

**Assessing the Logic of Foreign Currency Use in  
East Asia: A Descriptive Analysis of the  
perception of the euro in South Korea**

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## 1. Introduction

“There has already been a common currency in East Asia, which is the US dollar”

This is what one official at the ECB explained, at the interview, the situation of East Asia in terms of foreign currency use. Even though this is not the official view of the ECB this statement full of latent meaning can be, to a certain extent, plausible. Governments in East Asia, despite the censure and pressure from the outside world, notably from the United States, have intervened in the market of buying dollars in order to stabilise their exchange rates against the dollar. It leads these countries to significantly accumulate their foreign exchange reserve in recent years,<sup>1</sup> although unfortunately there is no way to measure the adequacy of reserves (Kenen and Yudin 1994: 227; Gros and Thygesen 1998: 376),<sup>2</sup> for holding international reserves. According to *The Economist* (5 February 2004), Asian central banks financed over half of both America’s current-account deficit and its budget deficit in 2003 (see also, *The Observer*, 22 February 2004), and are able to cover in 2004 more than the US government’s new borrowing needs at their recent pace of intervention.<sup>3</sup> To put it bluntly, East Asian countries buy the dollar denominated assets such as Treasury bonds, and thus, give indirect subsidies via seigniorage to the United States on the amounts of dollars held in East Asia. The continuous capital flow into American Treasury bonds from Asian governments can be supplied for American buyers enough to purchase Asian goods. This supply of and demand for the dollar between the United States and East Asia would be the *fait accompli*, but a reduced reliance on the dollar denominated assets could trigger serious problems such as a sharp fall in the dollar.<sup>4</sup>

Since the Asian countries’ experience of the financial crisis, which exposed that “traditional dollar tracking exchange rate policy” (Barrell and Choy 2003: 16) is not the optimal solution, the possibility of the euro’s involvement in the monetary policies of the East Asian countries has been elevated.<sup>5</sup> This is not only because the establishment of Economic and Monetary Union (EMU) on 1 January 1999 and the introduction of the euro as a legal tender on 1 January 2002 represent, without doubt,

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<sup>1</sup> Japan’s foreign exchange reserves soared by \$43.65 billion to \$543.1 billion in May, providing further evidence that the government has sharply stepped up its already massive efforts to weaken the yen (*Financial Times*, 6 June 2003). Korea’s foreign exchange reserves also increased by \$5.3 billion to \$14.15 billion, 27% of GDP (\$ 52.50 billion) helped by continued dollar-buying by the government as it tried to curb the won’s strength to help the country’s export competitiveness (*Financial Times*, 02 February 2004). There is also speculation that Korean banks even ordered the purchase of NDF (Non-Deliverable Forward) (*Money Today* (Korean daily economic newspaper) 08 October 2003). According to Bloomberg (5 March 2004), “in the last two years, Asian central banks hoarded \$240 billion of dollar assets. Japan and China alone hold more than \$1 trillion in dollars.”

<sup>2</sup> However, there is a warning by IMF; ‘Emerging Asian economies have boosted foreign exchange reserves massively in 18 months, presenting a new menace to the global economy’ (ClariNews, 11 September 2003); ‘some slowdown in the rate of accumulation may now be desirable’ (The Business Times, 12 September 2003).

<sup>3</sup> Indeed, *The Economist* describes Asia as ‘America’s saviour’.

<sup>4</sup> Alan Greenspan says, “Asian central banks may soon reduce their extraordinary U.S. dollar purchases” in his speech on Tuesday to the Economic Club of New York (Bloomberg 5 March 2004).

<sup>5</sup> According to the report by Samsung Economic Research Institute (SERI) (2004), the financial crisis was triggered partly by the sudden withdrawal of billions of dollars in financial investments by America and other foreign investors.

one of the most significant events in the history of the European integration process. The EMU project was also expected to produce profound changes in foreign exchange and financial markets, and these are likely to affect the activities of a broad range of market participants, including private and official institutions, in the form of the standard typology of international currency use; a unit of account, a medium of exchange and a store of value. The recent trend of financial globalisation facilitated by capital mobility also adds more weight on this expectation. However, the situation even seems to be returning to the pre-crisis situation of adding more weight to the dollar (and the *de facto* dollar peg system) in spite of warnings about the volatility of the dollar exchange rate and of the possibility of another crisis attributable to over-dependence upon the dollar (Ogawa 2002: 92). This is especially the case because recent research on the East Asian region calls for the need to modify the US economy- and dollar-oriented economic structure.<sup>6</sup> These current situations on foreign currency use in East Asia deviate from the expectation that the euro would have its impact on East Asia and would challenge the dollar dominance in East Asia. Therefore, this paper will examine the logic of foreign currency use in South Korea, especially focusing on the perception of the euro in South Korea.

This paper proceeds first by exploring the reasons of dollar preference in East Asia based on empirical findings. The generated findings clarify the ideological consensus on dollar preference, structural conditions and policy directions which can delineate politics of foreign currency use in East Asia. It then analyses the perception of the euro in South Korea. In this section, although the euro has been regarded as an international currency after the US dollar, in particular at the ECB level, the different perception of the euro in South Korea as a regional currency is verified on the basis of empirical research, the secondary literature and official documentation. This paper concludes by attempting to draw out the possibility of the euro to become an international currency in East Asia.

## **2. Reasons for the marginal impact of the euro on East Asia**

### **2.1. Preference formation of foreign currency use in East Asia**

The methods to be used in this project will involve the analysis of the secondary literature, official documentation, journalistic sources, with the use of confirmatory semi-structured interviews to supplement these written sources. The central purpose for conducting the interview is that the reasons for the marginal impact of the euro cannot be obtained by analysing statistical data and on the basis of the existing

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<sup>6</sup> Taking the case of South Korea, some fears about Korea's over-dependence on the US economy have been fostered, mainly by academics, relating to current poor performance of the US economy. Professor Josua Iseman (University of California, Santa Cruise) asserts that Korea should vary her exporting countries more towards Europe, because the weakness of the US dollar is not likely to increase imports from Korea (*Dong-A Ilbo*, 23 July 2002, A10 (Korean daily newspaper)). The Seoul stock market, for example, plunged 4.47 % on July 23, 2002, following the steep decline in the US stock market compared with other Asian markets such as Japan -0.13 %, Singapore -1.54%, Taiwan -2.29 % (*Joong-Ang Ilbo*, 23 July 2002, p.5 (Korean daily newspaper)). In addition, corporate scandals and the Bush administration's *go-it-alone decisions* have contributed to making Japan and South Korea, the staunchest U.S. allies in Asia, increasingly uneasy about following American leadership either politically or economically (*International Herald Tribune*, 23 July 2002, p.1, 5).

literature alone, and the required information especially concerning foreign currency use is limited to only a select group of people.<sup>7</sup>

The empirical focus of this research is South Korea chosen as an example of an East Asian country.<sup>8</sup> The reason for selecting South Korea as a case is that South Korea meets more requirements for this research than any other country in East Asia: (1) indispensability of the economic structure reform of over-dependence upon the dollar after in the pivot of the Asian financial crisis in 1997; (2) officially adopting a free exchange regime in 16 December 1997, but in practice, adhering to the dollar oriented exchange regime – *de facto* dollar peg system; (3) an awareness of the importance of the euro as an alternative to the dollar and movement toward the regional cooperation on exchange rates; (4) a well-diversified trade relationship with the EU and the United States;<sup>9</sup> and (5) high sensitivity to exchange rate fluctuation due to its economic structure which is heavily dependent upon imported goods and the export performance.<sup>10</sup>

The generated findings from empirical research substantiate that actors in public and private sectors have common ground for their preferences for the US dollar in every dimensional activity. Private and public sectors' preferences for the dollar can be conceptualised as follows. First, an underlying principle of their economic performance and structure is to follow and maintain the rules and institutions of an American led 'liberal (world) economy' (Gilpin 2001: 99; Walter 1993: 150). For this, a free floating exchange rate regime has been adopted, and the market is placed at the centre as the exclusive decision maker regarding foreign currency use. Second, all interviewees involved in every activity assert the importance of the euro as an alternative international currency to the US dollar, mainly because all acknowledge the risk of excessive leaning on the dollar in case of severe fluctuation of the dollar exchange rate.<sup>11</sup> However, the antagonistic evaluation on the dollar and the euro

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<sup>7</sup> The majority of interviewees have been officials in governmental bodies (e.g. Ministry of Finance and Economy) and government-run banks (e.g. Bank of Korea), bankers and investors in foreign and domestic banks, persons dealing with foreign exchange in corporations, researchers and academics in government-run and private research institutes and journalists.

<sup>8</sup> East Asian countries indicate China, Hong Kong SAR, Macao SAR, Japan, South Korea, North Korea, Mongolia and Taiwan according to the European Commission – the Commission names this region 'North-East Asia' different from 'South-East Asia' including Brunei Darussalam, Burma / Myanmar, Cambodia, Indonesia, Laos, Malaysia, Philippines, Singapore, Thailand, Vietnam and East Timor. In this paper, East Asia indicates countries in 'North East Asia'. In addition, 10 countries in South-East Asia except East Timor established 'The Association of South East Asian Nations (ASEAN)' and have had a special relationship with the EU, so-called, 'EU-ASEAN Partnership'. See, for more details, [http://europa.eu.int/comm/external\\_relations/asia/reg/index.htm](http://europa.eu.int/comm/external_relations/asia/reg/index.htm).

