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The East Asian Dollar Standard

by

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Before the crisis of 1997-98, the East Asian economies—except for Japan but including China—informally pegged their currencies to the US dollar. These soft dollar pegs made them vulnerable to fluctuations of the yen against the dollar, as with the yen’s depreciation from mid 1995 into 1997-98 aggravating the great Asian crisis. To limit future exchange rate misalignments and “hot” money flows, the IMF argues that East Asian currencies should float more freely. Alternatively, several authors have proposed increasing the weight of the yen in the currency baskets of the smaller East Asian economies. However, I argue that the East Asian dollar pegs are entirely rational from the perspective of each country—both to facilitate hedging by merchants and banks against exchange rate risk, and to help central banks anchor their domestic price levels.

The evidence on actual central bank behavior supports my position. When exchange rate changes are measured at high frequencies, our econometric estimations show that the dollar’s predominant weight in East Asian currency baskets post crisis has been restored. By 2003 the day-to-day volatility of each country’s dollar exchange rate are not significantly different from the pre-crisis level. At lower frequencies, such as month-to-month exchange rate changes, the currencies of the smaller East Asian countries still exhibit more drift against the dollar than before the crisis. However, if Japan could narrow the range of variation of the yen/dollar rate and China succeeds in maintaining its rate at 8.28 yuan/dollar, the pre-crisis dollar pegging of the smaller countries could be fully restored—and macroeconomic stability in the East Asia as whole would be greatly enhanced.

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The rationale for dollar pegging does not primarily arise because of strong trade ties between East Asia and the United States. Table 1 shows the amazingly rapid increase from 1980 to 2001 in intra-East Asian trade, more than half of which is now with other East Asian countries—where China is becoming an increasingly important trading partner. At the end of 2001, Table 2 shows that the US accounted for only about 20.4% of overall exports of the smaller East Asian economies—and for only 13.1 percent of their imports—and that trade with the world outside of Asia is in relative decline.

More important than direct trade with the United States is the currency of choice for invoicing East Asian trade and capital flows. Although Japan is as important a trading nation in East Asia as is the United States (Table 2), almost all the intra-regional trade is invoiced in US dollars except when that trade is directly with Japan. Korea is a typical example. Table 3 shows that 85 percent of Korean exports and about 80 percent of Korea imports are invoiced in dollars—with about 12.4 percent of imports (from Japan) invoiced in yen. Despite strong trade and investment ties with Japan, yen invoicing is surprisingly small in Korean trade. In Japan's trade with East Asia more generally, the dollar is more important than is the yen as the invoice currency. And in trade between any other East Asian countries, say Thailand trading with Malaysia, or China trading with Singapore, the dollar is used almost exclusively.

Once this general voluntary use of the dollar in East Asian trade is understood, why individual East Asian governments choose to stabilize their dollar exchange rates (not always successfully) becomes clear. Most developing economies lack broad and deep bond markets in the domestic currency. Thus, they cannot *borrow* internationally in their own currencies—sometimes called the problem of *original sin* (Eichengreen and Hausmann, 1999)—and lack forward markets in foreign exchange. Their exporters and importers have trouble hedging against exchange fluctuations. In a debtor economy, however, the risks are compounded by private holdings of short-term dollar liabilities—as in Indonesia, Korea, Malaysia, Philippines and Thailand before the 1997-98 crisis. Then a currency attack forcing a domestic devaluation could cause, and did cause, massive domestic bankruptcies.

In the new millennium, however, East Asian economies are becoming dollar creditors. For two decades or more, Japan, Singapore, and Taiwan have run with current

account surpluses. China has had a current account surplus since 1995. Formerly crisis economies that have recovered strongly since 1997-98, such as Korea and Thailand, are running large current-account surpluses—and are rapidly transforming themselves from being debtors into creditors internationally. However, instead of building up claims on foreigners denominated in their domestic monies, most of the foreign claims—held either privately or as official exchange reserves—are highly liquid dollar assets.

Any international creditor country that cannot *lend* in its own currency cumulates a currency mismatch that I call the syndrome of *conflicted virtue*. Countries that are “virtuous” by having a high saving rate (most unlike the United States!) tend to run surpluses in the current account of their international balance of payments, i.e., lend to foreigners. For empirical estimates of the stocks of these liquid dollar claims see Goyal and McKinnon (2003) for the case of Japan, and McKinnon and Schnabl (2003) for the case of China. But, with the passage of time, two things happen.

- (1) As the *stock* of dollar claims cumulates, domestic holders of dollar assets worry more about a self-sustaining run into the domestic currency forcing an appreciation.
- (2) Foreigners start complaining that the country’s ongoing *flow* of trade surpluses is unfair and the result of having an undervalued currency.

Of course (1) and (2) interact. The greater the foreign mercantilist pressure to appreciate the domestic currency, the greater the concern of the domestic holders of dollar assets. As runs into the domestic currency out of dollars begin, the government is “conflicted” because appreciation could induce deflation ending with a zero interest liquidity trap—particularly if the domestic price level was already stable. But foreigners may threaten trade sanctions if the creditor country in question does not allow its currency to appreciate. Whence the syndrome of conflicted virtue.

