

Towards Robust Regional Monetary Cooperation in East Asia

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Motivation (1)

- Private sectors have been establishing production networks in East Asia while governments have gradually concluded Free Trade Agreements among East Asian countries.
- Established production networks have been promoting *de facto* economic integration in private sectors. The economic integration is accompanied with increases in intra-regional trade and FDI in East Asia. As the result, it is necessary to stabilize intra-regional exchange rates among East Asian currencies.

Motivation (2)

- Regional monetary cooperation has been strengthened under the Chiang Mai Initiative (CMI) since 2000. The CMI consists of currency swap arrangements for managing currency crisis as well as a surveillance process for preventing a future currency crisis while both Asian Bond Market Initiative (ABMI) and Asian Bond Fund (ABF) Initiative focuses on developing regional bond market.
- However, the global financial crisis exposed some problems regarding the currency swap arrangements. When the Korean won faced with an abrupt large depreciation, the Korean government had to rush to the FRB to conclude a swap currency arrangement rather than implement the currency swap arrangements under the CMI.
- It evidences that there any problems in implementing the currency swap arrangements under the CMI.

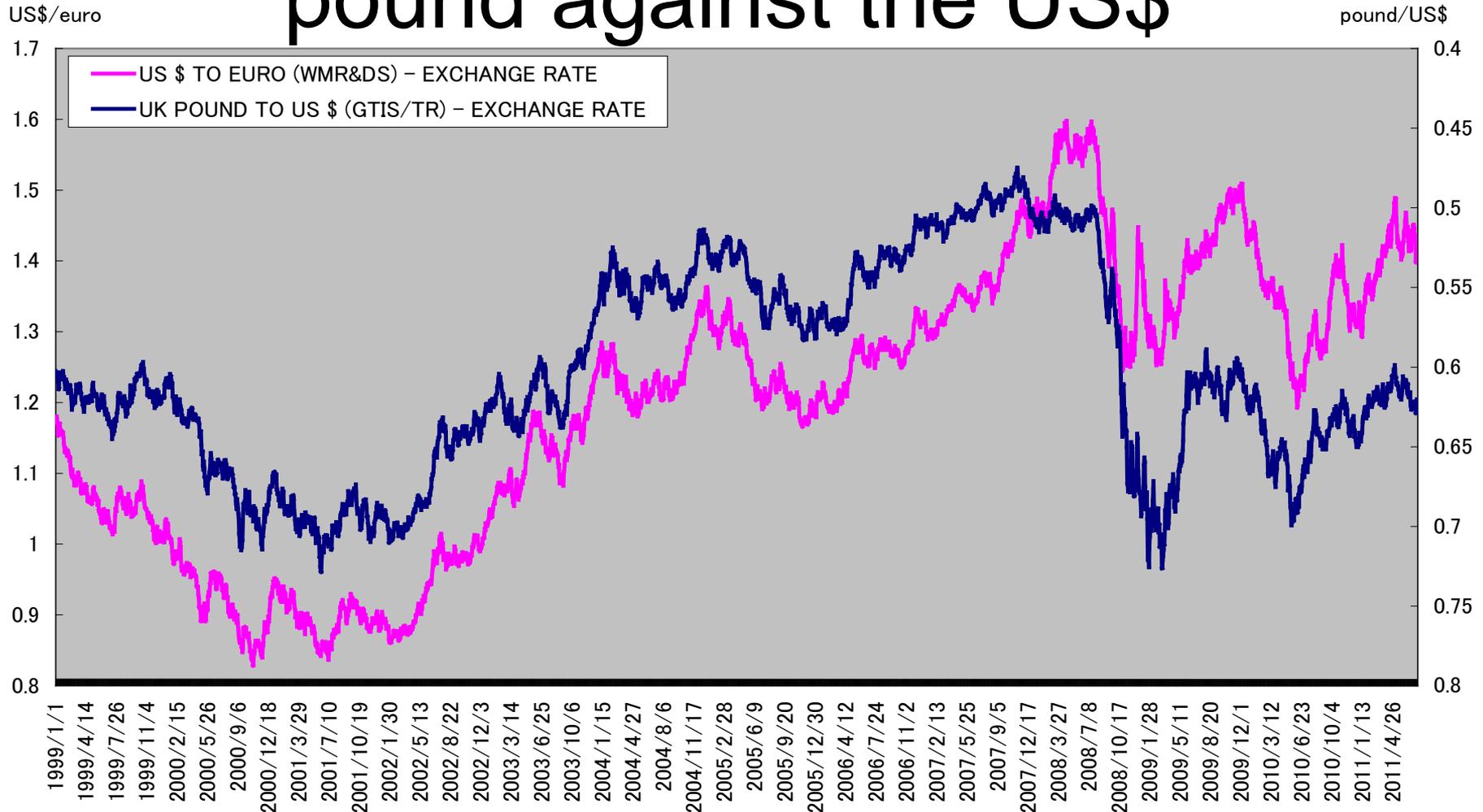
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(1) Currency turmoil during the global financial crisis

- The global economy experienced currency turmoil during the global financial crisis. The global financial crisis brought about (1) possible depreciation of the US dollar in the process of increasing fiscal deficits in the United States, (2) large depreciation of the euro and other European currencies due to both shortage in US\$ liquidity and expected contagion of the Greek fiscal crisis, (3) an asymmetric responses of Asian currencies to the global financial crisis, and (4) competitive currency depreciation.
- The abrupt large depreciation of the Korean won was caused by closing yen carry-trades made by US and European investment banks and raised money from Korea.

