CHAPTER 1

Introduction

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The importance of monetary and financial cooperation is a prominent theme in economic policy discussions in East Asia. Hardly a day goes by without a call by a central bank governor, finance minister, or any other official for closer collaboration in strengthening financial markets and fostering exchange-rate stability. Moving from words to deeds, the last decade has seen, among other measures, the Chiang Mai Initiative (CMI) of emergency financial supports and the Asian Bond Market Initiative (ABMI) to build more active and liquid bond markets.

From the perspective of North America, this emphasis is striking. The national economies of North America, like the national economies of East Asia, have become more interdependent, both economically and financially, with the reduction in transportation and communications costs and the expansion of intraregional trade and financial flows. North America is ahead of East Asia in building a free trade area, having signed the North American Free Trade Agreement (NAFTA) in 1994, where the ASEAN countries aim at completing their economic community only in 2015. But despite the expansion of trade and investment flows within North America, there is little perception of an urgent need to deepen monetary and financial cooperation. The US dollar, Canadian dollar, and Mexican peso float independently. There is no overt effort to coordinate monetary policies. The three countries regulate their financial markets independently. In all these respects, the contrast with East Asia is stark.

There are four explanations for why Asia is different or at least aspires to be so. First is the region's economic structure and strategy. In terms of strategy, Asian policymakers have long valued exchange-rate stability. The highly successful Asian model of the second half of the 20th century emphasized exports as an engine of growth and development. It saw stable exchange rates as valuable, even essential, for fostering the growth of export industries. Once upon a time, this meant the stability of exchange rates vis-à-vis Asia's principal extra-regional market. In other words, it meant stabilizing currencies against the US dollar. But with the growth of intraregional trade — both in parts and components as Asia elaborates regional production networks and in final goods as consumer demand rises with living standards — it has also come to mean the stability of exchange rates among the region's currencies themselves.

A second explanation is the financial crisis of 1997–98. The crisis revealed the deficiencies of prevailing monetary and financial arrangements. Pegging to the dollar exposed Asian countries to a deterioration in competitiveness if the dollar rose against the yen, as was the case in the mid-1990s. Moreover, pegging unilaterally might become prohibitively expensive or even technically impossible as the liquidity of international financial markets and the volume of international capital flows continued to rise, a reality revealed by the helplessness of Asian governments and central banks in the face of capital flight in 1997. Another lesson of the crisis was that the underdevelopment of local financial markets led to an excessive reliance on bank intermediation, creating too-big-to-fail and connected-lending problems. It led to overdependence on short-term foreign-currency debt, giving rise to the financial vulnerabilities associated with currency and maturity mismatches.

The conclusions drawn included the need for a monetary policy set with Asian conditions in mind, not one decided by the Federal Reserve Board as prevailed when Asian currencies were pegged to the dollar. They included the need for collective approaches to stabilizing exchange rates. They included the importance of working to develop regional bond markets, collectively as well as individually insofar as only a region-wide bond market would possess the scale and liquidity to compete with extra-regional financial markets and centers.

A third factor encouraging these initiatives is the greater financial resources now available for their pursuit. Asia is the world's fastest growing region, and as it has grown it has accumulated more wealth to be allocated via financial markets. More to the point, as a result of shifting from current account deficit before the crisis to current account surplus subsequently, the region has accumulated massive international reserves. Some part of these reserves can be allocated to the Asian Bond Fund (ABF) to help develop an integrated regional bond market. Another part can be committed to the CMI and thereby be made available to neighboring countries in financial need.

A final explanation is the desire for self-reliance and the growing self-confidence that come with strong economic performance. Asian countries were not happy with the hard line of the US Treasury and the International Monetary Fund (IMF) when the crisis forced them to seek financial assistance. Depreciation of the dollar in 2003–07 and the turmoil in US credit markets in 2007–08 did not enamor them of an international system in which the dollar was the main form of international reserves and the United States set the tone for global financial affairs. Better, they concluded, was to invest in developing a more autonomous regional monetary and financial system through which East Asian countries could provide the necessary functions for themselves.

The last 10 years have seen considerably more progress in the financial than the monetary sphere. In finance, there has been the CMI for emergency finance assistance. Established in 2000 as a collective endeavor of the 10 Association of East Asian (ASEAN) nations together with China, Japan, and South Korea (known collectively as the ASEAN+3 grouping), the CMI provides a network of bilateral swaps and repurchase agreements through which countries can obtain emergency assistance. Chapter 3 by Chai and Yoon describes and analyzes these developments in detail.

