Reforming the International Monetary System: An Asian Perspective

Masahiro Kawai
Asian Development Bank Institute

Conference on
"International Cooperation in Times of Global Crisis: Views from G20 Countries"
Organized by ICRIER, CEPII, Bruegel and ADBI

New Delhi 16-17 September 2010

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1. Introduction: Why Reform?

A well-functioning international monetary system should:

- ensure exchange rate stability,
- facilitate current account adjustment,
- provide sufficient international liquidity for the world economy, and
- promote international trade and investment

In sum, **it should provide an international framework for sound national economic policymaking**

1. Introduction: Why Reform?

- The current international monetary system is not functioning too well—exchange rate volatility, recurrence of currency and financial crises, persistent global imbalances, accumulation of US dollar debt abroad undermining the confidence of the US dollar, etc
- The use of the US dollar as the most dominant international currency creates tension between national and global monetary policy making
- The euro is a potential rival to the US dollar, but lacks a solid sovereign backbone
- What needs to be done?

2. Big Ideas

- **Global single currency system**
- **SDR-based system**
- **Tripartite currency stability**
- **Multi-polar currency system**
- **Not so big an idea: improved functioning of the dollar standard**

(1) Global single currency system

- The world's major countries adopt a common single currency backed by a single monetary policy (Richard N. Cooper 1987) and a unified fiscal policy (new lesson from Greece), while other countries may peg their exchange rates to the common currency
- Usefulness of money can be maximized under a set of conditions, such as optimum currency area criteria
- Consistent with a highly integrated global economy

But

- Are the advanced countries ready to work with each other and with large emerging economies?
- Are China, India etc ready to join the single currency?
- The world's single most influential central bank may not be under competitive pressure to achieve low inflation

(2) SDR-based system

- SDR as an international currency—for foreign exchange reserve holding, denomination of international trade, investment and financial transactions, etc—in parallel with other major international currencies (Zhou 2009, Stiglitz 2010)
- More balanced than a national-currency based system
- Requires market development of SDR instruments, a settlement and clearance system, and a quasi-central bank (IMF?) to regulate the supply of SDR

(3) Tripartite currency stability

- The world major currencies' exchange rates—particularly the US dollar, euro and yen—are stabilized (a la Ronald McKinnon 1974, 1988)
- Can the system work with or without involving major emerging economy currencies like the Chinese yuan?

(4) Multi-polar currency system

- Competition among the world's major reserve currencies can induce disciplined economies policies in reserve currency countries
- The euro needs to develop a solid sovereign backbone through integrating fiscal policy
- Asia needs to develop its own regional reserve currency through the evolution of the Chinese yuan as an international and convertible currency, or through the creation of an Asian currency basket, like an Asian currency unit (ACU)

(5) Not so big an idea: Improved functioning of the dollar

- Disciplined macroeconomic policy by the US including the restoration of fiscal sustainability
- Reduction of current account deficit
- Provision of US dollar liquidity at the time of dollar liquidity crunch
- Greater exchange rate policy coordination at the time of sharp, rapid fluctuations among major exchange rates

3. Volatility of Capital Flows and Exchange Rates

- Asian currency crisis of 1997-98
- Two episodes: Indonesia (summer 2005) and Thailand (December 2006)
- Global financial crisis and a mini-won crisis (fall 2008)

