0 billion Chiang Mai Initiative Multilateralization.

East Asian economies have been criticized as “mercantilist” for their huge accumulation of foreign reserves prior to the current global financial crisis. One of the reasons why they were eager to increase foreign reserves was to avoid a currency crisis such as the 1997 Asian financial crisis. This implies that the current international lender of last resort, the International Monetary Fund (IMF), is unable to prevent and cure the current global financial crisis. When the bubble in the US finally collapsed, the IMF proved to be ineffective in preventing financial crisis in the US and also supplying sufficient liquidity not only for the US but also for a crisis country. Because of a “bad memory of harsh conditionality” during the Asian financial crisis in 1997, crisis countries were very reluctant to get the money from the IMF. The real estate bubble and excessive leverage of financial institutions in the US could be financed by capital inflows from East Asian countries. The excessive level of US current account deficit was not disciplined, but was financed by borrowing from East Asian surplus countries. Even though the IMF is now increasing its role as an international lender of last resort in various ways, it is still doubtful whether it can successfully prevent and cure future crises.

Regional monetary cooperation among East Asian countries will help to stabilize the global financial system rather than destabilize it. Many East Asian
countries have already witnessed the asymmetric prescription of the IMF and the advanced countries in coping with the current financial crisis, compared with severely stringent measures imposed on the crisis countries during the Asian financial crisis. The role of the US dollar as a key currency has been challenged. Many people believe that the US dollar will not lose its current status immediately, but the current status will not last forever.

In the Chiang Mai Initiative in May 2000, the 13 ASEAN+3 countries also agreed to develop Asian bond markets\(^1\). If this plan succeeds, the economy in Asia can develop faster, however it has been unsuccessful so far. This bond is denoted in local currencies and is exposed to exchange rate risk. The regional credit rating and regional credit enhancing have been insufficient for the Asian bond market to successfully develop. The financial instruments are very underdeveloped, lacking diversity and depth. The regional level of infrastructure for credit rating and credit enhancing as infrastructure of regional capital market should be wisely designed. At the same time, bond denomination in the region should be diversified in an Asian currency unit as well as in local currencies.

The Asia Joint Fund was created at the 12th ASEAN+3 finance ministers meeting in Bali on 3 May 2009. A total of $120 billion is committed from member countries, with $96 billion dollars (80%) being from the People’s Republic of China (32%), Japan (32%), and the Republic of Korea (16%), and $24 billion dollars (20%) from ASEAN countries. The allocation of the fund among member countries is well structured. This is a very important step in the future development of East Asian monetary cooperation. It will help stabilize the foreign exchange market in the region and thus the financial institutions. Only 20% of the total fund, however, can be used without the consent of the IMF. I also believe that perfect independent operation from the IMF is important for increasing its efficiency. The coexistence of the Asia Joint Fund and the IMF will increase the efficiency of both institutions as global lender of last resort through competition.

The next step in regional monetary cooperation will be the invention of a regional currency, such as an Asian currency unit similar to the special drawing right of the IMF, and the ECU of EMS countries. The present country quota for foreign reserves pooling among member countries can also be a good criterion as a country quota for an Asian currency unit. Sharing a common unit of account in the region in whatever form will help Asian capital markets develop in every respect.

For this purpose the Asian Development Bank can play a limited role in the

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\(^1\) ASEAN+3 refers to the Association of Southeast Asian Nations (ASEAN) countries, plus the People’s Republic of China, Japan, and the Republic of Korea
early stages of the Asia Joint Fund. I think, however, that there should be a
distinction between a regional lender of last resort and a development bank. Furthermore, a regional financial regulatory cooperative body should be
established. Even though there may be minor differences regarding East Asian monetary cooperation, I firmly believe that any type of cooperation rather than war among the region will lead us all to peace, as in the European countries. It is also noteworthy that the role of the Republic of Korea is very important in moving towards East Asian monetary and economic cooperation economically, emotionally, and geographically.
Inchul Kim

There are three topics in the title for session three, and the three topics are all interrelated, but I would like to spend a disproportionate amount of time on global imbalances. As far as global imbalances are concerned, the concept and the scope of the content of the imbalances are not clear. I am not exactly sure whether imbalances are referred to as savings, trade surplus and trade deficit or the huge real income is transferring from the oil producing and exporting countries to the oil importing countries. So that’s too broad.

There are two views of the global imbalance, as you are aware. One is that global imbalances are the main cause of the regional and global crisis, and the other view is that the global imbalances are the result of market adjustments. I would go with the latter definition of the interpretation. The global imbalance is more or less the result of the allocation of resources between today and tomorrow. In that context it is very hard to blame or criticize the United States (US) for consuming too much and the People’s Republic of China (PRC) and oil producing countries for saving too much; that sort of statement doesn’t really sound attractive, especially when we try to look for the solutions to mitigate the adverse effects of the global imbalances and also to try to prevent regional and global imbalances. We’ll look to other sources for explanations rather than just the global imbalances as the cause.

One observation is that in today’s world, economic interdependency is so severe that if any one major corporate firm or financial institution goes wrong or bankrupt the effect is immediately transmitted to other firms in other parts of the world. I think that’s what happened in the US; Lehman Brothers had so much exposure in other places in the world, so when something went wrong with Lehman brothers or the other IB banks, it immediately affected other countries in large
measure. Given that, I think we need to be more cautious about the potential impact of factors in general. I noticed that economists tend to explain the crisis in terms of economic determinants. That is alright in terms of explaining the ordinary economic situation, but in trying to explain the crisis phenomenon I think we should look at non-economic factors as well. I would say that if any country is suffering from huge trade deficits, severe labor unrest, and at the same time competitive presidential elections, in more than 90% of the cases the country will run into a crisis.

I think that’s what happened in the US; it had been running trade deficits for quite some time, had severe problems with labor unions, and at the same time there was severe competition in the presidential election between Obama and McCain, and people were worried about who was going to win and what was going to happen depending on who gained power. So, this is the framework that I see—no matter how hard we try, things are really hard to control, and if, say, a country such as the Republic of Korea (henceforth Korea), in 5 years runs into the same political situation, we are likely run into a crisis.

Now, perhaps I could spend a minute on the Asian capital market development. In order to overcome the adverse effects of the global imbalances, developing the Asian bond market, which is the market for local currency bonds, is important. I think the main difficulty with this is the exchange rate risk. The local currency bond should be attractive enough to foreign investors, either sovereign or private investors. The thing is that they are worrying about the severity of the fiscal deficits of potential issuer countries. That is because the interest rate risk is so large that it will take a while for the Asian bond market to develop.

Chalongphob I will focus on East Asia financial cooperation in light of the subprime crisis.

Sussangkarn Basically, we started financial cooperation as an outcome of the previous crisis in 1997, and initiated a number of measures such as the Chiang Mai Initiative and the Asian Bond Market Initiative. Now, we’ve made some progress but it has been very slow, particularly in the last 5 years, and that is because countries felt that these initiatives were no longer urgent as countries now had lots of foreign reserves.

Given that we are now in the subprime crisis, and East Asia is now facing risks through the trade channel, the question is whether these initiatives that we kicked off as a result of the 1997-1998 crisis are still
relevant. One might feel that the current crisis is a global crisis and therefore the solution should also be found at the global level.

In my view, it is still extremely important for East Asian economies to push ahead with the measures we initiated in response to the last crisis, as well as initiate other measures in direct response to the current subprime crisis. This will help both in the short term, for countries to shore up their economy, and in the medium term, for them to be able to readjust their growth path and be less dependent on exports. It will also strengthen the region’s economic and financial resilience and protect it from future crises in the long term.

In the current crisis, it is really out of the question for East Asia to export its way out of the crisis, simply because there is no demand for exports. So, first of all, countries need to avoid protectionism, and they also need to avoid competitive depreciation. This is easy to say but not so easy in practice. This is because the first thing that happens is that the business sector, particularly the export sector which is very vocal, will demand that the government step in to weaken the currency, and they also point to the weak currency of Korea. It is difficult to explain that the situation for each country is different. It is not that Korea is trying to deliberately weaken its currency, but this is very difficult to explain to the export sector or the government in a country such as Thailand.

In the short term, for most of the countries, there will be more layoffs from the export sector, so social protection is important. This is what we learned in the 1997 crisis. For many countries now, if they are starting from a sound fiscal position, they will have the resources initially to inject for maybe 1–2 years in order to protect the social sector, particularly employment. In the case of Thailand, in 1997 we had difficulty in using and finding resources to shore up the social safety net. We borrowed from the World bank and the Asian Development Bank, but these agencies have their rules and regulations, procurement methods, etc., so we could not use the money quickly. Luckily Japan came forward and provided assistance to crisis-affected countries, which could also be dispersed very quickly. So in this crisis again, Official Development Assistance (ODA) loans will be important. In the case of Japan, it has already scaled up the size of ODA loans and I think other potential donor countries can also focus on this issue.

In the medium term, I think we are talking about restructuring the
growth path. Obviously, public infrastructure investment could be one measure at least in the medium term (3–5 years). But again, many countries will have fiscal constraints and need financial support, and for this the Asian Development Bank has been helpful and there are initiatives to set up an infrastructure fund. This was explored when I chaired the Association of Southeast Asian Nations (ASEAN) finance ministers meeting in Chiang Mai in 2007. This could be expanded to the entire East Asia region. Also, developing the Asian bond market should continue as it gives additional sources of financing for countries in the region.

Most importantly, however, I think the region needs to strengthen its regional architecture. And here, of course the Chiang Mai Initiative (CMI) is very important. This was agreed in principle in 2007 when I co-chaired the ASEAN+3 finance ministers meeting with my counterpart from the PRC, and it took 2 years before the amount of country contributions could be agreed upon. It is a big step because it is very political; countries think of contributions as voting quota, so they think that the more they contribute, the more votes they’ll have. But anyway, it was finally decided in Bali in May 2009.

The next thing is to decide what would be the implementing mechanism.

The first thing is to delink from the International Monetary Fund (IMF). It no longer makes sense to link to the IMF, because the IMF is giving money away freely now. What is the point of linking to the IMF when it does not have conditionality? So this is a very good time to decide. And by the way, the ministers agreed that the process should be implemented by the end of 2009. The officials are on the task of working out the details of the implementation.

Secondly, some people say that the $120 billion is too small for the mechanism. In fact, it is not too small because first of all, countries should be able to make bilateral contributions, as it was back in 1997 when Thailand borrowed $17.2 billion from the IMF. The money that came directly from the IMF was very small; it was the bilateral contribution from other countries that constituted the majority. If we allow bilateral contributions, the initiative will be much bigger.

Thirdly, the CMI should be able to provide swap facilities, not lending.

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1 ASEAN+3 refers to the Association of Southeast Asian Nations (ASEAN) countries, plus the People’s Republic of China, Japan, and the Republic of Korea
This is along the same line as swaps that some central banks have with the United States (US) Federal Reserve and other central bank swaps. Most importantly, and I think this is a political decision, East Asia needs to make a final decision on whether to set up a monetary organization. I mean, the reason why the link to the IMF was there was because every time we talked about a regional monetary organization independent from the IMF, the argument against it was that there will be moral hazard. Well, now we can forget about moral hazard because no one is talking about it anymore. If they mention moral hazard, we can say, Well, what about the US bailout programs, it’s all moral hazard. This is a time to really move ahead but the important thing, in my view, is not that this regional organization only has a regional role but will in fact be a very important part of the new global financial architecture. The problem we have with the current financial architecture is that there is no adequate surveillance of advanced countries. These are countries, particularly the US, where East Asia invests its money. So why don’t investors execute surveillance on the debtor?

This organization will contribute to that role. In a sense, it will eventually lead to what was discussed this morning, on why we don’t have ASEAN+3 finance ministers meeting more often. Once we have this sort of organization, meetings will happen more often, perhaps monthly, also including meetings of the central bank governors and so on. And they will review regional issues. Of course, conditionality within the region will not be easy to solve, but given that no one in the region now wants to borrow from the IMF, there is a big gap, and this is the reason why this organization is needed.

Doo Yong Yang

Actually I was informed that I’ll be talking about three issues: the origin of the global crisis, the Asian bond market initiative and Asian capital market, and lastly the CMI and monetary cooperation issue.

The causes of the global crisis are very important because, even though the current crisis will be subdued, there might be another deep cause of crisis remaining which may cause the global financial market to be vulnerable. There are generally two views, first is at the micro level, that the financial regulation and supervision were wrong, including structural bond issue, the incentive system, credit rating agencies, and so on. The other view is that the crisis was caused by excessive liquidity on the global scale for the last 5–6 years. So, with this kind of excessive liquidity, three factors are mentioned as the cause. First is policy error, such as expansionary monetary policies in major
If you look at figure one, you’ll see that from early 2000 there has been a huge expansion in monetary policy to get over the crisis period. So interest rates are going down but liquidity on the global level has increased. In addition, another structural problem occurred in late 1999 or early 2000, with the high savings and risk-averse behavior. In 1997 and 1998, Asia was extremely risk-averse after having lost a great amount of its wealth. Now, the US and developed economies, both investors and consumers, are extremely risk-averse. That kind of behavior affects not only the real sector but also the financial industry.

I simulated a two-country model to show what happens when we have risk-averse shock in terms of the utility function. I think this is a wealth effect after all, because if you lose your wealth there is a high chance that you’ll become risk averse. What I tried to show is that productivity shock only explains the current surplus or deficit in a small sense, but when you have risk-averse shock, like in Asia in 1997 or the US in 2008, consumption is reduced rapidly and so is investment. So there are overall changes in real activity. I think that’s one of the reasons for the global imbalance and change of capital flows internationally for the past 4–6 years.

The second issue is about the Asian Bond Market Initiative. Some people say that the initiative by ASEAN+3 has lagged; there are lots of discussions but no actual tangible output. But I think that is very natural, because it is very difficult to develop deep and efficient local bond markets in general. Several impediments to quick development were pointed out, such as market size, liquidity, tax differences, and so on. Governance, investment protection, or covenant is also strengthened to ensure the effectiveness of the bond market. Consistency of monetary and fiscal policies as well as financial and technical infrastructure are also important. Capital control, foreign exchange rate, or lack of a hedging market are very important in developing the bond market. There is lots of research on these issues but I think because these factors are affecting the development of the bond market simultaneously, it is not easy to develop an active and deep bond market in Asia. There have been, however, two small but very important steps recently to boosting the Asian Bond Market Initiative.

My question is, why is the equity market so active in Asia while the bond market is not? I think that it is very important to develop a more efficient capital market in Asia. If you look at the stock market, Asia’s
Sharpe ratio is actually a little higher than that of developed countries such as the US and Europe, and a little lower than that of developing economies generally. If you look at the turnover ratio, Asia’s ratio is not that small compared to developed countries, which means that there is active trading in Asian stock markets. If you look at the bond market, however, the liquidity of the bond market in Asia is small, meaning that it is not actively trading. Why is that? Perhaps there are several factors, such as the impediments that I mentioned earlier. We don’t have much of a hedge market or legal protection, and so on. Another thing is the difference between the bond and equity markets, as the upside to the return of bonds are fixed but for equity they are unlimited, at least in theory. Also, foreign investors in Asian bonds are relatively risk averse, while equity investors are risk takers—they don’t even hedge their investments made in the equity market. In this case, the existence of a hedging market is not important for the equity market but very important for the bond market.

The third issue is post-CMI and monetary cooperation. I think the decision made by the finance ministers of ASEAN+3 is a very important step, as mentioned by Dr. Chalongphob and Professor Eichengreen, but there are issues remaining. First is whether the CMI is big is enough. Some people say it is not enough since it is still linked to the IMF, which is also a big issue. Even if it is not linked to the IMF, $120 billion may not reflect all the important liquidity in the time of the crisis because the Asian economies are increasing in size. The second issue is the surveillance unit and the link to the IMF. I think that an independent and effective surveillance unit, delinked from the IMF, is the key to this regional pooling. However, ASEAN+3 has not yet reached a consensus on where this unit be located, what kind of steps have to be taken to build this sort of surveillance unit, and so on. The third issue is the relationship with the global financial architecture. The IMF is getting rid of its conditionality, so how do we reflect that sort of changing global financial architecture? The last issue is enlargement. The CMI is only for ASEAN+3 countries, but other countries such as India, Australia, or New Zealand may want to join the regional financial architecture. So we should think about whether ASEAN+3 should increase in size.

I think that the three conditions for the regional financial architecture are liquidity support, a surveillance unit, and policy coordination. We have stepped into the liquidity support part, pooling the reserves, but we are not concrete on the establishment of the surveillance unit and policy coordination. I still think that this is a big step. We’ve been
talking a lot about regional financial architecture after the Asian financial crisis, but it is because of the current global crisis that Asians are thinking more about the regional financial architecture. So I think more discussions can be had on the establishment of the surveillance unit and policy coordination, under the discussions of the CMI, to further develop the regional financial architecture.

Masahiro Kawai

By the way, the CMI has extended the membership by including Hong Kong, China. So Hong Kong, China is now a member, although it is not included in ASEAN+3.

Jongkyu Park

I’ll talk about the PRC. I would, especially, like to point out that the role of the PRC will be essential in curing the problem of global imbalance.

Recently, I came across the IMF’s current account forecast for countries to 2014. The US current account deficit, which was the ultimate source of this financial turmoil, is predicted to be stabilized from this year onward at around 2%–3% of the US gross domestic product (GDP).

What is disturbing was the PRC’s current account surplus, which is to grow for the next 5 years as fast as it did during the last decade. The forecast predicts that the PRC’s current account surplus will rise to $801.6 billion in 2014, which is double what it was in 2008.

I don’t know exactly what the assumptions for the forecast are or the details of the IMF’s economic forecasting model, but if the PRC’s current account surplus increases as predicted by the IMF, then the root of the global imbalance will remain even if the US current account deficit stops exploding. This is because the PRC will recycle its already high yet explosively growing foreign reserves somewhere in the world. As we all know, an oversupply of liquidity was brought about in the US as the PRC tried to store its financial wealth in dollar-denominated assets and the US monetary authority did not want to interrupt its economic boom, which was without runaway inflation.

Some time in the future, pretty much the same problem will occur in any country that the PRC chooses for recycling of its formidable amount of foreign reserves. If the financial system of the country is fragile, then the country will be vulnerable to a financial crisis, and if its financial system is linked with other countries, the financial crisis will spread globally.
The PRC’s export-oriented growth strategy has been splendidly successful for the last three decades. However, like Alice in the wonderland, the size of the PRC’s current account surplus has grown too much. As soon as Alice took a magic cookie, the size of her body outgrew the house. Likewise, with its undervalued exchange rate, the PRC’s current account surplus has outgrown the global financial architecture.

It is also remarkable that the PRC economy alone in the world is emerging almost intact from the global financial crisis. I think this proves the unique strength of the PRC economy. Some of the country’s high-ranking officials no longer conceal their aspiration for global economic supremacy, and claim that the renminbi should be respected by the rest of the world much more than before.

So, I think it is about time for the PRC to revise its growth strategy from an export-oriented one to a domestic-oriented one. As soon as Alice in the wonderland took another magic cookie, her body shrunk to normal size. Likewise, if the PRC raises the level of its minimum wage rate and opens its bond market and foreign exchange market, the domestic economy will be stimulated and the size of the current account surplus will shrink to a size which is comfortable for both the PRC and the rest of the world.

By doing so, the PRC needs to reform itself from “the factory for the world” to “the factory for its own people.” That transformation will be beneficial for curing the problem of global imbalance and at the same time for enhancing the welfare of the people of the PRC.

Masahiro Kawai

In this session, three topics were posed: global imbalances, Asian capital markets, and foreign reserve pooling. With regards to global imbalances, I thought the IMF forecast statistics just shown to us were very interesting. Regarding the question of whether global imbalances will reemerge if US consumption somehow recovers, it may be a happy situation for Asia. Because the engine of growth for Asian countries is coming back, even though it may imply a reemergence of global imbalances but with a stronger financial system in the US, it may be a better kind of payment imbalance than before, although it may not be sustainable for long. If US consumption does not recover, the question is whether global imbalances will reemerge. If the US current account deficit is 2% of GDP, it may be a problem for the US. The PRC may have a problem, but here the issue is that if US consumption does not
come back and if Asia countries try to grow by exporting, then it looks like its going to put deflationary pressure on the global economy because all countries cannot grow by exporting. So there may be some issues about whether the global payments imbalance comes back, and how it comes back.

On the capital market issue, Barry Eichengreen gave the impression that Korea did everything right in terms of financial market opening and development, and as a result the country suffered. I have a slightly different interpretation of what has been happening in Korea. I just want to pose this: the country’s short-term external debt rose before the crisis, and it did not really rise to the level of foreign exchange reserves, but if you include foreign investment in the equity market, then foreigners invested in Korea more than in foreign exchange reserves. Perhaps the jittery movement in the foreign exchange market and financial markets in Korea may have some reasons. So, I am not quite sure and I want to invite the Korean view on whether the country was borrowing excessively from abroad.

On the foreign reserve pooling issue, the CMI, and the IMF: in my view the CMI represented significant progress in the sense that the three countries in northeast Asia—the PRC, Japan, and Korea (and particularly the PRC and Japan)—were able to agree on shares. That was very significant. Japan has been insisting that its share has to be higher than the PRC’s, the PRC has been insisting that its share cannot be less than Japan’s, and Korea has been saying that its share should not be less than the PRC’s. If you take a look at the Asian Bond Fund (ABF) shares, Korea’s share is higher than the PRC’s but the result is that Japan’s share is 32%, the PRC’s share is 32%, Korea’s share is 16%, and ASEAN’s is 20%. So, Japan and the PRC made a compromise, and this arrangement preserved face in both countries because the PRC’s 32% includes mainland PRC (28.5%) and Hong Kong, China (3.5%). So the PRC was able to include Hong Kong, China as a member of the CMI, and the PRC’s mainland share was less than Japan’s share. I think Korea was very happy, because 16% is much bigger than the usual calculation we’ve been doing for Asian currency unit weight. Overall I think the three countries are very happy about the shares.

