

Quest for a Regional Monetary Framework in East Asia

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Financial System:
What Role for the European Union and East Asia?”

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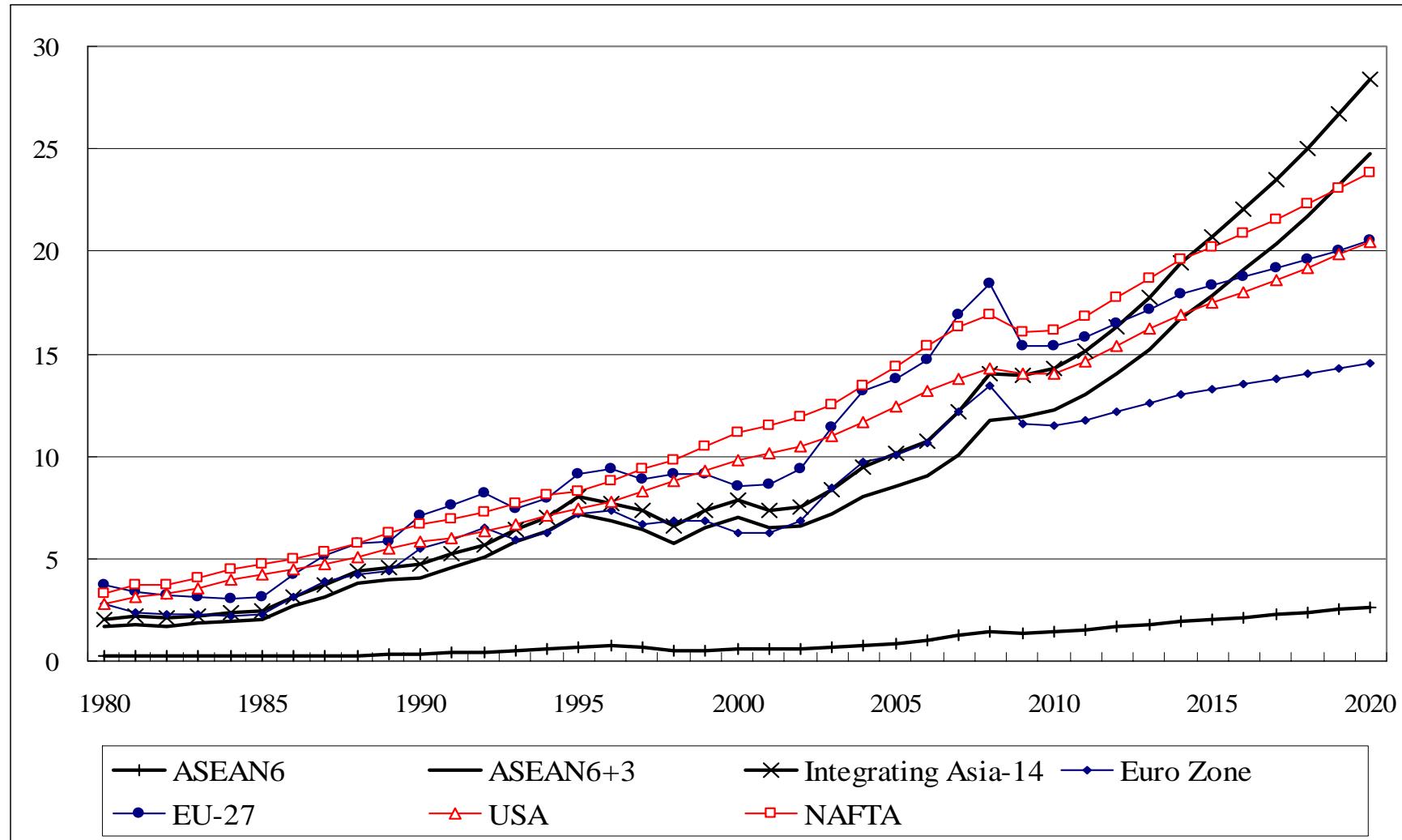
Outline

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1. Introduction: Key Issues

- Asia has become increasingly interdependent through market-driven trade, FDI and finance, and is heading to become the largest economic bloc in 5 years
- But, Asia has experienced several episodes of exchange rate instability led by capital flows
- Is it desirable for a large, integrated Asia to achieve intra-regionally stable exchange rates or even have its own currency?
- If so, how?
 - (1) Does Asia satisfy OCA criteria?
 - (2) What are the practical steps towards regional exchange rate policy coordination?
 - (3) Should it be led by the yen, the yuan, the US dollar, or a currency basket?
 - (4) Is there enough political will?

Asia will continue to grow if managed well



Note: The figures until 2014 are from IMF and those for 2015-20 are estimated by the author
Source: IMF, *World Economic Outlook*, April 2009.

China, ASEAN and India

Size of GDP	Trill. USD 2008	Trill. USD 2014	Trill. USD 2020
United States	14.3	16.9	23.8
EU-27	18.4	17.9	20.5
Japan	4.9	5.4	6.3
China	4.4	8.5	15.3
ASEAN	1.4	1.9	2.6
ASEAN+3	11.7	16.7	24.8
India	1.2	1.7	2.7

Note: The figures for 2020 are estimated by the author

Source: IMF, *World Economic Outlook*, April 2009.

2. Capital Flows and Exchange Rates in East Asia

Asian currency crisis of 1997-98

Two episodes: Indonesia (Summer 2005) and Thailand (December 2006)

The global financial crisis and a mini won crisis

Asian Currency Crisis of 1997-98

Twin crises: Banking & capital account crises

- Economic boom & overextension of bank loans, financed partly by short-term capital inflows
- Relatively fixed exchange rates against the US dollar, encouraging capital inflows
- Exposures to double (currency & maturity) mismatch
- Reversals of capital flows, contagion
- IMF interventions in Thailand, Indonesia and Korea, but not Malaysia (which used capital outflow control)
- The subsequent ASEAN+3 monetary and financial cooperation (CMI, ERPD, ABMI)

Episodes in Indonesia and Thailand

Mini rupiah crisis (summer 2005)

- Rapid rupiah depreciation due to concerns over rising inflation and expanding fiscal deficits
- Policies to tighten monetary policy and reduce fuel-related subsidies stabilized the market

Thai capital inflow control (December 2006)

