Asian Monetary Cooperation: What We Can Learn from EU?

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1.Progress in Asian Monetary Cooperation

Before the Asian Financial Crisis, monetary cooperation of whatever forms is virtually nonexistent. Asian countries had been satisfied with the protection of the IMF and abided by duly all rules and regulations with regard to balance payments and exchange rates set by IMF. Most Asian countries pegged their currencies to the US dollar. The so-called dollar standard was prevalent. The volatility of the Japanese Yen vis-à-vis the US dollar had caused some concerns, especially when the Yen devalued against the US dollar. However, on the whole situation was manageable, there was not much complain and there was even less concerns about the reform of international financial system let alone regional financial cooperation.

The belated awareness for regional financial cooperation came as a result of the shock of the Asian financial crisis. Asian countries suddenly found that they were easy pray of international speculators. Beside the problems with the current arrangements of international financial system, the lack of financial cooperation made them vulnerable when they faced the attack individually. They began to realize that there were common interests and if they had done something before the crisis, they would have feared better. Then what they have done after the breakout of the crisis and the Asian dragons and tigers fell one by one. Regional monetary cooperation in East Asian since the financial crisis can be broadly divided into two areas: the establishment of regional financial architecture and coordination of exchange rate regimes

The first initiative by an East Asian government addressing the need for regional monetary and financial cooperation was Japan's proposal in September 1997 to create an Asian Monetary Fund (or AMF). Its objectives were to encourage policy dialogue and regularize the extension of emergency financial support, which the IMF had failed to provide in timely manner and subject to acceptable conditions when it was needed most (Shinohara 1999). The AMF was intended as a mechanism for disbursing aid faster, subject to conditions that were less demanding and more in line with the "Asian way." The demise of the proposal reflected objections by the United States and the IMF itself to a regional arrangement that might undermine multilateral conditionality but also the limitations of communication and trust among East Asian countries, and especially between China and Japan.against this political backdrop, it is not surprising that the AMF proposal came to naught.

The next significant response was the Chiang Mai Initiative (CMI) announced by the finance ministers of ASEAN, China, Japan, and South Korea (ASEAN+3) in May 2000. The fact that this was a joint initiative of ASEAN+3 governments could mitigate the earlier concern, which had arisen in the context of the AMF. The participating governments were committed to strengthening policy dialogue and cooperation in areas related to the monitoring of capital flows, the reform of domestic financial arrangements, and the development of a more robust regional financial architecture. At the center of the CMI was the expanded ASEAN Swap Arrangement, a network of bilateral swap agreements (or BSAs). [2] Member countries were authorized to borrow liquidity collateralized by domestic currencies and subject to government guarantees. These credit lines are effectively a mechanism enabling the participating countries to pool a portion of their foreign exchange reserves and thus to better fend off pressures from international financial markets. The availability of these swap lines and credits should in turn attenuate the need for individual countries to accumulate large reserve balances as a means of self-insurance.

This network of bilateral swap agreements is sometimes seen as a first step toward the creation of a self-standing set of East Asian financial institutions and arrangements. Out of the Chiang Mai Initiative and the

BSAs negotiated under its umbrella, in this view, will eventually evolve a true regional lender of last resort and, ultimately, an Asian central bank. But realism requires observing that these outcomes are a long way off. Only 15 percent of the bilateral credits arranged under the umbrella of the Chiang Mai Initiative can be provided automatically upon request.[3] The remaining 85 percent will be made available only when the borrowing country successfully negotiates an IMF program and is therefore subject to IMF conditionality.[4] Thus, the possibility that the CMI might evolve into an autonomous regional financial institution has been reduced by self-imposed constraints, reflecting both outside pressures (continued skepticism on the part of the United States and the IMF about the efficacy of this regional arrangement) and East Asia's own doubts about the adequacy of regional surveillance. Significant progress in transforming the CMI into something resembling an Asian Monetary Fund will require eliminating the linkage with IMF conditionality, which presupposes a considerably higher level of trust and self-confidence in the region. It will require a more forceful and forthright surveillance process to assure the countries extending credits that they will be paid back - that their partners will not draw excessively or make reckless use of their BSAs.

