# FINANCIAL COOPERATION AND THE FUTURE OF THE DOLLAR IN EAST ASIA

*The second session of the East Asia Congress tried to addressed the future of the coordinated exchange rate regime in view of reduced US dollar influence. The session started with presentations from Masahiro Kawai, Dean and CEO of the Asian Development Bank Institute, Yi Jong-goo, the Standing Commissioner for Financial Services Commission, Republic of Korea, and Professor Augustine H.H. Tan of Singapore Management University. The moderators for the session were HRH Prince Samdech Norodom Sirivudh, Member of Parliament and Chairman of Board of Directors, Cambodian Institute for Cooperation and Peace, and Wang Yuzhu of the Department of Regional Cooperation Studies Institute of Asia-Pacific Studies, Chinese Academy of Social Sciences, China. ISIS Researcher **Nor Izzatina Abdul Aziz** reports.*


*(From left) Augustine H.H. Tan , Masahiro Kawai, Samdech Norodom Sirivudh, Wang Yuzhu and Yi Jong-goo*

**Masahiro Kawai** began by establishing the role of the US dollar in the international monetary system, and then spoke on the reform options for the international monetary system in view of the weakening influence of the US dollar. In the second part of his presentation, Kawai dwelt on the challenges in international financial cooperation, and the exchange rate regime for East Asia.

The reduced influence of the US dollar as the dominant currency in the international monetary system, beginning in the 21st century, calls for a reform, especially as the actions of the issuer of the US dollar, the Federal Reserve, have leaned towards domestic concerns rather the world's. To avoid the world being held hostage to the whims of the Federal Reserve, several propositions have been mooted. Among them are:

a) Introduction of a world single currency system (Cooper 1987);
b) Introduction of a Special Drawing Rights (SDR) standard (Zhou 2009);

c) Introduction of a multi-polar key currency system (Bergsten 2007) ;
d) Improving the current condition of the US dollar standard.

The proposition by Richard Cooper in 1987 centred on the establishment of a common currency for all industrial democracies, with a common monetary policy and a joint Bank of Issue to determine that monetary policy. The Central Banker for the Republic of China, Zhou Xiaochuan, in the meantime proposed enhancing the IMF's SDR as a super-sovereign reserve currency by increasing SDR allocation for members. With a broad SDR role, it should be able to satisfy fully the members' demand for a reserve currency.

**C. Fred Bergsten** of the Peterson Institute for International Economics later extended Zhou's suggestion by suggesting that US dollar reserve holders can have a separate International Monetary Fund (IMF) account for SDR and the SDR be denominated in a basket of currencies that can be 44 per cent dollars, 34 per cent Euros and 11 per cent each of yen and pound sterling. However this idea would not have been effective without the weight of the Yuan being placed in the basket.

Currently there are three pillars of financial cooperation in East Asia, namely, i) the economic and financial surveillance mechanism for information exchange, policy dialogue and peer pressure, ii) the liquidity support facility, through the Chiang Mai Initiative, to contain currency speculation, contagion and crises, and iii) Asian bond market development to mobilize Asian savings for investment. A possible addition to this list of cooperative measures is an Asian Financial Stability Board to promote financial system stability.

Kawai pointed out that despite close interdependence of East Asian economies, there has been no exchange rate coordination. Situations that might cause setbacks to exchange rate coordination in East Asia include i) the fear of allowing domestic currencies to appreciate ii) the holding of sizeable foreign exchange reserves, and iii) the lack of an anchor currency.

Kawai came out with several suggestions on overcoming these setbacks. One would be through a collective currency appreciation against the US dollar, which can maintain relative currency stability within the region and promote financial and macroeconomic stability while minimizing loss of price competitiveness.

Another is the creation of an Asian currency unit (ACU) as the anchor currency in the region. This suggestion came about since the Yen as a currency failed in its internationalisation effort while the Yuan currently is inconvertible. Apart from the creation of an ACU, a currency basket system can be adopted much like Singapore's foreign exchange model. The currency system can include SDR along with the Dollar, the Euro, the Pound sterling and the ACU in its basket.

More emphasis should be placed on the creation of an ACU in the future as although the system proposed is complex and hard to establish now, having it as a currency basket index is a useful starting point. Informal policy coordination by central bankers in the future can include the use of the ACU. Among its other uses is the developing of ACU-denominated bonds.

Kawai ended his presentation by saying that in the short run, East Asia should work with the global community to improve the functioning of the US dollar system, while at the same time increasing their exchange rate flexibility against the US dollar. Kawai feels that in the medium to long-term, East Asia should establish its own exchange rate arrangement or even a common currency. The importance of exchange rate policy management was stressed as it will be the key to the management of capital inflows for macroeconomic and financial system stability.