Exchange rates of the euro and the pound against the US\$

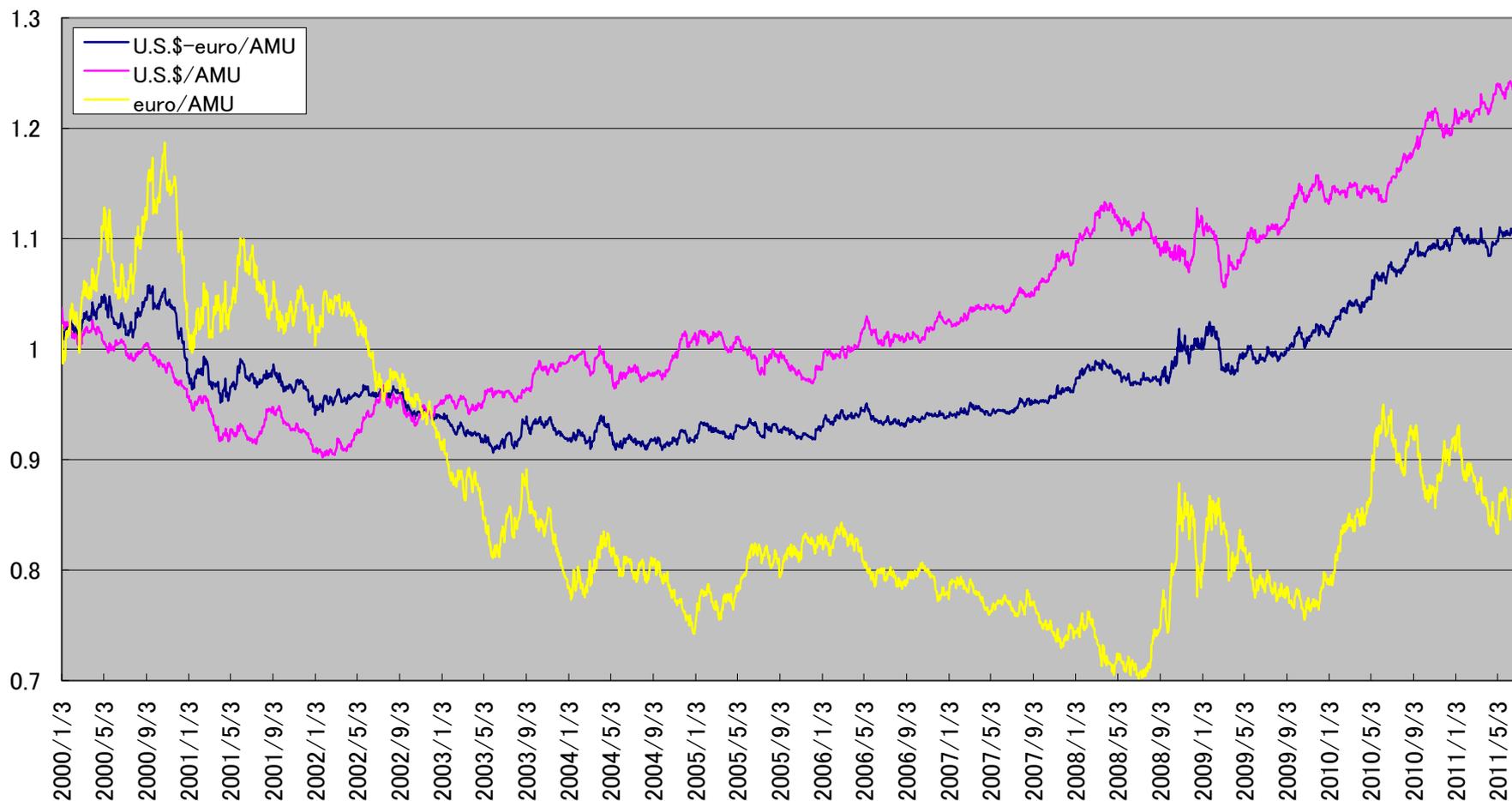


Data: Datastream

(2) Asymmetric responses of East Asian currencies to the global financial crisis

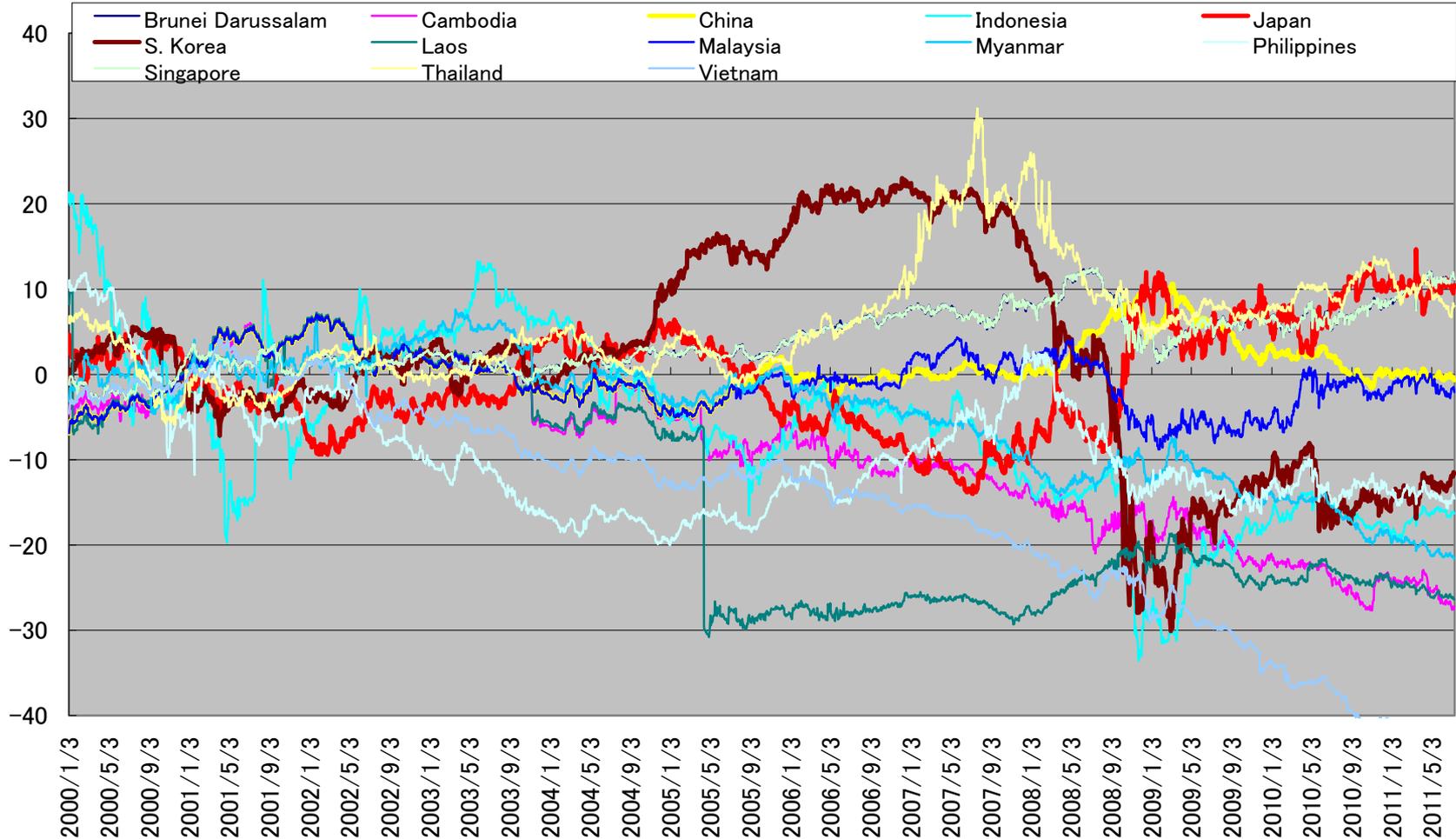
- Observation of Asian Monetary Unit (AMU) and AMU Deviation Indicators (see a website of RIETI (<http://www.rieti.go.jp/users/amu/en/index.html>))
- AMU: a weighted average of ASEAN10+3 (Japan, China, and Korea) currencies (weight: GDP and intraregional trade)
- AMU Deviation Indicators: Deviation of each East Asian currency in terms of the AMU compared with benchmark year (2000-2001)
- East Asian currencies had asymmetric responses (depreciating won, appreciating yen, and RMB's pegging to the US\$)