Unhedged individual or institutional holders of dollar assets are at risk should the domestic currency appreciate. For example, Japanese insurance companies, whose liabilities to annuity holders are in yen but a substantial share of their assets are in higher-yield dollar bonds, could be bankrupted should the yen appreciate against the dollar. The reduction in the yen value of their dollar assets could wipe out their net worth. Thus, as the economy’s dollar assets accumulate, their holders become more fearful of a run out of

dollars into the domestic currency followed by appreciation. And should the domestic currency actually appreciate when the world price level measured in dollars is itself quite stable, their governments worry about the sudden loss of mercantile competitiveness of their exporters followed by a domestic deflationary spiral.

The imperfect solution is for each East Asian government to keep its dollar exchange rate as stable as it can. This then reduces risk seen either by unhedged dollar debtors or by unhedged dollar creditors *within* the economy in question. Whence the resort to the “soft” or informal pegging dollar we observe in non crisis periods.

To be sure, some governments would like to give full assurance that the domestic exchange rate is never going to change. But no one government dares to commit itself to an absolutely fixed exchange rate when its neighbors, who are close trading partners, have not done so. The spillover effects from other countries changing their exchange rates are just too great for any country to risk becoming completely inflexible in responding. (Think of what happened to Argentina in the late 1990s when Brazil and Chile allowed large depreciations of their currencies.) So short of adopting a full-fledged system of regional dollar parities, a difficult exercise in collective action although a potentially great public good for East Asia, soft pegging is the result.

Of course, the collective macroeconomic consequences of all East Asian governments opting individually to peg to the dollar, if only softly, enlarges the effective zone of stable dollar prices far beyond its country’s direct trade with the United States. Thus each national central bank can lean more heavily on its own stable dollar exchange rate to anchor its domestic price level—which in turn helps its neighbors, with whom it is closely connected in trade, to stabilize their own. A virtuous circle for a change!

Using the dollar as the key currency for stabilizing relative exchange rates within East Asia is tenable as long as the US Federal Reserve Bank keeps the international purchasing power of the dollar fairly constant—as it has over the last decade or so. Perhaps in the very distant future, the dollar’s role as the central anchor currency in East Asia could be replaced by the creation of an “Asian euro”, which could float freely against the dollar like its European counterpart. Until then, East Asian countries should cooperate to keep their exchange rates stable against the dollar—perhaps coalescing around China’s benchmark rate of 8.28 yuan/dollar—and thus stable against each other.

Table 1: Intra-Asian Trade as Percent of Overall Trade, 1980-2001

	Exports			Imports		
	EA ₃	EA ₂	EA ₁	EA ₃	EA ₂	EA ₁
EA ₁						
1980			18.9			15.3
1990			22.2			19.6
2001			26.0			25.3
EA ₂						
1980		21.7			18.2	
1990		32.0			30.1	
2001		36.9			41.5	
EA ₃						
1980	32.0			31.8		
1990	39.6			42.9		
2001	46.5			53.1		

Source: IMF: Direction of Trade Statistics. EA₁ = Hong Kong, Indonesia, Korea, Malaysia, Philippines, Singapore, Taiwan, Thailand, EA₂ = EA₁ + China, EA₃ = EA₂ + Japan

Table 2: East Asian Trade with China, Japan, US, and ROW, 1980-2001

	Exports				Imports			
	China	Japan	US	ROW	China	Japan	US	ROW
EA ₁								
1980	1.5	19.2	23.1	37.3	4.7	23.8	17.1	39.1
1990	6.4	14.4	24.9	32.0	9.4	23.0	16.1	31.9
2001	13.1	10.8	20.4	29.6	14.7	19.6	14.3	24.8
EA ₂								
1980		19.6	20.9	37.6		24.2	17.4	40.2
1990		14.4	22.5	31.1		21.9	15.6	32.4
2001		12.3	20.4	30.4		16.2	13.1	29.2
EA ₃								
1980			22.6	45.4			17.4	50.8
1990			26.2	34.2			18.1	39.0
2001			23.1	30.7			14.4	32.5

Source: IMF: Direction of Trade Statistics. EA₁ = Hong Kong, Indonesia, Korea, Malaysia, Philippines, Singapore, Taiwan, Thailand, EA₂ = EA₁ + China, EA₃ = EA₂ + Japan, ROW = Rest of the World.

Table 3: Invoice Currencies in Korean Trade as Percent of Overall Trade, 1980-2000

	Exports (receipts)					Imports (payments)				
	\$	¥	DM	£	other	\$	¥	DM	£	other
1980	96.1	1.2	2.0	0.4	0.3	93.2	3.7	1.7	0.5	0.9
1985	94.7	3.7	0.6	0.3	0.7	82.4	12.3	2.0	0.5	2.8
1990	88.0	7.8	2.1	0.5	1.7	79.1	12.7	4.1	0.9	3.4
1995	88.1	6.5	2.4	0.8	2.2	79.4	12.7	3.8	0.7	3.4
2000	84.8	5.4	1.8	0.7	7.3	80.4	12.4	1.9	0.8	4.4

Source: Bank of Korea: Monthly Statistical Bulletin. Trade in services is not included.

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