I think your suggestion that an Asian currency unit now can be constructed by using these shares is a very good approach, because these shares are not that much different from the shares that we’ve been computing. It was the PRC that was telling the Asian
Development Bank not to go ahead and produce an Asian currency unit. The PRC, Japan, and Korea are the three countries that would decide the shares and the Asian Development Bank should not decide shares. If the three countries were able to agree on the shares, it would allow the Asian currency unit to be created quickly based on these shares.

Inchul Kim

I was wondering why the traditional problem of the liquidity dilemma had not been raised. Professor Cooper kept on asking the same question. It was not clear to him as to what problem the substitution of the special drawing right (SDR) for the dollar solves. I understand that you know all the economic reasons, and understand what was on Governor Zhou’s mind—that we want to reduce or avoid exchange rate risk or volatility, that we also wish to resolve the liquidity dilemma by substituting the SDR for the dollar, and lastly, perhaps, that as the PRC and Japan are holding so much in foreign reserves, the PRC is very sensitive to the change, especially in any weakening of the dollar. Perhaps that is what Governor Zhou had in mind when he made the proposal regarding the SDR issue.

Masahiro Kawai

For equity investment, we knew that in the case of Malaysia during the Asian financial crisis, and Dr. Chalongphob has been saying it in the context of Thailand, so I guess in Asia generally, we share the view that equity flows can be very short term in nature. Maybe foreign direct investment is a bit different. Changing weights could probably take place 3–5 years after an Asian currency unit weight change. Maybe in this region economic changes are taking place fast, so more frequent changes may be needed.

Richard N. Cooper

Two questions. One concerns the development of an Asian bond market, which has been on the agenda for some years, and has been mentioned here in a very positive way and as a very desirable thing to do. The question I have is, who are the potential buyers of these bonds on any scale? The answer to that question, in the US, is life insurance companies and pension funds, both of which have long-term liabilities and want to, roughly speaking, match the maturities of their assets with their liabilities. They are conservative institutions and therefore bonds are natural instruments for them to buy, and they overwhelmingly account for the holding of bonds in the US. Their liabilities are typically in domestic currency and, again, are consistent with their conservative nature. In both cases, you think they’d want to match the currency of their assets with the currency of their liabilities. So my question is a compound one. What is the state of development,
institutionally, of life insurance companies and pension plans other than the public pension system or, in the absence of those two, who are the alternative potential customers for bonds?

The second question goes to the currency of the bonds. If they are not in local currency, that is going to fragment the markets in East Asia. If they are not in local currency but in something like an Asian currency unit, then the exchange rate risk issue comes to the fore. Unless you can get life insurance companies to be able to sell life insurance in Asian currency units, or pensioners are willing to accept Asian currency units, then it seems to me you have a problem there.

So I come back to my first question asking who’s going to buy the bonds.

My second observation concerns the following: We’ve heard now several times today that IMF conditionality is gone. That’s a huge surprise to me. I don’t think it’s gone at all. It is true that, partly for institutional reasons and partly for real reasons having to do with the financial questions, the IMF created this new liquidity facility. But not all member countries qualify for that; in a sense, a prequalification is required there. For anyone else, it is business as usual now but perhaps on a faster time track in view of the urgency of the situation. But I don’t think we want to fall into the habit of thinking that IMF conditionality is history.

Kwanho Shin

Let me go back to the issue of foreign reserves. Dr. Kawai suggests that probably this time Korea had too low a level of reserves. And yes, we suffered a lot from capital outflows because this time it was mainly from stock market investments. But if you think in that way, you have to prepare for other foreign securities. How about long-term bonds? Once you look susceptible to a crisis, foreign investors may even dump long-term bonds. And if you think that way, and if you build reserves for all investment by foreigners, then why would you need international intermediation? You just use reserves instead of borrowing from foreign investors.

In a worst-case scenario, domestic residents may also want to convert domestic currency to foreign currencies. So, my view is that there will not be any limit in the calculation of the appropriate level of reserves, so maybe we need some other options instead of building up reserves.

Hee-Yul Chai

One comment on your question about the sufficiency of foreign
exchange reserves in Korea. I don’t have the exact figures in my hand but we have about $200 billion in foreign exchange reserves and our floating debt is about $200 billion, so almost the same. But if you count two types of short-term debt, one is the advanced receipts for shipbuilding that are recorded as the debt for financial institutions but which actually is almost a risk-free debt. Secondly there is debt related to foreign exchange futures. There was a lot of foreign exchange hedging by foreign investors in 2006–2007, so financial institutions had long positions to hedge these positions by borrowing short term. Therefore, the debt related to these foreign exchange futures is about $40 billion. If you exclude these two types of foreign debt, the risky foreign debt is about $120 billion.

This morning Professor Cooper asked why the Government of Korea did not use its reserves in its shortage of foreign exchange liquidity. In my view it is because the government felt that the foreign reserve was sufficient but the market saw that it was not sufficient in comparison to the amount of floating debt. So the government tried to persuade the investors and explain the situation of Korean debt. I think the foreign investors finally understood the real situation of the foreign exchange reserves and the liquidity problem in Korea. This is why, from last February, equity investment has increased in Korea, which is related, I think, to the understanding of the Korean foreign exchange problem.

There are several ways to explain the stabilization but I think foreign investment in the Korean equity market from March is related to the stabilization of the Korean foreign exchange rate, and to the understanding of the real situation of Korean exchange reserves related to short-term debt.

Richard N. Cooper The natural question that arises is, why didn’t that understanding exist last October? Either there was information which is now available but wasn’t available then, that’s one possibility. Another possibility is that foreigners were just not doing their homework, as we know they weren’t on some other issues. Or it could be some combination of the two.

Masahiro Kawai In March or April 2008, we heard from the Korean authority which made a presentation at the Asian Development Bank Institute (ADBI), and it was a very good explanation of the shipbuilding part, and there is a solid asset to back up, so there is no worry. That was really the argument, but then we saw what happened. Maybe that was not convincing for the investors because shipbuilding has long-term
delivery while short-term borrowing had to be rolled over, and there is a mismatch.

Richard N. Cooper  Maybe I misunderstood. I thought the explanation was that these were advanced payments, and therefore short-term liabilities in an accounting sense, but not in fact fickle.

Hee-Yul Chai  The only risk with this kind of debt is that the shipowners order the ship and refuse to pay for the shipbuilding, which will create a default risk. In general, the default risk is extremely low, and for some small shipbuilders there is a problem with this kind of short-term debt. This is not related to the obligation of the government to pay for the debt, so I don’t think it is something foreign exchange reserves should be used for. So it is a little strange to relate this kind of debt to the foreign exchange reserves.

Actually, that is not a debt but the record keeping. When there is a receipt, which is given periodically, the shipowners pay for the shipbuilding according to the construction stage. When money comes from the shipowners, it is recorded as a liability of the banks. That is not debt. So, that is an accounting question, as it is recorded as debt but it is not really the debt of the banks.

The debt related to the futures contract entered into by the shipbuilders is a different issue from the debt of the banks, which was to match the position with these futures.

So there are two different things. One is the debt related to the futures contract, and the second is the advanced receipts for shipbuilding. The advanced receipts for shipbuilding are considered as debt of the banks but these are not actually debt, and the debt related to the futures contract is risk free because it is matched with the receipt of the dollars in the futures market.

Richard N. Cooper  The point is that they are vulnerable.

My question still remains, why didn’t the Government of Korea use its reserves? It is precisely for this kind of contingency that one holds reserves.

Masahiro Kawai  I am very tempted to further pursue this line of argument but we are running out of time.
Changkyu Chai  I have data which may give some answers. At the recent conference in Beijing, a paper regarding a study by Citigroup on reserve short-term debt and foreign holdings of stocks and bond was quoted. In Korea’s case, I guess this data is based on as of the end of last year. At that time reserves were $201 billion and short-term debt was $191 billion, including shipbuilding. For foreign investors, the question is basically whether the country has enough foreign currency when they want it. Because Korea had a currency account surplus, short-term debt was reduced by $13 billion. Foreign holdings of stock were $111 billion, and foreign holdings of bonds $27 billion. So, in terms of external short-term debt, the figure was $316 billion, including mobile capital, compared to the $201 billion in reserves. The only other country that has more external short-term debt plus mobile capital than reserves is Indonesia. That’s why these are the two countries where the exchange rate fell the most.

Kyungsoo Kim  Let me just mention the difference in vulnerability in 2008 compared with 1997. Eleven years ago, the banks did stupid things. All the bank loans turned out to be rotten, but in 2008, as Barry said, we did all the right things. Exporters hedged their positions by selling forward, and the counterparty, the domestic banks, squared their position and dumped in the spot markets. But when they borrow short term, it’s cheaper than longer term. There are also asset management firms that tried to sell the dollar forward, which caused significant losses for overseas investments through the fund. Asset management firms had to counterhedge their positions, and the global financial crisis dried up liquidity. Everyone did their best and did rational things, but they just rushed to the central bank’s foreign reserves. What I am trying to say is that everyone did the right thing but that created a negative externality.
Section IV

One Money in Asia
A. Introduction

The ASEAN+3 finance ministers meeting held in Bali in May 2009 reached agreement on the implementation of the Chiang Mai Initiative (CMI) before the end of this year. At the same time, the finance ministers agreed to introduce the Credit Guarantee and Investment Mechanism. In contrast to these achievements belonging to the realm of financial cooperation, monetary cooperation in East Asia is still in its infancy. At the meeting held in Hyderabad in 2006, the finance ministers of three northeast Asian countries endorsed the need to introduce a regional currency unit (RCU) to enhance the surveillance mechanism, but no further progress is reported yet. There has been no official statement as to how to foster intraregional exchange rate stability and/or exchange rate stability with regard to third currencies.

However, I am convinced that monetary cooperation should be an important agenda item at ASEAN+3 finance ministers meetings in the future. One reason for such a viewpoint is that there are clear signs that East Asia is getting closer to becoming an optimum currency area (De Grauwe 2009). Another rationale to pursue monetary cooperation in East Asia has to do with the uncertain future of the dollar standard. One of the consequences of the current financial crisis would be the decline of the monetary hegemony of the United States (US). The huge fiscal deficit of the US and its reputation loss due to being the epicenter of the crisis are heralding the decline of the US monetary prerogative. The People’s Republic of China (PRC) is at the center of this geopolitical change. The PRC is endeavoring to heighten the international status of its currency through wider use of it as a denomination and settlement currency for trade with its neighbors. It seems, however, unlikely that the renminbi will become an international currency comparable to the US dollar in the near future. Besides, the fact that the use of an international currency is dictated by economies of scale and network externality, the lack of transparency in monetary policy in the PRC, the inconvertibility of the renminbi, and the underdevelopment of the capital markets denominated in renminbi make it improbable that the renminbi will become an international or regional key currency in the foreseeable future. The current financial crisis and the decline of US power would, rather, provide occasion for East Asian countries, including the PRC, to explore the possibility of forming a currency area in the region.

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1 ASEAN+3 refers to the Association of Southeast Asian Nations (ASEAN) countries, plus the People’s Republic of China, Japan, and the Republic of Korea.

2 These are the People’s Republic of China (PRC), Japan, and the Republic of Korea.
B. Alternative Approaches to Monetary Integration

There are several competing ideas for the constitution of a currency area in East Asia. The introduction of intraregional exchange rate stability similar to the European Union prior to the formation of a single currency area is an option. This option may be dubbed an exchange rate centered approach, or institutional approach. A parallel currency approach and harmonized inflation targeting are alternative approaches. The parallel currency approach argues that a smooth transition to monetary union can be realized in the long run if a common currency is allowed to circulate freely in Asian countries alongside their national currencies. Harmonized inflation targeting is based on the idea that, if the inflation rates of the member states are sufficiently similar, exchange rates are also likely to be relatively stable. Thus, it would be better to pursue harmonized inflation targeting for regional central banks before introducing exchange rate arrangements.

Eichengreen (2009) provides a comprehensive account as to why harmonized inflation targeting can be considered as the best approach to encouraging monetary cooperation in Asia. He compares the three different approaches (exchange rate pegging, parallel currency approach, and harmonized inflation targeting) against three criteria: robustness with respect to capital mobility, compatibility with prevailing political circumstances, and congruence with modern ideas about the conduct of monetary policy. Eichengreen maintains that harmonized inflation targeting is the best approach for the following reasons. First, it is less prone to speculative attacks in a world of capital mobility since it avoids creating fixed prices at which financial markets can shoot. Second, it is compatible with prevailing political circumstances in Asia in that it does not require a significant sacrifice of national sovereignty. Finally, it is congruent with contemporary ideas of monetary policy in that “it encourages central bank independence and accountability, a commitment to price stability, and the use of an information-inclusive operating strategy” (Eichengreen 2009).

I think that harmonized inflation targeting merits attention specifically because it is gradual and evolutionary, and thus better respects market forces than does the institutional approach. However, it is not clear whether this approach would by itself lead to monetary union. I think that political solidarity and voluntarism are required for that approach, as they would be for the institutional approach.

First of all, it would not be possible to agree on common or harmonized inflation targets when economic conditions and policy preferences—and the perception about them—are not the same among participating countries. Thus, harmonized inflation targeting implies a degree of political solidarity and
willingness to compromise national sovereignty. Second, a uniform inflation target for all, even if it were introduced, would turn out to be incompatible with the stability of bilateral exchange rates. The Balassa-Samuelson effect says that countries with higher productivity growth experience higher inflation rates when exchange rates are fixed. Alternatively, when a common inflation rate prevails despite productivity differentials, exchange rates should play the role of adjustment. So, a uniform inflation target does not seem to lead to a smooth path towards monetary integration. Harmonized inflation targets (not a uniform one), taking into account the differences of productivity growth and other factors, would better avoid the theoretical problem raised above. However, there remains the question as to when harmonized inflation targeting is changed into uniform targeting, which is a necessary step towards the fixing of intraregional exchange rates.

In my opinion, it is difficult in advance to assert that harmonized inflation targeting is better than an exchange rate centered approach, or vice versa. Monetary integration inevitably entails a certain “leap of logic” pushed by political solidarity.

A similar observation also applies to the parallel currency approach. The use of a common currency in the private sector needs substantial public support and political solidarity. This includes official definition of the RCU, use of the RCU in official transactions, stabilizing exchange rates among the constituent currencies, and introducing an efficient and reliable clearing and settlement system for private RCU claims (Chai and Yoon 2009). Furthermore, it is doubtful that the RCU can out-compete national currencies as reserve of value in countries with a strong currency. As far as investors in countries with a weak currency are concerned, the RCU may be attractive. However, it is doubtful that such countries would be ready to allow the RCU to circulate freely alongside their national currency for fear of a substantial loss of seigniorage gains.

In conclusion, I would say that the transition towards a currency area in Asia needs a certain mixture of the three approaches. It is good to start by establishing harmonized inflation targeting, and officially defining the RCU and promoting its use. However, the introduction of an exchange rate mechanism will eventually be needed for transition to a currency area. The institutional approach may be pursued at an early stage of monetary cooperation if it is supported by the political solidarity of key nations because it can shorten the transition to a monetary union.

C. Regional Currency Unit Creation and Use for Exchange Rate Mechanism
The official introduction of an RCU as a deviation indicator is a good starting point for monetary cooperation in East Asia. In Asia, the idea of introducing an RCU has been proposed by a number of scholars (Moon, Rhee, and Yoon 2000; Kuroda and Kawai 2002; Mori, Kinukawa, Nukaya, and Hashimoto 2002; Ogawa and Shimizu 2006). There are a number of technical issues to be addressed in introducing an RCU, including the currencies to be included in the basket, fixed shares versus fixed units of constituent currencies in the basket, choice of factors determining the weights of constituent currencies, determination of the base year, and periodicity of the change in the proportion of constituent currencies. The introduction of an official RCU has a political economic aspect since the information the RCU generates about the fluctuation of Asian currencies critically depends on the way the RCU is calculated. A currency taking predominant weight in the RCU will be relatively stable with respect to the RCU, which might be advantageous for the country issuing the currency, not only for its external credibility but also for the cost of intervention under an Asian exchange rate mechanism.

In any case, a properly designed RCU will convey useful information for the independent surveillance unit, which will be established to monitor and analyze regional economies and support CMI decision making\(^3\). It can also pave the way towards deeper monetary cooperation and the formation of a currency union in Asia.

The official RCU can be issued by the so-called Asian Monetary Cooperation Fund (AMCF) against dollar, euro, and gold reserves of the central banks in the region. Such a system is similar to the European Currency Unit (ECU) created by the European Monetary Cooperation Fund. Alternatively, it can be issued against national currencies instead of dollars, euros, and gold. Let me show here how the ECU created in this way can be used for the financing mechanism of an Asian exchange rate mechanism.

For RCU creation, each central bank transfers a certain amount of its currency to the AMCF and receives RCU deposits in return according to the central RCU exchange rate. The relative amount of each currency that a central bank transfers to the AMCF would be determined by respecting the proportion of constituent currencies in the basket. Each central bank will have its RCU account in the AMCF. There would be RCU deposits of the member central banks on the liability side of the AMCF balance sheet, and constituent currencies on the asset side. The AMCF would have some discretionary power to determine the total number of RCUs issued. Let me give a simple numerical example.

\(^3\) At the 12th ASEAN+3 finance ministers meeting, the ministers agreed to establish an independent surveillance unit.
Suppose that the RCU is composed of three currencies—yen, renminbi, and won—in equal proportions. The central bilateral exchange rates according to the AERM are supposed to be CNY1 = ¥10 = W100. One unit of the basket currency can then be defined as containing CNY1, ¥10, and W100. The central RCU rates are one RCU = CNY1, ¥30, or W300. Initially, if the AMCF had issued 300 RCUs, the balance sheet of the AMCF would be as follows:

<table>
<thead>
<tr>
<th>Asset</th>
<th>Liability</th>
</tr>
</thead>
<tbody>
<tr>
<td>CNY300</td>
<td>RCU 300</td>
</tr>
<tr>
<td>¥3,000</td>
<td>(People’s Bank of China: RCU 100)</td>
</tr>
<tr>
<td>W30,000</td>
<td>(Bank of Japan: RCU 100)</td>
</tr>
<tr>
<td></td>
<td>(Bank of Korea: RCU 100)</td>
</tr>
</tbody>
</table>

If the RCU was issued against national currencies, intervention at the bilateral margins could be conducted in a centralized manner; the central banks involved in the intervention would not be directly linked, but indirectly linked through the AMCF (Chai 2007). Now, suppose that the renminbi depreciates against the won and the yen by the same proportion in the exchange markets. (For the sake of simplicity, I suppose that there is no margin of fluctuation allowed in the AERM.) To stabilize the exchange rates, the Bank of Korea should sell won, and the Bank of Japan should sell yen to the AMCF at the central RCU rate, and accumulate RCU deposits proportionately. The People’s Bank of China should buy back renminbi at the central RCU rate by using its RCU deposits proportionately. Subsequently, the AMCF would sell won and yen in exchange for renminbi to make the proportion of constituent currencies in its assets identical to that of RCU. Those operations continue until the bilateral exchange rates between won and yen, and between won and renminbi return to the initial levels. The end results will leave the total issuance of RCU by the AMCF unchanged, the proportion of constituent currencies in the assets of the AMCF unchanged and equivalent to the definition of the RCU, the RCU deposits of the Bank of Korea and Bank of Japan increased, and RCU deposits of the People’s Bank of China decreased. If the operation needed a 10% increase in RCU deposits for the Bank of Japan and the Bank of Korea, the balance sheet of the AMCF would be as follows:

<table>
<thead>
<tr>
<th>Asset</th>
<th>Liability</th>
</tr>
</thead>
<tbody>
<tr>
<td>CNY300</td>
<td>RCU 300</td>
</tr>
<tr>
<td>¥3,000</td>
<td>(People’s Bank of China: RCU 80)</td>
</tr>
<tr>
<td>W30,000</td>
<td>(Bank of Japan: RCU 110)</td>
</tr>
<tr>
<td></td>
<td>(Bank of Korea: RCU 1,100)</td>
</tr>
</tbody>
</table>

It might be that the central bank issuing the weaker currency would be in need of RCU deposits to buy its own currency from the AMCF. The AMCF might
introduce a minimum level of RCU deposit for each country. If the deposit reaches the lower limit, the central bank can no longer use its RCU deposit to buy its own currency but has to borrow from the AMCF. The AMCF can charge the central banks interest on the credit and pay interest on the deposits corresponding to the credit, accumulating extra RCU deposits. If the credit can not be reimbursed within a predetermined time, it can be extended. On the other hand, the AMCF, as the creditor, can impose restructuring programs on the debtor country. The question is whether “weaker” central banks would be willing to accept this kind of arrangement.

Whether “stronger” central banks would be willing to accumulate RCU deposits is also uncertain. To be sure, RCU deposits accumulated by a central bank could be used to support its own currency, if necessary. Furthermore, interest payment could minimize the aversion to the accumulation of unintended RCU reserves. However, the continued accumulation of RCU reserves is not desirable, as the readjustment of central bilateral exchange rates implies the loss of the value in its deposits. These points highlight once again that an exchange rate arrangement without prior convergence in macroeconomic conditions may be fragile.

It is to be noted that the AMCF would be in a better position to manage the size of the RCU issuance than if the RCU was issued against dollars, euro, and gold. However, the issuance of the RCU against national currencies might be opposed by the central banks because such an arrangement implies the transfer of an important degree of national monetary prerogative to the AMCF. Thus, it will be important to introduce transparent decision making processes within the AMCF to induce cooperation from the central banks.

D. Conclusion

The current financial crisis and the ensuing decline of US power provides an opportunity for East Asian countries to form a currency area in the region.