<sup>9</sup> Hence, it is not the case that lopsided trade with the United States causes over-dependence upon the dollar.

<sup>10</sup> In general, large economies such as China and Japan are less vulnerable to external shocks than small ones (Bergsten 1999). In addition, Chinese Yuan including Hong Kong dollar is fixed to the US Dollar, with periodical adjustment according to fluctuations in the US dollar. The main reason for not selecting Japan as the case study is that Japan has a different reaction to the impact of the euro; that is, the introduction of the euro has encouraged Japan to increase the international role of the yen as a leading power in the Asian region. Other countries' economies are relatively less developed to measure the overall impacts of the euro on East Asia. My fluency in Korean as a mother tongue and my cultural background as a Korean are also important factors for conducting field work.

<sup>11</sup> One official at the Bank of Korea in Frankfurt even takes an example of the 1985 'Plaza Accord', which resulted in a 30% decline in the dollar over the next two years. It does not mean that another 'Plaza Accord' would happen or be expected; but he emphasises that over-dependence on the dollar is

derives from interviews, which suggests that private and public actors still have emphatic confidence in the value of the US dollar but have an incredulous view on prospects for the euro. Third, in addition to the second result, the dollar is deemed to be the single leading international currency, but on the other hand, the euro does not shake circumscribed reputation off as an European regional currency. Finally, the long standing conventional mores of dollar supremacy in business and bureaucratic society are retained regardless of the birth of a new international currency, the euro and the vulnerability of the dollar exchange rate.

## 2.2. Dollar preference, but euro reluctance

The dollar preference and disinclination to use the euro can be conceptualised along a recognisable inertia in the current management approach towards the US dollar; it would be characterised respectively as the *bureaucratic inertia* of the dollar in public sectors and the *bureaucratic fondness* for the dollar in private sectors. The *bureaucratic inertia* in public sectors is based on two factors; first, with regard to the foreign exchange reserve, relevant authorities cannot help being tenacious of a conventional way of holding dollars,<sup>12</sup> because managing the dollar account in the foreign reserve has been the major task for decades, which has accumulated experiences and information on the dollar and its management; and second, another crucial reason for dollar holding results from the belief that the dollar is the only one dominant currency in the world. Despite relatively high fluctuation of the dollar exchange rate, all in the public sector including private actors who seek maximum profits affirm that investing, holding and managing the dominant currency, the dollar is the only way to reduce the risk. This inertia is based on the immutable confidence in the dollar as the soundest asset which could give more profits than any other.

Some other factors capture the *bureaucratic fondness* for the dollar in private sectors. Although the principle of market decision in a market driven economy has been already built up, the institutional design of the foreign exchange market has privileged the US dollar over all other currencies. First of all, there is no direct euro – won market, but only the dollar – won market exists.<sup>13</sup> This structure exactly shows the dollar's role as a vehicle currency. Therefore, all other currencies but the dollar

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undesirable due to the unexpected fluctuation of the dollar exchange rate. This dollar dependence can be also shown in the Korean stock market as a consequence of exuberance of capital inflows. According to Yonhap News (27 January 2004), the value of foreign holdings of shares on Korea's main bourse exceeded \$135.7 billion, or 42.07% of Korea Stock Exchange's total market value. However, this dependence on capital inflows is recognised as a position of one converged currency, the US dollar of inflow investments. This inflow situation could be reversed depending on the market and economic situation, but the interviewees conjecture that the dollar will flow out at a stroke. The new report by Samsung Economic Research Institute (SERI) reveals that American investors held 47% of the \$59.2 billion in equity investments in the Korean stock market between 1992 and 2003.

<sup>12</sup> One major difficulty of shifting into the euro or other currency is raised from private and other (academic and journalistic) sectors, which is 'who is going to be responsible for this conversion? No one can be'. If someone's suggestion of converting into and holding the euro is accepted, but the euro is depreciated, what would happen to the person in charge? There is no other way but being reprimanded. However, the person cannot be in charge of the wealth of the nation, foreign reserves.

<sup>13</sup> The 'won' is the name of Korean currency. Although the yen – won market has been formed since 1980s, there is, in practice, no direct yen – won market any more (or just nominal market exists) due to less demand for the yen.

should be converted via the dollar into other currencies.<sup>14</sup> According to the interviewees in private sectors, the primary cause for no direct market between the euro and the won can be explained by less demand for the euro, and thus no need for it. It seems to certainly underpin what liberalists argue that foreign currency decision in a society dedicated to freedom is relying primarily on the market (Friedman 2002: 4). Furthermore, as Friedman (2002: 23) asserts the minimum role of government, frequent intervention of government in the foreign exchange market to prevent the won from appreciating against the dollar stipulates its principal task to protect the individual and the nation from external threat.

Although the market structure and mechanism shows the pursuit of liberal economy based on the market, the generated findings also tell us what could be the motive behind this market oriented mechanism; in short, preference on the dollar is based on full confidence on the US dollar itself. Actors in private sectors strongly assure the dollar's turning back to its value,<sup>15</sup> because they have seen the dominant role of the dollar despite of its regular rise and fall.<sup>16</sup> There are some plausible reasons for the preference on the dollar interviewees mostly agreed with; (1) despite having accepted over-dependence upon the dollar at the time of the financial crisis and still now, it was not and cannot be a cause of the financial crisis; (2) the European financial market still has structural inadequacy compared with the American market such as higher incidental and supply costs, low liquidity, small-scale and less-variety of euro denominated bonds, lack of information on the European market and belief in the euro and the EU as an unreliable and vulnerable currency and economy;<sup>17</sup> (3) the economic structure of Korea requires the dollar, because major trading partners such as China, Japan and South East Asian countries mostly use the dollar as a payment currency.<sup>18</sup> However, most of the interviewees erroneously believe that lopsided trade with the United States is the crucial reason for disproportionate use of the dollar.

From the business viewpoint, manufacturing companies are likely to stick to the conservative manner of dollar preference, because an exchange speculation is not their way of making profits. Although some of interviewees in companies accept that European companies formidably requisition the euro as a payment currency, geographical distribution of the euro usage in trade can be circumscribed in the

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<sup>14</sup> These double transactions, according to interviewees in private sectors, possibly expose private companies to exchange risk in the financial market.

<sup>15</sup> At the time when I conducted the interviews mostly, the dollar had been depreciated against all other major currencies. The *Financial Times* (26 September 2003) reports that the US dollar fell to near 3-year lows against the yen and 12-month lows against the Korean won and the Taiwan dollar. However, there are also some positive prospects for the dollar; for example, *International Herald Tribune* on 3 March 2004 analyses that the dollar may have turned the corner, quoting the chief currency economist at Morgan Stanley, "We've reached an important inflection point in this dollar correction."

<sup>16</sup> See, *The Observer* (22 February 2004), which shows the graph of dollar exchange rate movement from 1947. Having treated the euro as a regional currency which wants to become an international currency, the euro, private actors believe, cannot even enter into rivalry with the dollar. Only the possible case would result from self-destruction of the dollar.

<sup>17</sup> One currency analyst in European investment bank in South Korea suggests a good example. "There is no difference between AAA rating American bank and AA rating European bank or between B rating European junk bond and F rating American junk bond. The most important factor is the attractiveness which can appeal to customers."

<sup>18</sup> This is because the Chinese Yuan pegs to the dollar, and imported raw materials from South East Asian countries are priced in dollars. Moreover, using the dollar in trade with Japan becomes increased.

eurozone, Northern and Western African countries and CEECs.<sup>19</sup> In all other areas except several countries such as Canada and Australia, the dollar as a payment currency holds an unchallenged position. The finding which supports the dominant role of the dollar most clearly is that all interviewed companies readily prefer the dollar to any other currency and manage the dollar account, swiftly changing most euros they receive into the dollar.<sup>20</sup> This is because all market participants believe that the US dollar can provide much more liquidity, flexibility, safety, profitability and options in financial markets to cope with any potential problems than the euro or any other currency.

The psychological factors by reason of dollar dominance in East Asia should be also stressed. Given that the US economy and dollar still exercise an overwhelming influence over other economy and currency in terms of object-economy, psychological reverence for the political and economic power of the United States could materialise in an actual hegemonic role of the dollar. Besides, the experience of the financial crisis has increased this obsession with confidence in the dollar as a sound asset. This assertion is based on two facts; first in practice, one of causes for the financial crisis was the overly short-term oriented external debt structure and insufficient foreign reserves;<sup>21</sup> and second psychologically, the dollar is taken for granted as the only currency for foreign reserves. Political involvement of the United States in relation to security could also psychologically affect dollar supremacy.<sup>22</sup>

These empirical findings about the reasons for the marginal impact of the euro on East Asia can be brought to a conclusion of manifest dollar preference both in private and public sectors. The generated findings, however, also explore other factor, which not only helps this dollar preference to be more reinforced but also makes the East Asian market participants disinclined to use the euro; namely, the reason of dollar preference for the marginal impact of the euro is capable of describing parts, but not

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<sup>19</sup> The empirical findings also show that, in accordance with the importer's request, export to the eurozone countries is mostly settled in euros, but trade with the UK, Sweden, Switzerland and Norway still use each country's currency. Both the dollar and the euro are used in trade with Central and Eastern European countries (CEECs), but in most cases, the dollar is preferred.

