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Exchange Rate Arrangements for Emerging East Asia

WHAT TO DO about exchange rate arrangements is high on the policy agenda of emerging East Asia.[1] For decades, export-led growth has been integral to national development strategies in countries like South Korea and Taiwan. More recently, other countries, China and Vietnam among them, have adopted this same approach to initiating and sustaining economic growth. An exchange rate that is stable and competitively valued has been seen as necessary for penetrating foreign markets and successfully implementing this strategy.[2] This is the lesson drawn from Japan's high growth era, when the yen was pegged to the dollar for more than two decades and the country succeeded in transforming itself into an industrial powerhouse on the basis of manufactured exports.[3] For more than a half century, economic growth has been the common objective around which East Asian governments and societies have coalesced,

1. Emerging East Asia is taken here as including the ten members of the Association of Southeast Asian Nations, or ASEAN (Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, the Philippines, Singapore, Thailand, and Vietnam), together with China, Hong Kong, South Korea, and Taiwan. The main difference between "emerging East Asia" and "East Asia" is Japan, which nonetheless figures prominently in the discussion below. Throughout this volume, "Korea" refers to South Korea.

2. See Sachs and Warner (1995) for a powerful statement of the conventional wisdom.

3. Two contrasting interpretations of this experience are McKinnon (2005) and Eichengreen and Hatase (2005). A reasonably stable and appropriately valued exchange rate is also a precondition for the other pillar of the East Asian growth model—attracting foreign direct investment (FDI), particularly into the export-processing sector.

and the export-based strategy has delivered the goods. Given the historical association of economic growth and exchange rate stability, it is not surprising that Asian policymakers continue to long for stable currencies.

This was the context that rendered the Asian financial crisis of 1997–98 so traumatic. The crisis wreaked havoc with prevailing currency values. It interrupted the rapid economic growth that countries had come to take for granted. It reminded governments and their constituents that if confidence in policies were disturbed, the country might find itself helpless in the face of the pressures emanating from global financial markets. It taught officials that national economies could feel negative effects from financial disturbances and sharp exchange rate movements elsewhere in the region. East Asia's unhappy experience with aid and conditionality from the International Monetary Fund (IMF) then provided a stark reminder that the region could not count on reliable help from outside.

For all these reasons, the restoration of prosperity, stability, and growth has come to be regarded synonymously with the restoration of order to the region's foreign exchange markets. This is not to say that everyone necessarily agrees on what "the restoration of order" entails or on what constitutes the best means to this end. And post-crisis reform entails more than merely exchange market reform: it involves improving prudential supervision, building deeper and more liquid financial markets, strengthening corporate governance, and cultivating the skills needed to build a knowledge-based, innovation-intensive economy. Still, discussions of this reform agenda rarely get far before commentators launch into discourses on the exchange rate problem.

Now, with the explosive growth of America's current account deficit and the emergence of global imbalances as the dominant problem on the international economic and financial scene, it is not only Asian policymakers who are preoccupied by this set of issues. East Asian exchange rates have become a flashpoint globally. U.S. officials argue that Asian exchange rates pegged to the dollar at artificially low levels are contributing to imbalances jeopardizing global economic stability, or at least that they are preventing their orderly resolution. Restoring balance to the interregional balance of payments and hence to the world economy requires of Asia a combination of expenditure switching and expenditure increasing policies: expenditure switching to shift production away from exports, and expenditure increasing to provide adequate demand for that production at home. The expenditure increasing can be brought about through additional public spending and by financial market development to encourage consumer borrowing and obviate the need for very high levels of household saving. The expenditure switching requires a change in relative prices that can be brought about either through higher inflation in Asia or appreciation of the region's currencies against the dollar. The latter is unambiguously preferable from the point of view of price stability and central bank credibility.

U.S. officials therefore argue for a substantial one-time revaluation of the Chinese renminbi in the hope that other East Asian countries will then permit their currencies to follow. Or they argue that China should move to an exchange rate regime entailing greater flexibility, under which the value of the currency is "market determined," permitting it to also adopt a more flexible monetary policy. Or they argue that East Asian central banks should agree on a joint float and collective appreciation of their currencies against the dollar.

For Asian policymakers, these issues constitute a dilemma. Officials recognize that resolving the problem of global imbalances requires the dollar to fall against other currencies, including their own. But greater exchange rate flexibility and appreciation against the currency of the country that is a key export market may not be compatible with their traditional reliance on export-led growth. In addition, the appreciation of local currencies against the dollar raises the specter of capital losses on the region's dollar reserves.

Some of these problems could conceivably be ameliorated by collective action. Thus capital losses on dollar reserves might be limited if the process of reserve diversification were cooperatively managed.[4] Rather than selling off dollar reserves in a rush, Asian central banks could cautiously inject them into the markets at times of relative dollar strength. Exchange rate volatility might be reduced if the adjustment of exchange rates against the dollar were coordinated within the region. This is the basis for the argument that East Asian countries should coordinate their response to the problem of global imbalances. Some proponents go a step further and argue that cooperative management of exchange rates and reserves would be facilitated by creating a common set of agreed currency targets and commitments: in other words, by agreeing on a regional exchange rate regime.

