Chapter IV Use and Holdings of Foreign Reserves in Asia, and Foreign Currency Stabilization

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Chapter IV

Use and Holdings of Foreign Reserves in Asia, and Foreign Currency Stabilization

This chapter is a survey of the following three issues: use and holdings of foreign currency reserves in Asia; the effect of the recent (from the beginning of 1993 to the first half of 1995) yen appreciation on Asian financial field; and the issues to be addressed in stabilizing the Asian currencies. This survey incorporates the results of surveys conducted in Asian countries.

1. Currency Choices in Asia

(1) Domination of the U.S. dollar

Table 4-1 is a result of a survey conducted in January of 1996 summarizing the use and holdings of foreign currency reserves by Thailand, Indonesia, the Philippines, China and South Korea, and explaining the foreign exchange systems employed by these countries. The use of the Japanese yen as a international currency (expanded use and holding of the yen) did not move forward in Asia, and the U.S. dollar plays a dominant role in each field.

China, Thailand, Indonesia and South Korea, which all employ managed float systems, and the Philippines, which employs a floating rate system, all link their currencies to the fluctuations of the U.S. dollar. For instance, in China, South Korea and Thailand where the central banks publicize standard exchange rates of their own currencies, the exchange rates are tabulated using their currencies' exchange rates vis-a-vis the U.S. dollar as a base. Thailand's foreign exchange system, where its national currency is linked to a basket of currencies, is also in essence linked to the U.S. dollar since it is estimated that more than 80 percent of the currency basket is made up of the U.S. dollar.

In terms of the currencies used for trade settlement, the U.S. dollar is by far the most influential. With respect to Thailand, Indonesia and South Korea, where statistics are available, between 89 and 96 percent of exports and between 75 and 79 percent of the imports are settled in the U.S. dollar. In contrast, only 1 to 6 percent of the exports and 10 to 14 percent of the imports are settled in the Japanese yen. The reason the share of the Japanese yen is larger in settling imports than exports seems to be that a greater portion of the imports of machinery and other items from Japan is settled in yen.

No central banks make public announcements regarding the composition of foreign currency reserves they are holding. However, it is widely assumed that approximately 40 percent of the foreign currency reserves held by Indonesia are Japanese yen.

(2) Share of Yen-Based Trade Settlements in Japan's Exports to Southeast Asia

Next, using the statistics available in Japan, let us examine the patterns of use of the Japanese yen in Asia (Table 4-2). It should be noted that the share of Japanese exports to Southeast Asia settled in Japanese yen shows a sharp decline starting in the first quarter of 1993, a turning point in the latest yen-appreciation trend. The share of exports settled in Japanese yen was 52.4 percent in March 1993 and fell to 43.9 percent in September 1995 – a 8.5 percent drop in two and half years. Conversely, the share of exports settled in U.S. dollars rose by 9.3 percent during the same period, from 44.4 percent to 53.7 percent.

Two distinctive trends can be observed when the declining trend in the share of exports settled in Japanese yen is interpreted within the context of corporate activities. First of all, due to intensified competition within the Asian markets, it became harder for Japanese firms to obtain yen-based export contracts, which inherently transfer exchange risks to the importers. Second, in an attempt on the

