Prospects for Monetary Cooperation and Integration in East Asia

Ulrich Volz

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1 Introduction

The 1990s have seen dramatic changes in the international monetary landscape. The demise of the Soviet Union and the breakup of Yugoslavia caused the dissolution of existing currency areas and gave birth to new currencies. At the same time European countries decided to abandon their national currencies and replace them with a single common currency, the euro. In 2000, Ecuador relinquished its own currency and officially adopted the US dollar; in 2001, El Salvador did the same; and a year later, Guatemala introduced the US dollar as parallel legal currency. The traditional notion of "one nation—one money" cannot be taken for granted any more. The days in which "virtually all of the world's nations assert and express their sovereign authority by maintaining a distinct national money and protecting its use within their respective jurisdictions," and in which "[m]oney is like a flag; each country has to have its own" (Mussa 1995: 98) seem to be gone. Steil (2007) has announced the "end of national currency." A "new geography of money" is emerging, in which political frontiers do not necessarily coincide with the boundaries of money (Cohen 1998). Especially the introduction of the euro has led to a "redrawing of the map of currency areas" (Mundell 2000: 223) and has propelled thoughts about monetary integration elsewhere. Today, regional monetary cooperation and integration is being discussed in virtually all parts of the world, including East Asia.

East Asian countries were notably unconcerned about regional monetary integration until the late 1990s. The Asian financial crisis of 1997 to 1998 fundamentally changed their perspective on economic regionalism and sparked great political interest in monetary and financial cooperation and integration in the region. The crisis revealed the fragility of the region's prevailing exchange rate arrangements and highlighted the need for a strengthening of the regional financial architecture. Since the crisis, East Asian countries have been engaged in various forums and initiatives to promote cooperation. Cooperation already takes place in the form of regular consultations between finance ministers and central bank governors, the surveillance of regional financial markets, the pooling of foreign exchange reserves, and various schemes to foster the development of regional security markets. There is also a serious debate about establishing a regional exchange rate arrangement or even a common East Asian currency in the longer term. For instance, the Asian Development Bank (ADB) proposed in 2005 the creation of an East Asian currency unit akin to the European currency unit (ECU), which evolved into the euro.

The current developments in East Asia are intriguing and bear great importance for the future shape of the international monetary system. East Asia, which in this study is defined as China, Hong Kong, Japan, the Republic of Korea (which will be referred to as Korea throughout), and the ten member states of the Association of Southeast Asian Nations (ASEAN),[1] has become the most dynamic region in the world economy. With a combined population of about two billion people, almost a third of the world's population, and nearly a fifth of world output, changes in the monetary and exchange rate policies of East Asian countries will have repercussions far beyond Beijing, Seoul, Tokyo, or Jakarta.

This book investigates the prospects for monetary cooperation and integration in East Asia. The central question of this research is to what extent different forms of regional monetary cooperation and integration are promising options for the East Asian countries. Drawing on the traditional and more recent theoretical and empirical approaches to monetary integration, as well as on the European experiences, this work examines the economic conditions for monetary integration in East Asia and assesses the benefits and problems associated with it. It gives a comprehensive overview of all issues of monetary integration in East Asia that are under discussion among academics and policy makers, and provides the theoretical and empirical analysis to assess the policy options available.

While this study is first and foremost an economic analysis, it is key to acknowledge that monetary cooperation and integration is an eminently political process. The political dimension cannot be blanked out. The analysis will hence include politicoeconomic considerations, especially when discussing the choice of exchange rate regime and possible strategies for monetary integration for East Asia.

It is important to clarify what is meant in this book by monetary cooperation and integration. International monetary cooperation can be defined quite broadly to include, for instance, consultations among policy makers regarding the choice of monetary and exchange rate regimes and the exchange of information among monetary authorities. Cooperation is sometimes used interchangeably with the term coordination, which in the definition of Frankel (1988: 1) describes "the agreement by two or more countries to a cooperative set of policy changes, where neither would wish to undertake the policy change on its own but where each expects the package to leave it better off relative to the Nash noncooperative equilibrium in which each sets its policies taking the other's as given." In this characterization, monetary coordination is more specific than the definition for monetary cooperation given above, as coordination already involves the adoption of a mutually agreed policy stance. Maintaining a distinction between cooperation and coordination and adopting a broad definition of monetary cooperation helps to explicate that the latter—like monetary integration—is a gradual process in which lower levels of monetary cooperation may provide the basis for an active coordination of monetary and exchange rate policies.