Probing Deeper

A coordinated response is most likely if the potential participants in such an initiative share a common diagnosis of the problem they are being asked to solve and of the effects of alternative solutions.[5] However, as soon as one starts probing deeper, one discovers that there is little agreement on the nature of the

4. A suggestion along these lines, for an international reserve standard, is made by Truman and Wong (2006).

5. This point has been made in different ways by Frankel and Rockett (1988) and Eichengreen and Uzan (1993).

problem, much less on what constitutes a solution. For some, the problem is how to engineer a joint appreciation against the dollar as a partial resolution of global imbalances, followed by measures to restore the stability of the dollar rate, reflecting the continuing importance of the United States as an export market and source of foreign direct investment (FDI). For others, the problem is how to enhance exchange rate stability within the region, given the rapid development of intra-Asian supply chains and vertical intra-industry trade. For still others, the problem is how to obtain greater exchange rate flexibility as a way of enhancing monetary autonomy and strengthening the incentive for banks and firms to hedge currency risks. Not all these diagnoses of the problem point with equal force to exchange rate stability as the focus of policy-coordination efforts.

Even if one accepts the premise that East Asia would benefit from stable exchange rates, this leaves open the question of "stable against what?" Even if one agrees that Asian countries should cooperate in engineering the joint appreciation of their currencies to help resolve the problem of global imbalances, this leaves open whether that joint appreciation should be against the dollar; the dollar and the euro; or even the dollar, the euro, and the yen: pointing in turn to the question of whether Japan should be inside or outside such an agreement. Similarly, even if one is committed to the idea that Asia's future lies in intraregional trade and investment, the question is whether other currencies should be pegged to the yen, Japan being the leading source of FDI in the region, or the renminbi, with China emerging as its leading supplier of exports and leading importer of components and raw materials.

Once upon a time the existence of the Bretton Woods system finessed this dilemma. In the 1950s and 1960s, when all currencies of consequence were pegged to the U.S. dollar, stabilizing a currency against the dollar automatically stabilized it against other currencies.[6] But with the collapse of the Bretton Woods system in the 1970s, the yen and the dollar began fluctuating against one another, so that stabilizing exchange rates against the dollar, the traditional East Asian strategy, was no longer equivalent to stabilizing them globally. Eventually the consequences came to be important. Thus the appreciation of the dollar against the yen in the mid-1990s, in conjunction with the maintenance of de jure or de facto dollar pegs by Asian central banks, was widely cited, with benefit of hindsight, as having undermined the export competitiveness of the East Asian economies and thereby contributed to the 1997–98 crisis.[7]

6. For details, see chapter 4 by Shin and Wang later in this volume.

7. Kwan (2001) has generalized this analysis of how fluctuations in the yen-dollar rate, in conjunction with central banks' de facto dollar pegging policies, have affected competitiveness and growth in the Asian economies.

Now it is anticipated that the Chinese renminbi will eventually be allowed to display more flexibility against the dollar.[8] In turn this will have wider implications for the efficacy of dollar pegging. As noted, China has already emerged as the most important trading partner and destination for the FDI of its East Asian neighbors. Assuming that the rapid growth of the Chinese economy is sustained, it will not be too many years before this is the case throughout East Asia. East Asia is effectively committed to a pattern of vertically integrated intra-industry trade in which China—and, increasingly, other low-wage East Asian economies—import capital goods, parts, and components so as to act as assembly platforms for the region's exports of final goods to the rest of the world. Here, again, volatility of exchange rates among the participating countries could disrupt established economic relations. For those impressed by China's rise but who also value exchange rate stability, the question is increasingly: stability against the dollar or stability against the renminbi?

We should not leave the impression that the case for exchange rate stability is universally accepted. Some argue that the problem leading up to the Asian crisis was not that central banks and governments were inadequately committed to stabilizing their exchange rates but, to the contrary, that they were too slow to recognize the need for greater flexibility.[9] With the development of their economies and financial markets—and with accession to the Organization for Economic Cooperation and Development (OECD), in the case of South Korea—exposure to capital flows was heightened.[10] So long as exchange rates were pegged, growing capital mobility left less scope for autonomous monetary policies that might prevent economies from overheating and protect them from potentially dangerous lending booms. Monetary conditions were increasingly linked to those in the United States—such is the unavoidable implication of the combination of a pegged dollar exchange rate and high capital mobility—and monetary conditions in the United States were not obviously appropriate to conditions in Asia, where economies were at different stages of development and experienced fluctuations, for both economic and political reasons, on a different cycle. In practice, monetary policy became increasingly procyclical; since nominal interest rates were increasingly equalized across countries, faster growing

8. In July of 2005 the Chinese authorities took a first step in this direction, revaluing the renminbi by 2.1 percent against the dollar, and announcing that henceforth the exchange rate would be managed with reference to a basket of currencies and allowed to exhibit greater flexibility. In practice, however, the renminbi-dollar rate was allowed to exhibit little additional flexibility in the course of the immediately succeeding months. This Chinese policy initiative is discussed further in a number of the chapters that follow.

9. This is the conclusion of Goldstein (1998), for example.

10. The obligations of OECD membership required South Korea to relax and remove its capital controls following its accession to that body in 1996.

economies with higher inflation rates experienced lower real interest rates at the worst possible time. Meanwhile, one-time changes in the exchange rate against the dollar became more difficult to engineer as the capital account of the balance of payments opened. And so long as the exchange rate ostensibly remained pegged, banks and corporations had little incentive to hedge their foreign currency exposures—since the authorities continued to reassure them, all the while, that the price of foreign currency would not be changed.

