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## **East Asian Monetary Integration Revisited**

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## **(First draft)**

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### **Introduction**

Recent efforts toward regional financial cooperation in East Asia have come from the Asian economic crisis in 1997. In order first to alleviate the disastrous outcome of the Crisis and then to avoid it from being repeated, a number of proposals were advocated by government officials, business people and academic scholars. The Asian Monetary Fund (AMF) and the Chiang Mai Initiative (CMI) are among them. They are not, however, to propose any alternative exchange rate regimes such as a common currency.

Can we create a common currency such as Euro in East Asia? Noting that the Asian economic crisis in 1997 started from plummeting Thai bahts, if we have a common currency in East Asia, we might have prevented from the Crisis. Indeed, the closely knitted economic interdependence or real integration in the region might provide some rationales for even monetary integration.

In order to achieve this monetary integration, what conditions must be met? In this paper, we would like to put some thoughts to these questions, thinking about the meaning of several frameworks for regional financial cooperation. Let us first review why the Asian economic crisis led to these frameworks for regional financial cooperation.<sup>1</sup>

### **1. Regional Financial Cooperation in East Asia**

Immediately after the 1997 Asian economic crisis, several frameworks for regional financial cooperation have been pursued and realized. Among them included are the Asian Monetary Fund (AMF, 1997), the Chang-Mai Initiative (CMI, 2000), and the Asian Bond Market Initiative (ABMI, 2002).

Among these three, the AMF was not realized. Like the IMF, the AMF was to maintain the stability and sound management of monetary and financial systems in the region and to support macroeconomic adjustments in regional economies in trouble. Some worried about the duplication with the IMF and the moral hazard of borrowing economies, and others were reluctant because of the geopolitical reasons.

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<sup>1</sup> The first half of this paper depends on Kohsaka [2004].

Over some time, however, some key functions presumed in the AMF, i.e. swap agreements of official foreign exchange reserves, macroeconomic policy dialogues, and monitoring of short term capital flows, were instituted within the CMI. The CMI is a framework for regional cooperation to prevent the resurgence of the Asian crisis, which is of short run in nature. On the other hand, the ABMI is a framework to provide with stable long term capital and is of long run in nature. The ABMI is to create the regional capital market in order to circulate ample savings regionally with reduced exchange rate risks.

### **Restructuring regional financial systems**

The Asian economic crisis exposed several weaknesses of the financial systems in East Asia. The regional financial cooperation is to tackle these weaknesses by restructuring microeconomic structures and macroeconomic management (IMF [2000]). As to microeconomic aspects, efforts have been made to enhance transparency and accountability, to assess standards and codes, and to better identify financial sector vulnerabilities. Generally, they are intended to contribute to better-informed decision-makings for lending and investment. Restructuring macroeconomic management includes external debt management and alternative exchange rate regimes. The policy authorities in East Asia had not grasped who borrowed in what terms from abroad, which resulted in maturity as well as currency mismatches, unexpected reversal of foreign capital flows and excessive currency depreciation. In addition to external debt management, exchange rate regimes had to be fundamentally reshaped. It is well known that the virtual dollar peg regime suffers from fundamental flaws.

### **Lessons from the Asian economic crisis**

The Asian economic crisis differs from *usual* currency crises repeated in Latin American economies since the 1980s. These crises came from macroeconomic instability intrinsic to these emerging markets, i.e. persistent current account deficits and currency overvaluation eventually induced capital flights and currency speculation. On the other hand, in the Asian economic crisis, persistent high economic growth and macroeconomic stability aroused two problems. First, not current account deficit, but capital account surplus ultimately called on the reversal of capital flows. That is, capital inflows well over current account deficits did finance inefficient domestic investments and their becoming non performed loans caused investors to run away (Figure 1).

#### **>>Figure 1: Current account deficits and capital account surpluses: Thailand**

These excessive capital inflows were enabled by the virtual dollar peg regime. In view of several real exchange rate indicators, we do not see significant overvaluations in East Asian currencies and therefore overvaluation could not cause capital reversals through expected depreciation. At issue is not the exchange rate levels, but their being maintained for a long while since the early 1980s (Figure 2). This exchanger rate stability under the virtual dollar peg had given wrong signals to the market and to induce excessive risk taking, i.e. excessive unhedged external borrowing in foreign currencies. This is the second aspect of the Asian economic crisis.

> > **Figure 2: Exchange rates: East Asia**

## **2. External Financing**

External borrowing itself, of course, can be very useful. It adds to domestic saving and finances investment. It can also enhance competitiveness of domestic financial market and provide externality effects on financial management. External investors, on the other hand, also gain from increased opportunities in enhancing rates of returns and diversifying risks in their portfolios. In fact, capital inflows to emerging markets exploded in the 1990s (Figure 3). In terms of their composition, a shift from loans to FDI as well as portfolio flows was remarkable. The factors behind the trend include liberalization policies on capital account and economic growth in host countries on one hand, and the globalization of production networks of multinational corporations and the growth of institutional investors due to capital accumulation in investor countries on the other hand, and the global securitization trend and business cycles.