As with monetary cooperation, there is no generally accepted definition of monetary integration in the literature. This study follows the definition of Schelkle (2001a), according to which monetary integration comprises all forms of coordinated currency stabilization. Besides monetary union, which is defined as an area where there circulates a common currency issued by a single central bank, monetary integration comprises also less far-reaching forms such as coordinated pegging to the same anchor currency or currency basket, and the establishment of a common exchange rate system.

From this definition it follows that an analysis of the prospects for monetary cooperation and integration should not focus solely on the feasibility of and perspectives for an East Asian monetary union. Indeed, as will be argued later, talk of East Asian monetary unification is premature at this point in time—not because the economic conditions prohibit it but because the political determination to see through such a demanding project has not developed yet. Monetary policy coordination is a highly sensitive field that requires mutual trust and understanding; countries pursuing a course of monetary integration need to share common objectives and develop a common ground from which to tackle conflicting issues in a constructive and solution-oriented way. History has shown time and again that ill-conceived or badly managed monetary arrangements are prone to crisis. To avoid crises, it is therefore essential that any kind of coordination failure among the countries engaged in a process of monetary integration is ruled out. National authorities must be willing to subordinate national policy goals, at least at times, for the common goal of stability of the common monetary arrangement. These are requirements that are not yet met by East Asian countries. This study hence recommends a gradual approach toward monetary integration, with less demanding forms of monetary cooperation being pursued first, before highly challenging projects such as the creation of a regional monetary system, let alone monetary union, can be tackled. A step-by-step approach starting with informal forms of policy coordination would give East Asian countries time to develop an integrationist spirit and gain experience with cooperation before moving on to more advanced forms of monetary integration.

There are many sources of skepticism as regards East Asian monetary cooperation. The major concern that is frequently raised, and that was touched upon already, is that the political conditions for monetary integration are not in place, and that the region is lacking historical and cultural commonalities. In particular, it is often argued that the deep-rooted distrust and the historical antagonism that bedevil the relations between China and Japan, the two dominant countries in the region, obstruct cooperation. Relations between the other countries in the region are also strained at times, which is why calls for deeper economic integration are often dismissed as pure rhetoric. For sure, East Asia has not developed an "integrationist spirit" as in Europe as the region continues to struggle with political frictions and historical disputes. But dismissing the prospects for regional monetary cooperation because of an alleged lack of commonality is shortsighted and fails to realize that East Asia is a region undergoing transition, where some modest progress in the areas of monetary and financial cooperation has already been made. One example is the decision taken by the ASEAN+3 countries in February 2009 to institutionalize regionalism for the first time by establishing a common agency to conduct surveillance of regional financial markets. This is a modest step, but it shows their commitment to regional cooperation and illustrates that ASEAN+3 countries have found a practical way to work together despite the existing differences. In this context it is worth pointing out that European economic integration was initiated to overcome exactly the same sort of rivalry between European nations that can be observed in today's East Asia. In any case, the strong economic trade and investment linkages that have developed in the East Asian region over the past decades have resulted in a high degree of economic interdependency which has brought about an ever-growing need for closer macroeconomic cooperation between governments to safeguard growth and stability of the regional economy. What has been an essentially market-driven process of economic integration—which has manifested itself, among others, in the form of extensive regional production networks—has propelled the region's leaders to engage in economic cooperation. As will be discussed later, it appears that the political and business elites of East Asian countries are conscious of the need for government-led cooperation and that they have formed a broad consensus about the principle, if not the detail, of the desirability of monetary cooperation.

