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The Illusive Quest for an Asian Common Currency: Economic Mirage or Realpolitik?

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KOREA INSTITUTE FOR
INTERNATIONAL ECONOMIC POLICY (KIEP)
300-4 Yomgok-Dong, Seocho-Gu, Seoul 137-747, Korea
Tel: (822) 3460-1178 Fax: (822) 3460-1144
URL: http://www.kiep.go.kr

Kyung Tae Lee, *President*

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Executive Summary

The Asian Financial crisis underscored the folly of running fixed exchange rates, with an independent monetary policy, open capital accounts and volatile capital flows. Interest in an Asian Common Currency is growing, but the needed political commitment, institutions and market-based financial systems are absent. This paper benchmarks the quality of institutions and financial systems to assess the enigmatic roles of the Renminbi and Yen. A prioritized policy-matrix focused on building institutions and robust banking systems are outlined. Accelerated trade liberalization, economic co-operation and political integration are crucial before a joint float or a common currency can be envisaged realistically.

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Dr. James H. Chan-Lee is a professor at Maître de Conference Sciences-Po (Paris). He received his Ph. D. in Economics from Queen's university, Canada. His areas of interest are Asia Economy, Financial Institution, etc. His resent articles include "Averting Financial Crisis in China" (with Li-Gang Liu, *Journal of International Economic Policy*, 2004), "Do Common Cultural and Institutional Origins Imply Similar Financial Structures and Development in Japan, Korea and China?" (July 2003), and "Sequencing of Financial Liberalization to Avoid a Capital Account Crisis" (April 2003). E-mail: jchanlee@wanadoo.fr.

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The Illusive Quest for an Asian Common Currency: Economic Mirage or Realpolitik?

James H. Chan-Lee*

I. Introduction

Japan, China, Korea and the ASEAN countries (hereafter referred to as the ASEAN+3) contain 30% of the world's population,[1] its most dynamic economies and fastest growing foreign trade. These countries also have the world's highest savings rates, largest current account surpluses and a war chest of US$2 trillion in foreign reserves. But, Asia's massive savings are misallocated. China, Hong Kong and Malaysia are pegged to the US$ while Japan, Korea, Thailand, Indonesia, the Philippines and Taipei closely shadow it.[2] Fear of floating makes Asia a non-voting annex to the US Federal Reserve System, while its inability to facilitate inter-generational transfers channels Asia's excessive savings into US Treasury bonds, thereby subsidising US borrowing costs and consumer profligacy.

The irony is that the ASEAN +3 exports of savings are largely recycled back in the form of higher risk portfolio and FDI inflows (thereby subsidising foreign acquisition of its assets). Shadowing the US$, when integration with the USA is

* Maître de Conférence Sciences-Po, Paris, 27 rue Saint Guillaume 75337 Paris and Visiting Scholar KIEP, e-mail: jchanlee@wanadoo.fr.

1) ASEAN original members were Brunei, Indonesia, Malaysia, the Philippines, Thailand and Singapore. It now includes Vietnam, Cambodia, Laos and Myanmar. The plus 3 are Japan, China and Korea.

2) The IMF classifies Hong Kong as having a currency board; China and Malaysia with conventional fixed exchange rates against the US$; Indonesia, Thailand and Singapore with managed floats with no pre-announced paths; and the Philippines, Korea and Japan as having independent floating exchange rates. These classifications are doubtful, given the huge accumulation of FX reserves by Japan and Korea, while China's fixed rate system risks becoming a currency board's clone.

modest restricts monetary policy options and results in bizarre intermediation patters. This is partly due to the USA acting as a surrogate “efficient” offshore banking system for Asia. An Asian Common Currency (ACC) might remove many of these anomalies, but is decades away. Asia’s financial systems lack the institutional capacity to price risk, to affect inter-generational transfers or to allocate capital efficiently.

Moreover, given Asia’s modest degree of economic integration, the benefits of freer Asian trade would swamp those from financial integration for decades. The rub is that the related risk profiles are the opposite. In the event, political interest in regional economic co-operation is gathering pace reflecting:

- Frustration over the disparity between Asia’s economic prowess and its lack of financial and political clout;
- Rising risk from open-ended balance sheet exposure to the US$;
- The bitter controversy over IMF Stand-by Agreements with Asia’s crisis economies in 1997-98;
- The need to find a Plan B after the US veto of a proposed Asian financial safety net in 1998;
- The demonstration effect of the Euro;
- And the emergence of China as a regional superpower.

Nonetheless, Northeast Asia is objectively at least a decade away from a joint float. Against this backdrop, official Japanese proposals for a common currency by 2008 are a red herring.[3] The key issues are not an ACC per se, but what can be done over the medium-term to prepare for such an initiative.

Put simply, Asia lacks the political commitment to pursue closer integration orto create the regional sovereignty sharing institutions necessary for launching such a grandiose project. Pragmatic efforts to vigorously pursue regional trade liberalization and to forge closer economic and financial ties between Japan and

3) Japan’s Vice-Minister of Finance called for the creation of an Asian common currency to resolve Asia’s trade and currency imbalances by 2008, at the December 2003 Japan-ASEAN summit meeting.

China are needed. These are central to a joint float in the coming decade. But, the linchpin to any such project will be an “Entente Cordiale” on the enigmatic roles of the Chinese Renminbi and Japanese Yen. But, finding such a compromise between two arch-rivals with different socio-political, economic and institutional structures will require a sea change in attitudes, political will and imagination.

This paper looks at benchmarking and implementation issues. Part I discusses proposals for an Asian Common Currency, while drawing on the experience of the Euro. It then assesses initial conditions stressing China’s role as the engine of Asia’s economic growth. European experience and the role of a Japan-China “entente cordiale” are addressed in Part II. An implementation strategy framed within a policy matrix emphasising institution building and robust banking systems is sketched out in Part III. Good capital markets are a parallel, albeit secondary longer-term goal. But, the bottom line is that without a stronger political commitment to reform, the quest for a common currency is a mirage. Part IV presents preliminary conclusions.

II. Post-Crisis Asia in Perspective

Seven years ago East Asia was hit by a sudden stop in international banks' regional credit exposure, triggered by a run on the Thai Bhat. This shock provoked plunging exchange rates throughout much of Asia, an implosion of recklessly leveraged national balance-sheet positions and wiped out almost a decade of progress in fighting poverty in Indonesia and the Philippines. It was also a wake-up call for the risks of excessively rigid exchange-rate regimes and ignoring Mundell's policy tri-lemma.[4] A consensus emerged that the roots of the crisis were poor institutions, weak governance, and badly implemented capital-account opening combined with shaky bank-based financial systems. Vigorous reform and greater exchange-rate flexibility was thus needed (Yoshitomi et al. 2003).

1. Systemic risk has been controlled

Seven years later, the high systemic risk stemming from currency mismatch that triggered the crisis has been resolved, but progress in institutional and structural reform has been disappointingly slow. By 2000, Asia's reckless balance-sheet exposure to short-term FX borrowing (relative to FX reserves) had been rolled back, with "real" exchange rates near 30-year lows and huge current account surpluses. (Maturity mismatch was also reduced by cuts in short-term FX debt and an easing of long-standing restrictions on portfolio and FDI inflows.)

Asia continues to implicitly shadow the US$, while its huge build-up of FX reserves (costly insurance) risks trade retaliation, excessive money creation, asset

4) Mundell's tri-lemma is that a country can choose two of three options: a fixed exchange rate, an open capital account, or an independent monetary policy.

price bubbles, and rising balance sheet exposure to a falling US$.[5] With the emergence of strong regional growth the attractions of an ACC are clear. For many analysts, an exchange-rate system adapted to Asia's status is needed. But when will its institutions be ready? What alternatives are feasible in the interim?

A. Where do Asia's core institutions, opacity and capital accounts stand?

To assess these issues, inter-country comparisons of the quality of core institutions are essential, albeit difficult. Comparisons of Asia vis-à-vis its international peers, based on synthetic estimates of core institutions (Informational Quality of Financial Systems or IQFS)[6] and the degree of capital account opening (KAO[7] i.e., external financial suppression) are shown in Table 1.[8] These data "benchmark" Asia's strengths and weaknesses concentrating on the central criteria for a common currency: robust core institutions, open capital accounts and free capital flows. These data suggest that despite improvement, China will need a decade to match the current quality of institutions in Greece, Portugal and Spain, and a generation or more to catch the USA or Singapore.

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5) In Japan, China, Korea and Taipei (China) FX reserves by mid-2004 were some US$1.7 trillion. Reserve accumulation was equivalent to 2/3rds of China's nominal GDP growth measured in US$ from 1999-2003.

