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Asian Monetary Coordination and Global Imbalances

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An important reason for monetary cooperation in East Asia is that it can help resolve global imbalances. Global imbalances existed well before the 1990s, but they intensified after the 1990s. While the United States bears large responsibility for the creation of these imbalances, the fact that they have not yet been successfully corrected has cast doubts on whether the United States is the only one to blame for the lack of resolution. In particular, Asia might be seen as a region that could contribute to decreasing the imbalances.

One market-based measure to help resolve global imbalances would be balancing investments and savings (I-S) in Asia. Here investment refers to real investment. Facilitating cross-border real investments, including mergers and acquisitions, would make a meaningful contribution. Another measure would be exchange rate adjustments by each of the East Asian economies. This would be, in part, market-driven as well since most of the East Asian currencies are floating either freely or with limited government intervention.

While market-driven individual actions by member economies are welcome, I would like to stress the need for government-level monetary cooperation, both to facilitate cross-border investments as well as exchange rate adjustments in East Asia. East Asian economies have a lot to gain from such cooperation, for their own sake, as well as for the sake of contributing to the correction of global imbalances.

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1 Asia's Crisis and the Call for Monetary Cooperation

The Asian financial crisis of 1997-98 showed the world that the Asian economic miracle was vulnerable. This was new; people had become used to the success stories of Japan in the 1970-80s and the subsequent success stories of the so-called tiger economies. Problems that would collectively affect the performance of most of the Asian economies were difficult to imagine. The crisis-hit countries – Thailand, Indonesia, Malaysia, the Philippines, and Korea – and their affected neighbours suddenly realised that they were vulnerable due to the close trading links among countries in the East Asian region.

At a macroeconomic level, one may argue that imprudent investment practices leading to too-risky overseas commitments were one of the reasons behind the crisis. However, a more microeconomic look at the sources of the crisis in Korea's case supports the hypothesis that one of the main culprits of the crisis was a strain in the short-term liquidity of small-sized investment companies in their foreign investments in other Asian markets. Financial risks differ between markets whose rules and regulations are different. Rules and regulations are important elements of a financial system. The Asian financial crisis was, in part, the outcome of clashes between different financial systems. In the case of Korean financial firms that went bankrupt during the crisis, it has become clear that they miscalculated and believed that their working principles would function as well in foreign markets as in the domestic market.

The Asian crisis of 1997-98 was obviously also the result of a sudden reversal of capital flows in the international capital markets, caused by contagion and the herding behaviour of investors.

Because of the crisis, a movement toward Asian monetary cooperation ensued. There had never really been such common sentiment on the need for concerted efforts toward creating and stabilising regional financial markets. The series of policy suggestions that followed the crisis included the establishment of an Asian Monetary Fund, the Chiang Mai Initiative (CMI), and the Asian Bond market initiatives. Proposals on exchange rate arrangements, ranging from a basket system to a single currency similar to the European euro, have been discussed in the context of academic and policy forums. Very recently, the introduction of an Asian Currency Unit has gained momentum.[1] However, so far only the Chiang Mai Initiative – bilateral swap arrangements for

[1] See the chapter by Fan Gang in this volume.

liquidity shortages – has obtained binding policy commitments from the participating member countries.

2 Investing Abroad or At Home?

Around the time of the 1997-98 crisis, East Asian countries became capital exporters. The risk-adjusted rate of return for overseas investment was much lower than they thought. What happened afterwards shows this rather clearly. Many East Asian economies continued to produce local capital, and instead of investing in more risky assets at home or in the region, the main destination of this capital has been safer US treasury bonds and foreign reserves.

It is no longer attractive to keep purchasing US government securities at the same level, especially since US dollars will continue to devalue vis-à-vis East Asian currencies, and levels of foreign reserves in most East Asian economies are already high. However, investing in East Asian securities is not yet attractive enough.

A weakness of the East Asian financial markets lies in the absence of local financial institutions capable of intermediating local capital to regional overseas markets. This is one of the reasons why local financial capital is not circulating sufficiently inside the region. As a result, local financial capital is either invested back to the country of origin or in low-risk US assets, while financial capital from developed countries is invested in risky assets in East Asian markets, a well-known fact today. Research (Jeon *et al.*, 2006) shows that East Asian markets seem better integrated with the US market than among themselves.