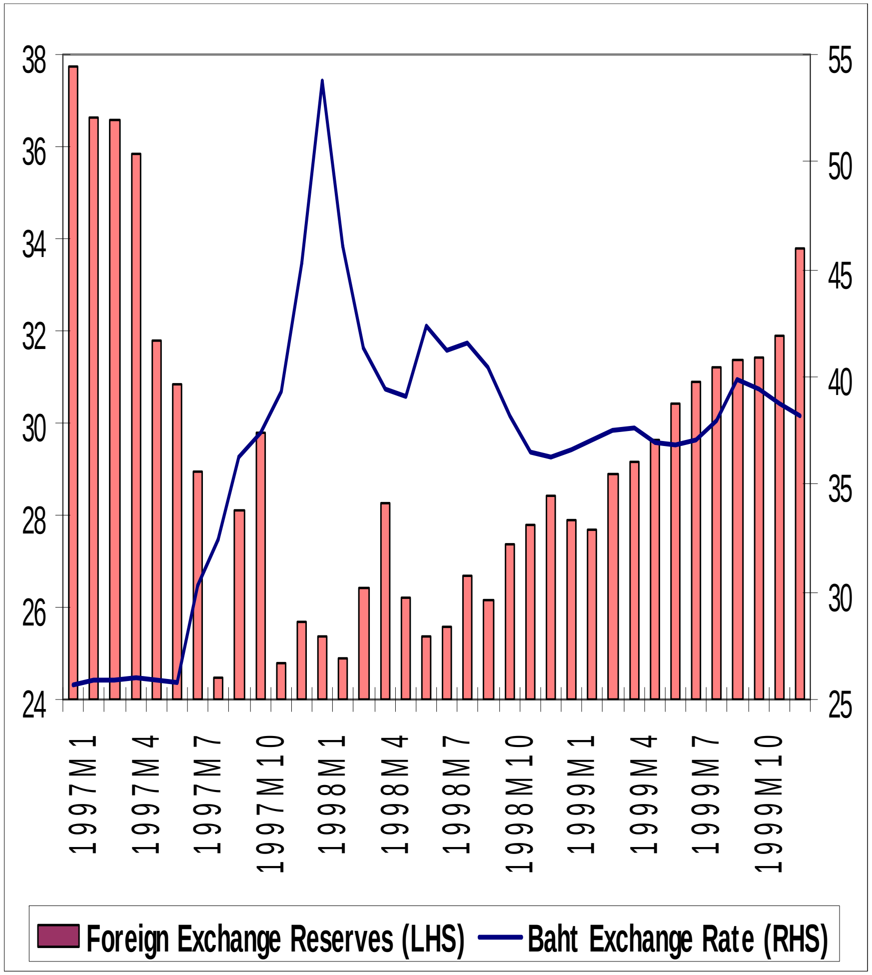
(1) Asian currency crisis of 1997-98

Twin crises: Banking & capital account crises

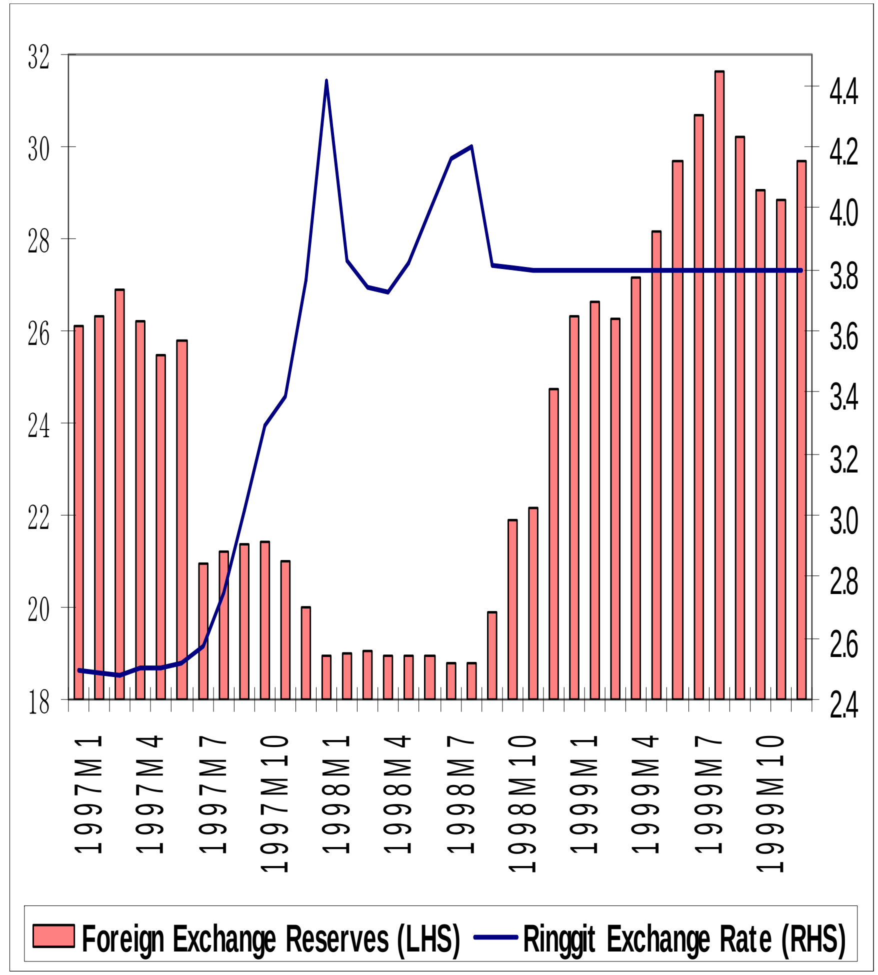
- Economic boom & overextension of bank loans, financed partly by short-term capital inflows
- Relatively fixed exchange rates against the US dollar, encouraging capital inflows
- Exposures to double (currency & maturity) mismatches
- Reversals of capital flows and crisis contagion
- IMF interventions in Thailand, Indonesia and Korea, but not Malaysia (which used capital outflow control)
- The subsequent ASEAN+3 monetary and financial cooperation (CMI, ERPD, ABMI)