Values of the AMU



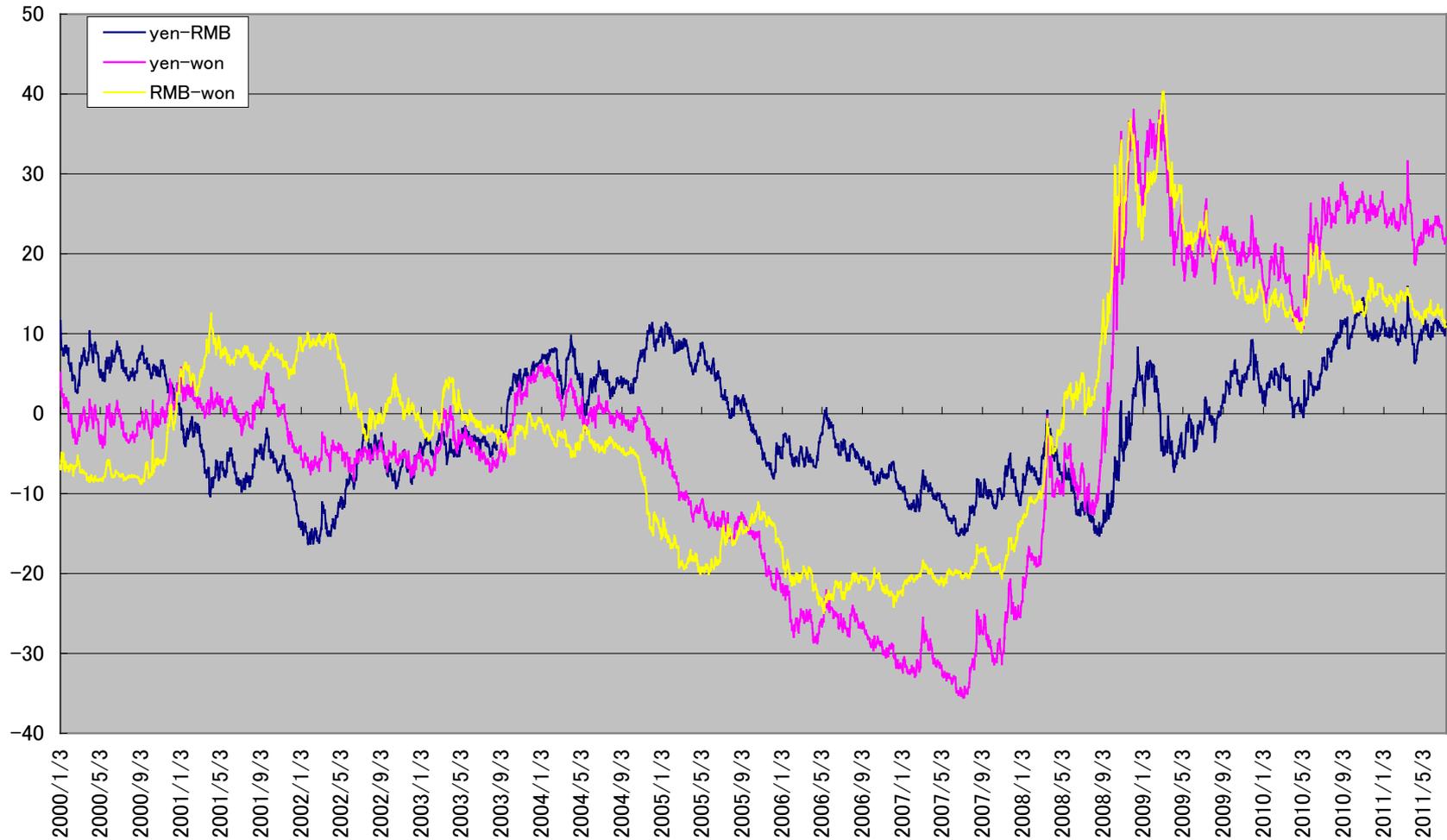
<http://www.rieti.go.jp/users/amu/index.html#figures>