A second source of reservation over the prospects of East Asian monetary integration stems from the fact that East Asian countries are diverse not only in terms of population size and political system, but also heterogeneous in respect of economic systems and stage of economic development. While this is obviously true, this is a static perspective which fails to recognize that monetary integration is a dynamic process in which economic structures change as a consequence of this very process. Moreover it disregards the potential developmental effects of monetary integration. It is important to ask what can and what will be achieved through a policy of monetary integration, and how monetary integration can contribute to the development of the least developed countries in the region. Monetary integration is no aim in itself; rather, this study highlights monetary integration as a strategy to overcoming structures that present obstacles to economic development and to create a stable macroeconomic environment that is conducive to investment and growth.

Although the interest of East Asian countries in regional monetary and financial cooperation has developed only recently, a process has been set in motion that might well result in a reshaping of the global monetary system. To be sure, East Asian monetary integration is an open process without predetermined outcome. Despite recurring comparisons with the European monetary integration process, from which many lessons—positive as well as negative—can be drawn, East Asia will have to chart its own course, and it is everything but clear that this course will take it to the creation of a common monetary union like in Europe. But whatever the policy choices of East Asian leaders will be, they will have far-reaching consequences for the international monetary system that will greatly affect us all.

This study is divided into three parts and structured as follows. Part I of the book investigates the main reasons that have prompted East Asian countries to consider a policy of regional monetary integration. Chapter 2 highlights the instability of the international monetary system and the recurrence of financial crises as factors that have nurtured a general, worldwide interest in regional monetary integration. Chapters 3 and 4 discuss two specific factors that have fueled East Asia's interest in regional monetary cooperation and integration: the Asian financial crisis and the rise of China.

Part II turns to an examination of the potential costs and benefits of monetary integration in East Asia. Chapter 5 first reviews the traditional framework for analyzing monetary integration, the theory of optimum currency areas, and the criteria that were developed in this theory to assess whether East Asia constitutes such an optimal currency area. Subsequently chapter 6 explains the flaws and limitations of the standard analysis and extends the traditional framework to take account of the endogenous effects of a policy of monetary integration. In particular, it highlights monetary integration as a dynamic process in which economic structures and conditions change due to a policy of integration. The analysis in chapter 6 includes an estimation of the trade-creating effects of monetary integration, an examination of the likely effects of real and financial integration on output correlations in East Asia, and a discussion of the potential role of regional monetary integration in overcoming the problems of asset and liability dollarization in East Asia. It also extends the discussion of the alleged costs of monetary integration by analyzing the region's current degree of monetary independence.

Part III then considers different strategies for monetary integration in East Asia. Chapter 7 briefly reviews the current monetary regimes in East Asia, which is followed in chapter 8 by a discussion of the principle exchange rate options for the East Asian economies, namely freely floating exchange rates, a continuation of the current system of dollar pegging in most countries, and a coordinated stabilization of intraregional exchange rates. Chapter 9 appraises the arguments for freely floating exchange rates in East Asia and analyzes the feasibility of floating rates with inflation targeting in the region. Chapters 10 and 11 then consider in detail two specific forms of regional coordinated exchange rate stabilization, namely the creation of a regional monetary system and the regionwide adoption of currency baskets, respectively. To assess the feasibility of and delineate lessons for a regional exchange rate system for East Asia, chapter 10 examines the credibility of the European Monetary System and the causes for its 1992 and 1993 crisis. Chapter 11 scrutinizes the regionwide adoption of currency baskets by constructing three different hypothetical currency baskets in order to compare the nominal effective exchange rates that would prevail under the basket regimes with the actual exchange rate policies conducted. Based on these results, it develops a strategy for regional monetary integration in which countries first opt for a managed float regime guided by the use of a common basket as numéraire and in which an Asian currency unit (ACU) is introduced as a virtual parallel currency to circulate alongside national currencies.

Chapter 12 concludes this study with reflections on the future of East Asian monetary relations, giving room also to historical and geopolitical considerations and an analysis of the political economy of East Asian monetary integration. Although the political realization of monetary integration might seem unrealistic because of differences in political systems, historical disputes, and economic rivalry among East Asian countries, a look into East Asian history and an appraisal of economic trends and geopolitical factors make the inconceivable appear less unlikely.