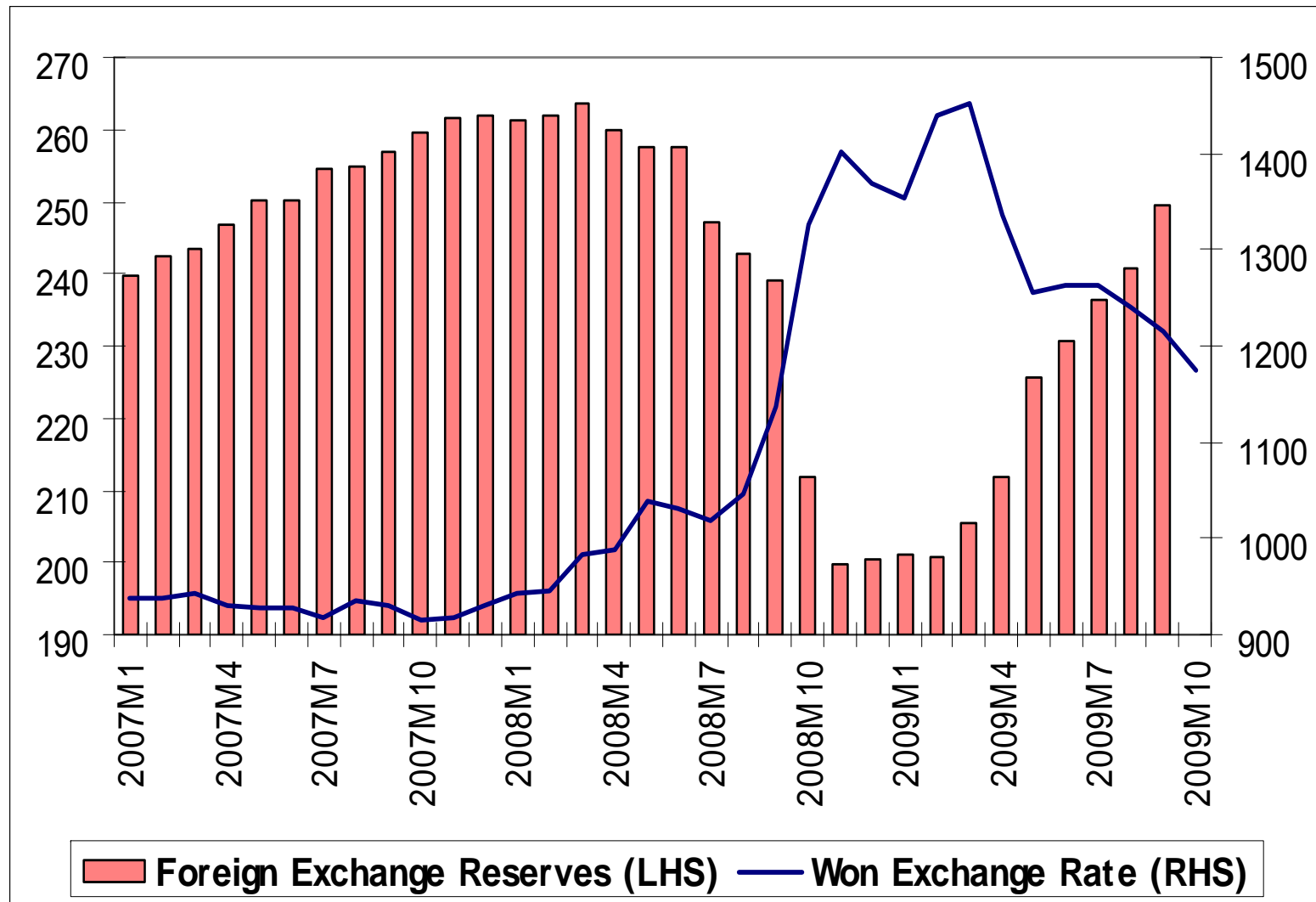
- Large inflows of capital throughout 2006 and upward pressure on the baht, raising concerns over the loss of international price competitiveness vis-à-vis other ASEAN & China
- Capital inflow control, introduced in December 2006, caused a sharp decline in stock prices, and had to be modified in January 2007

Impact of the global financial crisis on the Korean won

The mini won crisis in the fall of 2008

- Rapid capital flow reversals due to the outbreak of the global financial crisis in September 2008
- Loss of foreign exchange reserves (which had started since March 2008) from \$264 billion to below \$200 billion in November
- Won depreciation (which had started since November 2007) from 907 won/\$ (Oct. 2007) to 1,483 won/\$ (Nov. 2008)
- Unwilling to go to the IMF or CMI (which is tightly linked with IMF), the Korean authority secured a \$30 billion currency swap line from the US Fed and activated the swap, which helped stabilize the won
- In 2009, the low won helped export recovery and reserve accumulation to 249 billion in September

A rapid (temporary) loss of reserves and won depreciation



Source: IMF, International Financial Statistics, online

3. Exchange Rate Regimes in East Asia

Diversity of exchange rate regimes

Managing capital flows

A case for collective currency appreciation

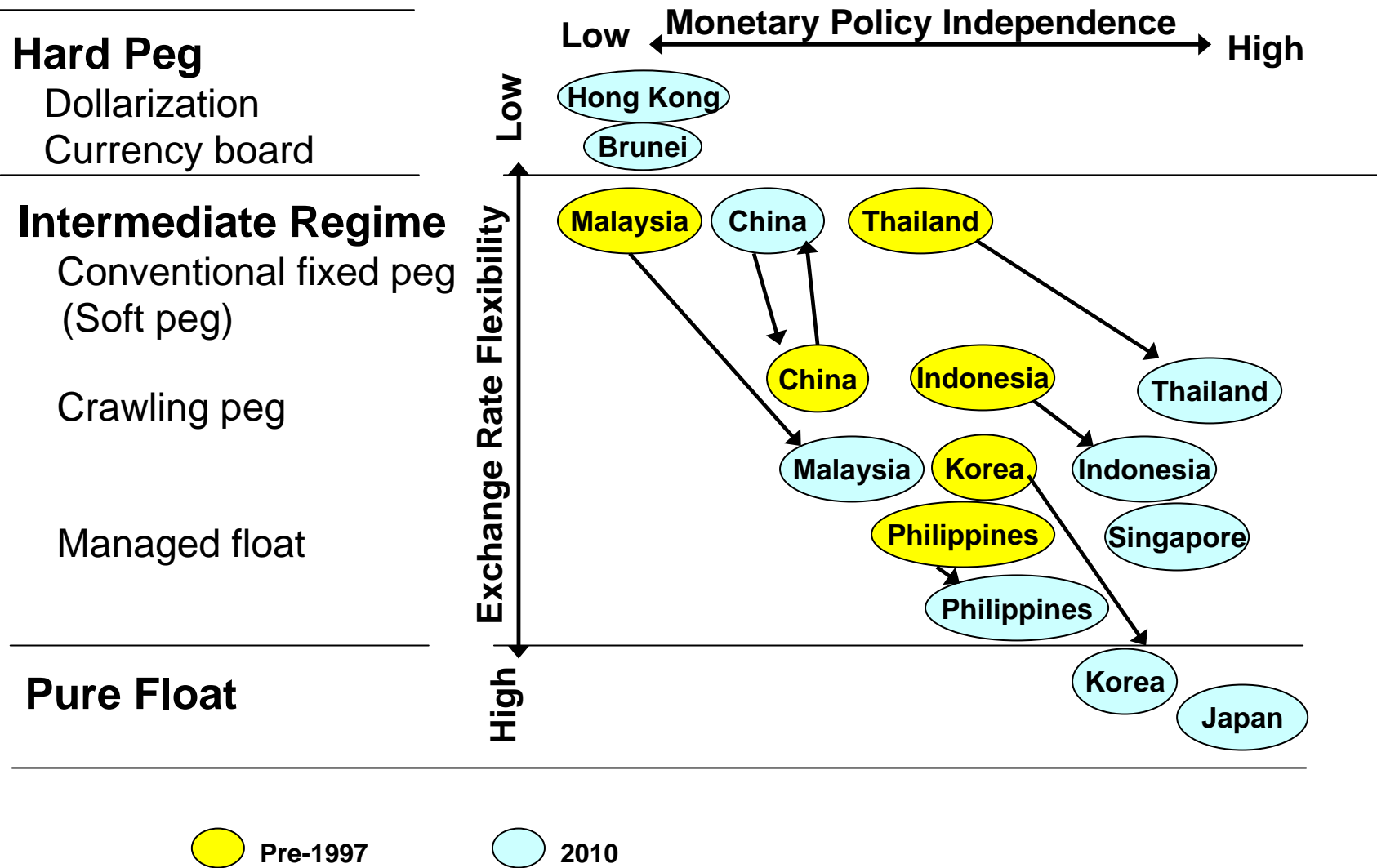
Which currency as nominal anchor: dollar, yen, yuan, or a basket?