Nominal AMU Deviation Indicators



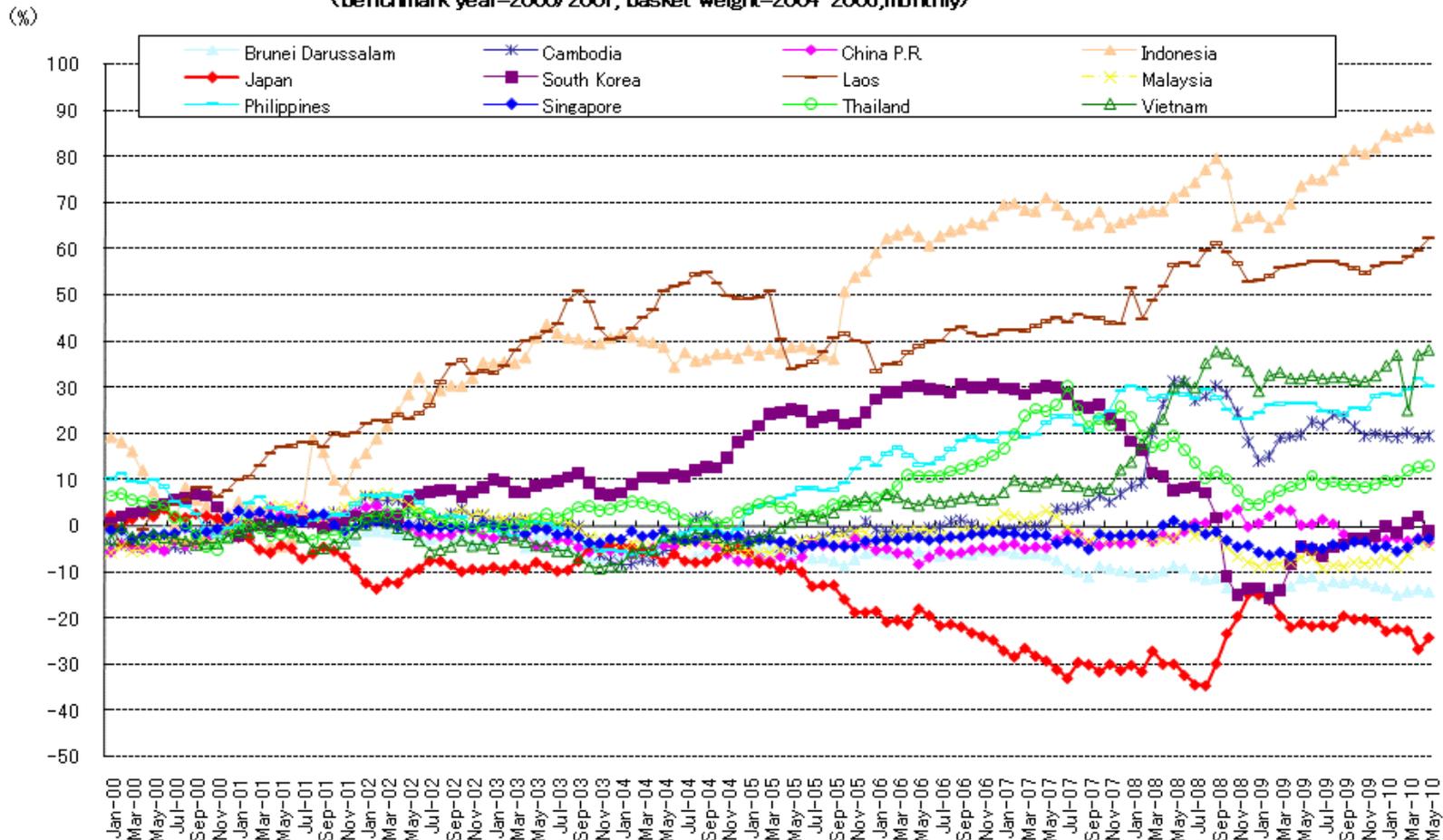
<http://www.rieti.go.jp/users/amu/index.html#figures>

Deviation among yen, RMB, and won



Real AMU Deviation Indicators

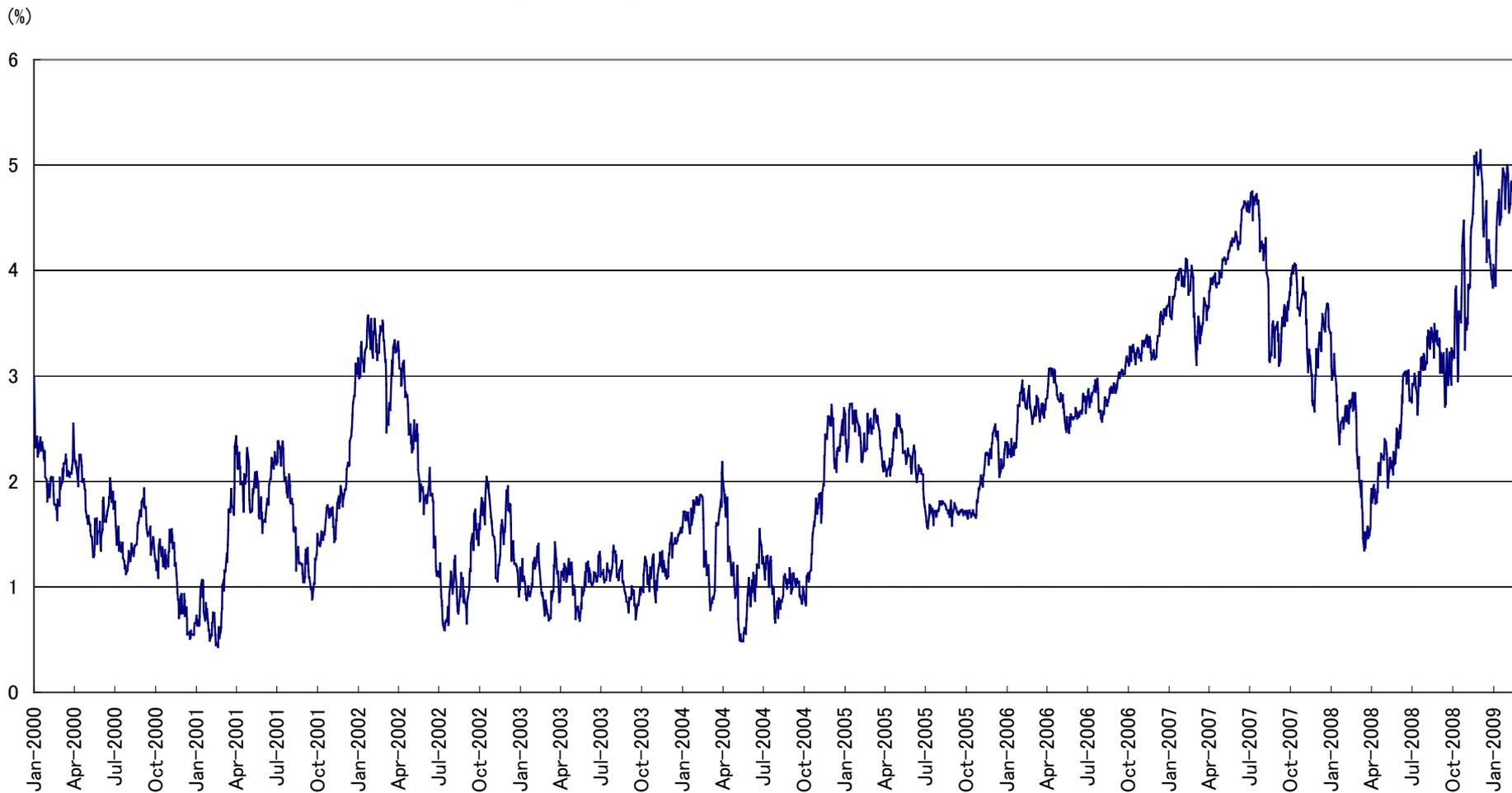
Figure 4. Real AMU Deviation Indicators
(benchmark year=2000/2001, basket weight=2004-2006, monthly)