> > **Figure 3: Net capital flows: Asia Pacific**

Capital flows to East Asia in the 1990s were excessive in dual senses. First, East Asian saving ratios had been at 30 to 40 percent of GDP, being far higher than in other regions. While current account deficits simply suggest their investment exceeded even this high saving, capital account surplus beyond current account deficit appeared to expand investment up to financing unproductive investment. In this sense, these capital flows were excessive. Second, as said above, the virtual dollar peg regime distorted exchange risk taking and the resulting neglect of these risks led to excessive capital inflows.

What was wrong with the choice of exchange rate regimes? It is well known that among macroeconomic policy targets we cannot simultaneously attain exchange rate stability, perfect capital mobility and autonomous monetary policy. According to this macroeconomic policy trilemma, in order to maintain autonomy in monetary policy, we must give up either exchange rate stability or perfect capital mobility. Namely, it follows that the Thai policy authorities tried inconsistent policy management. There are reasons, however, to stick to the dollar peg.

In the case of developing economies including emerging markets, it is difficult to borrow in local currencies so that foreign currency borrowing necessitates the stability of nominal exchange rate to minimize exchange rate risks. In addition, effective external debt management requires no small institutional costs. Consequently, few developing economies adopt floating exchange rates in reality, which is called as *fear of float* (Alesina and Wagner [2003]).

## **3. Domestic Financing**

Facing this macroeconomic policy trilemma, in order to maintain monetary autonomy, emerging markets in East Asia had to choose between capital controls (China and Malaysia) and floating

exchange rates (the rest). After the crisis, the net debt flows to East Asia turned negative (outflow), but non debt flows, i.e. FDI, have kept supplementing their ever high domestic saving.

Figure 4 shows saving-investment balances in East Asia (more precisely, the Asia Pacific region) and Latin America and the Caribbeans. Apparently, both saving and investment ratios are very high in East Asia and their differences, i.e. current account balances, are alternately in surplus and deficit at higher than average growth rate. In comparison, in Latin America, not only their saving and investment ratios are lower than in East Asia, but their current account deficits are persistent at the growth rate of average developing economies. In other words, East Asia has required less net foreign saving and has enjoyed its *virtuous cycle of investment and growth* where high investment for high growth can be domestically financed.

**> > Figure 4: Saving-investment balances and economic growth: Asia Pacific and Latin America**

These ample domestic savings have financed corporate business investments through financial intermediaries. We can think of an alternative channel of investment finance, i.e. capital markets for corporate stocks and debentures. Generally, in developing economies, capital markets are underdeveloped as compared to financial intermediaries (Levine [1997]), and this is also the case in East Asia. Then, the Asian economic crisis hit hard the very channel of domestic financing. Because banks themselves and/or their customers borrowed from abroad in foreign currencies, the deterioration of their balance sheets due to abrupt and large exchange rate depreciation pushed them to the brink of bankruptcy, because these foreign currency debts were not hedged against exchange risks.

Coping with this emergency, financial intermediaries disposed nonperforming loans, wrote off own capital and stopped supplying credits (Figure 5). Thus, the recovery of investment after the crisis was realized without private credits. Namely, despite this financial disintermediation, the corporate business sector resumed investment and growth through retained earnings from favorable export sales and/or through bond issuance in the capital market.

**> > Figure 5 : Private credits (real): East Asia**

Recently, the persistent U.S. external imbalance and the possible dollar crash have aroused worries, generating such terms as *saving glut* and/or the *global imbalance*. (IMF [2005]). The saving glut is equivalent to investment shortage, and the global imbalance stands for persistent current account deficit of the United States on one hand and persistent surplus in Japan, East Asia and oil exporters on the other. Particularly, in East Asia, the persistent external surplus has come from underinvestment, which in turn can be due to the malfunctioning of the domestic financial system.

As such, the Asian economic crisis made one big epoch in the history of the international financial market, which embodied opportunities and risks of the financial globalization toward the end of the 20<sup>th</sup> century. The crisis exposed intrinsic vulnerabilities of the capital market under the

globalization trend, and resulted in income losses, job losses and bankruptcies in a number of nations. The regional financial cooperation is an effort to compensate for these vulnerabilities intrinsic to the international capital market, to bring back to the original track the most dynamically growing and changing region in the world, i.e. East Asia, and to build up a regional safety net to preempt similar crises.

#### **4. The Road to Monetary Integration**

##### **Regional financial cooperation and monetary integration**

How is this regional financial cooperation related to monetary integration, then? We must remember the macroeconomic trilemma discussed earlier. One of the three targets among exchange rate stability, perfect capital mobility and monetary policy autonomy must be given up. Regional financial cooperation preconditions capital mobility and monetary policy autonomy and intends to prevent from destabilizing exchange rate volatility and to minimize its impact. In contrast, monetary integration pursues for regional exchange rate stability in exchange for individual monetary policy autonomy, which is a total regime change. Of course, regional exchange rate stability does not mean exchange rate stability with major currencies outside the region such as the US dollar and Euro. How large, then, is the cost of giving up the monetary policy autonomy in exchange for regional exchange rate stability?