<sup>20</sup> However, companies' regional branches in the EU gradually increased their holdings of the euro. For example, Daewoo Electronics holds euro accounts, accounting for about 30% of all accounts, which equates to the proportion of trade with the EU (about 30%).

<sup>21</sup> [http://www.asianinfo.org/asianinfo/korea/eco/economic\\_crisis\\_of\\_1997.htm](http://www.asianinfo.org/asianinfo/korea/eco/economic_crisis_of_1997.htm) Since the financial crisis, emerging markets need to reduce short-term external debt and to increase foreign exchange reserves in order to lower their vulnerability to crisis by having their own ammunition to defend their currencies in a crisis (Aizenman and Marion 2002a; 2003). However, a debate has been raised over how much foreign exchange reserves should be optimal holdings. This debate is mainly due to the dramatic accumulation in East Asian countries such as South Korea and Taiwan in the aftermath of the Asian financial crisis. In April 2003, Taiwan and South Korea's reserve holdings (excluding gold) were \$ 1,706.4 million and \$ 1,1235.5 million respectively, which remarkably surged from \$ 835 million and \$ 203.7 million at the end of 1997.

<sup>22</sup> A recent survey of public opinion in South Korea shows that 61.4% vote for stationing of US troops in Korea (*Hankook Ilbo*, 22 February 2004). Dr. Kim in Sejong Institute says in the interview, "The resolution of the security matter in Korea, generally in East Asia, can change the perception of the euro in this region." He also argues that countries acknowledge a special US behaviour, which is that the punishment will be given if the US political and economic loyalty is disregarded. Also in a New Year's address, President of Korea emphasised the importance of South Korea – United States relationship. "Strong ties between Seoul and Washington are essential to our security and economy and the stability of Northeast Asia." (*The New York Times*, 15 January 2004).

all of reasons. This is because every market participants has realised, after the financial crisis and the inception of the euro, the following three facts intimately associated with the euro: (1) the risk of the over-dependence upon the dollar; (2) the importance of the euro as an alternative currency in order to reduce the risk (1); and (3) the possibility of the euro and the EU to become a major superpower and challenger to the United States. In a nutshell, actors in East Asia are fully aware of the importance of the euro-involved activity on the one hand. On the other hand, the image of the euro these actors virtually face, notwithstanding its anticipated either important or crucial role in East Asia, seems to be different from what the EU believes the euro is now and what the EU level wants the euro to be. This different perception of the euro in East Asia holds an important portion in constituting 'preference for the dollar' and 'reluctance to the euro'. Hence, the next section analyses the different perception of the euro at the level between the ECB and East Asia, which also provides the reasons for the marginal impact concerning the euro itself.

### **3. Images of the euro in South Korea: Debate on International currency Vs Regional currency**

There is neither doubt nor hesitation for officials at the ECB to claim and even to brag of the success of the euro as an international currency. Top ECB officials such as Mr. Padoa-Schioppa, member of the Executive Board and Mr. Pineau, Deputy Director General at the department of the international and European relations determinedly emphasise, "the euro is an international currency" in response to the interview question. Many public speeches delivered by former and present officials at the ECB as well as the official documentation by various EU institutions also have accentuated the euro's international role, to some extent, admitting problems and obstacles to remain and to be solved. However, this perception of the euro as an international currency at the ECB level is directly opposed to that in East Asia. The empirical findings suggest that this different perception in East Asia regarding the international role of the euro would come from the way of defining the 'international' currency, which needs to reflect, from East Asian actors' points of view, the extent of euro-involved activity in the East Asian market.

#### **3.1. International currency at the ECB**

The conventional interpretation of the international and regional currency runs as follows: They can be bound together by common types of cross-border activity, what Cohen (1998) names, 'the deterritorialisation of money'. Due to the ambiguity of the term, 'regional', little help in defining 'region(al)' can be extracted from *Oxford dictionary*. It defines 'region' as 'a large area with definite boundaries', which exactly indicates the euro's restricted role in East Asia. Applying Cohen's two ways of cross-border use of money, 'currency internationalisation (CI)' and 'currency substitution (CS)',<sup>23</sup> the euro as an international currency can embrace the definition of CI in terms of the standard typology of international currency use, as the euro serves as a unit of account, as a medium of exchange and as a store of value in private and public

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<sup>23</sup>According to Cohen (1998: 2, 115), CI and CS means that a currency can be employed outside its country for transactions either between nations (CI) or within foreign states (CS).

sectors.<sup>24</sup> But, substitution of the euro in East Asia as a vehicle currency for saving, borrowing or investment or as a reserve currency for portfolio diversification is a different story.<sup>25</sup> According to ‘Triennial Central Bank Survey’ by BIS (2002), the most traded currency pair, which accounts for 30% of global turnover in 2001, is the euro-dollar, followed by the dollar-yen (20%). However, direct bilateral transactions between the yen and the euro only accounts for 3%, virtually no different from the currency pairs between the Deutsch mark and the yen (2%) in 1998. In addition, the share of the euro as a vehicle currency of Korean trade in 2002 accounts for 6%, compared with that of the US dollar, 86.6%.<sup>26</sup> However, the share of Korean trade with Europe accounts for 16.6% and 14.3% in exports and imports respectively, compared with 20.2% and 15.1% with the United States in 2002 (KITA 2003). As such, the euro seems to have played the role as an international currency alongside of the dollar in the international arena, but the marginal role of the euro in East Asia is anything but natural.

Nevertheless, the majority of speeches by top officials at the ECB such as Mr. Christian Noyer, the former Vice-President of the ECB in 2000 and 2001, and Mr. Eugenio Domingo Solans, Member of the Governing Council and of the Executive Board of the ECB in 2003 has focused on the growth of the euro’s international role as a financing and an investment currency. Recently, Mr. Jean-Claude Trichet, President of the ECB in his speech boasts of visibly increasing share of the euro-denominated bonds and (debt) securities.<sup>27</sup> As the *Financial Times* (20 June 2004) reports an anecdote of Bill Gross,<sup>28</sup> money has been shifted outside the US bond markets mainly to the euro land and the UK, though due to the fear of inflation in the US, which are less of a reflator than the US (see also, CNN Money 12 December 2003). But, one noteworthy feature of this euro’s international financial activity mainly in private sectors is the spatial limitation, which appears in Mr. Trichet’s speech, “In using the euro as an issuance currency, [...] mainly from mature economies, most notably the United States and the United Kingdom, [...]” Mr. Solans (2003) even brings numerical data of the euro’s international role to the public that “A very high proportion (of financial market activity in euro outside the euro area) is performed in the City of London. [...] 50% of foreign exchange transactions and 70% of loans.” This would be the reason for him to characterise the international role of

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<sup>24</sup> See, for more details on these three classical money functions, Krugman (1992), Hartmann (1998), ECB (2001), COM (2002) 332 and Mishkin (2003).

<sup>25</sup> In other cases such as investing in foreign stock markets, Brooks and Negro (2002) argues that unlike other regions, only within Europe has there been a significant decline in segmentation across national stock markets since the mid 1980s. Therefore, portfolio managers may be able to achieve much of the benefit from cross-country diversification by simply holding three diversified portfolio for the Americas, Asia and Europe rather than diversifying across dozens of countries due to much lower transaction cost.

<sup>26</sup> The data is collected from Korean national statistical office (KNSO) (<http://www.nso.go.kr>). The Deutsche mark still remains in the category in 2002, but it is assumed that the mark is used instead of the euro.

<sup>27</sup> The speech was delivered at the ‘Schierensee Gespräche’ in 14 May 2004. Mr. Trichet takes an example of the share of the euro in the stock of international bonds, which increases from 20% in 1999 to 30% in 2003 (See also, Mr. Solans (2003)).

<sup>28</sup> Bill Gross, Director of PIMCO, has been often referred to as ‘the bond king’, ‘the bond guru’ or ‘the Warren Buffet of the bond world’. Mr. Gross says at the interview with the *Financial Times* that the maximum (of the bonds) in terms of what clients will allow has been taken into the outside the US bond markets, because inflation is the enemy of the bond.

the euro as *regional*. However, this limited role of the euro within a limited region falls under the category of the international currency at the ECB level. In the same vein, Frankel (2000) illuminates the euro's status in the international financial market; "While the frenetic activity (of the euro-denominated bonds) seems to be related to the debut of the euro, it does not meet the definition of international currency use, because it is taking place inside the currency's home region."

