

ASIAN MONETARY COOPERATION: LESSONS FROM THE EUROPEAN MONETARY INTEGRATION

WOOSIK MOON*
YEONGSEOP RHEE**

With the recent currency crises accompanied by the launch of the euro, interest in Asian monetary cooperation is increasing. In fact, interdependent Asian economies are in good condition to support it. If Asian monetary cooperation happens, Japan is expected to play a leading role given its economic importance in the region. The currencies of Asian countries can be in one way or another linked to the Japanese yen. The question is whether Japan would be willing to assume its full responsibility as the key currency country. There is, however, little hope that Japan will take this role in the near future as the current proposal for an AMF does not include any hint of a lender of last resort, which has been such a precious asset to the viability of European monetary integration.

1. INTRODUCTION

The recent currency crises accompanied by the launch of a single currency, the euro, in Europe has raised serious discussions about possible Asian monetary cooperation.

Many studies indicate that the Asian currency crises resulted from exchange rate mis-alignment between the yen and Asian currencies, triggered from a sudden exchange rate variation between the yen and the dollar. The effect of the sharp depreciation of the yen vis-à-vis the dollar turned out to be devastating, given that Asian countries had mostly pegged their currencies to the dollar while their economies had been deeply linked to the Japanese economy. Greater exchange rate instability and uncertainty in the region were not only causes of the crisis but will also be big obstacles to regional economic growth and recovery.

The launch of the euro may intensify the exchange rate instabilities of Asian currencies because the increasing chances of policy conflicts between the US, Europe, and Japan will lead to greater mis-matches of exchange rates between the dollar, the euro, and the yen. In particular, if the European Central Bank (ECB) becomes inward-looking and adopts a benign neglect policy as the US does, many countries will be victims of the mutual benign neglect policy of two superpowers and the movement of exchange rates between the euro, the dollar and the yen may be dangerously destabilizing.

To stabilize the currencies of Asian countries and prevent the crises from re-occurring requires close regional monetary cooperation. Currently, the need for Asian monetary cooperation is stronger than ever (Yam, 1998; Curtis, 1998; Moon, 1999).

So far, studies on Asian monetary cooperation, for example, Bayoumi and Eichengreen (1994), Eichengreen and Bayoumi (1999), Frankel and Wei (1994), Goto

*Professor, Economics, Graduate Institute for International and Area Studies at Seoul National University, Korea.

**Professor, Economics (International Finance), Sookmyung Women's University, Korea.

and Hamada (1994), Kwan (1998) and Rhee (1999), have focused largely on evaluating the economic conditions for regional monetary integration and have not dealt with concrete proposals. However, Japan has recently proposed the setup of an Asian Monetary Fund. There are two good reasons for this. First, Japan wants to keep its hegemonic position in the region by seeking to dilute the criticism that it has triggered and extended the Asian currency crises. Second, as the world economy is polarized into dollar and euro blocs, Japan feels increasingly isolated and fears that the yen will lose its international currency role in the international monetary scene. This has led Japan to actively grope for a new international or regional monetary system. For instance, even after the initial proposal for an Asian Monetary Fund received strong opposition from the US and the IMF, Japanese finance minister Miyazawa announced again a plan to set up a 30 billion dollar support fund for Asian countries in his speech at the IMF-World Bank meeting in 1998. More recently during the visit to Europe in January 1999, Japanese Prime minister Obuchi proposed a reference exchange rate system between the dollar, the euro and the yen, which can be considered as a sort of exchange rate target system.

But, there seems a basic limit to these proposals because the attitude of Japan remains basically unchanged. First, Japan is not yet ready to assume full responsibility for Asian countries but seems only to enjoy the seignorage benefits from the increased use of the yen. Until recently, Japan had been lukewarm about the internationalization of the yen on the grounds of the loss of monetary autonomy and the reduction of the current account surplus. Given that the current proposal for an AMF consists of providing a finite amount of US dollars as emergency loans, it seems that these Japanese concerns have not disappeared at all. It is then doubtful whether Japan is really committed to bear the burden as the key currency country. Second, these proposals are too Japan-centered and do not attempt to reflect equally the interests of other Asian countries. For example, the focus of the Obuchi plan seems fixed on the US and Europe, not on Asia even though exchange rate stability between the key currencies may help all countries including Asian countries.

The present paper aims to examine Japan's proposal on Asian monetary cooperation and derive some lessons from the European monetary integration experience. Especially, from the success of the EMS it will show that what is essential for the stability of exchange rates is the provision of sufficient liquidity. This can only be guaranteed by the condition that the central bank with the weak currency can resort to unlimited intervention credit from the central bank with the strong currency.

The paper is constructed as follows. In section II, the need for Asian monetary cooperation is briefly reviewed. In section III, the current economic conditions in Asia are evaluated and compared with those in European countries to see to what extent Asian monetary cooperation is possible. In section IV, the past yen bloc and the current proposal for an AMF are assessed and criticized. In section V, the liquidity support facility that can be considered as the most essential element of European monetary integration is explained and in this context the limits of an AMF are examined.

2. THE NEED FOR MONETARY COOPERATION IN ASIA

With the introduction of the euro as well as the outbreak of the Asian crises, there are at least four important reasons for Asian monetary cooperation.