6) IQFS is scaled from 0 to 10, with higher scores indicating greater institutional capacity to transform heterogeneous information into continually priced risk. Scores are normalized. Hence, a country's relative score can slip, even if there is no change in its absolute performance, as others advance.

7) The frequent use of the IMF's summary of the number of capital account restrictions in place (relative to the total number possible) is highly misleading, as no allowance is made for the degree of restriction. An outright ban has the same weight as a market based restriction (e.g. a dual exchange rate). Our measure codes the type of restrictions in place ranging from a complete ban (0) to completely free (2). Each component of the current account, capital inflows and outflows are coded using a rules based system proposed by Quinn (see Chan-Lee 2003).

8) Updated IQFS estimates draw on Chan-Lee (2001). The PWC's Opacity index is an un-weighted average of 5 indicators in 35 countries for corruption, legal systems, government macroeconomic and fiscal policies, accounting standards and the regulatory regime. Higher scores mean higher opacity. Similar surveys are available by the Kurtzman Group on the Milken Institute web site and Transparency International.

These institutional weaknesses are corroborated by the constraints that multinational firms face in doing business in EMEs: ineffective contract enforcement, poor transparency, unpredictable corporate governance and pervasive corruption. For example, the Price Waterhouse and Coopers' (2001) survey of business perceptions of countries' corporate governance, accounting and disclosure standards have been combined into an index of "opacity" and sovereign risk premia. Interestingly, opacity is generally higher in countries with close government-bank-business relations, compared with more "arms-length" developed capital markets. Opacity is, as expected, tightly correlated with corruption and poor property rights. These findings are salient for policy analysts because measures to improve transparency and competition have low systemic risk and high returns. International business perceptions[9] of opacity in Asia (excluding)

Table 1. IQFS Opacity and KAO

	IQFS (scaled 0 to 10) 2003	*PWC opacity Index 2001*	*Opacity risk Premium Basis points*	*KAO 1998-99 Scale 0 to 4*
Japan	6.9	60	629	3.5
Korea	5.4	73	967	3.5
China	2.7	87	1,316	1.5
Malaysia	5.7	n.a.	n.a.	3.0
Indonesia	1.9	75	1,010	3.5
Philippines	4.3	n.a.	n.a.	3.0
Thailand	3.9	67	801	2.5

9) Surveys of multinational enterprises have a bias in favor of capital market based governance systems. Claims of the superiority of capital market based governance systems abound, but have been undermined by the spate of high profile scandals related to flagrant manipulation of accountancy rules, fraud, looting and the abysmal failure of "independent" corporate boards to provide checks and balances to dominant CEOs in the USA.

Table 1. Continued

Taipei (China)	6.6	61	640	2.5
Hong Kong (China)	6.9	45	233	4.0
Singapore	7.1	29	0	4.0
USA	9.1	36	0	4.0
Argentina	2.8	61	639	2.5
Greece	3.8	57	557	3.0
Portugal	4.6	n.a.	n.a.	3.0
Spain	6.2	n.a.	n.a.	3.0
Brazil	3.2	61	645	3.0
Turkey	2.0	74	982	3.0
Venezuela	1.9	63	712	2.0
Zimbabwe	0.6	n.a.	n.a.	2.5

Source: Chan-Lee (2003) and Price Waterhouse Coopers 2001

Hong Kong (China and Singapore) are bleak. Hence, vigorous enforcement, and better accounting and disclosure standards have large scope for fostering better financial markets and lowering sovereign borrowing costs. Japan has the same opacity rating as Argentina and Brazil, despite a far better IQFS rating. This anomaly is capital. A currency union's aim is to raise institutional and transparency standards to the highest common denominator, not the inverse.

Finally, open capital accounts and free capital flows are necessary conditions for any functioning currency union. As China is the linchpin to any such initiative, the timeframe for such a project will depend on China's progress in building core institutions consistent with a market based banking system (a 5-6 range) and open capital accounts (3+range). Despite recent landmark reforms China's 2003 ratings were 2.7 IQFS and 1.5 KAO.[10] Although these benchmarks

10) The 1.5 score for China's KAO relates to 1998-99. Cautious albeit, minor measures were taken in 2002-04 to open up portfolio investment inflows through Qualified Institutional Investors, to partially reduce the rigid segmentation between class A and B shares and to allow greater flexibility for FDI outflows. Taipei has taken similar measures to liberalize its capital account over the past 2 years.

represent considerable progress since 1985 (Table 2 below) the job is at best half done.

B. Recent trends in core institutions

Historical data for IQFS in Table 2 illustrate that Hong Kong and Korea took decades to build their institutions. By contrast, institutions can be quickly destroyed (Argentina, Venezuela, Zimbabwe). KAO estimates dating from the shift to open capital accounts in the late 1970s are also collated. These data support the view that countries with sound institutions have the luxury of choosing more flexible exchange rate regimes (the UK, Canada, Australia, New Zealand), while those with poor institutions and restricted choice often benefit from hard pegs (c.f. EMEs in Asia).[11] The worst case is when bad institutions oblige countries to have open capital accounts, owing to their inability to stem capital flight. These data also suggest that the reasons for joining a currency union probably depend more on politics than economics.

Table 2. Trends in IQFS and KAO

	IQFS (scaled 0-10)		*KAO 1978 scale 0 to 4*	*KAO 1998-99 scale 0 to 4*
	1985	*2003*		
Japan	7.4	6.9	1.5	3.5
Korea	3.8	5.4	1.5	3.5
China	1.5	2.7	0.5	1.5
Malaysia	5.9	5.7	3.0	3.0

11) Husain, Mody and Rogoff (2004) show that wealthy countries benefit from flexible exchange rate regimes. By contrast, at low levels of wealth, fixed exchange rate regimes are better suited to maintaining stability. These observations are consistent with our emphasis on the central causal role of the quality of institutions in determining the choice and viability of exchange rate regimes.

Table 2.Continued

Indonesia	0.8	1.9	2.0	3.5
Philippines	2.9	4.3	1.0	3.0
Thailand	3.3	3.9	1.5	2.5
Taipei (China)	5.2	6.6	1.5	2.5
Hong Kong (China)	7.2	6.9	4.0	4.0
Singapore	7.4	7.1	4.0	4.0
USA	9.6	9.1	4.0	4.0
Argentina	3.7	2.8	3.0	2.5
Greece	3.6	3.8	1.5	3.0
Portugal	4.2	4.6	1.5	3.0
Spain	5.6	6.2	2.0	3.0
Brazil	3.6	3.2	1.5	3.0
Turkey	1.8	2.0	1.0	3.0
Venezuela	3.3	1.9	4.0	2.0
Zimbabwe	2.6	0.6	1.5	2.5

Source: Chen-Lee (2003)

Salient features illustrated above include the gradual erosion of US IQFS scores from 1985-2003, following the bursting of the technology bubble and its accounting and corporate governance scandals. Even so, the US (and Singapore) has the lowest absolute rating in terms of the PWC opacity index. By comparison, Japan has seen similar erosion in its IQFS ratings, but on the back of a far weaker financial system. In contrast, Korea and China[12)] made big advances in IQFS from 1985-2003. Indeed, China has better institutions than Indonesia and Turkey, and is where the Philippines was some 20 years ago.

12) China's rank in the International Country Risk Guide index covering 151 countries improved from 60th in 2001 to 39th in 2003, while Hong Kong's ranking has slipped.

C. The gap between rules and practice remains

Against this backdrop, the main obstacles to a common currency are Asia's weak institutions and poor legal enforcement. For instance, many post-1997 changes largely reflect better "external rules" rather than shifts in behaviour. Widespread efforts have been made to upgrade external pressure points, such as bankruptcy legislation and disclosure rules (Korea, Indonesia, and Thailand). Accountancy standards, prudential regulation and (external) corporate governance requirements have all similarly been upgraded. But, internal mechanisms such as court rulings, liquidation of collateral and collection of bad debt remain spotty and slow. Similarly, contract protection and enforcement of creditor and minority shareholder rights are problematic or fickle (Indonesia, Thailand, Malaysia and Korea).

D. And is mirrored in slow financial reform

These shortcomings epitomize the obstacles to creating a credit culture and are central to Asia's slow progress in creating sound banks and financial systems (excluding Hong Kong and Singapore). Good progress has been made in re-capitalising banks and carving-out non-performing loans into Asset Management Companies in the crisis hit Asian countries, China and Japan (Hanna and Maxino 2003). But, difficulties in reducing government ownership and especially political meddling[13)] with credit allocation by establishing a market-based "credit culture" persist. A good proxy of the latter is foreign bank influence in the banking system, where Asia still significantly trails Latin America (with the exception of Korea, where foreign shareholdings rose to some 40% in 2004). Interestingly, on the back of decisive government reform and foreign take-overs of its three largest

13) Asia is not alone in having a large degree of state influence in bank activities. France, Germany and Italy have a long history of government influence in bank lending in State Champions such as Airbus, Credit Lyonnais, Euro Tunnel, EADS, Alstom, Bull, Aventis, etc.

banks[14] Korea has also achieved one of the most impressive turnaround of any banking system since 1998-99.

