ASIAN CURRENCIES AND GLOBALIZATION

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The international currency markets look stable at first glance, but a closer look reveals potentially strong volatility even fragility auguring upheavals in the years to come.

The main problem is that a currency anchor is missing. A currency anchor is the currency commanding respect and credibility — a currency trusted by other countries, lending itself to be a safe haven in case of turbulence on the markets. When fluctuating it does so gradually and with small steps; the market takes the view that its value is largely correct.

For many years, the U.S. dollar has served the world as a currency anchor. When talking about fluctuations in a currency's value it was always seen vis-à-vis the U.S. dollar. The U.S. economy was without comparison the strongest, most buoyant and dynamic economy in the world. Even more important, economic globalization is apprehended as a global edition of American capitalism albeit with modifications and adjustment. This gave the U.S. dollar an unparalleled strength.

This is not so anymore. After many years, the deficit on the U.S. balance of payments seems to latch on to a size of 5 to 7 per cent of GDP. That is manageable for an economy like the American one in a short period, but not any more as it now looks more or less permanent. The fears are creeping into the soul of many investors that the U.S. real estate market is in for a real downturn pulling the economy along with the inevitable result that former high growth at 3 per cent per year or more will fall visibly, even dramatically. All in all, the picture of a less strong American economy appears on the horizon, making the U.S. dollar less attractive as an anchor currency.

But what are the alternatives? The euro has now been in place for about six years and survived its initial phases, which many observers expected to present the crucial test. It is doing well on the market. After having fallen to approximately US$80 to 100 euro in early autumn 2000, it rose to approximately US$135 in 2005 to stabilize around US$125 during most of 2006.

The euro is an attractive alternative to the U.S. dollar but is still new and to a certain extent unproven to the markets. The European Central Bank in Frankfurt has apparently gained a fine reputation for itself as a respectable central bank,

- There is a risk of volatile international currency markets.
- Small and individual currencies will be in the firing line.
- This makes it worthwhile to think about currency rate cooperation among the Southeast Asian countries making them less vulnerable or exposed.

but it takes a long time to build up a reputation comparable to that of the Federal Reserve System in the United States and the former German Bundesbank. Many countries may look to the euro, but not put all their eggs in that basket. The low growth in Euroland, problems for some of the major member states such as France and Germany to respect the ceiling for deficits on the public finances and rumours about political forces in Italy contemplating to take the country out of the euro — though completely unrealistic — complicates the picture and puts a question mark on the future strength of the euro.

The Japanese yen is a serious contender on the market, but neither the Japanese economy nor the Japanese financial markets have reached a size and a strength making them a solid foundation for an anchor currency or, as it is sometimes called, a reserve currency.

Growth disparities among the three main economies and large imbalances in the United States and Japan gives further credence to expecting swings on the currency markets.

For the smaller currencies dependent on economic globalization this is bad news. Experience indicates that the first victims in case of trouble will be the smaller and more vulnerable currencies not having the size and the strength to withstand speculation as it was seen during the financial crisis in 1997–98. They are the weak links in the chain and have to shoulder the first onslaughts.

Robert Mundell, who won the Nobel Prize for his work on optimum currency areas, once formulated this by saying that if you throw a stone in a small pond it will make heavy waves but if you throw it in a lake it will hardly be noticed.

For the Asian currencies, which apart from the Japanese yen, are exposed to the whims of the currency markets, the challenge is to create a lake instead of a small pond.

This is the background for the talk and various proposals about an Asian Currency Unit or a stronger cooperation among Asian countries with regard to currency rates.

The question may be asked right away: Why are stable currency rates preferable, why not let market supply and demand determine the rates?

The answer falls in two parts. Firstly, fluctuating currency rates convey an impression of a political system that is not able to control the national economy and lay down an economic policy. Experience indicates that highly volatile currency rates go hand in hand with weak political systems. So a large majority of politicians prefer stable currency rates, to inspire confidence in their political system instead of the other way round.

Secondly, even if the empirical evidence is neither uncontested nor unequivocal, there is a growing consensus that stable currency rates promote trade as industry knows the currency rates and regard them as fixed. Stable rates help in the planning and implementation of investment and trade runs without fear of unpleasant surprises stemming from fluctuating rates that may jeopardize the investment calculus.

For countries in Southeast Asia which are heavily dependent on economic globalization, strong volatility among their currency rates would unquestionably be detrimental to trade, investment, and economic growth.

This opens the door for ideas as to how to introduce currency rate cooperation among not necessarily all but most of the Southeast Asian countries. Such cooperation may at a later stage fit into a larger Asian cooperation. In this regard, there are three points to look at:

- Consultation about national economic policies to achieve, if possible, a higher degree of convergence. It is not imperative to have analogous economic policies but a certain degree of convergence is called for.
- Mutual credits among central banks to assist partners whose currencies are exposed to speculation. This is important because without international credits no individual country can withstand pressure emanating from the international markets.
- There should be a system based upon the keywords "fixed but adjustable currency rates" meaning that in principle the currency rates are fixed vis-à-vis each other but they can and should be adjusted if comparative competitive analysis warrants it.

The true test for currency rate cooperation comes when the system is under stress. The solidity will then depend on the willingness of the strong countries to lend and the readiness of the weaker countries to realize that strings and conditions for national economc policies will be attached to currency credits. The markets are not impressed by the size of currency credits. The markets look at economic policies to remove the underlying causes and only if these policies are judged effective will the storm blow over.

These are some of the valuable lessons drawn from the mechanism of European Monetary System (EMS) in the late 1970s and early 1980s. An Asian Economic and Monetary Union, like the European one, is not on the cards in the foreseeable future. But the lessons learned by the Europeans to achieve currency stability under difficult circumstances are available free of charge.