

Spurred by the success of the European Union's single currency as well as by the trauma of the Asian financial crisis of 1997-98, the idea of greater Asian monetary integration has proven to be an alluring goal for regional policy makers.


There are plenty of reasons, though, to go slow, argues Barry Eichengreen.

The Misguided Dream of Asian Monetary Union

By Barry Eichengreen

ASIAN MONETARY UNION is the idea that will not go away. The persistence of this vision, however, is more than a little peculiar. To start with, Asia's economies are heterogeneous. On the one hand, there is China, which is growing too fast for comfort. Chinese authorities are willing to see the renminbi continue to appreciate at least to a limited extent in order to put a damper on this runaway expansion. On the other hand, there is Japan, where doubts remain about whether sustained growth has resumed and the authorities are happy to see the yen depreciate as a way of boosting exports. Under the circumstances it is hard to imagine policy makers in either country happily embracing a common monetary policy. In addition, there is a reluctance to create regional institutions capable of defining and implementing a common policy, much less pursuing broader regional political integration. Schemes to create a single Asian currency would seem to have the cards stacked against them.

And yet the notion continues to grow, nourished by two factors. One, is the memory of the Asian financial crisis of 1997-98, in which exchange rates collapsed, companies with foreign-currency-denominated liabilities were thrust into bankruptcy and serious recessions followed in several countries. This characterization of the crisis is oversimplified, to be sure. Not all exchange rates were destabilized — not China's, for example. Not all banks and companies suffered irreparable balance-sheet damage. And the decline in economic activity, while severe, proved short-lived; as early as 1999, growth had resumed across much of Asia. Still, the crisis was traumatic for a region unaccustomed to even brief interruptions in its "miracle growth." With help from public figures like Malaysian Prime Minister Mahathir Mohamad, the financial crisis came to be associated with the volatility of international capital flows and the instability of national currencies. It drove home the point that local currencies are small boats subject to the rough seas of interna-



tional liquidity. It fostered the desire to transfer to a larger vessel — a single regional currency — better able to navigate these stormy waters.

The second source of nourishment, of course, is the euro, which came into being when the European Central Bank began operations at the beginning of 1999 — that is, immediately following the Asian crisis. It illustrated that there existed an alternative to both pegged exchange rates, on whose viability the Asian crisis had cast doubt, and floating rates, to which Asian policy makers looked with misgivings because of the traditional association of exchange rate stability with export-led growth. The euro, it seemed, successfully ring-fenced Europe from financial instability. Neither the terrorist attacks of September 11, 2001 in the United States

nor the 2004 train bombings in Madrid (known as 3/11 in Spain) — nor any of the other political and economic events that shook Europe in the last eight years — resulted in exchange rate instability comparable to that of 1992-93, when Europe suffered its own currency meltdown.

By enhancing price transparency, the euro encouraged the growth of intra-regional trade — another objective of Asian policy makers. It also freed Europe from the tyranny of the dollar, and by eliminating currency risk it stimulated the growth of deeper and more liquid regional financial markets, yet another goal of Asian policy. The euro is a currency with international stature and hence the potential to rival the dollar on the global stage. Finally, the euro symbolizes Europe's independence from the International Monetary Fund (IMF), because if

a European bank or government now requires foreign financial assistance it can obtain it from the European Central Bank (ECB).

As appetizing as these two examples may be, they do not constitute a full policy diet for backers of a regional Asian currency — memories of the 1997-98 financial crisis and Europe's success with a single currency are unlikely to sustain a vigorous movement toward monetary union in Asia. Memories of the financial crisis will fade, and with more time to contemplate Europe's experience, Asian observers will come to realize that monetary union requires a commitment to political integration that Asian countries, with their distinctive historical backgrounds and tensions, are not yet prepared to make.

THE POST CRISIS ASIAN FINANCIAL ORDER

Monetary union is not needed to prevent another Asian financial crisis because there is little risk of another episode like that of 1997-98. Asia is now in current account surplus rather

to the 1997-98 crisis and subsequent hangover — is no longer on the menu.

