

ever emerge in Asia? Third, what sustains the international role of the dollar, will the renminbi displace it, and, if so, what would be the consequences for Asia's relationship to the United States and the rest of the world? After reviewing recent history and contemporary monetary relations in Asia, we review the scholarship on these questions with an eye toward three levels of analysis—national, regional, and global.

We argue that the US dollar's dominance as a currency for international transactions in Asia has been a stable equilibrium. As such, the use of the dollar has served the political and economic purposes of most of the export-oriented Asian countries and has been reinforced by path dependence, network externalities, and the political difficulties of establishing regional currency initiatives. We argue that widespread use of the dollar has facilitated a shift on the part of many Asian countries toward shadowing the renminbi as the weight of the Chinese economy increases within the region. Shadowing the movements of the Chinese currency is likely to continue, but the extent to which the renminbi displaces the US dollar as a trade, investment, and vehicle currency remains to be seen. We conclude with lessons for analyzing international relations of Asia and discussion of alternative futures for the region's currency relations.

16.2. MONETARY RELATIONS IN ASIA

During the last six decades East Asia has thrived under the dominance of the “top currency” in the international hierarchy, the US dollar (Helleiner and Kirshner 2009). With the exception of Japan—which began to float the yen against the dollar as the Bretton Woods system ended in 1971—the East Asian currencies have been pegged to the dollar, the pound sterling, or a basket of key currencies, or floated with close management (Reinhart, Ilzetzki, and Rogoff 2008). The Asian monetary authorities have generally chosen to maintain stability of their currencies against the dollar at low rates that many analysts (such as Goldstein 2006; Bergsten 2007; Gagnon and Hinterschweiger 2011; and Bhalla 2012) describe as “undervalued.” China, which moved from an erratic dual exchange rate regime to a stable unified one in 1994, implemented a fixed exchange rate strategy by closely managing the renminbi-dollar rate through mid-2005 (Goldstein and Lardy 2008). India adopted current account convertibility in 1994 and floated the rupee during the Asian financial crisis of 1997–98 (AFC) but otherwise maintained a de facto dollar peg until the mid-2000s. The Reserve Bank of India liberalized capital movements gradually and intervened in the foreign exchange market to sustain the peg, though much less heavily than Chinese authorities (Panagariya 2008, 2013; Patnaik and Shah 2009, 2011).¹ Even after the currency shock of the AFC, when Southeast Asian currencies were forced off their (mainly) dollar pegs and lost value precipitously, most of them subsequently returned to regimes in which they moved closely with the dollar and the renminbi, with the exception of the Korean won (McKinnon 2005). As the Soviet Union disintegrated in 1991 and Russia created a new ruble in 1993, the five new Central Asian republics (Kazakhstan, the Kyrgyz Republic, Tajikistan, Turkmenistan,

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and Uzbekistan) left the ruble zone and adopted separate currencies with volatile floating exchange rates until the late 1990s and early 2000s. With differing commitments to the market economy, these republics then adopted managed floating or crawling peg regimes against the US dollar with limited capital controls (Broome 2010). (See table 16.1.)

Table 16.1 Exchange Rate Regimes in Asia, 1990, 2000, 2010

Groups	Country	1990	2000	2010
Southeast Asia	Brunei Darussalam	De facto CB narrower than $\pm 2\%$	De facto CB narrower than $\pm 2\%$	De facto CB narrower than $\pm 2\%$
	Cambodia	NA	NA	De facto crawling peg
	Indonesia	De facto crawling peg	Managed floating	De facto CB $\pm 5\%$
	Laos	De facto CB narrower than $\pm 2\%$	Dual market w/ missing data	NA
	Malaysia	De facto CB narrower than $\pm 2\%$	Preannounced peg or currency board arrangement	De facto CB $\pm 5\%$
	Myanmar	Freely falling	Dual market w/ missing data.	Dual market w/ missing data.
	Philippines	De facto crawling peg	De facto CB narrower than $\pm 2\%$	De facto CB $\pm 5\%$
	Singapore	Moving band $\pm 2\%$	Moving band $\pm 2\%$	Moving band $\pm 2\%$
	Thailand	De facto peg	Moving band $\pm 2\%$	Moving band $\pm 2\%$
	Vietnam	NA	NA	De facto crawling peg
Greater China	SAR Hong Kong, China	Preannounced peg or currency board arrangement	Preannounced peg or currency board arrangement	Preannounced peg or currency board arrangement
	China	Managed floating	De facto peg	De facto peg
	Taipei Republic of China	De facto crawling peg	De facto CB narrower than $\pm 2\%$	De facto CB narrower than $\pm 2\%$
Asian Advanced Economies	Japan	Freely floating	Freely floating	Freely floating
	South Korea	Preannounced CB narrower than $\pm 2\%$	Managed floating	Managed floating