The solution to these problems, according to some economists, is not to restore exchange rate stability but instead to move to greater flexibility, using a band-based system à la Singapore or an inflation targeting regime like that adopted by Korea in recent years.[11] East Asian countries need more monetary autonomy and room for maneuver, not just vis-à-vis the United States but relative to one another, since they are a heterogeneous lot. Since levels of economic and financial development differ among them, different exchange rates and, more fundamentally, different exchange rate regimes are desirable in different national cases. In this view, simply replacing dollar pegs with yen pegs, yen-euro-dollar basket pegs, or an intraregional currency grid would be a retrograde step.

Not for the first time, different economists are able to discern support for these different positions in the same set of data. East Asian currency regimes, it would appear, are a bit like a Rorschach test: there is a tendency for economists to see in their evolution more or less what they expect. Ronald McKinnon, a believer in the merits of pegging to the dollar, observes the relatively limited volatility of currencies against the greenback and concludes that this is evidence of the resurrection of the de facto East Asian dollar standard.[12] Leonardo Hernandez and Peter Montiel, who are more convinced of the merits of flexibility, look at the same data and conclude that the majority of East Asian countries have moved to at least somewhat greater flexibility.[13] The safest conclusion is probably that East Asian countries have not all moved in the same direction. As Masahiro Kawai shows in chapter 5 later in this volume, there is a growing diversity of arrangements. Thus while Hong Kong maintains its dollar-based currency peg and Taiwan continues to stabilize its exchange rate against the dollar even more tightly than before the crisis, Indonesia, the Philippines, Singapore, South Korea, and Thailand have all moved to at least somewhat greater flexibility against the dollar. China and Malaysia appear to be in transition between these two states.

11. See Goldstein (2002).
12. See McKinnon (2005).
13. See Hernandez and Montiel (2003).

Debate over what exchange rate regime is best in general has been ongoing for the better part of the last century. Many economists probably subscribe to Jeffrey Frankel's (1999) conclusion that no single regime is best at all times and places—that the only general answer to the question of which regime is best is "it depends." If so, it would also seem to follow that no single regime is right for all of East Asia. The region is made up of very heterogeneous economies, ranging from the high-income Japan to the low-income Myanmar, from the technologically sophisticated South Korea and Taiwan to the much less technologically advanced Cambodia and Vietnam, from the heavily agricultural Laos to the entirely urban and industrial Singapore. It is hard to imagine that a single set of monetary and financial arrangements could be suitable for all members of this eclectic grouping. In a sense the growing diversity of exchange rate arrangements in the region is itself evidence of this fact.

To be sure, western Europe is a diverse subcontinent as well, and that diversity has not prevented it from successfully navigating the transition to a common regime—indeed to the most uniform such regime, a common currency. But, by most measures, levels of diversity are even greater in East Asia.

Precedents and Proposals

Proposals for currency reform, perhaps predictably, are equally diverse. These range from recommendations that Asian countries should all move to floating exchange rates, backed by some form of open-economy inflation targeting, to plans for a swift transition to a single regional currency. Other alternatives lie between these ends of the spectrum. These include the idea that the emerging markets of East Asia should adopt basket pegs against the dollar, euro, and yen, which will better insulate them from disturbances associated with changes in the yen-dollar and yen-euro rates while still encouraging trade and financial flows with the rest of the world. They include the idea that by adopting the same basket weights and pegging relatively strictly to that basket, emerging East Asian economies might at the same time succeed in stabilizing their exchange rates against one another. The obvious objection here is that while substituting a G-3 currency basket for the dollar as the reference point for policy reduces exposure to yen-dollar and yen-euro fluctuations, it eliminates none of the other problems associated with external anchors that came home to roost in the Asian crisis and that will arise again if East Asian countries adopt such a basket and again peg to it relatively strictly.[14]

14. Many of these same points are powerfully made by Reinhart and Reinhart (2003).

Alternatively, it is argued that emerging East Asia should concentrate on stabilizing intraregional exchange rates rather than exchange rates vis-à-vis the United States, Europe, and Japan. Intraregional trade has been the most rapidly growing component of East Asia's total trade. Regional supply chains and production networks are best fostered by limiting exchange rate variability within the region, not by limiting variability vis-à-vis the rest of the world. Since exchange rate stability is valued by foreign investors, stable intra-Asian exchange rates may be important for encouraging the cross-border participation in local currency bond markets that is the goal of the Asian Bond Fund and the Asian Bond Market Initiative.[15] These observations provide the motivation for proposals that East Asian countries agree on the creation and maintenance of a multilateral regional currency grid analogous to the European Snake of the 1970s and the European Monetary System (EMS) of the 1980s and 1990s, which stabilized exchange rates among the participating European countries, to one degree or another, while allowing them to float against the dollar and the yen—and not incidentally paved the way for the creation of a single regional currency.

