Preliminary and Incomplete

What Kind of Currency and Financial Cooperation in Asian Economic Integration?

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2 August 2007

Paper prepared for the FONDAD-ISIS Conference, Globalization, Asian Economic integration, and National Development Strategies: Challenges to Asia in a Fast-Changing World, Kuala Lumpur, Malaysia, 14-15 August 2007.

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Background to Recent Integration Initiatives: Gone with the Wind

A financial typhoon appeared in the Gulf of Siam on July 2, 1997, first toppling the Baht and the Thai economy and then sweeping to-and-fro across East Asia for the next eight months, doing severe economic and political damage to South Korea, Indonesia, and Malaysia. The ripples of the typhoon were felt as far as Brazil and Russia, with an equally disastrous outcome in the latter. Post-mortems have abounded since; initially in the form of media and official assertions; next in dissertations from academic dissections; and finally in Paul Blustein's excellent book, The Chastening (Public Affairs, 2001). Each autopsy report typically contained the following three findings, with each work differing in emphasis on the importance of individual findings in each country.

Finding 1: The victim died because she was already so wasted internally by self-inflicted wounds that she keeled over when the wind started blowing. The role of the storm was happenstance because a sneeze later on would also have caused her to crumble when her constitution had been rendered more fragile by the soft rot.

> *Translation: Prior to July 2 1997, crony capitalism and economic mismanagement in these Asian economies had loaded their national financial systems with weak loans, and hence rendered their continued high growth unsustainable. These Asian economies imploded for the same reasons the Soviet bloc economies had imploded in the early 1990s. Their industries were viable without various forms of subsidies (e.g. directed credit, protection), and the aggregate subsidy had reached a level in 1997 that the state could no longer provide.*

Finding 2: The victim died because she was crushed in her sleep by the coconut tree brought down by the gale.

> *Translation: International financial markets, just like domestic financial markets, are susceptible to bouts of mania, panics and crashes, causing them to help stoke booms and busts in their clients' performance (which in the periods of irrational exuberance are often dignified with self-congratulatory honors like The Asian Miracle, and Japan as No. 1). Paul Volcker (1999) has put the matter well: "International financial crises, I might even say domestic financial crises, are built into the human genome. When we map the whole thing, we will find something there called greed and something called fear and something called hubris. That is all you need to produce international financial crises in the future."*

Finding 3: The victim died not from the bad cold she caught with the change in weather but by the mistaken administration of nitrogen instead of oxygen while in the ambulance on the way to the hospital.

> *Translation: The incompetence of the IMF turned a downturn into a depression with contractionary "rescue" packages, and helped to exacerbate (if not initiate) the regional panic with dire diagnoses of the patient. The Koreans were correct to dub the perfect storm they found themselves in "The IMF Crisis."*

While the Asian financial crisis was most probably the product of all these three factors, it would be irresponsible to completely avoid apportioning blame because this would deny the importance of accountability. It is convenient to embrace Finding 1 readily because no economy is without flaws. However, the fact that output in Malaysia, South Korea and Thailand rebounded just as quickly as they had fallen falsifies the initial IMF belief that, beside monetary-fiscal tightening, drastic overhaul of the economic system and incentive structure similar to those undertaken earlier in the former Soviet bloc (e.g. immediate increase in the capital adequacy ratio and abrupt large-scale closure of financial institutions) were necessary to restart growth. This initial misjudgment explains why the IMF kept under-predicting until the end of 1998 the strength of the growth that occurred.

The IMF had expected the recovery profile to be U-shape because it believed that there would have to be new investments and substantial reorganization of the surviving enterprises before growth could restart. However, the actual recovery profile for Indonesia, Malaysia, and South Korea was V-shape, and this fact favors Finding 2 as the primary cause of the Asian financial crisis. Output plummeted when the international financial markets panicked, and output recovered once the panic had run its course. There can be no better confirmation of this "panic" interpretation than the subsequent reversal of IMF policy recommendations from early 1999 onward. This does not mean however that Finding 1 does not apply, the fragile domestic financial system certainly deepened the output dive but it would have not imploded on its own at that point.

The many careful studies in the voluminous literature on the Asian financial crisis have produced many valuable insights on every dimension of the crisis: the origins, early detection, pre-emptive interventions, emergency-room macroeconomics, and post-crisis recovery. For the topic of the type of exchange rate and financial cooperation that are appropriate for Asia, there are two lessons that are particularly useful. The first lesson concerns the natural working of the market mechanism, and the second concerns the availability of help during a financial crisis.