<http://www.rieti.go.jp/users/amu/index.html#figures>

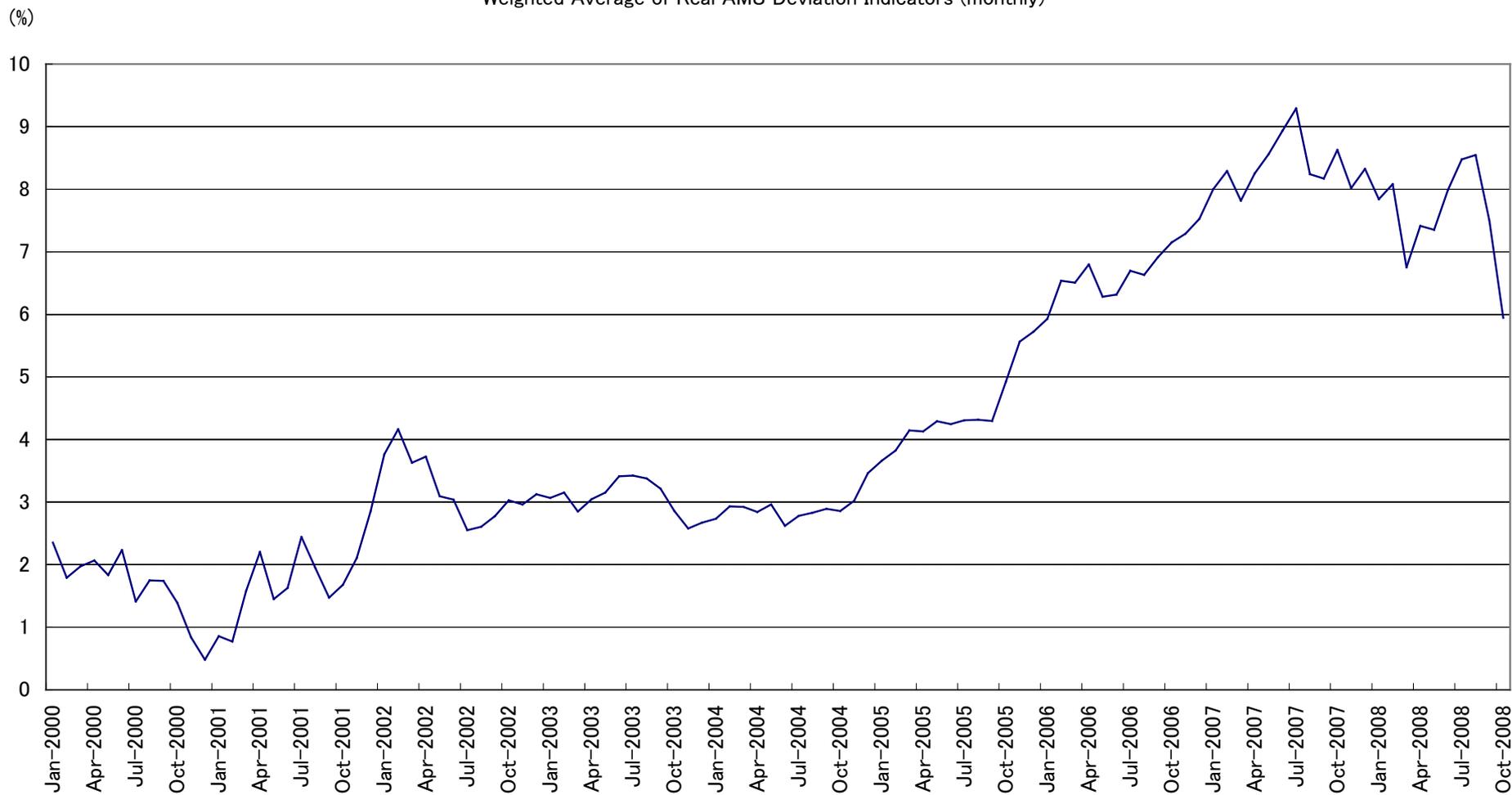
A weighted average of nominal AMU Deviation Indicators