Rapid reserve loss & currency depreciation during the Asian financial crisis

Thailand

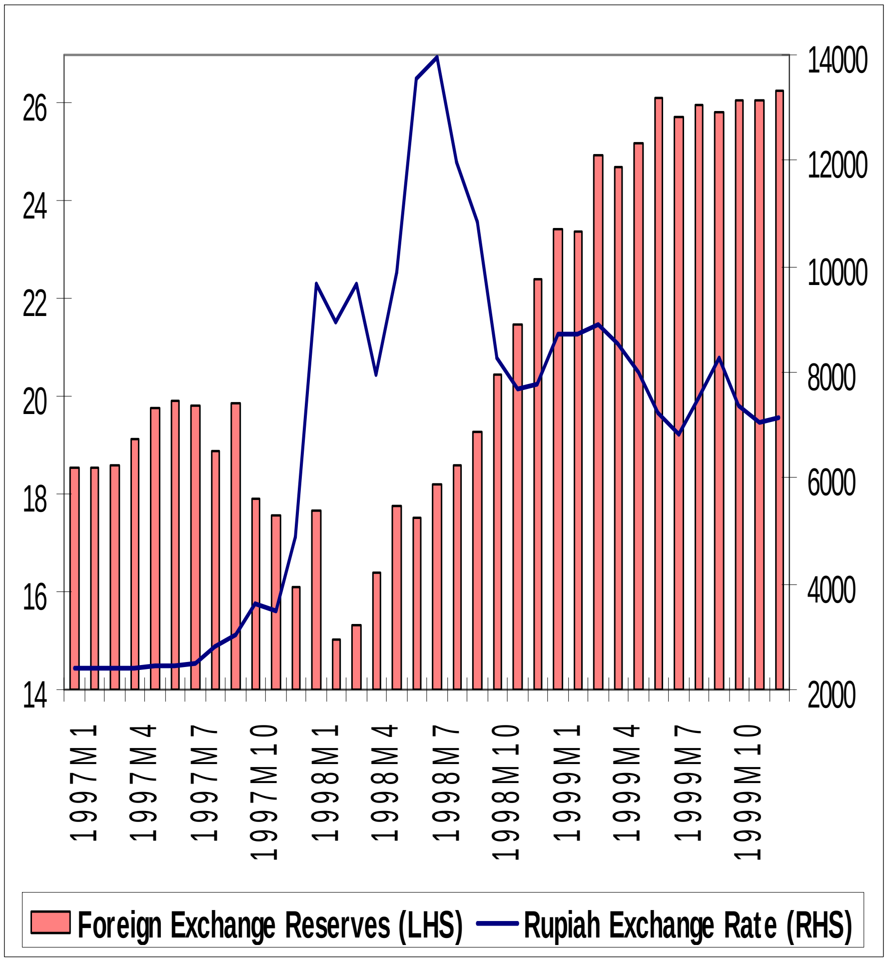


Malaysia

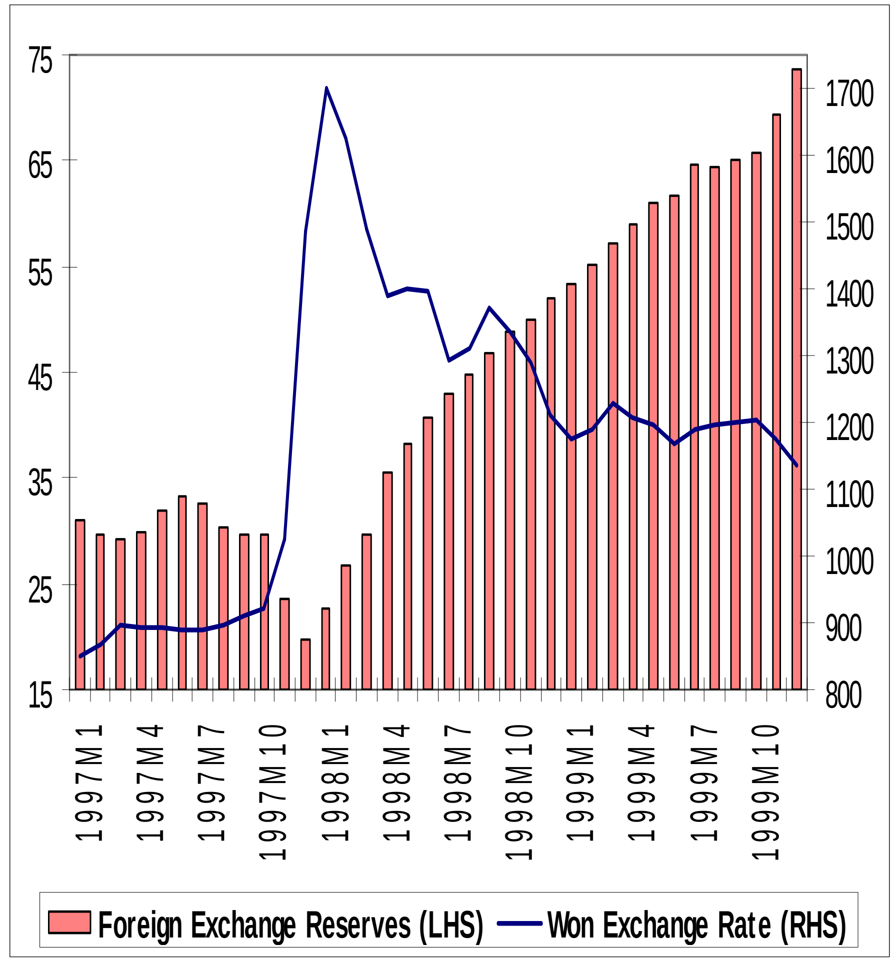