There has also been the ABMI and the ABF to develop regional debt markets. The ABMI, also an initiative of ASEAN+3, focuses on developing a stronger bond-market infrastructure, relying on the analysis and findings of regional study groups. The ABF, an initiative of the Executives' Meeting of East Asian and Pacific Central Banks (a grouping that includes not just East Asia but also Australia and New Zealand), seeks to foster the participation of investors on those markets by creating a Pan Asia Bond Index Fund, a passively managed fund administered by private-sector managers, and a series of dedicated national index funds.

Both sets of initiatives have continued to evolve. Participants in the CMI have committed to transforming their scheme into a regional reserve pool capable of being deployed all at once in the event of need. They have taken steps to create a surveillance mechanism designed to identify financial vulnerabilities, call for corrective action, and monitor the adequacy of the steps taken in response. Better information on the causes of financial difficulties and on how governments are responding to them, of the sort that can be assembled through such surveillance, should help members of the CMI to determine when activation is appropriate and make them more confident that they will ultimately be paid back. The original ABF, now referred to as ABF1, has been succeeded by an ABF2, which creates indices and passively managed funds in sovereign and quasi-sovereign bonds denominated in local currencies, its predecessor having been limited to bonds denominated in dollars.

To be sure, there are grounds for questioning the significance and success of these initiatives. In the case of the CMI, the extension of credits beyond the first 20 percent still requires prior negotiation of a program with the IMF. Moreover, its swaps and repos have never actually been activated — not in response to Indonesia's fiscal crisis in the summer of 2005, Thailand's exchange rate and stock market crisis at the end of 2006, or Vietnam's current account crisis in the spring of 2008. East Asian countries are reluctant to point to deficiencies in the policies of their neighbors or to attach demanding conditions to their loans. They are reluctant to infringe on the sovereignty of other nations in a region where political sensitivities often run high. But without firm surveillance and strict conditionality, the CMI will remain a hollow shell. As for the ABMI and ABF1 and 2, Asian bond markets may have grown, but they still lack depth and liquidity. This is especially true of corporate bond markets, the segment that matters most for the development of the Asian economies.

Such reservations notwithstanding, it remains the case that progress has been more extensive in the financial than monetary sphere, where there has been much talk but, as yet, little collective action. The reasons for this difference are not clear. East Asia is highly diverse, both economically and financially, and this heterogeneity of circumstances complicates the task of deciding on a common set of arrangements. But it is not obvious that circumstances relevant to the design of optimal financial arrangements are less heterogeneous than those relevant to choice of monetary-cum-exchange-rate regime. Alternatively, it simply could be that there is more intellectual consensus on the question of how to regulate and develop financial markets than on the appropriate monetary and exchange-rate regime.

Indicative of this wide range of opinions on the question of how to manage exchange rates is the existence of a host of different proposals for enhancing exchange-rate stability. At the less ambitious end of the spectrum are authors like Eichengreen and Ito in this volume who advocate leaving exchange-rate determination to the market but suggest that the volatility of intra-Asian rates will decline to more tolerable levels if central banks adopt inflation targets and pursue them consistently. The question here is not whether inflation targeting in emerging markets is feasible — a growing body of evidence and experience from different regions, including East Asia, confirms that it is. Rather, it is whether coordinated inflation targeting will deliver the requisite exchange-rate stability. Eichengreen cites evidence suggesting that it will, but not everyone may be convinced.

Somewhat more ambitious would be to allow Asian currencies to float subject to some degree of economic management while also taking steps to encourage regional monetary integration. One idea, discussed by Eichengreen *et al*. in this volume, is to create a regional currency — an Asian Currency Unit (ACU) or Regional Currency Unit (RCU) — that would circulate side-by-side with national currencies. Governments would agree on the definition of the RCU as a basket in which the currencies of larger countries have heavier weights. They would issue bonds denominated in RCU. The idea is that international investors would regard RCU-denominated bonds as more attractive than bonds denominated in a single foreign currency, since the diversification offered by a currency basket would offer more stability in terms of domestic purchasing power. Once a market in RCU-denominated sovereign bonds begins to develop, corporations funding themselves internationally may choose to issue RCU-denominated bonds as well. Banks would offer RCU-denominated deposits and extend RCU-denominated loans. In this way, a private market in RCUs would begin to develop. Eventually, trade across borders would be quoted and settled in RCUs. Ultimately, the RCU would come to resemble a regional currency.

