

# EAST ASIAN MONETARY COOPERATION

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# Issues

1. Why regional solutions to monetary and financial instability?
2. Rationale for regional currency arrangements in Asia
3. Options for an AMS: Can Asia replicate the EMS?
4. Supporting institutions and mechanisms

# Search for Regional Solutions

- All three legs of the BW architecture have disappeared:
  - Multilateral discipline over exchange rate policies: gone with US default on gold link
  - Restrictions over capital flows: eroded gradually starting with euro-dollar markets
  - Provision of adequate international liquidity to prevent deflationary adjustment to short-term BOP difficulties: gone with IMF pro-cyclical conditionality
- European search for regional currency stability to avoid a repeat of inter-war experience, culminating in a single market and EMU.
- DCs response to international financial stringency: Andean Reserve Fund, Arab Monetary Fund (both in 1976); 1997 Asian attempt to establish an AMF, then the CMI (first as bilateral swaps then as a regional fund)

# Asian Regional Monetary Cooperation

- The CMI is designed to deal mainly with yesterday's problems and has not been effective (Korean swaps with US and Japan, rather than drawing on CMI). It can become significant if part of a broader arrangement for RMC.
- Acid test for RMC: exchange rate arrangements
- Coexistence of incompatible exchange rate regimes in EA:
  - At one corner independent floaters: Japan, Korea, Philippines
  - At another HK with a currency board
  - In between; intermediate regimes of China and Malaysia (tightly managed pegs) and Thailand and Singapore (more flexible regimes)
- Consequently intra-Asian exchange rates manifest high degree of instability in periods of large swings in the dollar (table). All appreciating against the yuan during sub-prime boom, depreciating during bust and now appreciating again. Intra-SEA currencies are also unstable

# Asian Currency Swings during Subprime Bubble/Bust

	<i>Dollar rates</i>		
	<b>Boom</b>	<b>Bust</b>	<b>Recovery</b>
Chinese Yuan	9.3	10.7	0.1
Indian Rupee	19.2	-16.6	5.4
Indonesian Rupiah	- 2.7	-20.0	20.2
Malaysian Ringgit	10.0	-4.5	4.5
Philippine Peso	17.9	-3.0	- 2.0
Singapore Dollar	14.7	0.3	6.9
S. Korean Won	28.8	-33.5	20.9
Taiwan Dollar	5.9	-2.7	6.2
Thai Baht	43.4	-14.3	6.3

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Boom : From January 2003 to July 2007  
Bust : From August 2007 to February 2009  
Recovery : From March 2009 to September 2009

# Rationale for Exchange Rate Cooperation

- Benefits recognized: can save transaction costs; make it easier to attain stability for smaller countries; promote intra-regional division of labour based on fundamentals; and prevent beggar-my-neighbour policies and conflicts.
- Costs: Giving up monetary and exchange rate policy autonomy can cause difficulties in maintaining high employment and growth. Often judged on OCA criteria: benefits exceed costs if there is sufficiently close integration, shocks are symmetrical and labour markets are flexible enough.
- Most studies show that Asia meets OCA criteria as much as EU or US even though it is less integrated. Trade shocks are common because of close linkages in production networks. Capital account shocks are even more so.
- Endogeneity of OCA conditions: joining a monetary union moves countries closer to each other in economic structures and to conditions for OCA.

# Options for Regional Currency Arrangements- I

- European model: float externally, fix internally (snake, snake in the tunnel, EMS and ultimately EMU).
- Can EA replicate EU and float externally and fix internally? Not really. Asia is not only trading and competing with each other. Trade and competition still important with rest of world; instability against third currencies will thus matter for Asian economic performance.
- This also means that Japan cannot be part of a common exchange rate system– it cannot really go back from floating to managed yen.

