Last Minute Comments on Kawai

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- This paper provides an intelligent discussion of the case for exchange rate stability, exchange rate coordination and ultimately a common regional currency in Asia.
- Leading me to my first comment:

- Comment: these three things – exchange rate stability, exchange rate coordination, and a single regional currency – are not the same thing.
- From the point of view of effects (viz. Andy Rose) and sustainability (viz. Charles Wyplosz), a agreement to stabilize rates* and a single currency are very different. And it is not self-evident that "coordination" (whatever exactly that means) is sufficient for achieving either of them.
- The three could be better distinguished in the paper.

  * Especially in the absence of capital controls

- Second comment: the argument for currency stability/coordination/unification (even if we are prepared to treat them as interchangeable) is underdeveloped.
- The NAFTA economies are tightly integrated.
- They trade heavily (including lots of VIIT) and engage in lots of bilateral foreign investment.
- They have increasingly developed vertical supply chains and transnational production networks.
- Yet their exchange rates float freely, virtually without intervention.
- (OK, Mexico has been forced to intervene because of the crisis, but then so too have a large number of other floaters.)
- But there is no appetite for exchange rate stabilization, much less monetary unification, in North America.
- And this is not simply because one country (USA) is so much larger than the other two participating in the integrated economic zone.

- How can the NAFTA economies do this?
- Answer: The existence of hedging markets (futures trading on the Chicago BOT, and a deep forward market in Canadian dollars) means that firms can hedge their exposures.
- The obvious question then is: Why can't Asia build these markets too?
- To be sure, there is an argument that they cannot hedge the exposures arising at the long durations relevant to capital investment decisions.
  - But this does not appear, in practice, to have impeded cross-border investment in the region.
  - My own work, with Hui Tong, using a gravity-theoretic model, does not show much of an effect of exchange rate volatility on bilateral FDI flows in the region.
  - I am prepared to believe that volatility discourages integration.
  - But not without evidence.

So let me turn to the evidence

- Table 1 in the paper shows changes over time in the trading of different currencies since the turn of the century.
- The big story of changes in that table is (wait for it…): no change.
  - The dollar share of total foreign exchange turnover has fallen very slightly, from 90 to 86 per cent.
  - The yen’s share has fallen very slightly.
  - The euro’s share has basically held stable.

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    - And the big winner is: the Australian dollar (I'll return to this)

- Same picture emerges from the author’s analysis of the relative importance of different currencies in international reserves.
- There is, admittedly, more movement here, but this appears to reflect mainly revaluation and devaluation effects due to exchange rate changes.
  – [A useful thing for the author to do in the paper would be to correct for this effect.]

- The most change is apparent in the relative importance of different currencies as anchor currencies for other countries' exchange rate regimes.
- But this change is accounted for almost entirely by the rising importance of the euro as the anchor currency in Greater Europe – exactly what you would expect from EU enlargement.*
- In particular, there is no evidence here of an increase in the relative importance of the yen or other Asian currencies.

* OK, as Richard noted, a few countries have switched from dollar to basket pegs, but this is "small potatoes" in the aggregate data.

- The underperformance of the yen as an international currency is a well known fact.
- It is also over-determined (many explanations for one data point).
  - Japan's reluctance to internationalize the yen historically
  - Continuing heavy regulation of some market segments.
  - Lack of deep and liquid onshore markets
  - Disappointing economic growth
- There would appear to be a clear sense on the part of most potential counterparties that other currencies (RMB) will dominate in the future.

- This last set of observations leads me, for one, to question the author's conclusion that one can make a case for the yen as the dominant international currency in Asia in the future.
- If China continues to grow 2 to 3 times as fast as Japan (a pretty conservative forecast), just as the U.S. grew 2 to 3 times as fast as the UK after 1880, sooner rather than later the yen will be dominated by something else.
- And research does not suggest that the incumbent can rely on first mover advantages for long, in the face of another country's faster economic and financial growth.
  – So suggests my research with Marc Flandreau, "The Rise and Fall of the Dollar, or When did the Dollar Replace Sterling as the Leading International Currency?"

