East Asia can benefit from a coordinated foreign exchange rate policy

By MOHAMED ARIFF

A common currency for the entire East Asia region has been bandied about as a long-term goal, which may take many decades to materialise. No doubt, a common currency would be a great boon to intra-regional movements of goods and services and factors of production. But this proposition would make sense only if East Asian economies are successfully integrated and the thorny issue of national sovereignty can be sidestepped.

A currency union for East Asia will represent the highest form of regional integration. It is important that this goal is not lost sight of, although it is extremely difficult to draw a timeline for it. It is best achieved through evolution, not decree.

While the common currency idea is kept in the backburner, it will be in the interest of East Asian economies, in the interim, to cooperate and coordinate with one another in their exchange rate management.

It will not be difficult to put in place a coordinated basket peg so that there can be flexible, but stable, exchange rates in the region. This will facilitate increased intra-regional economic transactions and render the region financially resilient.

The currency basket need not necessarily be identical. Weights assigned may vary depending on the trade patterns of countries. However, it will be necessary to have close coordination on macroeconomic maters so that the exchange rate alignment stays in sync with macroeconomic realities.

Realising that the medium-term coordinated basket peg proposition will take a while to be debated and adopted, it will be prudent for East Asian central banks to begin the process by immediately initiating networking. This is extremely urgent in the face of current erratic dollar movements.

As the global exchange rate system is in a state of flux, it is important for East Asia to work towards a convergence of exchange rate policies in the immediate term. There has to be a clear understanding among the foreign exchange authorities on the kind of interventions that may have to be made in the near term.

A well-coordinated and concerted action by East Asian countries will be far more effective rather than these countries were to go it alone. The situation warrants more than an informal arrangement. A consultative council of East Asian central banks would provide an avenue for meaningful interaction.

Regional trading arrangements, aided by geography, have moved East Asia closer to a regional trading bloc. But regional cooperation in trade and investment would be incomplete without cooperation on exchange rates. For a start, priority should be given to building the necessary regional institutions, and formulating formal mechanisms, similar to those of European integration.

Exchange rate integration, given East Asia's diversity, is likely to be a very long and challenging process. Despite having greater political will and lesser cultural, economic, and political diversity than East Asia, it still took Europe 50 long years to come together as a monetary entity.

It will not be easy to construct a collective exchange rate system that would be acceptable to all participating countries. A transitory regime like a coordinated basket peg system could be the first step. towards a common exchange rate regime for the region.

The merit of a basket peg is that it has the attributes of a currency peg without being shackled to any single anchor currency. It means that the exchange rate of a currency will be tied to a basket of key currencies (e.g. euro, dollar and yen) so that variations in the exchange rate will be smaller due to offsetting impacts of currencies in the basket.

A common basket for all regional currencies would mean that the exchange rates of regional currencies would not deviate much from one another, if the weights assigned to the component currencies in the basket were identical for all. That seems like a tall order, as the weights would depend greatly on the trade patterns of individual countries.

An identical foreign exchange rate regime for all East Asian countries is neither feasible nor desirable for now, because the grouping is highly heterogeneous with different economic and market structures with varying degrees of sophistication, and balance-of-payments adjustments may not be forthcoming to the extent that exchange rate movements are constrained.

A more down-to-earth approach would be to balance between idealism with pragmatism. One should look for exchange rate arrangements that would allow commonality with some latitude for variations.

Given the preference for hybrid regimes in East Asia, a coordinated basket peg system could serve as an acceptable premise for exchange rate management, providing flexibility and stability in exchange rates.

A common denominator would be the composition of the currency baskets. One suggestion is that euro, dollar and yen constitute the basket for all East Asian countries (except Japan whose currency is yen). To avoid being put into straightjackets, weights given to the anchor currencies may vary from country to country or from time to time.

As the movements in euro, dollar and yen would tend to be partially offsetting, the regional currencies would be fairly stable vis-à-vis currencies in the basket, and since the regional currencies would also be tied to similar baskets, intra-regional exchange rates would be even more stable.

This system cannot ensure that all regional currencies move strictly parallel, but it can ensure they all move in the same direction, somewhat in tandem, appreciating or depreciating together.

Such a system could work smoothly, especially if there are no serious bilateral trade imbalances within the grouping.

All this would call for continuous consultation among East Asian countries, especially on macroeconomic policies. East Asian central banks will have to work very closely with one another, and this consultation-cum-coordination process will have to be institutionalised. But there is no need for a supranational East Asian central bank in the absence of a single currency.

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