An objection to this line of reasoning is that Europe's experience with the EMS and now with the euro has not been entirely happy. The stability of the EMS rested on the presence of capital controls; as soon as these were removed, in the early 1990s, the incompatibility of an intraregional currency grid, open capital markets, and political pressures for central banks to temper their exchange rate commitments manifested itself in a dramatic way, namely in the currency crises of 1992–93. Only after bands were widened and a deadline was set for the transition to monetary union—and countries like the United Kingdom and Sweden reluctant to move in that direction were permitted to drop out and adopt more flexible exchange rates—did that instability recede. This reading of European experience suggests that Asian countries would expose themselves to the same risk of instability if they prematurely adopted a regional currency grid: more so to the extent that international capital mobility has risen further in the intervening decade.

Nor would all observers necessarily give high marks to Europe's experience with its single currency. Monetary cohabitation has not been an entirely happy experience for the participating countries. Some fast-growing European countries would have benefited from a tighter monetary policy. Such a policy, for example, would have helped Ireland by limiting the excesses associated with its housing boom. Meanwhile, other slower-growing countries, such as Germany, would have preferred a looser policy. But both preferences could not be accom-

15. For more on these initiatives, see chapter 3 by Yu and chapter 5 by Kawai later in this volume.

modated, given a single currency and a single monetary policy. More recently, there has been the emergence of serious problems of international competitiveness in countries like Italy, which have been disproportionately hit by the growth of Chinese competition given their industrial structures. In the presence of a national currency, adjustment can be facilitated by a discrete devaluation, which steps down domestic currency labor costs, assuming limited compensatory wage inflation. In the absence of such a currency, adjustment can take place only through a grinding deflation, which draws out the pain. This suggests that East Asia might similarly experience severe discomfort if it attempted to fit all the countries of the region into a single monetary straitjacket.

To be sure, this may be an overly pessimistic reading of Europe's experience with the euro. Monetary union has succeeded in eliminating exchange rate instability among the participating countries. It has ring-fenced Europe against financial instability emanating from outside, precisely as its architects intended. Indeed, it is hard to imagine that there would have been no exchange rate problems among the members of the euro area in the face of the September 11, 2001, terrorist attacks in the United States, the Madrid bombings, or the Iraq war, had a dozen regional currencies still been in circulation. This success at ring-fencing the region against outside financial pressures will have considerable appeal to Asian observers, especially in light of the interpretation of the 1997–98 crisis that implicates instability in global financial markets.[16]

Another objection to the presumption that East Asia should follow the European example is that other regions, notably North America, have been able to make significant progress in regional economic integration without stabilizing their exchange rates, much less moving toward a regional currency arrangement. The North American Free Trade Agreement (NAFTA) has led to the very significant further elaboration of supply chains and production linkages between the three participating economies since its establishment in the first half of the 1990s. The production of motor vehicles and parts, to take one example, is increasingly linked across North America's internal borders.[17] The northern part of Mexico is increasingly specialized in assembly and production operations for the U.S. market. That the Canadian dollar and Mexican peso continue to fluctuate against the U.S. dollar has not obviously posed an obstacle to the progress of real economic integration.[18]

16. On this view, see for example chapter 3 by Yu.

17. See Arndt (2006).

18. Indeed, not just the Canadian dollar but also the Mexican peso have been allowed to fluctuate increasingly freely against the U.S. dollar over time, as the Bank of Mexico has moved to an inflation targeting regime and shunned intervention in the foreign exchange market.

One can argue that the compatibility of exchange rate variability with production integration in North America reflects the unusual availability of hedging instruments. Forward exchange rate contracts are freely available on both sides of the U.S.-Canadian border, while Mexican peso futures can be bought and sold on the Chicago Mercantile Exchange. Producers in Asia, for their part, lack such markets, making it harder for them to hedge the associated risks; hence exchange rate fluctuations will be more disruptive to trade. But the availability of hedging instruments is in part a function of demand. If Asian currencies are allowed to move more freely, the increased demand for hedges will help to stimulate the demand of the relevant forward and futures markets—although how quickly remains to be seen.[19]

One can also argue that exchange rates within North America have been unusually predictable because the region's three central banks have all been following stable monetary policies, the Bank of Canada and Bank of Mexico, in particular, in the context of inflation targeting regimes. The evidence suggests that credible inflation targeters have more stable exchange rates, other things equal, minimizing the volatility that is arguably disruptive to regional integration.[20] Asia has less experience with inflation targeting, creating worries that abandoning its traditional exchange rate–centered monetary policy strategy might open the door to volatility that would interfere with regional integration. The counterargument is that there is no fundamental obstacle to the successful pursuit of inflation targeting in the region.[21]

European and North American experience also differ in two further respects. First, the European model in which the integration of markets in goods and services is accompanied by a regional exchange rate stabilization arrangement leading ultimately to the creation of a single currency is more obviously conducive to financial market integration. The advent of the euro has had a strong positive impact on the growth of cross-border financial transactions and on the growth of a regional corporate bond market in particular.[22] This reduced funding costs for European corporations, which have used their new access to debt finance to undertake mergers and acquisitions, a process that should ultimately result in some further rationalization of European industry

19. This is a lesson of the same Japanese experience in the era of high growth referred to in the opening paragraph. There the absence of deep and liquid forward markets in foreign exchange was cited as an impediment to greater exchange rate flexibility. As things turned out the advent of greater exchange rate flexibility prompted the development of deeper and more liquid forward markets.