The alternative approaches for monetary cooperation seem complementary rather than just being substitutes. The parallel currency approach and harmonized inflation targeting are gradual and evolutionary, and thus better respect market forces than does the institutional approach. However, political solidarity and voluntarism are required for implementation, just as with the institutional approach. It is not clear whether these approaches would by themselves lead to monetary union. The introduction of an exchange rate mechanism will eventually be needed for a transition to a currency area. The institutional approach may even be pursued at an early stage of monetary cooperation, if supported by the political solidarity of key nations, because it can shorten the transition to a monetary union. However, an exchange rate arrangement without prior convergence in
macroeconomic conditions may be fragile. Therefore, it would be good to pursue harmonized inflation targeting for regional central banks before introducing exchange rate arrangements. Officially defining the RCU and promoting its use can pave the way to the eventual creation of a single currency in Asia.

Regarding RCU creation and the exchange rate mechanism, Asian countries may introduce a system different from that used Europe. The RCU can be issued against national currencies instead of dollars, euros, and gold. If the RCU is issued against national currencies, intervention at the bilateral margins can be conducted in a centralized manner. This kind of arrangement is technically possible but its successful implementation hinges on how much the member states show political solidarity and how much their economies show convergence.

References


MONETARY COOPERATION IN ASIA

Eiji Ogawa

A. Introduction

This paper considers the following questions:

(i) Which of the following alternative approaches to monetary cooperation in Asia is the best way, and briefly describe what should be done to make your chosen approach advance one step further.
   (a) Harmonized inflation targeting.
   (b) Parallel currency approach.
   (c) Exchange rate arrangements.

(ii) Can a regional monetary unit (RMU) or regional currency unit (RCU)¹ in Asia, if it is properly constructed, play a pivotal role in monetary stability in Asia? How can it be used for macroeconomic surveillance in the region?

(iii) Will the RMU be used as a denomination currency in capital markets or international trade? Are there preconditions for that?

The second and third questions particularly have been studied by the Research Group under the ASEAN+3 financial ministers meeting for the 2 years from 2006 to 2008². This discussion paper is based on the reports that the Research Group presented to the ASEAN+3 financial ministers meeting to discuss the questions (Institute for International Monetary Affairs [IIMA] 2007, 2008).

B. Alternative Approaches to Monetary Cooperation in Asia

Regarding the first question—which of the alternative approaches to monetary cooperation in Asia is the best way among harmonized inflation targeting, parallel currency approach (Eichengreen 2006), and exchange rate arrangements—it may be better to consider whether they are alternatives or not.

A relationship between harmonized inflation targeting and exchange rate arrangements means the two are not considered as alternatives. Rather, they have

¹ There are several names for the regional monetary unit in Asia. The ASEAN+3 financial ministers meeting named it the RMU (ASEAN+3 refers to the Association of Southeast Asian Nations [ASEAN] countries, plus the People’s Republic of China, Japan, and Republic of Korea). The Asian monetary unit (AMU) was named by Professor Takatoshi Ito’s team of the Research Group under the ASEAN+3 financial ministers meeting. The Asian Development Bank named it Asian currency unit (ACU). The RCU was named by a Korean team of the Research Group.

² ASEAN+3 refers to the Association of Southeast Asian Nations (ASEAN) countries, plus the People’s Republic of China, Japan, and Republic of Korea.
a complementary relationship with each other. In European experience, the Maastricht Treaty required the candidates introducing the euro to satisfy convergence in terms of the inflation rate as well as stability of intraregional exchange rates based on the European Currency Unit under the European Monetary System.

In the long run, countries should have the same trend in terms of inflation rates in order to prevent misalignments and, in turn, reduce frequency of realignments of the countries’ currencies. On one hand, in the short run, exchange rate arrangements can prevent volatility of exchange rates on a daily or a weekly basis while harmonized inflation targeting is kept on an annual basis. The exchange rate policy and the monetary policy might make for a division of labor as long as both policies are conducted consistently with each other. That is, the exchange rate policy focuses on the short-run stability of intraregional exchange rates while the monetary policy focuses on the long-run stability of prices or value of home currencies by conducting harmonized inflation targeting in the region.

However, we should in fact consider which of the monetary authorities that are in charge of monetary policy and in charge of exchange rate policy prefer international or regional policy coordination. If the authorities in charge of exchange rate policy prefer regional policy coordination in Asia, exchange rate arrangements should be chosen as a better approach to regional monetary cooperation in Asia.

Between the parallel to the exchange rate arrangements and/or the harmonized inflation targeting, the parallel currency approach should be adopted in Asia because Asian countries have different stages of economic development at the moment. It is impossible for all of the Asian countries to adopt a single common currency. They have to take a stepwise approach to regional monetary coordination in terms of covering Asian countries. This approach might include the parallel currency approach.

1. **Regional monetary unit for monetary stability in East Asia**

Some currencies in East Asia, affected by the global financial crisis, have been depreciating against the United States (US) dollar, although before the financial crisis began they had been appreciating due to massive inflows of capital into their countries. A typical example of this is the won. On the other hand, the yen, which had been weakening against the US dollar, has now started appreciating. Moreover, the renminbi has stopped revaluation against the US dollar, although it had been gradually revaluing against the US dollar at an almost constant speed since the summer of 2008.
The RMU and the related measurements are useful for surveillance of the exchange rates of Asian currencies. The exchange rate of the RMU in terms of the US dollar and the euro shows movements of a weighted average of Asian currencies against outside currencies. On one hand, deviation indicators of each Asian currency from a benchmark period based on the RMU shows how much overvaluation or undervaluation there is of each Asian currency.

An Asian monetary unit (AMU) is an example of the RMU, while AMU deviation indicators are an example of the deviation indicators. AMU and AMU deviation indicators were created by Ogawa and Shimizu (2005) by following the European Currency Unit. The AMU as created is a regional common currency unit for East Asia that is a weighted average of the East Asian currencies which includes currencies of the ASEAN+3 countries. The weight of each currency in the basket is based both on the countries’ respective shares of gross domestic product (GDP) measured at purchasing power parity and their trade volumes (the sum of exports and imports) in the total of sampled countries. These two shares are calculated as the average of the 3 years (2004–2006) for which data is available. Also, an AMU deviation indicator is measured for each East Asian currency’s deviation from the AMU. The indicators are set at zero during their benchmark period of 2 years in 2000–2001 when trade imbalances of East Asian countries during 1999–2006 were at their smallest.

Figure 1 shows recent movements in nominal exchange rates of the AMU in terms of a US dollar and euro currency basket, as well as in terms of the US dollar and the euro separately. The currency basket consists of 65% of US dollars and 35% of euros based on trade shares of the East Asian countries with the US and the euro area in 2001–2003 in order to reflect the value of the AMU in terms of the currencies of major trading partners. Figure 1 shows that the AMU was gradually depreciating against the currency basket of the US dollar and the euro before May 2003, when the AMU depreciated about 10% compared with the benchmark years of 2000-2001. However, it returned to almost the same level as in the benchmark years (2000–2001) before October 2008. The AMU was gradually appreciating against the US dollar before April 2008, though it has been depreciating since April 2008. It was gradually depreciating against the euro before July 2008, though it has rapidly appreciated since July 2008.

Figure 2 shows deviations of East Asian currencies against the AMU in terms of nominal exchange rates from the benchmark years of 2000–2001. The won and the baht have shown characteristic movements in recent years. The won was overvalued against the AMU or a weighted average of East Asian currencies from

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3 Both the AMU and AMU deviation indicators are available at the websit of the Research Institute of Economy, Trade and Industry (http://www.rieti.go.jp/users/amu/en.index.html).
the end of 2004 to early 2008. It was overvalued by more than 20% compared with the benchmark years, especially from March 2006 to July 2007. However, the won has been depreciating quickly since the end of 2007. The baht was appreciating quickly from the end of 2006 to August 2007. It was overvalued by about 30% compared with the benchmark years. Since August 2007 it has been depreciating quickly. On the other hand, the yen and renminbi have been appreciating in recent months.

Figure 3 shows deviations of East Asian currencies against the AMU in terms of real exchange rates from the benchmark years. The real AMU deviation indicators of East Asian currencies were limited to between +20% and −10% during 2000–2001. The rupiah and the kip have appreciated against the AMU in terms of real exchange rates because of higher inflation since 2003. The won was also overvalued against the AMU in terms of real exchange rates due to the appreciation of the nominal exchange rate from the end of 2004 to October 2007, although it has been depreciating quickly due to depreciation of the nominal exchange rate. The baht has quickly appreciated in terms of real exchange rates because of the quick appreciation of the nominal exchange rate since the end of 2006. The yen was depreciating because of a combination of yen depreciation in terms of nominal exchange rate and the deflation in prices from January 2005 to July 2007. It was undervalued by 30% compared with the benchmark years in July 2007. However, the yen has been appreciating in terms of real exchange rate since August 2007.

The RMU and the RMU deviation indicators have been so useful that we have been able to identify movements and misalignments of Asian currencies against both outside currencies, such as the US dollar and the euro, and neighboring country currencies. The intraregional exchange rate and the exchange rates against outside currencies should be focused on East Asia, where production networks or supply chain systems are establishing in the region. Moreover, active intraregional capital flow, such as yen carry trades, and the effects of the current global financial crisis have caused fluctuation in and misalignment of intraregional exchange rates, which include the yen-won exchange rate. Ogawa and Yoshimi (2009) used both convergence methods in the context of economic growth to show that East Asian currencies have had a tendency to diverge, especially since 2005.

In parallel with the IMF surveillance, the Economic Review and Policy Dialogue of the ASEAN+3 financial ministers meeting, an independent regional surveillance for East Asia, is expected to play an important role in preventing a currency crisis. Regional surveillance is expected to monitor contagion, spillover, or transmission of macroeconomic conditions and risks in the region; solve coordination failures of exchange rate policy; and deal with problems arising from
the access limit of the IMF lending. Therefore, monitoring the RMU and RMU deviation indicators, in addition to the main economic and financial indicators and those used as early warning systems such as the ratio of short-term external debt to foreign reserves, will make regional surveillance more effective.

2. Using the regional monetary unit as a denomination currency in capital markets or international trade

The RMU has two important characteristics. The first is foreign exchange risk diversification, evident from the fact that the RMU is a composite of a range of Asian currencies. The second is that it offers the weighted average interest rate of the component currencies. As long as foreign exchange risks are within acceptable bounds, the countries with relatively low interest rates among Asian economies can conduct their funds management in RMU-denominated financial instruments, thereby benefiting from higher interest rates than if management operations were conducted in their own currencies. On the other hand, by raising funds through RMU-denominated financial instruments, those economies with relatively high interest rates can raise funds with lower interest rates than through financial instruments in home-currency denominations. Because of such features, RMU-denominated financial products can be the bridge between the abundant savings and high investment demand in the region.

The RMU could be used in the following ways in the private sector:

(i) The private sector could be used as the denoting currency for current account and capital account transactions.

(ii) The private sector could be used as the vehicle, transaction, and settlement currency in current and capital account transactions. (This would, however, be difficult to realize unless there was an RMU-denominated fund settlement system.)

(iii) The private sector could be used in asset denomination. Assets could include deposits, loans, securities, and derivatives.

What are the conditions for promoting the use of an RMU? The answer to the question of what conditions a currency has to meet to be chosen as a key currency from among a wide range of choices should lie in the stability of the value of the currency and its low transaction cost. Similarly, the condition for promoting the use of an RMU should lie in the stability of its value and its low transaction cost. Unless the value is stable, it is not suitable as an accounting unit or a means for storing value, and unless the transaction cost is low, it would not be logical to adopt it as a payment method.

To secure the stability of the value and the low transaction cost, network externalities, economies of scale, and intraregional economic and financial
integration would play important roles.

What does the stability of an RMU’s value mean? The RMU has an extraregional (external) and an intraregional (internal) value. Of the two, it is not realistic to aim for the stability of its external value. It is hardly possible to try to stabilize the value of an Asian RMU against the US dollar and the euro, which are extraregional currencies. However, the stability of the RMU’s internal value could be achieved by close cooperation within the region.

The stability of the RMU’s value, which is the key to promoting the use of an RMU, translates into the stability of its internal value, as the discussions presuppose the use of an RMU in the region. It is clear that the stability of the internal value of an RMU is the same as the stability of the intraregional foreign exchange rates. Monitoring the value of regional currencies against the RMU for surveillance under the framework of regional surveillance in Asia is the most effective method to stabilize intraregional foreign exchange rates. Although it would be difficult to coordinate foreign exchange rate policies in the region, discussions towards coordination should begin.

The transaction cost of the RMU is the cost that is incurred when trading RMU-denominated financial products. This includes the cost that is incurred when hedging the foreign exchange and interest rate risks that are associated with buying or selling RMU-denominated financial products.

Apparently, a low transaction cost is important in promoting the use of an RMU. In addition to the transaction cost, there is also the information cost associated with collecting information related to any transaction. The term “transaction cost” includes such information cost.

The following two conditions must be met to lower the transaction cost and for the low transaction cost to promote the use of an RMU.

A market participant who has a short RMU position in their balance sheet can hedge their foreign exchange risk by buying RMU-denominated financial assets or RMU forward contracts equal to the amount of their short position in the market. However, if it is difficult to buy RMUs in the market due to a shortage of RMU liquidity, it would be necessary to purchase the composite currencies of the RMU at the ratio equivalent to the weight of the currencies within the RMU. This is called bundling of the RMU composite currencies. The opposite operation is called unbundling of the RMU composite currencies.

This means that the cost of bundling and unbundling the RMU must be low enough for the RMU transaction cost to be reasonably low. Since bundling and
unbundling are purchasing and selling of composite currencies, it would be critical for the transaction cost of the RMU composite currencies to be low.

It is important to note that, to promote the use of the RMU, the RMU transaction cost must be lower than the transaction cost of the RMU composite currencies. If the composite currencies transaction cost is lower, it would be logical to break up the RMU-denominated financial product into financial products denominated in RMU composite currencies according to their weighted ratio and to trade those products rather than to trade RMU-denominated financial products.

In Asia, with only a few exceptions, currencies do not have adequate convertibility. Financial and capital markets have not developed enough, making the transaction cost for most currencies quite expensive. Accordingly, the transaction cost of the possible composite currencies of an Asian RMU would be much higher than those of special drawing right (SDR) composite currencies which include major international currencies.

There is an important aspect to be emphasized regarding convertibility, and that is the contradiction between capital account deregulation and stability of intraregional foreign exchange rates. There are the following scenarios.

Capital account deregulation in each East Asian country should be realized for full convertibility of the RMU’s component currencies. Only if this is accomplished will foreign exchange trading of the component currencies increase. In this situation, the increase in foreign exchange trading increases the liquidity of trading and, in turn, lowers the transaction cost associated with the bundling and unbundling of the RMU. On the other hand, increased foreign exchange trading increases the volatility of the exchange rates.

Lowering the transaction cost is desirable, and increasing the volatility of the exchange rates is not. As the “Impossible Trinity” shows, this is because if the autonomy of national monetary policies is assumed, then it is not possible to achieve both progress in the convertibility of component currencies, which is part of capital account liberalization, and stability of intraregional foreign exchange rates.

This is why the measures to reduce the volatility of the regional foreign exchange rates discussed under the RMU for surveillance have important connotations for transaction involving the RMU. If a member country joins the RMU for transaction as a composite currency by achieving full convertibility of the currency, it is inevitable that closer intraregional coordination of macroeconomic policies will be needed to avoid excessive volatility of the
In the future there could be a framework for intraregional coordination of macroeconomic policies, including exchange rate policy as well as monetary policy or inflation targeting. The most binding measure for intraregional exchange rate stability would be the construction of a regional exchange rate regime such as the European Monetary System. There could be discussions about the kind of regional exchange rate regime to be established in the era of financial globalization. Some regional exchange rate regime would be necessary to make the value of the RMU stable enough so that the use of the RMU for transactions would significantly increase.

In addition to convertibility of the RMU’s composite currencies, we should consider a transaction-cost reduction effect of network externalities. In retail transactions, it may be possible for RMU transaction costs to be sufficiently lower than the transaction cost of the RMU composite currencies, as it may be costly for retail customers to put together RMU-denominated financial products out of the RMU composite currencies. However, as the size of transactions increases, the difference between the two could easily shrink, and some serious thinking is necessary to assure that the RMU transaction cost is lower than the transaction cost of bundling and unbundling of the RMU composite currencies. Such a condition would be met if the effect of network externalities was spread sufficiently.

Network externalities work for circulation of money; the same applies for the RMU. To promote the use of an RMU, a mechanism must be created whereby people use the RMU because others are doing so. If such a mechanism was developed, RMU-denominated transactions would increase and the economies of scale would decrease the transaction cost. Currently, most of the cross-border transactions in Asia are denominated in US dollars, and one would instinctively think that it is much more convenient to use the dollar than the RMU. Hence, some creative thinking is necessary to introduce a mechanism whereby an RMU is used because others are using it.

**C. Conclusion**

This paper considers the three questions related to monetary cooperation in Asia. The RMU and RMU deviation indicators are useful for the regional surveillance that the monetary authorities of East Asian countries are regularly conducting. Effective surveillance should be undertaken regularly as well, thereby preventing a currency crisis. To achieve these goals, holding meetings, such as the Economic Review and Policy Dialogue, once or twice a year is not enough. It is necessary for the region to create a standing institution to fulfill these tasks. The Chiang Mai
Initiative should be developed into an institution that has a permanently installed organization.

It would take a long time for the RMU to be used as a denomination currency in capital markets and international trade under the current international monetary system which has the US dollar as the key currency. The RMU’s component currencies should have full convertibility in terms of current and capital transactions so that the private sector can hedge against foreign exchange risks related to holding and transacting the RMU. The condition of full convertibility of its component currencies is necessary for the RMU to be available for the private sector.

References

Figure 1: Movement of East Asian currency


Figure 2: Nominal AMU Deviation Indicators (daily)

Asia needs more cooperation, not a single currency

Figure 3: Real AMU Deviation Indicators (monthly)

ASIA NEEDS MORE COOPERATION, NOT A SINGLE CURRENCY

Thomas D. Willett

A. Comparing Inflation Targeting, Exchange Rate Targeting, and Parallel Currency Approaches to Monetary Stability

1. Primacy should be given to inflation targeting

In my judgment, some aspects of each of the three approaches—harmonized inflation targeting, a parallel currency, and mutually agreed exchange rate arrangements—can complement each other, but primacy should be given to a flexible form of coordinated inflation targeting. There is certainly a strong case in principle for the coordination of exchange rate policies, at least to some degree, among Asian economies. However, to both minimize the risks of crises and maximize the effectiveness of such coordination, this needs to be undertaken within the context of broader coordination of monetary and fiscal policies.

All too often governments have focused on exchange rate policies as the centerpiece of a strategy for cooperation and/or the unilateral establishment of monetary stability, with destabilizing results over the medium term. The major reason for the current popularity of inflation targeting is that it provides a method of mitigating the short-run biases of the political process without committing to a specific operating target, such as money growth or the exchange rate. This makes it more robust than the other approaches. Experience shows that economies are hit by a wide variety of shocks and that, as a result, the focus on any one fixed operating rule for monetary policy is likely to prove to be destabilizing under some types of shocks. For example, a money growth rule will be destabilizing in the face of large shocks to velocity, while a simple exchange rate rule will often be destabilizing in the face of shocks that affect equilibrium real exchange rates. Inflation targeting provides a more robust commitment technology to counter the short-run political pressures that can lead to escalating inflation.

Rigid adherence to a narrow inflation target could also prove destabilizing, however. Thus, inflation targeting should be pursued in a flexible manner so that monetary authorities have scope to pay attention to other objectives in the short run, as long as this doesn’t result in seriously escalating inflation. In open economics such as in much of Asia, successful inflation targeting automatically requires paying a good deal of attention to exchange rate movements, as these will generate pressures on domestic prices. However, flexible inflation targeting gives monetary authorities some scope to pay attention to real shocks and movements of exchange rates not strongly related to developments in the fundamentals.
2. Challenges to inflation targeting

I do not agree with the recent verdict of Martin Wolf that the current crisis shows the failure of inflation targeting. What I think it does show is that keeping inflation low is not always sufficient to avoid bubbles in financial and real estate markets. This had already been shown by the development of low inflation bubbles in a number of Asian countries prior to the 1997 Asian financial crisis. This crisis also sharply illustrated some of the limitations of the value-at-risk approach to risk management. The behavior of financial variables in the recent past may give little warning of the dangers of a bubble bursting or a major currency depreciation occurring. Unfortunately, however, insufficient attention was paid to these lessons by both the official and private sectors in the United States and a number of other industrial countries.

There has been considerable disagreement among economists about how much attention monetary authorities should pay to the behavior of asset prices. My own answer is that considerable attention should be paid to them as signals, but little, if any, as targets. The problem of bubbles in financial and property markets should be addressed primarily through better supervision and regulation. Another clear lesson of the recent crisis is that regulatory authorities need to pay more attention both to avoiding the continuation of grossly perverse incentive structures facing both lenders and borrowers, and to adopting countercyclical policies that pay attention to macro developments in credit and leverage, not just the micro positions of the individual institutions they supervise. Of course the implementation of such supervision and regulation will never be perfect but the recent failures have been so colossal that substantial improvements should be practical. Thus, we need to expand Morris Goldstein’s managed floating plus inflation targeting to add another plus—stronger systems of prudential regulation.

I acknowledge that, as Gong-Pil Choi (2007) argues, inflation targeting can be more challenging for developing and emerging market countries than for industrial countries, but I agree with the assessment of Genberg and He (2007) that for the more advanced Asian economies such as the Republic of Korea (henceforth Korea), these problems have been largely overcome and that inflation targeting on the whole has been rather successful.