Diversity of exchange rate regimes

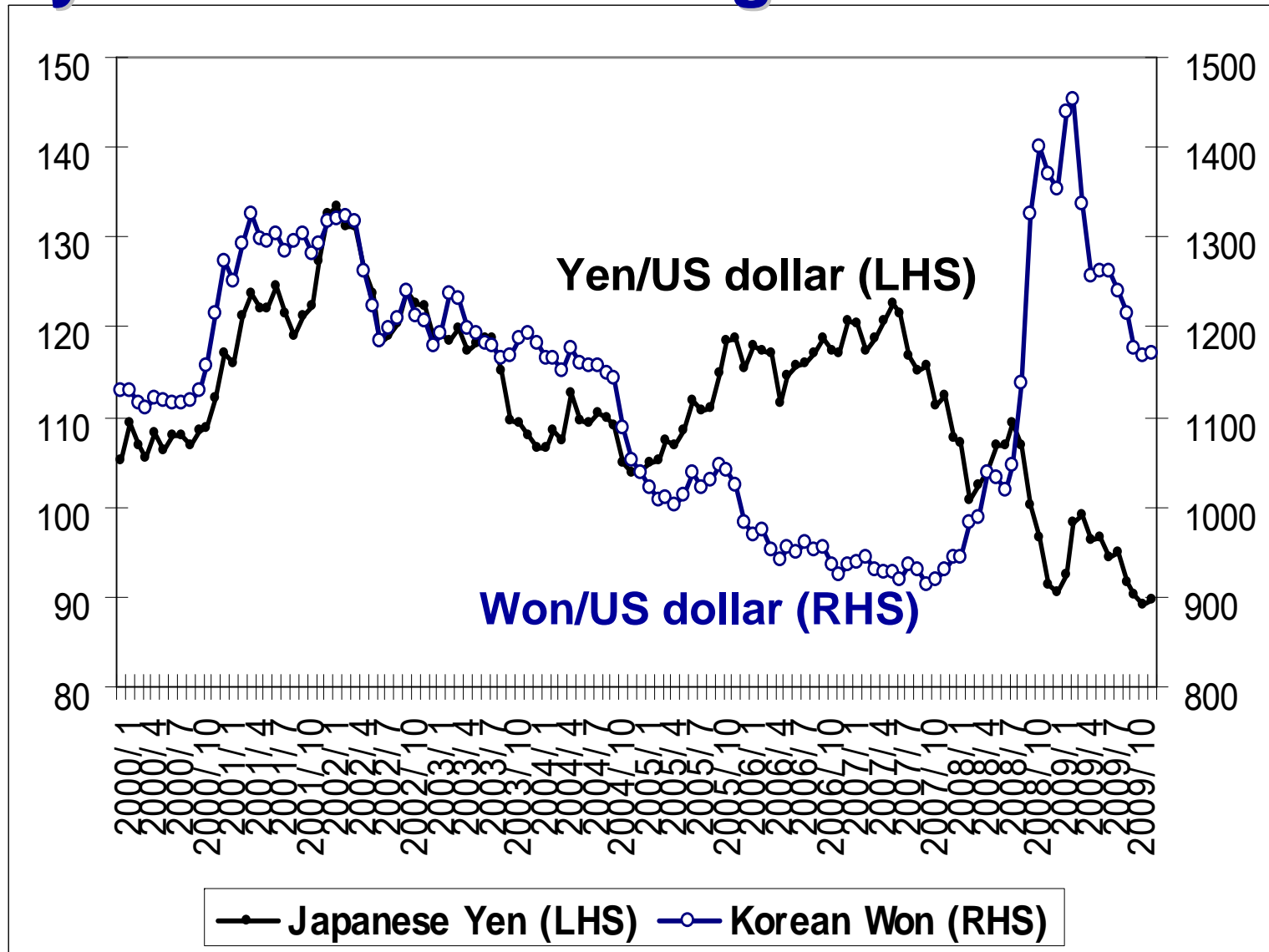
Lack of exchange rate policy coordination

- Despite rising economic interdependence of East Asian economies through trade, investment and finance, there has been no exchange rate coordination yet
- Asian exchange rate regimes are very diverse and in serious disarray, with Japan adopting a pure float and China returning to a *de facto* dollar peg
- Other currencies are in between (with the exception of Hong Kong and Brunei), and tend to be constrained by RMB policy
- China's RMB revaluation in July 2005 and its shift to a managed float (followed by Malaysia's similar shift to a managed float) suggested the beginning of greater RMB flexibility, but China returned to US dollar peg in July 2008

Changes in exchange rate regimes in East Asia

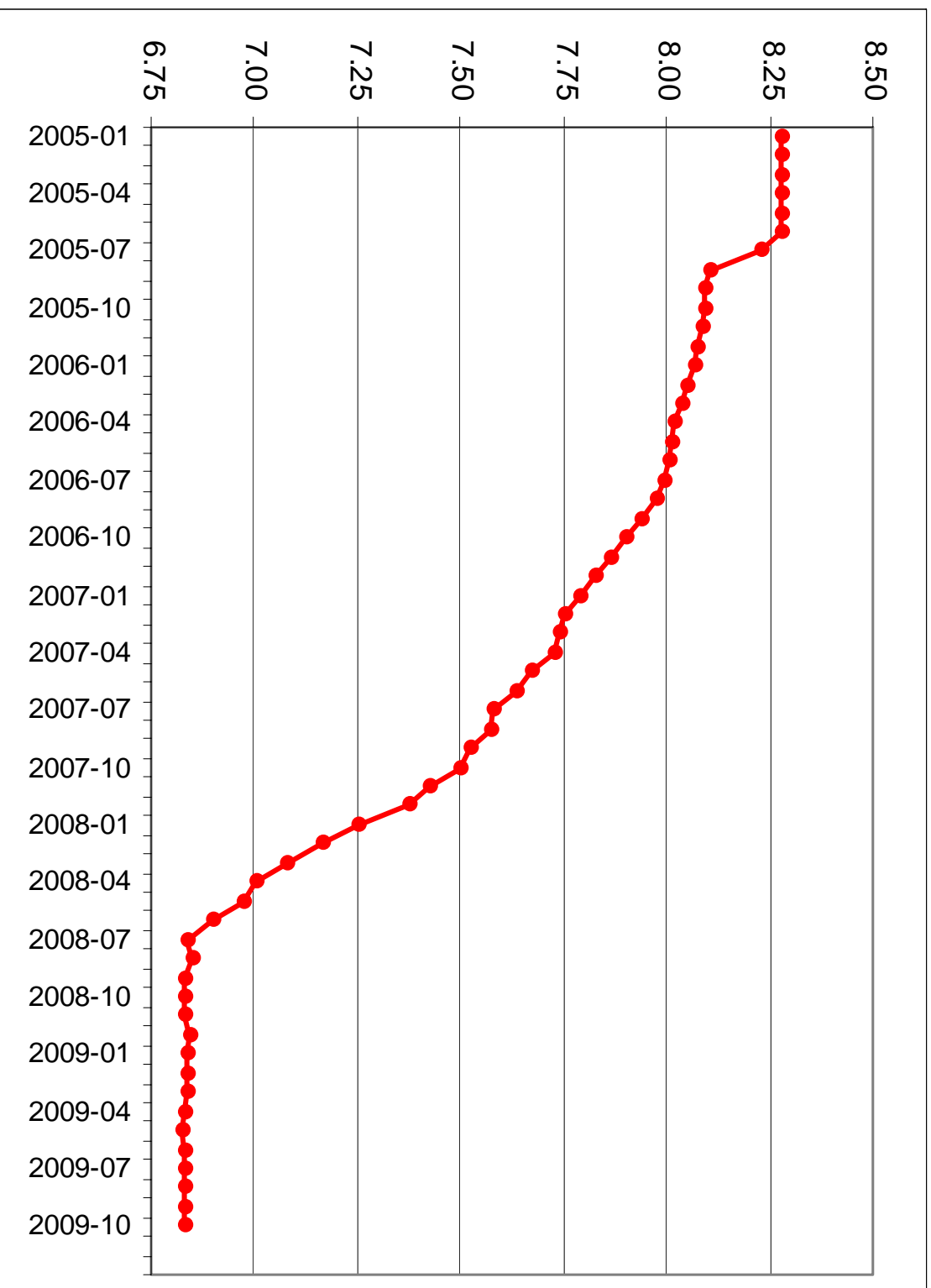


The yen and won began to deviate from early 2005 and the divergence has widened



Source: IMF, International Financial Statistics, online

China returned to a US dollar peg



Managing capital flows

- Asia, like any other emerging market, has been vulnerable to sharp changes, including reversals, in capital inflows
- Once the US financial system stabilizes, Asia can again attract large capital inflows, given the region's robust economic prospect relative to the industrialized world and other regions.
- To reduce domestic financial and macroeconomic risks (overheating, inflation, and asset price bubbles) due to rapid surges in capital inflows, each economy needs to manage the domestic financial system and macroeconomic policy in a prudent way, including allowing currency appreciation.