Moreover, the goals to which the CMI might ultimately be put - will it be used to support a regional system of exchange rate pegs, for example? - were purposely kept vague. This constructive ambiguity was adopted to deflect the kind of criticism that had been directed at Japan's earlier proposal for an Asian Monetary Fund. But this stance has costs, since governments are unlikely to invest significant resources in an arrangement unless its objectives and hence its prospective benefits are clear.[5] Asian countries to continue accumulating international reserves. And as reserve holdings continue to mount, the urgency of expanding and multilateralizing regional swap arrangements, and making their administration autonomous from outside entities, diminishes accordingly. Thus, failure to specify objectives has meant that the ASEAN+3 countries have been unable to slow their accumulation of reserves, and their continued accumulation of reserves has reduced the pressure to specify objectives.

The next significant step in the development of a regional financial architecture was the Asian Bond Market Initiative (ABMI) in 2003. This initiative reflected the perception that a fundamental cause of the East Asian currency crisis of 1997-98 had been excessive reliance on the banking sector as a source of investment finance, coupled with the double-mismatch problem (the existence of pervasive currency and maturity mismatches on national balance sheets, which heightened financial fragility). The ABMI is designed to foster the development of an alternative: a pan-Asian market in long-term debt securities denominated in local currencies. Bringing together investors and issuers in a pan-Asian market promises economies of scale, lower spreads, and greater efficiency. Regional working groups were quickly established under the umbrella of the ABMI, and these have held numerous conferences and seminars. In addition there has been progress in building the relevant bond market infrastructure and some experimental issuance, notably by the Asian Development Bank, of local currency bonds. Optimists like Kuroda (2004) predict that within a relatively short time, say three to five years, the preconditions for regional bond market development can successfully be put in place.

A related initiative by the Executives' Meeting of East Asia-Pacific Central Banks was the creation of the Asian Bond Fund (ABF).[6] The ABF is designed to catalyze the growth of Asian bond markets by allocating a portion of the reserves of regional central banks to purchases of government and quasi-government securities. The initial US$1 billion of investments, known as ABF-I, was devoted to Asian sovereign and

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2 ASEAN countries had already established their own, relatively modest network of swap arrangements; the BSAs of the Chiang Mai Initiative were, in a sense, an elaboration of this earlier effort.

3 The original figure was ten per cent, which was modestly increased subsequently.

4 As initially negotiated, the CMI would have also allowed this remaining 90 per cent if the borrowing country had negotiated a Contingent Credit Line with the IMF, but the CCL facility was allowed to expire subsequently.

5 See Eichengreen (2003).

6 The members of EMEAP are all regional central banks, including the Bank of Japan, Bank of Korea, Bank Indonesia, Malaysian State Bank, Central Bank of the Philippines, Monetary Authority of Singapore, Bank of Thailand, People's Bank of China, Hong Kong Monetary Authority, Reserve Bank of Australia, and Reserve Bank of New Zealand.

quasi-sovereign issues of dollar-denominated bonds. ABF-II is twice as large and includes bonds denominated in regional currencies. It has two components: a US$1 billion central bank reserve pool to be overseen by professional managers for local bond allocation, and a US$1 billion index unit designed to list on eight stock exchanges beginning with Hong Kong in 2005. The latter is designed to facilitate one-stop entry for retail and institutional buyers and to provide a benchmark structure for tracking pan-Asian performance.[7]

To date, concrete results from these initiatives have been limited. Issuance on Asian bond markets has risen only modestly. Turnover rates and market liquidity remain low by international standards. There is no lack of initiatives to develop Asian financial markets, but there is still a lack of progress.
These, then, are the regional initiatives in the areas of money and finance providing the backdrop to ongoing discussions of the desirability of coordinating the management of exchange rates in East Asia.