First, Asian monetary cooperation is needed to stabilize the value of Asian currencies. One of the underlying reasons of the Asian crisis was that the exchange rates of Asian currencies could not reflect the exchange rate fluctuation between the dollar and the yen. Before the crisis, Asian countries had mostly pegged their currencies to the dollar, while their economies had been deeply linked to the Japanese economy. Through the second half of the 1980s to the beginning of the 1990s, the yen appreciated against the dollar, benefiting Asian countries. They recorded high growth, rapid export increase, and relatively stable inflation. The scene changed dramatically after the yen depreciated vis-à-vis the dollar. Since 1995, the yen had depreciated about 50 percent and the following appreciation of Asian currencies against the yen brought about devastating real effects through the worsening of the balance of payment and excessive production. Some say this discrepancy of Asian currencies was caused by the pegged exchange system of the Asian countries. However, it was caused by the yen/dollar exchange rate instability due to the benign neglect policy of the US rather than the pegged system itself.¹

With the introduction of the euro, the exchange rates of Asian currencies may become more unstable because the chances of policy conflicts among the US, Europe, and Japan are becoming greater. Also mismatches of exchange rates between the dollar, the euro, and the yen can be increasingly serious. If the ECB becomes inward-looking and adopts the same type of exchange rate policies as the US Fed², as some fear it will, many countries will be victims of the benign neglect policy of two superpowers. In order to reduce the exposure of Asian currencies to the vagaries of outside currencies and prevent detrimental effects on trade and the economies, Asian countries need a monetary cooperation through which their currencies can be stabilized.

Second, to prevent another crisis, a monetary cooperation instrument through which enough liquidity can be provided in urgent situations is essential. In a world of financial integration, most countries cannot be insulated from global movements of capital. In particular, Asian countries have been at the forefront of the worldwide movement toward increased financial integration, and even with the best economic management they are now very vulnerable to disruptive effects of international capital flows.

If the IMF or other international organizations can readily provide enough liquidity when Asian countries are attacked by vagrant international capital and temporary shortages of liquidity, then Asian countries only have to promote sound economic policies, following the suggestions of these organizations. As we have experienced, however, they cannot depend on these organizations as lenders of last resort to provide international liquidity to countries that are temporarily illiquid but ultimately solvent.

¹McKinnon (1998) also pointed out that the Asian crisis was not caused by the pegged system itself but by the instability of the yen/dollar exchange rate.

²The policy of the US is summarized by the expression that "the dollar is our currency but your problem".

Thus, Asian countries that want to avoid the detrimental effects of exchange rate crises due to international capital flows must protect themselves. Liquidity is the key to self-protection (Feldstein, 1999). A country that has substantial international liquidity is less likely to be the object of a currency attack, and can defend itself better and make more orderly adjustments when it is attacked. However, no matter how much liquidity a country holds, it is dwarfed by the magnitude of international capital flows and a country cannot protect itself alone against the attack of international capital. Therefore, a monetary cooperation through which a ready source of international liquidity is available is needed for Asian countries, in particular, small Asian countries.

Third, monetary cooperation is also needed to escape from economic turbulences caused by the currency crises and reduce the risk of competitive depreciation in Asia. When a country is severely damaged by a currency crisis, its best policy to overcome it would be the promotion of exports, because the country can accumulate foreign currencies and boost its economy through export expansion. Thus, Asian countries under pressure were tempted to use a devaluation policy, raising fear of competitive devaluation of Asian currencies.

However, as the experience of competitive devaluation in the interwar period showed, this beggar-thy-neighbor policy will deteriorate international trade and lead to a worldwide recession. Therefore, Asian countries need monetary cooperation to overcome the crisis by preventing the devastating effect of competitive devaluation.

Also, currency stability through monetary cooperation is needed to overcome the crisis by enlarging economic potential as well as by preventing competitive devaluation. Since Asian countries are all together affected by the crisis, their domestic demand is reduced and cannot afford to import. For the time being, only the US and Europe are absorbing the exports of Asian countries. But it cannot be sustained; there are already reports that US trade deficits are increasing at historically record levels. Therefore, in order to eventually overcome the crisis, Asian countries together have to stimulate their economies. But a country that unilaterally takes an expanding policy may fall prey to a drain of foreign reserves and speculative attacks. To boost Asian economies without the loss of foreign reserves, it would be better to promote intra-regional trade based on stable currencies through monetary cooperation.³

Finally, the polarization of the world monetary order into the dollar bloc and the euro bloc also encourages the Asian monetary cooperation. On one hand, the launch of the EU provides a good example that various currencies can be fused into one currency through compromising domestic policies. This will boost hitherto lukewarm support of monetary integration analogous to the EU in many areas over the world.

On another hand, when a region forms a monetary union, incentives emerge for outsider countries in the rest of the world to form countervailing monetary unions to compensate for the loss of welfare due to the original union. A formation of a monetary union benefits member countries and costs outsider countries for the following reasons. The gain in economic efficiency due to currency stability through a monetary union

³The pursuit of a trade bloc will enhance the possibility of a monetary bloc and conversely the strengthened monetary cooperation will complete the internal trade liberalization. This is especially clear for Europe because the introduction of the euro was presented as the completion of a single market.

may benefit both member countries and outsider countries. But the cost reduction of intra-regional transactions due to the exchange rate stability will make intra-regional trade more profitable, and intra-regional trade will be increased at the expense of inter-regional trade. Also, when a region forms a monetary union, the currency of the union will be used more and more while the currencies of outsider countries will be used less and less, according to economies of scale. Then, the trade of outsider countries will be more constrained by a lack of international liquidity than before, and negatively affected by the formation of the original monetary union. The formation of the EU and the expansion of the dollar bloc may have these damaging effects on Asian countries, and a countervailing Asian monetary cooperation is needed to compensate for the loss of welfare.⁴

3. EVALUATIONS OF THE CURRENT CONDITIONS IN ASIA

We can consider the following criteria to evaluate the conditions of monetary cooperation in Asia: symmetry between shocks affecting countries in the region; factor mobility; openness and economic interdependence of member countries; and similarity of policy objectives.