A case for collective currency appreciation

- In the face of persistent capital inflows, traditional policy of sterilized foreign exchange market intervention to prevent currency appreciation cannot be sustained for a long time
- Asian economies need to work together for collective currency appreciation vis-à-vis the USD while keeping relative currency stability within the region, so that financial and macroeconomic stability is maintained and loss of price competitiveness minimized
- This requires greater exchange rate flexibility

Which currency as nominal anchor: dollar, yen, yuan, or a basket?

Dollar, yen or yuan as an anchor for East Asia?

- Relying solely on the dollar is not desirable due to the lesson learned from the 1997-98 Asian currency crisis
- The yen (failed internationalization, size relatively declining) or the yuan (inconvertible, weak prudential supervision, non-independent central bank) alone cannot assume a nominal anchor currency role
- The yen, the yuan and other important currencies can share the nominal anchor role for East Asia.

Currency basket system

- SDR-plus currency basket (dollar, euro, pound and ACU—basket of Asian currencies): Singaporean model
- ACU-based system: complex and hard to establish internal anchor for now, but a very useful starting point

4. OCA Criteria and Convergence

Is East Asia an OCA?

Macroeconomic convergence

Structural convergence

OCA criteria

Table 3 Identified Optimal Currency Areas¹⁷

	China	Hong Kong	Taiwan	Japan	South Korea	Singapore	Malaysia	Indonesia	Thailand	Philippines	Other ASEAN countries	Australia and NZ	India
Bayoumi et al. (2000)													
Loayza et al. (2001)													
Yuen (2001)													
Baek et al. (2002)													
Chow et al. (2003)													
Lee et al. (2003)													
Kawai et al. (2004)													
Kwak (2004)													
Zhang et al. (2004)													
Girardin (2005)													
Sánchez (2006)													
Tang (2006)													
Ogawa and Kawasaki (2006)													
Huang et al. (2006)													

Notes: Shaded boxes indicate that countries are included in optimal currency areas identified in each paper. If several optimal currency areas are identified in a paper, the boxes corresponding to each area are surrounded by thick lines. The boxes marked with diagonal lines indicate that those countries are not covered by the respective studies.

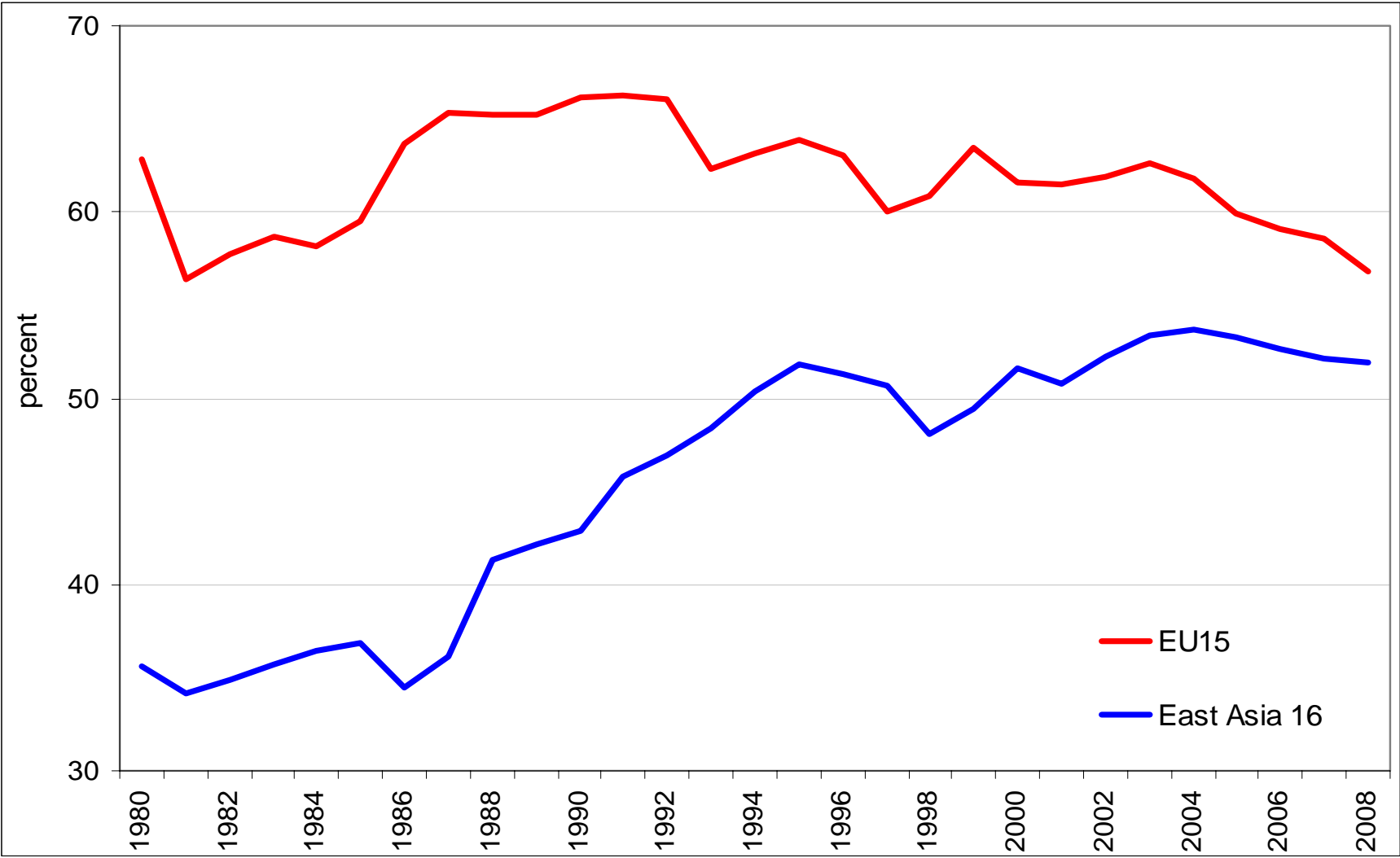
1. Openness
2. Product, factor and financial market integration
3. Symmetry of shocks
4. Similarity of macroeconomic policy responses
5. Fiscal policy coordination

Source: Watanabe and Ogura (2006)

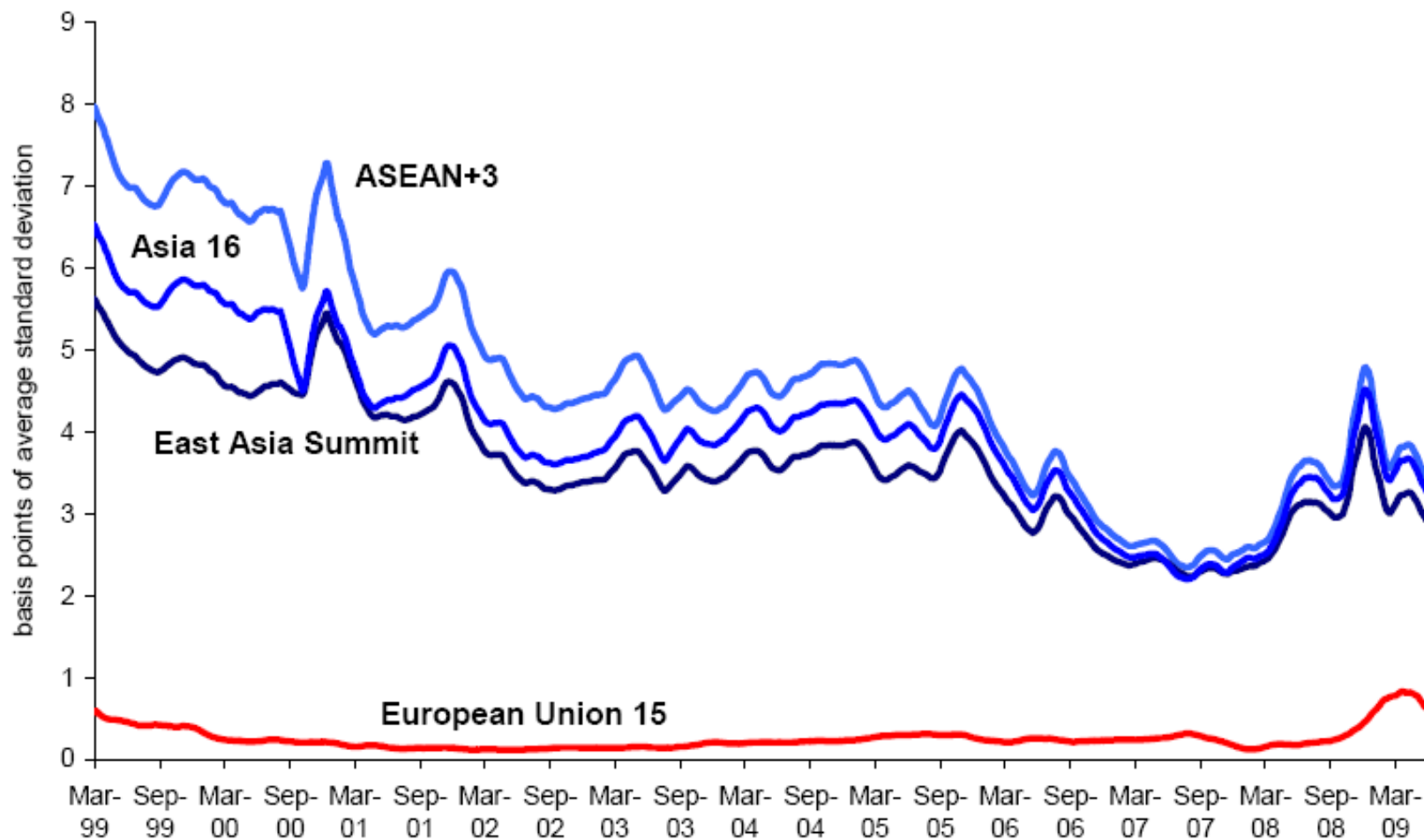
Is East Asia an OCA?