# Options for Regional Currency Arrangements- II

- Since the region is a de facto dollar block all should fix *formally* to the dollar. This gives internal stability. External stability could be secured by tighter prudential regulations over destabilizing capital flows (McKinnon).
  - But the region is not a dollar block; a variety of regimes
  - Prudential regulations cannot prevent capital flow and exchange rate instability
  - Will beat the purpose; subordinate monetary policy to US. Asia is not OCA with US
- ACU like ECU: Use of ACU alongside national currencies can create currency mismatch. ECU never played key role in EU integration. Needs strong political support to give it legal tender status. If such is forthcoming then go for tighter arrangements.
- A common basket in three reserve currencies (Williamson). Fine, but cannot secure adequate discipline without commitments to central parities and bands. Thus a common BBC regime with commitments. ASEAN5+2 can move into such a regime right away; it has a greater degree of macroeconomic convergence than Europe had achieved during the late 1970s.

# Supporting Institutions/Mechanisms

- A common capital account regime
- Intraregional lending
- Rules for policy adjustment
- Development finance

# Capital Account Regime

- EU experience:
  - Highly restrictive until the 1988, notably vis-à-vis third-party flows
  - Liberalization in 1988 but provisions for safeguards in the 1988 Directive— used by Spain in 1992
- East Asia:
  - ASEAN5+2 is financial more integrated with ROW than regionally. Can afford greater capital account openness among themselves than was the case in EU during the first decade of the EMS.
  - RMB as a regional reserve currency (recent moves by China)

# Intra-Regional Lending

- EMS:
  - No regional fund, relied on bilateral lending, often by Germany
  - Joint interventions by strong and weak currency countries or unlimited amounts of VSTF by strong currency country, to be settled in 45 days.
  - Not flexible enough for deficit countries; allowed Germany to opt out of its obligations.
- East Asia:
  - Multilateralization of the CMI and establishment of a fund is a positive step.
  - But existing thinking regarding conditions to be attached to such lending cannot be carried over to intra-regional currency arrangements, which should rely on a separate set of policy adjustment rules

# Policy Adjustment Rules

- EMS had no clear guidelines for policy adjustment in the presence of market pressures; when to adjust interest rates and when to adjust parities.
- In practice no symmetry between strong and weak currency countries. German hegemony not matched by its responsibilities. Its monetary policy did not always pay attention to conditions in others. Burden of adjustment pushed onto deficit countries. Seen as the price to be paid for the stabilization influence of Germany.
- Avoid ECB-type monetarism and arbitrary (and highly contentious) rules about government debt and deficits which resulted in unnecessary growth losses in the convergence process (Maastricht).

# Development Finance

- European arrangements included development finance for less developed members and sectors through budgetary transfers from richer countries and loans from European Investment Bank owned by the member states.
- EA emphasizing ABMI to mobilize investment finance while avoiding currency and maturity mismatches. But not enough attention to downsides, including instability (why import the failed Anglo-American model of finance?) Most DEEs going for bond markets starting in the 1980s have ended up with a rapidly growing public debt and debt market (indirect financing) rather than corporate bond market- also in EA? Foreign access aggravating instability despite shifting out the currency risk.
- Need also to focus on intra-regional banking with common guidelines for regulation.
- **Bank of the South:** totally owned by DEEs of the region (South-South Bank) for translating CA and savings surpluses into productive investment in sectors and countries in need, rather than investing them in low-yielding US papers.

# Prospects

- Lack of culture of regionalism is a main obstacle. But big changes (which often come after serious disruptions) are never foreseen until they happen.
- Smaller countries' fear of going with China:
  - In Europe smaller economies main beneficiaries. Losing autonomy to Germany but gaining autonomy vis-à-vis IMF and international financial markets.
  - With or without formal arrangements monetary and exchange rate policies of smaller economies will be dominated by China– just as CH is dominated by EU– particularly as RBM becomes convertible and starts enjoying reserve currency status (which may be sooner than most people expect).
  - Thus better to have some reciprocal commitments with China. Smaller economies in Asia have greater bargaining power than were those in EU: they do not depend on the stabilizing influence of another CB.