Table 4-1: Use and Holdings of Currencies in Five Asian Countries

	China	Thailand	Indonesia	The Philippines	South Korea
1. Foreign Exchange System	Managed Floating System. The People's Bank publicizes a standard exchange rate of its currency relative to the U.S. dollar.	Managed Floating System. Thailand utilizes a currency basket system consisting of the currencies of eight major trading partners. However, about 80 percent of the basket is the U.S. dollar. The share of Japanese yen in the basket is estimated to be no more than 10 percent. The Central Bank announces its exchange rates vis-a-vis the U.S. dollar and other currencies on a daily basis.	Managed Floating System. Indonesia utilizes a currency basket system comprising the currencies of major trading partners. However, in actuality, its currency is linked to the U.S. dollar fluctuations and allowed to be freely traded within a certain fluctuation range. In recent years, its currency, the rupiah, has depreciated relative to the U.S. dollar at a steady rate (approximately 5 percent per year).	Floating Exchange Rate System. The Philippines employs a volatility band system for containing the peso's fluctuations to within 1.5 percent of the standard rate.	Managed Floating System. South Korea switched over to Market Average Rate System in March 1990 (allowing a certain range of fluctuations using a weighted average of the previous day's market rates).
2. Trade Settlement Currency (1) Export:	(No statistics available, however, it is estimated that the majority of its exports are settled in the U.S. dollar.)	U.S. dollar: 91.0 percent; Japanese yen: 4.8 percent; Deutsche mark: 1.1 percent Singapore dollar: 0.8 percent (1992)	U.S. dollar: 95.8 percent; Japanese yen: 1.4 percent; Singapore dollar: 1.4 percent (1994)	Over 90 percent in U.S. dollars.	U.S. dollar: 88.8 percent; Japanese yen: 6.3 percent; Deutsche mark: 2.9 percent (1992).
(2) Import:	(No statistics available, however, the majority of the currency used for trade settlements is estimated to be in the U.S. dollar)	U.S. dollar: 74.5 percent; Japanese yen: 12.3 percent; Deutsche mark: 4.6 percent, Singapore dollar: 1.6 percent (1992)	U.S. dollar: 74.8 percent; Japanese yen: 9.8 percent; Deutsche mark: 6.1 percent (1994)	Approximately 80 percent in U.S. dollars.	U.S. dollar: 78.6 percent; Japanese yen: 13.6 percent; Deutsche mark: 3.8 percent (1992).
3. Foreign Currency Reserves (including gold, end of 1994)	51.6 billion in U.S. dollars.	30.3 billion in U.S. dollars.	13.2 billion in U.S. dollars (of which approximately 40 percent is in Japanese yen, and 40–45 percent in U.S. dollars).	7.1 billion in U.S. dollars.	25.6 billion in U.S. dollars.
4. Currency Composition of Long-term Debt (end of 1993)	70.3 billion U.S. dollars (21.0 percent yen-based; 54.2 percent dollar-based)	26.1 billion U.S. dollars (52.1 percent yen-based; 21.8 percent dollar-based)	68.9 billion U.S. dollars (40.7 percent yen-based; 13.2 percent dollar-based)	29.0 billion U.S. dollars (38.3 percent yen-based; 30.2 percent dollar-based)	35.0 billion U.S. dollars (32.0 percent yen-based; 45.7 percent dollar-based)

Reference data :

1) Settlement Currencies used by Japan in trading with Southeast Asian countries. (based on survey conducted by the Ministry of International Trade and Industry in September, 1995): for exports, 43.9% in the Japanese yen; 53.7% in the U.S. dollar; 2.4% in other currencies; for imports: 26.2% in the Japanese yen; 71.9% in the U.S. dollar; and 1.9% in other currencies.
2) According to sources, the total traded amount (between April, 1994 and October, 1995) at China's Foreign Exchange Center has reached U.S.$95.04 billion. Currency breakdown is U.S. dollar (92.2%), Hong Kong (7.5%), Japanese yen (0.4%).

Source: Foreign Exchange System: *"Asia's Economy 1995"* Economic Planning Agency; based on surveys conducted in Asian Countries.
Trade Settlement Currency: For Thailand and South Korea; Bank of Thailand, *Papers on Policy Analysis and Assessment 1994.* For Indonesia; Bank Indonesia, *Indonesian Financial Statistics* (Oct. 1995). For other countries; based on survey conducted in each country.
Foreign Currency Reserves: IMF; *International Financial Statistics,* and statistics compiled by each country. For Indonesia, the data is based on survey conducted in the country.
Currency Composition of Long-term Debt: The World bank, *The World Debt Tables 1994–95.*

Table 4-2: Breakdown of the Currencies used by Japan in Settling Trade Transactions with Southeast Asian Countries.

(unit: %)

Exports		Southeast Asia Yen	Southeast Asia US Dollar	Southeast Asia Other Currencies	World Yen	World US Dollar	World Other Currencies
1987		41.1	56.5	2.4	33.4	55.2	11.4
1989		43.5	53.6	2.9	34.7	52.4	12.9
1993	Mar.	52.4	44.4	3.2	42.8	45.6	11.7
	Sep.	52.5	44.3	3.2	39.9	48.4	11.7
1994	Mar.	52.0	45.1	2.9	40.7	48.6	10.7
	Sep.	49.0	47.9	3.1	39.7	48.3	12.0
1995	Mar.	47.2	49.9	2.9	37.6	51.5	10.9
	Sep.	43.9	53.7	2.4	35.7	52.7	11.6
Imports		**Southeast Asia Yen**	**Southeast Asia US Dollar**	**Southeast Asia Other Currencies**	**World Yen**	**World US Dollar**	**World Other Currencies**
1987		11.5	87.6	0.9	10.6	81.7	7.6
1989		19.5	78.8	1.7	14.0	77.0	9.0
1993	Mar.	23.4	74.8	1.8	18.2	75.0	6.8
	Sep.	25.7	72.0	2.3	20.9	72.4	6.7
1994	Mar.	30.1	67.4	2.5	21.6	72.1	6.3
	Sep.	23.6	74.2	2.2	19.2	73.9	7.0
1995	Mar.	34.1	64.2	1.7	24.3	68.9	6.8
	Sep.	26.2	71.9	1.9	22.5	70.4	7.1

Source: Ministry of International Trade and Industry

part of Japanese firms operating in Asia to enhance price competitiveness, the firms are lessening their reliance on their parent companies in Japan for the procurement of parts and materials, and instead establishing regional divisions of labor within Asia.

