A Common Regional Monetary System Is Imperative for the Future of Japan and Asia[1]

YAMASHITA Eiji

Professor, Graduate School of Economics, OCU;

Individual Member, the Council on East Asian Community (CEAC)

[1] This paper is based on Yamashita (2002a), (2002b), (2006a) and (2006b), but particularly (2006a).

Summary

Europe maintained its intra-regional fixed exchange rate regime, EC Snake and EMS, for almost 27 years from April in 1972. And, at the Beginning of 1999 Europe accomplished an historically great achievement by creating a unified currency, the "euro" as the ultimate form of its intra-regional fixed exchange rate regime.

Although the value of the dollar has been swinging dramatically for more than 30 years, European countries have been able to protect themselves considerably from the negative effects generated by undisciplined US economic policies and the dollar's consequent instability, due to the existence of an intra-regional common exchange rate system in Europe. On the other hand, Japan has been fully affected by the negative impact of the dollar's instability, because there has been no such monetary framework in Asia. Learning from this extremely important lesson, Japan must push forward with East Asian regional cooperation and integration very strongly on the basis of the framework of "ASEAN+3 (Japan, China and South Korea)" which includes 13 countries. To be concrete, we in Asia must establish a common intra-regional monetary system with the fixed exchange rate regime, like the EC Snake or the European Monetary System (EMS).

Introduction

In this paper, I would like to raise three issues, as mentioned below.

Firstly, I am going to review and evaluate the unique experiences of the European intra-regional fixed exchange rate regime for almost 27 years since April in 1972 under the global currency system of floating exchange rates. Europe created a unified currency under the framework of the European Economic and Monetary Union (EMU) at the beginning of 1999, and the euro became the only legal tender among the 12 countries participating in EMU since the beginning of March 2002. As Europe is far ahead of Asia in terms of regional integration, there are many more things for Asia to learn from the European experience with a fixed exchange rate regime, the EC Snake and the EMS (the European Monetary System) rather than the EMU.

Secondly, I would like to clarify the implications of these experiences of the European currency systems for international monetary reform on a global basis.

Thirdly, I would like to clarify the implications of these experiences of the European currency system for Japan's international currency policy, including the establishment of an Asian intra-regional currency system.

1. Evaluation of the European Experience with an Intra-regional Fixed Exchange Rate Regime

I would like to evaluate Europe's own intra-regional fixed exchange rate regime with the EC Snake and the European Monetary System (EMS) for almost 27 years.

The purpose of the EC Snake which started April 1972 was ① to accomplish Europe's dearest wish since the "the Ansiaux Report"[2] in October 1970 to remove the dollar as an intervention currency in Europe, and ② to minimize the negative effects of floating exchange rates on the European economy which were triggered by the collapse of the Bretton Woods System. Meanwhile, the main purposes of the EMS were ① to accomplish de-dollarisation in Europe and to assure the independence of European currencies, and ② for Germany to share the very heavy burden of the dollar's sharp depreciation with other European currencies.

[2] "The Ansiaux Report" was annexed to "The Werner Report" in October 1970.
Barron H. Ansiaux was the then president of the Central Bank of Belgium.

Eventually, these purposes were almost completely accomplished. The German mark became the intervention and reserve currency within the EMS, replacing the dollar from the mid-1980s, and EMS member countries succeeded in mitigating the adverse effects from the dollar's repeated unrest via the isolation effect of the EMS. Germany was able to diffuse the adverse effects of the dollar's sharp depreciation with respect to other EMS countries, as intended. Hence, the development of the real effective exchange rate for the German mark has been fairly stable, despite the sharp appreciation of the German mark against the dollar.

Thus, I understand that the experience of the European fixed exchange rate regime from April 1972 through the end of 1998 was as great a success as could be imagined.

I would like to look into the fruits produced by the EMS in more detail. The substantial strengthening of the role of the German mark as the intervention currency within the EMS was triggered by the dollar' s sharp decline after the Plaza Accord in September 1985. So, the Plaza Accord was certainly a necessary condition for the German mark to become the intervention and reserve currency in the region. More importantly, however, the most sufficient condition was provided by the continuation of the fixed exchange rate regime within the EMS.