**Table 1. Countries with exchange rate regimes linked to the euro (31 December 2001)<sup>1</sup>**

Regions	Exchange rate regimes	Countries
European Union	ERM II	Denmark
	<i>Pro memoria:</i> Independent floating	Sweden, United Kingdom
Accession countries	Euro-based currency boards	Bulgaria, Estonia, Lithuania
	Unilateral shadowing of ERM II	Cyprus, Hungary
	Peg arrangements based on a basket involving the euro	Latvia (SDR) Malta (euro share: 70%)
	Managed floating with the euro as reference currency	Romania, Slovak Republic, Slovenia
	<i>Pro memoria:</i> Independent floating	Czech Republic, Poland, Turkey
Western Balkans	Unilateral euroisation	Kosovo, Montenegro
	Euro-based currency boards	Bosnia and Herzegovina
	Managed floating with the euro as reference currency	Croatia, FYR Macedonia, FR Yugoslavia
Other regions	Euroisation	European microstates (Republic of San Marino, Vatican City, Principality of Monaco, Andorra) French territorial communities (Saint-Pierre-et-Miquelon, Mayotte)
	Peg arrangements based on the euro	14 African countries of CFA Franc Zone, 4 countries of French overseas territories, Cape Verde, Comoros
	Managed floating with the euro as reference currency	Tunisia
	Peg arrangements based on the SDR and other currency baskets involving the euro (share of the euro)	Israel (21.8%), Seychelles (31.2%), Botswana, Kuwait, Morocco, Vanuatu, Jordan, Libyan Arab Jamahiriya, Qatar, Saudi Arabia, United Arab Emirates <sup>2</sup>

<sup>1</sup> There are several changes according to the change of countries exchange rate regimes between 2001 and 2002. This table is mostly based on data in 2002. For example, Bangladesh and Iceland were in the list of 'pegging to other currency baskets including the euro' in 2001.

<sup>2</sup> Oil-producing countries which formally peg to SDR (Qatar, Saudi Arabia and the United Arab Emirates) peg their currency *de facto* to the US dollar.

Source: ECB (2001, 2002) *Review of the international role of the euro*. IMF Annual Report 2002.

Another achievement which has been trumpeted at the ECB with regard to the international role of the euro as an anchor or reference currency is captured in public sectors. At the end of 1999, more than 50 countries, mainly in central and Eastern Europe and in Africa were using the euro as a reference currency for their exchange rate regime, either in isolation or as part of a reference currency basket (European Commission 2001: 23; 2002:41). *De jure* and *de facto* 54 countries outside the euro

area involve the euro in their exchange regime (ECB 2001, 2002; IMF 2002).<sup>29</sup> Table 1 describes that the use of the euro in third countries' exchange rate regimes has a strong geographical and institutional underpinning, with many of these countries being close to the euro area and having special institutional arrangements with the EU. Therefore, geographical adjacency and close trade and financial links with the euro area remain the main factor behind the choice of the euro as a reference for exchange rate policy. In addition, most of the countries are small economies and their combined GDP amounts to less than 4% of world GDP, or 16% of euro area GDP. This strong regional focus<sup>30</sup> of the euro would be possibly related to the official policy of the ECB, 'the choice of unilaterally anchoring a currency to the euro does not involve any commitment on the part of the ECB' (ECB 2001: 20; ECB 2002: 45). As all top officials at the ECB admit, the international use of the euro as a vehicle currency, as a pricing and quotation currency or as a reserve currency has remained limited, compared with the US dollar.<sup>31</sup>

In short, the euro has been internationally used as a medium of exchange for foreign trade, as a unit of account for commercial invoicing and as store of value for international investments at the private level in terms of CI, though specific gravity of the euro in circulation in East Asia is small; at the public level, the euro as a reserve and intervention currency and as a peg for exchange rates (Cohen 1998: 93) has been mostly used in neighbouring countries and regions. In a more strict term, the euro can be rhetorically described with the term, 'regional' instead of 'international', because its brisk circulation is distinctively limited in peripheral region. One interviewee at the Bank of Korea argues, "No one can claim the Korean won is an international currency, even if it could be used in trade with Japan or China, or foreigners purchase the Korean currency denominated assets for the purpose of investment. This is the limitation for the Korean currency which cannot become an international currency though the government wants." In terms of CS, the euro's substitution for domestic currency such as 'euroisation' has not been the case in East Asia, but the authoritative domain of the domestic currency remains even with close adherence to the US dollar. As Cohen (1998: 94) describes, though capital liberalisation<sup>32</sup> technically facilitates CS, the dollar preference in East Asia is unreciprocated and even difficult to reverse.

All interviewed officials at the ECB express their positive prospects with regard to the euro's role in East Asia. Although the ECB has neither any strategy nor commitment for internationalising the euro, the ECB believes that there have been changes in the market, in a way of being involved in the euro such as consideration by Russia to denominate oil in the euro. It is not the policy of the ECB, however, to take an active hand in this kind of matter, but to preserve its neutral standpoint; that is, any monetary

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<sup>29</sup> Solutions adopted range from very strict – or even full – links to the euro (e.g. formal entitlement to use the euro as legal tender, euroisation and currency boards) to looser forms of anchoring (e.g. peg arrangements, crawling fluctuation bands and managed floating) (ECB 2001: 20).

<sup>30</sup> According to Gomel (2001: 5), currency pegs or anchors are to a predominant degree 'regional' in character.

<sup>31</sup> According to the *Financial Times* (27 May 2004), Ms de Palacia, EU energy and transport Commissioner, in a meeting for the possible oil crisis, expresses her passion for pricing oil to be based on a basket of currencies which includes the euro, instead of the dollar alone.

<sup>32</sup> For the argument of 'capital mobility', see, *inter alia*, Frieden (1991), McKenzie and Lee (1991), Andrews (1994), Helleiner (2000) and Pauly (2000).

change associated with the euro wholly depends upon the national authority. One top official stresses the ECB's neutral position and explains the role of the ECB:

“If any government in East Asia reviews and modifies its monetary and fiscal policy considering the euro, of course, we would like to know and to be informed. This is only because the ECB wants to be in a position, *ex ante*, to assess and figure out possible implications, which is what the ECB is only interested in.”

In addition, the ECB assures that the euro will become more internationally attractive in maintaining the ECB's main objective of price stability, which is designated by the Maastricht Treaty mandate to keep a low inflation, not exceeding more than 2%, for the eurozone (see Table 2, p.18). However, there is an opposite argument from market participants in East Asia that the euro area is more likely to gear its economic policies to domestic rather than external objectives (Gomel 2001: 11). This stability bias of the euro area is often criticised to possibly impede the economic growth of the euro area (Depler 2004: 11).

Obviously, the role of the euro as an international currency has been gradually increased, which allows top officials at the ECB to travel abroad and deliver speeches about its successful growth and position as the second international currency after the dollar. However, market participants in private and public sectors consider the euro from an utterly different standpoint, at least in East Asia, that the euro is still far behind to become an international currency as such before overcoming its geographically and, more importantly, practically limited role as a regional currency. This is why all interviewees in East Asia incredulously ask back that the euro is an international currency.

### **3.2. Regional currency in East Asia**

The perception of the euro common to all sectors is that the euro is still a regional currency from the view of East Asia, although the euro is recognised as an alternative currency to the dollar. This antithetic concept on the euro also indicates ambivalent opinions: every sector admits that the euro is the second most used currency in the world after the US dollar in a numerical term; but, this nominal order, the *second* currency does not spontaneously mean such an international currency as the dollar. Cognisance of the euro as a regional currency in East Asia means that the euro will be used only in the euro-involved activity such as trade with the eurozone. As Kirshner (1995: 23) argues, “there are no small specialists” in terms of monetary power,<sup>33</sup> a regional currency, the euro and an international currency, the dollar in East Asia should have big difference in use. This main perception of the euro in East Asia comes from the fact that the euro is not necessary as much as East Asian countries need and want the dollar; that is, the euro is not able to encroach upon the dollar's territory in East Asia. It is the phenomenon that, on the contrary to the ECB's affirmation of the euro's international role, the dollar is still used in every means of financial activity in public and private sectors in East Asia, while the introduction of the euro has not exceeded the sphere and capacity of the role of its legacy currencies,

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<sup>33</sup> According to Kirshner, small, rich states such as Sweden can pursue their interest in the areas of international trade and aid, but only very large states can be agents of monetary power. “This is because money is naturally hierarchical.”

notably the Deutsche mark. As one interviewee at the foreign exchange and trade finance team in Daewoo Electronics Co. explains, “The only favourable change after the euro is that we do not need to receive small amount of franc, mark, lira or peseta. But, there is nothing different in that the euro is only used instead of 12 different currencies in trade with the euro area. Hence, we do not need to be exposed to exchange risk twelve times, but only once after the euro during exchanging these currencies into the dollar.” Then, why is the euro a mere regional currency for actors in East Asian markets?