- Past studies suggest that, despite rising regional economic interdependence, East Asia as a whole is not a strong candidate for a single currency area at least for now
- But subsets of East Asian economies appear to begin satisfying some key OCA criteria, such as economic integration and symmetry of supply shocks
- These subsets may include: Japan and Korea; Singapore, Malaysia and Brunei
- Hong Kong may be better off by switching to a RMB peg and eventually adopting the yuan

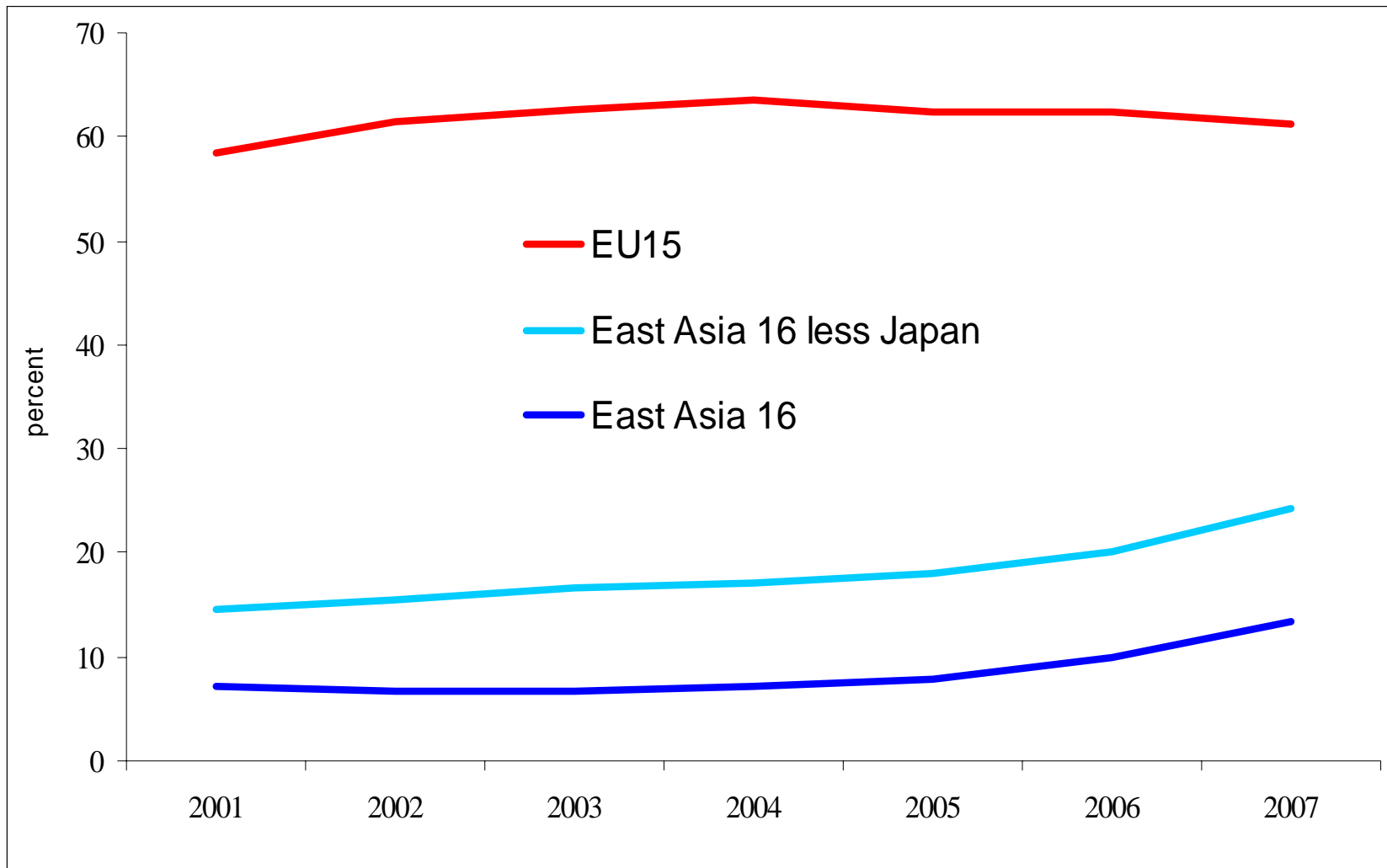
Intraregional trade shares in East Asia and EU-15



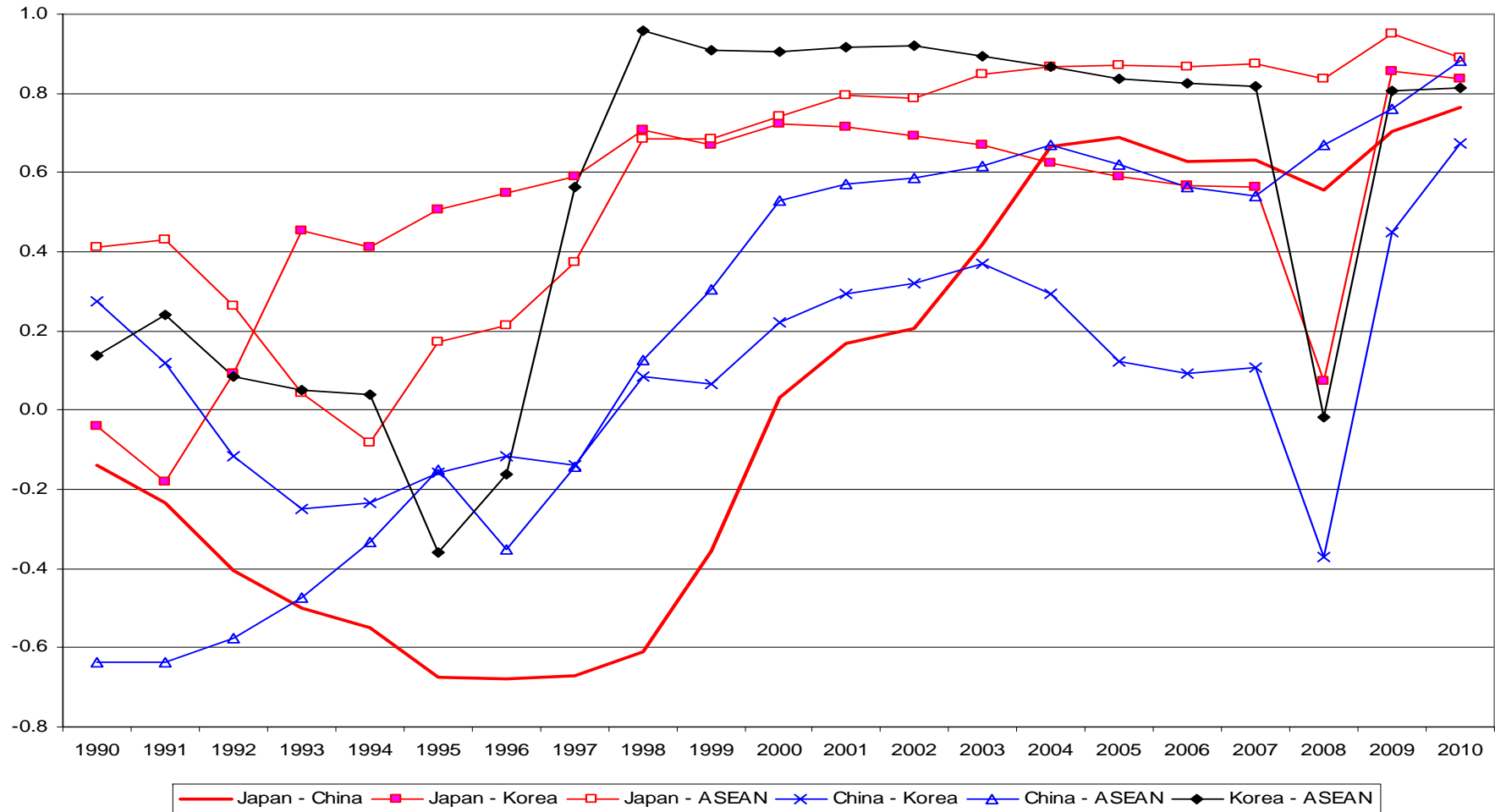
Intraregional interest rate convergence (Cross-market differentials in 10-year government bonds)