##### **Optimum Currency Area (OCA)**

The theory of optimum currency area discusses conditions which determine the scope of the area best for one currency. We trade off between the transaction cost to have multiple currencies and the benefit to allow for exchange rate adjustments among the currencies. If the cost is larger, we prefer a common currency, but if it is smaller, we had better maintain monetary policy autonomy under multiple currencies. Alternatively, focusing on macroeconomic linkages, we may put it as follows. That is, the higher the correlation of demand and supply shocks within region, the less needed exchange rate adjustments (expenditure switching), thus a common currency is desirable. Moreover, the faster the adjustment through factor markets and policy responses within region, a common currency is preferable.

##### **Comparative macroeconomic linkages by region**

Particularly, regarding the United States as a region consisting of several subregions, we can compare estimated intra-regional macroeconomic shocks and simulated adjustment speeds after shocks among the United States, EU and East Asia (including Japan) during the period of 1970-95, using multi-country VAR models (Kohsaka [2000]).<sup>2</sup> The results can be summarized as follows: 1) The correlations of shocks were significantly higher in the United States than in the other two

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<sup>2</sup> Based on the framework of Blanchard and Quah [1989]. See also Bayoumi and Eichengreen [1993].

regions. 2) The speeds of adjustments after shocks were significantly larger in the US than in the other two regions. 3) As to both the correlations and the speeds, there were not much difference between EU and East Asia.

If we interpret the above results straightforwardly, it follows that the US economy is more fit to common currency compared to East Asia. However, since the US has established itself as a common currency area for a long while, it may not be adequate to directly compare with the other two regions that have never experienced a common currency. More interesting is the finding that there was no difference in shock correlations and adjustment speeds between EU and East Asia. That is, if EU is eligible for a common currency, East Asia too may meet the eligibility.

### **5. Does the EU suggest East Asian Monetary Integration?**

Now, does the emergence of the Euro and the EU currency unification suggest the counterpart unification in East Asia? To answer the question, we, first of all, need to examine the performance of the EU currency unification.

The rationale for the EU regional integration has been discussed from both the economic and political aspects. The EU integration intends to promote economic growth by improving microeconomic resource allocation through trade and investment liberalization as well as capital market deregulation and currency unification. The EU integration also intends to intensify the presence and power of EU in the international economic systems. Hereafter we focus on the economic aspect of the integration, among which we particularly try to examine the sustainability of Euro as the core of the EU monetary integration.

#### **The Euro Zone: current conditions**

Let us briefly review the current macroeconomic conditions of the Euro Zone, i.e. the twelve EU economies, in comparison with the other industrial economies including the United States. Since the introduction of the Euro was in 1999 as a unit of account and completed in 2002, it might be too early to fully assess this historical regime change, but, so far, we may be able to summarize that it has been successful in financial aspects, but not in real aspects.

First, we can point out significant achievements in inflation control and financial integration (Figure 6). Indeed, the Euro Zone has witnessed closer linkages of interest rates and stock prices and the home bias in portfolio selection rapidly fading away, which suggests that financial markets are being more closely linked one another and financial deepening proceeded further in the Zone. On the other hand, however, the real sector achievements in terms of economic growth have remained less than those in previous periods and in non Euro Zone EU members (Figure 6). In addition, the growth differentials among Euro Zone economies are significant and even tend to increase further. Of course, we can note that, since we were in the midst of the recovery process from the IT bubble burst of the World economy in the year 2000, we must take into account of the

influence of the cyclical factor. Nevertheless, the relatively weak achievements in comparison with non Euro Zone EU members appear to imply some policy agenda to be considered below.

>> **Figure 6: Macroeconomic performance: EU**

### **Causes of Low Economic Growth**

Structural problems in labor market and fiscal policy have been among the top priorities in macroeconomic policy agenda in EU. Usually in comparison with the United States, such structural characteristics of the EU economies as strong labor unions and extravagant social welfare systems have brought along rigidities in real wages and fiscal expenditures, supposedly hampering adjustments needed for cyclical and structural impediments.

Instead, we would like to focus on another issues, that is, those related to macroeconomic management such as monetary and fiscal policies. While we noted the achievements in inflation control, we may better look at the risk of the present inflation targets being too low. If this is the case, it may have deflationary impact on some sectors and constrain their investments, leading to weak overall investment. Furthermore, the very adoption of a common currency may significantly constrain macroeconomic management in monetary and fiscal policies. We consider this in the following.

## **6. Monetary Integration as a Constraint to Macroeconomic Management**

### **Constraint on monetary policy**

Since the introduction of a common currency unified interest rates in the Euro Zone, the monetary authorities = the European Central Bank (ECB) manage the short term interest rate (Euro interbank rate) as a monetary policy instrument in view of the macroeconomic situation in the Euro Zone economies. This is parallel to the Federal Reserve Board (FRB) managing the Federal Fund (FF) rate in the United States.