There has long been a tradition of resistance within the economics profession to acknowledge the phenomenon of disorderly market behavior. The most commonly used defense against claims of speculative bubbles is the alternative hypothesis that unstable asset prices reflect unstable government policies. The claim (labeled the "peso problem") is that observed flip-flop movements in asset prices reflected rational anticipations of changes in government policies that turned out not to occur. The truth is that the peso problem hypothesis cannot really be disproved -- there is just no way of getting around the sophistry of a determined peso problem believer.

The fact that financial contagion has been common in the 1990's cannot be in serious dispute: the European Exchange Rate Mechanism crisis in 1992-93, the Mexican and Latin American financial crisis in 1994-95, the Asian financial crisis in 1997-98, the conversion of the Russian ruble to a rubble in August 1998, and the collapse of the Brazilian real in January 1999. It stretches credibility and the imagination that all these governments coincidentally shifted to destabilizing policies in the same decade. Herein lays the first lesson from the Asian financial crisis: *occasional excessive price movements in financial markets are normal and should not be labeled 'peso problems' in a knee-jerk fashion.*

The unpleasant truth is that "bad things can happen to good people" and economic disasters are not necessarily penitence for economic sins. The rejection of the dogmatism of the peso problem approach leads naturally to the rejection of the dogmatism of unreflective market bias. The use of temporary capital controls in Malaysia during the crisis is instructive. The faintest praise for the Malaysian capital controls is that they did not render the recovery in Malaysia to be slower than in the other crisis countries. More fulsome praise would point out that the 1998 collapse in Malaysia was smaller than in Thailand and the Philippines, and that the 1999 recovery in Malaysia was faster than in these two countries. The main cost of the controls was that Malaysia missed most of the international capital that returned to the region at the end of 1998. The temporary controls do not appear, to have engendered any long-run negative impact because the risk premium today on Malaysian-issued Eurobonds is not higher than those charged of its neighbors.

The second important relevant lesson from the Asian financial crisis is that *"the only form of reliable help during an economic emergency is self-help."* The IMF could not be counted upon to be always correct in its diagnosis upon its first reading of the situation. Moreover, the United States could not be expected to be always ready to help out countries in desperate straits. In the three-decade long rule of General Soeharto, he had been bailed out several times before by the US and its allies (notably Australia, Japan, Holland, and the international financial institutions), and it was thus quite natural for him to expect some external aid when things started going awry in the last quarter of 1997. Soeharto was mistaken. He did not realise that with the end of the Cold War in 1992, he was dispensable to US security and ideological interests just as his fellow general, Joseph Mobuto of Congo-Leopoldville, was; that a newly-impoverished Indonesia, not being an immediate geographical neighbor to the US, could not send a tsunami of unemployed workers into the US as a newly-impoverished Mexico could; and that as he neared the end of his natural life-span, the Americans (after their costly experience with hanging on to the Shah of Iran until the bitter end in 1979) had become more interested in who would be replacing him than in maintaining him in power.

The only country that was willing to commit immediate large-scale financial assistance to the crashing Asian economies was the neighboring country of Japan, which proposed the Asian Monetary Fund (AMF). Japan did not succeed in establishing the AMF, however. Three of the key reasons for the failure of the AMF initiative were that some important developed countries believed in the crony capitalism explanation of the crisis and concluded that an AMF would merely mean throwing more money to the undeserving, corrupt elite of these countries, some other developed countries wanted to protect the monopoly position of the IMF so that they could continue to command a disproportionate influence on world affairs, and China was not prepared to be rushed by events into supporting a new regional institution without careful consideration of all the implications.

These two lessons propelled the East Asian countries after their recovery to go on a reserves accumulation spree to insulate themselves from future speculative attacks (i.e. be independent of the supervision of the IMF). These lessons also led the Asian countries -- the 10 ASEAN countries, China, Japan and South Korea, collectively called ASEAN+3 -- to start the process of currency and financial cooperation when they met in Chiangmai, Thailand, in 2000. The resulting Chiangmai Initiative had two major components:

1. The countries agreed to come to each other's aid if similar speculative attacks were to reoccur. This pooling of reserves to defend the existing values of their exchange rates was enabled by each country entering into a web of bilateral swap arrangements.
2. An Asian Bond Market (ABM) would be established to keep funds within the region. The assumption is that if there were an unjustified (i.e. panic-stricken) capital flight from one Asian country, the existence of the ABM would channel these funds to the other Asian countries. ABM is a defensive mechanism (just like the anti-ballistic missile), and it worked by reducing the probability of a collective capital flight out of Asia.

