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Article

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Sequencing Regional Integration and Monetary Cooperation in Asia. Are there Lessons from the EU?

(Abstract paper)

I. The Policy Problem

The launch of a common currency among 12 member countries of the EU has raised much attention in those developing countries and emerging markets which for many years have been engaged in liberalising trade and factor movements among each other. Especially after the Asian crisis 1997, governments of these markets have started to analyse whether the entry into monetary cooperation by tying their exchange rates could protect their currencies against speculative attacks from financial markets. Furthermore, regional or bilateral stand-by agreements have been discussed as a first step towards creating a regional firewall against such attacks. Early experiences in the EU such as an implicit signal of the German Bundesbank to defend the French Franc/Deutsch Mark exchange rate since the second half of the eighties (which could never be proven) are thought to give support for similar endeavours in emerging markets even it is well-known that the state of real sector integration by forming free trade areas or customs unions has by no means as advanced in these markets as in Europe.

Therefore, the debate centres around the question whether one needs a sufficiently high level of real sector integration to make the entry into monetary cooperation credible and sustainable or whether an early entry into monetary cooperation can even give an impulse to further real sector integration and thus even create conditions for what is called in literature an optimum currency area. Technically, the question focusses on the so-called exogeneity or endogeneity of an optimum currency area OCA).

II. The Conceptual Problem of Sequencing Regional and Monetary Integration

The ruling view on sequencing regional integration and monetary cooperation has been recently labeled Mundell-I by Ronald MacKinnon (2004). Mundell in his earlier works argues that in a situation where

– economic structures of potential partner countries are diverse,

– labour markets are segmented,

– expectations are stationary,

exogenous shocks hitting the countries are asymmetric as they affect one country only. Therefore, a flexible exchange rate is needed to adjust to such shocks. OCA conditions are not given and they cannot be created by an early entry into monetary cooperation through fixing exchange rates. In more popular terms, this view has been called also Coronation Theory in the sense that after deep real sector integration by liberalising trade and factor movements economic structures of countries would converge, shocks would become symmetric and at the very end the entry into monetary cooperation up to the creation of a single currency would be the coronation of this long-term process.

In recent years, also stimulated by Robert Mundell, there has been the competing theory (Mundell–II) saying that expectations are not stationary or exchange markets would be forward-looking. Therefore, a common currency across countries could mitigate asymmetric shocks by better reserve pooling and portfolio diversification. In simple terms, a common currency would force trading partners to share the adjustment costs of an adverse shock. Under flexible exchange rates, costs of adjustment would have to be borne entirely by the country hit by the shock and that would have also negative implications for real sector integration. It could even put achievements of real sector integration reached in the past at risk. In popular terms, this view has also been labelled Vehicle Theory in the sense that monetary cooperation would be instrumental to promote real sector integration or prevent real sector integration from disintegration. Proponents of this view often point to the situation of Italy when it became evident that the country would be among the first round members of EMU. Interest rates on Lira-denominated bonds declined to a level of the other qualifiers and that "free lunch" helped Italy to stimulate growth and to be prepared for further deepening of real sector integration.

The question is whether Asian conditions reflect at least some of these European experiences.

III. Optimum Currency Areas: Do They Exist? Are They Needed? Can We Go Along Without Them?

It is obvious that Asia defined as Southeast and Northeast Asia (thereby excluding South Asia and Central Asia) is far from fulfilling the conditions even if one could argue that neither the US nor the EU meet conditions of a complete optimum currency area; there is no doubt that conditions in Asia are far less fulfilled than in any of the other areas. Economic structures are diverse between commodity producing countries and non-commodity producing countries. Income levels differ highly between Singapore and the Indochinese countries. Institutions such as the common external trade policy of a customs union do not exist, capital markets are segmented and labour cannot move freely across borders of individual countries). But what matters more is that currency blocs, trading blocs and capital blocs do not overlap. In Asian countries (except for Japan), external debt is Dollarised and not denominated in one of the regional currencies original sin. The countries have preferred to use different sorts of pegs to the Dollar. Trade is not invoiced in regional currencies. Even the Yen does not play a major role as an invoicing currency in Japanese trade. Trade is more intensive with the US and Europe than with neighbouring Asian countries though with the emergence of China in international trade this is now slightly changing. Capital transactions, as well as the reserve currencies and anchor currencies basically rely on non-regional currencies. No currency in the region qualifies for serving as an international currency. Even if monetary stability would be given such as in the Singaporean case, the Singaporean economy is much too small to shoulder the burden of an international currency for its currency. The Chinese Renmenbi is non-convertible. Financial markets in China are restricted and decoupled from the international financial system and the role of the Japanese Yen suffers from weakness of the Japanese banking system as well as from the relatively poor growth performance of Japan during the nineties. An important barrier against the stronger overlapping of regional trade and capital transactions is the resistance of the countries to accept some sort of regional hegemon, to surrender national sovereignties and to give regional institutions political clout. Simply there is no political will to proceed along the track of regionalism as it was started in Europe in the second half of the fifties.

IV. Deepening Integration in Goods and Factor Markets: The Institutional Lacuna

Weaknesses of an institutionalised regionalism become obvious when we look at the two approaches which are worth mentioning in Asia, the ASEAN Free Trade Area (AFTA) and open regionalism model of the East Asia-Pacific Economic Cooperation (APEC). The ASEAN Free Trade Area has not yet been completed and the main instrument to achieve this is (the so-called Common Effective Preferential Tariff Scheme) excludes important products and services and especially non-tariff barriers. A two-track approach of giving the less advanced Indochinese countries (Vietnam, Lao, Myanmar, and Cambodia) more time to participate in the system simply means that the deadline for meeting the requirements of a free trade area are shifted more and more towards the future. Sovereignty on all economic affairs is exclusively on the national side.