This would be a market-led approach to regional monetary integration, consistent with the larger regional integration process in East Asia which is driven more by economics and less by politics than in, inter alia, Europe. The problem is that markets in RCU-denominated assets would be relatively illiquid at the outset. Given the incumbency advantage possessed by existing national currencies, this raises the question of whether the RCU could ever gain significant market share. The case of the European Currency Unit, the internal accounting unit and proto-parallel currency created by the European Community (EC) in 1979, suggests that this is possible but only with concerted efforts by governments. For this approach to succeed, in other words, not just economic but also political leadership will be required after all.

Still more ambitious would be to establish a multilateral exchange-rate grid — an Asian Exchange-Rate System analogous to the European Monetary System (EMS) of the 1980s and 1990s — in which the movement of intra-Asian currencies was limited to narrow fluctuation bands, and governments intervened in the foreign exchange market when the edge of those bands was reached. This option is described by Moon and Rhee in this volume. It is more ambitious than the proposals described above because, given the liquidity of foreign exchange markets, governments and central banks would be committing very extensive resources to such an intervention. It is more ambitious in the sense that they would be subordinating domestic monetary policy to the imperatives of keeping the exchange rate stable. They would be committing to the idea that monetary independence matters less than exchange-rate stability. Finally, this proposal is more ambitious than those described above because the costs of failure would be high. When a central bank commits to pegging the exchange rate but fails, its credibility is damaged. And as the 1997 financial crisis reminds us, the economic and political fallout from such failures can cause serious damage.

The relatively ambitious nature of this approach leads some, such as Eichengreen and De Grauwe in their chapters, to question its feasibility. Governments whose legitimacy rests on their ability to deliver economic growth will not be able to indefinitely subordinate monetary policy to the maintenance of a currency peg. It is not clear who would set the tone for monetary policy systemwide. Asia does not possess a supranational institution analogous to the European Central Bank (ECB) or even an intergovernmental process by which such decisions can be reached collectively. Under such circumstances, monetary conditions presumably would be set by a large country with a strong culture of price stability, which would come to play a role analogous to that of Germany in the EMS. For example, the country in question could be Japan. But a monetary policy that was appropriate for a slowly growing mature economy like Japan might not also be appropriate for a fast-growing developing country like China. The consequent tensions might also excite worries about Japanese dominance. Given the history associated with such fears and tensions, this does not bode well for the durability of such a system. Alternatively, one can imagine China as the country setting the tone for monetary conditions region-wide, given its size and large trade and financial flows with its neighbors. But a China growing a 10 percent a year and battling overheating would presumably prefer much higher interest rates than slower-growing countries like Japan. Moreover, given the volatility of its securities markets, continued weakness of its banks, and unresolved inflation problems, it is not clear that China would be able to assume this leadership role.

And even if all these problems were solved, pegging would still be difficult, given the reality of high capital mobility. Asian central bank reserves may be large, but they are not large enough to buy back the entire money supply, as would be necessary if firms and households sought to liquidate it all at once to avoid the losses resulting from a crisis. A country whose currency fell to the bottom of its fluctuation band would have to receive unlimited support from the system's strong-currency countries. But the latter would be willing to put their own money at risk only if they were confident of being paid back. This would mean attaching strict conditions to their loans. Thus, the viability of a regional exchange-rate system would ultimately run up against the same problems limiting the development of the CMI.

The most ambitious alternative of all would be to move quickly to monetary union, creating an East Asian Central Bank and a single Asian currency. Economically, doing so is straightforward. East Asia today comes as close as Europe in 1999 to satisfying the economic preconditions for smooth operation of a monetary union, as De Grauwe shows in Chapter 6 in this volume. And where preconditions are still absent, they will tend to arise spontaneously in response to the move to a single currency.

Politically, in contrast, an early transition to monetary union would be more challenging. Monetary unification entails a fundamental sacrifice of national monetary sovereignty. Control of national monetary policy is given over to a supranational entity. And national sovereignty is not something that East Asian countries appear willing to sacrifice or pool. At the same time, De Grauwe suggests, again invoking Europe's experience, the political preconditions are as endogenous as their economic equivalents. Take a few steps in the direction of monetary integration — strengthen existing regional mechanisms for policy dialog on monetary policy, for example — and more political willingness will develop. Create an institution responsible for surveillance and advice on East Asian monetary affairs, and out of this seed, he argues, can grow an East Asian Central Bank. Indeed, Chai and Yoon suggest that East Asia already possesses the relevant institution in the form of the CMI and its surveillance mechanism.