The theme of **Mr Yi Jong-goo's** presentation was financial regulatory reform and cooperation among Asian countries. He highlighted two approaches in achieving financial system stability. Both approaches are based on two questions, i) what is the most effective regulatory/supervisory framework for financial system stability, and ii) what specific financial regulatory reforms are needed.

To achieve an effective financial supervisory framework, two more questions must be addressed. The first one is, who should be the systemic risk regulator, and the second, how should it be coordinated among financial authorities. Yi is of the opinion that while the questions can be applied in general, the answer will be that there is no one-size-fits-all framework because each country's unique circumstances must be taken into account.

Using countries like the United States, the United Kingdom and Korea as examples, Yi shows that the financial policy/supervisory framework of each is currently being reformed to prevent future meltdown. Financial system stability is now being added as a function of the Bank of England, while the same mandate has been in existence in several agencies in the United States.

Reform of the financial regulatory system must be in place to prevent a recurrence of the financial crisis. Yi outlined four steps towards reform. These are i) specific regulatory reform ii) clear reform timeline iii) consistent implementation of new rules and iv) monitoring of the implementation by the IMF or Financial Stability Board (FSB). FSB is a new outfit under the G-20 that is being tasked to reform financial regulations.

Despite praising the FSB for heading in the right direction, Yi feels that it needs to consider concerns of emerging market economies (EMEs), such as foreign exchange market stabilization, stronger information-sharing among supervisors, and reduction of moral hazards among too-big-to-fail financial institutions.

With respect to foreign exchange market stabilization in EMEs, Korea proposed a stronger role for International Financial Institutions (IFIs) to ensure stable foreign currency liquidity and stronger supervision of domestic/foreign financial institutions to stabilize foreign exchange and foreign currency funding markets. Yi mooted foreign currency liquidity insurance and the expansion of the multilateral currency swap arrangement.

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Under stronger information-sharing among supervisors, Yi said that there are three areas that need to be improved. These are, the operation of supervisory colleges, information on exchange of hedge fund supervision, and the exchange of Over The Counter (OTC) derivates transaction-related information. Yi suggested several approaches to reduce moral hazards among too-big-to-fail banks that included careful review of impacts on capital flows and local market conditions, and differences in legal or regulatory systems.

The role of IFIs like the IMF and FSB must be strengthened to ensure regulation takes place effectively. However both institutions must first seek clarification of their roles to avoid overlapping work areas and better coordination among national authorities and international standard setters.

He concluded by saying that at the regional level, coordination among regulators is desirable, since global rules may not apply. With the increasing involvement of Asian countries in G-20 and FSB, Asian views on regulatory reform can be heard but much more can be achieved with better co-ordination.

**Professor Dr Augustine Tan** outlined the factors that have reduced the economic influence of the United States over the world, at the core of which is China.

The rise of China as an economic powerhouse is reminiscent of the US ascent last century, only it is happening faster. Tan referred to the Peterson Institute for International Economics Study which projected that the international economic position of the United States was likely to deteriorate enormously due to a growing current account deficit and an exponential increase of net debt ($50 trillion in 2030). In this projected scenario, the United States would be transferring seven per cent of its GDP to foreigners every year in order to service its external debt.

US economic power will decline further as activities to finance its debt will raise real interest rates, while defence cut-backs will weaken its military power. This will lead to declining future growth rates. Tan believes there is a huge probability that the US will repeat the lost decade of Japan's economy. Factoring in all these conditions, it is likely that the US dollar's prominence as a reserve currency in the future will be reduced; a possible future scenario is the rise of the Yuan's value and influence.

The rise of the Yuan to prominence as the world's reserve currency and world currency of last resort has generated interesting outlooks for both China and the world at large. Tan warned however that the transition between the British Pound and the US dollar took decades to materialize. In view of this, he offered several medium-term suggestions that could help Asia.

The first is to review the viability of the Asian monetary union. In reassessing this, the example of the European Currency Unit will not entirely work in Asia. Second, the East Asian integration process through East Asia Economic Community must be reviewed to determine how inclusive or exclusive the process should be. Tan suggested China increase efforts to mobilize the Yuan around the world, relax capital controls, and make sure the Yuan is flexible enough to adjust. Finally, Tan suggested China takes appropriate action to make the Yuan the world's reserve currency.

The session closed with speakers agreeing they foresee the decline of the US dollar in the next decade or two, and pointing out changes that must take place in the global financial architecture as well as in its major players — mainly China.