East Asia needs to create regional financial markets for Asian capital. This can be fostered effectively through monetary cooperation by Asian policymakers. While only successful with the active participation of market players, there is demand for building a monetary infrastructure that will facilitate this movement. This requires concerted efforts by national or regional authorities. A regional clearance system, harmonisation of regulations, even preferential tax treatment between regional economies, and the extension of a bilateral swap arrangement to enhance further macroeconomic stability are immediate examples of monetary cooperation for this purpose. Financial market development in each Asian nation is becoming even more important as the management of financial wealth becomes more important. Cross-border barriers within the region should be lowered for regional financial capital. The kind of

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clash that was observed during the last crisis should be avoided. Building regional financial infrastructure will lessen the risks involved in overseas financial investments between Asian markets.

Another reason for enhanced monetary cooperation is to reinforce the macroeconomic stability of regional economies to better endure shocks that are transmitted faster and in a larger scale due to stronger trade linkages across economies within the region. Note in this regard that trade among East Asian economies is high. The share of East Asia in total exports and imports has been increasing and currently ranges between 40 to 60 percent for China, Japan, Korea, and the block of main ASEAN countries (with ASEAN being highest, followed by Korea). The trade channel is strongly present in the transmission of shocks to other economies. The more open the economy is, the larger the effects from the shock would be. The share of imports plus exports in domestic production is highest for ASEAN countries, at over 60 percent, followed by Korea and China both well over 40 percent, but it is below 20 percent for Japan. Although Japan is a relatively closed economy compared to its East Asian counterparts, given its important position in East Asia and the world and the high magnitude of macroeconomic interdependency across the region, monetary cooperation including Japan is necessary.

3 Hurdles to Monetary Cooperation

The most advanced form of monetary cooperation in Asia today is the coordination of monetary policies, in particular the coordination of exchange rate policies. This has been a focal area of policy discussions in Asia since the 1997-98 crisis. Yet no agreement has yet been reached, and Asian countries still carry out their exchange rate policies quite independently.

While exchange rates are the most effective policy tool for correcting external balances and allowing the domestic economy to adjust quickly, when jointly done, the abolition of national exchange rates has the benefit of almost instantly leading to financial integration, especially of money markets, creating a larger and more external-shock-resistant financial market. As seen in post-EMU Europe, the costs can also be high as adjustment processes differ across countries, and some countries invariably lose while others gain. Thus in practice, this form of monetary cooperation is hard to achieve and requires strong political commitment.

Table 1 Macroeconomic Heterogeneity in East Asia

	CA	Credit	GDPR	INF	M2	M2M1	Open	GDP per Capita
China	2.67	1.36	8.46	1.55	1.52	2.61	0.05	1,702
Hong Kong	6.65	1.48	3.54	-0.11	2.23	13.16	2.91	24,439
India	-0.49	0.53	5.97	5.75	0.56	3.30	0.26	729
Indonesia	2.65	0.56	2.57	12.95	0.52	4.94	0.64	1,279
Japan	2.62	1.46	1.34	-0.05	1.24	2.40	0.21	35,729
Korea	2.50	0.81	4.57	3.68	0.63	7.47	0.73	16,201
Malaysia	7.72	1.50	4.68	2.35	0.98	3.93	2.09	5,090
Philippines	2.67	0.63	3.88	5.55	0.60	5.17	1.03	1,157
Singapore	20.44	0.80	4.76	0.80	1.10	5.00	2.83	26,840
Taiwan	5.51	1.61	4.29	0.91	2.02	0.25	0.87	15,280
Thailand	4.59	1.10	2.63	3.06	0.98	8.10	1.13	2,813

Notes:
Average of the annual figures of 1996-2004 for CA (Current Account Balance as percentage of GDP), Credit (Domestic Credit as percentage of GDP), GDPR (GDP growth in percentage), INF (Inflation in percentage), M1 (M1/GDP), M2 (M2/GDP), M2M1 (M2/M1), Open ([Exports+Imports]/GDP). M1 is defined as "currency in circulation+holdings of sight deposits" and M2 as "M1+ holdings of time deposits". GDP per capita is in dollar and is as of the end of 2005.

Source: Data from Global Insight, Inc., 2Q/2006.

To get an idea of the complications this type of monetary cooperation is likely to face, it is useful to look at the differences between countries. Obviously, economies that are more homogeneous will find it easier to reach more advanced types of monetary cooperation than less homogeneous countries since conflicts of interests are smaller in the former.