Indonesia and Korea were also severely affected in 1997-98

Indonesia



Korea



(2) Recent episodes in Indonesia and Thailand

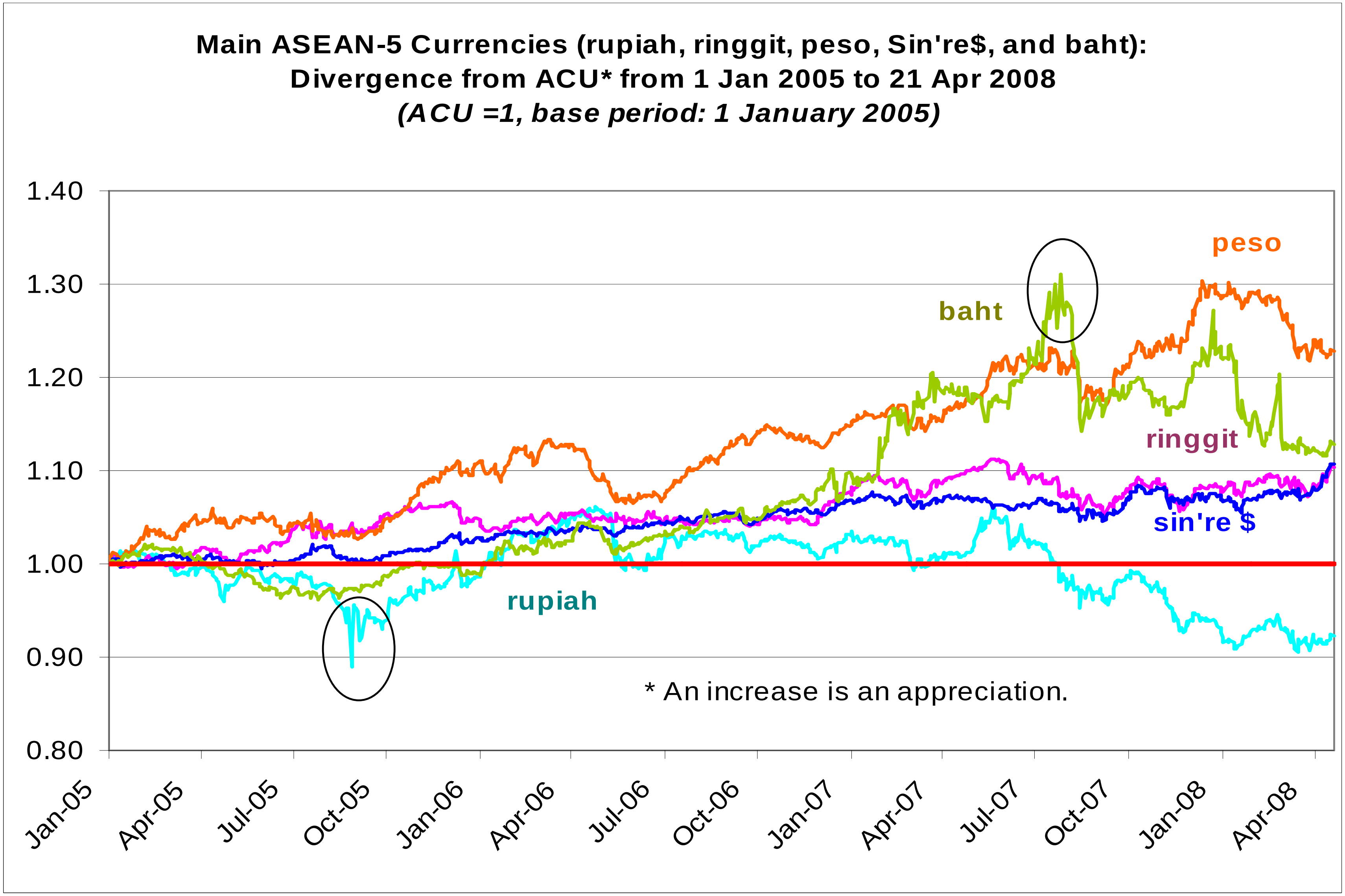
Mini rupiah crisis (summer 2005)