Most interviewees find its reason in the market of less demand for the euro in a market driven economy than for the dollar, as liberals argue. However, this research discovers what driving forces are, which makes the market demand the dollar. First, the economic structure based on imported raw materials and exporting performance inevitably requires the dollar. This is because raw materials such as oil are priced in dollars, and major trading partners such as china, Japan and South East Asian countries mostly use the dollar as a payment currency.<sup>34</sup> Products with dollar-pricing are more easily and conveniently compared with other products (regarding the price) and traded, according to interviewees, in the international market. They assure that, “Even if we want to price our products in the euro, we cannot simply do that. This is because all products except us should be in dollars, which certainly give us disadvantages and extra costs.” Namely, the US dollar has been used as a vehicle, pricing and quotation currency in the global market. But, the remaining question is that the euro has not been completely involved even in trade with the euro zone.

Private actors clearly prefer the dollar in every occasion, because managing one currency, the dollar, is much safer in the aspect of reducing exchange exposure and avoiding double transactions with currencies other than the dollar. This explains the motives for the government to concentrate on dollar exchange rate, intervening in the market to buy dollars for the purpose to protect the decline of the dollar against the won for the competitiveness of export. In retrospect of Kindleberger’s argument (1970: 204) that a country’s exchange rate is “more than a number” and “an emblem of its importance in the world”, the official exchange rate system could not be in accord with the system of free floating exchange rate, but would be with the system of ‘high-frequency of dollar pegging’ (McKinnon and Schnabl 2003), ‘the East Asian dollar standard’ (McKinnon 2004) or ‘a sort of floating Bretton Woods’.<sup>35</sup> Whilst some generated factors from empirical research are able to explain the reasons for dollar preference in foreign currency use, many different factors do seem to affect the marginal impact of the euro. All these other factors than dollar preference originate from the perception of the regional euro in East Asia. Furthermore, market participants in East Asia find the reasons for this perception in the problems of the euro itself, which also make them unwilling to use the euro.

Under the circumstance that “prohibitive restrictions have been imposed on the free

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<sup>34</sup> Because the Chinese Yuan pegs to the dollar, there is not exchange rate risk to use the dollar in trade with China. Moreover, using the dollar in trade with Japan becomes increased. In case of South East Asian countries, the dependence on the dollar with regard to the invoicing currency was 95% in Malaysia, 91% in Thailand (0.8% of the yen), 96% in Indonesia (1.4% of yen) and more than 90% in Philippines.

<sup>35</sup> This term is used by Harold James in the article of *the Korea Herald* (17 January 2004).

circulation of foreign currencies” (Cohen 2004: 6), ‘public-receivability’<sup>36</sup> of the euro is the salient and decisive factor, which discerns typical appetite for the euro in East Asia. In response to the question, ‘what are the reasons to avoid using the euro?’, all interviewees point out the problems concerning the euro; the euro zone; and the EU respectively. Whilst interest in the euro has increased after its inception as a legal tender and particularly after its appreciation against the dollar, this interest seems to be only a consequence of its unique place in international monetary history, not as a watershed event which could affect the traditional tenacity of dollar centred exchange rate policy. In addition, as most interviewees agree, the market remains sceptical about the euro’s strength against the dollar. This is because market participants believe that the euro’s strength in the market is not based on the better economic condition of the EU, but based on anxiety about the US economy. Thus, market participants are reluctant to convert into and hold the euro in their portfolios, because of their fears that the euro might be depreciated at any time. A fixed, very negative image of the euro and the EU’s economy has not deprived the attractiveness of the dollar and the US economy in that a superior growth performance in the United States covers up such apprehension of the US economy as the US current account deficit.

One recent example is brought from the overseas investment of ‘National Pension Corporation (NPC)’ in South Korea. The NPC, which is a governmental body and independently manages its own investment fund, ‘National Pension Fund (NPF)’ about 119,619 billion won (more than \$102 billion)<sup>37</sup> invested its fund, for the first time, in the US treasury bonds in 5-year maturity. There has been a speculation that the government, Ministry of Finance and Economy, secures the Korean won to intervene the foreign exchange market for buying dollars.<sup>38</sup> Two interviewees in the NPC, a strategist at investment strategy team and a manager at risk management team explain the reason for buying the US treasury bonds, clearly denying this speculation: “The NCP invested in the US Treasury bond, because stability should take precedence over proceeds under our position that we are not a profit-making institution with money from our people. It does not mean that the NCP always invest in dollar denominated assets, but other currencies including the euro can be also considered. But, the Treasury bond issued by the US government should be, we believe, so far the most stable, reliable and the safest of all money market instruments.”<sup>39</sup> Although anxiety and a gloomy view on the US economy, in particular regarding the US twin deficits, has been raised to the public as a serious issue, the US financial market and its instruments are still believed as a safe heaven. This is one of the reasons, according to interviewees, that market participants in East Asia prefer the US Treasury bills issued by the US government to diversified European bonds such as German Bund or

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<sup>36</sup> The term, ‘public-receivability’ is also quoted in the book, ‘*The Future of Money*’ by Cohen (2004).

<sup>37</sup> This figure is based at the end of June in 2003. The exchange rate between the dollar and the Korean won is based on 4 June 2004, which is \$1=₩1,164.8. Almost 80% of NPF was invested in the financial sector in 2003. See, <http://www.npc.or.kr/eng/enpsk.html?code=/.enpsk/a04.html>

<sup>38</sup> This speculation has been brought due to the contract of the won-dollar swap between Ministry of Finance and Economy and the NPC; that is, the NPC purchased dollar-spots, which amounts to ₩ 600 billion (\$ 500 million), and then bought the Treasury bonds. According to the NCP, the US Treasury bond is normally purchased with the US dollar, so the NCP only use the dollar the government retains. See, *Chosun Ilbo* (16 April 2004), *Money Today* (17 April 2004) and *ChoonAng Ilbo* (20 April 2004).

<sup>39</sup> See also, Mishkin (2003: 25-6). He says that the US Treasury bills have almost no possibility of default.

French OATs and BTANs.<sup>40</sup> Notwithstanding substantial strengthening – deepening and widening of the European government bond markets by the adoption of the euro, Federal Reserve Board Governor, Ben Bernanke (2004) appraises problems of the European government bond markets in two points; first, the European bond markets has not attained (“may never do so”) the liquidity of the US Treasury market; second, despite improving the quantitative magnitude of aggregate issuance of the euro zone government debt, its fundamental difference from the debt issued only by the US Treasury is “the debt of twelve sovereign entities”.<sup>41</sup> The ECB, however, acknowledges this matter of less credibility of each member state’s bond regardless of being issued by one currency, and one top official at the ECB clarifies, at the interview, a new scheme of bond-issuance that the Eurosystem should be in a position to provide standardised foreign exchange reserve management services to non EU central banks and institutions as from January 2005.<sup>42</sup> But, he also admits that governments are reluctant to issue uniform bonds in the euro area and still want to have national responsibility to issue the bond. In a broader aspect, bringing about a single – unified, liberalized and efficient – European financial market set out in its Financial Services Action Plan (FSAP) was one of the objectives for European heads of governments at the Lisbon Summit. However, as Sir Howard Davies (2004) diagnoses, “Europe remains a long way from having a single financial market” irrespective of many of Lisbon Agendas having been put into practice. His conclusive argument, which is generally consistent with findings at the interview, is that what the EU needs to more focus on is not new legislation, but practical implementation due to barriers imposed for protection of their financial markets in some member states. The financial market integration from nation-based segmentation, which provides “different channel of risk sharing” (De Grauwe 2000: 220) should be an important factor which boosts the internationalisation of the euro.

The market participants in the private sector provide more detailed reasons for their reluctance to the euro. Even if the euro provides a more convenient way for managing foreign exchange in the place of the 12 former national currencies, the stability of its values as an international currency is still acknowledged as being vulnerable in the market. The main reason for this vulnerability, according to the interviews, is caused by the euro zone’s incomplete monetary integration, which would be only achieved by fixing each country’s currency value to a certain point (but that value would not perfectly reflect each member’s economic fundamentals).<sup>43</sup> This suspicion was advocated by the early Laidler (1978)’s argument that attempting to achieve a monetary union under the circumstances of disparate inflation rates between member states and depressed real economies of those states would be economically undesirable or even unsustainable.<sup>44</sup> Michael Deppler (2004: 9), Director of the IMF’s European Department also particularises the need for more convergence of macroeconomic policies within the ERM in the case of the European monetary system

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<sup>40</sup> Interviewees also do not favour Japanese government bond (JGB) due to the worry about credit risk.

<sup>41</sup> The direct quotes are from <http://www.iie.com/publications/papers/bernanke0204.htm>.

<sup>42</sup> Market participants in South Korea, however, still doubt about the yield on a Euro bond due to double transactions between the won and the euro.

<sup>43</sup> For this argument of the need for the real exchange rate adjustment, see, Vaubel (1978).

<sup>44</sup> Laidler’s argument basically criticised Basevi *et al* (1978)’s manifesto which recapitulates propositions for a monetary union with explaining how to cope with expected problems such as matters of unemployment and inflation. However, judging from optimum currency area theory, divergent economic structures prove detrimental to participants’ living standards (Baimbridge *et al* 1998).