The extent to which emerging Asia has strengthened its defenses against shocks from international financial markets and reduced the risk of another 1997-98-style crisis is evident in its response to the mortgage-market collapse in the United States. Starting in August 2007, this crisis in the so-called subprime, or high risk, mortgage market created strains in global financial markets and distress among American and European financial institutions, some of which had to be bailed out by their central banks. There have been sharp movements in exchange rates, capital flows and interest-rate spreads between high-risk and high-quality credit.

But there was no Asian crisis. Because Asian countries no longer rely on foreign banks to fund external deficits, they were not affected when foreign banks scrambled to raise liquidity by calling in loans. Countries whose currencies had appreciated in the preceding period could

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than deficit, reducing its dependence on foreign funding. More of what it now borrows takes the form of foreign direct investment and long-term debt securities, while correspondingly less is in the form of 90-day bank loans. Central banks and governments have accumulated vast foreign exchange reserves, while a number of countries, led by South Korea and Thailand, have embraced greater exchange rate flexibility. Thus, the deadly cocktail of short-term foreign-currency debt, inadequate reserves and a commitment to keep exchange rates from moving — all of which contributed

now simply allow them to decline. Because central banks no longer based their policy credibility on maintenance of a currency peg, modest currency depreciation did not damage investor confidence. With banks and firms showing stronger balance sheets, exchange rate movements did not do serious financial harm. And where declines in currencies were excessive, central banks had plenty of reserves with which to intervene in the market.

This does not mean that the Asian economies will be unscathed by the subprime crisis. If financial problems cause a recession in the US, as

some fear, Asia will feel damaging repercussions because the US is such an important market for its exports. If US growth slows, Asian growth will slow. But the channel through which this impact is felt will be trade, not finance. And even if Asia does experience a slowdown, this does not mean it will precipitate a financial crisis.

But saying that Asia is now protected from the risk of another 1997-98-style crisis is not the same as saying that it has acquired some magical immunity from financial instability. Risks remain; they just take a different form. The main risk now emanates from domestic asset-market booms and bubbles like the one underway in Shanghai. China and other emerging economies have liberalized their domestic financial sectors. This has allowed funds to flood into their stock and property markets, not so much from foreign investors as from domestic investors who, for the first time, have alternatives to low-yielding bank accounts. Many of these investors are new to the game. They have heard lots of get-rich-quick stories, but few cautionary tales about bear markets. Plenty of them have used borrowed money to leverage up their bets.

High-flying Asian financial markets could decline for any number of reasons. There could be bank failures or political problems in China. There could be a nuclear threat from North Korea. Asian growth and corporate profitability could be dented by recession elsewhere in the world. Investors could simply wake up one morning and realize that what goes up can come down.

An abrupt downward movement of asset prices could cause serious financial problems. Investors who had borrowed money to buy securities on margin would be forced to sell into a falling market. Those who bought multiple apartments, anticipating that capital gains would allow them to prepay their mortgages with profit left over, would be forced to abandon their properties. Banks could find that the collateral against which they had lent was no good, forcing them to write down capital. Loans previously thought to be safe would be reassessed as risky. Banks would stop lending, and the drying up of liquidity would feed a further

decline in asset markets. Banks whose solvency was impaired would experience runs. Given how little depositors know about the loan portfolios of their banks, there might also be runs on other, stronger, financial institutions.

This would be a full-blown financial crisis. Containing it would require central banks to maintain confidence in the banking system by injecting liquidity to prevent the payments system from seizing up, along the lines of the ECB and US Federal Reserve intervention in the summer of 2007.

