Transitional Steps in the Road to a Single Currency in East Asia

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It is a great pleasure for me to speak at this high-level seminar organized by the Asian Development Bank on the occasion of its 37th Annual Meeting here in Jeju. Indeed, the topic, "A Single Currency for East Asia－Lessons from Europe," is important and timely, since the integration of East Asian economies is proceeding rapidly, while the euro is now firmly established and the EU has just been expanded from 15 to 25 countries.

Today, I would like to discuss five necessary steps toward creating a single currency in East Asia. But, before doing so, perhaps I need to explain why a single currency is needed in East Asia.

Need for a Single Currency in East Asia

There are of course those who argue that a single currency is not needed or is even harmful for East Asia and others who contest that a global currency is needed rather than a regional currency.

In regard to the former, I would argue that the East Asian economies are well integrated, so that even a small intra-regional exchange rate misalignment can disturb trade and investment flows and create potential trade frictions among regional economies. This indicates the need for intra-regional exchange rate stabilization and ultimately a single currency in East Asia. In regard to the latter, I would emphasize that global integration is more challenging than regional integration, and the governance of a global central bank is far more difficult than that of a regional central bank. Let me elaborate on the two arguments further.

Economic integration in East Asia is basically market driven and is well underway.

For instance, intra-regional trade integration is comparable to that in the EU and NAFTA: the intra-regional trade intensity index for East Asia is 2.2, while that for the EU and NAFTA are 1.7 and 2.1, respectively. Intra-regional investment is also quite substantial, primarily because of large investment by Japan, but increasingly also by Korea, Taiwan, Hong Kong, and ASEAN, and recently even by China. Labor mobility in East Asia has traditionally been high and will increase more if Japan and Korea adopt more liberal immigration and visa policies.

Under these circumstances, many efforts have recently been made by East Asian governments to intensify the process of integration as will be explained later. This clearly shows that integration will be further enhanced in East Asia, and intra-regional exchange rate stability will become much more required and seriously sought after by regional governments. Since intermediate exchange rate regimes may become increasingly difficult to sustain under increased capital mobility, eventually a single currency will be needed for the region, and it could greatly improve efficiency. The conditions and necessary steps to introduce a single currency are many and daunting, but they could be implemented in the long run, as I will argue in a moment.

A global single currency is certainly far more difficult than a regional single currency, as shown by the fact that we already have a successful regional currency, the euro, while we have no such counterpart in the global arena. The history of the Federal Reserve System and the current situation surrounding the European Central Bank suggest that even a regional central bank is not easy to operate, and a global central bank would be almost impossible at this stage; for instance, it is unimaginable that the United States would forego the control of monetary policy, leaving it to a supranational body like a global central bank, unless it could fully control the bank.

Anyway, the current as well as prospective status of global economic integration has not yet made a global single currency a necessary or desirable institution, let alone a possible or likely one. Therefore, we can focus on a regional single currency for East Asia for some time to come.

First Step: Chiang Mai Initiative

Arguably, the *first step* toward a single currency in East Asia is already in place by way of the Chiang Mai Initiative agreed by the ASEAN+3 Finance Ministers in May 2000. The Initiative envisaged the establishment of a network of bilateral swap arrangements (BSAs) so as to avoid and resolve future currency crises like the East Asian currency crisis of 1997-98, i.e., sudden and large currency depreciations which tend to spread by contagion in the region. It also initiated the "economic review and policy dialogue" process, a regional surveillance to eliminate macroeconomic and financial vulnerabilities that may lead to such crises.

It was agreed that the mobilization of BSAs is basically conditional on the IMF program, although 10% of the amount can be mobilized without such a condition for a limited period. The total amount of BSAs already agreed has reached nearly $40 billion, and the Initiative is making real progress toward becoming the regional financial safety net. It is expected that the total amount will further increase, and the modality will be reviewed in 2004 in order to make it more effective and efficient.

One possible issue for future reviews is whether the BSA network should be transformed into a formal, multilateral institution like a reserve pooling mechanism. Another issue is whether its IMF linkage should be reconsidered and an independent conditionality imposed, while an independent secretariat being established by the ASEAN+3 countries. This issue is closely connected with the effectiveness of regional surveillance.