(EMS). Although the asymmetrical nature of the EMS system became more symmetrical through, for example, the Basle-Nyborg Agreement,<sup>45</sup> Tsoukalis (2000: 153) reasons that the contradiction between two original features of the EMS, ‘the European currency unit (ecu) and the divergence indicator’<sup>46</sup> became apparent. Member states’ inconsistency to meet the stipulated Maastricht Treaty criteria had also been one of critique concepts of EMU (Baimbridge *et al* 1998); the problem of policy mix of budgetary and monetary restriction in the Maastricht convergence criteria could lead to strong deflationary forces (De Grauwe 2000: 136). Moreover, the deflationary macroeconomic policies can contribute to sluggish economic growth and the rising unemployment, as observed during the EMS periods, in particular in the ERM crisis (1992-3) (De Grauwe 2000; Eijffinger and de Haan 2000; and Tsoukalis 2000).<sup>47</sup> Because the quintessential role of the nation state, the control of the money and fiscal policy such as interest rates and the exchange rate (Martin 1994: 267) is no longer possible within a monetary union, interviewees wonder with what mechanism and instruments each member state can response to external shocks. Furthermore, because of a no-bailout rule which prohibits the ECB from purchasing public debt directly from the issuer, especially highly indebted countries (Art. 101 of the Treaty and Art. 21 of the Protocol on the statute of the European system of central banks and of the European central banks), the risks of the banking system and bond market contagion in EMU has been also brought up (Eichengreen and Wyplosz 1998). In spite of the common currency, each member state with different economic fundamentals, the interviewees believe, needs to evolve different policy approach. Dr. Kim, Research fellow in the Sejong Institute argues, “Let’s assume that the economic condition of Germany seriously deteriorates. But, Germany can manipulate neither the interest rate nor the exchange rate. Hence, in case of the labour market, either lower wages or labour mobility can be helpful; otherwise unemployment will rise. Workers who will not accept lower wages can move across borders. However, in spite of introducing the single market programme and the Schengen agreement, we know that labour mobility between member states still remains low.<sup>48</sup> Consequently, its economic condition would be worse such as higher unemployment, which undoubtedly amplifies our uncertainty on the euro and the euro area economy. The remaining problem for the EU is to overcome this kind of pessimistic view from outside, which resulted from different economic fundamentals of member states and ignorance of these fundamentals in monetary integration.”<sup>49</sup> This argument would

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<sup>45</sup> The Basle-Nyborg Agreement in 1987 has extended the duration of repayment under the VSTF (very-short-term financing facility) to 60 days (from 45 days) and allowed this mechanism to support intramarginal intervention (Mayes 1998: 343).

<sup>46</sup> According to Tsoukalis (2000: 153-4), “the divergence indicator, intended to provide a certain degree of symmetry in the burden of adjustment between appreciating and depreciating currencies, was never put into effect,” due to another implicit feature of the EMS, Germany’s anti-inflation policy. Meanwhile, France and Italy complained and objected to the dominance of the Deutsche mark in the EMS in a sense that this dominance created ‘unfair, asymmetrical burdens and constraints’ on their economies (Featherstone 1998: 313).

<sup>47</sup> See, Emerson *et al* (1992) for the opposite argument.

<sup>48</sup> Frankel (2000) argues that the geographical radius of Europeans both within a country and across countries is smaller than that of Americans, especially in light of linguistic differences. Decressin and Fatas (1995) also show more active movements of the US workers depending on the region’s economic situation in terms of labour demand. However, Europeans are likely to absorb most of the shock in labour demand.

<sup>49</sup> See, Corden (1976: 4-7) for his earlier argument in terms of fixity of exchange rates in the monetary union. Corden argues that high wages and a demand management policy for full employment in one

clarify the necessity of creating an 'economic government' of which France is strongly favoured (Verdun 2003: 326-7). According to Verdun, as an authoritative government is able to apply 'a number of so-called automatic stabilisers'<sup>50</sup> depending upon the economic situation of different regions within a single country, an 'economic government' in the euro zone would be also able to mollify negative effects resulting from economic divergences among member states. Besides, the short history of the ECB is frequently considered an untested central bank, which is one of factors that outside the euro area considers the euro as risks which are not factors for other currencies. Most of interviewees express their wonder if this short history gives market participants a good gauge to how the central bank would react under different economic and political conditions.

In terms of the market structure, the interviewees mostly complain about the dearth of information on the euro in the market, for example, inadequate information on foreign investment, and also generally about the EU. The lack of information is likely to intensify the matter of 'public-receivability' of the euro in a sense that most interviewees concede a profound acquaintance with acquiring dollar-based information, but unfamiliarity with the euro due to rare necessity. One official at the ECB admits this complaint about the lack of information and explains, "The problem in euro area and the EU is that from the outside, you can have information about the euro provided either by the EU level or by national level." But, other officials at the ECB argue that the complaint of the lack of information is due to the lack of their interests. This seems to be rather something of a chicken and egg debate to formulate the relations between the lack of information and the lack of interest. However, providing abundant and appropriate information to those who want could alleviate complaints of the lack of information.

One good example is that all interviewees have incorrect information about the economic size of the EU compared with that of the United States. Although the identical size of the EU's economic fundamentals with the United States is the way to advocate the euro's international role (Bergsten 1997, 1999 and 2002; Eichengreen and Frankel 1996; Remsperger 2000),<sup>51</sup> the EU is regarded to lag far behind the United States in the economic size. In Table 2 (p.18), the EU's share of world GDP in 2003 is 19.9%, which is almost identical with that of the USA, 21.1% and much larger than that of Japan, 7.0%. However, given the condition that the GDP share of the only euro area, 15.9% is smaller than that of the EU, the opt-out of the United Kingdom in the euro zone as a major country in terms of financial activity also affects the public receivability of the euro's international role in East Asia. Interviewees

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country lead to a balance-of-payment deficit. 'Foreign borrowing facilitated by capital mobility can only deal with temporary disequilibria, but will not provide mechanism for bringing real wages down'. See also, Kleinman (2002: 147).

<sup>50</sup> See for more details of automatic stabilisers, De Grauwe (2000), van den Noord (2000) and Kattai and Randaveer (2003).

<sup>51</sup> Bergsten (1999: 12) argues that large economies are less vulnerable to external shocks than small ones and thus a 'safe heaven' for investors; a large volume of trade gives a country's firms considerable leverage to finance in the country's own currency; and large economies are more likely to have the large capital markets which are required for key currency status. He also takes the example of the Deutsche mark: the deutsche mark was the world's second key currency but never attained a market share greater than one-fourth that of the dollar, which was logically related the economy of the former West Germany, about one fourth the size of the United States (Bergsten 2002: 4).

concerned with foreign exchange in private sectors have a consensus of opinion that “the decision by the UK government not to join the euro yet is very suggestive to us, because we still believe the UK is one of the most influential country in the EU, especially in the area of finance.”<sup>52</sup>

Furthermore, they believe that the euro zone, compared with the United States, still has non-flexible labour market; relatively high unemployment rate; extra cost in dealing with the euro in the market – in other words, high costs of foreign transactions; less options and liquidity in smaller financial market than the US market; and uncertainty on the euro zone economy, especially centring on two big countries, Germany and France. Some economic indicators in table 2 show that these arguments are plausible in terms of higher unemployment and the sluggish economic growth in the euro area. According to table 2 (p.18), the unemployment rate in 2003 of the euro area and the EU is bigger than that of the United States and Japan, and even bigger in Germany and France. Although unemployment is one of main elements of the Lisbon agenda<sup>53</sup> with economic structural reforms in March 2000, the statistics show no improvements in the employment area.<sup>54</sup> Mr. Otmar Issing, Member of the Executive Board of the ECB admits to come to a standstill, “[...] many structural reforms have been found difficult to implement and the Lisbon agenda’s mid-term goals for 2005 are unlikely to be reached.”<sup>55</sup> While Aretis and Sawyer (1996) argue that the Maastricht criteria should expand to preclude adverse impacts on the real economy such as employment, output and inequality across the EU, Kleinman (2002: 149) claims, “there is no commitment from the member states to a target rate of unemployment, or even a band [...]. Quantitative estimates of the levels of poverty or inequality [...] are entirely absent.”

Additionally related to this economic structure, the EU, in an East Asian eye, is esteemed to establish a trade barrier, a trade bloc or a bloc economy, which makes, East Asian countries believe, their access to the EU’s market more strenuous and precarious. In consequence, not all but some interviewees who have a negative view of euro’s prospects in East Asia insist that the single currency in the EU could consolidate the European trading bloc. This obstacle seems to be amplified by the principle of the EU’s economy: that is, market participants in East Asia, compared with liberal market economy of the United States, regard the EU economy as

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<sup>52</sup> The importance of the UK in Europe is recently reported in the Korean Newspaper, *Chosun Ilbo* (13 June 2004). Taking a Korean conglomerate, Samsung as an example, it reports that Samsung’s recent success is based on the ‘area-experts system’. Samsung dispatches 2,080 area experts over 60 countries in the world. The number of experts in the UK is 142, which is the third most after 650 in China (including Taiwan) and 450 in the United States, but more than 132 in Germany, 37 in France and less than 10 in Belgium.