Their ways of monetary policy management contrasted significantly facing the IT bubble burst, though (Figure 7). While both the EU and the United States experienced rapid macroeconomic slowdowns in the period of 2000-2001, the FRB lowered the FF rate by 4.5 percent quickly and actively on the one hand, the ECB did the same only by 1.5 percent and that less quickly and actively on the other. Of course we cannot claim that this difference in monetary policy management is all to blame for the difference in economic growth performance, but, if the contrasting monetary management comes from the common currency system, this may suggest a non small problem.

> > **Figure 7 : Policy interest rates: Euro Zone and the US**

Look at the economic growth performance and the real interest rates in the Euro Zone economies. We found that the interest rate was the highest in the lowest growing Germany, while the interest

rate was the lowest in the highest growing Ireland (Figure 8). Admitting this as the extreme case though, we found many cases where slower growing economies experienced higher real interest rates, and faster growing economies experienced even negative real interest rates. This simply suggests that the macroeconomic shocks are not closely correlated so that unified monetary policy could hardly cope with these situations. Therefore, there is institutional reasons for monetary policy in the Euro Zone to be slow and inactive, and then maybe ineffective.

> > **Figure 8: Real interest rates and economic growth: EU**

### **Constraints on fiscal policy**

Naturally, our next question is if fiscal policy as an alternative macroeconomic policy instrument compensates for the malfunction of monetary policy. Fiscal consolidation in EU went over the peak in the mid 1990s (IMF [2001]). Indeed, the introduction of a common currency intends to bring in disciplines to macroeconomic policies among member economies and to constrain the policy authorities (or political systems) from indulgent and myopic monetary and fiscal policies. Despite much progress in fiscal consolidation in the 1990s, however, fiscal indicators such as fiscal deficits and government debts have not been strong enough to substitute for monetary policy (Figure 9). Namely, *even if we dare neglect the skepticism* against the effectiveness of fiscal policy in aggregate demand management, fiscal policies cannot afford to cope with individual macroeconomic shocks even in a complementary way to monetary policy.

> > **Figure 9: Fiscal deficits and economic growth: EU**

As a matter of fact, the policy authorities in the Euro Zone are under the Growth Stability Pact (GSP) which explicitly constrains a room for fiscal policy so that there are little scope for active fiscal management to cope with individual situations. Incipiently, since the GSP is to introduce a rule based macroeconomic management instead of arbitrary one, the resulting fiscal constraint is indispensable part of the common currency regime.

### **The cost of EU currency unification**

Looking at the EU experience so far, it appears that the frustrating macroeconomic performance in the Euro Zone since the currency unification has something to do with the currency unification itself. That is, macroeconomic shocks in the Euro Zone have been asymmetric in a significant way, but monetary policy cannot effectively cope with individual situations under the intrinsic constraint of the common currency regime, while fiscal policy on top of the legacy of the past cannot cope with not only individual but also regional situations under the constraint set out by the GSP, in order to help alleviate the burden put on monetary policy.

Presuming the common currency, it is trivial for monetary policy to cope with asymmetric shocks among member economies, so that, in order to compensate for monetary policy, the fiscal transfers under regionwise aggregate fiscal policy are indispensable. In addition to harmonize fiscal

institutions such as expenditure compositions, taxation, social welfare, and to accelerate fiscal consolidation, it would be necessary to enlarge the inter-country transfers and to introduce the fiscal federalism.<sup>3</sup> We are well aware that, although constrained by the GSP, fiscal policy is a fortress of national sovereignty in economic policy. It would not be an exaggeration, however, to say that the sustainability of the common currency regime depends on the feasibility of the fiscal federalism.

## **7. Concluding Remarks: Road to East Asian Monetary Integration**

Now, in turn, what can East Asia learn from the experiences of the Euro Zone? Although their experiences were not long enough to draw any decisive lessons, we will be able to summarize at least the following two points.

One, the coherence of political wills among members would be indispensable to the realization of monetary integration. The EU succeeded in establishing the resolute political will to have a resolute presence as a group in the international economic system. Even the EU has taken more than thirty years to attain the goal. Is there any condition for East Asia to spare time and energy enough to attain the same goal?

Another is the feasibility of economic management under the common currency. In the past decades, East Asia has demonstrated praiseworthy macroeconomic stability and growth not only beyond other developing economies, but also as compared to developed ones. They have never controlled inflation by any regional disciplining device, but attained exceptionally high economic growth under relatively mild inflation through individually pursuing own disciplined policy managements. This caused excessive capital inflows to the region and the resulting Asian economic crisis was regarded as most unexpected by the rest of the world. The swift recovery from the crisis again showed the fundamental strength of East Asia.