As for the latter trend; a number of Japanese auto manufacturers are following the footsteps of the electronics manufacturers, forerunners in this regard. A number of large firms within these industries are establishing their regional operational headquarters in places like Hong Kong and Singapore to centralize all their corporate functions such as foreign exchange transactions, procurement of parts and materials, and distribution. Faced with an appreciating yen and intensifying competition in Asia, many of the Japanese companies operating in Asia resorted to the above described actions, which in turn resulted in lowering the share of Japanese exports to the Southeast Asian countries settled in yen.

2. Effects of the Recent Yen Appreciation in Asia (from 1993 to the first half of 1995)

(1) Influences on Prices

It is difficult to accurately grasp the effects of the appreciated yen on the prices of imported products in the countries where surveys were conducted, due to insufficient data on the prices of imported items.

On the basis of hearings conducted in each country, many seem to be of the opinion that the effects of the appreciating yen on the prices of imported products and domestic merchandise are minimal. In recent years, Thailand, China, Indonesia and the Philippines implemented tight monetary policies purported to curtail inflation rates. It is pointed out that the following are the major causes of inflation: overheating economic boom period; high rate of wage increases; increased money supply triggered by influx of foreign capital; rising prices of food items caused by natural disasters (flooding in Thailand). There is a view that the lowering of custom duties neutralized the negative effects of the appreciated yen on the prices of domestic products in Thailand.

It was a minority opinion that the appreciated yen pushed the prices of imported items substantially higher and thus induced a price hike in the domestic products. For Japanese firms operating in Asia, it is going to be increasingly difficult to simply shift cost increases caused by the appreciating yen into prices hikes in the face of intensifying competition in the local markets.

(2) Adjustment of Foreign Currency Reserve Holdings

It has been reported in Japan that the ratio of the Japanese yen to the foreign currency reserve holdings of Asia's central banks increased as a result of the active yen purchasing activities by the central banks when the yen appreciated sharply during the first half of 1995. However, it is hard to interpret that the yen assets were purchased as balance of payment reserves or for currency intervention, which are some of the traditional reasons for holding foreign currency reserves. As noted earlier, in Asia a majority of trade is settled in U.S. dollars and a high percentage of the transactions on the foreign exchange markets is conducted in the U.S. dollar.

Therefore, the Japanese yen purchasing activities during the first half of 1995 are presumed to reflect acts on the part of the Asia's central banks to increase yen assets holding in anticipation of further yen appreciation.

For the countries where the ratio of yen-based loans to the total long-term debt is high, it is beneficial to increase the yen assets holding because they are able to offset the negative impact of the appreciating yen. Since the Japan's interest rates have been historically low in recent years, increasing the ratio of yen as foreign currency reserve currency may not necessarily produce benefits as working capital.

(3) Repayment of Yen-Based Loan

One area where the appreciating yen has an immediate impact is in the repayment of yen-based loans. As the yen appreciates against the U.S. dollar, the borrower would have to increase exports settled in the U.S. dollar in order to repay Japanese yen based loans , since most of the export income among the Asian countries is generated in U.S. dollars.

Table 4-1 shows the breakdown of the foreign currency reserve holdings for the payment of the long-term debt among the Asian countries. Each country is faced with an increased interest payment burden precipitated by the appreciation of the Japanese yen against the U.S. dollar. However, none of these countries experienced worsening repayment burden when the value of the Japanese yen jumped sharply against the U.S. dollar during the first half of 1995 because they all held sufficient foreign currency reserves and they were able to obtain foreign capital relatively easily. The exception to this is Indonesia. In Indonesia 41 percent of balance of liabilities to foreign countries in the public sector is yen-based, and its interest payment burden is large.

(4) Movement of Global Capital

As noted in Chapter III, highly marketable funds are aggressively coming into Asia's financial and capital markets. It appears, however, that the effects of the yen-dollar fluctuations on the movement of highly marketable funds are minimal. This is because most of this private capital flowing into Asia's capital and financial markets comes from the U.S. and European countries (included in this group are Singapore and Hong Kong). Since many of the Asian currencies are linked to the U.S. dollar, the capital inflow from the U.S. is not affected by the yen-dollar fluctuations.