20. Eichengreen and Taylor (2004) provide econometric evidence to this effect.

21. For more discussion of this argument and its limitations, see chapter 6 by Choi later in this volume.

22. A good summary of bond market developments in Europe since 1999 is Pagano and von Thadden (2004).

and improvement in the region's international competitiveness. Officials also see the development of deep and liquid regional financial markets as a step toward making the euro a serious rival to the dollar as an international currency, something that has been an objective of European politicians since at least the time of Charles de Gaulle. If Asia's goal is not just economic integration, as in North America, but also financial integration, as in Europe, then the case for following the European model is correspondingly stronger.

Second, Europe's commitment to exchange rate stability was buttressed by its pursuit of other regional programs like the Common Agricultural Policy (CAP), whose operation was vulnerable to exchange rate fluctuations, especially in its early years.[23] Under the CAP, European governments sought to stabilize domestic currency prices for agricultural products in several countries simultaneously, something that would have been impossible in the face of persistent large-scale fluctuations in the exchange rates between them.[24] Asia may or may not be similarly inclined to establish sectoral price support programs; economists, at least, would generally hope not. But the case for exchange rate stabilization and hence for an EMS-like system is correspondingly stronger in the presence of such programs.

That there is a strong case for regional monetary integration tends to be taken for granted in Asia. An economic analysis suggests that here, as in many circumstances, there are trade-offs. Pursuing monetary integration entails giving up something else, namely monetary autonomy at the national level. Sacrificing the latter is not costless, as is evident in Europe's own experience since 1999. Whether doing so is desirable depends not just on an assessment of these costs but on one's view of what Asia is ultimately trying to achieve.

Politics

A further objection to the notion that Asia should attempt to put in place a regional mechanism resembling the European Monetary System is that the operation of such a system has formidable political preconditions, and that Asia differs from Europe to an even greater extent politically than economically.

23. This point was famously made by Giavazzi and Giovannini (1989).

24. If exchange rates had been allowed to move, there would have been strong incentives for cross-border arbitrage, undermining price floors in the countries whose currencies appreciated. Europe attempted to finesse this problem by creating a system of de facto dual exchange rates (the so-called "green rates" of the CAP alongside the market rates that applied to other transactions), but this only created inefficiencies and further incentives for arbitrage (between the two rates, where possible).

Stabilizing exchange rates within the region requires, first and foremost, harmonizing monetary policies and conditions. In Europe there existed a natural focal point for such efforts: namely, the monetary policies of the German Bundesbank, whose commitment to sound and stable policies was beyond reproach. Moreover, it was palatable to delegate responsibility for the common monetary policy to the Bundesbank because monetary cooperation was part of a larger political bargain. In effect, other European countries agreed to assign responsibility for the common monetary policy to Germany because Germany was prepared to defer to the others in the formulation of the common foreign and security policy. As this was sometimes put, the European Monetary System and then Economic and Monetary Union were devices for locking a peaceful Germany into Europe. Or, in a more narrowly economic formulation, the European Commission in Brussels delegated the common monetary policy to Germany in return for Germany's agreeing to participate in a broader process of economic integration led by Brussels.

East Asia lacks an analog to the Bundesbank. Japanese monetary policy in the first half of the 1990s was hardly a paragon of stability, and since then the Bank of Japan has followed a policy of quantitative easing (associated with near-zero interest rates) appropriate for the exceptional economic and financial circumstances of that country but unsuitable for the region as a whole. The People's Bank of China has been allowing that country's monetary and credit aggregates to expand at rates approaching 20 per cent per year, which makes sense for a country growing by 10 percent a year and experiencing a process of progressive monetization but which is again unsuitable for the larger region. East Asia's own paragon of stability, the Monetary Authority of Singapore, makes policy for a small, specialized economy whose ups and down are governed by the global high-tech industry, leading it to adopt policies that are less than ideal for its neighbors.

Even more fundamentally, Asia lacks a political setting that would make unilateral leadership by a single national central bank acceptable. China would be reluctant for reasons stemming from history to put its monetary fate in the hands of Japan, and vice versa. Korea would be understandably reluctant to assign its monetary policy to either of its larger neighbors.

These observations encourage talk of a multilateral currency arrangement in which each country defines its parity relative to the other participating currencies or to a weighted average of a group of regional currencies.[25] This symmetri-

25. This weighted average might be given a name in order to encourage its use as an accounting unit; it might be called the "Asian Currency Unit" (or ACU), in parallel with the European Currency Unit (or ECU) established in the 1970s.

cal arrangement would be more acceptable, the argument goes, because all participating countries would be on an equal footing. But this ignores the fact that virtually all multilateral systems in the past have operated as de facto follow-the-leader arrangements. In every historical case of note, one national currency has emerged as the "sun" around which the other national currencies revolve. This was true of the gold standard, when Britain acted as "conductor of the international orchestra," of the Bretton Woods system, when the U.S. dollar was the key currency, and of the EMS itself, which had been intended as a symmetrical multilateral regime but soon evolved into a German-led system.[26]

This outcome is not surprising. Creating a multilateral currency grid does not eliminate the need for a monetary anchor. Logically, the anchor will be the country with the soundest policies and the deepest financial markets. That country will have the prerogative of deciding the monetary policy to be followed by the entire grouping. It will therefore have disproportionate sway over the operation of the system.[27]