This fundamental strength, however, implies weak motivation to improve economic performance via regional integration as opposed to EU. Even without monetary integration, as compared to other regions, East Asia has shown unprecedented economic performances under de facto regional integration through private sector production networks built by multinational corporations. Maybe they have incentives to prevent from recurrences of crises, but little strong motivation to pursue for further integration beyond the deepening of the production networking.

On top of these, the most serious worry would be the potential costs of losing individual monetary autonomies under the currency unification. East Asia contains members of different development stages, divergent industrial and external trade structures. When they face diverse economic shocks, the cost of losing monetary autonomies and effective policy instruments might be

enormous. Furthermore, the economic rationale of the fiscal federalism beyond sovereignty to compensate for the loss of monetary autonomy may be dubious, and the political feasibility of the fiscal federalism looks out of the question.

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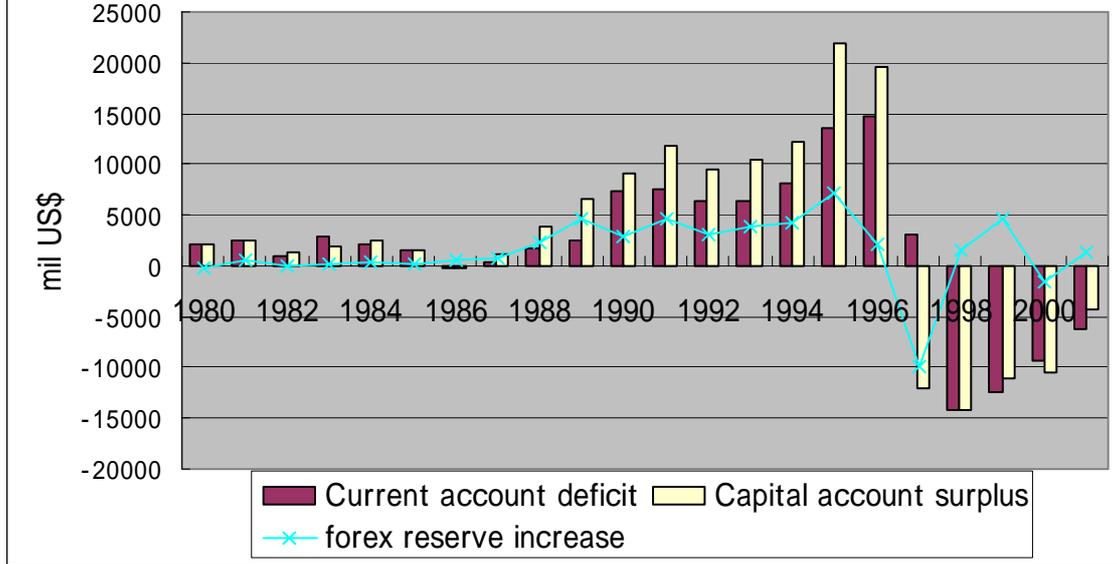
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**Figure 1. Current account deficit and capital account surplus:  
Thailand**