(Continued)

placed much higher priority on compiling an internationally competitive capital stock to expand industrial production and absorb excess labor. The costs of holding dollar reserves—higher returns on these investments that were forgone and capital losses resulting from dollar depreciation—were thought to be a relatively small price to pay for rapid economic development. In the view of this school, these interests were complementary to those of the United States and the international monetary system and the constellation of payments imbalances that resulted—current account surpluses for Asia and deficits for the United States—could remain stable over several decades.

For most of the East Asian countries, the exchange rate regime has been an important underpinning of economic success because it allowed them to maintain export competitiveness by keeping their currencies undervalued during their rapid growth era. The incentive to maintain stable and undervalued exchange rates, particularly against the US dollar, was a priority for these countries. This is because a large portion of the goods produced by the region's manufacturers—which are often price sensitive (Wade 1992)—have traditionally been absorbed by the United States. Since the 1990s, as intra-regional production networks expanded in the form of “Factory Asia” (Baldwin 2006), East Asia continued to depend on US and European demand for its final products (ADB 2010). The tradable goods sectors, both export and import-competing, favored a stable and low-valued currency and dominated countries' respective exchange rate policies (Kojo 1998; Liew and Wu 2007; Steinberg and Shih 2012). Furthermore, such interests are supported by the states, often characterized as the “developmental state” of East Asia (Johnson 1982; Woo-Cummings 1999, whose catch-up strategy and economic-growth mandate led the region's governments to support their export sectors even at the expense of purchasing power for consumers.

Japan and South Korea are the two countries in East Asia in the 2000s with currency regimes characterized by less stability and currencies that were not generally undervalued. Their greater tolerance for exchange rate fluctuation is attributable to the maturity of their economies, which boast firms that operate globally with highly hedged foreign exchange positions (Hatch 2010). By contrast, consistent with its development model, China's insistence on the undervalued renminbi—sometimes fixed to the US dollar and at other times floating in a closely managed fashion against the US currency—sustained the extraordinary growth in the country's exports to the United States even after the global financial crisis (GFC) of 2008–9 (Huang 2009).

This developmental strategy of expanding exports and industrial production at the cost of domestic consumption is complemented by financial repression—controls on credit, interest rates and external capital movements (Lukauskas 2002, 380)—through which the government directs or influences the allocation of capital in the economy.² As a result, East Asian governments tend to control financial channels heavily, with banks serving as the main financial channels for businesses (Wade and Veneroso 1998) and with relatively limited development of the financial and capital markets, particularly that of corporate bonds (McCauley 2003).

Over time, however, this soft-pegging and undervalued-currency strategy has begun to impose substantial costs, which are rising. During the 2008–9 crisis, these soft pegs

proved to be difficult to sustain. The maintenance of undervalued currencies required massive foreign exchange intervention and the accumulation of unprecedented amounts of US dollars in foreign exchange reserves. In addition to having to invest a large portion of the country's foreign exchange reserves in liquid short-term US Treasury bills, which typically have lower returns than domestic assets, Asian central banks are exposed to losses on dollar reserves arising from inflation and dollar depreciation over the long term. The accumulated foreign exchange reserve holdings of East Asian countries, which amounts to ~~nearly \$6 trillion~~ ^{ed / 2 / 7}, represent an effective subsidy to these countries' tradable goods sectors.