First, when the shocks to the countries in the region are symmetrical, they can be offset with a similar stance on monetary policy and the costs of giving up an independent monetary policy will be small. To measure the degree of synchronization of real as well as monetary disturbances among Asian countries and to compare the degree of synchronization with that among EU countries, Goto and Hamada (1994) performed principal component analysis.⁵ According to their results shown in Table 1, in the case of real disturbances (IS disturbances), the first principal component explains 46.1 percent of the total variance in Asia, whereas it explains less than one-third of the total variance in Europe. This implies that Asian economies are subject to real disturbances that are more synchronized than European countries. For monetary shocks, on the other hand, the first principal component explains the total variance in Asia slightly more than in Europe, which means that monetary shocks show about the same degree of symmetry for both Asia and Europe. Based on these results, they conclude that there are at least as good reasons for forming a currency union in Asia as in Europe.

⁴Goto and Hamada (1995) show the damaging effect of regional economic integration on outsider countries in a trade model with increasing returns to scale and product differentiation.

⁵A more detailed description of the procedure of principal component analysis, see Goto and Hamada (1994).

Table 1. Principal Component Analysis of Macroeconomic Disturbances

	Asia	Larger EU	Smaller EU
Real disturbances	0.461	0.259	0.303
First principal component	0.657	0.491	0.575
Second principal component	0.809	0.678	0.747
Third principal component			
Monetary disturbances	0.410	0.320	0.385
First principal component	0.634	0.529	0.593
Second principal component	0.772	0.686	0.755
Third principal component			

Source : Goto and Hamada (1994), p.379.

Note: 1. Asia includes Korea, Taiwan, Singapore, Indonesia, Malaysia, Philippines, and Thailand.

2. Larger EU includes Germany, France, Italy, United Kingdom, Spain, Netherlands, and Belgium.

3. Smaller EU includes Luxembourg, Ireland, Portugal, Greece, Denmark, Belgium, and Netherlands.

Second, if labor and capital mobility is high among the countries in the region, it will be easy to redress macroeconomic imbalances arising from asymmetric shocks and the costs of joining a monetary union will be small. Since comprehensive data for labor mobility in Asia are not easy to obtain, we only present data for capital mobility in Table 2. The table shows the ratio of intra-regional foreign direct investment (FDI) to the GDP of the region. The ratio of intra-region FDI to the regional GDP is the highest in Asia (1.02 percent), followed by the EU (0.82 percent) and the lowest in the NAFTA (0.18 percent). Moreover, most FDI of Asian countries flows to Asia. For example, Asia invested more than 64.9 percent of total outward FDI within Asia in 1996, which is higher than the figure for the EU (51.6 percent) and the NAFTA (14.6 percent). This implies that the degree of capital mobility among Asian countries is as high as that among the EU countries, which could be another rationale for creating a common currency area in Asia.

Table 2. Intra-regional FDI, 1996

	Asia	EU	NAFTA
Intra-regional FDI (A)	70.8	62.6	14.0
Regional GDP (B)	6968	7603	7967
Total FDI Outflow (C)	109.1	121.2	96.5
A/B	1.02	0.82	0.18
A/C	64.9	51.7	14.5

Source : JETRO (1998b) ; International Financial Statistics.

Note : 1. Asia includes Japan, Asian NICs (Korea, Taiwan, Singapore), ASEAN 4 (Thailand, Malaysia, Philippines, Indonesia), and China.

2. EU countries are 15 nations.

3. NAFTA includes Canada and US.

Third, if a country is very open, its ability to affect output and employment by exchange rate is very limited. For example, when a very open country devalues its currency to promote exports and the economy, it will quickly be faced with the problem that a devaluation just raises the domestic price level without affecting the real exchange rate, and its exports and output will be little affected. Therefore, the costs of giving up an autonomous monetary policy are small for an open economy. To compare the openness of Asian countries with that of EU countries and the US, we present data on the ratio of the amount of trade to GDP in Table 3. According to the table, Asian countries have an extremely high degree of openness ; the amount of trade in some countries such as Singapore, Hong Kong, and Malaysia is even greater than their GDPs. Among Asian countries, Japan has the lowest degree of openness at 18.4 percent. Compared to the EU and US whose degrees of openness are respectively 17.2 percent and 18.7 percent, Asia has a higher degree of openness at 37.6 percent. This data also implies that Asia is a good candidate for a currency union with a fixed exchange rate system.

Table 3. Degree of Openness and Intra-regional Trade

	Degree of Openness	Intra-regional Trade (%)
Asia	37.6	75
EU	17.2 (52.0)	62
US	18.7	54

Source : International Financial Statistics and Langhammer (1998).

Note : 1. Degree of openness is the ratio of trade to GDP in 1997.

2. Intra-regional trade is the ratio of intra-regional trade to their total trade in 1995.

3. The number for EU in () includes trade among member countries.

When the economy is open and its intra-regional economic interdependence is high, not only is the cost of a monetary union small but the benefit is also large. The major benefits of a currency union are gains in economic efficiency due to the elimination of transaction costs and the elimination of risk coming from the uncertain future movements of exchange rates. With economic integration within a monetary union in terms of trade, labor movements, and capital flows, the benefits of joining the union increases. Economic integration can be represented by intra-regional trade. The share of intra-regional trade in Asia (75 percent) is much higher than in the EU (62 percent) and in the US (54 percent), as shown in column 2 of Table 3, which suggests that the potential benefit of an Asian monetary union is large compared to other regions. The increase in intra-regional trade has largely reflected the growing importance of the Asian NICs and China, and the potential benefit will increase with the growth of those economies.