<sup>53</sup> The Lisbon Strategy commenced in March 2000 at the Lisbon Summit when Heads of State and Government set a goal for the European Union over the next decade to become: “the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion.”

(<http://www.eu2004.ie/templates/standard.asp?sNavlocator=5,11,240>)

<sup>54</sup> The unemployment rate is gradually growing since the Lisbon Agenda, 8.0 % (7.4%) in 2001, 8.4% (7.7%) in 2002 and 8.8% (8.0%) in 2003 in the euro area (the EU 15). In addition, majority of the new member states of the EU is even higher than the average of the euro area and the EU; for example, Poland reaches at 19.2%, and Slovakia at 17.1%.

<sup>55</sup> The speech by Mr. Issing is delivered at the 32<sup>nd</sup> Economics Conference of the Austrian National Bank, 28 May 2004.

‘regulated capitalism’ or ‘social market economy’, which embodies interventionism, protectionism and overregulation (Hooghe 2001: 81).<sup>56</sup> According to Hooghe’s empirical research, “Commission officials overwhelmingly prefer regulated capitalism to market liberalism”<sup>57</sup> (Hooghe 2001: 92), which construct a certain model for the EU different values and models from the United States or Japan. One research fellow in Trade Research institute, Korea International Trade Association (KITA) explains, “We (Korean market participants) are baffled by defining the principle of the EU economy, but we give priority to the US market because of conviction that we should be guaranteed to have a fair competition in the US liberal market economy.” Moreover in case of trade openness, market participants believe that the EU is more vulnerable to the external shocks, which, they think, could give more influences inimical to their export oriented economic structure. This is because the euro area is currently a large and relatively closed economies, but more open than the United States and Japan, which indicates that the euro area is more exposed to external shocks (Anderton *et al* 2004). The average openness of the euro area, which is varied from 55% for Italy to 175% for Luxembourg (OECD 2002), is 37%, somewhat greater than that of the United States, 26% and Japan, 20%. However, Tavlas (1998) argues that if all 15 EU countries and accession countries into the EU eventually join the euro area, the possibility to be a more closed economy will help make the euro area less susceptible to exchange rate changes.

**Table 2. Important indicators for the United States, the EU and Japan in 2003**

(GDP growth and HICP are annual percentage changes)

	GDP <sup>1</sup>	GDP growth (2003)	Unemployment (2003)	HICP <sup>2</sup>	Balance of Payment <sup>3</sup>	Trade Openness <sup>4</sup>
<b>United States</b>	21.1	4.3	6.0	1.6	-541.8	26
<b>Germany</b>	4.5	-0.1	9.9	1.3	52.89	-
<b>France</b>	3.2	0.2	9.3	1.9	16.61	-
<b>Japan</b>	7.0	2.7	5.3	-0.9	136.00	20
<b>Euro area</b>	15.9	0.4	8.8	2.2	32.20	37
<b>EU (15)</b>	19.9	0.8	8.2	2.1	36.1	-

<sup>1</sup> Share of world GDP in 2003

<sup>2</sup> Harmonised Index of Consumer Prices (HICP) is a measure of consumer prices (rate of percentage change in 2002)

<sup>3</sup> Current Balance in 2003 (billions of the US dollar)

<sup>4</sup> Sum of exports and imports as a percentage of GDP in 2000<sup>58</sup>

Source: IMF (2004) *World Economic Outlook*, ECB (2004), *Annual Report 2003*, ECB (April 2004), *Statistics Pocket Book*, Federal Statistic Office Germany (<http://www.destatis.de>), Eurostat (2003) and OECD Statistics and *Statistics Brief* (2002) (<http://www.oecd.org>)

Most of all, however, the monetary policy of the ECB is pointed to as being significantly flawed on two grounds. Firstly, actors in East Asia believe that the ECB has been slow to respond to changes in economic conditions, and that when it does eventually act, it has often implemented inappropriate or ineffective policies. It has been criticised that the European institutions, mainly the ECB take the insufficient

<sup>56</sup> However, according to Kleinman (2002: 83-4), underlying principle of the Treaty of Rome is the ‘expansion of the market and the operation of market forces’ originated from neo liberal and pro-market, which results in welfare such as higher living standards and better working conditions. See, for more details of the EU’s social policy, Leibfried and Pierson (1995: 43-77), Streeck (1995: 389-431) and Hantais (2000).

<sup>57</sup> She also reveals that only 20 % of Commission officials oppose the regulated capitalism.

<sup>58</sup> If intra-trade within the euro area is included, the openness of the euro area is 73%. However, the openness indicator would become even lower if the three remaining European Union countries join the euro area (OECD 2002: 4).

measure in setting interest rates, and thus do not effectively engage in “countercyclical demand management policies” (Depler 2004: 11).<sup>59</sup> Secondly, there is very little confidence in the cohesion and capacities of the ECB’s decision-making, rather, it is seen as being riven by internal discord and national interests, what Obstfeld (1998) calls it, ‘national political identity’.<sup>60</sup> The economist, De Grauwe finds out that the problem of the dubious policy<sup>61</sup> to create confusion about the ECB’s true intentions instead of creating clarity on the monetary policy is in governance at the ECB; namely, this disputably interpreted monetary policy should be ‘the result of strong disagreements within the governing council – the rate-setting body comprising the 12 national central bank governors plus six permanent ECB members’ (The *Financial Times* 13 May 2003). A top official at the ECB strongly denies that at the interview, “This is simply not true. Some different views have been raised in our (the ECB) governing council, because 18 different persons in the council are just independent persons. However, the fundamental policy line is shared and formulated in very much the same terms from all of us (*sic*).” However, most of interviewees cite the same example: “Whenever and whatever Alan Greenspan, Chairman of Federal Reserve, speaks in public, all relevant government ministries and private market participants, at least in East Asia, make their efforts to read between lines for the purpose of coping with the forthcoming economic impact. But, to what extent does the announcement of changing the interest rate by President of the ECB affect the economic policy in East Asia and in the world?” This is because, according to the interviewees, some other announcements, comments or even critiques from member states are supposed to come after the ECB. They additionally assure that this is the difference between a chief of the international currency, the dollar and that of the regional currency, the euro. It seems to the interviewees that the original goal of the ‘single money and monetary policy among many states’ still has difficulty due to the ‘single currency but many voices’. This is what Bergsten (2002: 7) points out, “With regard to the internationalisation of the euro, even European institutional cohesiveness will not assure a rapid rise in the international position of the euro because monetary issues are still dominated by intergovernmental activities.” The lack of control on different remarks regarding the euro, according to Kaji (1999), also inflicts impairment on the euro’s possibility of rivalling the dollar.<sup>62</sup>

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<sup>59</sup> Particularly since the euro has been appreciated, the EU’s export was suffering in the global markets, growth prospects were undermined and therefore, heavy pressure to cut interest rates was given to the ECB. However, the ECB insists that the strong euro which brings cheaper imports to customers is conducive to keep price stability and low inflation (*Financial Times* 1 February 2003; 13 May 2003).

<sup>60</sup> For the second argument, see, Simachi (2004). He argues that divergences of EU countries in the IMF still prevail, which undermines the EU’s impact on IMF policies. Montes (1998) also points out that European, although they have more votes in the IMF than does the United States, do not have a single identity, which can also make the euro a competitor to the dollar. See also McNamara and Meunier (2002).

<sup>61</sup> Two new monetary policy strategies announced by the ECB are ‘downgrading the importance of the money supply (M3)’ and a ‘new inflation target’. According to his argument, the ECB announces that holding the old definition of price stability that inflation should not exceed 2% over the medium term, ‘in the pursuit of price stability it will aim to maintain inflation rates *close* to 2% over the medium term’.

<sup>62</sup> In contrast to the United States – only two people, the chairman of the Federal Reserve and the Treasury Secretary are allowed to comment publicly on their currency, member central banks as well as the ECB have several different voices regarding the euro (Kaji 1999: 78).

#### 4. Conclusion: Dollar Colossus in East Asia

The most visible feature of foreign currency use in East Asia is dollar preference in public and private sectors. The first section in this paper shows that the US dollar plays its dominant role in every means of currency use, which therefore provides market participants in East Asia with convenience to focus solely on dollar exchange rate, information on the US financial market and the US economic situation, as they have done for decades. In addition, as long as the euro provides private actors with more convenient ways of currency management instead of 12 different currencies, they will use the euro as a payment currency, mostly in case of exporting goods and services to the eurozone. However, they perceive that there is no incentive for them to replace the most reliable, familiar and favoured currency, the dollar with a new currency. As a result, the euro, for East Asian countries, will not be used in regions other than the EU, if it is not obligatory. This is mainly based on two factors; preference for an international currency, the dollar, and reluctance to a regional currency, the euro.