But, unlike 1997-98, this would be a crisis in which international factors played little role. Indeed, the main measure that Asian central banks have taken to bulletproof their economies from financial instability — accumulating foreign reserves — would be largely irrelevant in this situation. Since the assets and liabilities of Asian banks are mainly denominated in local currency, a stabilizing intervention would mean providing them with local-currency-denominated credit in a timely fashion. There is no constraint on the ability of central banks to create domestic credit and supply it to the banking system if they are willing to let the exchange rate move. The stock of foreign reserves is not a constraint on their ability to print domestic currency and lend it to the banking system. Nor would governments need support from a regional central bank — some Asian equivalent of the ECB — in order to intervene in this manner. In other words, a regional central bank is not needed to solve this imagined problem.

In fact, a regional monetary union, or even an agreement to stabilize intra-Asian exchange rates, would heighten the danger of such problems arising in the first place. When exchange rates are pegged — and even more when countries join together in a monetary union — the same level of nominal interest rates necessarily prevails throughout the monetary zone. But inflation is higher in fast-growing regions where incomes are rising most rapidly. The resulting demand drives up the prices of locally-produced services, resulting in higher inflation. (Economists refer to this as “the

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Balassa-Samuelson effect,” after the two economists who first wrote about it.) Higher inflation together with identical nominal interest rates means lower real interest rates in the fast-growing region. Thus, as a consequence of its fast growth, investors in that region will face a lower real cost of borrowing. The fast-growing economies are likely to have frothy asset markets in any case, but this mechanism encourages yet more borrowing in order to pour still more money into speculative investments.

We have seen this mechanism in operation in Europe. Following the advent of the euro, fast-growing countries like Ireland had the lowest real interest rates and the most dramatic asset-market and property bubbles. More recently, Baltic states that peg their currencies to the euro have experienced the same symptoms, but in exaggerated form. We have also seen this syndrome in China, where reluctance to countenance significant fluctuations in the dollar-renminbi exchange rate has limited the ability of the authorities to decouple Chinese interest rates from those in the US. Real interest rates have been too low in China, feeding the country’s asset-market bubble. The authorities have attempted to damp down financial speculation by raising bank reserve requirements, but there are too many other channels besides the banking system through which funds can flow into

Chinese asset markets. The only solution is to let the exchange rate move so that interest rates can be set at levels appropriate to China.

Other Asian countries that shadow the dollar have experienced similar problems. And the problem would be general if Asian countries decided to form a monetary union or attempted to peg their currencies to one another. In that case the region’s monetary conditions would be set in Tokyo rather than Washington, D.C., but it would be no more appropriate to the circumstances of individual Asian economies. And the implications for financial market stability might be quite devastating.

WHY THE EUROPEAN MODEL SHOULDN’T APPEAL

For Asian policy makers, the euro offers a tantalizing model for how to resolve their region’s monetary dilemma. By reducing transaction costs, the euro has encouraged intra-regional trade. It has stimulated financial development, creating a corporate bond market that is continental in scope and which therefore features the liquidity that fragmented markets in bonds denominated in Europe’s national currencies previously lacked. And it has removed the pesky exchange rate problem.

Why this should be appealing is obvious enough. Economic growth in Asia depends on

the expansion of intra-regional trade. The region's high-income countries create the technology, design and sophisticated components for products that are assembled in lower wage, less developed neighbors. In part this is the story of China's emergence as an assembly platform, but the pattern is more general. Indeed, something quite similar is happening in Europe with the integration of the low-wage economies of what was formerly the Soviet Bloc into Western European supply chains. Efficiency increases are achieved by breaking up the production process into a larger number of smaller segments distributed among the economies best suited for undertaking them. For self-evident reasons, firms sourcing components and labor throughout the region prefer an environment of relatively stable exchange rates.

Similarly, the fact that the advent of the euro stimulated the explosive growth of European bond markets speaks to those for whom bond-market development is a priority. Since the turn of the century, Asian policy makers have invested significantly in the Asian Bond Fund and Asian Bond Markets Initiative with the goal of cultivating regional bond markets. But the results have been modest. This encourages the belief that a single regional currency is needed for significant progress on this front.