The macroeconomic statistics of Table 1 show that East Asian economies are very heterogeneous. But they are also institutionally heterogeneous. Table 2 shows that the degree of heterogeneity is high in the development and styles of the legal systems that reflect the practices and quality of the business services sector. For example, financial capital that prefers a common-law system and equity participation would not find Indonesia or Korea attractive. It is no wonder that financial capital from developed financial centres of New York

Table 2 Degree of Investor Protection

	Tradition of Legal System	Equity holders	Creditors	Efficiency of Judicial System
Japan	Civil	4	2	10
Hong Kong	Common	5	4	10
Singapore	Common	4	4	10
Korea	Civil	2	3	6
Taiwan	Civil	3	2	6.75
India	Common	5	4	8
Indonesia	Civil	2	4	2.5
Malaysia	Common	4	4	9
Philippines	Civil	3	0	4.75
Thailand	Common	2	3	3.25

Note:
The higher the figure is, the better the investors are protected.

Source: La Porta *et al.* (2000).

or London chooses Hong Kong or Singapore as their first destination. The projected costs can be estimated for a specific type of monetary cooperation. If we take a single currency area as an example, what would be the impact of a symmetric external shock in this area on member economies?

Table 3 indicates how different the reactions of each economy would be for the same magnitude of external exchange rate shocks over 1 year to 15 year-time after the shock, assuming a fixed exchange rate system or a single currency. Economies react very differently to symmetric external economic shocks. The absence of a national exchange rate policy under a single currency would make each member country go through very difficult, time consuming, and often costly adjustments, e.g. labour wages or prices, to correct them. This is evident in post-EMU Europe.

Ex ante heterogeneity in economies and institutional infrastructure across East Asia together with the lack of leadership and the concerns of the potential costs that would result from stricter exchange rate arrangements are significant reasons why more concrete commitments have not been reached.

Table 3 Asymmetric Effects from Symmetric External Shocks: Projected Effects of Devaluation of the Dollar by 20%[1]
(percentages)

		Korea	Japan	China
Price[2] (% changes)	+1 year	-5.36	-0.82	-1.86
	+5 year	-13.93	-2.53	-6.00
	+15 year	-25.56	-7.69	-12.36
GDP (% changes)	+1 year	-3.83	-1.14	-1.78
	+5 year	-5.19	-2.03	-3.42
	+15 year	-3.02	-2.85	-2.99
Trade Balance with the US Market (% of GDP)	+1 year	-0.91	-0.39	-1.12
	+5 year	-0.68	-0.58	-1.11
	+15 year	-0.15	-0.56	-1.10
Trade Balance with the Extra-East Asian Market (% of GDP)	+1 year	-1.54	-0.21	-1.31
	+5 year	-1.66	-0.31	-1.20
	+15 year	-0.43	-0.30	-1.08
Trade Balance with the Intra-East Asian Market (% of GDP)	+1 year	-0.05	-0.16	-0.12
	+5 year	0.05	-0.20	-0.67
	+15 year	-0.37	-0.22	-0.31

Notes:
[1] The effects are estimated compared to those at the time of the shock.
[2] Price is GDP price.
Source: Saglio *et al.* (2005).

4 Concluding Remarks

The creation of Asian financial markets for attracting local financial capital and market initiatives to increase the level of cross-border real capital investment within the region would help to resolve global imbalances, but it takes time before tangible results will be achieved. A more direct and effective measure would be the simultaneous appreciation of East Asian currencies vis-à-vis the US dollar. However, whether Asian economies are ready to coordinate their monetary policies and what the best way would be to go about doing that remain unanswered.

The hurdles are greater in the East Asian case compared to the EMU countries. Because of that, East Asia may not want to aim at a strong commitment such as a single currency. More flexible arrangements could be more suitable.

The present social, economic and political landscape of East Asia is evolving rapidly as China surfaces. Barriers are being lifted and market players as well as policymakers have learned their lessons from past experiences. With or without government-level initiatives, Asian markets appear set to develop and further explore opportunities. This is an essential and necessary condition for any type of macroeconomic-level cooperation to gain momentum and be successful. Therefore, the present state is an opportunity for Asian policymakers to develop and intensify their cooperation and coordination. Such coordination will help to resolve global imbalances.

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