Ironically, Asia's poor banks are a paradox. Asia's high savings rate and rapid economic growth should make it a highly profitable market for efficient banks and good financial services if keen competition and new entry were allowed. The crux of the problem is that Asia's banks are "socialized" meaning burdened by a legacy of too many inefficient, over-staffed, and often formerly state-owned banks. This is the very antithesis of a risk-based "credit culture." Moreover, weak banks provide no competitive discipline for Asia's host of badly regulated local and near banks, shaky credit co-operatives, savings and loans associations and under-capitalized insurance companies, let alone Asia's corporate borrowers. Finally, Asia remains "over banked"; hence even though M&A activity is growing modestly this has usually been a strategy to protect the weak (Japan and Malaysia) instead of a reflection of Schumpeterian competitive forces. In short, Asia lacks an active market for corporate control and a sensible exit strategy for weak or failed firms and banks.

In sum, it is unsurprising that Moody's stand alone "Bank Financial Strength Ratings" for most of Asia have long been not much above default levels, while those for subordinated bank debt are below those of Latin America (Chan-Lee 2001). Indeed, Asia's strong post-war growth performance has been achieved despite its "socialized" banks and incomplete financial systems. This is crucial; it differs totally from simple financial-growth models based on crude correlates between economic growth, credit and equity market capitalization – but with no

14) Control of three of Korea's largest banks was bought after 1999 by private equity funds (Koram by Carlyle Group and JP Morgan, Korea Exchange by Lone Star and Korea First by Newbridge Capital). New management and radical restructuring rapidly returned these banks to profitability and some sold for huge profit, triggering sharp criticism over foreign exploitation. Currently, Korea's best bank (Kookmin's) is 78% foreign owned. Indeed, independent foreign banks have opposed government "inspired" bailouts to protect shareholder value. The recent suspension of the President of Kookmin's for "accountancy irregularities" over widely used tax deductions, has provoked sharp criticism and controversy over the role of the Financial Regulators.

allowance for the role of institutions (e.g. Levine and Zeros 1998).[15] Correcting this misconception is capital: building good banking systems have huge potential efficiency gains.

E. A market-based banking system is the key

Bank-based financial systems will dominate Asia for the foreseeable future. Asia's best banks are in Hong Kong (China) and Singapore, while the rest (including Japan) are convalescing or mediocre (Chan-Lee 2001). Given these initial conditions, an ACC must start by building core institutions that underpin market-based banks. But, an unresolved issue is whether this is also a sufficient condition, i.e. whether good equity and bond markets are also needed? And, if good banks and functioning long-term government debt and equity markets suffice, what other specific institutional and macroeconomic pre-requisites are needed for success?

If these narrow sets of initial conditions are sufficient, a focused project might be feasible, with luck, in say 20-30 years (while bond markets are being built). But, if the launch of an ACC also needs robust long-term private bond markets (which are empirically the last market to be created) the time frame is decades. This empirical issue is salient because fashionable initiatives such as fostering an Asian Bond Market may need to be reassessed.

2. How relevant is the Euro to Asia?

To shed light on these issues, analysts have usually drawn on the Euro. The rub is that the European Monetary Union is an oddity. Hence, drawing policy lessons would be tricky, even if Asia follows a similarly eccentric political path.

15) These simple 1st generation models failed to differentiate between "quality" and quantity, whereas second generation models include institutional proxies to capture these effects. In Asia, financial problems have emerged largely through the concretization of contingent private-sector liabilities. By contrast, Latin America has been characterized by a large over-hang of public-sector liabilities and fiscal populism.

Based on standard measures of intra-regional trade to DP,[16] Asia is now similar to pre-Maastricht Europe (1991), hence proposals for an ACC are not unrealistic. Interestingly, recent analysis of Optimal Currency Areas (OCAs) has shifted away from Mundell's earlier emphasis on economic integration and fiscal stabilization mechanisms,[17] towards assessing the stability of "real exchange rates" in the face of demand and supply shocks (Bayoumi and Eichengreen 1997, Bayoumi, Eichengreen and Mauro 2000, Baek and Song 2002). Baek and Song's study (which expands and updates Bayoumi et al 2000 to include Japan, China, Taiwan and Hong Kong) has a clear message. On technical grounds, an inner core of Asian countries[18] is roughly where Europe was in the early 1990s. Similarly, Cheung and Yuen (2004) show that from the perspective of stabilising output, Japan, Korea and China are a coherent grouping.

Notwithstanding these positive technical findings, virtually all analysts point to huge gaps in political commitment and the "will" needed to realize such a grandiose project (Bayoumi et al 2000, Wyplosz 2001 and Mundell 2003). Indeed, the hurdles are formidable, including:

- A low degree of labour and capital market integration;
- The reconciliation of ingrained mercantilist, export-led biases to economic growth with a political commitment to stable regional exchange rates;

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16) Asia has a lower share of intra-regional to total trade than Europe, but a higher degree of external openness.

17) Mundell's criteria for an OCA were a high degree of goods, labor and capital market integration, to limit the impact of asymmetrical shocks. The existence of federal fiscal stabilizers was an additional cushion against such shocks. These criteria were framed in the context of inter-country or regional specialization in different commodities. Globalization has led to an explosion in intra-industry specialization within similar SITC commodity classifications, diluting the relevance of the OCA criteria, e.g. those used by Kwack (2003). Finally, it is unclear whether intra-industry as opposed to inter-industry trade reduces the asymmetry of shocks.

18) Baek and Song (2002) single out an inner core of Japan, Korea and China plus Indonesia, Malaysia, Singapore and Thailand, along with Hong Kong and Taiwan as possible candidates for a common currency. Our shortlist excludes Indonesia on the basis of its weak institutions and a patchy record of reform.

- The absence of a regional financial hub, and
- The lack of the requisite regional institutions and governance structures for sharing national sovereignty.

These are not insurmountable. But, the big missing element to realize such a project is an “Entente Cordiale” between Japan and China.

A. Monetary union historically follows political union

It cannot be overstated that the cause of the EMU’s endless internecine conflicts is that historically, long-lasting monetary unions among sovereign countries have never been observed in the absence of strong political integration.[19] As currency is an icon of national sovereignty, monetary union is often one of the first acts following political union. The Euro is thus an exception and not the rule. Over the past 200 years, a dozen or so monetary unions were created. The USA, Germany, Italian and Peseta Unions remain, but the Latin and Scandinavian Unions were disbanded, as were the Austro-Hungarian Empire, the Soviet Union and the former Czechoslovakia, usually for reasons of national interest (OECD 1999). If Northeast Asia takes the path of monetary union before closer political integration, perpetual internal conflict is probable. Asia’s political integration and functional inter-governmental entities lag far behind the EMU of the 1990s.[20] However, Asia also has huge advantages relative to the EU, notably

19) The gap between monetary union and political integration underlies the friction between the EU Commission’s application of “rules” in conflict with National government’s political self-interest. Thus, France and Germany’s on-going violation of the 3% GDP budget deficit ceiling of the GSP, stands in stark contrast to Portugal’s forced adoption of spending cuts, to avoid tough economic sanctions for a similar breech.

20) Asia’s weak political integration is reflected in the scarcity of meaningful Intergovernmental Institutions other than the Executives’ Meeting of the East Asia-Pacific Central Banks and the Chiang Mai Initiative. By comparison, Europe had long established institutions such as the European Coal and Steel Community, the European Court of Justice and the European Parliament, as well as the European Payments Union, the OEEC, the European Commission and Investment Bank prior to the establishment of the EU.

a high degree of nominal wage and price flexibility[21], small government, a tradition of fiscal rectitude and massive FX reserves (Indonesia and the Philippines being exceptions). Assessing these offsetting factors is tricky as politics rather than economics are usually decisive.

B. The EMU's: "stupid" rules

With weak political integration, a clear requirement of any Common Currency is clear fiscal rules to avoid "free-rider" problems. But given the political fiasco surrounding the "suspension" of the Growth and Stability Pact's (GSP) stupid fiscal rules – a salient question is: why would a rapidly growing region like Asia be tempted to follow such a Byzantine path? A part of this criticism is misplaced. OECD and IMF empirical estimates show that the lion's share of the EMU's high unemployment is structural. Hence, monetary and fiscal policy has limited scope and the crux of the European problem is the lack of political "will" to tackle unpopular reforms and deregulate ossified labour markets. Indeed, economic performance in the EMU might have been worse without the discipline of the GSP and the European Central Bank[22].