Finally, the European example suggests a glide path for Asian monetary integration. In the first step, governments would agree to link their currencies in a regional currency grid. Each currency would have a central parity defined in terms of other regional currencies, but that parity would be surrounded by a fluctuation band within which the exchange rate can still move. In the second step, the band would be narrowed, eventually producing a system of pegged intra-regional rates. In the third stage, exchange rates would be irrevocably locked. National currencies would be exchanged for a new regional unit, and a regional central bank would be established to regulate credit conditions in the integrated monetary zone.

This, with some simplification, is the path that Europe followed in the 20-year run up to the

euro. In Asia, a regional currency issued by a regional central bank might be a bridge too far, but it is not necessary to move immediately to that goal. At this point it is only necessary to take limited steps in the direction of stabilizing exchange rates. If Europe's experience is any guide, those initial steps will encourage closer collaboration among the region's central banks and governments. Information exchange, policy coordination and mutual financial assistance will in turn foster support for deeper monetary integration. It will pave the way to the ultimate goal.

In fact, a closer look at Europe's experience suggests a more complicated story. While the stimulus given to intra-European trade by the euro is undeniable, it is not clear that pegged exchange rates, much less a single currency, are needed in order for companies to build regional supply chains. Very similar production networks have been elaborated in North America, with the US playing the role of Japan and Mexico that of China, despite the absence of regional monetary integration. All that has been needed is sound policy on the both sides of the U.S.-Mexico border to provide a modicum of stability, and a market in currency futures at the Chicago Mercantile Exchange so that companies can hedge their exposures.

And while currency stability is helpful for building a regional bond market, a simpler means to this end is for bond issuers and traders to concentrate their activity in a single financial center. The UK, which is outside the euro area, has developed a deep and liquid bond market by supplementing domestic issuance with issuance by foreign entities and creating an efficient trading platform to attract foreign as well as resident investors. With adequate infrastructure and policy reform — and a willingness on the part of policy makers to let competition determine the location of the region's financial center — Tokyo, Singapore or even Seoul could play an analogous role.

Most importantly, it is not clear that Europe's glide path is feasible in Asia. In Europe, the initial step in the transition, which involved pegging exchange rates within wide bands, took

place in an environment of pervasive capital controls. Most European countries retained the full panoply of restrictions on cross-border capital flows well into the 1980s — that is, long after they established the European Monetary System in 1979. Controls loosened the link between domestic and foreign interest rates, and allowed central banks to tailor credit conditions to local needs while at the same time intervening to stabilize exchange rates. They also offered insulation from speculative pressures.

Today's world is different. Domestic financial liberalization provides market participants with more ways of evading controls on cross-border transactions. It has made the enforcement of controls increasingly disruptive. Rather than backtracking on liberalization, high-income Asian countries have responded by relaxing

Europe's monetary union works because the political context makes it possible. But the political context is different in Asia.

restrictions on cross-border flows. Meanwhile, lower-income countries such as China have seen their residual capital controls grow increasingly porous. Unlike the situation in Europe a quarter of a century ago, any effort to stabilize intra-Asian exchange rates would necessarily occur in an environment of deregulated financial markets and quicksilver capital flows. Central banks would not retain even a modicum of policy autonomy. They would have no protection from speculative pressure. This is a recipe for macroeconomic imbalances and financial fragility.

Herein lies the real lesson from Europe. The Single European Act, designed to create an integrated European market not just in goods but also capital and labor, mandated the removal of capital controls by the end of the 1980s (and by 1992 in the case of a few of the Community's low-income members). No sooner was this process completed than currency speculators

