

Exchange Rate Cooperation in East Asia: A Simple Solution

Charles Wyplosz and Yung Chul Park

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Current orientation

- Two pillars
 - Asian Bond Market Initiative
 - Develop regional markets in regional currencies
 - Chiang Mai Initiative
 - BSAs and now SRPA
- Both deal **indirectly** with monetary cooperation
 - A defensive approach
 - Exchange rates out of the picture

Contrast with Europe

- Similarity
 - European Monetary Cooperation Fund
 - Reserves pooling
 - Never worked
- Differences
 - Global integration of bonds and other financial markets
 - Direct agreement on exchange rate management
 - ERM, eventually single currency

The difficulties of exchange rate cooperation

- Requires commitments
 - To tie down monetary policy
 - To provide mutual support
 - To choose an anchor
- The temptation of regional currency unit
 - ACU, proposed by EDB
 - ECU in Europe
 - Formal but largely useless

A suggestion (not new, but with a twist)

- Williamson: common basket (variable) pegs
- ACU
 - a basket of regional currencies
 - evaluated vis à vis a basket of international currencies (US\$ = 65% and € = 35%)
 - basket used as divergence indicator for surveillance (soft cooperation)
- Our proposal: own basket (variable) pegs

Arithmetics of basket pegs

- Effective exchange rate

$$e_i^{eff} = \sum_{j \neq i} w_{i,j} e_i^j$$

$i \notin I = \text{ASEAN} + 10$
 $j \in J = I + K \rightarrow \text{Others}$
 $\searrow Z = (\$, \text{€}, Y)$

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- Own basket (in US \$)

$$h_i^{\$} = \sum_{z \in Z} h_{i,z} e_z^{\$} \longrightarrow h_i^{eff} = \sum_{j \in I, j \neq i} w_{i,j} h_i^j + \sum_{k \in K} w_{i,k} h_i^k$$

$$h_i^j = h_i^{\$} - h_j^{\$}$$

$$h_i^k = h_i^{\$} - e_k^{\$}$$

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$$c^{\$} = \sum_{z \in Z} c_z e_z^{\$}$$

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- Common basket (in US\$)

$$c^{\$} = \sum_{z \in Z} c_z e_z^{\$} \longrightarrow c_i^{eff} = \sum_{j \in I, j \neq i} w_{i,j} c_i^j + \sum_{k \in K} w_{i,k} c_i^k$$

Arithmetics of basket pegs

- Result

$$h_i^{eff} - c_i^{eff} = \left(\sum_{z \in Z} (h_{i,z} - c_z) e_z^{\$} \right) - \sum_{j \in I, j \neq i} \left(w_{i,j} \sum_z (h_{j,z} - c_z) e_z^{\$} \right)$$