Nonetheless, any sensible "Asian" GSP would need to be radically overhauled to eliminate the short-term biases and perverse incentive structures that plague the EMU. Hence, an Asian GSP would need to embody much greater flexibility to reflect big differences in trend growth rates within Asia. Moreover, pragmatic rules must be designed to encourage medium-term structural and institutional

21) Obstfeld and Rogoff (2002) argue that the welfare gains from monetary co-operation and policy co-ordination are small, when the feedback rule for monetary policy is to stabilize domestic output. This is because domestic distortions dominate, not the spill over effects from foreign countries. Ironically, greater nominal flexibility in Asia might encourage them to agree to economic co-operation, but sit on the fence concerning tighter regional exchange rate arrangements and sharing sovereignty. By contrast, EMU countries with rigid labour markets have more to gain from monetary co-operation, while countries with more flexible markets have the luxury of choosing (the UK, Sweden, Norway).

22) Moreover, its successes should also be noted: the launch of the Euro sparked a huge expansion of the Euro bond market – and in marked contrast to the ERM joint-float in the 1970s – not a single serious currency attack.

reform, while facilitating rapid trend TFP[23]. Paradoxically, compared with Europe's ossified labour markets, Asia's Achilles' heal is its socialized banking systems and flawed institutions; and it is hard to say which will be harder to resolve.

C. Asia's daunting technical challenges

The Asian quest faces formidable technical challenges that were never faced by Europe. How does one achieve a consensus on economic priorities when policy goals differ widely (growth, inflation control, balance of payments constraints) between countries? In light of these differences, conflicts may arise even in the face of identical shocks. How to create exchange rate convergence criteria, when trend growth rates range from 7-10% in China to 1-2% in Japan? And last but not least, who will play the lead and secondary roles in such a bold enterprise: China or Japan? These technical difficulties imply that:

- Creating a common currency without a consensus on priorities is a zero sum game;
- Opting for a common currency when goods and factor market integration is weak can be very costly in the absence of flexible markets (Argentina);
- Although, a political decision to create an OCA will have endogenous effects on integration (Frankel and Rose 1998)[24], a rules-based system faces a difficult task of balancing the needs to:

23) This could be done, *inter alia* by setting cyclically-adjusted budget criteria, by distinguishing between current and capital-account spending, while treating R&D, education and health care as quasi-investment spending, as well as setting-up rainy day contingency funds in good times.

24) Mundell's OCA criteria were static and did not allow for the endogenous effects of integration arising from a political decision to promote or join an OCA. Gravity models used by Rose and Wincoop (2002) imply that currency unions can triple the volume of intra-union trade with no trade diversion. But, these results depend on the assumptions of homogenous goods and very high substitution elasticities. International trade in "homogeneous commodities" is small compared with heterogeneous manufactured products and services, thereby substantially reducing the relevance of gravity models.

- Assure medium-term fiscal sustainability;
- While providing needed short-term flexibility to deal with cyclical and exogenous shocks.[25)]

Lastly, once the institutions are in place there are fewer reasons to opt for a common currency and surrender monetary sovereignty.

D. Restricted or open entry?

Finally, the complexity of decision-making increases by the square of the size of a club. Hence, the number of participants, political relations, membership and voting rules count. For example, the latest EU entrants foresee big benefits from upgrading their institutions via a rules based-system, and presenting EMU members with the challenge of living up to the spirit of their own rules.[26)]

Similar difficulties would arise if a core group is enlarged to include Vietnam, Laos, Cambodia and Myanmar on political grounds. Pragmatism argues for creating an inner core first (Japan, China and perhaps Korea) and then gradually enlarging, to include Malaysia, Singapore, Thailand, Hong Kong and Taipei — with Indonesia and the Philippines on the waiting list. Common entrance criteria should, however, be based on strict transparent rules such as: decent institutions, balanced budgets over the cycle, sustainable debt/export/GDP ratios, low inflation and specific commitments to structural reform (akin to IMF Letters of Intent).

E. Lower risk interim steps to a common currency

There is a misconception concerning implementation. Establishing the Euro was not a quantum leap onto Germany's unlimited speed "Autobahn". Rather, the earliest version of the Exchange Rate Mechanism was a mix of German Autobahns and potholes filled dual carriage French and Italian National routes

25) The 1992 Maastricht Treaty and the draft EU constitution appear to fail on the two above criteria, which bodes ill for the future adaptability of the GSP.

26) Living-up to the "spirit" of the GSP budget and debt-GDP rules would entail avoiding differing rules for large vs. small countries and discouraging free-rider behaviour.

that saw several high speed accidents. The Euro was a multiple-tier 50+year incremental project, which underwent numerous corrections to redress imbalances and systemic risk. Time was also given for institutions and behaviour to adapt to more demanding rules. Moreover, few of the historical examples above were strict monetary unions, with a common currency and single monetary policy. In the 19th century, these were fixed rate systems with gold or silver parities.

This distinction is salient because the rules of the gold standard together with capital mobility invoked similar disciplines on countries' macroeconomic policies to maintain their gold pegs over time, as a common currency. That said, it should be underscored that the critical factor that made the gold standard "work" was not its commodity-based currency, but rather credibility in the governments' commitment to fiscal sustainability. This distinction is capital, as the path towards an ACC can be seen as a spectrum of pegged-rate regimes of varying degrees of "hardness" (and concomitant fiscal discipline[27]) ranging from:

- An independent floating rate;
- Floating rates with undeclared fluctuation bands;[28]
- Managed floats against a basket of currencies (the US$ and Euro);
- Managed floats, while shadowing a key currency;
- A co-ordinated joint float, with tight fluctuation bands;

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27) This implies a similar degree of fiscal discipline, as a common currency is held together by macroeconomic similarities. It is preferable that these similarities embody fiscal discipline, but generalized fiscal laxity will also be reflected in exchange rate crowding-out to the extent that standard Flemming and Mundell conditions hold.

28) The UK, Canada, New Zealand, Australia, Sweden, Switzerland, Japan and the USA are among the few countries with the institutions needed to float their exchange rates. By contrast, countries that cannot fix their exchange are condemned to float (or rather sink). Discussions of exchange-rate regimes in EMEs are often misplaced. The issue is not the regime *per se*, but whether the necessary institutions exist to make a choice (Calvo and Mishkin 2003). Indeed, Mundell's tri-lemma is irrelevant to many EMEs, as they cannot attain either an independent monetary policy, fixed exchange rate or open capital account, given their weak institutions.

- Fixed but adjustable pegs vis-à-vis a key currency or a basket;
- A single currency – (or dollarization).

F. Asia is far away from a co-ordinated joint float

Following this taxonomy, Asia's current exchange rate regime is a mixture of the second to the sixth categories. This situation reflects Asia's modest degree of financial development, huge gaps in per capita income levels, core institutions and growth rates that will require periodic adjustments to maintain reasonable regional "real exchange rate" relations. In fact, the US$ is Asia's implicit common currency or "nominal anchor" and this stability accounts for a large part of its post-war economic success. This raises the following issues:

- Why change a winning formula?
- As large benefits flow from a joint-float against the US$ or a currency basket, why bother with an ACC?
- Will the benefits of replacing the US$ by an ACC exceed the costs?
- If desirable, under what time frame is an ACC feasible?

G. A co-ordinated joint float may be on the political horizon

We address only the last issue here. Political chatter suggests that a co-ordinated joint float may be on the 5-10 year Asian political horizon. Although Asian economic integration is similar to that of the EMU in the 1990s, establishing an ACC could be far more difficult. Even though Northeast Asia has flexible economies, many hurdles noted below were not present in Europe. Our economic pre-requisites include *inter alia*:

Common problems with the EMU

- Defining economic goals and priorities;
- Enhancing economic integration and policy co-ordination;
- Creating and adhering to viable fiscal rules;

- Establishing functioning regional institutions to co-ordinate economic policies while pooling national sovereignty.