Intraregional portfolio investment shares in East Asia and EU-15



GDP growth rate correlations among Japan, China, Korea, ASEAN (10-year moving windows, incl. 1998)



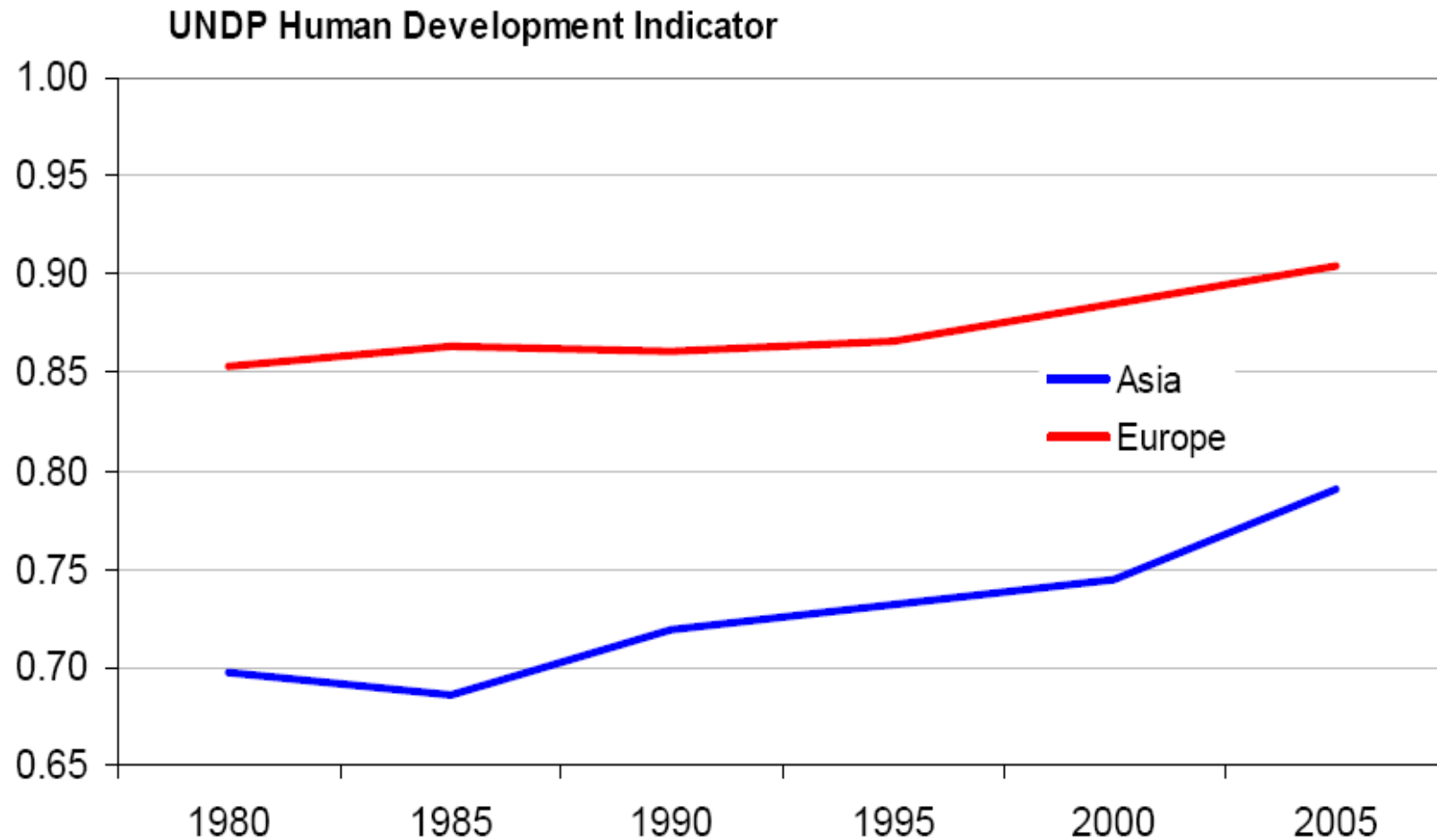
Macroeconomic convergence

- East Asia has not achieved macroeconomic convergence—inflation, interest rates, fiscal deficits and fiscal debt (Maastricht criteria)
- Macroeconomic (and structural) convergence is not part of OCA criteria, as a country with weak macroeconomic conditions can unilaterally peg its currency to that of a stronger performer
- However, macroeconomic convergence is critical once countries form a single currency area as equal (or symmetric) partners.
- For many economies, the first priority is to pursue macroeconomic institutional reforms so as to strengthen macroeconomic policymaking to promote sound macroeconomic performance

