Building Exchange-Rate Governance Within the ASEAN+3 Process

By Kaewkamol Karen Pitakdumrongkit

The risk of currency manipulation done in the belief that it will lead to benefits in the form of increased exports remains a threat in Southeast Asia. Carried to extremes, it can lead to retaliation and devastating economic consequences in a globalized world. While the Asian region lacks effective exchange-rate governance, within the ASEAN+3 framework there exist institutions that can be used to enhance governance. Kaewkamol Karen Pitakdumrongkit outlines a new approach.

CURRENCY MANIPULATION — or exchange-rate manipulation — happens when countries employ policies that secure “fundamental exchange-rate misalignment in the form of an undervalued exchange rate [in order] … to increase net exports.” In short, countries deliberately devalue or keep their currencies undervalued for the purpose of enhancing trade competitiveness. This issue needs to be addressed for several reasons. First, political uncertainties and protectionist measures driven by anti-globalization forces in recent years can tempt the governments of the so-called ASEAN+3 (the Association of Southeast Asian Nations plus China, Japan and South Korea) to pursue currency manipulation. Such policies can disrupt the deepening of transnational production networks and undercut regional economic integration. Illustratively, given that intra-ASEAN trade amounted to about a quarter of ASEAN’s total trade, exchange-rate manipulation could thwart the ASEAN Economic Community (AEC). Second, the effects of this manipulation can spread beyond the region, leading to greater market distortions, resource allocation inefficiency and global welfare reduction. Third, this beggar-thy-neighbor policy can invite retaliation. History has taught us that other states may respond by competitively devaluing their currencies, which ultimately resulted in currency wars and partly contributed to the Great Depression of the 1930s.

In addition, a governance gap exists in exchange-rate management. Since the collapse of the fixed-exchange rate Bretton Woods System, the world has witnessed little formal exchange-rate co-operation. The revised Article IV of the International Monetary Fund posits that a member shall avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members. Despite the guidelines granting the IMF power to conduct a special consultation on its members concerning their exchange-rate policies, the IMF has launched such consultations only twice — with Sweden in 1982 and South Korea in 1987. Regarding the G-20, disagreements among its members prevented them from forging fruitful collaboration on currency matters, as witnessed in the Plaza and Louvre Accords in the 1980s.

East Asia also suffers a severe deficiency in exchange-rate governance. It should be emphasized that it does not lack regional architectures governing financial and monetary matters. The Asian financial crisis led to the emergence of the ASEAN+3 financial co-operation process in 1997 in the areas of short-term liquidity provision, under the Chiang Mai Initiative Multilateralization (CMIM); capital market development, under the Asian Bond Market Initiative (AMBI); and surveillance, conducted by the ASEAN+3 Macroeconomic Research Office (AMRO). These available structures notwithstanding, co-operation over exchange rates is absent.

This means that the region lacks vision or ideas about how to multilaterally manage currency matters. For instance, numerous scholars have called for the creation of a regional currency. Other experts entertain the idea of the Asian Currency Unit (ACU) as a means to track the collective movement of regional exchange rates against both external currencies and individual East Asian currencies. However, these proposals have not become actual initiatives and formal exchange-rate co-operation in the region remains largely missing.

To sum up, the ASEAN+3 process lacks governance regarding exchange-rate matters. Although experts have suggested ways to improve governance, their ideas have not been translated into policy actions by East Asian governments. Therefore, what is needed is a more effective regional regime over currency manipulation, or better governance over exchange-rate matters, which can enhance economic welfare, lessen financial instabilities and conflicts and prevent the history of the 1930s from repeating itself.

POLICY RECOMMENDATIONS

To achieve this goal, the ASEAN+3 governments should: 1) expand the surveillance functions of AMRO to cover currency manipulation in the region; and 2) incorporate AMRO consultations into the 2004 ASEAN Protocol on the enhanced dispute settlement mechanism (DSM).

Why should AMRO address the governance deficiency problem? In short, why was the entity selected to carry out the above recommendations among other available platforms? It is mainly because unlike other regional groupings, AMRO is under the ASEAN+3 framework, which includes all East Asian countries as members. Hence, enhancing exchange-rate co-operation via this platform could be faster than the other alternatives. Illustratively, other regional entities, namely the Executives’ Meeting of East Asia and Pacific Central Banks and the Financial Stability Board’s Regional Consultative Group for Asia do not cover all East Asian nations. For these mechanisms to advance currency governance, they must first accept the East Asian non-parties into the blocs. Accessions might take some time because such decisions must be determined by their current members.