Prior to the Asian financial crisis, East Asian currencies were effectively pegged to the dollar.[8] This link provided the nominal anchor for domestic price levels. It also stabilized intra-regional exchange rates, since East Asian currencies were all pegged to the same external numeraire.

After the financial crisis exchange rate regimes in the region has undergone important changes. The majority of East Asian countries have moved to regimes of greater flexibility. Since 2006 July, China and Malaysia have adopted pegging to a basket of currencies. Except for Hong Kong, all economies in the region have adopted either free floating or some middle way exchange rate regimes. Although there are many studies and discussions on what should be the right form of coordination of regional exchange rate regimes, virtually nothing has been done in this area.

To be sure, pegging to the dollar has weaknesses. Since the Plaza Accord of 1985, economic growth in Asia has tended to accelerate whenever the yen appreciates and decelerate whenever the yen depreciates (Kwan 2001). Thus, pegging to the yen rather than the dollar - or, more plausibly, in addition to the dollar - could buttress macroeconomic stability and moderate the severity of macroeconomic cycles. Since emerging Asian countries export to both the U.S. and Japan, their effective exchange rates would be more stable (Yoshino et al. 2005). And imported disturbances to aggregate demand would be less.

Typically, this argument enjoys political support in periods when the yen depreciates and East Asia finds it more difficult to maintain its growth momentum. Conversely, in periods like 2002-4, when the yen appreciated against the dollar, East Asia enjoyed an accelerating recovery, and the urgency of shifting to a basket peg came to be seen as less. The consensus view that the dollar depreciation is likely to go forward as a result of America's twin deficits suggests that there will be continued difficulties in marshalling political support for this case.

If the idea of a basket peg is accepted, the next step would be to reach agreement throughout the region on common basket weights. The idea of a common basket peg has been advanced by a number of authors, most notably John Williamson. In his view, it would be particularly advantageous to [East Asian countries] if they were all to adopt the same basket. "This would guarantee that no change in third-country exchange rates could disturb the trading relationships among the East Asian countries themselves."[9] Other advantages include the creation of a favorable environment for further advances toward regional monetary integration, should that be the desired goal.[10]

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[7] In a related proposal, Ito (2004) has suggested that Asian basket currency government bonds (ABC government bonds) could be created to help diversify the currency risk and reduce the reliance on bank loans. Participating governments could create a financial entity that would hold assets that were provided by the governments in the depository and issue obligations-ABC Bonds that match the value of assets-comprise different proportions of GBs issued by different governments in East Asia. According to Professor Ito, by mixing the bonds, the yield would be higher than JGB, and the currency basket lessens the currency risk compared with single-currency bonds such as US bonds.

[8] McKinnon (2000) has dubbed this arrangement the East Asian dollar standard

[9] Williamson (2005), p10

[10] Ditto.

But there are also problems with a common basket. East Asian economies differ in their economic structures, their trading partners, and their policy objectives. This is evident when one contemplates proposals that they all revalue by the same amount to help alleviate the problem of global imbalances. Revaluing by the same amount would have different impacts on different regional economies.[11] Indicative of this fact, different countries have in fact allowed their currencies to adjust against the dollar by different amounts in the first half of the present decade. Some East Asian countries allowed their currencies to appreciate by 25 per cent or more between 2002 and 2005. Other countries have sought to more strictly limit the movement of their currencies.[12] Thus, at the time of writing, China has limited the appreciation of the renminbi relative to the dollar to 2.1 per cent, while Hong Kong has prevented its exchange rate against the dollar from moving at all.