Chai and Yoon also offer an interesting twist on the preceding options. Rather than alternatives, they argue, a number of these approaches to monetary integration are in fact complementary and should be pursued simultaneously. In particular, an Asian Monetary System limiting the variability of intra-Asian exchange rates would complement the creation of a RCU. Only if exchange rates were reasonably stable would cross-border trade and financial flows continue to expand strongly, creating a demand for RCU-denominated assets. And only if currency risk was limited to tolerable levels by a credible regional exchange-rate arrangement would investors be willing to hold RCU-denominated bonds. Of course, one can also argue the opposite — that if exchange-rate risk is eliminated there will be a greater willingness on the part of foreign investors to hold bonds denominated in national currencies and a greater tendency to quote and settle trade in domestic units, and therefore no demand for the RCU. This suggests that there is an optimal level of exchange-rate variability, greater than zero but less than infinite, that would optimally complement development of the market in RCUs.

A related point also made by Chai and Moon is that efforts to foster monetary and financial cooperation are strongly complementary. Stable and well-developed financial markets will make it easier for central banks to pursue policies of inflation targeting. In turn, stable exchange-rates, whether achieved through harmonized inflation targeting or a regional exchange-rate mechanism, make it easier to maintain financial stability by reducing the threat from currency mismatches. Stable exchange rates also make it easier to develop deep and liquid bond markets, a fact that has been established in a series of empirical studies.

Regardless of whether the issue is monetary or financial cooperation, progress will heavily depend on the commitment of East Asia's two largest economies, China and Japan. It is revealing in this connection that recent efforts have been spearheaded by ASEAN+3, which expands ASEAN to include China, Japan, and South Korea, and by EMEAP, whose 11 East Asian and Pacific central banks again include China, Japan, and Korea.

The observation is not original to us; the analogy between the role of Germany and France in the European Union (EU) and the role of China and Japan in East Asia has long been noted by aficionados of regional integration. But the final two chapters in the volume, by Yu and Itoh, develop the implications further. Yu describes how China's dynamic growth has brought it to the forefront of international monetary and financial affairs, not just in East Asia but globally. China's exchange rate is a matter of concern for the United States, which sees it as contributing to the problem of global imbalances, but also in other East Asian countries, for which China has emerged as a significant competitor and an important market for final goods. Asian countries may recognize the need to allow their currencies to rise against the dollar and the euro to address the problem of global imbalances, but they hesitate to move until China moves first or unless it moves with them for fear of losing out to Chinese competition.

China, for its part, remains reluctant to let its exchange rate appreciate too rapidly for fear of undermining the operation of a tried-and-true growth model. Industrialists in export-oriented sectors are influential, and the government's legitimacy rests on its ability to deliver export-led growth. China is increasingly aware of its role as a monetary and financial leader, but domestic political and economic constraints continue to limit its ability to exercise that leadership and to promote regional monetary cooperation.

Constraints are also evident in the financial domain. Bank restructuring and financial development are works in progress, as is the development of mechanisms for investing China's international reserves. Yu discusses this last problem, which the Chinese authorities are addressing by creating a sovereign wealth fund. As he explains, the creation of a sovereign wealth fund raises many issues, including those of mandate and administration. There may also be important implications for the other countries of East Asia. These include: will China's sovereign wealth fund invest mainly in the region or elsewhere, and will it act as a buy-and-hold investor or trade actively and thus add liquidity to regional financial markets?

Itoh, in the closing Chapter 8, argues that Japan has long been conscious of its stake in East Asia and that it has sought to exercise monetary and financial leadership. An example is its proposal in 1997 to create an Asian Monetary Fund, an initiative that foundered on opposition from the IMF and the United States and received a lukewarm reception in China. As this episode illustrated, Japan's leadership efforts must overcome the legacies of history: other East Asian countries, still mindful of Japanese expansionism in the first half of the 20th century, worry that Japanese leadership would mean Japanese control. In addition, Japan, like China, faces political constraints on its ability to lead and even support regional cooperation. Itoh cites the example of Japanese farmers, whose opposition has hindered efforts to negotiate regional trade agreements. At the same time, he suggests that the situation is changing and that domestic politics may pose less of an obstacle in the future than the past.

The end result of these processes is clear: East Asia will become more integrated both monetarily and financially. The question is exactly how and when. It is our hope that this volume takes us some way toward answering it.