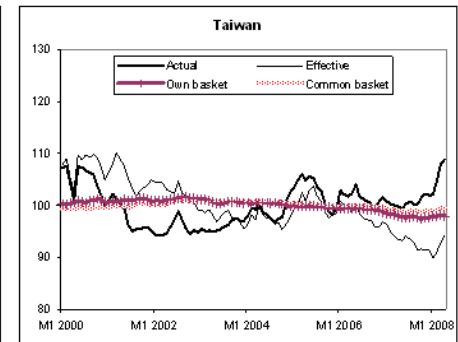
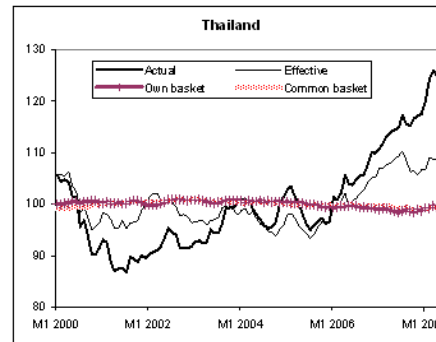
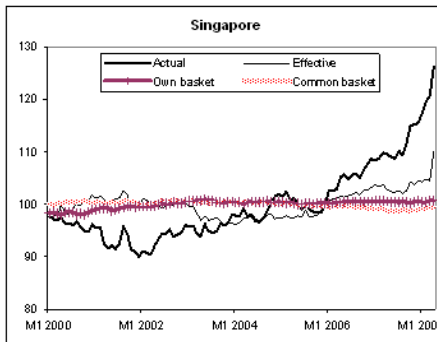
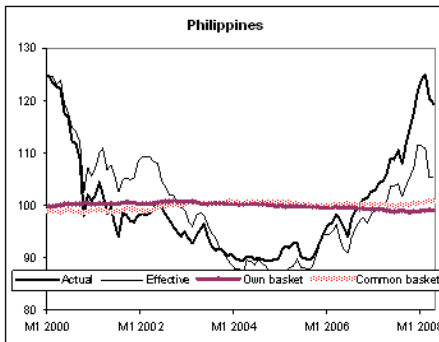
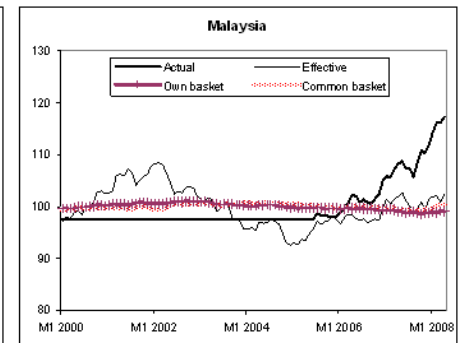
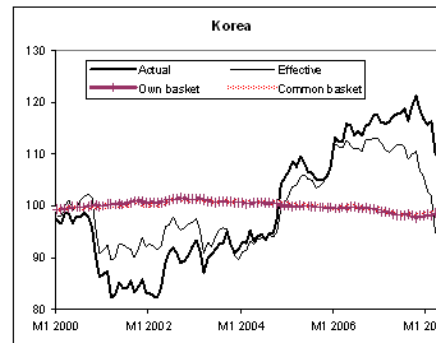
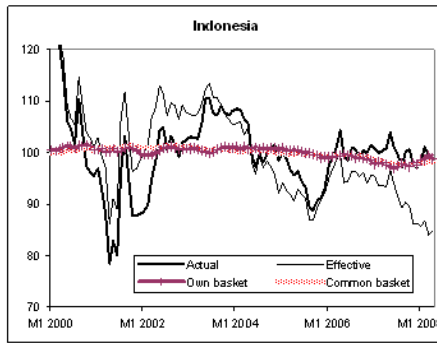
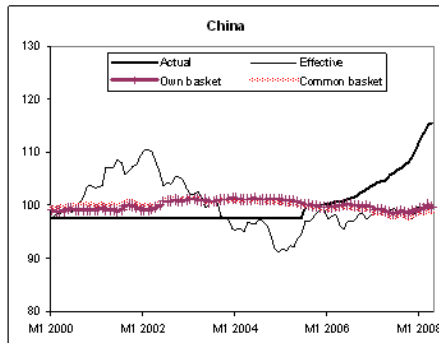
Differences in home
country weights