When contemplating such schemes, it is important to recall that individual Asian currencies are small boats adrift on highly liquid international financial markets. They can be buffeted by waves of speculation, and stabilizing them may require extensive foreign assistance. In the economist's lingo, extensive financial assistance may be needed for the credibility of the currency arrangement.[28] But countries will agree to support their neighbors financially only if they think that doing so will be productive and only if they are confident of being paid back. In turn this requires confidence that the recipients of their largesse will undertake the requisite policy adjustments. And this supposes firm surveillance of national policies. Asian countries would have to agree to firm regional oversight of their policies—and specifically to accepting blunt criticism when things go wrong or even threaten to go wrong. This is not the

26. A forceful statement of this view is Giovannini (1989).

27. Until, that is, the participating central banks are prepared to take the next, momentous step of creating a transnational central bank under their common control responsible for conducting the common monetary policy. This, of course, is the key step toward monetary union, which is a much more ambitious scheme for regional monetary reform than under discussion here. It is sometimes suggested that perhaps Japan and China would serve as the dual motors for East Asian monetary integration, analogous to the dual roles of France and Germany in European integration. This would of course require a level of diplomatic rapprochement and political comity that the two Asian powers have not yet begun to display. Moreover, there is the objection that while France and Germany worked together to push forward the larger European project, when it came to the Snake and the European Monetary System there was room for only one leader—the country with the strongest and most stable monetary policies—and that was Germany.

28. Otherwise, speculators may think that by engaging in extensive sales of a currency they may be able to ratchet up the pressure on the authorities sufficiently that the latter feel compelled to abandon the peg, as in so-called second generation models of balance of payments crises.

"Asian way," which is instead characterized by deference to one's neighbors' policies and a reluctance to engage in overt criticism.

This raises questions about whether the kind of extensive financial supports needed for the operation of a multilateral currency grid are feasible in East Asia. One sees the tension in the design of the Chiang Mai Initiative, the network of bilateral swap arrangements negotiated among ASEAN+3 countries starting in 2000.[29] Extension of these swaps beyond the first 15 percent is contingent on the negotiation of a program and hence subject to the conditionality of the International Monetary Fund.[30] In effect, qualms on the part of the funders about whether firm surveillance can be exercised led them to delegate this surveillance function to an outside authority. There continues to be talk of the desirability of "multilateralizing" the Chiang Mai Initiative, so that currency swap agreements, now negotiated between pairs of countries, come to be made available to the entire regional grouping. Whether the goal is desirable depends on one's view of the advisability of establishing and attempting to defend a regional currency grid. Whether it is practical hinges on the development of political solidarity sufficient to render individual Asian countries comfortable with delegating control over their financial resources to their partners in the regional arrangement.

Thus ensuring that countries pursue the requisite high levels of policy harmonization and guaranteeing them adequate levels of support in the face of market pressures will require a higher level of political solidarity than currently prevails in East Asia. A decade ago it was easy to dismiss schemes for an East Asian monetary union on political grounds.[31] The region lacked a tradition of integrationist thought comparable to that of postwar Europe. China and Japan, unlike France and Germany, did not draw from the experience of World War II the lesson that the way to prevent future conflicts was by pursuing a politically led integration process. However, now that Asian countries have had time to digest the lessons of the 1997–98 crisis, there are signs that this may be changing. Countries realize that the only way for the ascending region to exert power comparable to that projected by the United States and Europe is for its members to act collectively. They understand that regional problems like the underdevelopment of local financial markets will be easier to solve if they act collectively rather than individually. This new commitment to regional cooperation is evident in the Chiang Mai Initiative and the Asian Bond Fund. The readiness of East Asian governments and central banks to commit

29. On this, see chapter 3 by Yu.

30. Originally this was the first 10 percent, but the ratio was raised subsequently.

31. See for example Bayoumi, Eichengreen, and Mauro (2000).

meaningful financial resources to these regional initiatives signals a departure from the status quo ante.

These steps, however consequential, are also reminders of how far East Asia has to go before it will be in a position to create a durable system of regional currency pegs, much less a regional monetary union. Much more will have to be done in terms of cultivating political solidarity and cohesion. That completing this process took Europe half a century does not mean that it will necessarily take that long in Asia; the follower economies of Asia having shown the capacity to telescope into a shorter period processes that took longer in other parts of the world. But neither does it suggest that the process will be completed overnight.

In addition, the fact that political circumstances are different than in Europe suggests that the process of ongoing integration leading ultimately to monetary unification will be more market led and less politically led than was the case in Europe. European integration, it is sometimes said, was at root a political process; the Common Market and then EMU were economic means to a political end. In Asia, in contrast, markets play a larger role, and politicians a smaller one, in driving forward the integration process. This is clearly evident in trade integration, where the completion of the ASEAN Free Trade Area and now an ASEAN+3 Free Trade Area have been slow, but de facto integration propelled by vertical intra-industry trade and the associated FDI has been rapid. One way of thinking about the challenge facing East Asian policymakers—and one of the ways it is put in the remaining chapters of this book—is how to best enlist economic forces in furthering these processes.