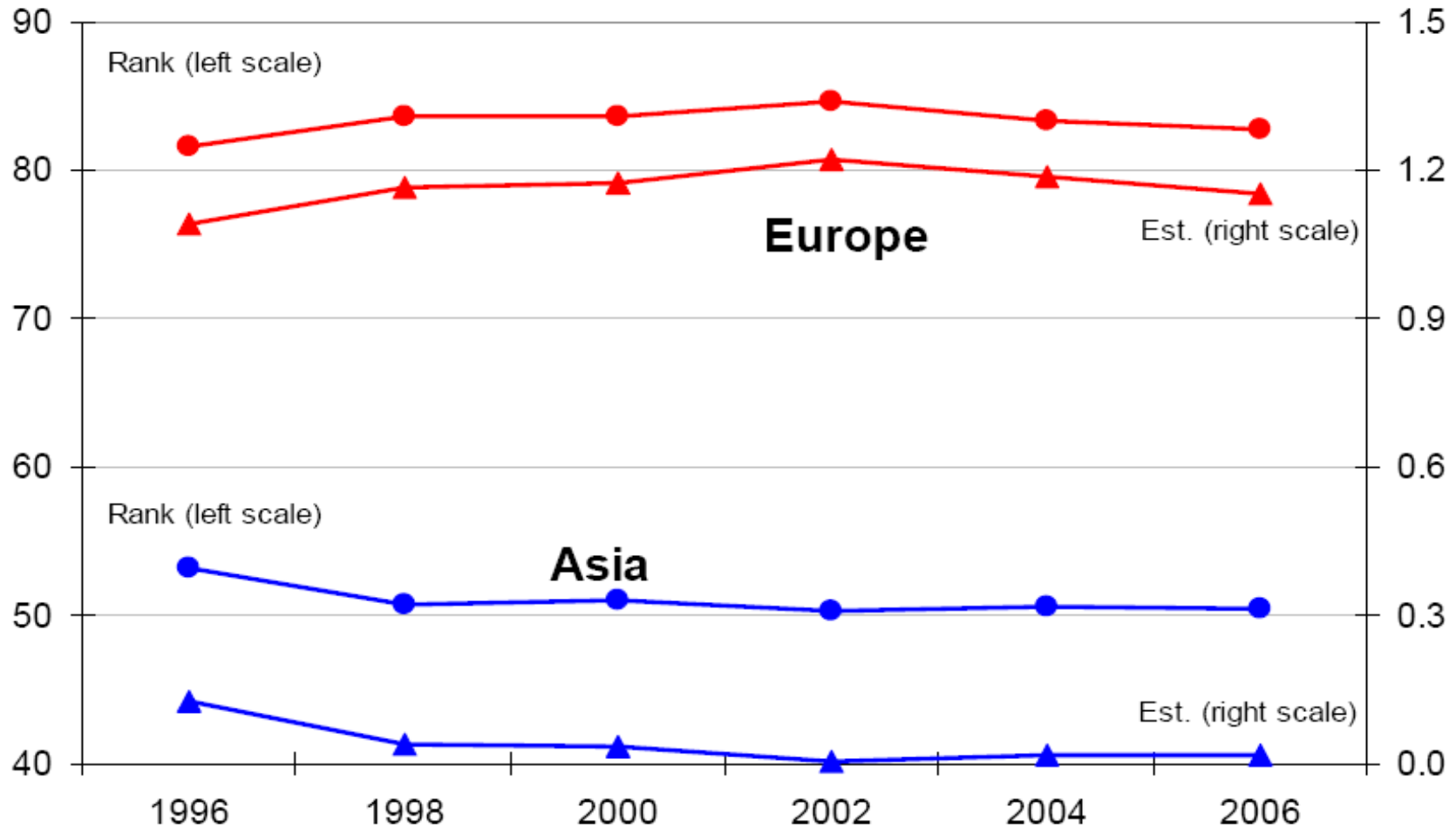
Structural convergence

- East Asia has not achieved structural convergence—such as per-capita incomes, industrial structures, financial sector development, capital account openness, policy and institutional quality, and market infrastructure
- Structural convergence is not part of OCA criteria, and a country with weak institutions can unilaterally peg its currency to the currency of country with high degrees of institutional quality
- However, for many economies, the first priority is to continue to pursue structural reforms so as to strengthen domestic economic and structural fundamentals as a prerequisite to structural and macroeconomic convergence

Human development index in Asia has been rising but is still generally low



Overall governance quality in Asia is still low, in comparison to Europe



Simple average of WB Indexes for the following categories: (i) Voice and Accountability; (ii) Political Stability and Absence of Violence/Terrorism; (iii) Government Effectiveness; (iv) Regulatory Quality; (v) Rule of Law; and (vi) Control of Corruption. "Est." provides the point estimate. "Rank" refers to the average ranking among the entire world dataset.

5. Steps to Closer Exchange Rate Policy Coordination

Step 1: Intensive policy dialogue

**Step 2: Informal coordination
(regime choice)**

Step 3: Formal, loose coordination

Step 4: Tight coordination

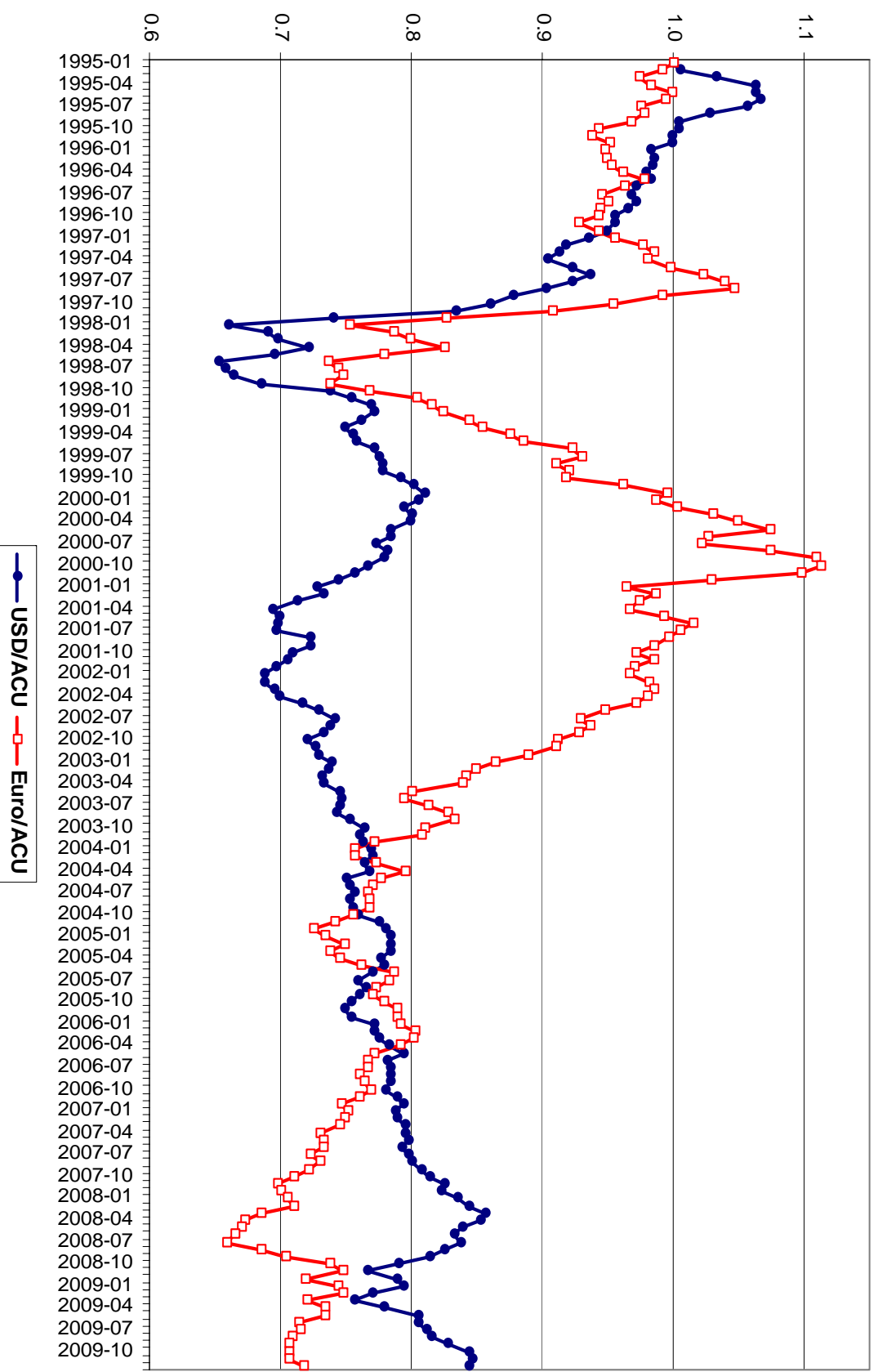
Steps for closer exchange rate and monetary policy coordination

Progress	Exchange rate policy	Supporting institutions	Trade-investment
Current State	Uncoordinated exchange rate arrangements	CMI & regional surveillance	Uncoordinated FTAs
1. Intensive policy dialogue on exchange rates	Intensive policy dialogue on exchange rates; use of an ACU index for surveillance	Secretariat for CMI multilateralization & regional surveillance	Coordination of rules & provisions among FTAs
2. Informal coordination (exchange rate regime)	Greater exchange rate flexibility vs. US dollar; An SDR-plus currency basket as loose reference	Asian Monetary Cooperation Fund	A single East Asia-wide FTA ; East Asian Investment Area
3. Formal but loose coordination (exchange rate policy)	SDR-plus currency basket system with clear rules for intraregional rate stability	Very short-term liquidity facility	Asian customs union
4. Tight coordination (monetary policy)	ACU-based system: Asian Snake” or “Asian ERM”	ACU clearing and settlement system	Asian common market
5. Full coordination	Asian monetary union	Asian central bank	Asian single market

