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Monetary Co-operations in Asia
: Lessons from the experience of the euro and Japan[1]

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1. Experience of the euro

Today, many people are questioning whether the euro is really a stabilizer of European economy. If the East Asian countries introduce a single currency, will it become a safeguard of the regional economy? I will discuss this issue on the following four fronts.

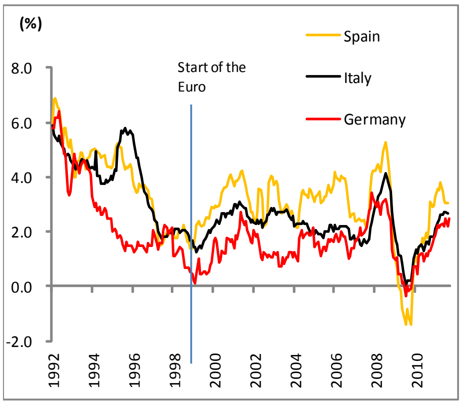
(1) Inconvenience of inflation gaps

The first is the euro and inflation gaps. The inflation rates certainly converged greatly before the start of the euro. But once it started, the single currency and the single monetary policy worked on the member economies in different ways.

High contrast was typically observed between Spain and Germany in early 2000s. The Spanish economy was in boom centered on the construction and real estate sectors, while the German economy was in slump. A country in boom shows a higher inflation rate with which real interest rate becomes lower. And a country in slump shows a lower inflation rate with which real interest rate becomes higher. This situation escalates pro-cyclicality of the economies and the inflation gap widens as a result. It was actually what happened in Spain and Germany.

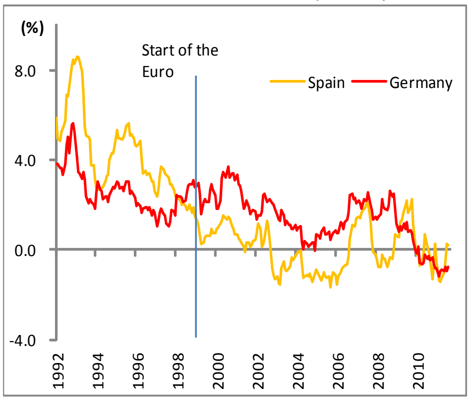
1 This paper is based on the speech text delivered at a conference "Post-crisis Restructure of International Financial System: The Role of Asia" held in Beijing by Institute of Finance and Banking, CASS and Korea Capital Market Institute, on December 8th, 2011.

Inflation rates of Euro countries



(Source) Bloomberg

Real interest rates of Germany and Spain



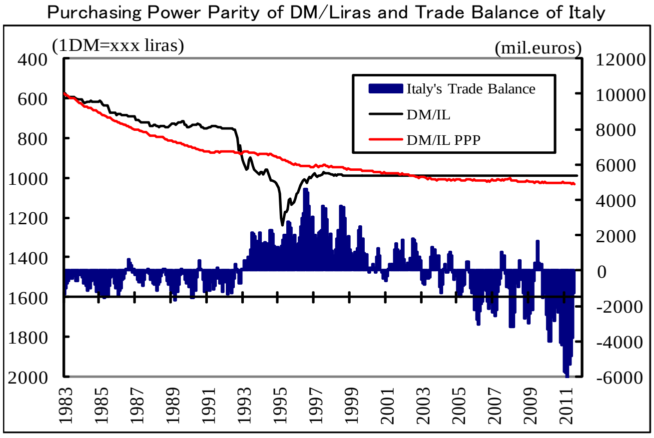
(Source)Bloomberg

(2) Discrepancy between a market exchange rate and purchasing power parity

The second point is the external balance within the single currency area. Remaining inflation gap causes discrepancy between Purchasing Power Parity and market exchange rates.

In case of Germany and Italy, Germany's inflation rate almost always stayed lower than Italy's. This gap has remained even after the start of the euro. The persisting gap has pushed the real exchange rate of Italy higher than its purchasing power parity against the DM. This has damaged Italy's export competitiveness and made import goods cheaper for Italy. In Germany the situation has been the other way round. The result of this discrepancy is a widening trade imbalance for both countries.