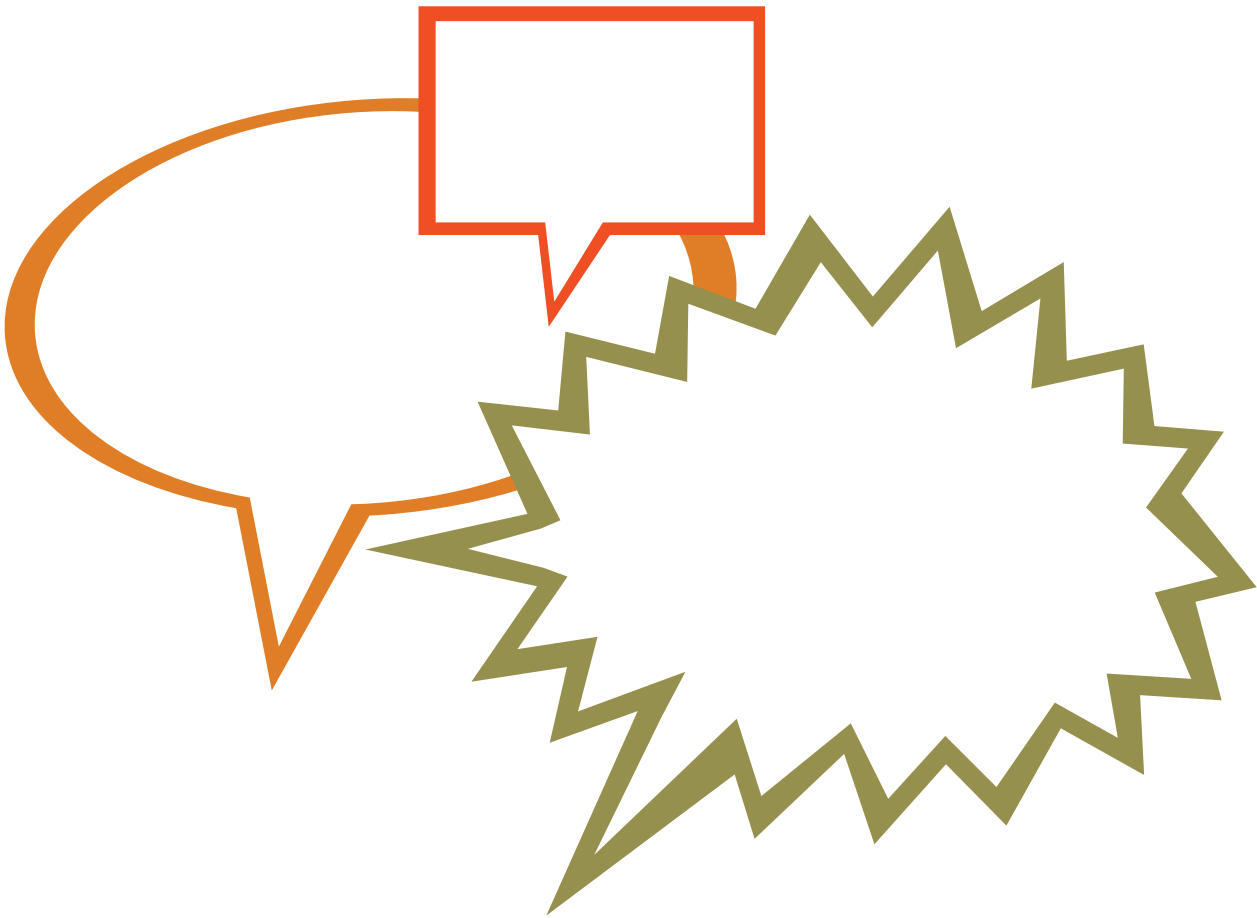
blew up Europe's exchange rate bands in the crisis of 1992-93.

A second difference is that European countries then, unlike Asian countries now, were prepared to extend short-term credits to their partners in the Exchange Rate Mechanism. They lent money to countries under pressure using the Short-Term and Very-Short-Term Financing Facilities of the European Monetary System. These financial supports, grounded in political solidarity, buttressed the stability of the system.

