CEAC Commentary

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Dollar, Euro, Yen and Asian Currencies: Toward the Better Stability of the International Monetary System

By UTSUMI Makoto

It is my honour to participate in the third East Asian Conference and to speak before such a distinguished audience.

Among the various fields in East Asian Financial Cooperation, I would like to focus on International Monetary issues.

The East Asia―Natural Dollar Area?

In the East Asia, the intra-regional economic integration has risen rapidly. The intra-regional trade now accounts more than 50% to aggregate trade of the East Asian Region. This ratio is approaching to that of the NAFTA (56%) and the EU (67%).

Here, I want to draw you attention to the fact that around 90% of the cross-border transaction are dependent on the U.S. dollar for invoicing and settlement purpose. Accordingly, monetary authorities and business circles in East Asia have been focused on the dollar exchange rate implications for the expansion of international trade and investment.

Reflecting this background, though East Asian countries have adopted either fixed exchange rate system, or various forms of floating exchange systems, general tendency has been to seek for the stability vis-à-vis the U.S. dollar. Consequently, the foreign exchange reserves of these countries have been predominantly the U.S. dollar.

Through the Asian Crisis in 1997, Asian countries learned the risk of the excessive dependence on the U.S. dollar. Still, we are witnessing the tendency of the currencies of the Region to revert to the reliance on the U.S. dollar. Some economists describe this tendency of the Region as a 'natural dollar area.'

The Weakness of the Current International Monetary System

The weakness of the Current International Monetary System is the lack of Symmetry between the U.S. dollar and the other currencies. As far as the U.S. dollar is the only one key currency of the world, its stability is the necessary condition of the world economy. But the problem is that Americans do not care so much of it.

Americans make settlement in the U.S. dollar (hereafter: Dollar), not only in their country, but also every corner of the world. So, they tend to be much less sensive to the change of the relative value of their currency vis-à-vis the other currencies than Europeans or Asians. In particular, after the suspension of the Dollar’s convertibility with gold in 1971, there is no constraint for them to maintain the value of the Dollar vis-à-vis gold. So, the American Authorities sometimes take the attitude of ‘benign neglect’ when the Dollar depreciates vis-à-vis the other currencies. In contrast, the other countries are always living in this external constraint that the lack of sound macro-economic policy would inevitably lead to the fall of the currency value, and/or running out of foreign exchange reserves, which would result in their economic crisis. Thailand, South Korea and many other Asian countries in 1997 and Argentina in 2003 are these examples.

Market Focus versus Stability

The market economy has conquered the world. Ten years ago, the population belonging to the market economy was less than 1 billion. Now, it covers 5 billion.

While the world economy is undergoing this profound change, we have noticed a marked tendency in this market economy. That is: every country has its strengths and its weaknesses. But markets tend to see only the strengths when a country is going on a shining path and only the weaknesses when a country is undergoing difficulties.

One typical example is the U.S. from the late 1980s to early 1990s. A Japanese economist was jokingly saying: ‘Let us express the U.S. economy in the Alphabet. A: airlines (Pan Am disappeared) / B: banks (all banks were in difficulties. Not only Bank of America, but also Citicorp) /C: cars (Japanese cars were taking over market shares) / D: defense industry.’ And finally, he said: ‘What is E? The American economy itself.’ The market did not see the emerging light behind the shadow, which, in the later years, pushed up the U.S. economy as the strongest one again in the world.

On the contrary, the Japanese economy was on a brilliant path in late 1980s until 1991. And Japan, including its business management method, was thought to be the model of the developed economies. The Japanese themselves were overconfident. In those days, there was a joke going around among financial and business people in the U.S. An airplane got an engine trouble in the middle of a flight with three passengers abord. The pilot finally said to the passengers, ‘I am sorry, but the engine trouble is so serious that we cannot continue to fly. So please make your last wishes.’ The three passengers were: a French, an American and a Japanese. The French passenger said, ‘I want to sing La Marseillaise.’ The Japanese passenger, who was a businessman, said, ‘I want to give you a lecture on Japanese management.’ The American passenger said, ‘I want to die before hearing his lecture.’ The markets as well as Japanese themselves did not see the creeping shadow behind the light.

This tendency of the market can be seen in connection with currencies, stock prices, raw material prices etc. etc.

Consequently, we observe sometimes the overshoot of the market. And when the overshoots happen in the foreign exchange markets, the U.S., being very respectful to market forces, rarely takes action against them.

For example, in the first term of Reagan Administration, Secretary Regan and Under-secretary Sprinkel were, so to say, the market fundamentalists. I still remember what happened when Japanese Minister of Economic Planning met Mr. Sprinkel in his office. At that time, the Dollar was on the level of 250 Yen par Dollar (it was before the Plaza Accord in 1985). Japanese Minister started the conversation by saying ‘this overshoot of the Dollar~’ then Mr. Sprinkel interrupted, ‘no, there should not be the overshoot in the market. The market is always right.’

The Plaza Accord in September 1985 was an epoch-making event in the history of currencies in the sense that the Finance Ministers and Central Bank Governors of the G-5 clearly admitted for the first time the existence of the overshoot in the market: that the markets do indeed produce foreign exchange rates, which are not justified by the economic fundamentals. Then, they committed themselves to a concerted action in the markets on the basis that ‘some further orderly appreciation of the main non-dollar currencies against the Dollar is desirable.’