On the other hand, Japanese investments in Asia's stock markets are at a higher risk of being negatively impacted by the yen-dollar fluctuations. The Japanese presence and influence in the Asian stock markets are not substantial in comparison to those of the U.S. (table 4-3)

Table 4-3: Portfolio Investment into Thailand and the Philippines

[Thailand]			(unit: million bath)
	1992	1993	1994
Japan	-1,145	531	-115
U.S.A.	-705	3,745	4,593
Europe	-7,067	321	-20,734
Hong Kong	20,634	10,165	5,705
Singapore	-1,850	51,130	-2,169
World Total	11,512	67,850	-10,283
[Philippines]			(unit: $ million US dollars)
	1992	1993	1994
U.S.A.	166	502	641
Japan	1	4	46
World Total	727	1,491	3,229

Note: For Thailand, net investment is used.
For the Philippines, the gross investment is used.
Source: Bank of Thailand, *Quarterly Bulletin* (June 1995)
R. V Fabella and C. Paderanga, *The Philippines and Cross-boarder Division of Labor* (1985 - 1995)

3. Toward Stability of the Asian Currencies

(1) The Potential for Mexico-Type Currency Crisis in Asia

As noted in Chapter I, Asian currencies' fluctuations vis-a-vis the U.S. dollar have not been large since the mid-1980s. However, there are some countries that have devalued their currencies against the U.S. dollar in recent years. It is feared that Asian currencies may be exposed to speculative selling pressures as the inflow of marketable capital into Asia increases.

From the end of 1994 to the beginning of 1995, Mexico was forced to substantially devalue its currency. Having implemented monetary policies linking its peso to the U.S. dollar, the nation secured the capital needed for fostering its economic growth with a massive inflow of short-term capital from overseas. However, once the view that the foreign capital could not be used to finance the deficit in the balance of payments and the budget deficits became an accepted norm, a rapid outflow of capital ensued and the Mexican peso depreciated drastically against the U.S. dollar. Since this development, Mexico's exports have been growing because of the depreciated peso. However, the domestic economy is experiencing a sharp downturn due to the government's tight monetary policies and the high interest rates.

As pointed out by many policy makers and researchers, the possibility of a Mexico-type currency crisis occurring in Asia is minimal for the following reasons: 1) high savings rates; 2) many countries with balanced budgets; 3) clearly stated policies to stabilize currency fluctuations relative to the U.S. dollar; and 4) a steady inflow of direct investments. In January 1995, when the Mexico-type currency crisis was on the verge of appearing among the Asian currencies (Thai bath, Hong Kong dollar and Philippine peso, and so on), the Asian currencies were successful in resisting currency depreciation, and able to regain their stability in a short period of time.

A negative chain reaction, (the loss of credibility for government policies, the collapse of the foreign exchange system, rapidly expanded market risks, and a subsequent capital outflow), which caused the Mexico-type currency crisis has yet to occur in Asia.

(2) Toward the Establishment of International Cooperative Systems

The current risk of the Asian currencies being exposed to the speculative investments is not smaller than that which existed in January 1995. It is realized that the degree of dependency on external short-term capital for financing current account deficits is growing rapidly among some Asian countries. Given this background, there has been an escalation of the movement among the Asian countries to construct international cooperative schemes or mechanisms in order to avoid the occurrence of a Mexico-type currency crisis. This movement was also prompted by the recognition on the part of the countries concerned of the need to bring about an improvement in the fundamentals of the economic system.

In January 1995, when Mexico's currency crisis spread to Asia and the Asian currencies were sold in reaction, high-level central bank officials from six Asian countries and regions gathered in Hong Kong and exchanged information regarding the speculators' activity. In November of the same year, high-level officials form the central banks of the Asian and Pacific region met again in Hong Kong to ink out bilateral cooperative agreements for the purpose of deterring a Mexico-type currency crisis (Hong Kong, Thailand, Malaysia, Indonesia, and Australia). The central bank in the Philippines entered into a cooperative agreement with Hong Kong's Monetary Authority in December 1995, and then signed similar cooperative agreements with Thailand and Malaysia in January 1996. Furthermore, the Chinese People's Bank and Hong Kong's Monetary Authority signed a memorandum in Hong Kong on a cooperative agreement for the protection of their currencies in February 1996.

It is necessary to establish a currency-stabilizing mechanism in the age of global money. In addition to the types of bilateral cooperative agreements described above, it is imperative that multilateral policy adjustment mechanisms among a number of countries and regions be forged vigorously in consideration of the fact that the scale of transactions in Asia's foreign exchange markets is quickly expanding.