The current crisis does present a major challenge to the implementation of the inflation targeting approach. This has been just the type of major shock in which inflation targeting must be applied in a flexible manner. Justifying monetary ease in the face of the crisis is easy but keeping financial and credit markets functioning is generally likely to require considerably more short-run easing than strict inflation targeting would imply. While determining the direction of
monetary policy is no problem, getting the magnitude right is extremely difficult. Even harder technically will be the need for future draining of liquidity as economies and credit and financial markets recover. In both Korea and the United States considerable concern has been expressed about the potential inflationary consequences of the monetary and fiscal stimulus undertaken to cushion the effects of the crisis. Given the quality of economic and monetary officials in both countries, I believe that such concerns can easily be exaggerated. It is extremely unlikely that either country will manage its exit strategy perfectly—the uncertainties are just too great—so, as the recovery progresses, it wouldn’t be at all surprising to see a year or two of above-average inflation. That said, I see little danger of the prolonged inflation that some commentators have predicted.

Of course there is the danger that at times even fairly flexible exchange rate and inflation targets may conflict. In such cases the literature on optimal currency area (OCA) analysis implies that the weight given to the exchange rate over and above its effects on domestic prices should increase as the openness of the economy increases. In my judgment, however, few of the Asian economies are so open that weight should be given exclusively to the foreign exchange market in setting domestic monetary policy, as would be done in a fully fledged currency board or within a common currency area. Hong Kong, China has been rather successful with its currency board, but Singapore, which is also small and highly open, has done well with a (heavily) managed float. Thus, while there is still considerable controversy about the implications of OCA theory for the minimum size of optimal currency areas, we have considerable evidence that feasible currency areas can be rather small (Sweden and Switzerland provide additional examples.)

### 3. A single Asian currency is not feasible or desirable

A number of economists have argued for fixed exchange rates over broad areas, including Asia. Under the assumptions of the strongest forms of new classical macroeconomics, where expectations are fully rational and economies are highly flexible, there are few costs to giving up independent monetary policy. Further, under the strongest forms of global monetarist models, changes in nominal exchange rates have little effect on real exchange rates. Therefore, economists who believe strongly in such models advocate for fixed rates for virtually all economies. The problem facing this view is that few economies in the real world actually approximate the assumptions necessary for the conclusions of such models to hold.

Another group of economists have conducted empirical studies that find that on some OCA criteria some sets of Asian countries score as well as the members of the euro zone before it was established. We can learn a great deal from such studies but they are often misinterpreted as supporting the case for creating a
common Asian currency. When looked at more carefully, most of these studies cover only a few OCA criteria, and the country groupings found to meet these criteria vary a good deal from study to study. For one of the most frequently analyzed criteria—that of patterns of shocks and degree of business cycle synchronization—the correlations often vary considerably over time. Thus, while fixed rate areas may make economic sense for a small number of Asian economies, Asia is currently far from meeting the conditions for the adoption of a broad-based common currency to make economic sense. It bears mentioning that at present the political obstacles to such an arrangement are even greater.

It is intellectually stimulating to debate the costs and benefits of a common Asian currency but this should not be allowed to divert primary attention from the much more practical (if less dramatic) task of improving cooperation within a system of independent monetary and exchange rate regimes.

4. Cooperation on exchange market intervention

It is hard to argue that speculation in the foreign exchange market is always strongly stabilizing, so there will be cases where sterilized intervention is justified. While many Asian economies face substantial international capital mobility, research suggests that it is not usually so high that sterilized intervention cannot have some effectiveness in the short run (Willett, Ahn, and Keil 2002; Keil, Rajan, and Willett 2008). In my view, a good start toward increasing effective Asian monetary cooperation would be developing greater consultation about the situations in which countries should engage in sterilized intervention. This is the area in which meaningful agreements about the coordination of exchange rate policies should be the least difficult, and fits logically with agreements about intraregional financial support.

The next step in the evolution of cooperation would be efforts to coordinate monetary (and fiscal) policies. Only after there is considerable success on this score do I believe it would be appropriate to consider negotiating systems of exchange rate bands, unless they are so wide and soft as to be of questionable value.

The reason for this suggested ordering of steps toward strong monetary cooperation is straightforward. There is considerable evidence that emphasis on exchange rate objectives without corresponding agreements on the conduct of monetary policy runs considerable danger of generating the types of longer-run inconsistencies between monetary and exchange rate policies that are so frequently the cause of currency crises. While some see such agreements as a

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1 See Yu 2007. For detailed analysis and references to the literature on these economies and political considerations, see Willett, Permpoon, and Srisom (forthcoming); and Willett et al. (forthcoming)
source of increasing domestic monetary discipline, they can equally be a source of increased time-inconsistency problems that increase incentives to delay needed adjustments. This is a major cause of the instability of adjustable-peg exchange rate regimes in a world of high capital mobility (Angkinand, Chiu, and Willett 2009; Willett 2007).

A potentially fruitful approach to dealing with this problem is to agree on limits to unilateral unsterilized intervention. Beyond agreed thresholds, continued sterilized intervention would require justification to a regional surveillance group. As the magnitudes of sterilized intervention increased, presumptions would shift in favor of the need to receive approval from the surveillance group. Such a surveillance group would be best served by having a high-quality secretariat that could also be a source of analysis to support discussions among national monetary and finance department officials about the broader aspects of monetary and fiscal policy cooperation.

5. The dangers of time-inconsistent policies

This suggested approach shares one of the virtues of the parallel currency proposal, with which it is perfectly compatible—it lets developments determine the pace of movement toward stronger monetary integration. As Eichengreen notes, with the parallel currency, economics rather than politics determines the rate of progress. My approach allows politics to also play a role but in a way that minimizes time-inconsistency problems. Increased exchange rate stability is “earned” through the willingness of countries to bear the costs of coordinating monetary policies in order to achieve the concomitant benefits. Of course, politically it’s more attractive to receive the benefits first without having to pay most of the corresponding costs but we know that such approaches frequently fall apart in the medium or longer term.

One of the latest examples of this something-for-nothing approach is the idea that endogenous OCA theory tells us that any group of countries can quickly become an optimal currency area if they just have the political will to make the commitment to creating a common currency. Endogenous OCA analysis has made many useful contributions but the claim that it would allow countries to painlessly reverse the traditional sequencing and put monetary integration before trade integration is based far more on wishful thinking than on careful theoretical analysis and study of the available evidence (Willett, Permpoon, and Srisorn [forthcoming]; Willett et al. [forthcoming]).

B. The Parallel Currency Approach

On the issue of creating a parallel currency in Asia, there is little I can add to
Barry Eichengreen’s excellent recent analysis of the issues involved and interpretations of the European experience with the European Currency Unit (ECU). I would like to see the creation of such a parallel currency for the same reasons as Barry, while sharing his lack of optimism that it will become an overnight success. For numerous reasons, I agree with him that the creation of an Asian currency unit (ACU) would be preferable to using the dollar. I am fully cognizant of the political problems involved in reaching agreement on the currencies to be included and their weights, but until such problems can be overcome I see little hope of deeper monetary cooperation in Asia.

Let me also add one caveat to Barry’s analysis. He rightly notes that the increased use of sophisticated financial instruments could make private sector use of an ACU spread considerably faster than occurred with the ECU. He wrote before the deepening of the current crisis, which has resulted in considerable criticism of financial engineering (a not inconsiderable part of which is deserved). The creation of an ACU would not be one of these engineering excesses but I see some danger that it might be somewhat tainted with guilt by association. It would be important to make special educational efforts to minimize this danger.

As with the ECU, I would expect the use of an ACU by the private sector to be much greater initially for longer-term financial instruments such as bonds than for transactions use. Thus, this approach is unlikely to appeal to anyone whose primary objective is to move to a common Asian currency as swiftly as possible. But for those who view a common Asian currency not as an end in itself but as a potential means to greater monetary stability, the parallel currency approach has considerable attraction and the likelihood of the spread of its use being gradual would help minimize the dangers that its use would lead to financial instability.

**C. Surveillance Indicators**

On the use of an ACU for macroeconomic surveillance, I defer to Professor Ogawa who has given a great deal of attention to this issue. I will only note that indicators such as the ones Professor Ogawa has developed can be useful for surveillance discussions even before there is political agreement on an official ACU.

**References**


MONETARY COOPERATION IN EAST ASIA

Junggun Oh

A. Needs of Monetary Cooperation in East Asia

Most East Asian currencies have shown extreme instability since the middle of last year due to the recent crisis. First, extra-regionally, most East Asian currencies, except the renminbi and yen, have substantially depreciated against the US dollar, and, second, intraregionally, the degrees of depreciation by country have shown considerable difference. In particular, the won, rupiah, peso, and baht have substantially depreciated during the crisis period (Figure 1).

Figure 1: Exchange Rate Movements in Major East Asian Countries after Recent Crisis
(Feb. 2002=1)

[Graph showing exchange rate movements]

Source: Board of Governors of the Federal Reserve System

These unstable movements of the East Asian currencies are mainly driven by the sudden reversal of capital inflows of the respective countries. It is notable that the Republic of Korea (henceforth Korea), Indonesia, the Philippines and Malaysia, in particular, show net outflows of the financial account during the crisis period (Figure 2).
Of course, these large outflows of capital from East Asian countries are driven mainly by the process of deleveraging because of the United States (US) financial crisis. However, it is still very important to understand why some countries experienced much larger outflows of capital than other countries in the same region.

One of the reasons could be weaker external soundness. Looking at the external soundness based on international reserves, external debts, and the current account, the external soundness of Korea, the Philippines, and Indonesia is relatively weaker than in other countries in the region (Figures 3 and 4, Table 1).
Figure 3: Current Accounts in Major East Asian Countries


Figure 4: International Reserves and External Debts in Major East Asian Countries

Source: International Reserves; IMF. 2009. International Financial Statistics. May; External Debts; World Bank and Respective Central Banks
Again, it can be questioned why the external soundness of these countries was weaker than others in the region. There may be many reasons, but among them it could be noted that the currencies of these countries have appreciated, in particular between February 2002, when the US dollar began to be depreciated, and the middle of last year, before the recent crisis (Figure 5). That may be one of main causes of the deterioration of the current account and consequently the worsening position of international reserves and external debts in these countries.

Most East Asian countries have similar economic structures and development policy strategies, i.e., export-oriented economic policies targeting almost the same markets including the US market. Accordingly, low valuation of the currency of a certain country, such as the People’s Republic of China (PRC), may result in the deterioration of the currency in neighboring competing countries (Oh 2004a, 2004c, 2005a).

In addition, the so-called beggar-my-neighbor policies of some countries, helped by relatively weaker currencies, seem beneficial to them in the short run. In fact, the crisis in certain countries in the region may spread to other countries rapidly due to contagion effects or herding behaviors of foreign investors through a real economic channel as well as a financial channel. That is a lesson of the Asian financial crisis of 1997–1998 and the recent global financial crisis (Oh, 2006a).
Accordingly, it is crucial to maintain the stability of the intraregional as well as extra-regional exchange rates for the whole region with regard to major international currencies.

**Figure 5: Exchange Rate Movements in Major East Asian Countries before Recent Crisis**

![Exchange Rate Movements Graph](source)

(Febr. 2002 = 1)

**Source:** Board of Governors of the Federal Reserve System

### B. Agendas for Monetary Cooperation in East Asia

We can divide East Asian monetary cooperation agendas into short term and medium-to-long term. In the short term, exchange rate stability should be increased. However, disharmonious movements of exchange rates among East Asian countries have been due mainly to the different exchange rate regimes and policy operations among the countries. In East Asia, Indonesia, Japan, Korea, and the Philippines have adopted freely floating exchange rate regimes; and the PRC, Malaysia, Singapore, Thailand, and Taipei, China have used managed regimes, while Hong Kong, China has employed a fixed one. Accordingly, first of all, I think, it seems necessary for East Asian countries to have converging exchange rate regimes and policy operations.
Table 2. Monetary and Exchange Rate Regimes in Major East Asian Countries

<table>
<thead>
<tr>
<th></th>
<th>Inflation Targeting</th>
<th>Exchange Rate Targeting</th>
<th>Interest Rate Targeting</th>
<th>Monetary Targeting</th>
</tr>
</thead>
<tbody>
<tr>
<td>Freely Floating</td>
<td></td>
<td></td>
<td></td>
<td>Korea, Indonesia, Philippines</td>
</tr>
<tr>
<td>Managed Floating</td>
<td></td>
<td></td>
<td></td>
<td>Thailand, Singapore, Malaysia, PRC (BBC), Taipei, China, Viet Nam</td>
</tr>
<tr>
<td>Fixed</td>
<td></td>
<td></td>
<td></td>
<td>Hong Kong, China (BBC)</td>
</tr>
</tbody>
</table>

BBC = , PRC = People’s Republic of China
Source: My Classifications based on the Information of Respective Central Banks

With macroeconomic coordination, cooperative intervention among countries over the region will be necessary. Harmonized inflation targeting suggested by Eichengreen (2009) could be included in this macroeconomic policy coordination scheme. However, I think harmonized inflation targeting alone, in spite of a lot of merits such as robustness with capital mobility, congruence with monetary policy, and compatibility with political constraints, seems insufficient to stabilize regional exchange rates extra- and intraregionally.

First, it may not be easy to reach an agreement on inflation targeting among countries over the region because of different economic conditions, policy preferences, etc. (Chai 2009). In particular, monetary policy regimes over the region are varied (Table 2). Second, although inflation targets are agreed, if the inflation forecast changes after the agreement due to unexpected new economic circumstances in a certain country, the rate of interest in the country should be changed to achieve the already adopted inflation target, and, as a result, exchange rates would be unstable due to capital flows following the difference in interest rates. The European Monetary System crisis of 1992 had a similar background.

For the supply of emergent liquidity, the Chiang Mai Initiative Multilateralization (CMIM) should be increased. For instance, it is agreed that contributions of member countries will be collected in accordance with the contribution ratio of member countries once a certain country requests the support of the CMIM. However, the risk of a certain country is likely to spread easily to neighboring countries. In such a case, are there no problems to collect the contribution? Accordingly, it would be crucial to preemptively identify the risk of a certain country and to implement countermeasures to prevent the spread of the risk. In addition, an independent regional surveillance unit will be necessary to analyze regional economies and support CMIM decision making.

In the medium-to-long term, schemes for exchange rate stability and for the supply of emergent liquidity should be institutionalized. For instance, an ARM for
the stability of the exchange rate and an Asian monetary fund for the supply of emergent liquidity could be examined.

Table 3: Agendas toward Monetary Cooperation in East Asia

<table>
<thead>
<tr>
<th>Short term</th>
<th>Exchange Rate Stability</th>
<th>Supply of Emergent Liquidity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Macroeconomic Policy</td>
<td>Multilateral CMI</td>
<td></td>
</tr>
<tr>
<td>Coordination Scheme</td>
<td>(Harmonized IT etc.)</td>
<td></td>
</tr>
<tr>
<td>Cooperative Intervention</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

| Medium term (institutionalization) | Asian Monetary System (ARM, Nominal Key Currency, etc.) | Institution for Regional (LLR and surveillance (AMF, etc.)) |

Table 4 shows the results of examination of various options for monetary cooperation, and for exchange rate stability in particular. First, it was examined whether the options will meet the targets, i.e., extra- and intraregional exchange rate stability, whether they will satisfy the issues to be considered, and what merits and drawbacks are.

Among options, a common basket seems to meet the both targets but not satisfy the issues. On the other hand, an Asian currency unit (ACU) composed of regional currencies seems to satisfy the issues but it seems to satisfy only intraregional exchange rate stability and not the stability of extra-regional exchange rates, and effective exchange rates in particular because important extra-regional currencies such as the US dollar and the euro are not included.

Accordingly, I think an ACU composed of regional currencies as well as some important extra-regional currencies could be proposed. Perhaps it could meet both targets and satisfy the issues to be considered.
### Table 4: Options for Monetary Cooperation in East Asia

<table>
<thead>
<tr>
<th>Options</th>
<th>Targets</th>
<th>Issues to be considered</th>
<th>Merits</th>
<th>Drawbacks</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Extra-Regional Exchange Rate Stability</td>
<td>Intraregional Exchange Rate Stability</td>
<td>Robustness with Capital Mobility</td>
<td>Congruence with Monetary Policy (flexible IT)</td>
</tr>
<tr>
<td>A Particular Regional Currency</td>
<td>X</td>
<td>O</td>
<td>O</td>
<td>X</td>
</tr>
<tr>
<td></td>
<td>Regional Currency Stability</td>
<td>Triffin’s Currency Stability Dilemma</td>
<td>Asymmetric integration (key currency country influence)</td>
<td>Key currency country instability</td>
</tr>
<tr>
<td>Basket (composed of some regional and extra-regional currencies)</td>
<td>X</td>
<td>O</td>
<td>O</td>
<td>O</td>
</tr>
<tr>
<td>Own Basket by country</td>
<td>X</td>
<td>O</td>
<td>O</td>
<td>O</td>
</tr>
<tr>
<td>Common Basket</td>
<td>X</td>
<td>O</td>
<td>O</td>
<td>O</td>
</tr>
<tr>
<td>ACU (composed of regional currencies)</td>
<td>X</td>
<td>O</td>
<td>O</td>
<td>O</td>
</tr>
<tr>
<td>ACU (composed of regional and some extra-regional currencies)</td>
<td>X</td>
<td>O</td>
<td>O</td>
<td>O</td>
</tr>
<tr>
<td>Harmonized IT</td>
<td>X</td>
<td>O</td>
<td>O</td>
<td>O</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Note: Tentatively made for discussion
Issues: mainly based on Eichengreen (2007) and others
References


____. 2005b. Weak Dollar: Cure or Disaster?-Causes and Consequences of Recent Weak Dollar. BOK Institute Discussion Paper No. 051. May.


THE GLOBAL FINANCIAL CRISIS, FUTURE OF THE DOLLAR, AND THE CHOICE FOR ASIA

Gong-Pil Choi

A. System Diagnoses

Excess, not shortage, remains the real cause of major crises globally. Historically, Asian surplus is built on a savings glut that relies on excess spending in other parts of the world. Global imbalance reflects systemic structural problems with the global financial system.

Even with developed financial systems in advanced countries, the global financial system as a whole is not tailored to accommodate globalization that hinges on huge imbalances. By no means does the global financial system function properly, and this dysfunction frequently triggers massive jolts in exchange rates. The current global financial system per se is just a juxtaposition of different systems without proper supervision and regulation. Systemic risks and poor governance kept on growing without any responsible intervention by national authorities, which resulted in delayed and disorderly corrections. In fact, the global dumping ground for excess turned out to be the United States (US) subprime market, whose currency value largely dictates our wealth. Global imbalance and missing supervision over systemic risks simply brought down the Bretton Woods II. Disparate exchange rate regimes only exacerbate problems, and any future architectural fix needs to take this into account.

Ill-equipped financial systems and patch-up supervisory responses only add up to unyieldingly excess leveraging, recurrent bubbles. As a result, we will still be sitting on a seriously battered system globally. Credits cannot flow properly and banks try hard to recapitalize to remain in business. Banking business has undergone serious structural changes from “originate to distribute” to credit risk transfer-imposed shadow banking, whose deleveraging still has some way to go. We need to think carefully to restore credit flows in this wildly dispersed credit risk world. Currently, things look stabilized but the fundamental capital shortage in the banking system has not been addressed. If we cannot fix the banking system globally, this crisis will lead to a long period of stagnation.

B. Responses

Even with its temporary stabilizing effect, the current coordinated liquidity provision will have side-effects if the improved market situation cannot help recapitalize the banking system. Real side is only recoverable with a steady flow of capital, which hinges on adequate capital cushioning within the banking
system. Unclogging the system with TARP still has some way to go, as incentives are distorted via volatile market conditions and likely government support.

Policy coordination across countries can help cushion the fall but an extra capital buffer is the only reliable hedge against collateral damage. We cannot yet find enough private capital to replace public capital. Liquidity support needs to be followed by private capital-raising and restructuring. As always, market confidence with active private participation remains the pillar for future recovery.

Admittedly, it is time to get serious about recapitalization, especially for those that do not yet suffer from bad numbers in their books. Containment policy based on incrementalism cannot shield the global economy from the harsh reality of depressed global demand. Those of us in Asia who are sitting on the latter part of the contraction curve have not made enough progress on that front. We need to be ready for restructuring and market recovery, and private recapitalization is the only way to prepare for it.

C. Directions for Change

First, sustainability conditions need to be imposed across countries that are at similar stages of development. Sustainability cannot be defined solely by inflation or growth rate, rather it needs to be supplemented by potential spillovers of systemic risks. In short, sustainability-driven growth remains the pillar for global financial stability. Growth should not result in, or hinge on, the massive deficit of a key currency country.

Similarly, growth accounting needs to be revisited and myopic growth urgently needs to be reined in by extended sustainability criteria. There is simply no other region which can run extra deficit to generate enough demand for Asian products and services. We cannot deny that excess growth and surplus savings in Asia led to excess leverage, with dire financial consequences. Mercantilist ideas should be replaced with a modern version that is firmly rooted in the region.

Second, market expansion in the region needs to be accelerated. The current crisis vividly underscores the fact that regional cooperation without fundamental improvement, such as expanded markets, cannot help overcome a dire situation. Further tweaking of a regional liquidity arrangement, setting up extra institutions, and experimenting with a regional currency would do little to solve our fundamental problems. Rather, a properly designed, more balanced growth paradigm, and adequate supervision and regulation, are better responses for Asian economies. This calls for developing domestic and regional markets through multilateral free-trade agreements. Specifically, a regional financial system based on an alternative exchange rate regime or regional parallel currency that helps
recycle huge surpluses needs to be activated, or a more consumption-oriented economy should be developed lest extra surpluses do not support the deficits of mature economies. Cross-border leveraging or deleveraging will lead to recurrent bubbles and panics. We need to be able to absorb extra savings by producing more diverse financial products in an integrated environment. The dollar is already overstressed.

Third, core deposit-taking banks need to be well-supervised and protected. Gradual balance sheet fixes will enable us to enjoy a stronger, well-supervised financial system in the future. However, banks face difficult times ahead. Even with trade links, recapitalization will take time and regulatory changes will have unintended consequences. Banks need to be reshuffled to better cope with hugely increased systemic risks. If not, they will be forced to pay extra insurance fees to avoid future failure. Already, there are concerns that Treasury, the International Monetary Fund, the US Federal Reserve, FDIC, SEC, FSF, among powerful systemic regulators, are becoming the source of future systemic risk. At the same time, a new type of business model will emerge in a new regulatory structure.