APEC which includes countries of the Western Pacific Rim is not based on a formal agreement but reflects the very limited possibilities of a regional coherence but hoping that peer-driven competition between the neighbouring countries would bring the region towards free trade by the year 2020 at the latest. Ways to achieve this are left to the discretion of the individual countries. It is very likely that such shallow integration is meaningless if it comes to fixing a minimum level of institutionalised regionalism which appears necessary to learn from the European lessons of monetary integration. The same holds for factor market integration as free mobility of labour and capital does not exist.

V. Improving Monetary Cooperation: Options and Risks

In recent years, in spite of their low level of institutionalised relations, Asian countries have tried to establish some instruments of monetary cooperation. The Chiang-Mai Initiative of "ASEAN plus Three" introduced bilateral explicit stand-by agreements. Yet, as these agreements are limited in terms of the amount of funds which are covered they are unlikely to impress financial markets. Implicit bail-out signals have not yet been sent. And, given the low state of real sector integration and political will, promises would probably face the so-called Groucho Marx problem: One should never become a member of a club which accepts you as a member, or bluntly, joining a club with bad reputation can or definitely will damage your reputation of a joining member.

Yet, there are small technical steps possible, one has been propagated by John Williamson (1999) and others claiming that the countries could jointly peg to a common basket of currencies instead of only to the US-Dollar. The countries could also agree on common weights of currencies in their joint basket. The problem of this approach is two-fold. First, countries maintain very different trade relations with non-regional trading partners such as Europe and the US. The Philippines, for instance, are much more oriented in trade towards the US than Thailand, which is more oriented in trade towards Europe. Strong fluctuations between the Euro and the Dollar could drive a wedge into a common basket peg making common weights unsustainable. The second problem is that countries manipulate their exchange rates for different reasons. For example, Singapore has manipulated its exchange rate in the past often in an upward direction in order to decouple the country from international inflation or it has used its exchange rate to put pressure upon the domestic industries towards upgrading and relocating labour-intensive manufacturing abroad. Commodity-producing countries like Indonesia could suffer from 'Dutch disease' problems and thus manipulate exchange rates in order to lower the burden for exports of non-commodity sectors. Such asymmetries could also make a common basket peg very difficult to sustain.

Clear proposals come from Robert Mundell (2003) to either introduce a parallel currency in the region supported by reserves of an "Asian Monetary Fund" to compete against the national currencies and to convince the Japanese government to irreversibly fix the exchange rate between the Yen and the US-Dollar. The latter step in fact would be the first credible internal anchor of further monetary integration. It is very likely that other countries would join this peg and also fix their national currencies to the Yen/Dollar peg. Yet, it would place an enormous burden of adjustment pressure on the Japanese economy as an autonomous national monetary policy would then be no longer possible. Given the differences in the economic structures in the US and the Japanese economy (the Japanese economy is more an old economy type based on the manufacturing sector against the US economy much more resembling the new economy type based on services), especially the Japanese financial system (banking and insurance) would have to master the adjustment burden. Japanese trade would also be exposed to the volatilities of the US/Euro exchange rate. In view of the strong exposure of the Japanese industry on the European market, any appreciation of the US-Dollar against the Euro would immediately impede the competitiveness of the Japanese manufacturing supply in Europe.

Above all, there is the so-called “original sin” problem of emerging markets in Asia that a regional bond market does not exist. Unless there is trade in bonds denominated in the national currencies in the region it seems very difficult to establish such a market which then would become also attractive for institutional investors outside the region.

VI. What to Learn From Europe and What Not

Asia can learn from Europe that a minimum level of regional sovereignty is very likely to be necessary to make the start to monetary cooperation credible, meaningful and sustainable. Currently it does not seem that such regional sovereignty including the state of real sector regional integration has already been achieved.

Second, with non-stationary expectations, there is today more to say in favour of the Vehicle Theory than two or three decades before. That would mean that the entry into some sort of monetary cooperation by coordinating or finding common elements of national exchange rate regimes should not wait until economic structures have sufficiently converged so that exogenous shocks have become symmetric. Even if one can argue that the very much advanced stage of real sector integration in Europe has led to the convergence of economic structures and to the symmetry of shocks, the Germany unification has shown that an exogenous shock, hits one country over-proportionately compared to the other countries if the shock comes from within the region. That means that shocks will never become completely symmetric nor will business cycles be completely synchronised. But this even holds true within a single country like the US where deep specialisation has made US states more diverse in economic structures than in the past. Finally, Asia should learn from Europe that regionalism can only be successful in terms of avoiding the setbacks and the inefficiencies of trade diversion if regional integration is accompanied and even preceded by multilateral liberalisation. Only multilateral liberalisation helps countries to become competitive internationally so that they can also expose their sectors to regional competition especially to regional competition with China within Asia.

VII. The Likely Scenario: Asia Will Follow US Bilateralism Not European Regionalism

The likely scenario is that Asian countries will not follow European regionalism, neither in trade nor in integration but that the so-called hub-and-spoke systems of bilateral treaties will be a copy of US bilateralism. Probably, in the future we will see more bilateral stand-by agreements as we will see more bilateral free trade agreements. Whether this will also lead to some sort of regionalism in trade and monetary agreements between the spokes is still open. It strongly depends on the future development of the Chinese economy and on the restrengthening of the Japanese economy. Above all, the political will to share the burden of exogenous shocks is absolutely vital.

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