1 International Monetary Fund (IMF), Articles of Agreement. Article IV, Section 1(a).
4 The Jamaica Agreement of 1976 declared floating exchange rate regimes are acceptable, marking the final end of the original Bretton Woods System.
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8 G-B, disagreements among its members prevented them from forging fruitful collaboration on currency matters, as witnessed in the Plaza and Louvre Accords in the 1980s.
Recommendation 1: Expanding AMRO’s surveillance to cover currency manipulation

AMRO should be allowed to conduct independent research and publish cost-benefit assessments of currency-manipulation policies. Its reports should highlight the reduced benefits as well as increased costs of attempts by governments to manipulate their exchange rates.

These elements are important because they can help alter the ASEAN+3 authorities’ cost-benefit calculations, discouraging them from pursuing exchange-rate manipulation. To demonstrate the lower benefits, AMRO should gather trade-in-value-added (TIVA) data, which better captures current trade characterized by transnational production networks (TPNs) as opposed to traditional trade data, enabling more accurate assessments.

Under TPNs, a policy to depress currencies would not yield the gains it might have under the old trading paradigm in which final goods were produced solely from domestic inputs. In other words, TIVA data can more precisely demonstrate that the effect of exchange-rate devaluation on enhancing a state’s trade competitiveness pales under TPNs because such policies affect only the value-added portion a country contributes to final goods and services.

The above logic can be further demonstrated using a hypothetical example. Suppose the ingredients for ketchup are tomatoes, sugar, and salt. Prior to the emergence of TPNs, nations produced ketchup using ingredients supplied solely by domestic producers. Suppose Country A produces the ketchup and its cost of production is US$100. The country one day decides to devalue its currency by 10 percent. With that, the ketchup’s cost of production by Country A drops from US$100 to US$90. Assuming that the goods are sold at a zero profit margin, this will constitute a 10 percent price reduction.

In contrast, states in a TPN scenario source inputs from one another to make final goods. Suppose Country A imports tomatoes and salt from Countries B and C, respectively, while using its domestic sugar to produce ketchup. The cost breakdown of producing US$100-worth of ketchup is: tomatoes US$85, salt US$5, and sugar US$10. Suppose that Country A, wanting a greater market share of ketchup, suppresses its currency by 10 percent. This alters only the sugar component (US$10), which is sourced locally. If Countries B and C do not depreciate their currencies, Country A’s ketchup cost is reduced by US$1. Assuming that the goods are sold at a zero profit margin, the ketchup price from Country A is lowered from US$100 to US$99, only a 1 percent price reduction. This minor change is unlikely to alter consumer behavior in the same way that a 10 percent price reduction as shown above might do. Thus, due to TPNs, Country A’s devaluation does not result in greater trade competitiveness.

Critics may question the feasibility of getting TIVA, arguing that acquiring the information requires constructing an input-output table that is costly and time-consuming. I contend that such data collection is doable by utilizing trade information from a country’s export-processing zones (EPZs). This is less costly and quicker to undertake than assembling an input-output table. Also, the difference between the trade values coming into EPZs and those leaving EPZs constitutes a rough estimate of a nation’s TIVA.

In addition to showing the reduced advantages of currency manipulation, AMRO’s studies should focus on revealing the negative effects and increased costs of exchange-rate devaluation, including the risk of capital loss to foreign-exchange reserve values, domestic financial instability and speculative attacks.8

One may counter-argue that currency manipulators holding a large amount of others’ currencies could inflict harm on the latter. For example, dumping currency on the international money market can cause financial instability in the target economy by creating a huge loss of that currency’s value. However, such a sell-off is self-destructive, making it unlikely for manipulators to do so. For one thing, such dumping will reduce the values of the remaining target’s currency that the manipulators hold.9 Another counter-argument is that a central bank can conduct “sterilization” (which involves intervention in a bond market) to lessen inflationary pressure, alleviating domestic financial instability. Although sterilization can dampen inflation, it can have other negative effects on a country. Selling bonds leads to the build-up of liabilities on the bank’s balance sheet. As a result, the entity is tempted to raise money for debt repayments, and it usually does so by investing abroad in the form of foreign-denominated assets. However, evidence suggests that the cost of foreign-exchange intervention often exceeds the rate of return from such investment, ultimately leaving a central bank with financial losses at the end.11 Additionally, a state’s domestic interest rate is kept higher than the rates in other nations, carry trade usually occurs. This brings upward pressure on the currency, leading to additional burdens on its central bank to intervene, exacerbating a risk of financial losses as earlier demonstrated.12