Facing the situation of the dollar's sharp decline at that time, if weak currency countries intended to intervene in the foreign exchange market by selling the dollar in exchange for buying their own currency, as they had done in the past, in an attempt to keep their currency's parity with the mark which was always the strongest currency within the EMS, it would have provoked an even further decline of the dollar. In other words, this method of market intervention could have invited further speculative selling of the dollar which would have made the situation worse. Therefore, these weak currency countries intervened in the foreign exchange market mainly by selling the German mark in exchange for buying their own currency from the mid-1980s. As a result, the German mark became the exchange standard currency and intervention currency within the EMS from the mid-1980s. At the same time, the German mark naturally became the reserve currency within the EMS. This means that the German mark had finally become the key currency within the region at that time.

Thus, Europe accomplished de-dollarisation within the region which had been its dearest wish since "the Ansiaux Report" in October 1970. The most important lesson here is that the German mark could not have become the intervention currency without the European policy discipline which developed under the intra-regional fixed exchange rate regime, although the move was triggered by the dollar's sharp decline.

However, there was certainly some important asymmetry between Germany and other EMS countries. First of all, Germany could always seek its own domestic monetary policy target, while other EMS countries were always obliged to follow the German Bundesbank's monetary policy.

Matthias Kaelberer at Iowa State University said[3] that Germany had the weapon of "exit threat" from the EU framework; consequently, it had virtual "standard setting" power in the intra-regional system. He stressed that there was profound asymmetry between Germany and other European countries in such standard setting. Since any European economic framework without Germany obviously did not have sufficient credibility, other European countries feared either a German exit from the existing system or German absence from the new system. Therefore, the substance of the major EU system including the EMS and the EMU was set almost as Germany wanted.

Next, let us move on to the issue of asymmetry between balance-of-payments surplus countries and deficit countries. Generally speaking, if countries intervene in the foreign exchange market in an attempt to keep their currency's parity under a fixed exchange rate regime, foreign exchange reserves in the deficit countries decrease while those in the surplus countries increase. Said differently, deficit countries have some quantitative restrictions on their foreign exchange reserves, unlike surplus countries. Consequently, balance-of-payments discipline will surely be imposed on deficit countries under a fixed exchange rate regime. In particular, I would like to stress that this asymmetry is of the greatest benefit among those which the fixed exchange rate regime inherently has. In reality, a consensus on the preference for a stability-oriented policy among EMS members had been formed ever since the French socialist government made a major change in its

[3] Matthias Kaelberer (2001), p.141

macro economic policy in March 1983 under the Mitterrand administration. This resulted in "the disciplinary effect of the EMS", which Horst Ungerer said [4] was functioning very well within the EMS.

I do not think it meaningful to discuss the asymmetry problem between the surplus countries and deficit countries from the viewpoint of simple "fairness". Balance-of-payments discipline to the effect that any country must discontinue large long term deficits in its current account should be a crucial and very healthy proposition for macroeconomic policy management. And, a very strong balance-of-payments discipline is imposed on deficit countries under a fixed exchange rate regime.

After liberating the yoke of gold via the Nixon administration's "the New Economic Policy" in August 1971, the United States proposed its newly forged idea of "the argument for a surplus country's responsibility for adjustment", and demanded that Germany and Japan reduce their balance-of-payments surplus during the Carter administration in the latter half of the 1970s. It was the so-called "locomotive argument for Japan and Germany". In reality, however, "the argument of surplus country's responsibility" never functions well, unlike "the argument for a deficit country's responsibility for adjustment" under a fixed exchange rate regime. This is because "the argument for a deficit country's responsibility" means "credibility exports" from surplus countries to deficit countries. But, "the argument for a surplus country's responsibility" leads to "exports of morale hazards (discredit exports)" from deficit countries to surplus countries. Subsequently, the soundness of the world economy is impaired as a whole under the rule of "a surplus country's responsibility". International financial system, like any domestic financial system, must be conducted by creditors' logic, not by debtors' logic.

Inherently the status of surplus countries and deficit countries is not unchangeable. It can be changed by each country's policy efforts. The incentive for deficit countries to turn into surplus ones and release themselves from quantitative restrictions on their foreign exchange reserves is a very healthy mechanism. In reality, deficit countries in the past such as France, Belgium, Denmark, and Ireland have turned themselves into constant surplus countries, when historically reviewing each country's performance in the EMS.

In sum, I believe that the EMS functioned well because it had asymmetry. If symmetry had largely prevailed in the European Monetary System, its functions would have been weakened considerably.