The foreign exchange intervention necessary to depress the value of the currency carries an additional cost in the form of distorting domestic financial markets. Official purchases of US dollars and other foreign currencies causes an expansion of domestic liquidity unless offset by sterilization operations by the central bank. Such operations include selling bonds for domestic currency, jawboning or requiring domestic banks to hold them, raising reserve requirements, and suppressing domestic interest rates, thereby *reinforcing* financial repression (Goldstein and Lardy 2008).

Chinese authorities unpegged the renminbi from the US dollar in July 2005 in the first of two phases of controlled appreciation. Over the course of the next seven years—interrupted by a year of repegging after the GFC—the Chinese currency appreciated by more than 30 percent against the US dollar in nominal terms. A further increase in Chinese prices and wages contributed to an appreciation of the renminbi against the dollar of about 40 percent in real terms. Followed by several other currencies within the region—discussed below—this realignment helped to reduce the large trade and current account surpluses that China had developed prior to the 2008–9 crisis. The realignment in turn substantially ameliorated disputes with the US government over currency manipulation and payments imbalances, conflict that had begun during the first administration of President George W. Bush. Whether this conflict dissipates or re-emerges (Gagnon 2012) depends on the evolving currency practices of China and its neighbors in the region.

16.3. REGIONAL CURRENCY COOPERATION

East Asia has seen a rapid increase of intra-regional trade and investment and, in the aftermath of the AFC, some successful efforts in regional financial cooperation.³ Would a regional currency ever be a viable option? European integration has illustrated the feasibility of detaching a region from the dollar standard while retaining exchange rate stability by establishing a monetary union or regional currency arrangement. The theory of “optimum currency areas” (OCA) specifies the conditions under which a group of countries can benefit from surrendering the exchange rate as an instrument of balance-of-payments adjustment in the process of creating a monetary union (Mundell 1961).⁴ Even though East Asia's regional currency arrangement

\$ 7 trillion

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Second, the political rivalry between Japan and China makes choosing to peg explicitly to the renminbi or the Japanese yen difficult for Southeast Asian governments. These governments prefer instead to balance the two large states against one another and exploit, where possible, the rivalry. For their part, neither the Japanese nor Chinese authorities are likely to be willing to allow the other's currency to prevail in the regional setting (Grimes 2003, 2009; Kwack 2004).

Finally, the dollar as the de facto focal point of coordination has allowed Asian governments to avoid having to negotiate a joint peg or common basket. As discussed above, over the last decade, there have been various proposals for joint pegging to a common basket for Asian currencies, including the ACU.⁹ Most such proposals would require *joint* decisions on the part of East Asian countries in general, Japan and China in particular. None of these proposals has been adopted owing to the political difficulty in agreeing on such critical details as the weight of the various national currencies in the regional unit. For these reasons, broad use of the dollar as an international currency in Asia has been a stable equilibrium.

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16.4. THE ROLE OF THE DOLLAR AND RENMINBI

A central question surrounding Asia's currency arrangements is how long the dominant role of the US dollar will continue. Subramanian (2011, 109) predicts the "possible eclipsing of the dollar as the premier reserve currency" by the renminbi by 2020, not just in Asia but globally as well. McKinnon (2013) emphasizes the stability of the dollar standard despite its being "unloved." Eichengreen (2011, 135–47) argues that the renminbi could become a regional reserve currency but not a dominant reserve currency globally for the foreseeable future. Currency dominance rests on the balance between the forces of inertia and the rise of China.

The dollar remains dominant in East Asia due to path dependence, domestic preference, regional economic and political environment, and network externalities. We have included the use of the dollar as the facilitator of informal currency cooperation in the region among these forces of continuity. For its part, of course, the United States reaps several substantial advantages from issuing the top currency, ranging from savings in transaction costs, ability to borrow in its own currency—thereby avoiding currency risk—seigniorage, political prestige, and power to coerce (Kirshner 1995; Cohen 1998; Helleiner 2009). Most recent scholarly attention, however, focuses on the potential sources for change.