Fourth, some kind of basket-peg based on an Asian or regional currency unit index needs to be developed to help stabilize excess exchange rate volatility within the region. Given the dollar supremacy, an alternative currency arrangement, such as a regional currency unit, cannot gain enough traction to be accepted internationally. Therefore, an alternative exchange rate arrangement will not fix the problem in the short run, and a sustainability criterion makes further sense.

Putting things together in the right direction will be critically important to reviving the global economy. We need various rating agencies to fill the valuation gap. Capital insurance, contingency contracts, and fair-value accounting standards need to be rewritten to further reduce procyclicality. Also, a contingent reserve management, with a better institutional design for liquidity support, will visibly enhance the regional institution. I do hope things go well for all, because in this interconnected world we cannot be okay when our neighbors are in serious trouble.
Roundtable Discussion:

Moderator: Barry Eichengreen
Panelists: Hee-Yul Chai
Eiji Ogawa
Thomas D. Willett
Taeyoon Sung
Gong-Pil Choi
Inchul Kim
Richard N. Cooper
Masahiro Kawai
Peter Morgan
Duck-Koo Chung
Fan He
Junggun Oh

Eiji Ogawa I was a member of the research group established by the ASEAN+3 financial ministers meeting, and that performed research on the regional monetary unit¹. We experienced asymmetric responses of the East Asian currencies during the global financial crisis. We discussed the depreciation of the won, and the appreciation of the yen and since last summer the renminbi has been fixed to the US dollar. So we have asymmetric responses to the global financial crisis.

We understand the movement of the exchange rates of the East Asian currencies, but we should consider the movement and misalignment or fluctuation of the East Asian currencies when the regional monetary unit is used.

The regional monetary unit (RMU) is for the surveillance of exchange rates. So for example, we create an Asian monetary unit (AMU) which is the origin of the RMU. Everyone can download data on the AMU and related data from the website, and the AMU is the weighted average of the East Asian currencies, which are the ASEAN+3 currencies. In this case, we weight-based on gross domestic product (GDP) and the trade volumes in the total of the sample countries. We also created the AMU deviation indicators, which show the deviation of each Asian currency from the benchmark period of 2000–2001. For example, this figure shows the exchange rate of the AMU against the currency basket of the United States (US) dollar and euro, or against the US dollar, or against the euro. So we can see the relatively stable

¹ ASEAN+3 refers to the Association of Southeast Asian Nations (ASEAN) countries, plus the People’s Republic of China, Japan, and the Republic of Korea
movement of the AMU, but when we look at each of the currencies, we can find some deviation or divergence among East Asian currencies. For example, from 2005 the won was overvalued but from 2007 it depreciated. So looking at the figure, we can find which currencies are overvalued or undervalued. This information is very important for the surveillance process over the exchange rate among East Asian countries. And this figure shows the AMU deviation indicators in terms of the real exchange rate. So I can say that there is independent regional surveillance in East Asia; for example, the Economic Review and Policy Dialogue of the ASEAN+3 is expected to play an important role in preventing a currency crisis. Regional surveillance is expected to monitor contagion, spill-over, or transmission of macroeconomic conditions and risks in the region; solve coordination failure of exchange rate policy; or deal with problems arising from the access limit of IMF lending. Therefore, monitoring the RMU and RMU deviation indicators, in addition to the main economic and financial indicators and those used for early warning systems, such as the ratio of short-term external debt to foreign reserves, will make regional surveillance more effective.

The third question is related to the private use of the RMU. I have a feeling that it is easier for us to use the RMU for surveillance but it is difficult for the private sector to use the RMU.

The RMU has the following important characteristics. It reduces the foreign exchange risk because of the risk diversification as the RMU consists of composite currencies and it offers the weighted average interest rate of the component currencies. The RMU could be used in the following ways by the private sector: as the denominated currency for current account and capital account transactions; as a vehicle, transaction, and settlement currency in current and capital account transactions; and for asset denomination.

But we should consider conditions for promoting the use of the RMU.

First is the stability of its value. It is hardly possible to try to stabilize the value of the RMU against the US dollar and euro because it is difficult for us to stabilize each of the East Asian currencies against the dollar and the euro. However, stability of the RMU’s internal value could be achieved through close cooperation within the region.

The second condition is related to the transaction cost. We should decrease transaction costs so that we use the RMU for financial
transactions and international transactions. This cost includes the cost that is incurred when hedging the foreign exchange and interest rate risks that are associated with buying or selling RMU-denominated financial products. This second point is very important but I think it is difficult for us to decrease the transaction costs.

Another point related to the transaction cost is the convertibility of the RMU’s composite currencies. For example, the private sector likes to hedge foreign exchange rate risk, so the hedging cost is one of the transaction costs, which depends on the convertibility.

The last condition is the network externality, which was also discussed this morning. When we think about creating the RMU, we should also consider the network externality regarding its use. Unfortunately, network externality is not expected to have such a big impact, as the volume in comparison to the transactions made in US dollars is small. But when we compare the transaction volume of the RMU with each of the currencies, the trade volume of the RMU should increase and be larger than the transaction volume made with each of the East Asian currencies.

So these points are also important in promoting the use of the RMU in private use.

Junggun Oh I would like to discuss why we need monetary cooperation in East Asia, and how we should have this monetary cooperation.

Looking at this chart, during the recent crisis most East Asian currencies have depreciated very sharply and, in particular, the won. On the other hand, the renminbi maintained a similar level and the yen even appreciated. Even with the global crisis, when most East Asian currencies have depreciated, the People’s Republic of China (PRC) and Japan managed to maintain a stable level.

Why did some countries’ currencies depreciate? We can understand why when looking at this chart, which shows the capital flows in East Asian countries. The capital outflow from some countries, in particular the Republic of Korea (henceforth Korea), was enormous after mid-2008. Why did these countries experience capital outflow? We can point out two main reasons. One is a deteriorating current account, and the second is the international reserve and external debt. As discussed earlier, countries such as Indonesia, Korea, and the Philippines had external debts larger than their international reserves; others, such as
Thailand and Malaysia, had reserves slightly larger than their debt. So combining these two figures, we can look at external soundness. Countries such as the PRC and Japan had reserves much larger than their external debt. The case of Singapore is a different story as it is a totally open financial market.

Also in terms of current account, we can classify countries by large surplus and small surplus, but overall surpluses are decreasing and depreciating.

In the case of Korea, we have some short-term debt which can not be classified with traditional short-term debt, such as the short-term debt to hedge the exchange rate risk from the shipbuilders. Since mid-2008, even the role of the US dollar as the key currency is decreasing, and even the International Monetary Fund (IMF) is unable to play the role of lender of last resort. So, even in such data regarding the market, there may be an information asymmetric problem which may have been a reason for the capital outflow.

So, why has external soundness been deteriorating, particularly in Korea? Looking at the exchange rate movement in the main East Asian currencies before the recent crisis, since February 2002 (which was when the US dollar began to depreciate), most Asian currencies have appreciated very sharply. The won continued to appreciate very sharply even when the yen was depreciating. On the other hand, the renminbi continued to appreciate gradually.

Sometimes I think that some currencies, such as the renminbi, have appreciated relatively slowly compared to other countries. This seems to be beneficial to the PRC in the short run. However, other countries may suffer from the deterioration of the current account. There is also the repercussion effect to the PRC through the real economic channel or through the financial channel. That’s what we call the contagious effect, which will spread very easily to all regions, and is why we need monetary cooperation in the region.

We need extra-regional exchange rate stability as well as intraregional stability.

How do we achieve the two important targets through monetary cooperation in East Asia? Looking at the table, most of the major East Asian countries have their own monetary and exchange rate regime. So, I think we probably firstly need to study how to converge these
different regimes, and then harmonize inflation targeting. Then we could have cooperative innovation and an Asian monetary system.

Finally, we already have knowledge on the various options for a regional cooperative scheme. This chart shows the options to achieve the two targets—extra-regional exchange rate stability and intraregional stability—and the issues regarding monetary cooperation. Based on this I suggest use of an Asian currency unit as a regional currency, and this could help achieve the target.

Gong-Pil Choi

I would like to provide a case study of the reality that I experienced last year, when I had real trouble in getting dollars last autumn. I found my efforts useless and we couldn’t get any help from the Chiang Mai Initiative, IMF, or any other official institutions. We did get help from the US Federal Reserve, and that was the harsh reality. We are not over the crisis yet, but this kind of talk should be built on reality, which is that we are not in a position to trust each other because I think there are some fundamental problems in the region. Especially, all countries in Asia are export-oriented countries and we want to protect our export growth no matter what. That is the bottom line.

When we tried to hedge the exchange rate risk through the forward market, we ran into problems, as summarized by Professor Choi, but still we have this problem with exchange rate instability that determines the credit flow within the system. Exchange rate stability is something we desperately want to have but seems to be no answer to the problem. Even with all these efforts, especially regarding an Asian currency unit and regional currency unit, I think if you go through this you realize that this kind of effort should be linked to micro-management practices. What I am saying is that to overcome the problem that we continuously experience, we have to deal with Alice’s cookie problem that was mentioned previously. That is, our economies are very similar and we are all export-oriented economies and there is a long way to go before we change our economies towards being more consumption oriented. The PRC mentioned this need in 2004 and declared this as the national agenda but didn’t achieve anything and still has the US economy as its economic driver. So, my experience as a bank executive during the last year reminded me that I think we need deeper understanding of the issues. In a globalized environment, we need to have a better financial system, and there should not only be discussions but actions taken to achieve stability within the system.

Even with the developed financial system, especially in the US, I think
the global system is still yet to be developed to accommodate the globalization that we experience, and globalization hinges on huge imbalances which need to be stopped. This imbalance-driven growth is bad for everybody. We can actually overcome this crisis in a short period of time by creating another huge imbalance, but that is not good as it makes us forget about what is needed to get the system moving in the right direction.

Currently, it seems like the situation is a somewhat stabilized, but it does not fundamentally address the capital problems in the global banking system. This means that credit flows will not be normalized in a short period of time and the real economy will not recover soon. We are not even half way through the crisis yet, because we have not dealt with the root cause of the problem. Even the US has a long way to go, especially the recap effort by the Federal Reserve and the Treasury ignores the reality of the top fund used to unclog the financial system. So I don’t know how they are going to revitalize the credit system, but it seems like we will face similar problems in Asia because we are not facing the real problem as yet. We have to recap our banking system and we have to deal with the private capital and not the public capital, because it is the market confidence we have to get through raising capital in the market. We haven’t really touched the surface yet, but unfortunately the numbers do not tell us the real story. It is the result of the preemptive efforts by the authorities (and I think they have done a great job in doing that) but the real challenge lies ahead of us, and that’s basically protecting the banking system from going bankrupt. I think nobody is courageous enough to address these issues in a preemptive manner, but the US experience tells us a very dramatic story, and by the time US is out of the tunnel, we will experience serious problems.

The PRC seems to be the hope for everyone right now but their infrastructure and capital system has not been tested in an open environment. I would suggest sustainability to be the key, and I think they set the goal too high. Their desire to achieve high growth is killing everyone, creating credit bubbles and commodity bubbles, etc., and we can not use the US as a dumping ground for excess leveraging. The dollar is already overstressed and there is no alternative to it, even though we talk about an Asian currency unit and a regional currency unit, and even the euro is not in a position to replace the dollar as the key currency.

Everyone talks about sustainability in environmental science but it should be applied in economic growth too, because mercantilist ideas
are old and should be replaced with a more sensible and responsible paradigm.

System risk and poor governance resulted in the lack of proper checks and corrections in a timely manner. I think we can’t just overuse the US-based international financial system to destroy our values overnight. This is a very dangerous equilibrium we are heading towards, and it requires everyone in the global environment to behave more responsively.

I think banks need to be reshuffled to better cope with the increased huge system risk requirements. I myself am a bank executive in a large international complex institution and we are expecting some tightened regulations in the future. There should be some systemic regulator. I don’t know if the IMF can assume the role but there should be a real fix to the global financial system. No matter what we strive to, there should be some survival test for everyone and we have to shrink the balance sheet to some extent. And that is very painful, but otherwise we are creating a systemic problem which will destroy everyone. So the real test lies ahead, and we should be prepared for it, and the regulatory changes should take that into account. As Barry has been engaged in this subject for many years, let us create a global economic environment where everyone can be more responsible and can have more sustainable growth for the future.

Taeyoon Sung

I would like to emphasize exchange rate policy issues in terms of monetary cooperation.

Recently we were in the turmoil of a global financial crisis. Many countries also faced volatility in exchange rates. Korea was not an exception. Rather, the won was substantially and rapidly depreciated, even compared with other countries. Although there were a lot of complaints regarding the huge depreciation from the public in Korea, there was a rapid change in the current account. The increase in exports has contributed a lot to slowing the drop of the Korean economy. I am not sure whether that has been intentionally designed by the Government of Korea or not.

On the other hand, there were some economies heavily dependent on exports that did not face such change in exchange rate. However, those economies faced serious difficulties and a huge drop in gross domestic product (GDP). This experience gives potential room for exchange rate policy change. Particularly in the period of the economic crisis, some
countries might be tempted to intentionally depreciate their currencies. However, the problem is that some countries try to depreciate their currency, and as a result of this other countries may suffer the adverse effects from that depreciation and decide to retaliate with their own exchange rate policy, even though not expressing the intention to depreciate their currencies. I guess it can provide motivation or justification for monetary policy coordination, or in some sense, it can be used as a foundation for having a common currency. This is because if we have some room for exchange rate policy, other countries might try to use competitive depreciation, a result of which may be making your neighbors poor. But, I think, even though there may be a motivation for a common currency, it should not be exaggerated in the sense that it would also be a motivation for monetary policy coordination rather than just adopting a common currency. I am not sure whether having a common regional currency would necessarily help to avoid this kind of crisis. We know that we do not have sufficient labor mobility in East Asian economies. So, in that situation, I guess monetary cooperation to achieve exchange rate stability might be a better and more practical way of having a stable exchange rate in this region.

It is important to increase Asian monetary and financial cooperation rather than introduce a common currency as it has too many difficulties and it might not be very realistic. So, it would be more practical to focus on monetary policy cooperation and have an in-depth discussion. Even at the time of the current economic crisis, we could get some help from other central banks, as mentioned by Professor Cooper, as there is trust among central banks. It is more natural to have relationships between central banks because they usually have less political pressure and long-running relationships. So, monetary policy coordination between central banks, especially on the exchange rate policy, can be very useful in the Asian region.

For the common currency issue, while we have heterogeneity among Asian countries, some subset of Asian countries might satisfy the criteria for a common currency but some other subsets of countries do not satisfy those criteria. There is of course some research on that issue but it is not so robust. In some cases it can be justified but sometimes not, which means that there are many differences in the empirical results. So rather than focusing on creating a regional common currency, it would be more practical to have monetary cooperation across the central banks.
Inchul Kim

If someone is arguing that the global imbalances are the cause of the global crisis, it becomes difficult to say anything about the liquidity dilemma. We have heard from all countries that they do not desire to become a key currency country. There is a view that the US has been running a trade deficit for so many years just because US people have been consuming too much. But is that the only reason? No, there were many other reasons. So, on that score, it is hard to believe that the global imbalances were the cause of the global crisis. Then, it is hard to find solutions. How can we persuade the PRC to reduce its savings, how do we convince oil producing and exporting countries to reduce production, and so on.

There must be some comment or suggestions about how we go about dealing with the liquidity dilemma, because the grand contraction and financial deleveraging all has to do with the liquidity dilemma.

It used to be one of the old arguments that, because the US dollar is the key currency and many parts of the world demand the dollar, unless the US is running a trade deficit people outside the US cannot have an international currency. So, by structure the US has to run trade deficits if it wants to allow other countries to secure enough liquidity to buy goods and services when global capital mobility is very low.

Richard N. Cooper

In a world of capital mobility, that proposition ceases to be true. The rest of the world has to sell something to the US but it doesn’t have to be goods.

Masahiro Kawai

What the rest of the world wants, really, is short-term US dollar liquidity. The rest of the world acquires short-term assets against the US, or the US can provide long-term assets. So, the key currency country does not necessarily have to run a current account deficit.

I don’t think the United Kingdom (UK) before World War I was running a current account deficit. The income account and services account surplus was very large. The UK may have run a trade merchandise deficit, although I don’t remember very well, but the UK did not run a large current account deficit during World War I.

Peter J. Morgan

Just on the question of the contribution of the global imbalances to the global crisis, I also share the view that it might have been a contributing factor to the downward pressure on global interest rates, and that it may have contributed to some sort of a bubble-type condition developing in the US housing market and elsewhere. But,
ultimately, I think it is primarily the responsibility of the authorities. Perhaps it was a kind of a great test of various theories the US Federal Reserve had about the whether or not it is best to prick a bubble before it bursts or clean up the mess afterwards, and how much you want to rely on self-regulation by markets. Unfortunately, the Federal Reserve seems to have had the wrong view on those things, and obviously this has been proved. But I do think it was primarily the responsibility of the monetary authorities—the supervisory authorities—not to allow that problem to get out of control.

Gong-Pil I think you cannot attribute the failure of bank and supervision regulation as being the direct cause of the crisis, because we knew that was happening. If you draw a risk map chart, we can see that there was an investment risk building up. We just couldn’t stop the music, and everyone was enjoying the dance. There is no way to preemptively force the market to reduce leverage and be more responsible.

I don’t think there is a great expectation for correction of this error because there are two steps, and if you do not deal with the system risk that I talked about with the growth objective of the PRC, it will not be corrected. I think in an interconnected world everyone should behave responsibly. When you pose a potential risk to somebody else, there should be somebody overseeing these problems and stopping them, whether it be high growth or massive credit expansion or whatever. Otherwise we continue to live in a dangerous world and crisis seems to be the only solution to the problem. BSR is just cleaning up the mess, and there is really nothing that we can expect from them.

Junggun Oh Just getting into the issue that you raised, I think looking at the progress of the crisis, we can understand easily what the main cause of the current crisis has been. Subprime mortgages were the beginning, but then the US financial institutions started to fall and the deleveraging process became severe. Due to the deleveraging, all the countries suffered from the foreign exchange crisis. In that sense, I think the main reason for the currency crisis has been the failure of supervision over subprime mortgages. Lastly, the key currency problem is now the issue.

Masahiro Kawai Yesterday, we had some discussion on this.

The view that global payment imbalance was the cause of the crisis implies that Asians were also responsible for causing the crisis. We argued about this when you were not there, but I feel that you’d also
agree with this because Professor Cooper agreed. It may be true that Asia’s large savings may have maintained relatively low global interest rates and the US long-term interest rate. However, for macroeconomic management and finance sector management, foreign countries have no mandate over US policy instruments and, given any sort of shock coming from abroad, it is the country’s total responsibility to manage macroeconomic conditions and finance sector conditions. So, it is in a sense blaming others for what happened in the US rather than expressing that the policy makers failed to achieve financial and macroeconomic stability. There were instruments; maybe monetary policy could have been a bit more restrictive and financial supervision and regulation oversight could have been used.

Duck-Koo I think the world has been integrated almost under a single uniform standard during the last 20-30 years, but there are many countries in the world and a variety of history, development stages, income levels, and infrastructure building of a market economy. However, as globalization has progressed, the world has become increasingly integrated. Some countries have been well familiarized with, and have quickly learned about, a market economy, price mechanisms, and infrastructure building, etc. Other countries have failed to follow that kind of speedy development in the process of globalization. Some countries argued during the last 30 years that they would accept financial globalization but the sequence and the speed should be decided by the nations. However, in the course of the globalization campaign, during the last 20-30 years, the idea of domestic criteria of sequence and speed was not so acceptable internationally. Without having fully modernized the infrastructure to that of a market economy, many countries opened their capital markets. Normally things would have run beautifully, but at the time of the current crisis there are many system risks rising from country to country.

The second observation is mainly about different development stages. Each country has an income target. In the case of US and Japan, their annual per capita GDP is over $40,000 and their welfare level is very high; their policy goals are stabilization and sustainable growth. However, in some countries such as the PRC, Thailand, and even Korea, they have upper-level income targets in the course of implementation of development strategies. They have to import as much foreign capital as possible because they do not have large enough domestic capital bases. At the time of the crisis, this kind of system doesn’t work well, and they don’t have enough expertise to deal with these malfunctioning international systems. Also, countries when hit by
the crisis may have different income targeting; they aggressively import foreign capital in normal circumstances.

Lastly, countries are still in the learning process of the pricing mechanism. Academically, there is an “impossible trinity” in the macroeconomic policy formulations, but because countries have clear political income targets, their flexible interest rate policies sometime have some strong constraints imposed from their political arena which may cause malfunctioning.

This is the reason why the Government of Korea maintained an almost fixed exchange rate during 1997, along with a huge current account deficit at that time. I think that was one of the things that instigated the exchange rate crisis. Now, Korea has been efficiently handling the situation for the last 9 months because we have already experienced handling macroeconomic policy during the 1997 crisis. However, other countries may not be as familiar with this. Even the US Treasury seemed to be puzzled in the early stages of the current global financial crisis. We are in the process of learning what will happen during the height of the crisis.

Richard N. Cooper

I would just like to come back to the question you posed about the role of global imbalances. I think you posed a false dichotomy. In a general equilibrium system, everything influences everything else. I think both the global imbalances and the regulatory environment are implicated in this. Some people like metaphors, and one metaphor is that when a hanging takes place, you don’t usually blame it on the rope, but the rope is necessary. I would say that the global imbalances provided the rope, and in this particular case, via low interest rates worldwide, which had a wide range of economic implications, especially in the US housing market. But having provided the rope does not ensure that a hanging takes place, and it was the regulatory environment that did the hanging.