If a method of foreign exchange market intervention using the European Currency Unit (ECU) would have been established in the EMS, as France proposed when it was planned in the late 1970s, would it have functioned well? It seems to me that a basket-based artificial currency of the ECU could not have competed with the major national currencies. The scope for using an artificial currency might have been very limited. Therefore, even if an ECU intervention method would have been established from the start, a big question remains whether the ECU could have functioned sufficiently as an intervention currency in the EMS. I think it was quite right that Germany stuck decisively to its method of bilateral parity grid rather than the ECU intervention method when the EMS was planned. Germany rightly argued that it was the substance of the entire system. Fortunately, the method of bilateral parity grid in the EMS was finally decided on at the German Schmidt and the French Giscard d'Estaing Summit in Aachen in July 1978.[5]

Looking back on the entire history of the EMS, the asymmetry between Germany as the central currency country and other member countries contributed positively to the stability of the EMS. It is no exaggeration to say that the success of the EMS can be attributed to the existence of this healthy asymmetry and the subsequent balance-of-payments discipline imposed on member countries. And, Germany as the central currency country of the system contributed tremendously to the success of the EMS with good economic performance due to a very sound macro economic policy that put a great emphasis on anti-inflation.

But, the profound asymmetry which has existed between the U.S. and other countries in the current global monetary system from the latter period of the Bretton Woods System through the present-day system of floating exchange rates is an extremely serious issue. We in the international community must find a solution to this problem eventually. In this sense, it was quite fair and right that France demanded a thorough reform of the international monetary system in the 1960s, severely criticizing the lack of U.S. policy discipline.

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[4] Horst Ungerer (1997), pp. 192-193
[5] Yamashita (2002), p.227

Another major accomplishment of the EMS was stabilising the developments of real effective exchange rates for its member country currencies. This means that EMS member currencies were relatively stable against outside currencies. Although the global monetary system had been very unstable because of the dollar's often sharp declines, the EMS was able to protect its member countries from the system's raging waves. In this sense, I call it "the EMS Hard-shelled Capsule" [6]. In sum, Europe was able to defend itself from disorder in the outer world by maintaining an intra-regional fixed exchange rate regime and ever closer economic integration through the market integration. In other words, the EMS had a definite "the isolation effect".

Throughout the almost 27-year periods of the EC Snake and the EMS, currency realignments, which even included small realignments such as only one bilateral ones involved, happened once a year on average. If we count only relatively large examples such as "multilateral currency realignments" [7] involved, they happened once every three years on average. Although it is often said that the EMS failed, I do not agree. It is not meaningful to evaluate the EC Snake or the EMS, by analyzing their performance in each period of time divided into several shorter periods. It seems to me that the most important thing is to broadly evaluate the varied experience of the EC Snake and the EMS throughout the whole period. I understand that Europe maintained its intra-regional fixed exchange rate regime via the EC Snake and the EMS for almost 27 years, and from the beginning of 1999 the European currency system finally succeeded in evolving into a unified currency which is the ultimate form of intra-regional fixed exchange rate regime.

2. Implications for the Reform of the Global Monetary System

I would like to move on to the second raised issue which was mentioned in introduction of this paper. Before proceeding to the Asian issue, first we have to look at the implications of the experience of the European monetary system for the reform of the global monetary system.

he current global monetary system is absolutely contradictory because the world's most heavily indebted country is seated in the central currency country status in the whole international monetary system. As a result, the major international currencies are volatile, and there is no yardstick of the value or numeraire in the world economy. Consequently, the world economy is extremely unstable. Therefore, the current situation must be substantially changed. I believe that basic exchange rates among the three major currencies of the dollar－the euro and the yen (or hopefully a unified Asian currency in the future)－ should be fixed. In other words, we in the international community should aim for a global monetary system of "competitive equilibrium", with the three major currencies checking each other.

The crucial point is how to prevent the reserve currency country from falling into moral hazard. Under floating exchange rates, the reserve currency country does not have balance-of-payments discipline, because it is able to finance its deficits by its own currency virtually freely. In an attempt to prevent the reserve currency country from doing so, "a rigorous restriction" should be imposed on the country. Since an artificial currency does not function as "a rigorous restriction", I think it is no way other than linking to gold in some method. Said differently, in that new global monetary system basic exchange rates among the three key currencies －the dollar, the euro and the yen －should be fixed, and at the same time each of them should have its own gold parity. I called this new Bretton Woods System "The Contestable Key Currencies System (CKCS)" in my paper [8] in 1996.