Fourth, if policy objectives differ widely among Asian countries, then the effort to design a monetary union will be complicated even if they share similar shocks and have high factor mobility and degree of openness. The economies in Asia are a very

diverse group; there are wide differences with regard to political institutions, economic systems, development levels, etc. Thus their policy objectives are believed to be conflicting, and the concession of their sovereign right over monetary policy to a supranational institution will be accompanied by high costs. To consider the similarity of policy objectives, we compare inflation rates because “in the short run, a country’s inflation rate depends on factors ranging from various shocks to economic structures and policy responses, but in the long run, it largely reflects the preferences of the policy authorities” (Kwan, 1998). Table 4 shows inflation rates of Asia, the EU, and the US in the period of 1982-1996. In the period, the average and dispersion of Asian countries’ inflation rates were respectively 5.8 percent and 3.6 percent a year, which are slightly lower than the annual average and dispersion of 6.1 percent and 4.1 percent for EU countries. Although EU country’s inflation rates converged in recent years, a smaller group of Asian countries including Japan and Asian NICs also showed signs of convergence in the same period. This result suggests that policy similarity criterion based on inflation rates also favors Asian currency union as much as European monetary union.⁶

Table 4. Inflation Rates in Asia, EU and US 1982-1996

	Asia	EU	US
Average	5.8	6.1	3.7
Dispersion	3.6	4.1	--

(%)

Source : Kwan (1998) ; International Financial Statistics.

Note: Dispersion is the standard deviation of inflation rates among member countries.

There seems no reason not to form an Asian economic or monetary cooperation on economic grounds. As pointed out above, almost all economic indicators suggest that Asian countries are well prepared to try some forms of monetary integration, no matter what the exact form may be. Then, given the prominent economic position of Japan in Asian economy, Japan is likely to take a more active role in forming a regional monetary cooperation. A yen bloc⁷ may not be a remote possibility on economic grounds. Japan, however, was not prepared to assume a responsible role as an anchor country. In fact, compared with the EU, what is missing in Asia are the political preconditions for the successful operation of a currency system. Political distrust, the wide divergence in economic development, and the aspirations of Japan and China to become the dominating power in the region make the process of setting up an Asian

⁶Some may have a different opinion on this. For example, based on Takagi’s (1996) result that the Korean won and the Malaysian ringgit tend to follow a depreciating yen while the Singapore dollar closely follows an appreciating yen, Eichengreen and Bayoumi (1999) says that “these asymmetric responses, reflecting different national priorities attached to export competitiveness and price stability, would complicate efforts to design a collective currency peg”.

⁷A yen bloc is defined here to refer to a grouping of countries among which the Japanese currency is used as an international currency, and where countries maintain fixed exchange rates against the yen. See Kwan (1994).

monetary cooperation institution a much more difficult task than in Europe.

4. EXPERIENCE OF THE PAST YEN BLOC AND ASSESSMENT OF THE PROPOSALS

(1) The yen bloc under the 'Asian Co-prosperity Sphere'

The formation of the yen bloc goes along with the Japanese military occupation of the Asian countries. For example, with the occupation of Manchuria in the beginning of 1930s, the national currency of Manchuria was linked to the Japanese yen on a 1-1 basis with the strict control of capital. Also, as with the outbreak of the Pacific War, most of the East Asian countries were transformed into a set of colonies, satellites or occupied territories, they were forced to adopt the yen standard system. Two features are worth while to note. First, the yen bloc was based on a clearing system, modeled after the German Nazi's system. The exchange rate between the yen and the Asian currencies was pegged equal and on this basis the settlements between nations were implemented via transfers in the special yen account of the Bank of Japan. This is in contrast to the then UK or US system that consisted of setting up an exchange stabilization fund and intervening in the exchange market to fix the exchange rate.

Table 5. Movements of Wholesale Price Index in East Asia

	Japan & Colonies			China			Occupied South Asia				
	Japan Tokyo	Taiwan Taipei	Korea Seoul	Manchuria Changchun	North China Beijing	Central China Shanghai	Philippines Manila	Borneo, Kuching	Java Batavia	Singapore	Myanmar Langoon
1941. 12	100	100	100	100	100	100	100	100	100	100	100
1942. 6	101	103	102	102	124	156	---	---	---	---	---
1942. 12	102	103	106	113	157	206	200	114	134	352	---
1943. 6	107	109	113	116	229	399	247	141	166	807	900
1943. 12	111	115	118	123	267	700	1196	153	227	1201	1718
1944. 6	119	122	126	136	410	1390	5154	388	492	4469	3635
1944. 12	126	---	132	---	890	5700	14285	827	---	10766	8707
1945. 6	150	---	---	---	---	---	---	---	2421	---	30629
1945. 8	154	---	---	---	---	---	---	4000	31197	---	185648

Source : Shimazaki (1989).

(Shimazaki, 1989) Second, the use of the yen was not voluntary but imposed on the occupied regions. The occupied regions were especially obliged to meet the increasing Japanese war expenses, and as a consequence, their local central banks, most of which would be controlled by Japan, had to issue more and more the money. In fact, the farther the regions were away from Japan, the higher was the increase in their money supply. Simultaneously the inflation differential between Japan and Asian countries widened. This increasing economic divergence was surely one of important reasons for the collapse of the yen bloc after the Pacific War.