- Rapid rupiah depreciation due to concerns over rising inflation and expanding fiscal deficits
- Policies to tighten monetary policy and reduce fuel-related subsidies stabilized the market

Thai capital inflow control (December 2006)

- Large inflows of capital throughout 2006 and upward pressure on the baht, causing loss of international price competitiveness vis-à-vis other ASEAN & China
- Capital inflow control, introduced in December 2006, caused a sharp decline in stock prices, and had to be modified in January 2007

Rupiah mini crisis in Aug. 2005 and Thai capital control in Dec. 2006

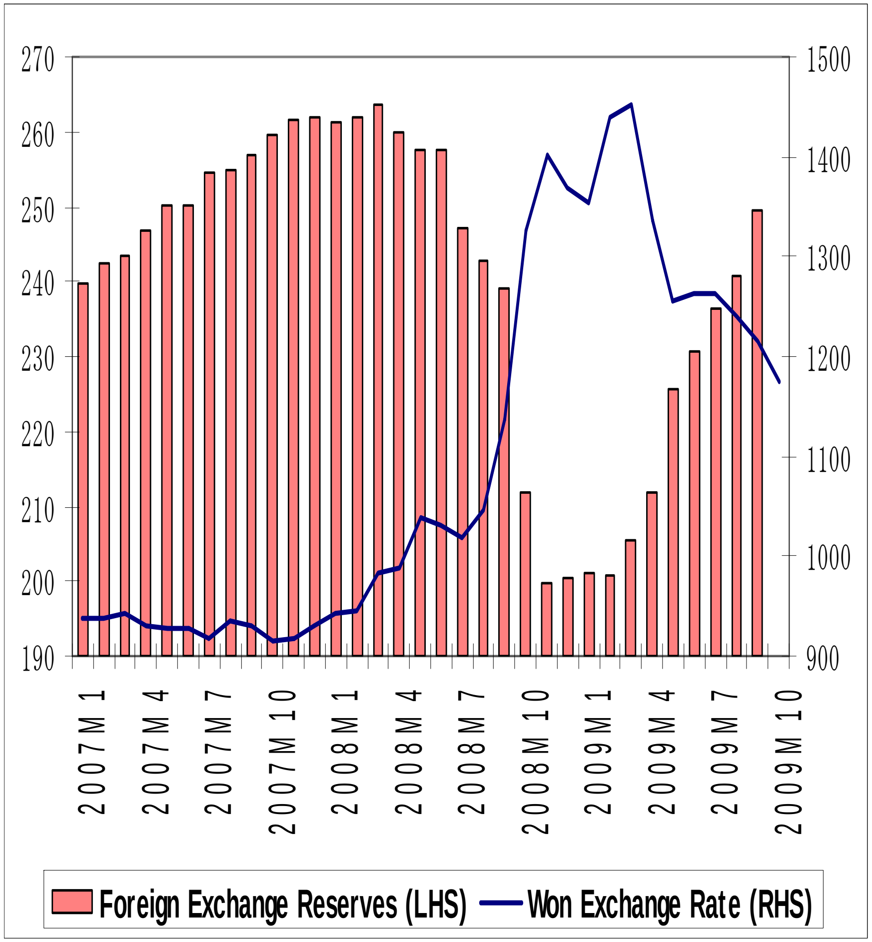


(3) Global financial crisis and the mini-won crisis (fall 2008)