By the way, if we aim to build a new Bretton Woods System based on a fixed exchange rate regime with the three key currencies which I have advocated, the greatest obstacle would be the United States. I think that there is no major theoretical or technical problem with a fixed exchange rate regime. The current system of floating exchange rates is extremely convenient for the United States, because it is impossible to impose policy discipline on the U.S. as the reserve currency country. Since the U.S. has huge vested interests in the current floating exchange rates, it would necessarily oppose the idea of a fixed exchange rate regime with three key currencies.

In an attempt to promote this new Bretton Woods System, it is extremely important for Japan to

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6 Yamashita (2002), pp.237-240

7 "Multilateral currency realignment" means currency realignment which involves more than three currencies at the same time.

8 Yamashita (1996)

establish a Franco-Germano-Japanese Initiative first. Since the greatest victim of the current global monetary system is apparently Japan among industrial countries, the Japanese Prime Minister should appeal directly to the German and French leaders toward the establishment of a new system. And, each leader of the three countries (Japan, Germany and France) should appoint his or her substitute (expert) to study and design a concrete scheme. It should be noted that Japan has experienced huge losses due to the outrageously sharp appreciation and volatility of the yen over the past almost 30 years. The so-called "the Lost Decade" or "the Lost 15 Years" of the Japanese economy commencing on the beginning of the 1990s ultimately came from the outrageously steep appreciation of the yen ("chou-endaka" in Japanese) which often promoted by talking intervention of the U.S. high officials, such as "Bluementhal's talking intervention" in the late 1970s, "Baker's talking intervention" in the latter half of the 1980s, and "Bentzen's talking intervention" in the first half of the 1990s, as shown in the chart.

3. Implications for Asian Integration

What we in Asia should learn from European Integration is extremely large in number and scale. Japan must recognize it well and to conduct its own international monetary policy and policy for international monetary system very strategically from a view point as a member in Asia.

As far as international monetary policy is concerned, the development of real effective exchange rates for the major international currencies shows the victory of the German policy and the complete failure of Japan due to the lack of its own policy in the region (see the chart). The global monetary system was obliged to turn to floating exchange rates since the United States which was the core country of the Bretton Woods System became a rule breaker via the Nixon administration's "the New Economic Policy" of August 1971. It was not a positive choice at all for the international community to adopt floating exchange rates in early 1970s. Under the circumstances, Europe adopted a fixed exchange rate regime as its intra-regional currency system and from then on it has been minimizing the adverse effects of floating exchange rates, by evolving its own regional currency system. However, since Japan has been utterly unable to devise any appropriate measures to cope with the situation, it has been tossed about by the volatility of floating exchange rates and the extremely selfish policies of the United States. As shown in the chart, the pronounced difference in the development of real effective exchange rates between Japan and Germany is simply a great tragedy for Japan.

Japan's economic security has been tremendously impaired by this complete failure of international monetary policy which became a root cause behind the prolonged economic distress. Japan must recognize that its international monetary policy and a policy for the global monetary system form the core of the nation's economic security. In accordance with a firm national strategy, Japan should build and strongly promote its own international monetary policy and a policy for the global monetary system.

But, if Japan had tried in the past to seek some regional framework of Asian economic cooperation, it would have been very difficult to achieve because no other Asian country had similar economic development to Japan. However, the time is now ripe for planning some kind of regional framework in Asia, since Japan's neighbouring countries' economies have grown very rapidly.

I would like to point out what the targets are and what should be done when we promote East Asian regional integration. First, what basic targets should we aim at?

First of all, we should aim at Asian Integration which includes the South West Asia centering on India eventually, although it may take a long time. For the time being, however, we should strongly promote East Asian Regional Integration through a framework of "ASEAN+3 (Japan, China and South Korea)" basically. But, hopefully Taiwan and Hong Kong will also be included in this regional framework, considering their importance in the East Asian economy.

Secondly, on the economic front we should promote regional integration in real economy and financial aspects in tandem. In other words, we should build an intra-regional trade and investment framework together with some kind of common regional currency system, as well. In the European Union, the currency union is closely related to the market integration on the real economy. Both have acted as "external pressure" which the Europeans created by themselves, and they have been able to impose structural reform to some extent on member countries. In Asia too, the regional integration of real economy and financial aspects could have a major impact on the structural reforms within member countries.

