Regional Currency Problems

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I. Paradoxes of Asian Financial Markets

1. Intra-Asia trade account for more than a half of Asia's external trade, but most of intra-Asia trade is denominated in US dollars.
2. Cross-borer banking activities in Asia are provided mostly by European and American banks, and by Japanese banks to a lesser degree.
3. Asia's stock markets have a large presence of foreign investors from US and Europe, but few foreign players from the rest of Asia. Foreign listings on Asian stock exchanges are limited.

I. Paradoxes of Asian Financial Markets

4. Despite the efforts to develop an Asian bond market, the results are not yet satisfactory.
5. Asian central banks hold an increasingly large amount of foreign exchange reserves, mostly in US-denominated assets:

   China: over US$1 trillion

   Japan: over US$850 billion

   Taiwan: over US$260 billion

   Korea: over US$209 billion

II. Global Imbalance

1. In 2005, US balance of payments deficit in goods and services amounted to US$716.7 billion, and current account deficit amounted to US$791.5 billion, the latter is equivalent to 6.35% of GDP.
2. In the first six months of 2006, US balance of payment deficit in goods and services was US$391.6 billion, 17% above the previous-year level.
3. US gross liability is US$11 trillion, and net liability US$3 trillion (more than 20% of GDP). The gross liability is growing at 10% per annum vs. assets at 2%.
4. In 1985, when Plaza Accord was struck, US current account deficit was only US$118.2 billion, or 2.8% of GDP.
5. The ever-increasing US BOP deficit created big anxiety in the international financial market. Is this trend sustainable?

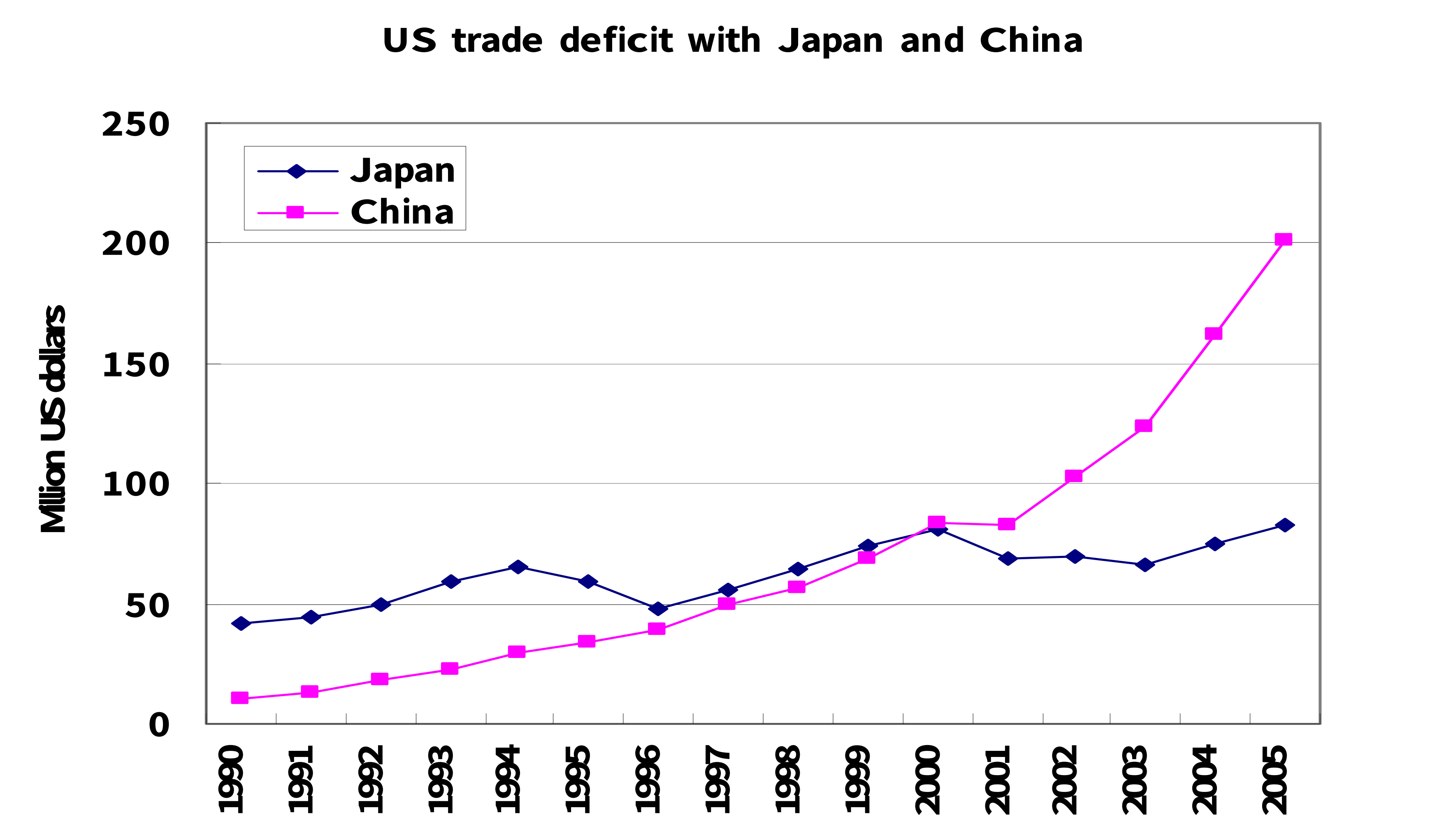
III. How today differs from 1985?

