

MONETARY INTEGRATION IN EAST ASIA
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I am currently collaborating with Ellen Meade of American University on a book that examines the prospects for regional monetary integration in various parts of the world. My remarks today draw on our chapter on East Asia, one of the few regions in which we believe that regional integration may flourish in the years ahead. I will deal briefly with four topics: (1) existing and future arrangements for balance-of-payments financing; (2) the problems posed by the need for mutual surveillance in East Asia; (3) exchange-rate policies and arrangements; and (4) the prospects for a sub-regional monetary union in South East Asia.

Arrangements for Balance-of-Payments Financing

The design and ongoing enlargement of the financial facilities commonly known as the Chiang Mai Initiative (CMI) were widely praised, notably by governments and others that opposed the 1997 proposal for an Asian Monetary Fund (AMF). But the amounts and availability of the financing provided *via* the CMI may prove to be inadequate, for three reasons: (1) the limited amounts of financing available from the two largest potential creditors, China and Japan; (2) the need for a country seeking a large drawing on the CMI to have an IMF program in place; and (3) the right of each potential creditor to opt out unilaterally when another seeks to draw on the credit arrangements of the CMI,

Would an Asian Monetary Fund (AMF) solve these problems? Not unless it was able to formulate quickly an appropriate set of policy conditions and, to that end, engage in continuing, comprehensive surveillance of its member countries' economies and policies, and I will return to that matter shortly. Viewed from the standpoint of outsiders, moreover, the creation of an AMF would pose a potential threat to the global primacy of the IMF.

It would, I believe, be better for the East Asian countries to liberalize the CMI by providing for veto-proof collective activation and by further enlarging the amounts of

financing available through the CMI. Alternatively and in conjunction with any collective exchange-rate arrangement, such as common-basket pegging, the countries involved should create open-ended short-term credit facilities like those of the European Monetary Cooperation Fund (EMCF) that backed up intervention in the European Monetary System (EMS). There is, in addition, the possibility of reserve pooling, to reduce the need for each Asian country to hold large reserves of its own, though that would not circumvent the need for mutual surveillance to protect the integrity of the reserve pool.

What to Do About Surveillance

A number of bodies have been created to support and conduct surveillance, including the Office of Regional Economic Integration established within the Asian Development Bank. Initially, these bodies were concerned with the gathering of data on capital flows and other economic variables that could be used as inputs to analysis aimed at preventing and containing future monetary crises. There was, in addition, reliance on data and documentation available from the IMF. Nevertheless, there are reasons to question the quality and candor of the advice produced by these processes, because they were designed to achieve consensus rather than offer candid criticism of the members' policies.

It would perhaps be unrealistic to substitute a 'confrontational' model, in which finance ministers engage in blunt criticism of their partners' policies. But there is another *modus operandi* akin to the one employed by the Organisation for Economic Cooperation and Development (OECD). There, each government confronts the candid analysis and policy recommendations of the OECD staff, and it has to respond to them. And there is no attempt to produce a communiqué aimed at achieving consensus.

If and when some of the Asian governments undertake closer cooperation in matters involving exchange-rate management and the associated national policies, they must be prepared to engage in forthright criticism of each country's policies. They must breach the long-standing Asian tradition of non-intervention in the partners' internal affairs. An exchange rate is, by definition, a 'shared' variable, not the property of any single government. All of which brings us to the matter of exchange-rate arrangements.

Exchange Rate Policies and Arrangements

The advent of the European Monetary Union (EMU) in 1999 led to a widespread revival of interest in exchange-rate arrangements for Asia, including the possibility of an Asian monetary union encompassing some or all of the East Asian countries. Before discussing the options and problems three preliminary observations:

- (1) A full-fledged monetary union involves much more than the introduction of a single currency; it also involves the introduction of a single monetary policy and the creation of a single central-banking system. Too few recent writings on the case for an Asian monetary union pay enough attention to this matter and to the institutional framework required to create and govern such a system and render it accountable to the governments and citizens of the member countries.
- (2) The transition to monetary union, including the crucial decisions about eligibility for membership, is a complicated process. Yet the path followed by Europe need not be mimicked fully by other country groups. It is necessary, however, to construct a real-time inter-bank settlement system and to eliminate those capital controls that would interfere with the prompt transmission of the single monetary policy.
- (3) A monetary union between one large country and a group of smaller countries is not likely to work well. Canada and Mexico are unlikely to join a monetary union on terms acceptable to the United States. They would not agree to be annexed to the Federal Reserve System, and they would assuredly insist on a formal role in choosing the Chairman and members of the Board of Governors and on the right of their national parliaments to hold hearings on the conduct of monetary policy. Similarly, the ASEAN countries are unlikely to join a monetary union with the People's Republic of China, because the monetary policy of that union would necessarily be designed to meet China's needs. That would be true even if each member a country had a seat on the governing body. Economic developments in China would necessarily dominate decision-making in a pan-Asian monetary union, just as developments in the United States would dominate decision making by a North American monetary union.

What, then, are the options for exchange-rate management? Let's consider three single-country options and two multi-country options.

The Three Single-Country Options

At one extreme, a country can let its currency float independently, without foreclosing the option of episodic intervention to limit the size or speed of exchange-rate changes. In this case, of course, the exchange rate cannot anchor the price level, which is why several countries with floating rates have committed themselves formally to inflation targeting. At the opposite extreme, a country can tie its currency firmly to a basket of foreign currencies, typically those of its main trading partners, and then intervene in the foreign-exchange markets to keep the actual basket value of its currency from crossing the boundaries of the band surrounding the chosen basket value. But it can also raise or lower the chosen value of the basket and thereby raise or lower the position of the band. Some early versions of the so-called BBC regime (for basket, band, and crawl in the basket value) aimed at offsetting domestic inflation, but a rule of that sort might weaken the ability of the basket peg to safeguard price stability.