Differences in other
ASEAN countries
weights

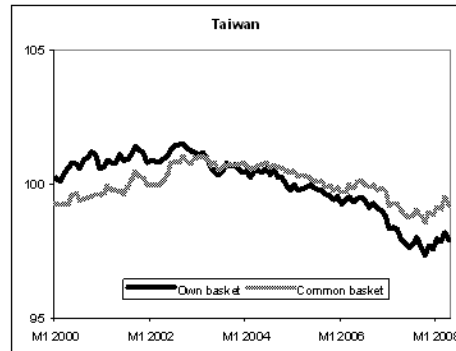
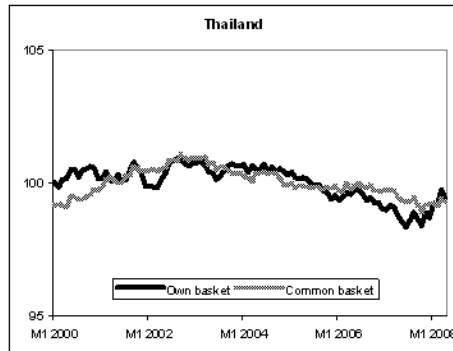
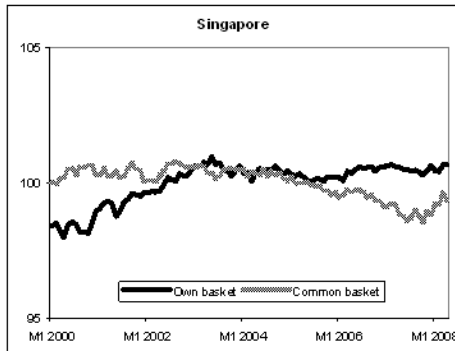
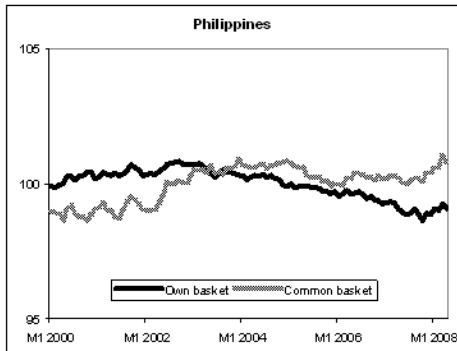
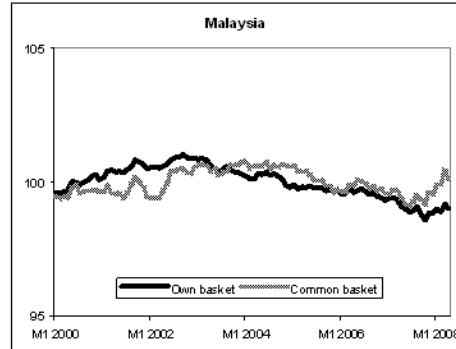
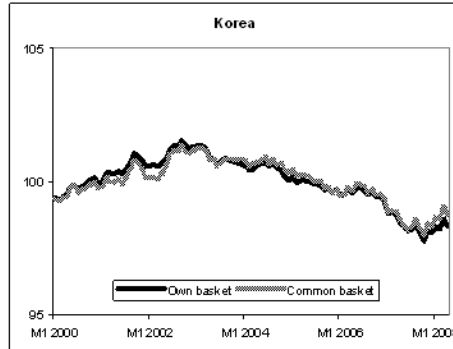
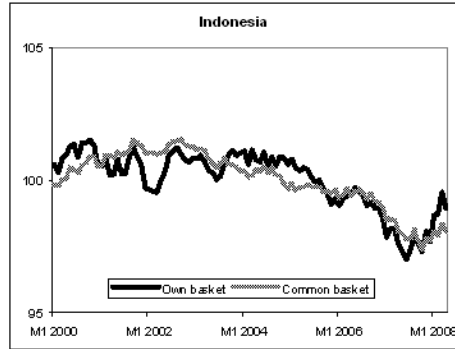
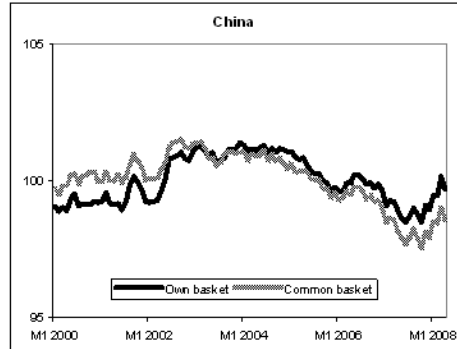
Counterfactuals

- Not all ASEAN countries
- $K = 49$ countries
- Trade weights: 2000-2

Counterfactuals



More details



Implications and questions

- No need to seek agreement on common baskets
- Three-currency basket pegs greatly stabilize currencies
 - But pegs must be upheld
 - Loss of policy autonomy
 - Stability may not be desirable
 - Issue of mutual surveillance
 - A positive role for CMI
 - Similar to ERM