More importantly, effective regional surveillance will be a prerequisite for any currency stabilization effort to be successful. The ASEAN+3 Finance Ministers decided to strengthen the economic review and policy dialogue process in May 2001 and started enhanced surveillance from May 2002. Thus ASEAN+3 surveillance has been strengthened and become more candid, but it is still insufficient; it is urgently needed to discuss much more frankly the exchange rate and related policy issues based on objective analysis provided by independent staff.

<u>Second Step: Asian Bond Markets Initiative</u>

Although East Asian economies are rapidly developing and becoming well integrated, their capital markets, in particular their bond markets, are still very much underdeveloped and not well integrated except in Japan. In this connection, it may be recalled that one of the fundamental causes of the East Asian currency crisis of 1997-98 was excessive reliance on the banking sector as the source of financing investment, coupled with maturity and currency mismatches (the "double mismatch" problem). In order to introduce a single currency, highly functioning, integrated capital markets are absolutely necessary for East Asia.

Therefore, the *second step* toward a single currency in the region will be bond market development. The basic idea is to mobilize through the regional bond markets the region's vast pool of savings for direct, efficient use in the region's long-term investment, thereby simultaneously reducing the double mismatch problem and facilitating smooth intra-regional flows of investment. For this purpose, the largest possible number of investors and issuers must be attracted to the market, and market infrastructure, such as information dissemination and disclosure, credit rating, credit enhancement, and benchmarks, needs to be improved.

Based on the proposal made by Japan, Korea, and Thailand, the ASEAN+3 Finance Ministers embarked on the Asian Bond Markets Initiative to develop the regional bond markets in August 2003. Ministers agreed to intensify their efforts, and several working groups have been established to further discuss a range of key issues, such as securitization, credit guarantees, promotion of local currency denominated bonds, credit rating, and foreign exchange transactions and settlements.

It is hoped that within a relatively short time, perhaps three to five years, all necessary conditions for regional bond market development will be met. In this context, capital controls remaining in the region must be carefully reconsidered. Although the premature abolition of capital controls in some East Asian countries induced massive capital inflows to the region and then equally massive capital outflows, resulting in the currency crisis in 1997, it is also true that capital controls inevitably hamper the development of regional bond markets. Therefore, those countries that retain capital controls should gradually liberalize them, particularly outflow controls, while closely monitoring capital flows and strengthening financial sector supervision.

Third Step: Free Trade Agreements (FTAs)

Unlike in Europe, here in East Asia, financial cooperation started before trade cooperation, simply because the currency crisis of 1997-98 necessitated financial cooperation, while countries in the region adhered to the WTO and multilateralism with the exception of the AFTA created by the ASEAN. But now, in view of the expanding EU and growing NAFTA, and based on the rapidly increasing intra-regional trade in East Asia, trade cooperation through FTAs has become prevalent in the region. This could be the *third step* toward a single currency

Japan and Singapore first established a bilateral FTA in 2002, China and the ASEAN are negotiating a regional FTA, and Japan and ASEAN have agreed to start formal negotiations on a possible regional FTA from 2005. In the meantime, Japan has started negotiations on bilateral FTAs with Korea, Malaysia, Thailand, and the Philippines, and may start negotiations with Indonesia shortly. China has proposed a regional FTA among China, Japan, and Korea. Even a regional FTA for the entire ASEAN+3 is possible in the medium to long run, for instance, in 10 to 15 years.

Economic integration in East Asia has been largely market driven so far, but with an extensive network of FTAs, it will become strongly supported by the regional governments' deliberate efforts. Surely, movements toward a single currency will be further promoted by such integration efforts.

Fourth Step: Intra-Regional Exchange Rate Stabilization

The *fourth step*, cooperation for intra-regional exchange rate stability, could follow, but preferably, will go hand in hand with the third step. This is because economic integration is already well advanced even though FTA networking has only just started. If East Asia is to form a free trade area, exchange rate stabilization will be sorely needed of course.

Before the currency crisis, most East Asian currencies were formally or informally pegged to the U.S. dollar, and were thus quite stable vis-à-vis each other. Then, during the crisis, many of the currencies were floated with a few, such as the Chinese renminbi, remaining pegged to the dollar. Even the floating currencies have been managed to various degrees. Consequently, intra-regional exchange rate relationships have become very complicated, posing a potential risk of regional conflict. The Chinese currency regime in particular has been subject to increasing criticism from some East Asian countries.