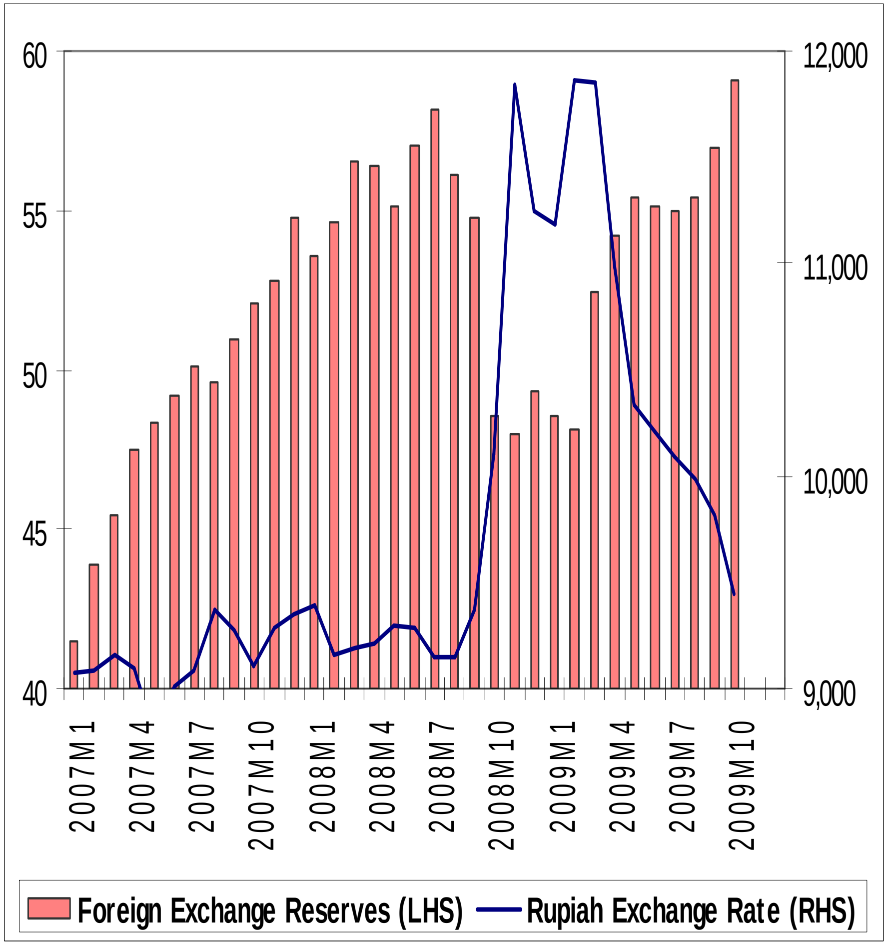
- Rapid capital flow reversals due to the outbreak of the global financial crisis in September 2008
- Loss of foreign exchange reserves (which had started since March 2008) from $264 billion to below $200 billion in November
- Won depreciation (which had started since November 2007) from 907 won/$ (Oct. 2007) to 1,483 won/$ (Nov. 2008)
- Unwilling to go to the IMF or CMI (which is tightly linked with IMF), the Korean authority secured a $30 billion currency swap line from the US Fed and activated the swap, which helped stabilize the won
- In 2009, the low won helped export recovery and reserve accumulation to 249 billion in September