Fan He

When talking about global imbalances, maybe we are using two related concepts. One is that the US accumulated trade deficit while the PRC and others accumulated trade surplus, and this is not sustainable. From the chart that we saw in this morning’s presentation, this may change faster than we expected, with households in the US readjusting their savings and consumption behavior. This means that exports from East Asia will also drop in the future. I don’t know whether, when exports drop, the imports of Asian countries will also drop. It means that, even if imports do not decline, trade surpluses in this area will shrink. Even
if trade surpluses decline, however, it is doubtful whether this will lead
to a reduction of savings in this area. I doubt there will be automatic
changes in the savings. So, I think if we are talking about global
imbalance in regards to excessive savings in this region and excessive
consumption in the US, it will be tricky to deal with.

Also a comment on Professor Eichengreen’s proposal on exchange rate
coordination, I think that it is important but technically speaking more
difficult because if you look at regional monetary cooperation, we are
progressing with the Chiang Mai Initiative and also reserve pooling,
and these are low fruit that we can pick easily. That’s why we have
made progress in this regard, but if we get into regional exchange rate
coordination, which implies the monetary authorities in this region, to
some extent they have to give up monetary policy autonomy, which I
don’t think they are very prepared to do. In the PRC’s case, if there is
coordination of exchange rate policy in this region, the benefit for the
PRC is that we’ll no longer be singled out and be pointed out by the
US or IMF as manipulators. But the cost may be as follows. Because
we import a lot from neighboring countries, if the PRC appreciates the
renminbi individually, the purchasing power of the PRC will increase
and therefore imports from neighboring countries will increase. If there
is collective action, however, we may actually import less compared
with when we make an individual movement. So there are benefits and
costs, and these trade-offs need to be further calculated.
Summary Discussion:

Moderator: Duck-Koo Chung
Panelists: Richard N. Cooper
Shinji Takagi
Peter J. Morgan
Fan He
Masahiro Kawai
Chalongphob Sussangkarn
Sang Ki Min

Duck-Koo Chung: I think it is time to conclude the 2 days of discussion. Initially I want to summarize the discussions.

Through the discussions made during the past 2 days based on the topics—the global financial crisis and the role of the G-20, the future of the United States (US) dollar standard, global imbalances, Asian capital markets and foreign reserve pooling, and monetary cooperation in Asia—we have tried to analyze the current financial crisis and find solutions through future currency and regional financial and monetary policies.

Economists tend to agree that the current financial crisis is beginning to enter, or has already entered, the recovery stage. One of the purposes of the G-20 was to present solutions to the current crisis and make a cooperative effort to prevent further occurrence of such a crisis in the future. However, the practicality of the group has been questioned, and the improvement of the institution will only be possible when the emerging economies, including and especially Asia, raise its voices in the group.

As a part of the efforts to take the initiative, discussions on a regional institution and monetary fund is surfacing. The role of the US dollar as the key currency for the time being is an unquestionable fact. Even if it is not the most efficient monetary vehicle, the inertia of the current system and the world financial structure makes this quite certain. The question is, what will replace the dollar and will this be the solution? There are several currencies that are considered as possibilities, such as the euro, renminbi, and yen. However, considering the role and capacity of these currencies, it is neither feasible nor desired by the respective countries. Nevertheless, we see the emergence of a regional governance and regulation tool as an unavoidable part of the many changes required for further development of the Asian economy.
Panelists also emphasized the need for a regional key currency to mitigate the impacts of external macroeconomic shocks to East Asian economies and lessen the volatility of exchange rates.

Professor Cooper, especially, noted that the renminbi can be used as an alternative if the International Monetary Fund (IMF) plays a significant role. The special drawing right (SDR) cannot be the solution unless it is a part of a larger change. Dr. Chalongphob noted that, without full convertibility, it is too costly. Fan He also mentioned that the People’s Republic of China (PRC) does not have very much interest in making the renminbi a key currency for the time being. Chery mentioned that the euro is not a key currency in terms of the global financial market but the euro zone is working in a regional sense. As with the euro, even if East Asian economies can not come up with a new global key currency, regionally they could still make a local currency or the SDR work.

Regarding the foreign reserve, Professor Cooper’s idea was that the Republic of Korea (henceforth Korea) should use foreign reserves to relieve recent economic and financial crises. He also pointed out that accumulated reserves were the reason for excessive exchange rate volatility. The others opposed the view and insisted that the main use of the reserves should be for emergency. I pointed out that East Asian countries with nonconvertible currencies should always be very cautious about a situation where no countries are willing to lend money to small countries. Others also argued that, even though Korea seemed to possess large foreign reserves, financial investments made by foreign investors in fact outweighed the amount of foreign reserves. Dr. Chalongphob also presented the idea that, since East Asian countries have high costs in diversifying foreign reserves, increase in the use of either local currencies or the SDR can be a way of mitigating the negative effect of future economic crises.

Various opinions and prospects regarding global imbalances, Asian capital market development, and multilateral cooperation for alternative ways of protection have been presented today. Global imbalance may not be the cause of the current crisis but just a reflection of market adjustments for other underlying reasons. The impact of the actions of risk-averse investors is also much emphasized, together with the lack of adequate surveillance or non-economic factors, as potential reasons for the current crisis. It was, in general, agreed that the exchange rate risk plays a significant role and requires further regional cooperation among East Asian countries.
Is the global imbalance the cause of the crisis, or is global imbalance just the result of economic crisis and people just attribute the wrong reason to it?

Some scholars argued that emerging countries such as Korea made adequate policy efforts, especially after the policy reform that occurred during the 1997-1998 Asian financial crisis. One of the reasons why the Korean economy was hit so hard is the fact that the market was already developed. Rapid deleveraging had already taken place after the 1997 crisis. In term of its transparency level and regulatory system, the Korean financial market can be considered sound.

Nevertheless, Korea’s financial market suffered due to its accessibility to external investors. Learning from Korea’s case, East Asian economies including Korea can use foreign reserve pooling or financial support from other international organizations. In doing so, instead of regional reserve pooling, global reserve pooling might also be used. Some scholars, such as Eichengreen or Junggun Oh, argued that East Asia should establish global rather than just regional multilateral cooperation.

This kind of practice can contribute to reducing the exchange rate volatility and might also help to alleviate global imbalance. The Chiang Mai Initiative (CMI) might be a step forward, but there are many practical issues to be dealt with. In the long term, creating an independent body that has the authority to disburse the funds could be an alternative. Also, the importance of policy coordination will be critical.

This is the summary of the discussions we have had during the last 2 days. Now I will pass the floor to the moderators to summarize and comment on the discussion.

Richard N. Cooper

I feel like I am an outsider coming into the middle of ongoing discussions among people who are psychologically committed to further monetary cooperation, of one kind or another, in East Asia. I find myself asking the question, what is the affirmative case for such cooperation, and what are the expected gains? Analogies are often made with Europe, and I want to remind you of the European background that, as far as I am aware, is not directly relevant to Asia.

The Europeans set out after World War II to assure that Europeans, and
particularly France and Germany, never fought one another again. Their second attempt to cooperate was in the area of defense, and that failed because of domestic French politics. So they turned to economics as the vehicle to bring about a more integrated Europe, starting from the common market in the mid-1950s and then moving on, finally to a common currency. The history of the common currency is itself interesting. The Europeans were moved to create an exchange rate mechanism because of an impossible complication in managing their common agricultural policy. They had a common agricultural policy but exchange rates began to float and in 1973 common price targets in agriculture were set in ACU. With exchange rates fluctuating, it meant that farmers faced price changes in local currency during the year. Farmers always liked price increases but when there was a price decrease they protested. So they set up a complicated set of green rates and finally moved to the new Bretton Woods system for Europe, driven by two motives. One was another stepping stone toward what I still call a federal Europe, what I see Europeans these days call the republic of Europe. And the other was to deal with the common agriculture policy. Then, in the mid-1980s they created a single European market, eliminated capital controls and so forth, but they still had separate currencies and were persuaded that the presence of separate currencies and exchange rate variations were an intervention to trade and intervention to competition within the common market. So they then moved to the euro, again with two views in mind. One was the republican vision or the federalist vision, and the other was to completing the single European market by making prices more transparent through a common currency. So that is the background in Europe.

I am not aware of an explicit political objective in Asia. Maybe there is one that I am not aware of, and if there is there should be discussions, at least among the private parties, because in Europe that was the driving motivation.

If there is no political reason, then you return to what economic gains the region can expect from closer monetary cooperation. I think one needs to be explicit about that, as institutional change is always difficult and, in order to motivate it, you need to bring out the prospects of very significant gains.

This touches on a number of issues that we discussed today. For example, you just mentioned reserve pooling. Countries are risk averse, they want high reserves, and holding high reserves is costly, and one
can achieve real economic gains by pooling those reserves. But of course that works only when the probability of being hit by economic crisis or shock are asymmetric to the participants, which means neighbor countries tend to be exposed to common shocks. What is the maximum differential shock at the global level?

The US has a recession and exports go down for manufacturers throughout the region. So, if you are going to pool reserves and you are looking for tangible economic gains, you want to encompass divergent shocks as much as possible, which means regionalism is not the answer. Chalongphob told us about the costs today of foreign exchange transactions. Will a regional monetary arrangement improve significantly the costs, and if so where do the gains come from?

I sympathize with being upset with fluctuating exchange rates. I heard the term “exchange rate stability” on many occasions. Unlike many economists, I think it imposes very high costs, especially in long-term business planning. However, if your exchange rate stability is really the objective, attack it directly instead of dealing with it indirectly through inflation targeting. It is simply a myth, which was strongly endorsed 40 years ago, that under a system of floating exchange rates, exchange rate movements will largely be driven by inflation differentials. The implication is that, if you get inflation differentials down to zero, exchange rate movements will be very small. We know that’s not true. Look at the movements between the yen, the dollar, and the euro. They are all largely diversified economies with moderate inflation, and nonetheless huge exchange rate movements. That has to do with capital movements, and one can call them speculative or not—and that is a discussion in itself.

My main point is that there is a challenge, unless there is a latent political objective, in which case we should make it explicit. I think instead of just pushing forward into new institutional arrangements, you need to ask where the expected gains are because that should influence the choices of which directions you take in terms of the institutional revolution.

Duck-Koo Chung To my mind, regionalism is not a single answer for stabilization of the regional economy, but I think regionalism could be complementary to global governance, in which case it will be useful. That’s why we may be in the same boat in fostering a regional cooperative framework, even with strong consensus from the US, IMF, and the World Bank. In that case it would be practical to make a regional safeguards framework.
I am committed to financial integration so, while talking about it, I can respond to some of your questions. The rationale is not purely economic—it is both political and economic. Prior to the Asian financial crisis, we in this region regarded ourselves as being strong financially, especially with the savings surplus. Yet, somehow some countries in the region ran out of foreign currency and then we were dictated to by foreign organizations to make all kinds of very tough measures—structural policies in regards to privatization, liberalization, selling off assets, etc.—which have been proven to be unwarranted. So the region was angry. That was one thing.

We were told by the IMF that what we wanted to do was a moral hazard and that it was not possible. We were also told to reform our system to be like that in the advanced economies, as if this was the best practice. Well now, with the subprime mortgage crisis, the region is even angrier because the practice which was regarded as the best practice has turned out to be bad practice. And all the policies that are carried out in the US create so much moral hazard—the kind of things we were told not to do. I think this is the reason why the discussions for regional cooperation started. This is a political decision because ASEAN+3 could not be envisaged before the crisis. Malaysia had suggested at some point the formation of the East Asian Economic Caucus, but that didn’t fly, even within the region. So I think my own view is that we have to push ahead, and I want to talk about the practicality of doing it. It’s not that simple and it is not the academic discussions that will get things ahead, but this is the opportunity now given that the officials are working on the mechanism, at least for this year.

First of all, it is very important to go one step at a time. The most dangerous thing is to give the impression that by having this organization to coordinate the CMI, somehow we are moving towards a single currency. Politically this would be the end of the matter. If officials think that this will somehow lead to a loss of monetary sovereignty, the whole thing will just stop. It is so easy to stop because the processes of these things are so cumbersome. First of all, if you want to get some radical change, such as delinking from the IMF for example, and set up a new organization, officials are not in the position to initiate this kind of radical change. So, basically, we need some champion to initiate such changes. Where is the champion going to come from, in terms of a country? I think that the champion should be

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1 ASEAN+3 refers to the Association of Southeast Asian Nations (ASEAN) countries, plus the People’s Republic of China, Japan, and the Republic of Korea.
Korea.

First of all, Japan and the PRC can’t propose radical changes out of the blue, because if the other doesn’t agree, there is the problem of losing face. But Korea is in a good position. Even ASEAN cannot do it, because ASEAN is not united and there is no real leadership. So Korea needs to be the one to push the process along. I think this is why it is very important to try to provide some input into this. What kind of things should this new organization do if it can be moved forward? I think there are a number of initiatives that can be done. First of all, it will be important to begin to develop the region’s currency markets. It is true that we are not going to be able to replace the US dollar, but at least we can do something in terms of the trade that we have with each other. We should use local currency more but to do so you’ll need to have the currency market, because once you have fluctuation you’ll need a hedging instrument, and without developing the currency market, that can not happen. This also promotes what Professor Cooper was asking about the Asian bond fund. We have what is called the Asian Bond Fund 2, which is a fund investing in local currency bond of various countries in the region. However, these bonds are pooled together into an instrument denominated in US dollars, and it becomes an exchange traded fund, which is traded in Hong Kong, China. The problem is that when you buy it there is an exchange rate risk as it is denominated in dollars. So what you need is to have very good currency markets to be able to hedge the risk.

The last thing is that we in the region need to think about is financial regulation. Based on the idea of trying to make our systems closer to the West, we have been implementing various measures. Now, when this crisis happened, the authorities have not yet thought through what to do. Are we going to blindly go along with Basel II, or have more roles for credit rating agencies, etc.? Credit rating agencies are something we have to do something about. I am very annoyed because now Moody’s and S&P come along and say we’re going to have to downgrade Thailand because of the export situation. I mean, they have made such a mess of rating the subprime toxic asset as AAA. In the region, we talked about doing something about credit rating agencies 10 years ago and we have done nothing.

Duck-Koo I have one idea, and would like to propose a good safeguards framework: the “three H movement”. Not hasty, no hesitation, but harmonization with the global financial architecture framework. I think it is the best way.
Masahiro Kawai

I think it is always good to have somebody who has a fresh and objective mind about regional monetary and financial cooperation, because if we are talking about ourselves only, we tend to forget about the important questions, such as the questions Professor Cooper was asking.

Clearly, Asia does not have the kind of political vision that the Europeans had, but, on the other hand, politically the region is quite diverse in terms of development stages, per capita income levels, institutional developments, depth of financial markets, various measures of governance indicators, and even human development indicators. Asia is, among ASEAN+3, quite diverse but the economic links are becoming stronger. This market-driven economic integration process has progressed so much but there still are many issues, such as diversity and the absence of an institutional mechanism, that would make this whole development a smooth one. So, I think one deep effort for this notion of high regional market integrating but without institutional coordination is needed for a better Asia. That is the sort of underlying idea which means that more convergence is needed, meaning that the countries lagging behind need to be incorporated into the growth process, institutional building, the upgrading of social conditions, and so forth. Those sorts of aspects are extremely important challenges. For example, for ASEAN this is a very important component, as it is for ASEAN+3. So that is the whole background.

From a monetary and financial perspective, I think Asians have always wanted to stabilize the exchange rate against the dollar. Beginning with Japan, flexible exchange rates were adopted in 1973 but for more than 10 years since then, Japan has been wanting to somehow stabilize the exchange rates against the dollar but have not been able to. Pegging to the US dollar is very difficult and up until the Asian financial crisis many economies other than Japan were trying to stabilize the exchange rate. So, looking at the US dollar, exchange rates may be flexible but are still trying to stabilize along some trend, which has become very difficult. Yet, economic integrated region and Asia has become a one factory with the supply chains and production networks and having wide exchange rate movements would not be a good idea. So the indirect way of mutually stabilizing exchange rates by pegging the rates to the dollar is now not as viable, and now the PRC is facing this problem—the same problem that Europeans had in the 1960s to early 1970s. Europe has found a way to stabilize its own mutual exchange rate. In Asia, Japan was alone before, but after the financial crisis of 1997-1998, other crisis countries have joined in and now the PRC is
being pushed to divert from the US dollar. Often political pressure not to peg the exchange rate against the dollar comes from the US.

Asians have to think about something ourselves, and having an uncoordinated approach is quite counterproductive because of the interdependence among Asian countries. Of course, Asians depend on the US but the US does not want Asia to peg the exchange rate, so Asians have to come up with something. So, that's one important motive behind monetary and financial cooperation. Also on the financial side, the Asian bond market initiative—the Asian Bond Fund—is a collective effort rather than an individual country trying to develop an independent and separate bond market without consulting. In a sense, the countries are trying to jointly pursue finance sector reform; if neighboring countries make some advancement, then other countries feel that they have to catch up. So this sort of collective reform is a very important part of financial cooperation.

Foreign exchange reserves are too large. Japan and the PRC definitely have too much but if Asian countries were united through, for example, a common currency, then of course foreign exchange reserves could be much less. Of course, a common currency is a long way off and may not be realized but all the policy efforts towards that direction can make Asian economies stronger, more resilient, and also better because of the interdependence.

I also take Dr. Chalongphob’s view. I thought it is very interesting when you said the IMF is a foreign organization. Thailand is a shareholder country, which makes it one of the owners of the IMF. This shows that minority shareholders are neglected and not protected. That is really against the corporate governance approach, especially when the IMF is run by the US and Europe and they had no sense, at least at the time, of the Asian financial crisis. They had no sense of trying to understand Asian economic situations. The way the IMF is working now may be okay in Europe, because the managing director is a European who understands Eastern European socioeconomic conditions, so it may have been easier for the IMF and the European Union to work together. I am not sure if that would be the case in Asia now. So, there is a lot of doubt about the IMF, which is very unfortunate but Asians have to do something about that—regional reserve pooling, CMI, an Asian monetary fund, and so on. The whole thing is quite consistent.

Richard N. I have a response to what the others have said. I understand the views Cooper
but I’ve never heard the political objective of wanting to avoid going to the IMF being said so explicitly. Again, that suggests to me not that you prefer to do it this way but that you’re willing to pay some price actually in terms of less-efficient arrangements in order to avoid the IMF.

You have three options. The IMF is not a compulsory organization, you can withdraw. We have seen over history Czechoslovakia and Cuba both withdraw from the IMF. The less drastic option is simply not to use it. That was Malaysia’s choice and Brazil’s choice in 1981. So you go there and you have your votes but you choose not to use it at all. The third and most constructive choice, however, if you agree with Professor Kawai and me, is that it is unfortunate that the IMF has developed such a bad reputation. I would have thought that a lot of your coordination should focus on what you want out of the international monetary system, not in the region. Asia, taken together, has enough weight to get the rest of the world’s attention, not necessarily to achieve exactly what it wants but certainly to get the attention of the rest of the world. So, I would have thought that some constructive use of seminars such as this, consistent with what Mr. Chung said, would be to focus on the international monetary system and what it should look like from Asia’s point of view. I think the rest of the world would be receptive to that.

Chalongphob: It is not an either-or issue. Even though Asia may have its own financial cooperation, it doesn’t mean that we are not going to be involved in the global system, because we are clearly involved.

Fan He: I think this is a very good time to have this conference. I don’t know the stories in the other countries but in the case of the PRC it is quite true that regional monetary cooperation has the political support of the top political leaders. This is because as early as 1997-1998, soon after the Asian financial crisis, we have done some research, pure academic research, on regional monetary cooperation. Then later, the Ministry of Finance and People’s Bank of China came to us and as far as I know the background is that that was when the former premier Zhu Rongji made a spontaneous announcement supporting regional monetary cooperation, and the responses from Asian countries were surprisingly good. So after that, the PRC realized that this is a very important issue. Right now in the international arena, the PRC accepts a lot of invitations—to the G-7, G-8, G-20, United Nations, and ASEAN+3—and the regional issue has always been the priority of the Government of the PRC, and that is why government officials are so busy.
Besides the benefits mentioned by Dr. Chalongphob and Professor Kawai, I think there are also some positive by-products. One is that we can utilize regional cooperation to strengthen bargaining power at the multilateral level. The second is that we can create linkage through different issues. So there is not only regional monetary cooperation but also regional trade cooperation and international organization. Some countries in this region are also talking about the possibility of large cross-boundary infrastructure, and that may also be a potential area that we could think about.

Regional monetary cooperation can create a kind of linkage of different issues and create a very friendly atmosphere and bring about a positive result.

Last but not least, in other areas, in the US and Europe, finance ministers and central banks may take it for granted that there is already a network among central bankers and finance ministers. However, in Asia it is a pretty new phenomenon for finance ministers and central bankers to have a meeting, and the think tanks in this region will hopefully create a lasting network. So this is a very good platform to foster friendship in this region, and it will play a very important role. Currently we are not only talking about the CMI and reserve pooling but we are also thinking about building our own surveillance system, which was very difficult to do just 10 years ago when we had difficulties even sharing data. Now we will be happy to see that we are moving towards a more independent surveillance and monitoring system. The Asian currency unit is also very helpful for creating this kind of surveillance system. This will pave the way for the building of the fundamentals, based on which we can move forward. I think the story of Asian monetary cooperation will be quite different from European monetary cooperation. We lack the prerequisites of western Europe but we also enjoy some advantage.

My final remark is about internationalization of the renminbi. I think, for the time being, internationalization of the renminbi will be very helpful for Asian monetary cooperation because if the renminbi becomes fully convertible it can play a more positive role in regional monetary arrangements. Otherwise, if the PRC participates in this bilateral currency swap without the renminbi being fully convertible, other countries may not have the incentive to accept the renminbi. Also, for the PRC, internationalization of the renminbi may also be very important. To some extent, I think it is more or less the same.
situation as we faced when the PRC negotiated for entry to the World Trade Organization (WTO). If you calculate the pure economic benefit, it was marginal, because the PRC’s trade sector is already very open. The major benefit of WTO entry was the lock-in, based on which we were able to secure new momentum to accelerate market-oriented reform. If we can have new progress in internationalization of the renminbi, it can play the same role in many ways, and have the same result.

