Comments by Klaus Regling

on

Exchange Rate Cooperation in East Asia: A European View and a Simple Solution
by
Charles Wyplosz and Yung Chul Park

Tokyo Club Foundation, Tokyo, 11 November 2008

I agree with much of what the paper says.
Therefore, I will

1) Highlight a few points in the European experience that I consider to be particularly important for Asia.
2) Look at the Asian reality today, as I see it, and make some comments on the paper's proposal for using "own pegs".
3) Conclude with two key questions that are relevant for the future development of Asian monetary cooperation.

First, what are the **lessons from Europe's monetary integration experience**, which led to the euro, **for Asia**?

I agree with the main points in Charles and Yung Chul's paper:

- Europe's monetary integration has been mainly inward looking. We talked about that this morning.
- The existence of the ECU was not important for progress in monetary integration.
- It was the Exchange Rate Mechanism (ERM) that was instrumental.

However, I want to add two qualifications:

- Even if exchange rate coordination is the key for achieving monetary cooperation, countries need more than "just" monetary cooperation to prepare for a monetary union. Other macro-economic policies are important as well, like fiscal policies, and some key structural policies. The objective must be to reach more convergence in economic developments overall, not only in monetary developments.
- 2nd qualification: I don't fully agree with the paper's statement that the ERM went through its crisis in the early 90s because capital controls were removed. Several

countries in the ERM had already removed capital controls much earlier, including Germany, Austria, the Netherlands and the United Kingdom. As you know, exchange rates between Germany, Austria and the Netherlands were stable in the second half of the 80s and through the 90s until the begin of EMU. The Pound Sterling, on the other hand, had to leave the ERM.

This shows that other factors were at play in the ERM crisis of the early 90s. It was not a question of the free flow of capital or at least not predominantly but, again, more a question of convergence in economic policy making and convergence of economic developments.

Second, how is the Asian reality today with respect to monetary cooperation?

Again, I agree with Charles and Yung Chul that, so far, "Asian countries have [mainly] focused on treating the symptoms, not the causes of currency instability."

It seems that the political will to go further and to create the mechanisms needed for real cooperation across a range of economic policies is not there. In addition, on the exchange rate side, as the paper notes, cooperation in ASEAN+3 is not really possible with Japan (as long as Japan wants to be a "floater") nor with China (as long as China is – basically– pegged to the US$ and imports Fed-monetary policy).

All this leads to the interesting question, which countries in Asia could or should work more closely together. The paper dos not try to address this question. It deals mainly with ASEAN+3 although Taiwan is also mentioned at one point.

But other possibilities exist:

- Prof. Woo talked about ASEAN+6 earlier today which, importantly, would include India. However, adding countries would make cooperation and coordination even more complex.
- Should only the 10 ASEAN countries move ahead? ASEAN has the objective of creating a Single Market by 2015. And work is going on in many policy areas to move in that direction. Take, for example, aviation where an integrated market is scheduled to be achieved by 2012; relevant agreements were signed last week. It is details like these that led to a sufficient degree of economic integration in Europe that allowed EMU to become possible.

Without the political will to cooperate across a wide range of policies, it is understandable that Charles and Yung Chul looked for soft options for monetary policy cooperation. The proposal that countries use their "own pegs" could be such a soft option.

However, I have two observations:

a) Such an approach does not really "resemble" the ERM strategy in Europe (page 13). The ERM worked also because the ERM had a clear anchor currency, the DM, with the lowest inflation rate, the lowest interest rate and an important economic weight; and because the ERM was underpinned by a strong, institutionalised surveillance mechanism.

b) The proposed "own peg"-approach may appear soft initially. But what happens if a country needs to change its peg? Would this require agreement or even consensus with the partners as in the ERM?

The paper only discusses the case that the initial peg might be too low or too high and argues that this could be easily corrected through temporarily higher or lower inflation than in the partner countries. This is a bit theoretical. To achieve temporarily higher or lower inflation than in partner countries is not that easy to engineer and can be costly.

In addition, as our experience in Europe shows, economic imbalances can emerge even if the initial pegs were correct. Divergent economic policies and/or Balassa-Samuelson effects (wich could be particularly important in Asia) may make changes in the initial pegs unavoidable. Therefore, a mechanism to deal with changes in exchange rate pegs needs to be established. Moreover, if partner countries are asked to defend jointly the agreed pegs with joint interventions in the foreign exchange market, surveillance mechanisms need to be in place.

The proposal by Prof. Wyplosz and Prof. Park may therefore appear soft initially, but stronger cooperation would be required sooner or later.

Let me end with two conclusions.

a) Monetary cooperation and exchange rate coordination require a lot of political will to be successful. Technically well designed mechanisms, like "own pegs", can be helpful to get the process started. To go as far as Europe, common binding rules (in Europe laid down in a Treaty comparable to a constitution) and common institutions (European Commission, European Parliament, European Court of Justice) are indispensable. Without binding rules and efficient institutions, integration cannot proceed very far.

b) If the political will to achieve much stronger exchange rate cooperation does not exist at the moment or for some time, could the ACU play a stronger role in Asia than the ECU in Europe?

As the paper says, and I agree, the ECU did not play an important role for monetary integration in Europe. But this may be different in Asia if integration cannot proceed very far. In that case, the ACU may be helpful to develop a regional bond market in Asia.

Charles and Yung Chul do not attach much importance to this possibility and argue that if the demand for such an instrument existed, private institutions and the markets would have created it.

I am not convinced. We may see a market failure here. The value of the ACU would be more stable than the value of any of its constituent currencies. Borrowing in ACU would be less risky than borrowing in foreign currency. And if, with the initial help of governments, ACU bonds became an important market, they could soon be more liquid than national bonds, thus reducing transaction cost. All this could reduce the vulnerability of Asian borrowers (sovereigns and corporates) and might also provide an impetus for more cooperation and surveillance.

Therefore, if deeper monetary integration in Asia proves to be impossible, the ACU option should be kept on the table even though the ECU was unnecessary in Europe.