A rapid (temporary) loss of reserves and won & rupiah depreciation in 2008-2009

Korea

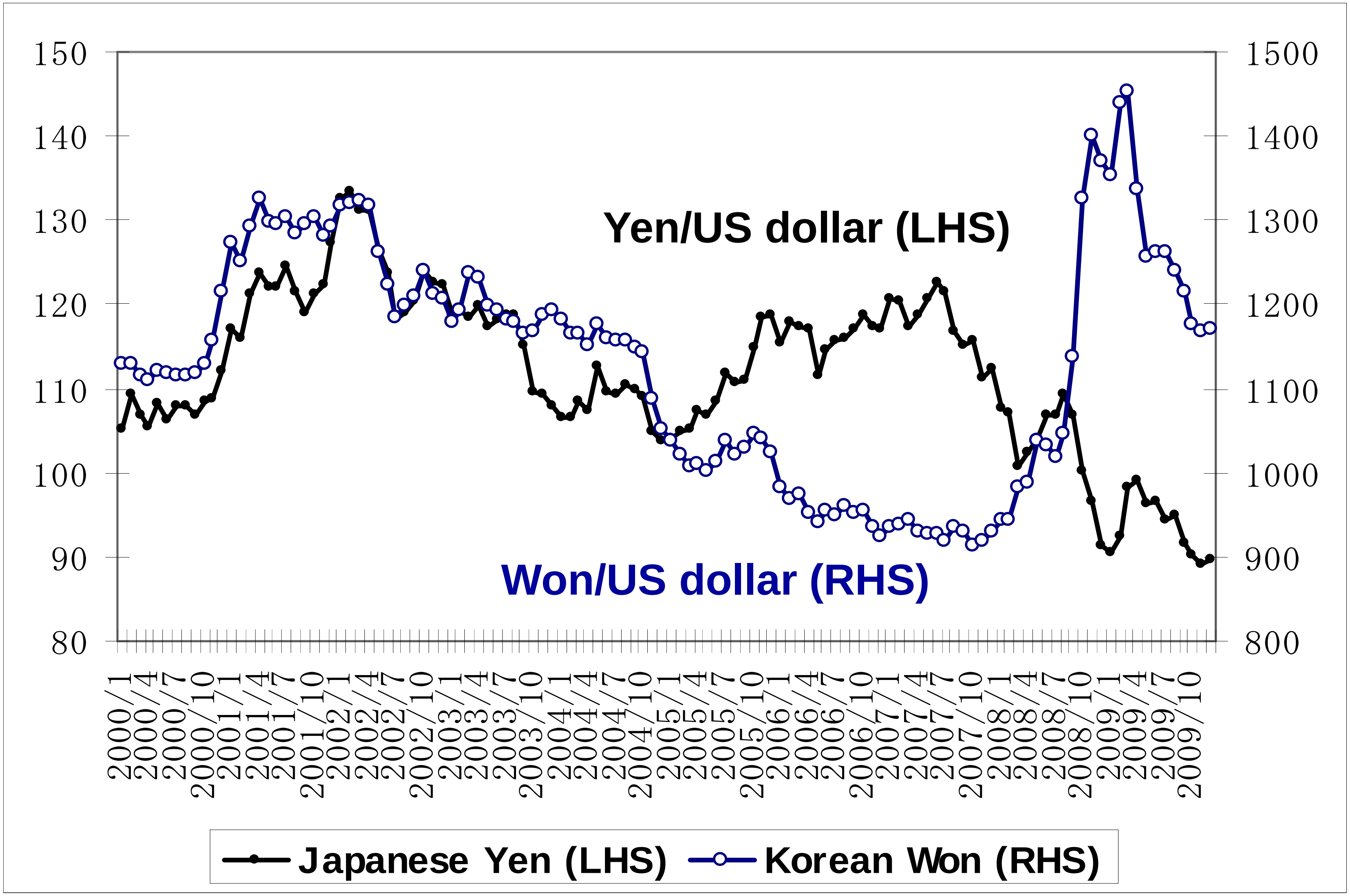


Indonesia



Source: IMF, International Financial Statistics, online

The yen and won began to deviate from early 2005 and the divergence has widened



Source: IMF, International Financial Statistics, online

Lessons from the Korean mini-currency crisis

- Supervise banks so they manage external foreign currency positions (assets & liabilities, including maturity mismatches) in a prudent way
- Deepen the domestic financial markets and make the currency (won) fully convertible internationally
- Avoid excessively large exchange rate fluctuations
- Strengthen global and regional financial safety nets
  - remove IMF stigma
  - make CMIM more flexible

4. What Needs to Be Done?

- Reduce exchange rate and capital flow volatility
- Strengthen financial safety nets
- Improve macroeconomic-financial surveillance
- Promote currency internationalization (yuan, won..)

(1) Reduce exchange rate and capital flow volatility

- Increase intraregional exchange rate stability by adopting either a common or country-specific currency basket system rather than pegging to the dollar
- For this purpose strengthen exchange market monitoring, by using Asian currency unit (ACU) indexes
- To stem volatile short-term capital flows, use well-designed temporary—as opposed to permanent—capital controls in a coordinated way across countries that are targets of rapid capital movements, rather than individual countries reacting unilaterally

(2) Strengthen financial safety nets

- Improve IMF lending facilities that focuses on automaticity precaution in the event of externally driven financial turmoil through the strengthening of the FCL, introduction of a widely accessible PCL
- Strengthen the CMIM by introducing precautionary (non-crisis) facilities a la FCL
- Use the CMIM in a flexible manner at the time of externally driven financial turbulence without requiring conditionality or IMF links
- Improve the functioning of regional economic surveillance so that CMIM can be structurally delinked from IMF
- Explore how an independent CMIM can work with the IMF to define the menu of policy choices—to prevent a race-to-the-bottom in conditionality-based lending

(3) Improve macroeconomic-financial surveillance

- Strengthen IMF surveillance over systemically important economies such as the US, EU
- Provide a newly established ASEAN+3 Macroeconomic Research Office (AMRO) with adequate resources to allow high-quality regional economic surveillance
- Develop a regional framework for financial system stability through the establishment of an Asian Financial Stability Dialogue (AFSD)—involving the region's finance ministries, central banks and supervisors—in helping standardize regulatory frameworks across countries and coordinating with BIS and FSB

(4) Promote currency internationalization

- Accelerate the process of currency internationalization, and in some cases the process of making the currency fully convertible
- Develop and deepen domestic financial markets, including local-currency bond markets

5. Toward an Asian Monetary System

- A single currency for Asia?
- National efforts and regional policy coordination
- Which currency as nominal anchor?

(1) A single currency for the world's largest, integrated region, Asia?