Duck-Koo Chung: Let me make a joke. Thinking of an extreme case, repeated recurrence of the crisis will expedite regional financial and monetary cooperation. Everyone forgets after some years, but when another round of global risks emerges, they will start to expedite discussion on the regional safeguards framework. But in that sense, we may have a second or third round of small or big financial crisis around the world. We can assure the importance of the regional framework so it can play its role as the town fire extinguisher.

I have one practical question for Fan He. You are saying that not now but in the future the renminbi will play a key role in international financial transactions as a reserve currency or a key currency. However, you have to take a necessary step towards that goal. I am sure you will not sacrifice independent monetary policies because you have an income goal and an income target in the future. There are two alternatives; that you may give up the fixed exchange rate, or you allow more flow of capital movement or, in some cases, both. In the case of Korea, we all of a sudden moved to the floating exchange rate, along with the free flow of capital and before entering the Organisation for Economic Co-operation and Development (OECD). In that respect, what’s your basic stance over this kind of problem?

Fan He: I think in the long term the PRC will definitely relax capital control and have more free movement of international capital; at the same time, the exchange rate will become more flexible. So, it doesn’t necessarily mean that we have to give up the autonomy of our monetary policy, because gradually the exchange rate will become more flexible. Even the fact that we will gradually open our capital account does not mean that there will be no regulation.

Take Hong Kong, China as an example. Although the Hong Kong dollar is fully convertible, they still have a lot of regulation. One very important regulation is that you cannot get the Hong Kong dollar outside of Hong Kong, China—to get Hong Kong dollars you have to
borrow from a bank in the Hong Kong, China market. In that way, the local monetary authority may have the final say, and if they find some speculation, they can easily increase the interest rate. In Malaysia’s case it is different because when there is speculation concerning the Malaysian ringgit, people can get ringgit from Singapore, which makes it very difficult to control. Maybe this is one reason why, after the Asian financial crisis, Malaysia introduced this capital control. I mean it will definitely be difficult to move to a more open financial system and more flexible exchange rate regime.

The PRC’s experience is that we will take a gradual approach and then experiment, and if that is okay then the government will endorse that as the national policy. Also, the advantage for the PRC is that we can learn from the experience of other countries. Actually we are not copying the US model, because that’s too far away. When we are talking about internationalization of the renminbi, the case we are looking at is either the yen, won, Singapore dollar, or Hong Kong dollar. That’s the near future for internationalization of the renminbi.

Duck-Koo Chung I pose one question to Peter Morgan. Currently there must be some symptoms of rebalancing of the world economy. The US is beginning to consume less and save more, and East Asia is trying to consume more and save less. There are also some symptoms of rebalancing. If this kind of track progresses well, do you think we can ease the global imbalance situation in the future?

Peter J. Morgan I suspect, and going back to my charts, probably the worst of the global imbalance was associated with the worst of the US housing bubble, so to that extent, that has burst. We’ve now seen a realization by US households that if they want to save money, they have to go back to the old fashioned way—they have to put money in, they can’t just wait for asset prices to rise automatically. I think there has been a significant self-correction, at least on that side. Of course that’s not the only part of the picture; there is still a whole question of what might happen on the Asian side to encourage consumption, and perhaps encourage saving rates to come down. I think that what we are seeing here is that the savings rate in Asia is down, basically for negative reasons, with sharp declines in corporate profits due to the export fall and that sort of thing. That’s neither a desirable nor a sustainable kind of reaction.

So, what we need to do is find a route towards a more positive mix of ways to reduce the size of imbalances, and perhaps the initial shock gives some time to make positive moves in that direction.
Richard N. Cooper: There is a Chinese curse—may your wishes be granted. Everyone around the world said Americans need to increase their savings rates. Everyone, as far as I could tell, except me; I was not in this school. Sure enough, we have increased savings rates now, and of course there has been a decline in the current account deficit. What is the consequence? World recession, and increased budget deficits everywhere, and I think we have to at least contemplate the possibility, which has not been on anyone’s screen for 1,960 years, of underconsumption at the global level. I think it is premature to make that judgment, but I am very skeptical, given the demographics, that we are going to persuade the Japanese public to spend more, we’re going to persuade the German public to spend more, or we’re going to persuade the PRC public to spend more. I think that’s a highly doubtful proposition. So, if the American public is going to save more, we have two possibilities: one is permanent budget deficits in the world, where public consumption makes up for the deficiency in private consumption, and the other is a very slack world economy. Those may be our two choices, and I think we need to contemplate that possibility and how we manage them.

Masahiro Kawai: The second scenario, where fiscal authorities continue to spend, for 10 years or so like Japan did, I don’t think is going to work at the end of the day unless the fundamental part of the problem is fixed. I think if US consumption does not come back, then Asia will be forced to do something, which is a very big challenge—regional demand and regional supply, regional production and regional consumption, producing more and consuming more. Another possibility is that US consumption may not come back so strongly but may still come back, and Asians relax and start exporting. I think that no matter what the situation, the best solution for Asians is to do many things, so that consumption can be higher and regional production can be higher. That’s what the Government of Korea is now trying to do, and it is something that many Asian countries also have to do, I think—focus on high value-added services, green growth, knowledge, plus fundamental reforms of social sector protection.

Duck-Koo Chung: Traditionally, Asian countries, especially East Asian countries, are similar in that they have family-based social systems. The welfare system consists of the so-called family safety net, where the eldest son takes care of the parents. However, recently the situation has become quite different, and that’s why we need development of a new social safety net, which is not well developed at the moment. Especially for
aging people, pension systems are not well developed, and thus people have to save more from their monthly income when they are young. That is the basic constraint on this region, and that is the reason why we may have a critical defect and we are producing excessive savings on a yearly base.

Shinji Takagi

Just two things.

One to respond to Professor Cooper’s comparison between Asia and Europe. I think there is one other political dimension to Asian cooperation, and that is the issue of the PRC. Because the PRC is bound to grow, its status in Asia will increase, and I think all the neighbors are a little concerned. Cooperation is a good way, both for the PRC and its neighbors, to have a framework in which the rise of the PRC can be managed. It is also good for the PRC because otherwise it will not be able to continue to enjoy acceptance, such as free trade, and, at the same time, neighbors are more relaxed in dealing with the PRC. So, that is a very important political dimension to promoting regional economic cooperation, and it is equally as important as the political objective Europe that had.

One more thing is IMF conditionality. There is a discussion of whether or not the IMF should abolish its conditionality. I think this is still to be tested, because this policy change occurred only about a month ago and no country has borrowed under the new regime. Depending on what you mean by conditionality, it still exists. For normal IMF programs, there is still conditionality in the sense that the IMF and country intending to borrow would agree to a program. If we can call that a conditionality, then yes it exists. But the IMF no longer ties disbursement to the country to an agreed target. So some people may say that conditionality has been abolished.

Fan He

Two quick responses, one regarding the so-called PRC threat. I think monetary cooperation can provide one mechanism to enforce cooperation between the PRC and different countries. More important is that the PRC currently already provides a huge market for some countries, and that may have a more direct impact on the relationship between the PRC and the different countries. And a second quick response to Professor Cooper’s comment: actually, I think the PRC can still consume more. One, we can increase government consumption; the government should spend more money providing public goods, a social safety network, health care, and so on. In this way, people in the PRC may feel surer about their future, so we can increase consumption.
on other items. The tradition in the PRC is that we do not buy luxury goods or buy houses as Americans do. It is quite possible that families in the PRC increase their consumption on things such as education and health care. So, in a way this is not consumption, this is investment in human capital. People always say the net export is the engine of economic growth in the PRC, but this is not true. This only happened in the three years from 2004 to 2008, when net exports played a very important role in the GDP growth rate. Before that, the contribution of net exports to GDP growth was almost zero.

Duck-Koo Chung

Now it is almost time to close, but we have two very distinguished scholars from Korea. One of them is a famous professor of Seoul National University.

Sang-Ki Mim

I want to raise a question on the definition of internationalization. You talked very broadly about internationalization of the renminbi, but I believe internationalization can be defined on a very different level and in a very different context. Somehow your usage of the word “internationalization” is mixed with the term “capital liberalization”. Capital liberalization can be carried out without even starting internationalization. So in the future, when you discuss internationalization, I believe that a more specific definition of internationalization is needed.

In that context, Korea has been deliberating for a very long time on how to internationalize our currency. In terms of liberalization, I think Korea liberalized its capital account almost fully by 1998; less than 1 year after the Asian financial crisis. But still, the won is not internationalized in the sense that foreigners cannot hold Korean currency outside of Korea, nor can they denominate their bond issues in won outside of Korea. We are very interested in future development of renminbi internationalization because that also, somehow, influences our plans to internationalize the won. Whether we should proceed or follow the renminbi is a very important policy issue.

Fan He

Actually, I think, generally speaking, capital account liberalization will be one of the prerequisites for currency internationalization. Why this is a very important issue is because when you have currency internationalization, you have to calculate the benefit and cost. The cost of internationalization is mainly the cost of capital account liberalization. So that is why we are cautious about the potential risk related to capital account liberalization. Right now, as a part of renminbi internationalization, we are trying to encourage the use of
renminbi as a unit of account in international trade, and are also thinking of introducing foreign companies and foreign governments or international organizations so that they can issue the panda bond—a renminbi-denominated bond in the PRC. We are still in the very initial stages of internationalization. As I mentioned in my presentation, we do not have any plan or any ambition to replace the dollar; it is only a defense in trying to save the US dollar and find other ways to avoid holding excessive US dollar assets.

Masahiro A very short comment. Professor Ron McKinnon, who happens to be my thesis adviser at Stanford, wrote a book, I think in 1979 or so. In it he defined an international currency as a currency with current account convertibility. So, if a country becomes an IMF article 8 country, then that currency is an international currency. But that was back in 1979. The renminbi, in that sense, is an international currency. So capital account convertibility has to be the benchmark these days, not simply current account.

Chalongphob The full meaning is that there is an active offshore market for your currency. That is internationalization, and many countries don’t want that. Singapore, for example, doesn’t want it, or Thailand, as we learnt from pre-1997, because there were offshore markets for the baht in New York, Singapore, and so on, and this is where the speculators got ammunition with which to attack the currency. So that’s why many countries don’t want it.

Duck-Koo I think there are many remaining parts of the discussions, but I can promise you the next round of conferences will be held in the near future. I would like to close our 2 days of discussion.

The end is near but the end of our study is not near, and we put emphasis on finding a new beginning of our study.

There was no concrete solution, but some ideas and alternatives were suggested. Likewise, I conclude we have been in the same boat. Today we agreed not to agree on some part of the issues. We leave the unsolved part of the discussions for our next meeting. Because the situation is so critical, I propose more frequent gathering and a more practical approach in the near future.

I very much thank you all for joining us for the past 2 days.
Appendix

World Economic Roundtable: The Global Financial Crisis and the Asian Economy

Panelists: Richard N. Cooper
Masahiro Kawai
Duck-Koo Chung
Fan He
Peter J. Morgan
Kyung-Wook Hur

Richard N. Cooper
Welcome everyone to this panel discussion. The topics for this evening are divided into four: the impact of the crisis on the Asian economy, the world economy and global imbalances, the future of the dollar, and financial and monetary cooperation in Asia. The panel will discuss these topics under, but not confined to, the given guidelines. I encourage the panelists to raise wide discussions that are relevant and important.

Let me start out by asking Mr. Kawai to open the discussion by addressing the following issue. What we saw is a financial crisis that unambiguously started in the United States (US) although, interestingly, the first public indicator of it came from the HSBC bank in February 2008. So it already had an international dimension from the beginning and very quickly affected many US and European financial institutions. Asian institutions and Canadian financial institutions, however, remained relatively immune to the financial implications of the crisis. Of course, when output began to decline it became a worldwide phenomenon because the world is so heavily interconnected by trade. I would like to ask Mr. Kawai to open by giving his perspective on this issue.

Masahiro Kawai
Thank you very much. The output decline in Asia has been quite significant, especially because many Asian countries have been highly export dependent. Many Asian countries have been growing due to increase in exports and are running large trade surpluses. The US market in particular was a big market for Asian manufactured products.

The crisis in the US that emerged from the US housing market had a very big impact on US consumption. US consumers, whose (in some sense) excessive consumption was based on the housing market boom,
were forced to cut back on their consumption. This consumption reduction became really severe during the second half of 2008, particularly after September. Even though the finance sector turmoil was in the US, there was a wide psychological impact. Revenues of the manufacturing sector began to decline sharply starting from the autumn of 2008, causing a ripple effect for the producers of manufactured products. The supply chain of manufacturers is the main demand for labor in these countries. Once consumption begins to decline, affecting the supply chain, it begins to have a ripple effect on the various stages of the producers. In Asia, Japan’s decline was very significant, as was the case in Taipei, China; Singapore; and the Republic of Korea (henceforth Korea). Even countries like Malaysia and Thailand started to feel the impact. So, this production network and the supply chain played a very important role. When an order is cut back, the suppliers at each stage within the chain tend to react more negatively. So the initial impact spread through the supply chain, and the ultimate impact was much more severe than the initial cut back on consumption. Therefore, there was a big impact on the countries which have large supply chains within their countries. The People’s Republic of China (PRC) also played an important role, because many Asian countries were supplying parts or components to the PRC for export of final goods to other countries. When the PRC’s exports to the US and Europe started to decline, this also had a ripple effect on the suppliers of parts and components in Asia. So, essentially, overconsumption in the US began to adjust, causing producers to assume the decline, and I think it was because of this supply chain effect that the output decline was quite spectacular, particularly among Asian countries, based on the supply chain effect.

Richard N. Mr. Kawai is from the Asian Development Bank Institute (ADBI).
Cooper Peter Morgan will be standing in for Tom Willett.

Korea is our host and perhaps we could ask Mr. Hur to comment on what is the impact and the channels of impact.

Kyung-Wook Hur I go along with Mr. Kawai’s view. The first channel is exports. We are very much dependent on exports, and trade-driven economies—such as Singapore or the PRC, and to some extent Hong Kong, China—were severely affected by the crisis. One thing interesting that Mr. Kawai mentioned is the part of the PRC. It is our largest export market, accounting for almost 70% of our exports. So, we were hit directly from our exports, and then we were hit again from the reduction of the PRC’s export.
Perhaps the more important channel through which we were affected by the crisis is the financial channel, which is the second channel. This is because when there was deleveraging due to the credit crunch, it led to the domestic credit crunch. Trade financing in developed countries evaporated and this impacted our financial channel. There was less investment and less consumption, which again questioned Korea’s desirability as a country for investment, even with its massive foreign reserve. There was total deleveraging of about $40 billion, and investors worried whether we had enough foreign reserves. The credibility of the debt market was the origin of the problem, especially due to the reckless lending that occurred in the subprime mortgage market. Although Korea’s finance sector was relatively very sound and had little exposure to the subprime, the Korean financial market was hit much more quickly than other countries when the deleveraging started because the Korean market had been open to foreigners and was relatively liquid. This is part of the reason that the Korean exchange rate depreciated by around 25% last year.

The third channel is the psychological one. Many people in Korea still have the memory of the crisis 11 years ago very fresh in their mind, so when this crisis happened, people began to overreact. They limited spending and companies reserved cash, which is a good thing if they can get through the crisis but they simply did not want to make investments because they saw many big companies that were thought to be indestructible fall 11 years ago.

Richard N. Could I ask you to expand on the second channel, as it is new to me.

Cooper We know that some of the American and European financial institutions, not especially the banks but other financial institutions, were very highly leveraged. Correct me if I am wrong, but the Korean banks were not highly leveraged. So how did the deleveraging of Morgan Stanley, for example, and not to mention Lehman Brothers, affect the ability of Korean banks to extend trade credit to Korean exporters or Korean importers?

Kyung There are two subchannels.

Wook Hur First, the banking sector is the major sector that gets dollar financing on behalf of the entire nation. When the Lehman Brothers debacle happened, and the international credit market froze, Korean banks could no longer use their traditional financing and their access to international capital market was no longer available. Without foreign
capital they did not have the money for trade financing or for foreign investment. They could not provide dollar financing to the rest of the economy. This is the first subchannel.

The second subchannel, which is in a way peculiar to Korea, is the stock market. The Korean stock market was open to foreigners and at the highest point foreigners owned up to 42% of the stock market. However, when their own institutions faced financial trouble, they pulled back on their investments, selling the Korean stock market up to the point where their shares were 20% of the Korean market. Approximately $40 billion of foreign capital exited the Korean market. That naturally put a squeeze on the domestic market. When the stock market deflated with the uncertainty, exports declined and blocked access to the international market, a domestic crunch occurred, and consumption decreased.

Richard N. Cooper would like to come back to two issues. Why, since Korea has a relatively good savings rate, were the Korean banks dependent on the foreign banks for net inflow of funds? My other question is regarding the liquidation of the stock market and with the withdrawal of $40 billion dollars that you mentioned. I would have thought that it is precisely against such a contingency that Korea held such large foreign exchange reserves. So the question is, why did Korea not use the foreign exchange reserves, particularly with that shock or both of these shocks, in order to supply the funds that the foreigners were not supplying to the banks, or for the funds that the foreigners were withdrawing from the stock market? What was the reasoning in the soul for allowing the exchange rate to take the entire hit instead of using the reserves? You mentioned the memories of the Asian financial crisis, which was very hard for the countries that were involved, but the striking feature of it was how quick the recovery was for some countries, including Korea. I wonder if Mr. Chung could comment on whether there were special features to that quick recovery of 1998 and whether we could look forward to an equally quick recovery from the current situation in Korea.

Duck-Koo Chung In short, I think it would be unlikely to follow the same pattern we experienced 11 years ago. This is because, at the time, Korea was hardly hit by external shock. The main cause of the financial crisis at the time was the external shock, along with our traditional and accumulated domestic problems of our national development strategies. Likewise, in areas other than East Asia there was an export boom, with the information technology boom at the time. Thanks to international
economic growth, low interest rate policies, and strong dollar policies, the Korean economy recovered very quickly. Especially in 1999 and 2000, gross domestic product (GDP) growth was 9%, above the estimated potential at the time of 7%. Since then, we had a series of painful experiences from the bubbled economy, especially from the excessive use of credit cards and the real estate bubble, along with the expansionary monetary policies and excessive fiscal stimulus package in the wake of the financial crisis. We lost the opportunity to execute the exit plan of the central bank, the Bank of Korea, to contract our money spread over the market. It was due to the expansionary policies that we were able to record a growth rate in excess of 7%. However, failure to control the policies resulted in the asset bubble, and mismanagement of housing debt caused economic growth to be sluggish from then.

Prior to this round of global financial crisis, we recorded around 4.0% real GDP growth for the last 5 years, compared to around 4.5% growth potential. So, I don’t think we have any bubble in the macroeconomic situation at the time of this round of global financial shock. Our problems were country-specific issues, i.e., the deja vu effect. I think Korean people were seized with the fear of returning to the nightmare of a decade ago. Even the rich people, not to mention the poor, reduced their consumption as a result of this effect. Now, we are not running away from the psychological fear from the 1997 trauma, but the output decline was mainly from the export decline. Even though we diversified our exports throughout the world, our main exports were made directly to the US. Even exports to the PRC were components and intermediate goods for goods manufactured in the PRC and exported indirectly to US. That’s why even though we don’t have any serious experience of output decline from the bubble burst, we are experiencing serious downturn in output decline due to external factors. At the initial stage of the crisis, our finance sector was hit hard; it was an overly exaggerated shock from finance sectors globally. Also, as vice minister Hur noted, we have some country-specific issues on the maturity transformation of commercial banking around short-term inducement to long-term loan of household loan. This the reason why I think it is a very peculiar situation. The won was not hit hard in terms of bubble bust, but we experienced negative GDP growth last year and this year, and perhaps very little GDP growth next year. We recorded a very quick V-shaped recovery in the past, but this time it is more likely that we will face an L-shaped recovery. The actual shock was smaller but overall it will take longer to recover.
Richard N. Again, just to raise the point, the Korean memory of the economic crisis was deep and unpleasant but the recovery was very quick.

If one focuses on memories, people may think that because Korea recovered quickly before that it may recover quickly now. I know that that’s not your judgment but I am thinking that it might be the public psychology now and therefore consumption could be appropriate.

The PRC has been mentioned on several occasions. The PRC had a very sharp reduction in export in the latter part of last year but one reason why it decreased was due to a deliberate policy effort to limit the consumption boom that was going on in the PRC. So already the PRC was showing a downturn in demand at the beginning of the year coming from domestic policy. By the same token, the PRC I think was the first major country to announce a fiscal stimulus, so perhaps Mr. He could give us his appraisal of whether the fiscal stimulus is really as big as the Government of the PRC is saying it is. Is it really that fantastically big—16% of GDP spread over 2 years, or is there window dressing in there, and how rapidly is it likely to affect the economy? Can we expect a recovery in growth in the PRC (which seems to have already started) from the fiscal actions in the PRC?

Fan He For the time being, there are three major policy responses from the Government of the PRC. One is the CNY4 trillion stimulus package Professor Cooper mentioned, which was announced in November last year. Both the central and local governments promised to spend more that CNY4 trillion in the coming 2 years.

The major component of the package was infrastructure investment, building of railways, and more investment in the energy sector. In March this year, the government announced a revised stimulus package, a new plan with more emphasis on input into public goods such as education, health care, and environmental protection.

The second policy response was more specific policies, picking out 10 industries, most of which were those that had suffered the most during the financial crisis, such as steel and iron, shipbuilding, textiles, and machinery. Also among the 10 industries were information technology industry and logistics, which I think the government thought will provide new sources of investment and new sources of momentum for growth in the PRC.