Problems specific to Northeast Asia

- Building better institutions to establish market-based banking systems;
- Successful liberalization of China's capital-account;
- Creating mechanisms for a steady real appreciation of the Chinese RMB while maintaining "sensible" regional exchange-rate relations[29];

H. How far away is Asia from a co-ordinated joint float?

Given the formidable challenges of meeting these conditions, how far away is Asia realistically from a co-ordinated joint float? How long will it take to establish an ACC? Any answer is conjectural as there are no counterfactuals. Moreover, creating a common currency is path dependent, as illustrated by the impetus given to building better institutions in Portugal, Spain and to some extent in Greece from 1985-95 (cf. Table 2). But, how relevant is this experience to Asia? The litmus test here will be China's commitment to institutional reform, a market-based banking system and opening its capital account (Chan-Lee, Liu and Yoshitomi 2002). Our baseline scenario is for 10 and 20-30 year time frames,

29) The "appropriate" Renminbi exchange rate is a vexing issue. How to measure the real exchange rate when 63% of the population is rural, of which 200-300 million are redundant, with a zero shadow wage is unclear. Moreover, some 60% of China's exports are made by multinationals from processed imported inputs. In addition, data problems abound, with huge observed gaps between National Income and Expenditure trends; and the capital account is largely closed. Finally, the construction of "real exchange rate" adjustment mechanisms assumes that Balassa-Sameulson forces (differential productivity growth rates between tradeables and non-tradeables) are present. But, despite booming economic growth since 1979, standard real exchange rate proxies show little real appreciation, raising a host of issues (Liu 2004). Indeed, the manufacturing wage has been flat at some US$ 100 a month for some time. But, from 2000 to mid-2004, the increase in FX reserves was $274,2 bn. while nominal GDP rose $292,7 bn. In the absence of intervention, the RMB would obviously have risen sharply, thereby raising the real consumption wage via lower import prices.

assuming an error free "joint float" and a "common currency" respectively. But history has few examples of error free creations of such ambition.

I. Reserve pooling could facilitate a joint float

Many US analysts would view our time frame for a joint float as unrealistic. However, China has constantly confounded "US experts" since 1979. Indeed, recent constitutional changes to recognise private property rights, the late-2004 decision to lift the ceiling that commercial banks can charge to their riskier borrowers and the accelerated opening of the financial sector to foreign institutions are landmark steps. In addition the ambitions of China's Financial Regulatory Agency to accelerate bank reform, raise capital requirements, encourage stock market flotation of its largest banks and to restructure SOEs, bode well for the future. Finally, Japan, China and Korea have US$ 1.5 trillion in FX "up their sleeves." Judicious use of these reserves could save time compared with the shaky start of the European Snake (in the 1970s). Moreover, if reserves were pooled and policies co-ordinated this could greatly boost credibility in a "rational" set of trilateral exchange rates.[30] But, this is a political non-starter given the likely degree of political cohesion in the foreseeable future.

J. An ACC is limited by its poor institutions

At the same time, an ACC could easily take more than 30 years, as institutions and good banks are notoriously hard to build. The launch of the Euro took some 50 years (and a united Europe was dreamed of for centuries by such distinguished thinkers as William Penn, Rousseau and Victor Hugo) even with top quintile core legal institutions, good bank-based financial systems, and the attainment of a stringent set of macroeconomic and financial convergence

30) The European snake of the 1970s experienced speculative attacks on exchange rates that were "over" or "undervalued". But, as these economies became more closely aligned, attacks became less profitable and infrequent. It is unclear whether reserve pooling would have speeded this adjustment, as it was never on the agenda, to avoid free-rider problems. Pooling differs from Central Bank swap lines that place the onus of risk on the borrowing country.

criteria.[31] Moreover, these necessary conditions built on bond markets that delivered “risk-free” interest rates suffice for functioning forward exchange markets.

Where does Asia stand with respect to these criteria? As regards to fiscal prospects, Chinese and Korean medium-term outlook may be better than many EMU countries.[32] While Japan’s fiscal position is difficult, the lowering of its sovereign risk ratings owing to higher default risk was conceptually misguided.[33] If our fiscal assessment is correct, the critical issues are whether and when Asia’s institutions and governance mechanisms will be ready? And how quickly robust “market-based” banking systems can be put in place?

In sum, any currency is ultimately backed by its institutions and economy. Our error free scenario is that a joint float and an ACC anchored on Japan and China are at least 10 to 20-30 years away respectively. An ACC will need sensible, but binding macroeconomic rules (adapted to Asia’s higher and more variable growth profile) to rein in destabilising capital movements. New regional institutions will also be needed to monitor and co-ordinate members’ fiscal and monetary policies. This will require a pooling of national sovereignty based on yet to

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31) Judging by the informational quality of financial systems (cf. Table 1): France, Germany and Italy ranked 15^{th}, 11^{th} and 24^{th} out of 55 countries, while their banking systems ranked 11^{th}, 15^{th} and 21^{st} in 1998 before the launch of the Euro (see Chan-Lee 2001).

32) Japan’s gross debt/GDP ratio in March 2003 was 161% of GDP, however, its net debt ratio (netting out inter-governmental claims) was 46% of GDP (excluding contingent liabilities). The controversial down grading of Japan’s sovereign risk (recently reversed) reflected a misconception. Virtually all of its debt is domestically held. Hence, the risk of external default is nugatory. Moreover, given its low tax to GDP ratio, it has “room” to raise taxes. Nonetheless, budget deficits should be sharply reduced with economic recovery after a decade of stagnation, including radical pension and health reforms.

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be defined voting rights. The critical missing element to make this happen is a Japan-China “entente cordiale” and political will.

III. The Political Economy of a Common Currency

Establishing an "entente cordiale" is Asia's biggest challenge. Given its long history of rivalry and mistrust,[34] a good place to start is by building on the gains of a co-operative strategy. Together, Japan, China and Korea form an economic giant, but are separately financial-political midgets. Thus, according to the criteria for setting a country's IMF quota (GDP, FX reserves, exports and imports): the ASEAN + 3 surpass the USA and the EU (Kwack 2003). Yet, Asia has four IMF directors (compared to seven for Europe) – vividly illustrating Asia's lack of political and financial leverage.[35]

1. The Fund does not have the resources to help Asia in a crisis

Another pragmatic reason for economic co-operation and creating an ACC is that the IMF has limited capacity to help in the event of a severe financial crisis.

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34) The furore raised over Chinese academics claim that Kokoryu province of North Korea was under the suzerainty of the Chinese empire 1300 years ago or the public outcry in China and Korea created by the Japanese prime ministers annual visit to a Shinto shrine dedicated to Japan's war dead (albeit including condemned war criminals) are stark examples of the distrust between these three nations.

35) GDP (PPP in 2002) for the 5 largest European countries was 15.7% compared with 25% for East Asia. For foreign trade the ratios were 17.3% and 18.8%. Europe has 7 Directors (France, Germany and the U.K have appointed directors, Italy, Belgium, the Netherlands and Switzerland have elected directors) while the Managing Director has always been European. NE Asia has 4 Directors China and Japan have appointed directors, while Indonesia and India have elected directors. Thus, Canada has a population of 30 million and a GDP of US$ 900 billion, (PPP in 2002). but the same 3.02% quota as China with 40 times its population and 5-6 times its GDP; Belgium has a slightly larger quota than India. These disparities make little sense.

The Fund's capital base is small[36] compared with the huge scale of international capital flows (and the US Congress' refusal to approve an increase in the Fund's capital base). Indeed, the IMF's commitments to Argentina, Brazil and Turkey represent 16% of its capital base or 44% of the G-10 quota.[37] In the event, it is an open question whether the IMF has sufficient resources to cope with a large sovereign default (Argentina and Brazil) or another big financial crises.

A. The Fund's mixed record has prompted a search for other paradigms

Finally, the Fund's record in resolving financial crises in EMEs since the mid-1990s has been mixed. For its vocal critics, the Fund's role is to provide "temporary" bridge financing to overcome liquidity constraints. It is not to tackle problems of insolvency via root and branch structural and institutional reform.[38] Hundreds of papers have analysed the controversial microeconomic conditions and reliance on tight monetary and fiscal policies imposed by the IMF on Asia.[39] This controversy is unlikely to be resolved soon. However, it has sparked a search for post-crisis paradigms better suited to Asia's needs, including an eventual ACC (Yoshitomi et al. 2003). And critically, unlike Latin America and Africa, the means exist.

36) The IMF's capital base is $316 bn. However, useable free reserves are virtually restricted to the quotas of the G-10 countries (and perhaps Saudi Arabia). The G-10 quotas are 111.6 bn. SDRs plus 17 bn. SDRs under the General Agreement to Borrow. These amounts are minuscule compared with the volume of world capital flows and represent roughly 40% of the FX reserves held by China.

37) This is contrary to the Fund's own policy guidelines to avoid loan concentration and especially "lending into arrears" on a medium-term basis to countries such as Argentina.

38) The Fund's detailed structural reforms embodied in its Stand-by Agreements with the Asian crisis economies have been criticized as intrusion into areas of national sovereignty and beyond its mandate and competence.

39) A vexing issue is the IMF's insistence on transparency and accountability in dealing with crisis countries, compared with its own failings in these areas, in the event of policy mistakes and failure (e.g. seniority of IMF vs. other creditors' claims in Argentina's debt default).

2. The Economic case for an ACC

The economic case for an ACC rests on two complementary forces:

- Wealth creation via trade specialization and,
- Wealth preservation via harmonization of major macroeconomic parameters (conducive to creating an OCA),
- Additional factors are seignorage gains, political prestige and regional monetary policy autonomy.