Although the improving role of the euro as an international currency has been proclaimed at the EU level, public receptivity has been formed to perceive the euro as a regional currency in East Asia. This regional currency means that the euro can be only used in the activity involved in the euro area. This different perception of the euro in East Asia as a regional currency results mainly from the predominant role of the US dollar in this region. The recognition of the risk of the over-dependence upon the dollar, and thus of the euro's alternative possibility to the dollar in East Asia upholds the euro's involvement in the region's economic policy. Nevertheless, this paper proves this expectation is simply wrong, based on the argument of 'preference to the dollar' but 'reluctance to the euro' in East Asia. The reason for this argument can be summarised in two folds; first, the dollar preference formation in East Asia is based on the inertia for the dollar strongly underpinned by the belief in the value of the dollar, as an international currency; and second, various reasons regarding the euro, the ECB and the EU can explain the reluctance to the euro in East Asia, but the main reason is that the euro is not so much demanded in this region as the dollar is demanded. This is because market participants in East Asia believe that the international currency, the dollar is still able to provide everything every actor wants and needs, from psychological confidence via advantages of using dollars to convenience rather than the regional currency, the euro. The public receptivity of the euro as a regional currency in East Asia impregnates market participants in private and public sectors with the perception that the euro can be used in activities only with the euro area.

It is not very clear to identify the interactive influence between public and private sectors,<sup>63</sup> but some of interviewees in the private sector criticise the government's 'myopic policy'. One research fellow explains, "Since 2003, China has suddenly leapt into the most important trading partner ahead of the United States for South Korea. Now, every concern and interest has been focused on China in public and private sectors as we had done on the United States and Japan. Under this situation, we only

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<sup>63</sup> Wade (1995) see East Asia use disciplined state power in line with criteria related to the national economic interest. He criticises the neo-liberal view and characterises East Asian state intervention as 'governing the market' (See also, Chang and Rowthorn (1995)).

need to focus on the dollar exchange rate because the Chinese Renminbi pegs to the dollar, and we are the specialists to deal with dollar related matters.” This comment has something in common with the principal concern in Korean Ministry of Commerce, Industry and Energy. At the interview,<sup>64</sup> “We conducted our own research to investigate the extent to which the birth and the recent appreciation of the euro would have its impact on Korean trade. However, we concluded our study with no impact. We do need to focus on China now with continuous concerns of the United States.”<sup>65</sup> That is to say, the EU and the euro are still far away from the national economic policy. After taking everything at the interview into consideration, the matter of the EU and the euro is, at the present juncture, tied up within the limited area of Europe; the regional bloc, the EU is an important market which accounts for almost 20% of region’s exports, and for this purpose, the euro, a regional currency could be used in the case of trade with this region, the euro area, even not all the EU or Europe. The reason why the euro is not used up to 20%, which equates to the proportion of trade with the EU is that all private market participants clearly prefer and choose the dollar even in trade with the euro area, if they can choose. This explains the motives for the government to concentrate on dollar exchange rate, intervening in the market to buy dollars for the purpose to protect the decline of the dollar against the won for the competitiveness of export.

As the ECB and its officials assert emphatically, economic policy with regard to foreign currency use could be dependent upon national authority in a market driven economy. However, the way of perceiving the euro’s role in two regions, the EU and East Asia is distinctively classified. East Asian countries have their own reasons to prefer the dollar despite the warning of the over-dependence on the dollar. With regard to the euro, they do not avoid using the euro on purpose, but the euro has not given any attractiveness to actors in East Asia the dollar has provided. However, the official stance of the EU is no commitment for the internationalisation of the euro, but decision by the market. Throughout European integration, the EU in terms of trade matter already proved that it became another superpower with the United States.<sup>66</sup> The introduction of common currency in the EU was expected to improve the EU’s competitive position in the world economy, thus diminishing the EU’s dependence on the US economy and thereby challenging the hitherto undisputed economic hegemony of the United States (Dorsenrode 2002). The goal of internationalising the euro is self-explanatory insofar as the EU’s institutions, mostly by the ECB swagger about the growth of the euro’s international role. But, its limited international role would be terminated if new member states or other neighbouring countries to join the EU and finally the euro. In short, the euro needs to outgrow its regional image. Given that the East Asian region is in the absence of the ‘Asian euro’ (Kawai 1997; McKinnon 1999) and is the world’s largest foreign reserve holding region, this region should be

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<sup>64</sup> The interview was conducted in summer 2003.

<sup>65</sup> The recent survey for the newly elected members of the Nation Assembly in Korea shows that 52.3% of them still consider the United States is the most important country for Korea, followed by China with 34.9% (SERI 2004).

<sup>66</sup> The reaction to the most recent dispute over the new US safeguard measures on its imports of steel products indicates the EU’s economic power is a significant threat to the United States. Based on the judgement by WTO that tariffs imposed by the United States on some steel imports violate international trade rules, Pascal Lamy, EU trade commissioner said the EU had little choice but to insist on compliance with the WTO rules, as the US has done in previous disputes over bananas and beef hormones (The *Financial Times* (10 November 2003)).

important for internationalisation of the euro; the policy-changes of foreign currency use by Asian countries, for example, the shift of the region's dollar holdings into the euro and the change of the region's exchange rate regime associated with the euro from the *de facto* pegging to the dollar, can be a barometer for the internationalisation of the euro. As one European ambassador in East Asia says at the interview with the *Financial Times* (27 March 2004), however, "Europe's main problem is that we have not come to the conclusion that the world's economic centre is moving to Asia."

The reasons for the public receivability of the euro as a regional currency in East Asia does not seem to be easily transposed as long as the ECB does not recognise the euro's image in East Asia. Given that the US economic and political involvement in this region is by far more influential than that of the EU, it is unanimously brought up at the interview in East Asia that the EU needs to show its converged policy without interference of member states as well as its willingness of internationalising the euro. More political involvement of the EU in the East Asia region is also added up at the interview.<sup>67</sup> The neutral position of the ECB for the internationalisation of the euro would not be very helpful as the case of the Japanese yen, which has strived for its internationalisation for decades, indicates; in spite of the size of the Japanese economy and the efforts by relevant authorities, the possibility of the yen to be an international currency is low, and even lower recently due to its economic slump and failure of financial structure reform.<sup>68</sup> Although the inception of the euro ostensibly inspired the Japan's ambition of internationalising the yen,<sup>69</sup> its role even in the region is stagnant and decreasing.<sup>70</sup> What the euro can learn from the case of the yen is that the international currency is dependent, though not wholly, upon the 'public-receivability' – whether the public recognises the foreign currency as an international one based on economic fundamentals of issuing country (region) and its currency role, and whether they are willing to use it in various means. The EU might need to adopt more positive attitude in terms of the euro's role in East Asia, as it has done in trade issues.<sup>71</sup> What Chris Patten, the EU's external affairs commissioner and the final British governor of Hong Kong notices regarding the relationship between the EU and Asia is that although "[...] Asians are keen that we (the EU) play a rather larger role, but the difficult thing is to get Europe to recognise just how much it is wanted to play a more assertive role" (*FT Magazine* 27 March 2004).

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<sup>67</sup> In the occasional paper by the ECB, Winkler *et al* (2004) argue that in recent cases, opting for dollarisation / euroisation is mainly due to searching for domestic monetary credibility rather than political reasons which was the cases in both sustained and abandoned dollarisation / euroisation. However, the political reason still remains in cases of North Korea and Iraq which adopted the euro as an official foreign currency instead of the US dollar.

<sup>68</sup> For the minor role of the yen in East Asian region, see, Frankel and Wei (1992). Kawai (1997: 83-5) suggests four reasons of limits to the yen's international currency role, which are 'trade structure', 'money and capital market structure', 'historical context of Japan's postwar economic development' and 'East Asian economic structure'. See also, Kawai (1997) and Ogawa (2001).

<sup>69</sup> According to the welcoming statement to the birth of the euro by Kiichi Miyazawa, Finance Minister of Japan in 1 January 1999, the focus was centred on the importance of the internationalisation of the yen, emphatically expressing his opinion that 'the birth of the euro attests its importance'. See, <http://www.mof.go.jp/englis/ihf/ele060.htm>.

<sup>70</sup> For example in South Korea, although the yen – won direct exchange market has been formed since 1980s, there is, in practice, no direct yen – won market any more (or just nominal market exists) due to less demand for the yen.

<sup>71</sup> According to the European Commission (2003), the EU currently involves in 27 trade disputes with 8 countries and is a complainant in 15 of these cases.

The Italian Marxist thinker, Gramsci stresses, in defining hegemony, the process of establishing cultural and intellectual values over the Marxist argument of material depended power for the ruling class or group (Femia 1981: 3);<sup>72</sup> therefore, Gramsci's hegemony is constituted on the basis of consent by the governed rather than coercion of one class or group over others, and 'ethico-political' hegemony must have solid economic roots (Femia 1981: 24). Applying Gramsci's definition of hegemony regarding foreign currency use in East Asia, dollar hegemony in East Asia has prevailed with political and habitual consent on the basis of its economic power. Thus, given the dollar dominant situation in East Asia, surpassing the current perception of the euro as a regional currency towards an international currency would hinge upon the public receivability.

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<sup>72</sup> According to Femia, 'domination' and 'intellectual and moral leadership' are manifested in Gramsci's notion of the supremacy of a social group or class, and especially the latter type of supremacy constitutes hegemony. See, for more details about the concept of hegemony by Gramsci, Femia (1981: 23-60).

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