At the May 2006 meeting of the Asian Development Bank (ADB) in Hyderabad, India, the Asian Development Bank (ADB) led the call for the introduction of an Asian Currency Unit (ACU) to coordinate exchange rate movements within the region. This ACU proposal was similar to the first major step toward currency unification in Europe when the European Currency Unit (ECU), more popularly known as the European Currency Snake, was introduced in 1976 to coordinate a joint float against the US dollar. Would Asia in three years after Hyderabad, as Europe did in 1979, form the Asian equivalent of the European Monetary System? And then grow into an Asian Monetary Union another twenty years later?

The Chiangmai Initiative turned out to be only the first part of a more comprehensive program of regional economic integration. In November 2001, China and ASEAN agreed to start negotiations for an ASEAN+1 free trade area (FTA) that would be achieved in 2010. By November 2002, China and ASEAN had made enough progress to sign the framework agreement for the ASEAN+1 FTA. This fast pace of economic embrace between ASEAN and China had the synergistic effect of accelerating what has been a leisurely-paced process of incremental economic integration within ASEAN, and energizing Japan into active FTA negotiations with ASEAN.

The ambition of Asian economic integration, or at least its rhetoric, has continued to broaden. The annual ASEAN+3 conference in 2005 was supplemented by the East Asian Summit (effectively an ASEAN+6 conference) to include Australia, India and New Zealand; and the host of the 2005 conference, Prime Minister Abdullah Badawi of Malaysia, expounded on his vision of an Asian community.

Given the many parallels between the fast Asian developments in the last decade with the movement in Europe from the Treaty of Rome in 1957 that established the European Economic Community to the Maastricht Treaty in 1993 that formalised the European Union, the sense of history repeating itself is naturally a strong one. Is there an Asian Union in the offing? Would it come soon, just like a late industrializer normally taking off at an explosive speed compared to the first industrializer?

We know enough, however, to be wary of linear thinking, otherwise, there would never be any turning points in history. We also do well to remember the famous words of “History repeats itself, first as tragedy, second as farce.”

“And Now for Something Completely Different” (Monty Python, 1971) in format.

Why Economic Integration?

- Economics: Adam Smith The Wealth of Nations (1776) “Greater wealth with greater division of labor; so the more souls, the more merrier.” Optimum free trade area is the entire world, multilateral free trade system is ideal
- Politics: Norman Angell, The Great Illusion (1910), “Economic integration makes wars too costly to contemplate.” Book won him the Nobel Peace Prize but falsified by WW1 (when has high theory, be it economics or politics, ever been fazed by inconvenient facts?).

Forms of Integration

- Norm of economic integration is not EU but slowly-integrating customs union e.g. Mercosur, ASEAN.
- Only two large FTAs have actually worked in terms of deepening integration significantly, e.g. most ASEAN preferential treatments are under-used
- Table below sums key characteristics of two successful FTAs and the proposed Pan-Asian FTA

	EU	NAFTA	Proposed Asian Integration
Free trade	yes	yes	yes
Free capital movement	yes	yes	yes
Free labor movement	yes	limited	very limited
Common currency	yes	no	in (far?) future; exchange rate coordination now
Political union	yes	no	no

Background to European Economic Integration

- No more wars within Europe nations please
- Especially initially, strengthen ties within NATO coalition (at least no war amongst western Europeans)
- Subsequently, restrain the scope for unilateral actions by growing West Germany and then of united Germany
  - Realization of German economic might came when Mitterrand's attempt to lower interest rate was foiled by large capital movements from France to Germany. In short, the French interest rate is set in Frankfurt! The best solution to ensure that French interests are taken into consideration when setting the interest rate is to put a Frenchman in charge of German monetary policy, so let's have a European Central Bank. This is, of course, simplification: truth is that Cooperative Solution produces higher individual welfare than Cournot [uncoordinated] Solution, more on this later.
- Enabling factors for integration
  - Biggest countries wish to integrate
  - Common political system (democracy) and cultural heritage (Ukraine preferred to Turkey)
  - Similar economic structure – low adjustment costs

What kind of financial and exchange rate cooperation in Asian economic integration?