The Chapters of This Book

These are the issues taken up in the chapters of this book. Chapter 2 by Masaru Yoshitomi of the Research Institute of Economy, Trade and Industry (RIETI) in Tokyo sets the stage by placing the Asian currency issue against the backdrop of the global imbalances problem. Yoshitomi warns that the U.S. external position is unsustainable and that the differential returns on U.S. foreign liabilities and assets that have prevented the country's foreign debt from exploding can no longer be counted on as in the past. He acknowledges the need for some collective appreciation of Asian currencies against the dollar to contribute to global rebalancing but worries that this adjustment could be stymied by the existence of a prisoner's dilemma. Even if countries recognize the need for their currencies to strengthen against the dollar as group, in other words, they may be reluctant to allow them to adjust individually if they are skeptical that their regional neighbors will do the same, both because they see that revaluation by any one country—even China—will not be enough to make a significant dent in the imbalances problem (for this, Asian countries will have to move together), and because they fear that if other countries do not respond in kind the initiating country will incur a double competitive disadvantage: not only will it lose competitiveness against the United States, but it will also lose competitiveness relative to its Asian neighbors.

Yoshitomi argues that the coordination of policies will be easiest if all countries in the region operate the same exchange rate regime. In particular, if all of them frame policy with reference to the same or at least a similar currency basket, and if they all maintain relatively wide fluctuation bands against it, then it will be relatively straightforward to negotiate and implement a regionally coordinated appreciation vis-à-vis the dollar. It would also be helpful, he concludes, to build stronger regional institutions to enhance the credibility of commitments to such a move.

In chapter 3, Yongding Yu of the Chinese Academy of Social Sciences asks who will lead the process of regional monetary and financial integration. He describes how interest in exchange rate cooperation was spurred by dissatisfaction with the IMF's response to the 1997–98 crisis and observes that these concerns have not gone away. He notes further than Japan's influence in Asia has tended to wane as a result of its extended economic slump. But he warns that China, the heir apparent to the throne, is preoccupied by its own reform agenda. Conceivably, leadership on monetary and financial issues could be provided jointly, but here lack of trust and rivalry between China and Japan is a problem.

Yu concludes that China as the rising power will unavoidably set the tone for discussions of East Asian monetary integration in coming years. But, in turn, this implies that the pace of progress will be slow. China has its own problems, and it will take time for it to complete the transition to a market economy. Once that has happened, China will be able to devote more attention and exert more leadership on regional matters. But at that point, domestic demand will have caught up with economic growth, and the country will have become less oriented toward exports and therefore less preoccupied by exchange rate issues, in much the same way that the United States is less preoccupied by them. Hence it is likely to become more skeptical about calls for a common basket peg or a regional exchange rate stabilization arrangement, much less a common currency. This suggests that a process of Asian monetary integration dependent on Chinese leadership or even contingent on significant Chinese participation is likely to be a slow one.

In chapter 4, Kwanho Shin of Korea University and Yunjong Wang of the SK Research Institute delve further into the connections between trade integration and monetary integration. That Europe first created a customs union before moving to monetary integration has fostered expectations that East Asia will do likewise. But efforts to complete the ASEAN Free Trade Area have been slow, and the obstacles to an ASEAN+3 free trade area are even more formidable. Given that there is a desire for exchange rate stabilization, this raises the question: why not capitalize on this predisposition by first stabilizing exchange rates, which will encourage the growth of intraregional trade and endogenously generate support for trade liberalization—support that will then feed back positively to the campaign for monetary integration?

For this strategy to be feasible there must be robust feedback from exchange rate stabilization to trade, and this requires that trade liberalization must have first reached a critical facilitating stage. Shin and Wang ask whether this is the case in Asia: whether there is evidence that limiting exchange rate volatility significantly stimulates trade and enhances the trade-creating effects of regional and bilateral free trade agreements. Their findings are mixed: while there is evidence of the direct positive effect of more stable exchange rates on trade, its magnitude is small by the standards of Europe. And, in contrast to Europe, the indirect effect magnifying the trade-creating effects of free trade areas appears to be missing. On balance, the authors are skeptical that monetary integration can lead trade integration in Asia, as opposed to following it as in Europe.

In chapter 5, Masahiro Kawai of the Asian Development Bank (ADB) and the University of Tokyo approaches the question of what reference point is best for East Asian currencies by exploring the past and future of international currency competition. He observes that the traditional situation where the dollar was unrivaled in the international monetary and financial sphere is unlikely to persist. The advent of the euro has already created serious competition for the dollar.[32] A relevant question in this context is whether one or more Asian currencies might also emerge as rivals. Kawai cautions that both the yen and the renminbi have drawbacks from this point of view. Japanese growth has been poor, and the zero yield on Japanese government bonds (JGBs) has made holding them as international reserves unattractive. China for its part has major

32. This is especially true if one accepts the argument, advanced by Lyons and Moore (2005) and Eichengreen (2005), that the network effects that once made international currency competition—reserve currency competition in particular—a winner-take-all game are unlikely to operate as powerfully in a twenty-first century world where the existence of sophisticated financial markets and instruments will minimize the costs of switching between currencies and using a variety of them in both domestic and international transactions.

structural problems; it is still far from a market economy. Until the transition to a market economy and an open political system is complete, agents will not be fully comfortable in using its currency for international transactions.