The third policy, which is equally important, is the rapid bank credit
expansion in the first quarter of this year, providing new credit of CNY4.58 trillion which accounts for 90% of the quota this year. This shows that the government is adopting not only an expansionary fiscal policy but also an expansionary monetary policy. Quite a large part of this flowed into government-formed investment projects.

And what will come next? The Government of the PRC will announce more policy responses unlike the CNY4 trillion stimulus package, but perhaps there will also be more emphasis on investment in public goods such as the treatment of migrant workers. This year, for instance, there will be at least 20 million migrant workers who will lose their jobs, so the policies may be related to solutions regarding migrant workers and also more investment in health care and pensions.

When will the effect of the stimulus package be felt? For the time being, the statistics of the PRC economy are good—GDP is normal, investment is high, and consumption will remain moderate. However, we can not overexaggerate the effect of the stimulus package, because the CNY4 trillion will be spent over the next 2 years and covers investments by the central government as well as local governments. So this is not solely executed by the central government, and it was not made very clear whether this will be a newly created investment or includes the already executed amount, since we have recently invested a lot in these items.

I think one reason why the PRC economy will recover very quickly is the response of entrepreneurs in the PRC, who are reacting very quickly to some market signals. Many commodities were exhausted in December last year, based on which entrepreneurs in the PRC increased their production. From March or April this year, the stimulus package started to take effect, so I am quite optimistic about GDP growth this year. The actual worry is growth next year.

One potential risk is the fiscal situation of local governments. I am not worried about the central government, as we are in a fiscal situation where the central government in the PRC is still quite stable. The public debt to GDP ratio is below 20%, which means that there is still plenty of room to maneuver. However, the central government is currently relying on local government to invest in the projects that were mentioned, but the local government does not have enough revenue from taxation, and for most people tax is levied by the central government. Traditionally, they tend to source extra funds from selling land, but they have already sold their quota for the coming 10 or even
30 years. So there is not enough land left for sale; the only way they can get money is by borrowing from commercial banks. I am worried that in the future this fiscal pressure on local government will transform into nonperforming loans of commercial banks, which is a very serious problem and one that we have to keep a close eye on. What the PRC needs is not only the stimulus policy but also more radical reform, such as further liberalization of the service sector. This is because, although the PRC manufacturing sector is very competitive, the service sector lags behind. If we can further liberalize the service sector, one thing that will do is increase private investment. Private funds can be invested in health care and education, through which we can pave the way, for more stable economic growth in the PRC in the longer term. Without this structural reform, my worry is that the PRC may fall into a worse situation. Mr. Chung talked about V-shaped and L-shaped recoveries, but the worst scenario in the PRC will be a deep W-shaped recovery. Therefore, if structural reform is slow and we don’t change the traditional growth pattern, we will face more difficulty in the future, maybe early next year, especially if the global economy is still in recession.

Richard N. Cooper

Our second topic is the world economy and global imbalances. I would like to pose the question to Minister Hur, whether he believes, from Korea’s perspective, that enough has been done by the PRC, US, United Kingdom, and Japan by way of fiscal and monetary stimulus to see us through this recession. Or, do you think further fiscal and monetary stimulus is needed?

Kyung-Wook Hur

One of the differences between this crisis and the one in 1930s is perhaps the ability to combine government policy in terms of monetary and fiscal policy. So far I think it has done its job of mitigating the effect but, when looking forward, the recovery in many parts of the world has not started. Perhaps we are in a stage where the free fall has just finished. It is too early to talk about, as some scholars say, the exit strategy or pulling back the stimulus package. But do we need more stimulus policy? I think that’s uncertain, and it will be better to have more room. In many countries such as the US and Japan, there is no room for release of monetary and fiscal policy. Although it is uncertain whether we need further monetary policy, in Asian countries there is no room to ease the policies.

In many countries, the room is running out and one question in Korea is whether there is too much liquidity in the country. My belief is that we have enough liquidity. It is our policy decision to mitigate the
impact of the crisis; it is not yet time to think about the exit strategy. We have to make sure the economy has began to turn around before we think about the exit.

Richard N. I personally share that judgment but some American economists and perhaps economists outside the US have seen very rapid increase in liabilities or our central bank, the Federal Reserve system. The increase more than doubled since July of last year and they see the potential there for very high inflation. My view, like yours, is that it is vastly premature to worry operationally about very high inflation, but it does raise the question of what the exit strategy should be as the economy returns to normal. I know for a fact, in the case of the US central bank, that staff members are already writing memos on how to reverse the policies when the time comes. The key judgment, of course, is when the time comes.

The US economy has relied very heavily on the finance sector for part of its vigorous growth over the last decade or two. The finance sector has taken a big hit with the current deleveraging, and probably deserves to take a big hit.

Peter Morgan, you are based in Tokyo, and I don’t know how fast you follow the US economy, but do you have a judgment on how this contraction of the finance sector might affect the competitiveness of the American economy?

Peter J. Morgan
I think it is pretty clear that there has been a huge impact in the finance sector, in particular in the US. It is clear even if you are just looking at the numbers. If you look at the share of finance sector profits out of the total US domestic corporate profits, it peaked at over 40% at a certain point in this decade; this decreased to around 28% last year. That’s quite a big fall and it might not have hit bottom yet. I think that there are number of reasons to expect that it is not going to bounce back very quickly.

First as you mentioned, there already has been significant deleveraging. To some extent, the fact that you have less leverage means less possibility of pushing up profits that way.

Also, if you look at credit spreads, which is the second reason, there has been a big rise in funding costs. Although the spread has returned to a normal level somewhat, it is still pretty high by historical experience. I think that even AAA spreads on corporate bonds are
down to the peak of the previous cycle, so that the higher cost of funds is also going to have an impact on profitability.

The third point is that profits produced by the model have been busted. You had a model that originates to distribute. So the banks made loans, they packaged them, sliced them and diced them, and sold them off to investors. This was a very profitable exercise for all concerned, and I think that the brakes are on that model for the foreseeable future.

The fourth aspect, which is somewhat still imponderable at this stage, is regulation. It is clear that there is a perception that there were regulatory lapses, that the overall regulatory framework was not adequate. We are also seeing a general pull back from the idea that the markets are self-regulating and that there needs to be a firmer break, given the fact that the American financial industry was one of the less-regulated ones overall. If we see a trend towards more regulation over time, I think that it is going to make it more difficult for the US finance sector. So there certainly are obstacles.

Now, in terms of the overall competitiveness of the US economy, I am not sure if there are any direct implications for the other sectors, except to the extent that their credit costs have gone up and leverage is certainly less available. But the question is, how do you compare that with what’s going on in the rest of the world? I think that the impacts of the crisis have clearly been global, and finance sectors everywhere have taken huge hits on profits, sometimes for multiple reasons, and real economy sectors have taken a big hit too—look at the profitability of Toyota, for example. So it’s clear that there aren’t any big beneficiaries from the current situation. I would say, though, that there has been significant withdrawal of developed-country banks and both US and European capital from the region through lending behavior. There has been a general withdrawal of capital from the region, and that suggests that there is going to be scope for Asian banks to increase their lending. I guess that, at the very least, there is going to be an economic improvement in the position of Asian financial institutions in Asia.

Richard N. Global imbalances have been implicated in the current financial crisis. In fact, I heard 2 weeks ago that Mervyn King, governor of the Bank of England, said that the global imbalances were the major key cause of the current financial crisis and that we will not avoid future financial crisis unless we find a satisfactory way to correct those imbalances. I am not sure exactly what he meant by those two statements, and so far
as I can fill in, I don’t exactly agree with him. That involves some interpretation on my part but, Mr. Kawai, do you agree with Mervyn King? And if so, what shall we do about it?

Masahiro I do not agree with the governor and I share the same view as Professor Cooper. Perhaps the global payment imbalance was a reflection of the very imbalances which led to the crisis.

Perhaps there are two extreme views. One is that global imbalances were caused by excessive US consumption based on the housing market bubble, which was domestically created. This excessively expanded consumption generated imports from abroad, and Asians were in a position to supply the kinds of products that US consumers wanted. In this process Asia financed the US deficit. That is one view, which I think is reasonable.

The second view, and perhaps the view that global payments imbalance was the cause of the crisis, might say that it was Asians who provided the low-cost funding to the US, and US consumers were able to borrow money from abroad and that generated the housing bubble.

So if you take a look at these two views, I think what happened was largely close to the first view. Perhaps the result of the US deficit was because Asians provided the funding. In conclusion, Asia financed the US deficit, but still the housing bubble was fundamentally created by internal mismanagement of monetary policy and inadequate supervision and regulation of the US financial system.

The imbalance in a sense generated excessive production of the manufacturing sector in Asia, and currently this imbalance is in the process of correction. Recent data shows that the US current account with Asia is in surplus. So, clearly, there is a trend towards balancing. The US current account deficit is now shrinking and so is the Asian current account surplus. So, in a sense, it is a good direction, but it is happening in a very disruptive way.

Initially in the argument for global payment imbalance it was said that the so-called disorderly adjustment was going to be very disruptive, but this disorderly adjustment is expected to be accompanied by rapid, sharp US dollar depreciation, and that is what’s happening. What is happening is US consumption adjustment is forcing adjustment on the part of both the US and Asia, and in this process underutilization of capacity, unemployment, recession, and all of these are taking place.
simultaneously, which is quite disruptive.

One important question is, how can we make sure that the imbalance disappears more or less in the medium term in order to make sure that the balancing process is less disorderly and smoother? I think that more policy initiatives are needed on the part of Asian countries—investment stimulus in countries where investment has been low, consumption expansion from a more structural perspective, social security reform, finance sector reform, and even corporate governance reform in the sense of distributing large retained earnings. Also, supply-side changes are needed on the part of Asian countries in nontradable sectors such as services, as Dr. He mentioned in the PRC.

Regional market integration will also be very important, as what we want to see is an expansion of regional demand in Asia. Asians can trade more among themselves for regional consumption, so this sort of policy direction will be quite useful. For the US, the opposite is true—more saving and less consumption. For smoother adjustment, smooth exchange rate adjustment can be quite useful, such as orderly depreciation of the US dollar and orderly appreciation of Asian currencies collectively. That would facilitate a smoother adjustment of the world economy.

Richard N. Cooper Of the two hypotheses you put forward, I would give more credence to the second one. I think both of them have some merit but you tended to dismiss the second one.

My view of how the world economy has worked in recent years is that, largely for demographic reasons, there has been excessive savings in a number of major countries, Japan being an outstanding one but also a number of East Asian countries. Let us also not forget Europe. Europeans tend to conceal their role in the world by aggregating all of Europe together. In fact, Europe is still made up of a number of separate countries. There has been very large excess savings in the Netherlands, Switzerland, Sweden, Germany, and the number of economies closely associated with Germany.

I think that these excess savings, which as I see have their origin in underlying demographic change, the aging of society, and the decline in the number of young adults, lowered world long-term interest rates. This is a worldwide phenomenon not just a US phenomenon, although it had a particular impact in the US. Our tradition is that most home mortgages are for 15-30 years, and the interest on a 30-year mortgage
was lowered. To give the numbers, the interest on a 30-year mortgage declined from more than 8% in 2000 to less than 6% in 2003. On a 30-year mortgage, a decline in interest of more than 2 percentage points makes a huge difference in the monthly payment, so it permitted people who could not afford to have mortgagees under traditional practices to come into the mortgage market. It opened up the mortgage market to additional people and increased the demand for housing.

There were two responses. One, the price of existing houses began to rise more rapidly, and two, construction of new housing started. Both processes were going on and the domestic mistakes you mentioned began to take place. People follow the habit of thought that housing prices can only go up, they can’t go down; anyone who looked at it should have realized that it is not true. We were overbuilding houses; we were building houses way in excess of the demographic requirements for new housing, and the underwriting standards for the mortgages declined excessively. All these factors compounded the problem, but I think the globalization of the world capital market and excessive saving in some countries contributed to lowering and keeping low of long-term interest rates. The PRC is in a somewhat different situation from the other large surplus countries. Of course the oil prices went up and that was another factor—countries belonging to the Organization of the Petroleum Exporting Countries (OPEC) all became surplus countries, as did Russia. So I would implicate them, but implicating them falls far short in my view of Mervyn King’s judgment that they were the main cause and that they have to be corrected.

Kyung-Wook Hur I think this is the conundrum: the long-term interest rate was kept low and, if the authorities had known that the housing bubble had been going on, they should have acted upon this problem.

I think the view is that if you push too far the US couldn’t do anything. Of course there was excessive saving in some countries, and they were wrong. However, when it comes to policy matters, it is the country’s responsibility to choose how to run its macro economy and the financial system, and how to maintain stability. Asian countries have no authority over how to control housing prices in the US. US authorities are fully responsible.

Richard N. First of all, I am not saying anyone is wrong. I am not trying to find blame so far as we can learn useful lessons about policy, and I agree with you entirely on that point.
Our next topic is the future of the dollar. We’re going to have a discussion about the issue tomorrow but I would like to use the few minutes we have to discuss what is of special interest to this part of the world, which is financial and monetary cooperation in Asia. The events of the last 2 years have certainly created a new interest, but have they created a new impetus and new rationale for closer monetary and financial cooperation in Asia? Perhaps I could ask Minister Hur, since he is on the front line in these issues, if he could tell us what discussions have been taking place and where he sees them going in the near future.

Kyung-Wook Hur

In the last meeting in Bali, there was agreement on the Chiang Mai Initiative (CMI) to be activated by the end of this year, which is a very huge achievement. Will this create a new rationale? Yes it will. The initiative for the CMI began at the time of the crisis 11 years ago, with discussions of a bilateral swap, so there is a regional initiative. At that time the crisis originated from the Asian market and we knew that the Asian countries were to blame, maybe not totally but in some part. This time the crisis is different; Asian countries were not responsible, except for in regard to the global imbalances. The crisis started in the US and we were suddenly affected.

As long as we do not have the reserve currency we will always remain vulnerable, which is why we need insurance. The first insurance, of course, is the US reserve. The second is the institutions such as the IMF, but we also want an additional insurance scheme, which is the CMI. This is the reason why we were able to agree on this kind of schedule despite some difficulties with the negotiations. More importantly, we were able to agree on the proportion of funds among Korea, the PRC, and Japan. Credit should actually go to Japan, as it is the largest economy. If it wanted to stick to its previous position that the size of the GDP should be the criteria for allocating its capital, it would have been very difficult to create momentum in the given time. But Japan, in the spirit of cooperation in Asia and in the spirit of its regional insurance scheme, agreed on Japan and the PRC providing the same amount, and Korea following. It is not just the framework but it is practicing the spirit of working together that is important. So I think it deserves much credit. Finally, with all the talk about imbalances, there will be more integration in the economy of Asian countries and this framework will definitely have a regional impact.

Richard N. Could I ask you to spend one more paragraph on what is actually meant

Cooper
by implementation of the Chang Mai Initiative? The reason I ask is that, as a naive American, I thought that the Chiang Mai Initiative was set up 10 years ago and that it was open in the sense that lines of credit had been committed among the members of the region, which could be activated at any time. As far as I know, they were not actually activated but could have been activated at any time, so what does it mean to say there is a new agreement as of this month on implementation?

Kyung-Wook Hur: This time it’s more like a fund. All the bilateral swap is pooled together into a big fund of $120 billion, so it is more like an Asian monetary fund. Each country will make a contribution, so you no longer borrow bilaterally but from the fund. To put this into practice, we’ve come up with a supervision mechanism. It is not as fully developed as the IMF but we’ve agreed on the contribution of each country and on the timetable. Even though the remaining work is not easy, it is still much easier than what we had earlier agreed upon.

Richard N. Cooper: I assume this is bilateral, but others will be interested. Also, is this conceptually an Asian monetary fund as it seems to have a secretariat with bilateral relations between each member country and the new institution. Or is this just an accounting device by which when a country, say Thailand, decides it needs funds, it can go to the Chiang Mai Initiative and say I need funds, and then you have a formula for who puts the funds up but the actual implementation is bilateral?

Kyung-Wook Hur: It is not an accounting device. It is not fully developed but the idea is being a fund. It is no longer bilateral.

Richard N. Cooper: But if I again take Thailand as an example, and I want funds, to whom do I go?

Kyung-Wook Hur: The secretariat. And then we have a voting procedure.

Richard N. Cooper: Mr. Chung, you were active in these issues as an official 10 years ago. Do you see this as unrelated, all related, or as partially related to exchange rate cooperation among Asian countries? This is reserve pooling really, as distinguished from the exchange rate, but another important issue under the heading regional cooperation is cooperation of exchange rates.

Duck-Koo Chung: I think we have shown great endeavor to develop monetary cooperation but the outcome is not regarded as successful. This is because, as opposed to financial cooperation, monetary cooperation is very
sensitive and we have very different economic development backgrounds in south and north Asia. Especially in the north, the three northeast Asian countries have become more homogeneous in the last 12 years, but the developments in the south are still heterogeneous. That’s why we need a two-step approach in terms of monetary cooperation. It is not easy to coordinate macroeconomic management among Southeast Asian nations and the three countries in northeast Asia. That is why initially we are pursuing the coordination of the three northeast Asian countries, which is more feasible. Part of the macro policy coordination is exchange of information and exchange rate policies.

We experienced the financial crisis just 11 years ago and still feel the necessity for East Asian nations to find appropriate alternative ways of protecting ourselves from shocks triggered by the world economy, as has happened in the current world financial crisis. The situation can be compared to a small boat in a high sea. We want to catch the big fish in the Pacific Ocean but with a small boat.

So how can we protect ourselves from the big waves in the high sea? There are several observations. The initial question is how can we stabilize our exchange rates among the nonconvertible currencies, such as the won, renminbi, and baht, which were experiencing serious exchange rate volatility at the time of the crisis. This is one reason why we need some stepping stone towards monetary cooperation.

The further goal may be an alternative to establish one money in Asia with a regional currency unit. As an initial step, however, we need some creation and development of a regional capital market, and we have to achieve reserve pooling first. Even if it takes a long time, it should be well coordinated through development of new international financial architecture.

Some of the nonconvertible currencies such as the won are experiencing a serious situation in the face of the falling US dollar, especially when our foreign reserve is directly linked to the value of the dollar. So how can we find a place to hide? That is our underlying problem. We have a long way to go until the final destination, but we are trying to make a further step every year and that should be our main task in the coming years.

Richard N. Before we conclude, I think we should ask Professor He to comment on the fact that the PRC has become a very important player in
economic terms. There is increasing discussion on the use of the renminbi as an international currency. An American economist, Roubini, even sees at some unspecified time in the future the renminbi becoming a fully international currency, and I wonder if we could ask you to comment on what you see as the prospects of the PRC moving towards a fully convertible currency and opening the capital market to foreigners, all of which I believe are necessary before the renminbi can become an international currency.

I understand that this was high on the PRC’s agenda before the Asian financial crisis. In fact, the Government of the PRC had settled on 2000 for full convertibility of the currency. With the Asian financial crisis it did not abandon the objective but postponed the target date indefinitely. Could you just comment on what your thinking is and what you think the government’s thinking is on these set of issues, because I think this will be important for where Asia and the world goes in terms of currency arrangements.

Fan He Actually, before this financial crisis, there was already de facto internationalization of the renminbi.

First, in border trade, the renminbi was used as the denominated currency in neighboring countries, and you could get renminbi through all kinds of channels. The government’s attitude toward the internationalization of the renminbi changed dramatically after this crisis. Now, it is very positive in pushing the internationalization of the renminbi forward. One step was encouraging the use of the renminbi in international trade.

Second, after the US financial crisis, we signed a bilateral currency swap with a handful of countries, all using the renminbi and the local currency of the counterparty countries. I think the rationale for internationalization of the renminbi is not that the PRC has the ambition of replacing the role of the US dollar in the near future, but rather it is a defensive action.

The PRC is very worried about holding onto its massive US dollar assets, so the government is trying to think of all kinds of ways to avoid potential risk, and internationalization of the renminbi is one of the steps that they are taking. Still, this is just the first step of the long march. I totally agree with Professor Cooper that the real barrier is the fragile financial system, and reforming this is necessary before anything else can be done, and I think this will happen very quickly. If
you open the door slightly, you will have a lot of unexpected problems. My personal view is that this capital liberalization will come more quickly than most people expect, but in this process we will face a lot of difficulties. For the time being, I think internationalization of the renminbi will be good for regionalization because if the renminbi becomes fully convertible it can play a more positive role in regional monetary cooperation. So, there is a trade-off between regional monetary cooperation and reform of the international monetary system. If reform of the international monetary system proceeds faster, then probably regional monetary cooperation will come more slowly, but if reform of the international monetary system is slow then regional monetary cooperation will proceed faster and the PRC will be more enthusiastic in taking part in regional monetary cooperation.

Richard N. I think what we have done this evening is set the stage nicely for our meeting tomorrow. We can have more extensive discussions on these issues, including the one we omitted—the future role of the dollar—tomorrow.

Let me thank the panel for their participation.
“The US dollar is likely to remain the dominant international currency for many years, certainly the next decade and probably longer. Given its initial advantage of wide acceptance, no other currency seems likely to overtake it. International use of the euro will grow, perhaps even more rapidly than that of the dollar for some years, but because of limitation on issuers and financial markets, it is not likely to displace the dollar. In a growing world economy, there is room for both.”(p.95)

Richard N. Cooper, Maurits C. Boas Professor of International Economics, Harvard University

“A good start toward increasing effective Asian monetary cooperation would be developing greater consultation about the situations in which countries should engage in sterilized intervention.
This is the area in which meaningful agreements about the coordination of exchange rate policies should be the least difficult, and fits logically with agreements about intraregional financial support.
The next step in the evolution of cooperation would be efforts to coordinate monetary (and fiscal) policies.
Only after there is considerable success on this score do I believe it would be appropriate to consider negotiating systems of exchange rate bands, unless they are so wide and soft as to be of questionable value.”(p.199)

Thomas D. Willett, Horton Professor of International Economics, Claremont McKenna College, Claremont Graduate University