The second significance of the Plaza Accord is that major countries started to implement a new strategy. It was to prepare a theatre for the audience called ‘the markets’ and to send effective signals through it. The G-5 that gathered at the Plaza Hotel played a magnificent drama, astounded the markets, reversed the trend of foreign exchange rates and established an environment for economic growth without inflation.

This Plaza Accord was a trial to seek for the better stability in the foreign exchange market which became possible by Secretary Baker and Deputy Secretary Darman who were not the market fundamentalists and who understood the importance of the stability.

Since then, there have been swings in the American attitude, depending on the policy makers responsible of the International Monetary Affairs.

Since the first term of Bush administration, the cliché repeated by the Secretaries of Treasury has been: We support the strong dollar, but it is the market who decides. Since the year 2000, the U.S. has never intervened in the Foreign Exchange Markets.

Generally speaking, the Americans have stronger belief in the market forces and the Asians and Europeans tend to emphasize the importance of the stability.

The emergence of a New Key Currency 'Euro' and its impact

The birth of Euro is very important milestone not only for Europe but also for the history of the World currencies. Among others, it should have a serious impact on the Dollar, which had monopolized the key currency status and now sees its competitor appearing before it. As far as the Dollar is the only key currency, in spite of the accumulating current account deficits, the U.S. has not experienced a currency crisis. Even though the weakness of the Dollar was observed, there was a kind of natural limit in the shift of the Dollar assets toward the Yen, the DM or gold. But now that the Euro is rapidly establishing itself as an international key currency, it will be able to substitute for the Dollar in international assets and settlements. The certain shifts of the assets from the Dollar to the Euro have been observed since the beginning of 2003 in the foreign exchange reserves of some Asian and Middle Eastern countries. When there is the prospect of the weaker Dollar, such a shift would prevail. It means that the U.S. is not allowed any more to take the benign neglect approach. So, the Euro factor, would lead to the increased stability of the exchange markets.

Where the Asian Currencies are going?

When the currencies of the G-10 moved to the floating exchange rate system, no discussion was held in respect of the currencies of developing countries. It was taken for granted that currencies belonging to smaller economies would be pegged to one of the major currencies such as Dollar, Sterling Pound, French Franc etc. like satellites surrounding these major currencies. Nobody was foreseeing such a big change in the world economy leading to the kind of situation we are facing now. In other words, no one could anticipate that Asian countries, including China, would show such a fast growth and raise their profile in the world economy. They cannot be the satellites any more of the major developed economies and so of their currencies.

Now, observing the emergence of China as a very important economy in the world, it is quite natural that there are so many international voices surrounding the Chinese currency, Renminbi. There might be a day for Renminbi to move to the floating exchange rate system in future. In this connection, it would be the common interest for Japan, for China, for Asian countries and for European countries to have the U.S. involved in the commitment for the better stability among currencies through the strengthened co-management of the International Monetary System.

In these environments, where the Asian Currencies are going?

Is a single currency like Euro in Europe possible in East Asian Region?

Frankly speaking, I realize that it is not realistic approach for East Asian countries to explore the possibility of a single currency and the unified monetary policy conducted by only one Central Bank. Even in Europe, which has more coherent economies, societies, cultures and religions, it took more than 40 years to get this goal, which is still in unfinished status, the U.K. and some other members being outside of the Euro Zone.

My vision starts from studying the example of European Monetary arrangement called ‘Snake’, in which EC member countries tried to keep their internal fixed exchange rate system and adopted a joint float system vis-à-vis currencies outside the system. This ‘Snake’ focused only on the stability of exchange rates of the group of these countries. Members were free to make their own economic policies and had no need to transfer their monetary sovereignty.

If this system were adopted by East Asian Countries, the cross-border trade and investment would be able to get momentum and it would surely bring immeasurable benefits for the Region. But, here again, it is irrealistic to expect to step up to this stage with one bound.

My image is that, not entire group of East Asia, but those countries with greater similarities in economic circumstances could produce coordinated approaches as sub-groups in ASEAN+3. In such a sub-group, the countries agree to stabilize the exchange rates among them, for example, to keep their internal fixed exchange rate system (with certain fluctuation margin), which is similar to European ‘Snake’. As this kind of sub-group, one could imagine the original members of ASEAN.

At the next phase, different groups would also pursue the above-mentioned process and mechanism. Japan-Korea (+China, when it moves to the floating exchange rate system) might be conceived as one of the following sub-groups.

Each group would accumulate policy experiences, and non-group countries would be expected to join one of these sub-groups once their entry conditions were prepared and practiced. At the following phase, each sub-group would be expected to allow a wider band of exchange rate to be applied to each other or to newly participating countries. This wider band would provide participation incentives to new member countries and help enable them to meet the entry conditions.

Through a sequencing of changes in exchange rate arrangements at both the group level and the newly participating country level, experience would accumulate in both policy coordination and the group’s institutional mechanism, which would be further refined and substantiated. I think this is the most realistic approach towards broader regional currency cooperation. In the process of this regional currency cooperation, together with the dramatically increasing importance of the Region in the world, the Asian voice aspiring after the better stability would have the strong influence on the formation and the management of International Monetary System.

(This is the text of Keynote Speech delivered by UTSUMI Makoto, former Vice Minister of Finance for International Affairs and currently President and CEO of the Japan Credit Rating Agency, Ltd. at the 3rd NEAT Conference on East Asian Financial Cooperation in Shanghai on 7-8 April, 2007.）