One implication of Ricardo's theory of comparative advantage is that the larger the static efficiency gains from trade and specialization, the greater the disparities in technological capabilities (and factor endowments) among participants. In principle, world free trade is the best solution. Due to the slow progress in the Doha trade round and regional agreements bilateral deals have become popular. In fact, a proposed FTA between Japan, China and Korea is making slow headway in the face of fears of special interest groups.[40)]

A. Japan China "entente cordiale" is central

Against this backdrop, there is little doubt that a China-Japan FTA has huge wealth creating potential.[41)] Including Korea (and perhaps the ASEAN countries)

40) These fears may be overstated, as extreme specialization (implied by Ricardo's theory) is rarely seen. Ricardo's trade model assumed homogeneous commodities (wine and cloth) that are of scant relevance in a globalized economy focussed on lowest cost specialized producers. Moreover, globalization has taken the form of an explosion of intra-industry trade within the same SITC classifications. Once one allows for heterogeneous goods, transportation and information costs, decisions concerning plant location and jobs (within the supply chain) shift dramatically from relative to absolute cost advantage, and fit more easily into growth models emphasising economies of scale and endogenous growth theory. Such factors underscore the interest in stable regional "real exchange-rate" relations, to avoid beggar thy neighbour policies.

41) China and Japan provide vast scope for static and dynamic efficiency gains owing to the complementarity of China's unlimited supplies of semi-skilled labour and Japan's capital and cutting-edge technology.

would further increase such potential, but plaes in comparison to those from a China-Japan "entente cordiale." The latter is our top priority because regional intra-industry specialization and absolute cost advantage are likely to dominate investment decisions for some time – underscoring the need for reasonably stable regional real exchange rate relations.

The ASEAN+3 is the only major geographic zone lacking a dominant FTA or Customs Union. This reflects strong historical political-commercial ties with Europe and the USA and a legacy of regional mistrust and unresolved political rivalries. The bottom line is that Asia has no natural political or economic centre of gravity. Over the past 25-years, China's political "normalization" has created huge shifts in regional trade flows and "low risk" trade agreements are undoubtedly the most pragmatic steps towards political reconciliation.

B. Asia lacks a financial hub

While China is already the focal point for regional trade, Asia lacks a financial hub. Japan lacks robust institutions, vibrant banks, deep capital markets and "arms-length credit ethos" needed for a financial hub (otherwise Asia would be an extended Yen zone). China is the only other candidate, but it is uncertain how long it will take to achieve this status, despite its ambitions to make Shanghai Asia's financial centre. Another possibility is a dual-hub system, although European history suggests that this option slowed the transition towards a "co-operative" joint-float and a common currency (Mundell 2003[42)]).

C. The strategic interests of Japan

For Japan, the economic attractions of an "entente cordiale" (and eventual ACC) are strong, and indeed most of the initiatives to date have come from Japanese (or Western) academics. Overcoming the traditional mistrust between Japan, China and Korea will take decades. Even so, following the mid-1990s

42) The reluctance to accept Germany's economic dominance in the 1970s and rivalry between the UK and France slowed the introduction of the Euro by decades, according to Mundell (2003).

surge in Japanese FDI to China, Japan's worst fears were a hollowing out of its low and medium tech industrial base to a rapidly emerging Chinese giant.[43)] Perceptions of the China "threat" have shifted radically; rapid export-led wealth creation has triggered a textbook surge in Chinese domestic demand and imports, boosting job creation in Japan. China's trade with Japan swung into near balance in 2004 and will soon be Japan's largest trading partner; booming Japanese exports to China were central to ending Japan's decade long stagnation.

D. Facilitating intergenerational transfers

For Japan, an "Entente Cordiale" would lock-in the competitiveness of its cutting edge industries in the worlds' biggest and fastest growing market, and insure an unrivalled cost competitive export platform. Moreover, over the next 20-30 years, an entente cordiale makes an ideal fit in terms of demographic trends and intergenerational income transfers. Japan faces one of the largest and earliest demographic shocks among OECD countries (although Korea and China face even bigger aging shocks). Hence, Japan's strategy for decades, has been to save now, while investing abroad for the future. Japan is the world's largest international creditor, albeit the 4th or 5th most important source of FDI in China.

A salient issue is to what extent poor property rights and currency risk has limited Japanese investment in China?[44)] Most studies suggest that past rates of return on Japanese FDI have been mediocre. Part of this reflected the overhang of poor investments in the USA and the EU, when the Yen soared to less than 80

43) By 2002, the stock of Japanese FDI was some $16 US bn. with 14 000 joint ventures. Japanese FDI to China has continued to grow rapidly, but represent a small share of the stock of Japanese FDI. Japan is perhaps the 4th or 5th largest sources of FDI to China lagging behind Hong Kong, the USA, the EU, the Virgin Islands and Singapore. Much of FDI from Hong Kong and the Virgin Islands apparently reflects recycling of Mainland or UK capital to obtain investment subsidies.

44) A survey by the Japan Bank for International Co-operation (2022) shows that China is the favourite place for Japanese investors, but China's FDI policies and regulations lack maturity, transparency and predictability and is the worst country in which Japanese firms invest on these criteria. A study by the McKinsey Global Institute (2003) comes to similar conclusions.

to the US$. In addition, sharp swings in the Yen against the US$ and trend appreciation further reduced returns. Similarly, despite a rush of FDI into China since 1995, rates of return have been poor (averaging 4%) although Japanese firms have done better than average. The past few years have seen a sea change. US and Japanese firms are reporting profits in line or superior to their operations in other countries (US Chamber of Commerce and MITI). This big shift may reflect the fruits of China's first generation of reforms and its success in assimilating FDI and foreign technology. In sum, a Japan-China "entente cordiale" could accelerate these benefits; while a second generation of reforms (enhancing transparency, governance, contract enforcement, a better banking system, etc.) would build conditions for exchange-rate stability on which post-war Asian economic prosperity was founded. The big question mark is whether Japan would accept a secondary role in such an enterprise?

E. What are China's strategic interests?

A China-Japan FTA would have large mutual welfare benefits, and as the two economies are complementary, trade creation would dominate. And while modest initial levels of bilateral trade leave scope for trade diversion, this is a second-order problem given Japan's strong international competitiveness. By contrast, China's economic interests in backing an Asian FTA are nebulous.

An intriguing question is: as theory and empirical studies support the hypothesis that latecomers can gain from economic and technological "catch-up" by opening-up to multilateral free trade – why has China backed an ASEAN-China FTA by 2010? Standard CGE model simulations suggest that most of the potential gains from trade flow from entry into WTO (Yoshitomi et al. 2003).[45] Thus, on plausible assumptions, an Asia-wide FTA could redistribute a small part of China's gains to its trading partners; albeit probably from a larger pie, once dynamic wealth creation effects are considered.

45) This is a standard textbook result. China is such a huge country that constructing better domestic transport and infrastructure to its hinterland might result in wealth creation as large as WTO entry.

F. Geopolitics and supply diversification

In short, what are China's interests in a broader AFTA? Post-war history suggests that one aim is to foster a counter weight to US dominance, but the main reason may be to further dilute Japan's influence, while enhancing its own regional influence. Moreover, avoiding excessive dependence on the USA and Japan by tapping into the technology, management skills and capital of Korea, Singapore, Malaysia, and so on is a normal form of risk diversification. These goals explain in part China's recent measures to liberalise FDI outflows and joint ventures with other EMEs (Brazil, Chile, Argentina, Russia, Nigeria and South Africa), and to ensure stable supplies of basic commodities and energy. China clearly views its economic power as an instrument for leveraging a more forceful international role.

G. Is China a menace to Korea and the ASEAN?

One wag has described ASEAN as an adjective looking for a noun. This explains why enlargement of any project to include ASEAN should be selective and measured. Despite numerous official commitments to promote an ASEAN FTA, the share of intra-ASEAN trade has barely changed since the 1990s.[46] This is unsurprising; ASEAN countries have similar resource endowments, produce similar goods and trade liberalization has avoided the sensitive agriculture and services sectors. Under these circumstances, what are the strategic interests for Korea and ASEAN in joining an enlarged FTA? The answers are favourable access to the world's fastest growing market and limit the diversion of Asian bound FDI to China. In fact, many of these countries fear fierce competition from the top and bottom end of the supply chain from Japan and China.

These concerns are real. Japan has large human capital and technological leads. However, fear concerning China may be overstated. Is it possible for China to have a comparative advantage in producing everything? The vexing empirical

46) ASEAN's trade with the rest of the world has grown as fast as trade among its 10 members since the mid-1990s. Indeed trade with China has grown much faster and consistently than intra-ASEAN trade, explaining why recent measures of ASEAN+3 trade integration have risen to match the EMU's in the 1990s.

issue here is the relevance of Ricardian trade theory? The increasingly heterogeneous nature of manufactured goods and services limits this model. And, China is not a “single” economy but several. Last and most important, classical trade theory assumes full employment and competitive markets, which are from reality.