In theory, Asia has an analogous financing facility, namely the Chiang Mai Initiative of currency swaps and credits. In practice, however, the Chiang Mai Initiative provides little in the way of concrete support. There is a manifest reluctance on the part of countries to actually provide the swaps and credit they sign up to extend. The CMI was not activated when the interaction of high oil prices with domestic fuel subsidies worsened the budgetary outlook and caused a currency crash in Indonesia in the summer of 2006. It was not used when the Thai baht crashed in December 2007 due to the bungled imposition and removal of capital controls.

The CMI will help to stabilize exchange rates only if governments use it. So far they have shown no inclination to do so. Countries will lend hard-earned foreign reserves to their neighbors only if they are confident of getting their money back. They will want to see meaningful policy adjustments by the country receiving their support. In other words, they will attach conditions to their loans. This was feasible in Europe, where three wars between France and Germany in less than a century led the two countries to conclude that limited pooling of sovereignty was needed to reconcile nationalism with peace and security. The result was the dense network of institutions called the European Community through which policy conditionality could be applied.

Asia's history is different. Fifty years of Japanese occupation led China, Korea and other countries to see a strong nation, free from outside interference, as the best guarantee of secu-



rity. The result is a reluctance to interfere with the sovereign prerogatives of other countries, since he who interferes today may be the subject of inference tomorrow. There is even a reluctance to be overtly critical of the policies of other countries. Meaningful regional surveillance and policy conditionality not being possible, financial supports are never actually extended. The result is that the CMI is an empty shell.

Third and finally, Europe's exchange rate pegs were anchored by the commitment of the members to adopt a single currency within a fixed period. The Maastricht Treaty, which was signed in February 1992 and entered into force in November 1993, committed the signatories to complete the transition to monetary union by the beginning of 1999. Governments had to prepare for a situation where the exchange rate could no longer be used to vent domestic imbalances. By specifying that countries failing to remain within the Exchange Rate Mechanism of the European Monetary System would not be accepted into the monetary union, the treaty raised the stakes. It prompted governments to sacrifice other policy

objectives for a few years in order to keep their exchange rates stable and thereby qualify for participation. The treaty's stabilizing influence was especially important once capital controls were removed. Its existence goes a long way toward explaining how exchange rate stability was first restored and then successfully maintained following the crisis of 1992-93.

In Asia there is nothing vaguely akin to the Maastricht Treaty, nor is any such agreement on the horizon. There is no willingness to create a transnational institution of economic governance equivalent to the European Central Bank and to delegate to it significant sovereign powers. Europe's monetary union works because the political context makes it possible. But the political context is different in Asia. One day when the political climate is different, maybe 25 or 50 years from now, Asia could have a monetary union. But this remote prospect does little to anchor exchange rates now.

The bottom line is that pegging Asian currencies to one another would be risky. An Asian Exchange Rate Mechanism would be fragile

and crisis prone. Rather than providing a glide path to monetary union, it might permanently derail monetary integration. One must hope that Asian policy makers realize this before misguided plans come to fruition.

PRACTICAL ALTERNATIVES TO THE MONETARY-UNION DEAD END

What Asia needs is a practical solution that does not overreach or heighten financial risks. The experience of Mexico and of European countries like the UK and Sweden that are outside the euro zone shows that avoiding undue exchange rate volatility and building hedging markets are enough to encourage interregional trade and financial flows. None of these countries participates in a monetary union, yet all reap the benefits of regional integration. The key is that they have managed to avoid excessive exchange rate volatility and have provided banks and companies with markets on which to buy financial insurance against the volatility that remains.

Avoiding excessive exchange rate volatility requires creating an anchor for expectations. The modern way of doing so, utilized in Sweden, Britain and Mexico alike, is inflation targeting. This means empowering the central bank to set an inflation target and also requiring it to release an inflation forecast and to explain how it will deliver an outcome consistent with that forecast, as well as to publish an inflation report explaining deviations between forecasts and realizations. Under inflation targeting, policy is tailored to domestic price-level pressures instead of simply hoping that foreign monetary conditions are suitable for domestic circumstances. As the central bank gains credibility, it can allow temporary deviations from target inflation as necessary to dampen short-run output and employment fluctuations. If the medium-term target is fully credible, then loosening credit in the short run in order to support output and employment will do little to fan inflation. This combination of credibility and flexibility has led a growing number of countries, including Asian countries, to adopt this framework.