Even if no single Asian currency emerges as a serious rival to the dollar, a collection or basket of such currencies still could. Kawai suggests what East Asian governments and central banks can do to foster movement in this direction. Countries would first agree on a common G-3 basket peg, which would have the corollary benefits of limiting the volatility of intraregional rates and encouraging the use of local currencies in intraregional transactions. After strengthening surveillance, coordinating policies, and enlarging mutual supports, they could then create a truly multilateral Asian system along the lines of Europe's Snake and Exchange Rate Mechanism. Alternatively, they could increase the weight on the yen, in the limit transforming the G-3 basket into a yen bloc and stabilizing intra-Asian exchange rates still further. This approach would require dedicated Japanese leadership and a robust Japanese economy to make it more attractive for central banks and international investors to hold yen-denominated assets.

In chapter 6, Gongpil Choi of the Korean Institute of Finance and the Federal Reserve Bank of San Francisco also proposes a phased transition, although the details of his blueprint differ. While under the Choi plan the emerging economies of East Asia would again start by agreeing to formulate their monetary policies with reference to a common G-3 currency basket, they would be permitted to follow that common basket with different degrees of rigidity, in conformance with their different economic circumstances and conditions. Some regional currencies would fluctuate significantly against that basket, while others would follow it quite strictly. Consequently, in this first stage, intra-Asian exchange rates would continue to vary. Over time, strengthened surveillance and more extensive financial supports would permit governments and central banks to harmonize their policies more closely. As that harmonization proceeds, their policies toward the common external basket would be harmonized as well, and intraregional exchange rates would grow more stable. At this point the countries of the region would logically shift to a regional currency grid or local currency basket. From a multilateral currency grid or regional exchange rate stabilization agreement, the next logical step—which presumably would be a long way down the road—would be to a single East Asian currency and an East Asian Central Bank.

In contrast to these politically directed transition paths, in chapter 7 Barry Eichengreen of the University of California–Berkeley sketches a market-led approach. This would start with the creation of a synthetic regional unit—the

Asian Currency Unit, or ACU—that would be allowed to circulate in parallel with existing national currencies. This parallel currency would not replace national currencies, but it would circulate alongside them; in particular, it would have full legal tender status in the sponsoring countries. It would be more stable than existing national units in terms of aggregate East Asian trade and financial flows, and as such it should become increasingly attractive as a unit for keeping accounts, invoicing transactions, and making payments for governments, firms, and others engaged in significant cross-border transactions. Banks would presumably accept ACU deposits to meet these needs and match these with ACU loans; the stability of the parallel currency would also make it an attractive unit in which to issue regional bonds. All these uses of the parallel currency should become more extensive with the continuing growth of cross-border transactions within the region. Once the parallel currency gained popularity and acquired significant market share, it would it be clear that the time was ripe for the adoption of a single regional currency. Since residents would already be using this unit for the bulk of their transactions, eliminating national currencies in favor of the new unit would be painless at this point.

An important difference between this proposal and those of previous chapters is that it would not be necessary to limit the variability of East Asian exchange rates against one another. As Eichengreen notes, it would also be possible to establish a parallel currency defined as a basket of the currencies of the participating countries without adopting any peg at all. All that would be needed would be a set of rules and interventions that would maintain the ACU's value relative to the specified basket of regional currencies. If the constituent currencies floated against one another, then the ACU would rise in value relative to currencies that depreciated against the basket and fall in value relative to currencies that appreciated against the basket, without its value changing relative to the basket as a whole. Thus there is a distinction between the decision to establish a parallel currency defined as a basket of regional currencies and the decision to adopt a harmonized system of currency pegs—a point that all too often tends to be misunderstood.

This approach has the attraction that the pace of the transition to monetary union would be market led rather than politically led, consistent with the greater emphasis of Asian policymakers on market forces since the crisis of 1997–98. Its corresponding drawback—if it indeed is a drawback—is that the transition could be a lengthy one. Europe experimented with a parallel currency approach starting in the 1970s but ultimately gave it up for a more top-down politically driven strategy for creating a monetary union within a fixed period of time.

Summing Up

In sum, the authors contributing to this volume find common ground in the need for cooperation on exchange rate management in East Asia. They agree on the desirability of regional monetary integration. Despite coming from different places and adopting different perspectives, they concur on the need for greater flexibility of Asian currencies against the dollar in general and specifically to address the problem of global imbalances. At the same time, they acknowledge that the growth of intraregional trade—vertically oriented intra-industry trade, in particular—along with growing intraregional FDI flows creates a case for maintaining a reasonable degree of intra-Asian exchange rate stability. Together these observations create an argument that East Asian countries should coordinate the adjustment of their currencies against the dollar. Turning to the specifics of how they should do this, there is less of a consensus. Rather, there are a variety of plans.

For the longer run, the difficulty of holding stable the exchange rates of separate sovereign currencies suggests the desirability of deeper monetary integration, culminating in the creation of a regional central bank and a regional currency. But how this transition will occur, and under whose leadership, remains unclear. All this suggests that progress will be incremental and that the transition will not be complete anytime soon. Fortunately, Asian societies are not unfamiliar, or necessarily uncomfortable, with processes that take very long periods of time to unfold.

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