(2) Pacific Currency Area

At the end of 1960, Kojima (1970) proposed a Pacific Currency Area, which, to complete regional integration, was to be naturally accompanied by a Pacific Free Trade Area. The main idea was to pool international reserves so as to increase the international liquidity. Its five main characteristics were as follows. First, the Pacific Currency Area was expected to include as its members mainly the five developed countries, the US, Canada, Japan, Australia, and New Zealand, although the membership of other developing Asian countries was not excluded. Secondly, the pooling assets were gold and foreign exchange reserves. Thirdly, fixed exchange rates with regard to the US dollar were supposed to be maintained. In effect, the Pacific Currency Area would be a dollar Area. Fourthly, in adjustments in the Area's balance of payments vis-a-vis the rest of the world, the dollar's par value in terms of gold was allowed to fluctuate within a narrow band, and as a limitation of these exchange fluctuations, exchange equalization operations which could be effected in terms of gold were needed. Fifthly, the balance of payments among member countries could be adjusted through freer capital movement and changes in each country's credit with the reserve pool.

In a strict sense, it would be difficult to consider this as something like an Asian monetary cooperation. Japan's interest was to form a Japanese and US cooperation institution and not a Japanese and Asian one. The increase in the international liquidity by the pooled reserves will be also to a great extent insufficient to cope with speculative attacks, given the enormous size of short term capital flows.

(3) Asian Monetary Fund

The Asian currency crisis provided a new opportunity for discussing some kind of permanent monetary institution within Asia and in this context was born the proposal for the AMF. But with strong opposition from the IMF and the US fearing that it could undermine their leadership role in the region, the proposal for an AMF had to be withdrawn for a little while. Nevertheless, the idea of an AMF subsisted (Yam 1998; Curtis, 1998).

In October 1998, Japanese finance minister Miyazawa (1998) made the proposal again at the annual meeting of the IMF and the World Bank. His proposal is known as 'the New Initiative to Overcome the Asian Currency Crisis'. In that proposal, he emphasized the risk of a deflationary spiral of the world economy and criticized the IMF programs put in place in the region on the grounds that the economic turmoil in

Asia was in large part due to the abrupt flows of short term capital, not to changes in the fundamentals. Then, to overcome the Asian currency crisis, he proposed to set up a financial assistance scheme totaling 30 billion US dollars. In particular, he detailed that 15 billion US dollars would be provided as mid and long term financial assistance for the recoveries of the real economies of Asian countries and that another 15 billion US dollars would be used as provision against short-term capital needs of the region. Finally, pointing out that “over-dependence on the US dollar was obviously one of the causes of the currency crisis that erupted in Asia last year, and this has led many countries in the region to look to the yen to play a greater role,” (Miyazawa 1998: 9) he insisted that the increasing use of the yen, together with the dollar and the euro, would contribute to the stability of the international monetary system.

But this proposal has a basic limit. Given that this proposal consists of providing a finite amount of US dollars as emergency loans, it seems that Japan is not really committed to assume a responsible role as the lender of the last resort in the region. Japan should ensure other Asian countries to have access to emergency yen liquidity

Recently Bergsten (1998) modified that proposal to include the US and several other countries, and suggested an Asia Pacific Monetary Fund (APMF) instead of an AMF. He points out three reasons why such a regional scheme is necessary. First, according to him, no Asian countries could effectively lead the effort, because the rest of the region will reject any hint of Japanese domination and China is not yet ready for such a role. Second, an Asia only grouping would risk dividing rather than uniting the two sides of the Pacific. Third, the US could play a decisive role in making an APMF work. But basically underlying this proposal is the idea that the US should take the charge of leading such an institution with Japan’s role being limited to providing the necessary funds.

Together with the proposal for an AMF, more concrete ideas about regional monetary and exchange rate systems have been intensively examined in Japan within the context of the internationalization of the yen since the latter part of 1997.⁸ In particular, in the report, ‘proposals for coping with Asian currency and financial crisis,’ JETRO examines and compares a lot of policy options available in the region such as a floating exchange rate system, introduction of an Asian Currency Unit, and the use of regional currencies for international settlements. Its conclusion is that for the present time it would be most suitable for Asian countries to adopt a crawling peg type floating exchange rate system with the introduction of currency baskets on the basis of regional trade and industry structure. It adds that a common Asian currency unit is necessary together with an increased use of regional currencies for international settlement.

5. LESSONS FROM EUROPEAN MONETARY INTEGRATION

After the occurrence of the currency crisis, Asian monetary cooperation seems the only alternative to floating exchange rates. Given that the old Asian monetary order of pegging currencies unilaterally to the US dollar has already failed, the other alternative would be to let the Japanese yen play a more important role in the region. There are

⁸For example, see JETRO (1998a) and MOF (1999).

reasons for other Asian countries to increase the weight of the yen in their existing currency baskets⁹ or to peg collectively their currencies to the yen. But, as Eichengreen (1997) pointed out, such a policy would be prohibitively difficult without international cooperation, given the magnitude of current capital movements. Some international arrangements for liquidity support are necessary. In this regard, European monetary cooperation experiences could provide a very good guide.

In the whole history of monetary cooperation in Europe, the facility for the provision of liquidity has been constantly strengthened and constituted one of the most important instruments for monetary cooperation.

The first idea for a monetary support facility in Europe came from the Barre plan in 1969. It emphasized the need to create, as a solidarity instrument, between European countries, a short-term monetary support system to help a country with balance of payment difficulties to borrow the necessary currencies from its partner countries. After the collapse of the Bretton Woods system, exchange rate instability increased and intra-European trade stagnated. As the accomplishments of earlier European integration seemed in serious threat, European countries sought to stabilize exchange rates and the snake system came to be established in 1973. And the European Monetary Cooperation Fund (EMCF) was set up in 1974 to monitor European monetary policies, oversee the operation of credit facilities, and authorize realignments, mimicking the global role of the IMF. Finally, in 1979, the European Monetary System (EMS) came to be launched, with its objective being to guarantee monetary stability in Europe. In the meantime, the short term currency support facility was continuously strengthened. Two things deserve special mentioning.