The exchange rate plays a subsidiary role when monetary policy is conducted in this

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fashion. The central bank commits to hitting an inflation target, not an exchange rate target. When there is conflict between the two targets, it is the exchange rate that has to give. If the central bank loosens in order to prevent the exchange rate from appreciating, then inflation will overshoot, undermining the credibility of the policy regime. If the central bank is truly committed to targeting inflation, then targeting the exchange rate will have to be sacrificed.

This is not to say that the exchange rate is irrelevant to open-economy inflation targeting. The value of the currency is important for forecasting inflation, and the central bank will want to pay it close attention. But this is not because the authorities care about the exchange rate; it is because the exchange rate helps them anticipate movements in what they do care about, namely, inflation.

Even better would be harmonized inflation targeting. A group of countries could agree on a common set of inflation targets. Since investors would then be confident that inflation rates would move in parallel, they would have no reason to anticipate sharp shifts in the exchange rate in one direction or the other. Indeed, if sharp movements occur, for whatever reason, investors would attempt to offset them. Speculation would become stabilizing rather than destabilizing. Empirical studies

have shown that exchange rate volatility eases when the central banks issuing the currencies in question target inflation rather than when they conduct a less transparent monetary policy. There is also less volatility than when they attempt to peg the exchange rate but that peg collapses in a crisis.

Thus, harmonized inflation targeting would help to deliver the stability required for deeper regional integration. But it would also leave national central banks the policy flexibility required to attend to other problems. It would not require them to commit to defending the exchange rate at all cost when doing so is not credible or require compromises of national sovereignty inconsistent with Asian political reality.

The other step that Asian countries can take to encourage regional integration is to build hedging markets. These are forward and futures markets in foreign exchange on which producers and investors can trade away foreign currency exposures created by their other transactions. Asian governments recognize their importance. The Chinese authorities, for instance, have pointed to the further development of these markets as a precondition for moving to greater exchange rate flexibility.

But many forward and futures markets lack liquidity. High bid-ask spreads make hedging costly. Market participants, observing that the authorities remain reluctant to let the exchange rate move, then have little incentive to take out insurance. Their lack of participation drains the markets of liquidity, which in turn discourages their use in a vicious spiral.

The solution is straightforward: a bit of additional exchange rate variability will induce more banks and companies to buy insurance. Transaction costs on hedging markets will decline, drawing in additional customers and adding liquidity. The *vicious* spiral will turn into a *virtuous* spiral. Studies by the International Monetary Fund have shown that countries willing to tolerate a modicum of exchange rate variability make faster progress in building hedging markets. And, in turn, the development of those markets encourages the cross-border trade and

financial flows valued by the proponents of Asian integration.

CHOOSING A PRAGMATIC PATH

Asia's choice is between impractical schemes and practical next steps. Attempting to establish a system of regional currency pegs as the first step toward an eventual Asian monetary union is impractical on both political and financial grounds. It would be more realistic to engage in harmonized inflation targeting while investing in the development of hedging markets in which banks and firms can protect themselves against residual exchange rate uncertainty. This approach would not create dangerous financial risks or require politically unacceptable compromises of national sovereignty. But it would stimulate the growth of interregional trade and investment flows. It would encourage the further elaboration of regional supply chains and production networks and facilitate the emergence of a regional financial center. In other words, it would deliver the principal benefits identified by the proponents of Asian integration.

One thing that this approach would not do, admittedly, is put the region on a path to a single currency. This strategy has not moved Mexico and the US closer to monetary unification nor has it created irresistible pressure for Britain to adopt the euro; if anything the opposite has been the case. But would delay be a bad thing, given that Asia lacks the political preconditions for establishing a single currency?

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