- Question can be answered only if we posit what the circumstances of the future are likely to be.
- Use crystal ball of Smart Money, say Goldman-Sachs (2006) -- so much for "Que sera sera, the future's not ours to see" and hooray for false precision
- 3 groups: NAFTA, EU and Mahatir's East Asian Caucus (a Caucus without Caucasians as Dr M had predicted)

Case 1. NAFTA GDP: US dominates now and in future

2005$ trillion	USA	Canada	Mexico
2005	12.5	1.2	0.7
2025	19.6	1.8	2.4
2025	37.7	3.0	7.8

- US is and will continue to overwhelm rest of NAFTA
    - 1st characterisation is rest of NAFTA have no individual impact on US prices, and hence are price-takers;
    - 2nd characterisation is Stackelberg equilibrium, US is leader and rest of NAFTA are followers
    - Either characterisation means that US optimise and others adjust
- US dollar bloc in the sense of rest of NAFTA having currency boards
- Survival of individual currencies highly likely because currency unification is of no interest to economic giant, and Canadians and Mexicans are neither dysfunctional countries that can't be trusted to get things right nor small economies with swords of Damocles over them [think of Hong Kong] such that they have to dispel uncertainties with abdication of monetary sovereignty.

Case 2. EU GDP: Fairly equal size

2005$ trillion	France	Germany	UK
2005	2.3	3.1	2.3
2025	3.2	3.9	3.3
2050	4.9	5.4	5.1

- Each country has impact on the other, so we can either have Cooperative Solution or Cournot Solution; basis of Koichi Hamada's (1976) "strategic analysis of monetary independence"
- Economics: A common currency is effective instrument for achieving the welfare-enhancing Cooperative Solution
- Politics: A common currency is a good compromise among equals
- A common currency is a necessary outcome of <u>any</u> political union (undertaken in this case to prevent any more French-German wars)

Case 3. Asia GDP: Japan now, China in future

2005$ trillion	China	Korea	Japan
2005	1.9	0.8	5.3
2025	11.7	2.6	6.7
2050	48.6	3.7	8.0

- Definitely not a club of equals, NAFTA with different leaders in 2005 and 2050
- Yen bloc now and Yuan bloc in future?
- If NAFTA outcome in future, then present push for Asian Currency Unit could be wasted effort.
- China has no incentive in the future to have its monetary independence compromised.
- However, China's monetary independence will be compromised in the future if a regional monetary board (RMB) is set up today where China is a follower and membership on RMB is determined by economic conditions of today. The US has always picked the World Bank President, and the Europeans have always picked the IMF Director -- this is called institutional inertia. In the case of the IMF, no single European country matches Japan in economic might but yet institutional inertia has prevented a Japanese from being head of IMF even when the Japanese candidate arguably out-matched the German candidate.
- Therefore, if China does agree to monetary integration now with rules of RMB membership determined by present distribution of economic power, does this mean either that China does not expect institutional inertia to persist or that China is culturally-conditioned not to be unilateralist?
- Future of RMB will more likely be "ren min bi" rather than "regional monetary board"; and survival of national currencies is more likely than RMBB -- "ren min bi bloc"

What kind of feasible exchange rate cooperation in Asian economic integration if no common currency in future?

- Bilateral or multilateral swap arrangements not sustainable and won't increase to meaningful sums unless members believe that borrowed funds are used only to defend exchange rate against speculative attacks not justified by fundamentals (i.e. exchange rate has not been already rendered overvalued by domestic inflationary policy).
- Members won't have such faith unless a country is pre-qualified by an objective party that competent enough to recognise good behavior. Regional surveillance mechanism is required if regional swap arrangements (the pooled reserves) are to reach meaningful sums.
- An Asian Monetary Fund would be such a surveillance mechanism. Just as we have the World Bank and regional development banks, why not an IMF and regional monetary funds (RMFs)? Would "two heads be better than one" or "too many cooks will spoil the soup"? Well, Asia was in the soup and allowed to stew in its own juices when there was only one cook in 1997-1998.
- IMF can play helpful role in speeding up the institutional maturity of the RMF, and in keeping up the competition of ideas.
- There is no economic logic for a regional monetary fund to naturally morph into the regional central bank.
- Part of the pooled Asian reserves can be safely used to finance sound infrastructure projects in the poorest Asian countries rather than putting all reserves into assets of G7 economies. AMF can lend that part of the reserves to the ADB.

What kind of financial cooperation in Asian economic integration?