First, note the role of the EMCF. The EMCF was primarily a bookkeeping device between European central banks. Each member state should provide it 20% of their gold and dollar reserves on a revolving basis in return for an equivalent claim denominated in ECU. The EMCF arrangement did not involve reserve pooling. The depositing central banks continued to hold and manage on behalf of the EMCF their gold and dollars, and received interest on them. Settlements were initially made in international reserve assets and ECU. Only after 1987 were all settlements made in ECU.

Second, note that the provision of very short term financing facility is one of essential features of the EMS. In fact, speculative attacks can be interpreted as a run on central banks' foreign exchange reserves. The prevention of runs needs a lender of last resort. Whenever European central banks are obliged to intervene to fend off speculative attacks, then these central banks provide unlimited foreign exchange for them. This facility is known under the name of the Very Short Term Financing Facility (VSTFF). It already existed under the snake system, and was administrated by the EMCF. Under the VSTFF, the central banks of strong currencies have an obligation to provide unlimited amounts of their own currencies needed to defend the existing exchange rate margin, because the official reserve holdings that one country can use in order to intervene in the foreign exchange market are not sufficient to cope with the unprecedented magnitude of private capital movements. In the case of European

⁹For example, Kwan (1994) indicates that the Japanese yen should have a weight of more than 50% if the European rule applies to the Asian Currency Unit.

countries, the German Bundesbank took this role as the lender of last resort. For example, during the EMS crisis in September 1992, the credit that the Bundesbank supplied reached about DM 93 billion despite some apparent losses it expected to incur. Because EMCF liabilities are denominated in ECU, the value of German credits decreased after the devaluation of some ECU component currencies. The expected loss was estimated to be in excess of DM 1 billion in its VSTFF lending facility (Collignon 1996).

In addition, the ERM crisis in 1992-3 shows that even these EMS institutional frameworks were not sufficient to defend off the speculative attacks. Defending the parities would require, together with international intervention and an increase in interest rate differentials, a recycling mechanism to counteract the destabilizing speculative capital movements by providing temporary accommodation of the demand for currency diversification, and to change the market expectation. One such proposal is to remove the asset settlement rule of the ERM. In this case, the central banks that receive the intervention credit would no longer be obliged to repay the intervention balances in third currencies (Collignon 1996).

The European monetary arrangement and experiences are in sharp contrast to the proposal for an AMF, even though its concrete content was never sufficiently specified. It is clear that the economic problems of Asian countries will not be resolved unless Japan takes a more active role in the region. But, Japan seems reluctant to take responsibility for the growth and stability of the Asian region. The reason is that the AMF is meant to do nothing but provide a limited amount of dollar funds to Asian countries. With the establishment of dollar funds, Japan can insulate its domestic economy from external disturbances originating in Asian countries, and may feel no obligation to equilibrate its BOP surplus vis-a-vis other Asian countries. Japan wants to take the benefit but not the burden and responsibility of the internalization of the yen. The AMF is an option with little obligation but lots of benefits. In fact, Japan has been reticent about the internationalization of the yen because it will cause Japan to lose its monetary autonomy and reduce its current account surplus vis-a-vis other Asian countries as well. The creation of an AMF does not require Japan to play the role of the lender of last resort as the Germany did within the EMS system.

Simple provision of dollar funds the total amount of which is limited to US 30 billion dollars is greatly insufficient for other Asian countries to cope with the currency crisis. If Japan is really interested in taking a leadership role in the regional monetary cooperation, then it must use the yen as an intervention currency so as to be ready to provide whatever amount of emergency yen, not a fixed amount of dollars, is needed to defend against speculative attacks on neighboring Asian countries. Only in this respect can Japan assume full responsibility as the key currency country in Asia and play the same kind of role that Germany did. Otherwise the underlying intentions of Japan for an AMF can be doubted.

Recently at the Executive Meeting of East Asian Pacific Central Banks (EMEAP), it was agreed that the Bank of Japan would provide to 11 neighbor Asian central banks emergency loans in yen on the basis of the collateral of Japanese government bonds if they came under heavy speculative attacks. This may be a first significant step toward stabilizing the currencies of Asian countries. But it is uncertain if this agreement is really effective given the current meager holdings of Japanese government bonds by

Asian countries. The holding of Japanese bonds is limited because the Japanese financial market is regulated and under-developed.

The under-development of Japanese financial and currency markets is in fact one of the most serious problems for Japan to be the regional key currency country. Japan's weak financial system caused Japanese banks to retrieve money lent to other Asian countries early, adding financial difficulties to the currency crisis stricken Asian countries. Moreover, despite an enormous trade surplus vis-a-vis other countries, it caused the Japanese yen to depreciate, bringing about a loss of confidence, and damaging other Asian countries' exports to Japan.

The lender of last resort function is also very important to forge political solidarity. It can be recalled that in the case of Europe, the visions and the wills of political leaders were an essential ingredient in unifying Europe. Political solidarity is very weak in Asia compared to Europe. The result is the absence of common rules and institutions and in this respect the prospect for an Asian Monetary union seems dim. (Eichengreen 1997) In fact, the recent currency and economic crisis in East Asia has shown that Asian economic cooperation without common institutions is useless after the crisis has occurred. Unlike the EU, where the economic bloc was formed by mutual agreement at the government level for the purpose of integrating the market, economic cooperation in Asia has emerged as a natural consequence of increasing globalization and interdependence. Institutionalization such as has taken place in the EU is essential. Unfortunately, there is little hope that this will occur in the near future.