**Figure 2. Nominal exchange rates**

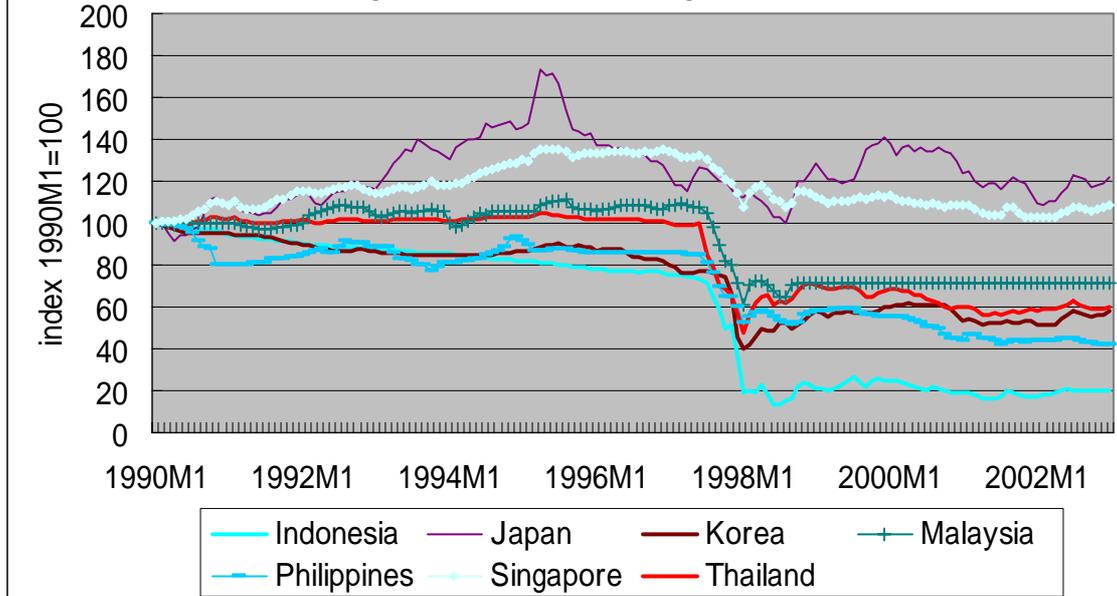
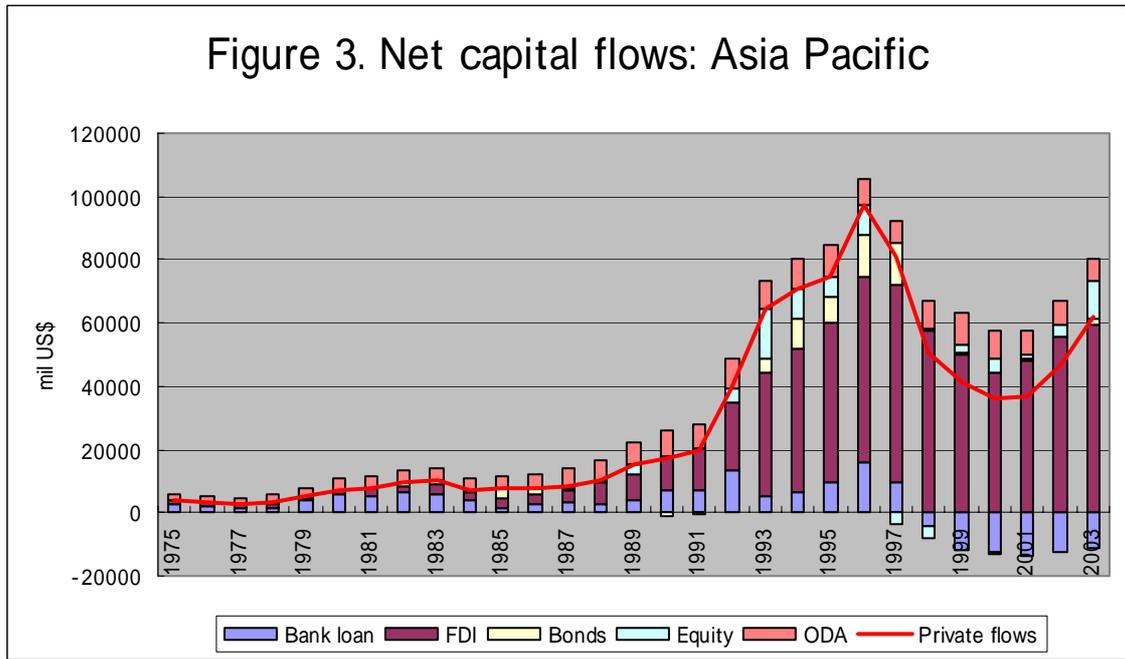
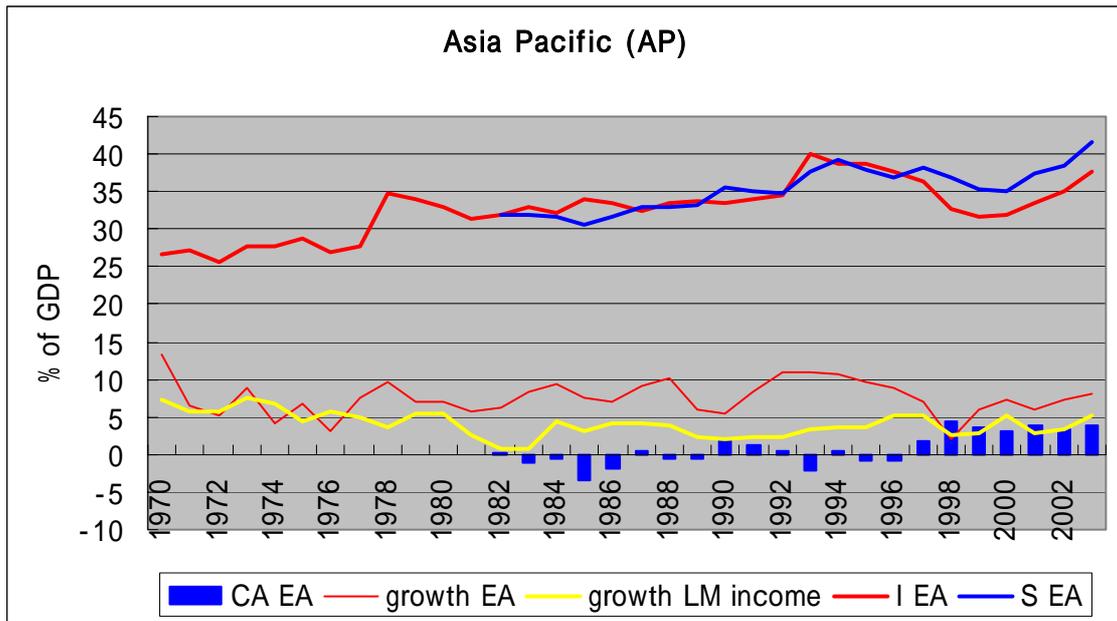