- Asian Bond Market Initiative -- How plausible is the assumption that Asian money won't panic and run away from Asia when non-Asian money panic and start running away from Asia? No support for this assumption from 1997-1998 experience.
- Establishment of a regional financial center that matches London and NY is the appropriate form of financial cooperation in Asia

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How might Asian economic integration come about?

1. Involuntary Integration!
2. Protectionism that results in either

- **Asian regionalism being imposed by default; or**
- **Asian regionalism being a defensive mechanism for the multilateral free trade system**

The International Atmosphere is Right for Protectionism

- Size of adjustment unprecedented because of
  - the 100 pct shock -- the doubling of the amount of labor participating in the international division of labor (see Table 1 below)
  - outsourcing via internet is making significant parts of the service sector open to foreign competition

Table 1: The Distribution of the Global Labor Force (millions)
(SIC countries = former Soviet bloc, India and China)

		The non-SIC countries			The SIC countries			
	Global Total	Non-SIC Total	*Developed Economies*	*Developing Economies*	SIC Total	*China*	*India*	*Soviet bloc*
1990	2,315	1,083	*403*	*680*	1,232	*687*	*332*	*213*
2000	2,672	1,289	*438*	*851*	1,383	*764*	*405*	*214*

Source: Freeman (2004). Our figure for "total" in 2000 is different from that in Freeman.

- Speed of adjustment: fast movement up value-added ladder
- Decline in US political tolerance toward trade adjustment in post-Cold War
- Unraveling of intellectual consensus in USA? Paul Samuelson’s (2004) bombshell that free trade reduces welfare of the developed country over time
- Post-September 11 syndrome in USA: insecure people don’t make the best decisions
- Europe’s likely response to US weakening support for WTO system; emergence of Fortress Europe

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Why are the US workers up in arms against globalization?

- The unemployment rate has fallen and real worker compensation has risen but churning of jobs has increased
- Worker anxiety because social safety nets in USA are particularly inadequate (see Table 2 and Table 3 below)

Table 2: US Trade Balance, Unemployment Rate, Total Compensation for Labor, and Job Tenure in Selected Years

	1987	**1996**	**2000**	**2006**
Trade Deficit as percent of GDP (%)	**3.1**	**1.2**	**3.9**	**5.9**
Unemployment Rate (in percent)	**6.2**	**5.4**	**4.0**	**4.6**
Total compensation for a full-time equivalent employee (at 2005 prices)	**$46,041**	**$48,175**	**$52,728**	**$55,703**
Median tenure at job for male workers by age group (in years)				
33 to 44	**7.0**	**6.1**	**5.3**	**5.1**
45 to 54	**11.8**	**10.1**	**9.5**	**8.1**
55 to 64	**14.5**	**10.5**	**10.2**	**9.5**

Table 3

US has among the weakest social safety nets within G7 in 2004

	% of previous pay received at start of unemplyment	Duration of benefits (months)
Germany	78	12
Canada	76	9
France	76	30
Japan	61	10
Italy	60	6
USA	53	6
UK	46	6

FINAL REMARKS

1. The Asian Situation

- Divisive factors
  - Historical factors e.g. Yasukuni
  - Different international camps (Japan and ROK are US security partners)
  - Dissimilar economic structure
- Cohesive factors
  - Establishment of EU and NAFTA
  - Experience of Asian financial crisis
  - Explosive growth of fragmentation trade
- Fundamentally, only the world market is big market enough for China and Japan
  - Regional integration as starting block, not stumbling block, for global integration?

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2. ASEAN+3 to ASEAN+6

- Integration to be starting blocks for global integration. FTA expands from ASEAN+3 to ASEAN+6 to APEC to ...
- East Asia focus broadened to include Australia, New Zealand and India in December 2005.
- Expansion balances China with India, and with Japan-ANZAC alliance (Japan-Australia security pact signed March 2007.)
- Inclusion of India is good economics (bigger the grouping, the larger the benefits), and good politics (avoids built-in confrontation between China and Japan-ANZAC alliance).
- Greater diversity means longer period to achieve deep integration, but avoidance of conflict makes outcome more certain.

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3. Different drivers for economic integration produce different forms of economic integration

- European Union – a politically-driven process powered by German money and French ideas to prevent future wars. A political union requires a common currency.
- Asia – a market-driven process powered by Japanese technological capacity and Chinese manufacturing capacity to harness division of labor. No political union, hence no common currency, needed. (*NAFTA – US plays Japan's role. Purely an economic union.*)