Therefore, an exchange rate regime that is flexible toward the outside but relatively stable inside will be appropriate for East Asian economies, and such a regime must be established in the region as soon as possible. The Japanese yen, which has been floating and is the only currency in the region that is traded globally, could have become the anchor currency for East Asian currencies, but it has not. This is probably because the yen-dollar rate has fluctuated so widely while the U.S. market continued to be more important for many East Asian economies, and the Japanese economy has experienced a decade-long stagnation and too-low inflation or even deflation for so many years.

However, the yen peg which has never been tried or the dollar peg which has already failed is not the only option available for East Asian currencies. A possible exchange rate arrangement for them may be a "basket regime," under which regional currencies are managed using as a reference a common basket of major currencies that should include the U.S. dollar, the euro, and the yen. This arrangement would minimize the fluctuations in their effective exchange rates due to exchange rate changes among the major currencies, and substantially reduce intra-regional exchange rate fluctuations.

ASEAN countries, particularly the original six ASEAN countries with well developed economies, may first establish such a regime among themselves with the AFTA completed by 2008. China may unilaterally adopt a basket regime as a way out of the dollar peg. Also, Japan and Korea may try to stabilize the yen-won rate once a FTA is established between them. But eventually, China, Japan, Korea, and the ASEAN may agree on a common basket in the long run. If Japan joins such a regime, the common basket will exclude the yen because Japan would then be inside the system, or a new basket of all member currencies may be established as a prelude to a single currency. In any case, a common basket currency regime would be a significant step toward a single currency

Fifth Step: Convergence Criteria and a Single Currency

The *fifth and final step* will be the application of convergence criteria and the introduction of a single currency in the region. As the European experience toward a single currency shows, it would take a few decades before it actually could be introduced.

Before creating a single currency, the East Asian countries would have to overcome several hurdles. First, the goods and services markets in the region must be fully integrated. For this, at least an ASEAN+3-wide FTA (or preferably a customs union) will be needed. Second, for greater integration of the labor market, freer movement of human resources supported by a liberal visa policy and harmonization of domestic regulations must be achieved. Third, a large integrated capital market must be established to mobilize regional savings for regional investment. Fourth, the economic structures and the level of economic development of the participating countries must be similar, and significant convergence must be achieved within East Asia.

Finally, considering that changes in exchange rates could no longer absorb external or asymmetric shocks in a single currency system, macroeconomic policy coordination would be essential. On the monetary side, of course participating countries would have to give up independent monetary policy and be subject to a single regional authority. On the fiscal side, participating countries would retain some leeway in fiscal policy, but within certain limits like the "Stability and Growth Pact" in Europe. Countries wishing to participate would be required to improve their fiscal position, some drastically. Strengthened regional surveillance in the ASEAN+3 could awaken East Asian countries to the need for macroeconomic policy coordination beforehand.

All the necessary efforts to overcome those hurdles presuppose a very strong political will, much stronger than that required for the first to the fourth steps toward a single currency. In fact, the first to the fourth steps may be implemented without going forward and reaching the final step, and yet it may contribute to some positive results. But that will not achieve the single currency and miss a great opportunity in the long run.

Concluding Remarks: Beyond a Single Currency in East Asia

Whether East Asia forms an optimum currency area might questioned. India, which is sizable and fast growing, could be a potential member of the Asian (or East Asian) single currency. Although at this stage, the Indian economy appears more inclined toward the U.S. economy, particularly in the field of computer software and services, in the future it might increase trade and investment relations with East Asia. Australia and New Zealand are more integrated with East Asia, and so could join the regional single currency relatively easily. There may be more countries which would join the single currency in the very long run.

This means that the size of the optimum currency area in Asia should be expanded through intensified economic integration and convergence as time passes. Eventually, the world may become the optimum currency area, and a global single currency might become a reality. But before going into a global single currency, a few big regional currencies might appear because of deeper economic integration, closer geographical proximity, and tighter political relationships; among such currencies should be the U.S. dollar, the euro, and an Asian single currency of some form.

The more we think about a single currency, the greater the political factor seems to dominate. Especially in Asia, where political systems vary so much from country to country and political rivalries between countries are still so intense, we tend to be pessimistic about a single currency even in the long run. However, if we look at the younger generations who are free from old nationalistic sentiment, we can be more optimistic.

Thank you for your kind attention.