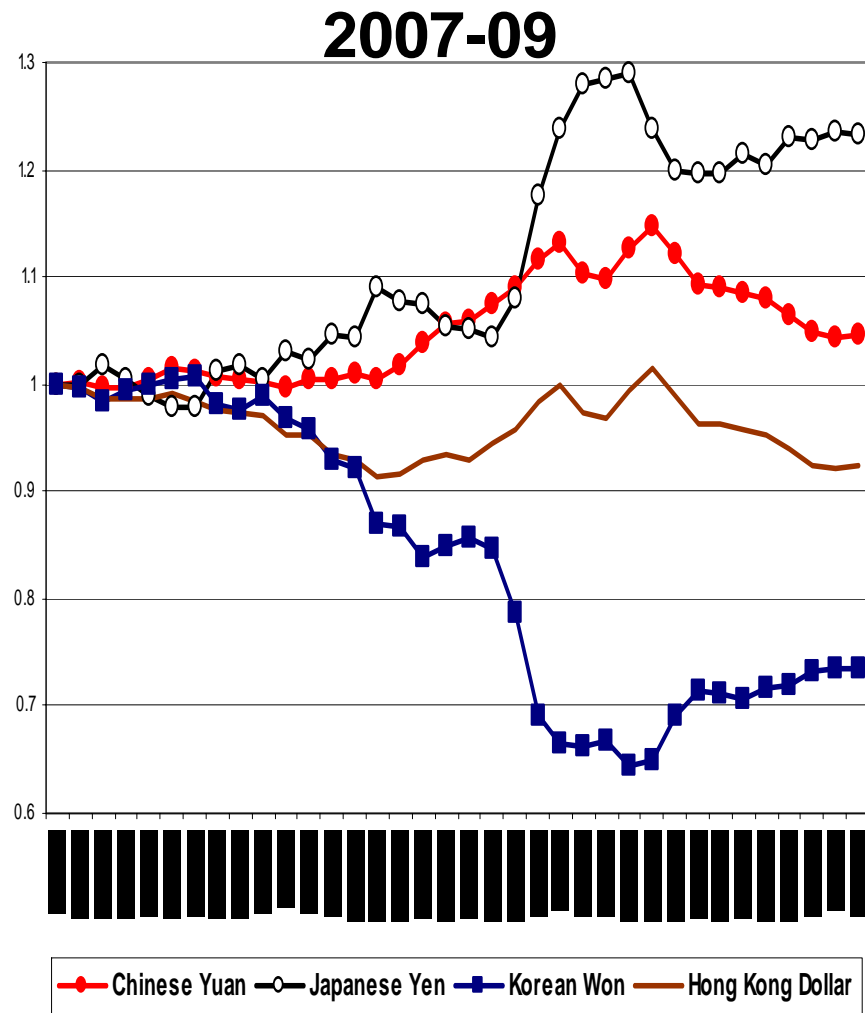
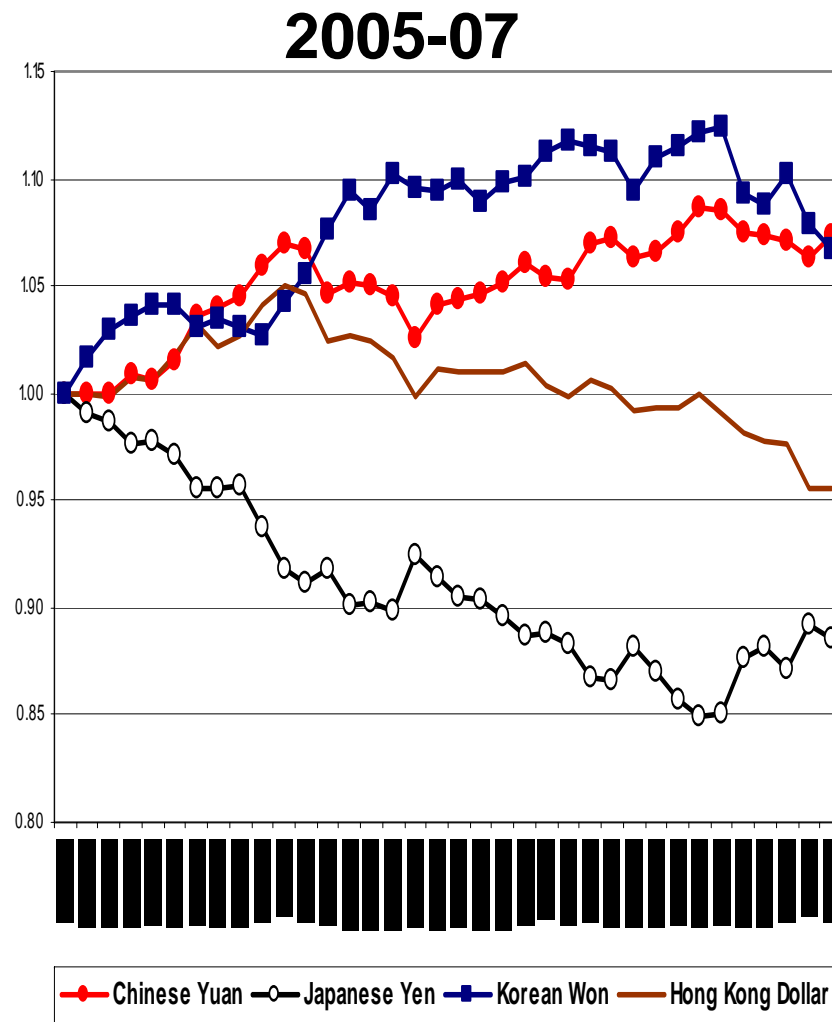
Step 1: Intensive policy dialogue

- Cultivate a culture that views exchange rates (including misalignments) as regional matters
- Introduction of an ACU index as one of the tools of regional economic surveillance
- Emerging East Asian economies can pursue structural and policy/institutional reforms to achieve convergence
- An independent secretariat for a multilateral, enlarged CMI, with participation of both finance ministers & central bank governors

ACU exchange rates vs. the US dollar and the euro



Deviations from ACU indicate large, intraregional exchange rate movements



Step 2: Informal coordination (regime choice)

- Greater exchange rate flexibility vis-à-vis the dollar, based on a basket of SDR-plus currencies (dollar, euro, pound, and ACU [= yen plus emerging Asian currencies])
- Stabilization of exchange rates against SDR-plus does not require significant macroeconomic or structural convergence
- Creation of an Asian Monetary (Cooperation) Fund by delinking the CMIM from IMF
- Real side integration needed through the consolidation of various, overlapping FTAs into a single East Asia-wide FTA

Step 3: Formal but loose coordination (exchange rate policy)

- Adoption of an SDR-plus currency basket with clear rules for loose intraregional exchange rate stability
- Intraregional exchange rate stabilization needs to be supported by a very short-term liquidity facility
- Greater macroeconomic and structural convergence required
- Real side integration required to proceed for the creation of an Asian customs union

Step 4: Tight coordination (monetary policy)

- Tightly coordinated intraregional exchange rate stability—a la Asian Snake or ERM using ACU as a reference—requires close monetary policy coordination and frequent use of a very short-term liquidity facility
- AMCF can be a clearing house of frequent currency interventions (due to short-term liquidity financing) for settling balances among the central banks, and issuance of official ACUs
- An Asian common market will be required
- Complete exchange rate and monetary policy coordination is feasible, if ever, only in the LR

6. Conclusion: Asia's Challenges

- An integrated Asia with the largest economic size will eventually require a single currency
- Given capital inflow risks, it is time to prepare for exchange rate policy coordination to better manage macroeconomic and financial-sector conditions, while maintaining intraregional exchange rate stability
- Asia needs to start intensive policy dialogue on exchange rates, informal coordination of exchange rate regimes, using ACU
- To support this process:
 - (1) Greater improvement in policy and institutional quality needed at the national level
 - (2) Asia must deepen various types of economic policy coordination (Asia-wide FTA, AMF, bond mkt, Asian FSB)
 - (3) Japan-China political reconciliation essential

Thank you

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