Weighted Average of Nominal AMU Deviation Indicators (daily)



A weighted average of real AMU Deviation Indictors

Weighted Average of Real AMU Deviation Indicators (monthly)



Reasons of asymmetric responses of East Asian currencies

- “coordination failure” of exchange rate system and exchange rate policy
 - (1) Free floating: Japan and Korea
 - (2) Managed floating with reference to the US\$: China
 - (3) Managed floating with reference to a currency basket: Singapore, Thailand, other ASEAN
 - (4) Currency board (US\$ pegging): Hong Kong
- Active capital inflows and sudden capital outflows: yen carry trades based on nominal interest rate differentials

Before the global financial crisis: capital flows from Japan to Korea and Thailand

During the global financial crisis: capital flows from Korea and Thailand to Japan

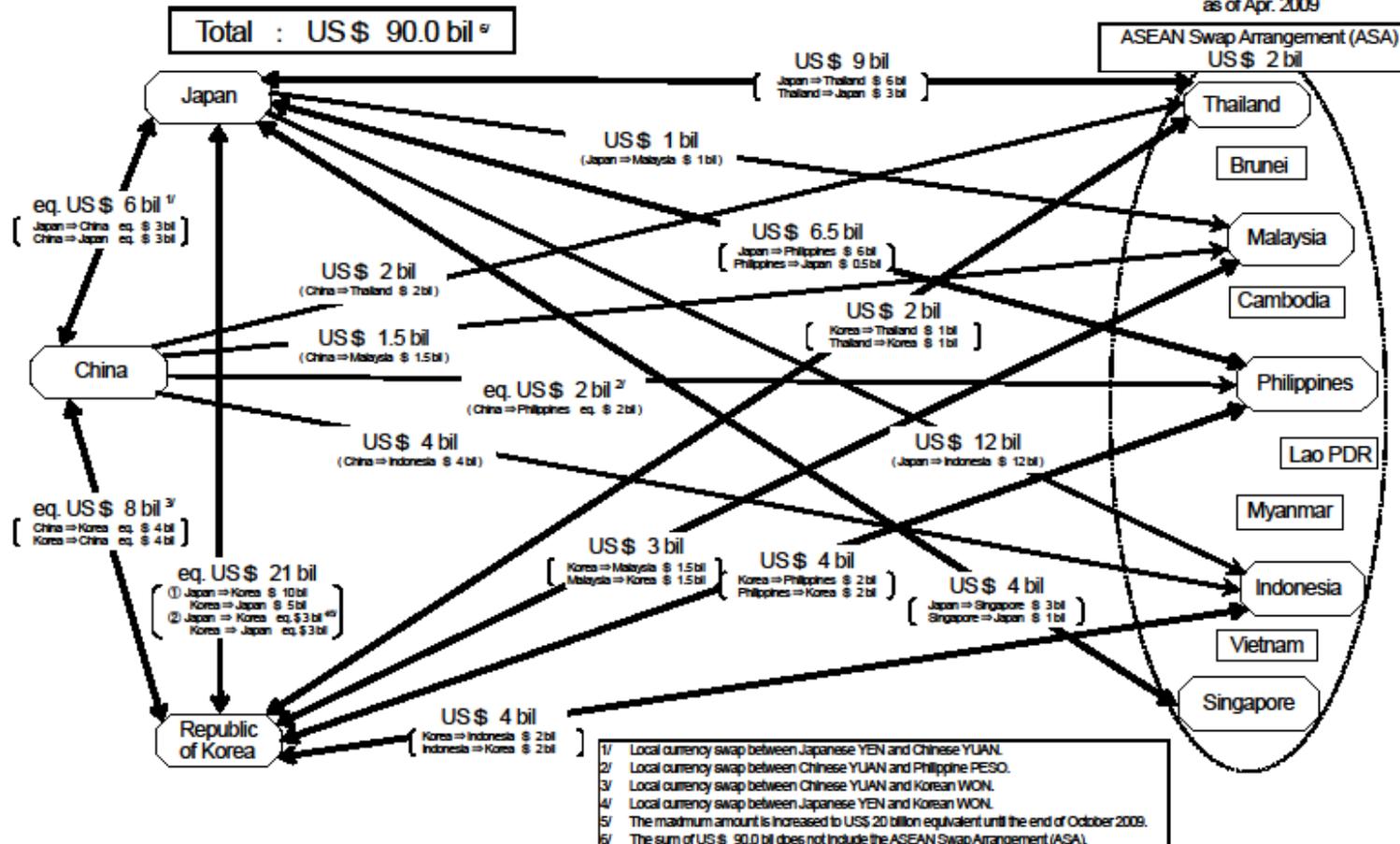
(3) From CMI to CMIM

- CMI: network of bilateral currency swap arrangements
- ⇒ CMI Multilateralization (CMIM): multilateral currency swap arrangement
- (1) Establishment of collective decision making mechanism and procedures
- (2) Total size (US\$ 90 billion to US\$120 billion)
- (3) Financial contribution: Japan = 32%, China (including Hong Kong (3.5%)) = 32%, Korea = 16%, ASEAN = 20%
- (4) Purchasing multiple: Japan and China = 0.5, Korea = 1, ASEAN5 and Hong Kong = 2.5, New ASEAN = 5

Network of bilateral currency swap arrangements under the CMI

Network of Bilateral Swap Arrangements (BSAs) under the Chiang Mai Initiative (CMI)

as of Apr. 2009



(4) Challenge of CMI: IMF Link

- The Korean government did not implement any currency swap arrangements under the CMI in order to stop the depreciating won. Rather it rushed to the FRB to conclude a new currency swap arrangement with the FRB and then implemented it to borrow US\$ liquidity.
- The main reason why it did not implement the currency swap arrangements under the CMI is that the CMI has “IMF Link”. The “IMF Link” covers 80% of the total amount of the CMI.
- “IMF Link”: A government, who faced a currency crisis and has willingness to implement a currency swap arrangement under the CMI, has to apply for financial support to the IMF and accept conditionalities which the IMF proposes for the financial support. No currency swap arrangements under the CMI are implemented before the financial support is accepted by the IMF.

Why the CMI needs the IMF Link?

- They need in advance daily surveillance over exchange rates and other macroeconomic variables in order to implement immediately a currency swap arrangement. It is necessary to establish a standing institute which make surveillance and implement currency swap arrangements.
- In the current situation where we have no standing institute related with currency swap arrangements under the CMI, the CMI has to depend on surveillance and decision-making of financial supports by the IMF.
- However, ASEAN+3 Finance Ministers have decided to establish an ASEAN+3 Macroeconomic Research Office (AMRO) for regional surveillance in East Asia.