One problem that arises in this regard is again the political solidarity of Japan with its neighbors. Is Japan a reliable partner for Korea and other Asian countries? Japan has never been a reliable partner for Asian countries. There are historical reasons for this and the bitter experiences of the past still haunt the region. Even worse was the role that Japan played in the recent Asian currency crisis. Japan did not play the role it had to do and in fact, exacerbated the turmoil in the region. For one thing, it is believed that if Japan had provided Thailand with \$10 billion rather than \$4 billion initially, then investors might have viewed Japan as a strong regional leader capable of altering outcomes in the region (Hale 1998). Also, it is said that Japanese banks prompted the Korean crisis by withdrawing their funds all together and not rolling over short-term debts.

The international lender of last resort function requires Japan to demonstrate its political solidarity with other Asian countries. The recent AMF proposal can at best be perceived as the minimum that Japan should offer to other Asian countries for that purpose.

6. CONCLUSION

There are two policy options that will allow a small country like Korea to avoid excessive volatility and mis-alignment of the exchange rate. The first option is the global approach, which consists of setting up a sort of exchange rate target zone system between international key currencies and particularly between the dollar, the euro and the yen. These ideas were suggested by former German Finance Minister Lafontaine and also under the name of reference exchange rate system by Japanese Prime Minister

Obuchi. The prerequisite for this option is close policy cooperation and coordination on the level of the US, the EU and Japan, but there is little room for a small country like Korea to do this on its own initiative. The second option is to create regional monetary bloc. In fact, Asian countries are showing growing interest in this and their interdependent economies are in good condition to support it. If this happens, Japan is expected to play a leading role given its economic importance in Asia. The currencies of Asian countries can be in one way or another linked to the Japanese yen. But the problem is whether Japan would assume its full responsibility. There is, however, little hope that Japan will take this role in the near future as the current proposal for an AMF does not include any hint of a lender of last resort, which has been such a precious asset to the viability of European monetary integration. Unlimited amount of intervention credit could be supplied. But this mechanism is absent in the case of the AMF. If Japan wants to lead the region, it will have to learn from Germany and the role that Germany played when financial crises took place from time to time in Europe. Otherwise, it may not be possible for Japan to strengthen its position in Asia.

REFERENCES

- Bayoumi, Tamin and Barry Eichengreen 1994, "One Money or Many ? Analyzing the Prospects for Monetary Unification in Various Parts of the World," *Princeton Studies in International Finance* 76.
- Bergsten, C. Fred, 1998, "Reviving the Asian Monetary Fund," *International Economics Policy Briefs* 98-8, Institute for International Economics.
- Choi, C. K., 1995, "Possibilities of Yen Bloc and Implications for Korea," unpublished (In Korean).
- Colligan, S., 1996, *Europe's Monetary Future*.
- Corden, W. M., 1972, *Monetary Integration*, Essays in International Finance, No. 93, Princeton, N.J.
- Curtis, Bronwyn, 1998, "Now More Than Ever: The Case for an Asian Yen Zone," *The International Economy*, January/February.
- De Grauwe, Paul, 1992, *The Economics of Monetary Integration*, Oxford.
- Economist, 1999, "A Survey of Global Finance: Time for a Design?" January 30.
- Eichengreen, Barry, 1993, *Reconstructing Europe's Trade and Payments: The European Payments Union*, Manchester University Press.
- Eichengreen, Barry, 1996, *Globalizing Capital: A History of the International Monetary System*, Princeton University Press.
- Eichengreen, Barry, 1997, "International Monetary Arrangements: Is There a Monetary Union in Asia's Future?" *Brookings Review*.
- Eichengreen, Barry, 1998a, "International Financial Cooperation: Lessons and Questions from the Asian Crisis," *mimeo*, University of California, Berkeley.
- Eichengreen, Barry, 1998b, "Does Mercosur Need a Single Currency?" *NBER Working Paper* 6821.
- Eichengreen, Barry, 1999, *Toward a New International Financial Architecture: A*