Volz (2009, 158–59; 2010) argues that Asia's reliance on the dollar can be problematic owing to (a) swings in the dollar-euro and dollar-yen rates, (b) dependence on US monetary policy, and (c) possible erosion of the international real purchasing power of the region due to inflation in the United States and depreciation of the dollar. The cost

of constraining domestic monetary policy by softly pegging to the dollar was placed in stark relief by the GFC of 2008–9. The Federal Reserve eased interest rates to nearly zero and then embarked on quantitative easing in 2010, presenting Asian governments with a choice between allowing their currencies to rise against the dollar or intervening more heavily to stabilize them. Because inflation rates had already begun to rise in Asia, and greater intervention would raise them further, the Fed's action prompted vituperative verbal exchanges that were dubbed “currency wars.”

Given the difficulty of creating a regional currency such as the euro, any regional alternative to the dollar would likely come in the form of fostering the internationalization of a national currency within Asia. The Japanese government tried to elevate the yen in this role beginning in the mid-1980s and particularly in the aftermath of the AFC of 1997–98 (Grimes 2003; Frankel 2011). With its postbubble economic stagnation, lasting two decades, and the unwillingness of the country's corporations and banks to shift their transactions to yen, however, the Japanese government gave up its multiple efforts by the early 2000s (Katada 2008; Takagi 2012). Currently, it is China and its policies to internationalize the renminbi that are attracting the most attention.

As China's economy grows and the amount of trade between China and the rest of the world increases even more rapidly, so do some of the incentives to use renminbi (Mattoo, Mishra, and Subramanian 2012). As discussed above, these forces have contributed to the shift in the weight of the renminbi in the currency baskets of Southeast Asian countries. In addition, since the mid-2000s and particularly after the onset of the GFC, the Chinese authorities took several steps to promote the use of the renminbi. This effort has an international trade track—through invoicing and settling transactions in renminbi—and a financial track—allowing renminbi accounts and bond issuance in Hong Kong and abroad.¹⁰ It includes an aggressive campaign by the People's Bank of China (PBOC) to introduce bilateral swap agreements with other central banks. Since 2008, PBOC has established such agreements with eighteen counterparts for a total of nearly 2 trillion yuan (roughly \$320 billion). While some of the correspondent banks are outside the region, most are Asian. In contrast to the CMIM, these agreements are bilateral and provide swaps of short duration to supply currency in which renminbi-denominated transactions can be settled. Unlike other international currencies where the market largely determined the process and speed of their respective global use, the Chinese government is taking deliberate steps in “managed internationalization” (McCauley 2011; Frankel 2011) of the renminbi. This effort to “manufacture” an international role for the currency, as Cohen (2013) emphasizes, is unprecedented in modern history.

However, the success of the Chinese government's efforts to internationalize the renminbi will hinge on several factors including management of the country's capital account liberalization, and increase exchange rate flexibility along with the country's financial sector development (Prasad and Yi 2012). As discussed earlier, China's financial institutions and foreign exchange regime preferences have long been heavily influenced by its export-promotion growth model and financial repression, and the embedded interests of its export sector and underdeveloped financial sector could

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become political obstacles to a fundamental shift in government policies (Liew and Wu 2007; Huang 2009; Steinberg and Shih 2012). Chinese capital controls indeed give rise to the need for the short-term central bank swaps. Without them, foreign firms could obtain renminbi for trade settlement directly from the onshore market. This raises the question as to whether these swaps would be useful, and whether offshore renminbi markets such as Hong Kong's could survive a liberalization of the Chinese capital account.