In addition, a basket numeraire "would leave traders in the participating countries without a mechanism for ascertaining the local currency value of trade contracts that will mature only in the future. An important advantage of a traditional peg to one of the main international currencies, like the dollar, is that trader can expect that a contract denominated in that currency will normally have an unchanged value in terms of the local currency when the contract expires,"[13]

2 Why Progress has been slow

In the area of establishing regional financial architecture, momentum seems having lost. After the CMI, progress is limited. In response to the Asian Financial Crisis, "emerging-market nations either chose or were forced into new strategies for managing international capital flows. In general, these strategies involved shifting from being net importers of financial capital to being net exporters, in some cases very large net exporters. For example, in response to instability of capital flows and the exchange rate, some East Asian countries, such as Korea and Thailand, began to build up large quantities of foreign-exchange reserves and continued to do so even after the constraints imposed by the halt to capital inflows from global financial markets were relaxed. Increases in foreign-exchange reserves necessarily involve a shift toward surplus in the country's current account, increases in gross capital inflows, reductions in gross private capital outflows, or some combination of these elements."[14] As a result, the accumulation of foreign exchange reserves in the form of US assets has surpassed 2 trillion USD for the region as a whole. It seems that there is no single economy in the region is worried about lack of foreign exchanges. On the contrary, the worry is how to get rid of excess foreign exchange reserves. On the one hand, governments in the region become more generous. On the other hand, pooling foreign exchange reserves together has been a much less relevant issue.

In the area of exchange rate arrangement progress is even more scanty, even though it is a very important issue needs to be solved without delay.

It is argued in literature that eliminating national currencies and moving to a common currency can be expected to lead to gains in economic efficiency. These gains in efficiency have two different origins. One is the elimination of transaction costs associated with the exchanging of national moneys. The other is the elimination of risk coming from the uncertain future movements of exchange rates.

The elimination of transaction cost also has an indirect gain: consumers who now can see prices in the same currency unit are able to make better price comparisons, and to shop around. This in turn should increase competition and benefit all consumers. More importantly, the introduction of a common currency will stimulate financial integration. This in turn may set in motion a dynamics of integration in other areas. For example, financial market integration is likely to push for further legislative harmonization.

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[11] A simulation analysis of the effects is McKibbin and Stoeckel (2003).

[12] But these limited movements have only fanned expectations of further appreciation, which have in turn only attracted further speculative capital into Asian financial markets, aggravating the difficulty of sterilization and forcing additional accumulation of foreign reserves (Genberg, McCauley, Park and Persaud, 2005).

[13] Williamson (2005), p.12.

[14] Ben S. Bernanke (2005), The Global Saving Glut and the U.S. Current Account Deficit, At the Homer Jones Lecture, St. Louis, Missouri April 14, 2005 *Updates speech given on March 10, 2005, at the Sandridge Lecture, Virginia Association of Economists, Richmond, Virginia*

A decline to real exchange rate uncertainty, due to the introduction of a common currency can reduce adjustment costs. As a result, the price system becomes a better guide to making the right economic decisions. The reduction of exchange rate uncertainty will lead to the reduction of the real interest rate. Risk aversion investors will demand a lower interest premium, which in turn will promote economic growth.[15]

On the other hand, there are costs for monetary integration in the form of common currency. The main costs of a common currency area are the loss of the independence of monetary policy, giving up the possibility of changing exchange rate when the change is necessary for achieving fundamental balances of the economy. According to Mundell (1961), the costs of adopting a single currency depend crucially on how easily an economic shock in one country is transmitted to other country in the same region. If a supply shock strikes one member of the union, and if correlations of shocks are high among the members, all members will be affected in the same way. A symmetrical set of policy mix can then be used to offset the shocks for all members, thereby eliminating the need for policy autonomy.

Traditional literature suggests a set of criteria for optimum currency area. Among the criteria are factor mobility (Mundell, 1961) trade integration (McKinnon, 1963), regional production patterns (Kenen, 1969), policy preference, high correlation of shocks among members, and so on. When applying the above-mentioned criteria, some studies found that Euroland is not an Optimum currency area. One reason is that at present there is neither a high degree of factor mobility within Euroland nor factor immobility outside Euoland.[16] In contrast, some other studies found that East Asian countries can form a monetary union without incurring so much opportunity costs of losing monetary independence and policy autonomy. The conclusion was based on the analysis of correlations of shocks.[17] The seemly-unexpected conclusions are actually not surprising at all. As Frankel and Rose pointed out "Trade patterns and income correlations are endogenous ..... A country could fail the OCA criterion for membership today, and yet, if it goes ahead and joins anyway, as the result of joining, pass the OCA criterion in the future."[18]