- Practical Post-Asia Agenda*, Institute for International Economics.
- Eichengreen, Barry and Tamin Bayoumi, 1999, "Is Asia an Optimum Currency Area? Can it become one? Regional, Global and Historical Perspectives on Asian Monetary Relations," in S. Collignon and J. Pasini-Ferry eds., *Exchange Rate Policies in Emerging Asian Countries: Domestic and International Aspects*, London: Routledge.
- Emerson, Michael et al., 1992, *One Money, One Money: Potential Benefits and Costs of Economic and Monetary Union*, Brussel.
- Feldstein, Martin, 1999, "Self-Protection for Emerging Market Economics," *NBER Working Paper* 6907.
- Frankel, Jeffrey and Barry Eichengreen, 1996, "The SDR, Reserve Currencies, and the Future of the International Monetary System," in Michael Mussa ed., *The Future of the SDR in Light of Changes in the International Financial System*, IMF.
- Frankel, Jeffrey and Andrew Rose, 1996, "The Endogeneity of the Optimum Currency Area Criteria," *NBER Working Paper* 5700.
- Frankel, Jeffrey and Shang-Jin Wei, 1994, "Yen Bloc or Dollar Bloc? Exchange Rate Policies of the East Asian Economies," in Takahashi Ito and Anne Krueger eds., *Macroeconomic Linkage : Savings, Exchange Rates and Capital Flows*, University of Chicago Press.
- Goto, Junichi and Koichi Hamada, 1994, "Economic Preconditions for Asian Regional integration," in Takatoshi Ito and Anne O. Krueger (eds.), *Macroeconomic Linkage: Savings, Exchange Rates and Capital Flows*, University of Chicago Press.
- Goto, Junichi and Koichi Hamada, 1995, "Economic Integration and the Welfare of Those Who Are Left Behind : An Asian Perspective," *RIEB Discussion Paper Series* 47, Kobe University.
- Gros, Daniel and Niels Thygesen, 1992, *European Monetary Integration: From the European Monetary System to European Monetary Union*, London.
- Hale, David D., 1998, "Hot Money Debate" *International Economy*, November/December.
- Ishiyama, Yoshide 1975, "The Theory of Optimum Currency Areas: A Survey," *Staff Papers* 22, International Monetary Fund, pp. 344-383.
- JETRO, 1998a, "Proposals for Coping with Asian Currency and Financial Crisis" (translated and summarized in Korean by the Korea MOFA).
- JETRO, 1998b, White Paper on Foreign Direct Investment.
- Kenen, Peter, 1969, "The Theory of Optimum Currency Areas: An Eclectic View," in Robert Mundell and Alexandeer Swoboda eds., *Monetary Problems in the International Economy*, University of Chicago Press, pp. 41-60.
- Kojima, Kiyoshi, 1970, "A Pacific Currency Area : A New Approach to International Monetary Reform," *Hitotsubashi Journal of Economics* 10(2), pp. 1-17.
- Krugman, Paul, 1998, "Will Asia Bounce Back?" *mimeo*.
- Kwan, C.H., 1998, "The Theory of Optimum Currency Areas and the Possibility of Forming a Yen Bloc in Asia," *mimeo*, Nomura Research Institute.
- Langhammer, Rolf, 1997, "The Expansion of Intra-Asian Trade: An Analysis of Structural Patterns and Determinants," *Kiel Working Paper* 792, Kiel Institute of World Economics.
- Langhammer, Rolf, 1998, "Regional Integration APEC Style: Are there Lessons to Learn from Regional Integration EU Style?" *Kiel Working Paper* 869, Kiel Institute

of World Economics.

- McKinnon, Ronald, 1963, "Optimum Currency Areas," *American Economic Review* 53, pp. 717-725.
- McKinnon, Ronald A., 1996, *The Rules of the Game: International Money and Exchange Rates*, MIT Press.
- McKinnon, Ronald, 1998 "Exchange Rate Coordination For Surmounting the East Asian Currency Crises," presented at the conference on *Financial Crises: Facts, Theories, and Policies*, IMF, November.
- Miyazawa, 1998, A speech addressed at the annual meeting of the IMF and the World Bank, Washington, October 6.
- Ministry of Finance, 1998, Internationalization of the Yen.
- Moon, W.S., 1998, "Introduction of the Euro and ASEM Monetary Cooperation," presented at KIET Symposium on ASEM (In Korean).
- Moon, W.S., 1999, "Euro-dollar-yen Exchange Rates and International Monetary Cooperation," Cae-One Kim ed., *Euro : Changes in International Economic Order and Options for Korea*, Parkyoungsa, forthcoming (In Korean).
- Mundell, Robert A., 1961, "A Theory of Optimum Currency Areas," *American Economic Review* 51, pp. 657-665.
- Rhee, Y. S., 1998, "East Asian Currency Bloc: Choice of Anchor Currency and Convergence of Economic Policy Targets," unpublished (In Korean).
- Rhee, Y. S., 1999, "The Euro and East Asian Monetary Cooperation," Cae-One Kim ed., *Euro : Changes in International Economic Order and Options for Korea*, Parkyoungsa, forthcoming (In Korean).
- Shimazaki, Kyuya, 1989, *Yennoshinlyakushi* (History on the Invasion of the Yen) (In Japanese).
- Taguchi, Hiroo, 1994, "On the Internationalization of the Japanese Yen," in Takatoshi Ito and Anne O. Krueger (eds.), *Macroeconomic Linkage: Savings, Exchange Rates and Capital Flows*, University of Chicago Press.
- Takagi, Shinji, 1996, "The Yen and Its East Asian Neighbors, 1980-1995 : Cooperation or Competition?" *NBER Working Paper* 5720.
- Tanaka, Soko, 1998, "The Euro and Its Perception by World Blocs," presented at the Coimbra Conference of Jean Monnet Chairs on *The Role of the Euro in the Balanced Development of World Trade*, September, Portugal.
- Vaubel, Roland, 1976, "Real Exchange-Rate Changes in the European Community," *Kieler Arbeitspapiere* 39, Kiel.
- Williamson, John, 1999, "Crawling Bands or Monitoring Bands: How to Manage Exchange Rates in a World of Capital Mobility," *International Economics Policy Briefs* 99-3, Institute for International Economics.
- Yam, Joseph, 1997, Asian Monetary Cooperation, *Per Jacobsson Lecture*, Hong Kong.

Mailing address: Woosik Moon, Graduate Institute for International and Area Studies, Seoul National University, San 56-1 Shillim-dong Kwanak-ku, Seoul, 151-742, Korea. Tel: 82-2-880-8524, Fax: 82-2-886-6303, E-mail: mwoosik@gias.snu.ac.kr
 Yeongseop Rhee, Dept. of Economics, Sookmyung Women's University 53-12 Chungpa-dong 2-ka, Yongsan-ku, Seoul, 140-742, Korea. Tel: 82-2-710-9530, Email: ysrhee@sookmyung.ac.kr