Finally, security questions and regional politics will continue to be factors that constrain the internationalization of the renminbi. Historical grievances that remain unresolved, conflicting territorial claims, and security flashpoints such as North Korea and sporadic border violence in Southeast Asia are likely to favor a role for the US dollar over any regional currency. This conclusion is reinforced by uncertainty about the trajectory of Chinese domestic politics over the long term. Shifting to use of the renminbi for reserve holdings, trade invoicing, and formal currency pegging would require overcoming substantial objections on political grounds in Japan, South Korea (Park and Song 2011), and other Asian countries. We return to the relationship between economic and security questions in the section below.

16.5. ANALYSIS OF INTERNATIONAL RELATIONS

The evolution of currency relationships in this region offers insights into international relations generally. The first insight relates to power analysis and the importance of domestic preferences. Scholars have sometimes viewed relationships among currencies in structural terms, wherein a dominant state exercises influence over weaker ones through its ability to issue the prevailing international currency (Cohen 1977; Strange 1971). In this perspective, the sticky institutional nature of currency use (Kindleberger 1967) and network externalities (Krugman 1984) constrain the choices of governments that issue lesser currencies. Over the past several decades, the dollar's structural role in the East Asian economy has been overwhelmingly dominant. China's spectacular growth, meanwhile, could be changing the foundations of the currency structure by giving Beijing more resources with which to influence the policies of others within the region and beyond, both directly and indirectly through market. The notion that a relative shift in power capabilities will lead to conflict between China, its neighbors in the region, and the United States has a long tradition in the study of international relations.¹¹

However, currency relations in Asia suggest that the increase in economic size of China alone does not explain exchange rate policy choices. Domestic politics establish state preferences, which in turn inform exchange rate decision-making. Hence, following Moravcsik (1997, 2008), a prior step in power analysis must be to establish the

capital markets, these developments would strengthen incentives for stabilization on a regional basis. A regional regime would receive a fillip, were the members of ASEAN+3 to harness CMIM and AMRO to this project.

The third future would witness the opposite transformation of exchange rate policies. Rather than adhere more closely to the renminbi or to a common regional mechanism, the emerging and developing countries over time would follow the example of Japan in its pursuit of independent floating of its currency. Such countries would shift the primary target of monetary policy from exchange rates to domestic inflation (Eichengreen 2004; Chung and Eichengreen 2009). Economic development, capital market liberalization, and the easing of financial repression would favor this outcome. Greater sophistication of capital markets in these countries would both permit firms to hedge exposure to exchange rate fluctuation (Knight 2010) and undermine the effectiveness of capital controls as a tool for stabilizing currency rates.

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NOTES

1. On Indian exchange rate policy, see also Acharya 2012; Bhalla 2012; and Gopinath 2005.
2. Through such measures, the governments of East Asia channeled credits to export industries and productive sectors to achieve rapid economic growth (Amsden 1992; Calder 1993; Wade 2004; Shih 2008).
3. Because the integration of trade and investment has been particularly pronounced in East Asia, and numerous proposals for monetary integration have been put forward, this section focuses on that region rather than Central Asia or South Asia.
4. McKinnon (1963) elaborated upon Mundell's formulation by emphasizing the importance of national economic characteristics and openness to economic exchange within the group of countries considering a currency area.
5. The major obstacles to satisfying the conditions for an optimal currency area are differences in the level of economic development and lack of convergence in per capita income.
6. See, among others, Grimes 2009 and Henning 2013a.
7. Between July 2005 and March 2012, the nominal value of the renminbi rose 32 percent against the dollar, while the Malaysian ringgit, Philippine peso, Thai baht, and Singapore dollar essentially followed it upward. Despite the 2008–9 GFC and significant fluctuations, the nominal value of these currencies in the first quarter of 2012 stood within 5 percent of their mid-2005 levels against the renminbi. By contrast, the Indonesia rupiah and New Taiwan dollar moved less than 10 percent against the US dollar, to which the Hong Kong dollar is fixed. Nonetheless, the rupiah and the South Korean won, which had floated relatively independently, have tracked the renminbi more closely since the 2008–9 crisis.
8. Exchange rate regimes and their relationship to domestic macroeconomic policies are described in detail by, e.g., Cavoli and Rajan 2009; and Willett et al. 2011.

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