In Search of a Stable Currency System in the 21st Century

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The switch from a fixed exchange rate system to a floating system after the collapse of the Bretton Woods System has presented new problems. Some of these problems include the rapidly growing size of international capital flow relative to that of international trade, and the instability of the foreign exchange markets as the speed of international capital flow increases. So, it is essential to find a new framework to stabilize the international currency system.

In this respect, it is necessary to consider alternatives for the present international monetary system. In particular, along with ongoing discussions over the currency board system, dollarization and regional unit currency, there is a growing sense that a target zone system has to be introduced.

Take a glimpse at what the international currency system will look like in two decades. The dollar will surely remain a vehicle currency, but the Euro will be palling with the dollar as European countries rush headlong to EMU. Hence, the existing dollar-based monetary system will be transformed into a bipolar currency system. At the same time, most Latin American countries will likely peg their currencies to the dollar through dollarization or a currency board system. Meanwhile, there is also considerations to create a yen block or Asian Currency Unit in the Asian region. If such a block appears, the international monetary system will be ruled by a triumvirate: the dollar, the Euro and the yen.

There’s still long way ahead to setting up a regional currency system in Asia. The obstacles result from a relative lack of political and economic homogeneity in that region (as compared to say, Europe) and the lack of common interests. However, the need for a stable regional currency has become a priority in connection with the region's economic development. Therefore, Asian countries are expected to cooperate to map out some measures to keep currencies stable. Under the Japanese leadership, China might play a bigger role in the region's currency system, based on its political power. We can also assume that the Japanese yen, Chinese yuan and Korean won will fall under a currency stabilization system similar to ERM(exchange rate mechanism).

Currency System in Asia

Let's look more closely at the currency system in Asia. Before the currency crisis of 1997, most Asian countries had pegged their currencies to the dollar. This system had helped their economies grow, but led to their collapse when the headlong depreciation of Japanese yen dealt a massive blow to their trade balances.

In the wake of the crisis, a considerable number of Asian countries adopted the floating foreign exchange rate system. However, the countries suffered from poor liquidity in foreign exchange markets, and lacked risk hedge tools. Under the floating foreign exchange rate system, the foreign exchange rate fluctuated violently in accordance with supply and demand in the market. This destabilized the overall economy. Some Asian countries, which adopted the floating exchange rate system, are now seeking ways to protect their markets from the effects of the liberalization of capital flow.

The alternative to the fixed exchange rate system and the floating exchange rate system is a currency basket system, which is a mid-point between the two. This system allows each country to link its currency to the currency basket, based on its trade weighting and economic situation. By doing this, countries have been able to maintain a more proper value for their currency than the dollar peg system. What's more, by allowing their currencies to move within a certain range (e.g. 10% up and down) from the base rate, the country can keep its monetary policy stable, and secure flexibility against outside shocks such as capital flight. To make the currency basket system a success requires a powerful international organization to govern the stability of the foreign exchange.

Foreign Exchange System in Korea

Until the 1970's, Korea's foreign exchange rate was substantially pegged to the dollar, even though the nation adopted a unitary floating exchange rate system. In February 1982, the nation introduced the currency basket system under which the won's value was linked to the currencies of major trade partners such as the US and Japan. Under the currency basket system, the governor of the central bank was expected to determine an optimal daily base rate by considering the international balance and interest differentials between home and abroad. But, at the time the Korean government was accused of manipulating the market to improve its trade balance.

In March 1990, Korea introduced the market average foreign exchange rate system under which supply and demand decided the foreign exchange rate. But, many suspected that the government manipulated the market again through "dirty floating."

In November 1997, during the foreign exchange crisis, Korea's foreign exchange market was penalized, and the government was forced to abolish all caps on the range of its floating exchange. When the free-floating foreign exchange rate system was implemented, the won/dollar rate immediately suffered from massive fluctuations. However, the market stabilized as it recovered its pricing function backed by the support of international financial institutions and Korea's commitment to economic restructuring.

Korea's foreign exchange market still has less market players and lower liquidity than that of its well-developed stock market. Therefore, the currency market is very sensitive to outside shocks, evidenced by the fact that the foreign exchange rate vacillates with minute changes in real demand.

To address the problems, the Korean government is building the infrastructure of a foreign exchange market designed to lift market liquidity and increase the number of players. In step with these plans, the government boosted liquidity by liberalizing its foreign currency transactions in April 1999. At the same time, it introduced a foreign currency broker system and opened its futures exchange to develop a variety of financial derivatives such as currency futures.