According to Prof. Sakakibara, Asian monetary cooperation is market-driven. This is a fair characterization. However, coordination of exchange rate regime not to say monetary union is an enterprise that cannot be achieved by market force. Traditional cost-benefit analysis of monetary union carries only very light weight in persuade governments engage actively in promoting coordination of exchange rate regime. Exchange rate coordination involves ever high cost for divergent economies in the region, including surrendering a large proportion of sovereignty. For East Asian Economies, the most important rationales for strengthening monetary cooperation and achieving a certain degree of monetary union are: strengthening regional economic integration and stop paying seinorage to the US that has become the source of global imbalances. However, Asian economies are faced with prisoners' dilemma if they wish to the dollar hegemony. Furthermore, this is more a political than an economic issue. If we check the history of European Monetary Union, we will have a better understanding why we are stalled in where EU has finally achieved the impossible goal.

3. What Can We Learn from the EU

The EC countries started their efforts in exchange rate stabilization in 1971 when they agreed a set of rules, namely the Snake, prescribed fixed fluctuation bands for the members' bilateral exchange rate. In 1997 new formal rules were formulated and European Monetary System (EMS) was established. The EMS was a limited-flexible exchange rate system and a more strict arrangement than the Snake. The EMS defined bands in which the bilateral exchange rates of the member countries could fluctuate. When a market exchange rate reached intervention points, the central banks were compelled to support these rates indefinitely through open market operations. The European currency unit (ECU) was conceived as a unit of account for EMS.

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15 P Grauwe: Economics of Monetary Union, Oxford University Press, 2003. p60.

16 Elinda Fishman Kiss: Optimum Currency Area: Euro as a Practical Paradigm? Rutgers, the State University of New Jersey

17 Tanawat Trivisvavet: Do East Asian Countries Constitute An Optimum Currency Area? Durham University. April. 2001.

18 Elinda Fishman Kiss: Optimum Currency Area: Euro as a Practical Paradigm? Rutgers, the State University of New Jersey. P3.

The ECU was an artificial "basket" currency that was used by the member states of the European Union (EU) as internal accounting unit. On January 1, 1999 the ECU was replaced by the new single European currency, the Euro, which marked the eventual establishment of the European Monetary Union (EMU).

It is interesting to know that "Until the mid-1990s there was almost a consensus among economists that the member states of the EC, and later the European Union (EU), did not for an OCA and that therefore, Economic and Monetary Union(EMU) is undesirable. However, European monetary integration has proceeded in the past 30 years."[19] How can it be! The answer lies in the role of leadership. According to Sadeh[20] "the inability of th EC member states to cooperate in exchange rate stabilization during 1972-1976 period was the result of week international leadership and specific reciprocity among them. On the other hand, the stabilization of exchange rates among the EC member states during 1997-1987 period was the result of strong international leadership by Jenkins, Schmidt and Giscard, and more diffuse reciprocity". In 1992 when sterling was attacked, German government refused to help in a timely fashion. As a result, the UK withdrew from EMS. It can be seen that works done by economists would have been fertile without the strong political will of the leadership of the EC countries, German and French political leaders, to push through the process of economic integration and monetary integration.

Lack of leadership with strong political will for the economic integration and monetary integration is the fatal weakness of East Asian Monetary Cooperation. All other factors are of secondary importance. Without a clear answer to the question of whether East Asian countries want to realize integration economically and politically and without strong leadership to push the process of integration through, can Asian monetary cooperation only be piecemeal and without substance.

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19 Tal Sadeh 2002, The Establishment of the European Monetary System, Annual meeting of International Studies Association, New Orlans, March 24-17 2002, p5.

20 Ditto.p.3.

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