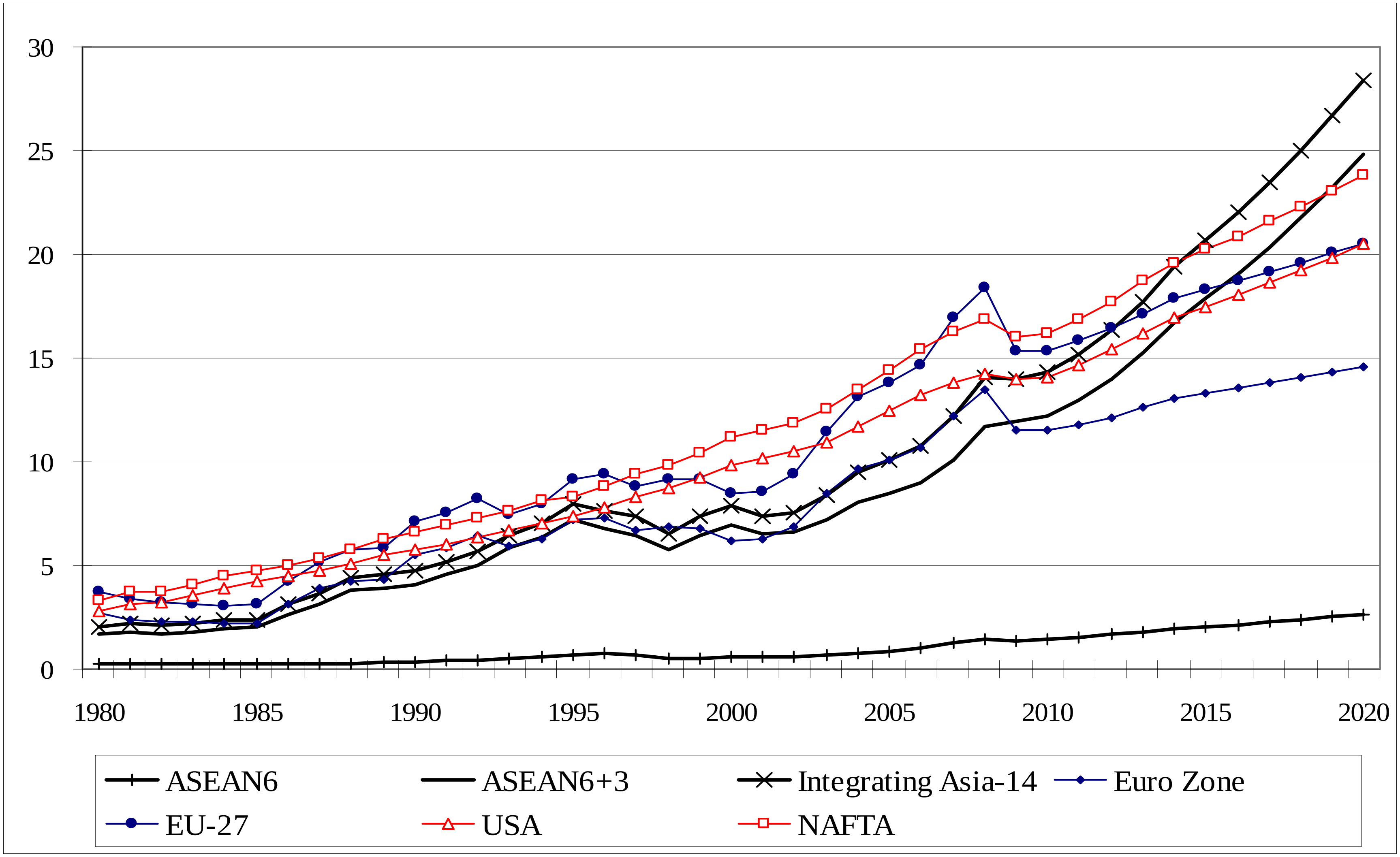
- Asia is heading to become the largest, integrated economic zone, which will eventually require a single currency
- Asia needs to :

  - achieve macroeconomic and structural convergence

  - eventually create its own internal nominal anchor

  - immediately start intensive policy dialogue on exchange rates, informal coordination of exchange rate regimes

Asia will continue to grow if managed well



Note: The figures until 2014 are from IMF and those for 2015-20 are estimated by the author
Source: IMF, *World Economic Outlook*, April 2009.

(2) National efforts and regional policy coordination

- Asia must make greater improvement in policy and institutional quality at the national level
- Asia needs to deepen regional policy coordination
  - Asia-wide FTA
  - Asian Monetary Fund
  - bond market development
  - Asian Financial Stability Dialogue
  - Japan-China political reconciliation

(3) Which currency as nominal anchor?: US dollar, yen, yuan, or a basket?

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

- Relying solely on the US dollar is not desirable due to the experience from the 1997-98 Asian currency crisis
- The yen (failed internationalization, size relatively declining) or the yuan (inconvertible, weak prudential supervision, non-independent central bank) alone cannot assume a nominal anchor currency role
- The yen, the yuan, the won, and other Asian currencies can share Asia's nominal anchor role

ACU: An Asian currency basket

- Asia is advised to develop an ACU-based system over time
- Encourage competition of central banks & currencies

5. Conclusion: The Way Forward

- Although the US dollar is not playing an adequate role as a truly international currency, the US dollar will likely remain dominant for the foreseeable future
- Given Asia's large and growing weight in the world economy, there is a growing possibility that the region would develop its own reserve currency
- The yen and the yuan (and the Indian rupee) need to work together while China (and India) improve(s) the quality of domestic institutions, governance and financial markets
- Developing an Asian currency basket—such as an ACU—seems viable and more realistic, and the key challenge would be how to make this commercially attractive

Thank you
For more information:

Dr. Masahiro Kawai
Dean& CEO
Asian Development Bank Institute
mkawai@adbi.org
+81 3 3593 5527
www.adbi.org