China’s huge reserves of semi-skilled and skilled labour have shifted decisions concerning FDI and plant location away from relative to absolute cost advantage and market access. Moreover, vertical specialization within and between multinational companies has vast scope in Asia. Such factors heighten the attractions of China as a destination for FDI and are why a stable Chinese-Japanese political-economic relation is key to overall Asian economic stability. Thus, China was lauded for keeping its fixed exchange rate during the 1997-98 Asian financial crisis while a weak Yen was a part of the problem. The wealth creation and strategic interests of a Japan-China “entente cordiale” are clearly huge, as are the advantages of stable “real exchange rate” relations. An enlarged ASEAN+3 FTA would also have big potential benefits, with low systemic risk. But this would depend on a favourable co-operative environment that would require self-constraint from the largest, to create trust among all.

IV. Framing an Interim Strategy

The final goals of a common currency clearly need to be defined well before framing an implementation strategy. Three goals have usually been defined in the literature: to stabilize output, to stabilize the current account and to maximize political prestige. We assume that the first goal is the most relevant, as current account deficits and foreign debt have typically not been constraints in North or East Asia (except Indonesia and the Philippines), while political goals are beyond our remit. Finally, stabilising GDP is more likely to lead to current account stability than vice versa, given nominal flexibility.

A. How important is Asia's missing market?

What are the main priorities in framing a pragmatic implementation strategy? The New Institutional Economics suggest that sound institutions and governance mechanisms are the pillars of a robust, market-based banking system, which are in turn our primary vehicle for accelerating structural changes needed for a common currency. It is thus ironic that post-1997-98, singling out the missing bond market, as the "silver bullet" to neutralize "maturity and currency" mismatch has become so popular. Indeed, six working groups have been set up to promote bond markets, credit rating agencies and to improve accounting, disclosure, audit and governance standards. Although these measures and having good bond markets are hugely positive the critical issue is their importance to a common currency.

In fact, European experience is ambiguous, as it is debatable what role, if any, long-term (private) bond markets played in framing the Euro. For example, looking at cross-border bond market activity (which remains segmented by cultural and regulatory barriers) the Eurobond market really took off after the Euro was established.

B. Sound Institutions and good banks come first

That said, European experience implies that the process of creating an ACC should start with building the institutions and governance mechanisms needed for sound banking systems. And this will in turn foster better bond markets. The lack of good corporate borrowers is the main reason for Asia's small long-term private debt markets; both being direct results of "socialized" banking system. In short, without a market-based banking system, M&A activity, internal restructuring of inefficient firms, disposal of damaged assets, and poor returns on capital will remain difficult to change.

C. Liquid Asian bond markets are decades away

Asia's bond markets have doubled relative to GDP since 1997-98, albeit this mostly reflects government bonds. More recently the ADB, World Bank and IFC have issued longer-term bonds in Hong Kong, Singapore and Korea to create a market for investment grade local currency bonds. The goals of these initiatives are to encourage *inter alia* better financial infrastructure such as the creation of regional credit rating agencies. Even so, judging by the experience of Spain, Portugal and Greece, the establishment of viable private bond markets is decades away, despite the "free rider" advantages of the Euro.

The need to create "market liquidity" on which deep financial markets and the efficient pricing of risk depends is a huge entry barrier. This creates a chicken and egg dilemma, as well as adverse selection bias. The reason why Asia's private debt and Japan's Samurai and Shogun bond markets remain small is precisely because they are not liquid, shallow markets; and thus unattractive to "good" corporate borrowers who have lower costs and better access to capital in New York, London and Frankfurt (Park 2003).

The question whether Asia needs good private debt markets is a red herring. The real issues are deal with the necessity of government intervention,[47] the lack of a clear target, and the priority to be placed on such a project. As noted below,

47) In other words, if bonds issued in a basket of Asian currencies are a desirable product, the market would quickly provid it.

our sequencing targets good banking systems firms, by building better institutions and governance mechanisms. This strategy would also encourage better regional bonds, but via integration with global markets, rather than as separate regional entities with scant competitive attractions.

1. Pragmatic first steps

Drawing policy lessons from the Euro is tricky, as conditions in contemporary Asia differ so radically from Europe. These uncertainties argue for a risk-based implementation strategy that weighs economic benefits relative to costs and systemic risk. This approach strongly suggests accelerated trade integration and enhanced economic co-operation as the first steps. These should then be quickly followed by measures to eliminate NTBs, to establish a level playing field throughout Northeast Asia, and vigorous efforts to reduce barriers to labour and capital mobility, including the standardization of accountancy, regulatory and disclosure standards, mutual recognition of national professional standards and legal protection. Initiatives to enhance transparency and competition have low systemic risk and very high potential returns (albeit with large up-front costs for powerful special interest groups and hence the need for targeted structural adjustment programs). They are also a litmus test of Asia's political resolve to the institutional and structural reforms on which the future of such a grandiose project will ultimately depend.

The EMU is not an Optimum Currency Area

Paradoxically, despite Mundell's support of the Euro, the EMU is far from an OCA based on his criteria, especially in labour markets.[48] Further, integrating financial before labour markets will exacerbate instability in the real economy, if

48) It is ironic that Mundell 2003 is a strong supporter of the EMU, even though its labour markets remain rigidly segmented, with differing professional qualifications, hiring and firing regimes, social-security and tax systems. At the same time, goods markets face differing regulatory standards for banking, public utilities, competition laws, etc. even though the single market initiative was launched more than a decade ago.

financial markets are prone to overshooting. If labour markets are rigid, this can be a recipe for stagnation. In our view, for Asia to follow a similar path would be folly, even with the advantages of small government, flexible markets and open economies. Our approach to sequencing stresses pragmatism.

2. Risk based sequencing

Our proposed sequencing steps are listed according to economic benefits suggested by the literature, compared with the degree of "systemic" risk encountered in typical financial crises in EMEs. Our list runs from low, to intermediate, to high systemic risk, typically based on the speed of market adjustment and the dangers of overshooting. A pragmatic approach is to start with low risk, high benefit structural reforms in goods and labour markets, even though these are often blocked by special interest political groups. Our approach to breaking a gridlock is to enhance international and domestic competition, to encourage transparency and to share the adjustment costs across society by targeting adjustment programs to losers lacking viable alternatives.

A complete roadmap to policy sequencing requires a detailed set of sufficient and necessary conditions and a sector by sector analysis over time. Ideally, each stage of the sequencing process should be integrated into a coherent strategy of long-term institutional and governance reform, as well as macroeconomic policies and financial constraints. Such a task is beyond the scope of this paper. A pilot study using a seven by seven policy matrix for analysing the next stage or reform in China is presented in Annex I. The same exercise remains to be done for Japan and Korea, as well as comparing these exercises to highlight points of convergence, potential conflict and strategies for co-operative strategies.

Proposed sequencing steps

Our risk based steps include: Steps I to III with low systemic risk and high potential returns, with a possible timeframe of 3 to 7 years. Most of these measures should start now, especially those aimed at improving institutions and governance mechanisms that may take decades to complete. The clear exceptions are the opening of China's capital account, the establishment of a joint-float, an eventual common currency or a move to an independent float.

Initial Steps: 3 to 7 year time horizon

- Regional free trade or customs union agreements, together with measures to promote greater regional labour and capital mobility and economic monitoring (while building better institutions and governance mechanisms via enhanced transparency and domestic competition);
- Monetary co-operation and joint surveillance of economic policies; (while gradually establishing regional consensual decision making institutions);
- Expand bilateral and multilateral swap agreements;

Intermediate steps with 5 to 10 year time horizon

- Improve banking and financial sectors (while setting up regional credit rating agencies, underwriting capacities, securitization and credit guarantees related to building better bond markets);
- Parallel efforts to improve regional bond markets;
- Phased opening of the Chinese capital account (2-10 years) using institutional benchmarks;

Longer-term initiatives 10+ year time horizon

- A Joint-float against the dollar or a currency basket – with broad bands. Introduction of broad macroeconomic guidelines to achieve convergence towards low inflation and sustainable fiscal deficit and debt positions (10-20 years);
- Introduction of narrower bands – with tougher convergence criteria akin to the Maastricht treaty adapted to Asian conditions and needs (20-25 years);
- A common Asian currency or truly independent floating currencies (25-30 years).

