Comments on Professor Wing Thye WOO's Paper on "A Realistic Vision of Asian Economic Integration"

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I enjoyed very much reading Professor Woo's paper, which provides a strong case for establishing an Asian Monetary Fund, based on the lessons drawn from the Asian financial crisis ten years ago.

Consequences of foreign exchange accumulation by Asian countries

The paper correctly pointed out that Asian countries have learnt the following two lessons from the 1997-98 crisis, namely, 1) occasional excessive price movements in financial markets are normal and 2) the only form of reliable help during an economic emergency is self-help.

These two lessons together propelled the Asian countries to accumulate immense foreign exchange reserves to insulate themselves from speculative attacks. Indeed, thanks to very large holding of foreign exchange reserves, the Asian countries have so far successfully weathered the ongoing global financial crisis.

However, the accumulation of foreign exchange reserves has led to some adverse consequences not mentioned in the paper.

First, the Asian countries' efforts to accumulate foreign exchange reserves by running large current account surpluses have been a major source of the global savings glut that pulled down global interest rates to historically low levels. In particular, large-scale capital inflow into the US, in the form of Treasury bond purchases by Asian central banks, allowed the US to live beyond its means, sowing the seeds for the current global financial crisis.

Second, in some Asian countries, notably China, the rise in foreign exchange reserves has boosted liquidity, leading to assets bubbles and rising inflationary pressure.

Third, it is inefficient, if not unfair, for poor countries such as China to lend immense amounts to such a rich country as the United States while the lender needs funds to put in place basic infrastructure – both hard and soft – at home. In the case of China, for example, this would include spending on education, health care, environmental protection, and a social security system that covers both rural and urban areas.

Finally, it has come to be realized that US Treasury bonds are not a risk-free investment when exchange rate and price fluctuations are taken into consideration.

How to minimize these side effects

What, then, should the Asian countries do to minimize these effects and to protect themselves?

First, pooling part of their reserves together in the form of an Asian Monetary Fund should help Asian countries economize on reserve holding because they could borrow from the Fund in case of emergency.

Second, instead of continuing to accumulate foreign exchange reserves, Asian countries should pursue such measures as better supervision of financial institutions and tighter capital controls to prevent another financial crisis from happening.

Third, Asian countries should improve their financial systems so that domestic savings can be transformed more efficiently into domestic investment.

Fourth, major creditor countries such as China and Japan should ask the US to issue Treasury bonds denominated in their currencies (that is, yuan in the case of China and yen in the case of Japan) as a condition for further lending. (We may call them "Obama bonds.") In addition to protecting them from the risk of a falling dollar, this should also impose discipline on the United States so that it would not abuse its privilege as the key currency country.

As a footnote here, I have some reservations about the feasibility of establishing an Asian bond market based on some form of ACU. In the absence of exchange rate stability among Asian currencies, the exchange rate risk involved would make this market unattractive to both borrowers and lenders. I think the priority should be put on the development of domestic bond markets instead.

Criteria for an optimum currency area

Turning to the possibility of forming a monetary union in Asian, the paper has emphasized the relative size of member countries as the major determinant. It is probably true that, as argued by the author, because of political considerations China would not accept a "yen bloc" dominated by Japan now, while Japan would not accept a "yuan bloc" led by China in the future. However, it is not obvious to me why, based on economic reasoning, countries with similar sized economies are more likely candidates for a monetary union. In reality, small countries such as Luxembourg and Malta have adopted the euro as their currency while the U.K., whose GDP is on par with that of Germany and France, has not. There are also examples of small economies, such as Hong Kong, pegging their currencies to the US dollar.

More emphasis should be placed on the relative level of economic development (as measured by per capita GDP), rather than relative economic size (as measured by GDP) of potential members when considering the possibility of monetary integration in Asia. With developing countries catching up with advanced nations, and interdependence among them growing as a result of rising trade and investment, we will see stronger synchronization of business cycles among Asian countries. As a result, the benefit of stable exchange rates among Asian countries will increase, and for these countries the cost of giving up control over their monetary policies will decline.

Is history repeating itself?

Finally, I would like to take this opportunity to raise one question not directly dealt with in this paper, but closely related to it. That is:

What is the major cause of the current US financial crisis? Should it be attributed to crony capitalism, or financial market panic, or the Bush Administration's incompetence?

Beside Professor Woo, I welcome comments from other experts around this table, particularly those from the United States,