Measures to the won depreciation during the global financial crisis

- On October 28, 2008, the Bank of Korea concluded a currency swap arrangement with the FRB in the situation where the Korean economy faced shortages in US\$ liquidity under the global financial crisis.
- In addition, on December 13, 2008, the Bank of Korea concluded currency swap arrangements in terms of yen-won with the Bank of Japan and in terms of RMB-won with the People Bank of China at the summit among Japan, China, and Korea.

(5) Policy proposals for a regional monetary cooperation in East Asia

- (i) Abolition or reduction of the “IMF Link” in the currency swap arrangements under the CMIM
- (ii) Standing institute (AMRO) for implementation and surveillance under the CMIM
- (iii) Monitoring capital flows under Japan-Korea currency swap arrangement

Policy proposal (i) : Abolition or reduction of the “IMF Link”

- It is necessary to abolish the “IMF Link” or to reduce 80% of coverage of the IMF Link” under the CMI in order that currency swap arrangements should be effective.
- The monetary authorities of ASEAN+3 need to establish a system where they should make decision of implementing a currency swap arrangement by themselves rather than depending on the IMF.
- Surveillance over not only the current macro-economic surveillance targets (GDP, inflation, and soundness of financial sectors) but also intra-regional exchange rate among East Asian currencies. Moreover, surveillance over fiscal deficits as well as establishing fiscal discipline are important under the CMI.
- In the future, we could go beyond the CMIM toward an Asian Monetary Fund.

Policy proposal (ii): Standing institute (AMRO)

- It is necessary to establish a standing institute which should implement currency swap arrangements and make surveillance over macroeconomic situation (and monitoring over abrupt capital inflows and outflows) under the CMIM in order that the “IMF Link” should be abolished or reduced under the CMIM. It has been decided that the AMRO will be established.
- Japan, China, and Korea should take a coordinated initiative for operation the AMRO. Specifically, it is necessary to make capacity building of the AMRO as a standing institute in order that it should observe and analyze movements in intra-regional exchange rates and abrupt capital flows.

Policy proposal (iii): Japan-Korea currency swap arrangement

- Japan-Korea currency swap arrangement is expected to have some effects on preventing and managing a currency crisis and larger depreciation of a currency because either the Bank of Japan or the Bank of Korea guarantees a counterpart to keep a level of foreign reserves by lending liquidity based on the currency swap arrangement.
- It is necessary to keep the Japan-Korea currency swap arrangement.
- As the same time, it is necessary to monitor volatility and misalignment of the exchange rate as well as abrupt capital inflows and sudden capital outflows in addition to the current surveillance over domestic macroeconomic economy and soundness of financial sector under the CMI.