V. Summary and Conclusions

An Asian common currency is a mirage

In summary, the quest for an Asian Common Currency is at present a mirage. Such a grandiose project has attractions, but Asia's lack of sound institutions, market-based banking systems and absence of "political will" renders it unrealistic. Comparing contemporary Asia, with Europe in 1990 is a red herring. While the degree of economic integration is similar, political assimilation and the creation of meaningful sovereignty sharing Asian institutions has barely started. Moreover, the obstacles are greater. Defining a viable relation between the Yen and Renminbi, given sharply diverging growth prospects is one issue. However, the principal conundrum is how to facilitate a smooth shift in the regional balance of power from Japan to China. Resolving these thorny issues are central to any viable Asian project. Indeed, the lesson to draw from Europe is that rigid policy rules juxtaposed onto a currency union with feeble political and labour market integration is a recipe for political strife and poor economic performance.

Greater economic integration and co-operation as interim steps

Another problem is, unlike Europe, Asia has no obvious economic and political center of gravity or financial hub. Japan is the obvious candidate, but is undermined by its rapidly aging population, a convalescing financial system and low potential for economic growth. China is the other candidate. It is already the driving force for Asia's economic growth, but the huge unknowns include its unknown capability for being Asia's financial hub, the uncertain effect of its economic reforms on social stability, and uncertainty of the evolution towards a multi-party participatory political system.

The Chinese authorities have clear ambitions to be the region's and world's next economic and financial superpower. The litmus tests for such a goal will be when they can establish a market based banking system and an open capital account, while gradually moving to a more flexible exchange rate regime? Establishing good bond markets would be useful albeit secondary goals.

Achieving these first goals will face stiff challenges from entrenched vested interests. In fact, even realising the low-risk interim steps of enhanced economic integration and cooperation will require a much stronger political commitment to institutional reform than seen to date. At the same time, China's recent reforms to protect private property rights and clean up the banking system are promising.[49] But these initiatives bring us at best half-way towards the pre-conditions for a viable banking system and eventual capital account opening.

The critical policy issues are whether China's reforms will gather pace and what are the risks of a meltdown of the US$ in the interim? We concur that the US budget and current account deficits are unsustainable, but that the systemic risks of a dollar collapse are exaggerated, owing to Asia's continuing need to intermediate intergenerational transfer of savings via the US financial system and its huge holdings of US$ denominated assets.

Ironically, the quest is more important than the final goal

In conclusion, the policy lesson from the Euro is that a sovereign currency is a political animal. Creating a common currency in Asia will ultimately hinge on fostering an "Entente Cordiale" between Japan and China; two rivals with a millennia of bitter mistrust and conflict. Just how to create this "political marriage" and the acceptance that China will eclipse Japan is a fascinating challenge. Concrete steps in this direction would be the rapid creation of a North Asia FTA, fostering economic co-operation through the sharing of offshore mineral and energy rights and accelerating cultural, academic and other exchanges. These would be the first low-risk, high benefit steps in a project that will take decades. Last but not least, we believe that what is critical is the quest; the final goal may well prove ephemeral.

49) Important measures include inter alia: to protect private property rights, to free bank interest rates, to raise capital adequacy ratios to BIS standards, to restructure commercial banks for early stock-market flotation, and major initiatives to raise legal certainty, including defining citizen's rights and government's responsibilities).

Table 3. A Roadmap for Financial Reform

Policy Goals	Existing Strategy	Problems and Limitations	Proposals	Possible New Risks
I. Restore Banking sector Solvency and Reduce Banking Sector Risks	Hybrid Approach: carving out a portion of LPSs and growing out the rest ; contingent liabilities are not fully recognized and need high growth to maintain fiscal sustainability	Undermining sustainable economic growth and possible medium-term fiscal stress	Quick resolution of LPLs via large-scale ownership diversificatoin. Sustaining high, medium-term growth via viable banks and SOE restructuring	Fiscal costs, moral hazard without ownership changes and weak corporate governance ; NPL resolution will entail short-term high debt to GDP ration
II. Change Incentive Structures	Attempt to build an incentive structure without clear property rights	Severe agency problems ; increased state assets stripping and related corruption	Clear property rights throught ownership diversificaton	Prossibility of transitional unemployment and social dislocation
III. Independence of the Central Bank and Supervisory Agencies	Under control of the state council ; multiple supervisory agencies subject to political interferences	Perpetuates government inteference and poor standards ; politicized exit policies	Full independence	Difficulties in cooordination fiscal and monetary policy and accountabilities
IV. Staged Interest Rate L iberalization	Adminstratively controlled interest rates	Improper pricing of risks	Phased interest rate deregulation with a balance on competition and bank's franchise ralue	Tips maturity structure to short term owing to distorted yield curve
V. New Domestic and Foreign Bank Entry	Administrative requirements for entry and restricted foreign entry	Maintain oligopoly financial innovation and competition	Encourage entry of reputable foreign financial institutions through joint ventures or M&A as a part of WTO commitment	Weaker competition maintains domestic monopoly power, de facto acceleration of KAO via relabeling of capital flows

Table 3. Continued

VI. Open the Capital Account	Relativerly restricted	Appropriate in the short run but with distorting capital costs	Risk-based sequencing	Currency and maturity mismatches
VII. More Flexible Exchange Rate and Active Participation in Regional Financial Arrangement	Pegged to the US dollar. China has signed bilateral swap arrangements with key countries in the region based on the Chiang-Mai Initiatives	Illusion of FX guarantee discourages hedging practices	Currency Basket System and formalized multilateral monetary arrangement	Greater volatility, management of expectation, difficulties of monitoring and moral hazard
Policy Goals	Institutional Requirements	Implementatoin Issues	Time-Frame for Implementation	
I. Restore Banking sector Solvency and Reduce Banking Sector Risks	Better functiongiing government bond markets and better equity market for privatization ; transparent budget in stitutions and strengthening tax administration	SOE ownership diversification and restructuring must accelerate. Rationalizing central and local fiscal arrangments ; widening tax base.	Start now and accelerate existing programs to maintain fiscal sustainability in the medium term.	
II. Change Incentive Structures	Effective legal system to enforce property rights	Converting pivate savings into ownership claims via shareholdings	Start now as it may take decades	
III. Independence of the Central Bank and Supervisory Agencies	Competent technocrats and regulators ; enforcement of reluesbased supervision ; better accountancy, transparency and disclosure standards	Appoint Independdent contral banker and regulators and improve the court system ; develop in direct monetary policy in strument via better interbank and money market	Short to medium term	

Table 3. Continued

IV. Staged Interest Rate Liberalization	Functioning interbank and money markets ; capacity to actively monitor credit growth to speculative sectors	Lending rates first followed by deposit rates	Start now	
V. New Domestic and Foreign Bank Entry	Level playing field for regulatory control ; "Fit and proper" criteria for entry, higher prudential oversight and transparency standards ; monitor net positions of banks and be aware of offbalance sheet risks	Encourage foreign financial institutions entry to improve information processing and enhance risk managment skills ; national treatment for foreign banks	Start now	
VI. Open the Capital Account	Better long-term debt markets and capacity to monitor short-term capital inflows	FDI, trade credits, followed by portfolio investment and bank loans depending on institutional capacity ; be aware of labeling of capital flows via derivatives	Medium term	
VII. More Flexible Exchange Rate and Active Participation in Regional Financial Arrangement	Greater transparency and consistency of economic policy ; regional monetary arrangement	Use dollar/yen/ Euro as key basket currencies ; actively participate in regional monetary cooperaton	Short-term for the exchange rate regime and medium term for the formal regional lender of last resort arrangement.	

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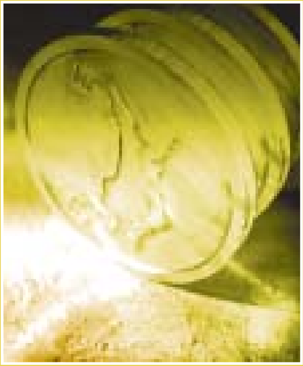
The Illusive Quest for an Asian Common Currency: Economic Mirage or Realpolitik?

James H. Chan-Lee

The Asian Financial crisis underscored the folly of running fixed exchange rates, with an independent monetary policy, open capital accounts and volatile capital flows. Interest in an Asian Common Currency is growing, but the needed political commitment, institutions and market-based financial systems are absent. This paper benchmarks the quality of institutions and financial systems to assess the enigmatic roles of the Renminbi and Yen. A prioritized policy-matrix focused on building institutions and robust banking systems are outlined. Accelerated trade liberalization, economic co-operation and political integration are crucial before a joint float or a common currency can be envisaged realistically.



KIEP Korea Institute for International Economic Policy

300-4 Yomgok-dong, Seocho-gu, Seoul 137-747, Korea
P.O.Box 235, Seocho, Seoul 137-602, Korea
Tel 02-3460-1001, 1114 / Fax 02-3460-1122, 1199
Http://www.kiep.go.kr

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