- More generally, Section 2 of the paper seems strangely “yen centric.”
- Why not comparable discussion of the RMB?*
  - One might ask: Is the paper written by Dean Kawai of ADBI or his alter ego, Professor Kawai of Tokyo University?

* Or, to have a little fun, the Sing dollar or the Aussie dollar?

- The paper then runs through the familiar OCA criteria and shows that Asia does not compare unfavorably with Europe on this score.
- This is correct.
- But it is also irrelevant.
- These criteria have little to do with the decision of whether or not to integrate and cooperation on regional monetary affairs.
- Politics, not economics, tells the tale.

- How about thinking, therefore, about whether regions satisfy the *political* preconditions for a regional currency or sustainable regional exchange rate arrangement.
  – Spell them out.
  – Quantify them.
  – Show us that Asia doesn't rank far behind Europe on this metric.

- Specifically, one could follow Bayoumi and Eichengreen, "Ever Closer to Heaven: On the Empirics of Optimum Currency Areas," and give countries numerical ratings not for economic criteria but for the relevant *political* criteria.
  - Willingness to cede national sovereignty.
  - Willingness to create transnational institutions.
  - Presence or absence of common political systems (parliamentary democracy, for example).
  - Comity of the two leading powers in the region.
  - Support from extra-regional powers for the creation of a regional currency (recall US support for Europe's initiatives, starting way back with the EPU, and contrast the US response to the Asian Monetary Fund).

- The paper then turns to Asia's actual exchange rate arrangements and their performance in light of recent events.
- Here is where I had hoped to find an analysis of some of the big things have been happening in the world – and the region – in recent months.
- We want a proper counterfactual analysis of the global credit crisis.
  - Would the spread of the crisis to Korea (and other countries) have been slower had the country pegged to the yen instead of floating?
  - Would it have been slower if Korea had maintained a basket peg?
  - What is the analogous verdict for other countries?

- The big problem for Korea and others has been dollar liabilities and limited access to dollar liquidity (except, now, from the Fed).
  - Would this problem not have arisen in the same way, or would it have been alleviated more easily, had Korea pegged to the yen or an Asian basket?
    - Would Korea have borrowed less?
    - Would Korea have borrowed yen instead?
    - Would this have been a good thing from the points of view of crisis avoidance and crisis resolution?
    - Would the BOJ have extended yen swaps?

- My own conclusions are the following. Had Korea been pegging to the RMB and yen rather than floating up against the dollar, borrowing in the dollar area would have been even greater.
- Vulnerabilities now would have been even more serious.
- Had Korea been committed to pegging against other Asian currencies, it would be in truly deep **** now that capital flows have turned around with a vengeance.

- This brings us again to the distinction between currency stabilization (pegging) and currency unification (a single currency with a single central bank).
- These are decidedly not the same (though they tend to be treated similarly if not interchangeably in the paper).
  – In Europe, pegging countries (Estonia, even Denmark) have been up the river without a paddle in the current crisis.
  – Members of the euro area, in contrast, have been sheltered because they enjoy a domestic currency lender and market maker of last resort with essentially unlimited resources.

- Finally, how can we continue to talk about collective pegging in Asia when there is such patent reluctance to extend financial supports?
  - Why no CMI activation in the crisis?
  - Where has been the formal agreement to pool reserves?
  - Why have there been no big, formal bilateral swap arrangements announced (only hinted) by Beijing and Tokyo?
    - If we know one thing about exchange rate pegging arrangements, it is “no reserve pooling, no sustainability.”

- My recommendation: let’s have a moratorium on calls for exchange rate coordination in Asia (I know – I already called for a moratorium on OCA comparisons!) until we first see actual extension of swaps and credits through the CMI and the creation of an honest-to-god reserve pool.

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- There is a sense, of course, in which the yen is the most important international currency not just in Asia but for the entire world.
  - That is the yen as the currency on one side of the carry trade.
  - Without this we would not have seen the financial boom and, now that carry trades are being unwound, bust in Asia.
  - I make this comment half in jest, of course. But there is also a serious point. Having other countries link to the yen (or to a basket in which the yen has a significant weight) is highly problematic for the rest of the region when Japan has close-to-zero interest rates (which are a recipe for carry trades).

- Bottom line: be careful what you hope for!
- Thank you very much.