Figure 3. Net capital flows: Asia Pacific



Asia Pacific (AP)



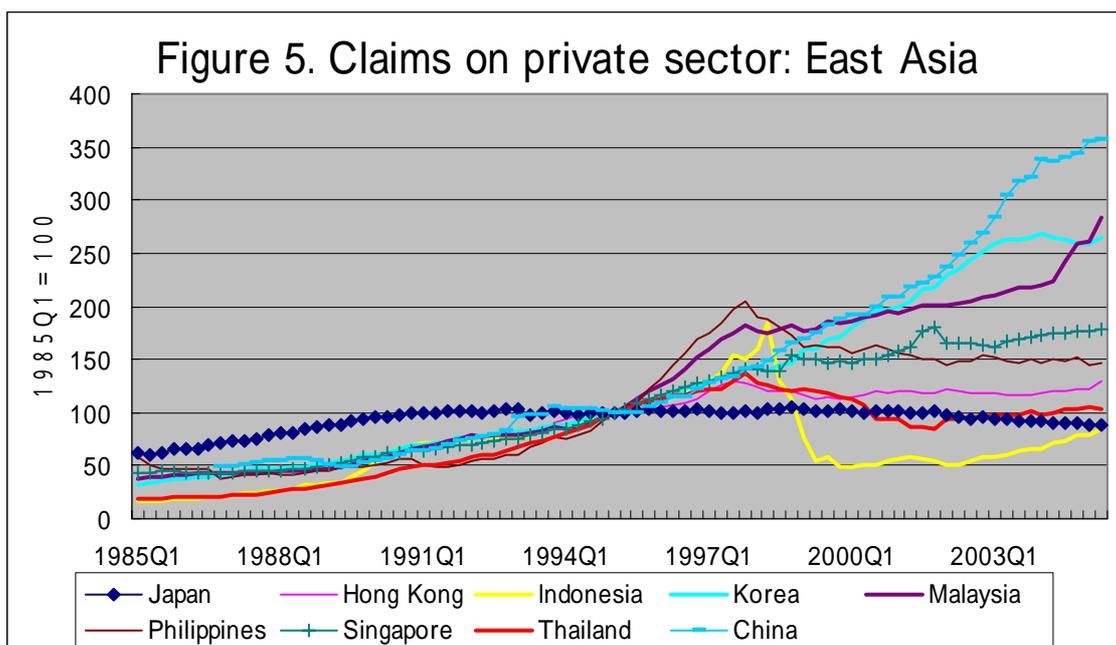
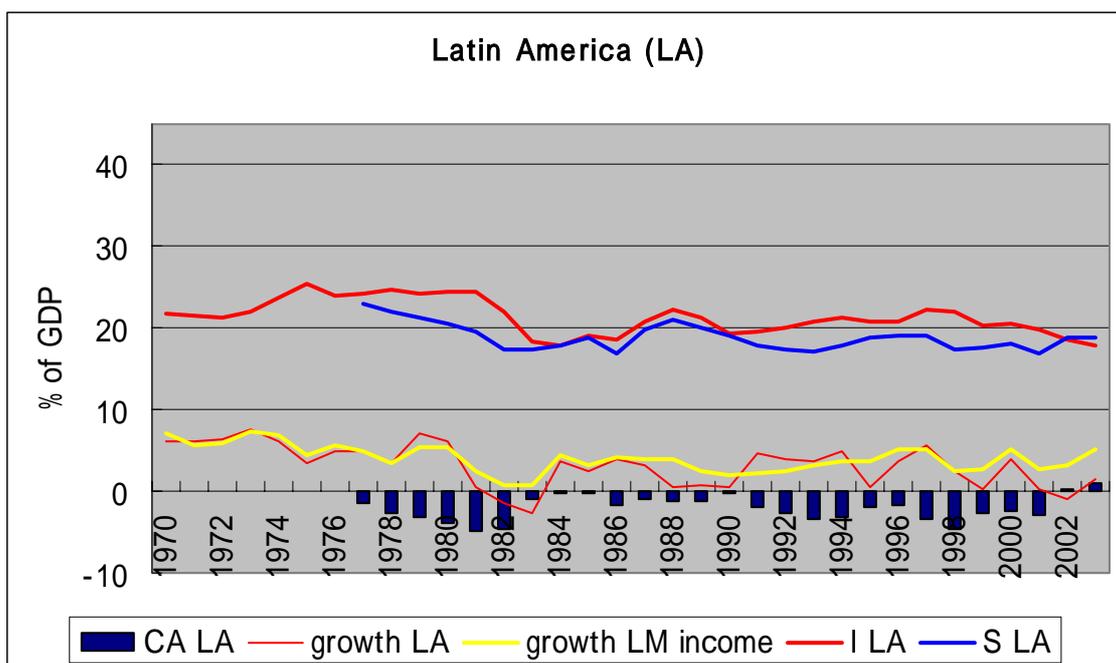