The third regime is one that uses a currency basket to inform the policy decisions of the monetary authorities rather than constrain them to defend it. This is Singapore's regime and the one that China and Malaysia ostensibly adopted when they abandoned their strict dollar pegs. Yet China also adopted a very narrow band for the renminbi-dollar rate, which is apt to deprive its currency basket of much operational influence over China's exchange-rate policy (unless, of course, it is willing to shift the renminbi-dollar band whenever its currency basket wanders away from its chosen value).

Two Multi-Country Options

There are two well-defined ways for a group of countries to manage exchange rates collectively: agreeing to adopt a regime, such as a common currency basket, to limit exchange-rate fluctuations, or forming a full-fledged monetary union. The first can be viewed as a permanent regime or, as in the European case, a way-station on the road to monetary union. The second requires the building of a new institution, a multinational central bank, all of the arrangements needed for its governance, safeguards for its

independence, and ways to hold it accountable for its decisions and performance. It also requires a well-defined way to manage its common external exchange rate – an issue that the Europeans did not resolve decisively.

When deciding to use a currency basket, countries must decide whether each one should it have its own basket or whether the group should adopt a common basket. They have also to decide whether the basket should include only outsiders' currencies (an external basket), only insiders' currencies (an internal basket), or a mixture of the two.

Time does not permit me to review all of the issues involved, but let me draw attention to crucial differences between the two sorts of baskets

When countries adopt an internal basket, which is what the Europeans did when setting up the EMS, they constrain the bilateral exchange rates of the member countries but let them float collectively *vis-à-vis* the dollar and other 'outside' currencies. If, by contrast, they adopt an external basket, they will still constrain their bilateral exchange rates but will also constrain the exchange rates between their own national currencies and those that they have put into the basket.

Then there is the matter of monetary policy. When countries adopt a common external basket, they 'import' to some degree the monetary policies of the key-currency countries whose currencies are included in that basket. When instead they adopt an internal basket, they have no obvious anchor for their monetary policies. They can, of course, adhere to inflation targeting, but some of them may fail to pursue it faithfully or in a manner consistent with their partners' practices. In the EMS, of course, the monetary policy of the Bundesbank constrained and thereby anchored the monetary policies of the other member countries. The Bundsbank, however, has no Asian counterpart.

The distinguishing characteristics of an internal basket – its inability to stabilize its member countries' currencies *vis-à-vis* the dollar, euro, and yen, and the absence of an anchor for monetary policy, combine strongly to suggest that a common external basket would be far superior to a common internal basket if the some of the mid-sized Asian countries decide to adopt a common basket.

It must be noted, however, that a common external basket would limit the flexibility of the Asian currencies *vis-à-vis* the U.S. dollar at a time when the reduction of

the U.S. payments deficit requires a significant appreciation of the renminbi and other Asian currencies.

The Case for a Subregional Monetary Union

I have already expressed grave doubts about the feasibility of a pan-Asian monetary union. Let me add another reason. China is growing and changing faster than its Asian neighbors, and there may be a compelling need for substantial changes in the real exchange rates of the ASEAN countries *vis-à-vis* the renminbi. Furthermore, the renminbi is apt to become one of the world's principal currencies, along with the dollar, euro and yen, even if it does not become a key currency in the conventional sense – one used to invoice third countries' trade and one held as a reserve asset by foreign central banks.

For these same reasons, moreover, it may be wrong to contemplate a monetary union embracing China, Japan, Korea, and other East Asian countries. It may be better to contemplate a monetary union comprising the six original ASEAN countries, but one that would be open to the other ASEAN countries and, if politically feasible, Taiwan as well.

The first step in that direction should probably involve the adoption of a common external basket – one that would include the dollar, euro, yen, and renminbi. It would also require the creation of a short-term credit facility to supplement the existing reserves of the member countries (and that might be done with the help of China and Japan, which agree to lend some of their own huge reserves to that new facility). The ASEAN countries participating in the new regime would forgo unilateral changes in the chosen basket value of their countries' currencies; exchange-rate realignments would have to be agreed, much as they were in the EMS.

The next step toward a true monetary union might take place fairly soon after the adoption of the common external basket. It would involve the formation of an ASEAN analogue to the Delors Committee, which was the principal architect of the EMU and of the transition to it. (The Delors Committee, however, consisted mainly of central-bank governors, and its ASEAN analogue would have also to include high-level government officials, because it would to design special-purpose entities to perform the various tasks presently performed in Europe by the institutions of the European Union). Most

importantly, it would have to break the ASEAN inhibition against intervention in its members' internal affairs.

If a committee of this sort could reach consensus or near-consensus on all of the difficult issues involved, it would then be necessary to draft a treaty analogous to the Maastricht Treaty, defining the path to monetary union, the institutional design of the union itself, and the task of the various bodies that would be needed to take on related tasks, including the setting of common standards for prudential supervision, the setting and implementation of exchange-rate policy for the new ASEAN currency, and, most importantly, the setting and subsequent application of the criteria for admission to the monetary union.

How long would it take to complete these tasks? I do not know. Nor do I know how many countries would qualify for membership. But I would not be very surprised if an ASEAN monetary emerged in the next ten years.