Recommendation 2: Establishing an AMRO-ASEAN to the Dispute Settlement Mechanism

Another way for AMRO to bolster regional currency governance is through the incorporation of AMRO contributions into the ASEAN Dispute Settlement Mechanism (DSM). Due to the close relationship between currency and trade matters, doing so can enable AMRO to assist ASEAN in settling trade disputes that involve balance-of-payments and exchange-rate matters. Doing so further enhances regional exchange-rate governance because it grants AMRO the ability to “name and shame” currency manipulators as well as enable plaintiffs to retaliate through DSM rulings.

ASEAN created its regional DSM in the 1990s as its participants signed onto the Protocol on Dispute Settlement Mechanism in November 1996. The agreement was superseded by the ASEAN Protocol on Enhanced Dispute Settlement Mechanism in 2004. Because AMRO was created in 2011, after the ASEAN DSM was formed, the link should be established between these entities by adding a provision to the ASEAN DSM document. The provision would mandate the ASEAN DSM panels to consult AMRO when trade-conflict issues arise about balance-of-payments or exchange-rate issues, and to accept AMRO’s decisions on these matters.

Critics may counter that nations can name and shame exchange-rate manipulators or even retaliate without law, hence there is no need to strengthen the DSM through such a linkage. However, going through litigation means that claims by plaintiffs are supported by an international community. This creates pressure on...
LEADERSHIP MATTERS

Leadership is needed to transform the above recommendations into action, which can be provided by a single country or a group of like-minded countries committed to the agenda. I would argue that Singapore, Thailand, and Vietnam should work together to enhance regional governance over exchange-rate matters for the following reasons: First, these countries are relatively more open to international trade than many other ASEAN+3 economies. For instance, trade as a percentage of GDP for Singapore, Vietnam, and Thailand in 2016 amounted to 318 percent, 185 percent, and 123 percent, respectively. Consequently, these states are likely to suffer more from potential currency manipulation, and hence have a greater incentive to take the lead in bettering regional exchange-rate governance.

Also, these Southeast Asian nations will serve as the chair of ASEAN in the period 2018-2020. Thus, I am reviving the idea of a “Troika,” having three consecutive ASEAN chairs working jointly to develop such a governance architecture. Having the three chairs continuously drive the agenda could raise the chance that these proposed ideas are achieved.

How do ASEAN+3 stakeholders view expanded AMRO functions? In short, are these recommendations feasible? These recommendations are likely to gain support from the ASEAN+3 governments. Evidence has shown that the countries endorsed AMRO’s surveillance roles. For instance, according to the Joint Statement of the 20th ASEAN+3 Finance Ministers’ and Central Bank Governors’ Meetings in Japan in May 2017, the participants continued “to support AMRO in enhancing its surveillance and organizational capacity to fulfill its mandate as an independent, credible and professional regional organization acting as a trusted policy advisor to members in the ASEAN+3 region” and “commended the Deputies’ endorsement of AMRO’s Publication Policy which will promote its accountability and visibility beyond the regional platform.” Also, the ASEAN+3 Cooperation Work Plan (2018-2022) adopted at the 18th ASEAN+3 Foreign Ministers’ Meeting in the Philippines in August 2017 posits that the regional states would “[m]aintain financial market stability in the region through … [s]upporting the ASEAN+3 Macroeconomic Research Office (AMRO) to strengthen its conduct of regional economic surveillance.” Therefore, given the consistent support by the ASEAN+3 parties, it is likely that they could welcome and adopt these recommendations.

In conclusion, East Asia lacks a formal exchange-rate governance regime. It is time for the regional states to seriously consider constructing the architecture to manage currency matters. Implementing the recommendations above would not only enhance financial stability, which undergirds TPNs and economic integration, but it would also help prevent competitive devaluations and trade conflicts in the region.

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