Figure 7. Policy interest rates: US and EU

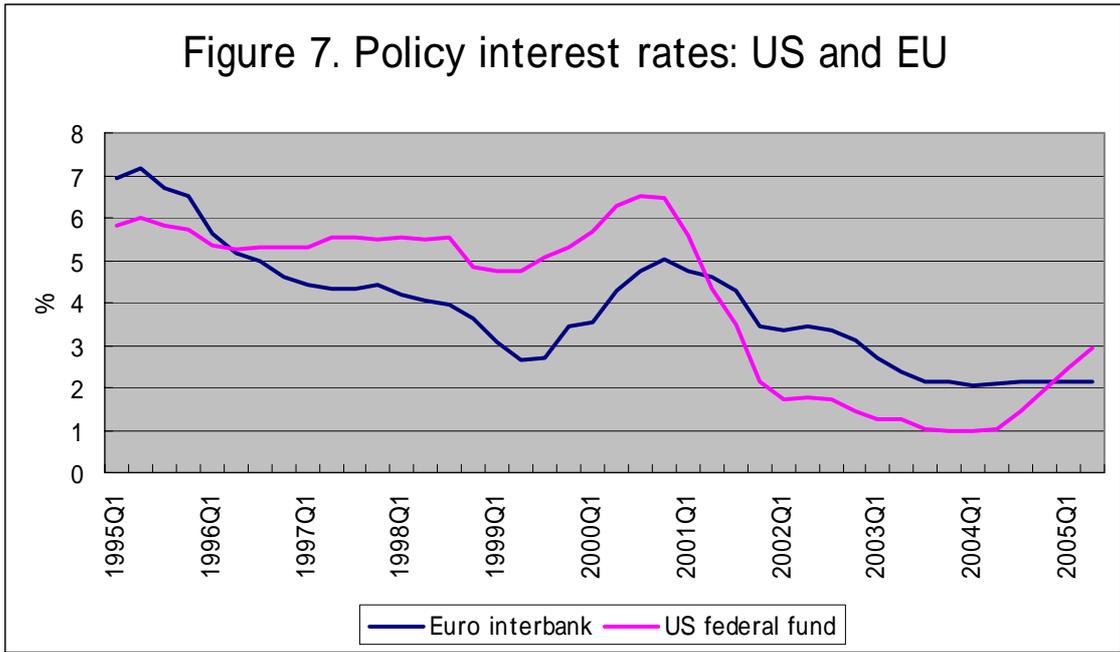


Figure 8. Real interest rate and economic growth: EU, 2002

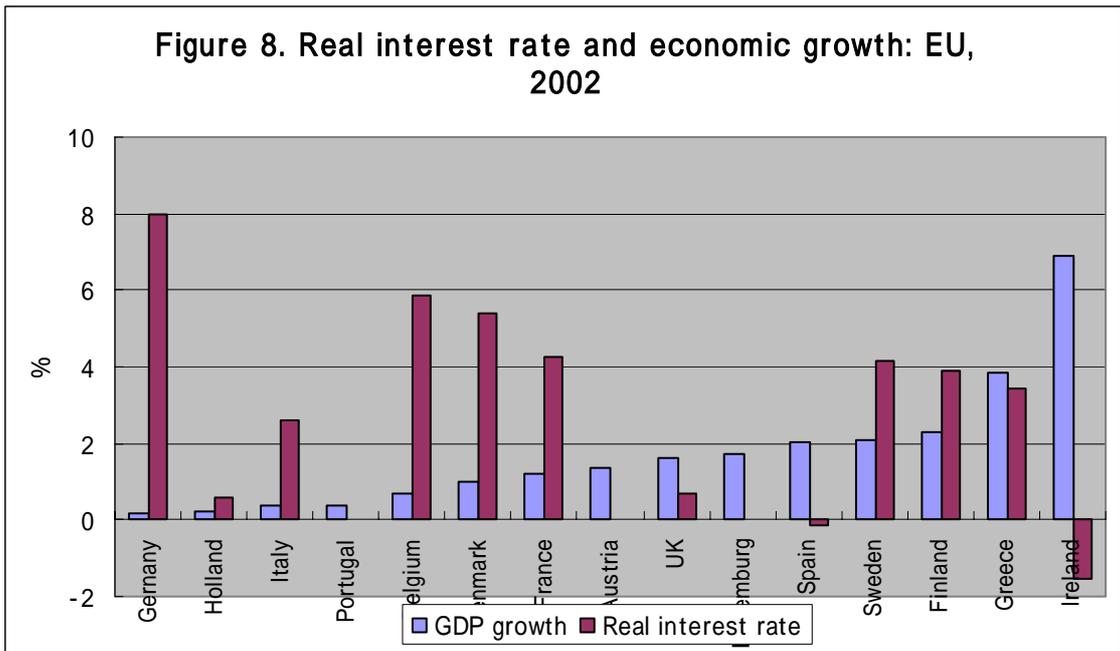


Figure 9. Fiscal balance and economic growth: EU, 2002