1. China has become the world's third largest trader (in terms of both exports and imports) and accounted for the majority of US trade deficit. In 2005, China's trade surplus (in goods only) with US was US$201.5 billion, accounting for 25.7% of US overall trade deficit. In comparison, Japan's trade surplus with the US was only US$82.5 billion, accounting for 10.5% of overall US trade deficit.
2. Chinese currency is pegged to US dollars today while Japan yen was floated in 1985.

III. How today differs from 1985?

3. There was a strong appetite of Asian central banks to hold US currency assets as foreign exchange reserves just to avert any liquidity crisis.
4. Although intra-regional trade in Asia is buoyant, most final goods produced in Asia are destined to US as exports. Therefore intra-regional competition for export market shares is intensive.
5. Intra-Asia trade is dominated by intermediate goods whose prices are quoted in US dollars. Currency risk is small.

Bilateral deficits of US against China and Japan



IV. Is US trade deficit sustainable?

1. US trade deficit is sustainable only if Asian investors, particularly central banks, have unlimited appetites for US assets, which is unlikely. Large central bank hoarding of US dollars safeguards against the liquidity risk, but creates a large currency risk.
2. Asia's central banks are willing to intervene in the foreign exchange markets to support the dollars in order to protect the value of their foreign exchange reserves. (But Japanese Central Bank has not intervene since March 16, 2004.)
3. Strong US dollars against Yuan favor FDI into China, allowing MNCs to acquire Chinese assets at low costs.

IV. Is US trade deficit sustainable?

4. As long as Chinese Yuan remains pegged to US dollars, it will be difficult for other currencies to make dramatic realignments because of the fear of losing market shares. (A coordination failure)
5. Recent increase of real interest rates in Asia, particularly in Japan, will make US-denominated assets less attractive, preventing further capital inflow into the US.
6. Net return on US overseas investment is 7.4% versus 3.4% payment on US liabilities, resulting in positive net investment income for US, but the gap is narrowing.

V. Possible ways out

1. A coordinated devaluation of US dollars against all major Asian currencies: But China has to take the lead.
2. Switching foreign exchange reserves from US dollars into Euro: This will further appreciate Euro and hurt the European economies which are already weak.
3. An expenditure-switching policy at the regional level of Asia, so as to reduce dependence on exports to the US markets: possible but difficult.
4. Allowing MNCs to recycle Asia’s excess savings in the form of foreign direct investment into Asia itself, particularly China. That is, Asian investors hold stakes in US companies, while US companies invest in Asia in terms of production and marketing.

VI. Asian Monetary System (AMS)

1. To create a basket of Asian currencies and allow these currencies to jointly float against the US dollars and Euro. Internally the constituent currencies are pegged to each other.
2. AMS will eliminates the problems of export competition considerations and overcome the “coordination” failure.
3. AMS also reduces the currency risks intrinsic to US dollars and Euro.
4. The challenge: AMS will not work without macroeconomic policy coordination, including monetary and fiscal policies. Policy coordination is difficult for countries with large development gaps. In Asia, China can not be paired with Japan. AMS without policy coordination will be chaotic.

VII. Asian Currency Unit (ACU)

1. To create an Asian currency unit as an unit of account for cross-border trade in Asia and central bank settlements. The value of ACU is to be defined by a composition of Asian currencies.
2. ACU can also be used to denominate Asian bonds.
3. Central banks can hold a basket of Asian currencies to hedge against ACU risk.
4. EU experience indicates that ECU was a slow process, and only accounted for a small proportion of European trade. Before ACU is fully accepted, there will be "parallel" currencies used in transactions. The speed of progress will be determined by economic factors rather than political factors.
5. The challenge: Can ACU compete with dollars without some political agreements reached beforehand?