Next, I would like to point out more specifically what we should aim for in economic field. Basically, I think we should aim ultimately for an "Asian Economic and Monetary Union (AEMU)" [9] or "Asian EMU" in three stages, as follows.

In the first stage, East Asian countries excluding Japan should adopt a triple currency basket -based fixed exchange rate regime, so that they are able to minimize any adverse effects from the volatility among the three major international currencies which contains the dollar, the euro, and the yen.

According to my estimates, the weight of the nine major East Asian countries/areas' [10] comprehensive economic relationship with the three major economic poles, all including international trade, foreign direct investment (FDI), indirect investment and Official Development Aid (ODA), was "Japan: US: EU = 4: 3: 3" immediately before the Asian currency crisis in 1997. In other words, this shows that the optimum currency basket weight for these nine East Asian countries/areas as a whole is "yen: dollar: euro = 4: 3: 3". Consequently, East Asian countries should first adopt this system to peg their own currency to the triple- currency basket with this weighting. By adopting this system, East Asian countries will always have the anchor fixed at the average level of the three major currencies, without being affected by any volatility among them. Hence, this will contribute tremendously to stability among currencies within the region.

In the second stage, we should have an intra-regional fixed exchange rate regime which consists of East Asian currencies including the yen. In other words, we should aim at an EMS-type fixed exchange rate regime. But, we should seek a smaller group with which to start this common currency system, considering that many ASEAN countries are still in the very early stages of economic development. I think that this group should consist of eight countries/areas, such as Japan, South Korea, China, Hong Kong, Singapore, Taiwan, Malaysia, and Thailand. By adopting this currency system, East Asian countries would benefit from the disciplinary effect and isolation effect (the Hard-shelled Capsule effect), which the EMS members had.

When the member countries' economies have sufficiently developed and converged, the time will be ripe for East Asia to formulate a plan for a unified regional currency. This will be the third stage which I have termed "the AEMU".

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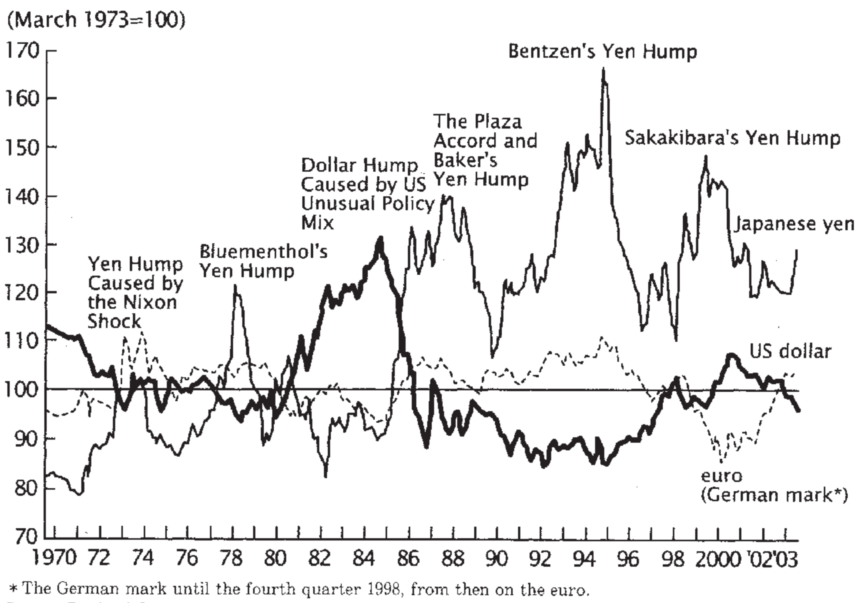
[9] The details of my idea about the AEMU are shown in Yamashita (2002), pp. 259-260.

[10] They include Malaysia, Thailand, Indonesia, the Philippines, Singapore, Hong Kong, Taiwan, South Korea, and China.

Chart. Real Effective Exchange Rate of the 3 Major Currencies
(1970～2003, Quarterly Data)



＊The German mark until the fourth quarter 1998, from then on the euro.
Source: Bank of Japan. The literal expressions in the chart have been made by the author.

YAMASHITA (2006a), p. 77

" The Promotion of Asian Integration by Learning from the European Experience: Establishing a Sino-Japan Core-Partnership as the Key "

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