Asian Currency Union

The Asian region must begin to scrutinize the introduction of a regional currency system, in line with the emergence of currency units in Europe and dollarization in Latin America. With the use of regional currencies, local currency barriers will disappear. The move might also spur new growth, as the currency system will help stabilize the regional currency and activate regional trade.

However, the emergence of a regional currency is still far from reality in that common historical, social and cultural traits each country shares give a wider room for a regional currency to be created. But, the economic structures of present Asian countries are still very different, and are reluctant to cooperate. Trust among them falls short, to boot.

Fortunately, a consensus exists that Asian countries have to pay more attention to the Japanese yen along with the dollar in operating their currency policies. Most Asian countries believe the creation of a yen block is for their national interests. But others, including the US and the International Monetary Fund are against the creation of such a block. Some point out that the yen is still no globalized in the transaction of goods, exchange of foreign currencies, issuance of bonds and in operation of foreign reserves. Instead of yen block, they propose a regional currency union based on a new type of Asian Unit Currency; the idea looks untimely as there is still no leading player or unity among the countries.

Yen's Globalization

Asia can reckons the yen’s globalization to be more realistic and helpful. The Yen's globalization should be dealt with in view of the stabilization of the global economy. Trade within the region accounted for 35% of total trade in Southeast Asia in 1996, up from a meager 25% 1986. At this point, enhancing the yen's role in trade and finance will contribute to stabilizing the Asian economy.

Of course, it will be in the interests of Japan to increase the frequency of yen use in Asia. Around 40% of its exports are destined to the Asian region. Hence, the stabilization of the yen and other Asian currencies assure the Japanese of solid exports, and the yen's globalization clears the way for Tokyo to become the hub of international financial markets.

Japan's efforts at making an efficient financial infrastructure to lift the yen's status to a vehicle currency are also crucial. To do so, it must reform its government bond market and short-term money market, and enhance its settlement and credit rating system. To boost the yen's liquidity in the Asian region, Japan has to open up its trade markets and import more from its Asian neighbors.

Co-implementation of Economic Policy in Asia

Along with the yen’s globalization, the need for co-implementation of currency policy among the Asian countries surfaces. It is critical that Asian countries cooperate with each other in foreign exchange and currency policies to prevent another crisis from recurring and to help the development of the regional economy: As evidenced in 1997, a currency crisis in one Asian country spreads easily to neighboring countries. And economic cooperation is needed to address the problems of excessive competition in exports and the glut of facilities.

The other reason is a matter of survival. Every time one country in the region devalues its currency to spur domestic economic recovery and export competitiveness, the possibility of trade war increases. Most of all, Asia must cope with a global trend of building economic blocks for common interests

Asian Monetary Fund

Asian countries have started to heed the need for a currency union for continued economic development and currency stabilization. The operation of a regional currency union provides a systemic tool for a country to protect its currency from international speculators although it has a handful of foreign reserves.

Required to launch AMF are to win sympathy and the cooperation both in the region and from the global society. With situation unripe, the creation of regional currency union is sure to fall abortive even though there is a desperate need for the creation of AMF. Hence, the Asian countries need to reinforce relationship on all fronts. That will be the first step to create a currency union in the region. To this end, most important is Japan’s role. Japan has to encourage troubled Asian countries to claw back to growth.

Conclusion: To Prevent Crisis in Asia

Most dilemma the Asian countries hunkered down in 1997 is largely of their own making: it originated from bubble-bust resulting from economic recession, a series of corporate bankruptcies, mounting bad loans in financial institutions, blundering economic policies, over-capacities, cronyism and many more besides. There were also outside factors. As most Asian countries adopted the dollar-linked foreign exchange rate system, the weakness of the Japanese yen since 1995 can be said to trigger the Asian crisis by debasing the price competitiveness of Asian export products.

As the century comes to a close, it is time to reflect on idea that have shaped it, and the lessons it leaves behind. To prevent the recurrence of currency crisis in Asia, Asian countries have to not only continue pedaling economic restructuring but prepare a system to ease the fluctuation of foreign exchange rate and fend off speculative capital flow. In particular, Asian countries must be dedicated to create a currency stabilization system in the region, then co-implement economic policies and seek common benefits in the region. As witnessed in the 1997 crisis, currency crisis a country suffered will not be a “fire across the river”.