Purchasing Power Parity of DM/Liras and Trade Balance of Italy

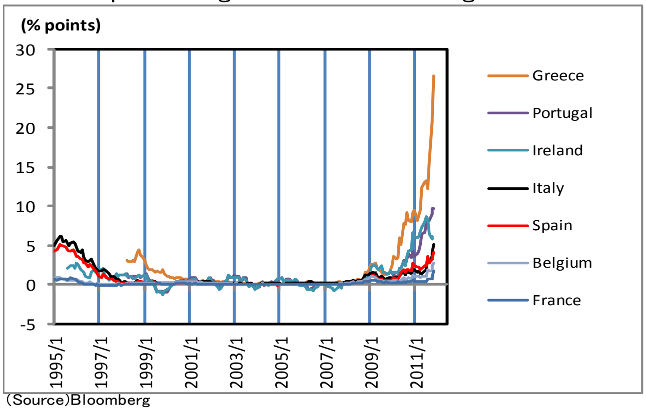


(Source) IMF, Bloomberg

(3) Excessive convergence of government bond yields

The third point is an excessive convergence of long term interest rates. Long term interest rates among the euro area countries showed even greater convergence than inflation rates. And it continued even after the start of the euro until the sub-prime shock. The introduction of a single currency removed the exchange rate risks even for the government bonds such as of Greece, Italy or Spain with higher yields and encouraged investors to purchase them more positively. The convergence of interest rates made too generous the financial costs of lower rating countries and helped easy credits to expand there.

Yield spread of govornment bonds against Bunds



(Source)Bloomberg

(4) Doubt on the role as a stabilizer by its nature

The forth point is the doubt against a single currency if it is really a stabilizer of an economy by its nature. They argue that the euro cleared the uncertainty of exchange rates but it also took away the alarming function of exchange rates against the external imbalances In general, an exchange rate of a country will fall when market participants start to doubt the sustainability of the balance of payment of the country. And this very movement of the market often forces the policy makers to take necessary actions to recover the confidence of the market.

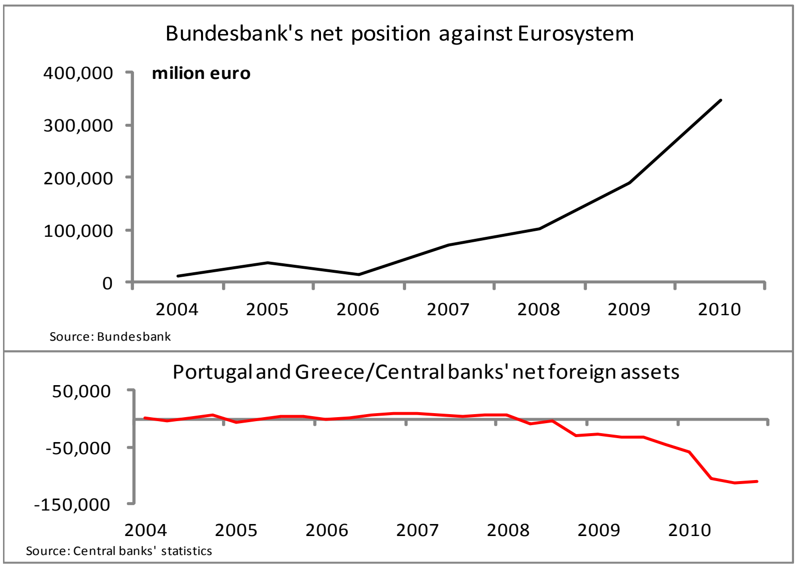
Introduction of a single currency, however, means permanent fixation of the exchange rates among the participating countries and disappearance of their individual currencies and exchange management as well. Thus, the euro exchange rate will not reflect internal imbalances among member states. In this way, market participants and policy makers failed to notice the alarming situation of the real economies in the peripheral countries of the euro area.

The doubters also argue that there is a fundamental deficiency in the design of the European System of Central Banks (ESCB). In the case of a normal country, the crisis of balance of payment will not suddenly come up to the surface but usually there are early signs in its foreign reserve outstanding. It happens in the following way.

Investors and bankers start to doubt the sustainability of the current account deficit in a country. They become more reluctant to lend or invest their money to the country. Then, the country is forced to use its foreign reserves to settle their net imports and its foreign reserves start to decline. This decline is very obvious and noticed soon by many because reserve statistics are periodically published. Market participants become more cautious about the country and the government becomes really serious to think about necessary policies so that they can avoid a crisis of the balance of payments.

But in the case of the Euro area, the process is different. Instead of the foreign reserves, whose movements are published as an aggregate of member countries, it is a country's account with the European System of Central Banks that reflects the alarming situation of its balance of payments. The movements of this account, however, have never worked as an alarm, because i) it is not so much statistically noticeable as the movement of the foreign reserves and ii) the position of this account is allowed to be negative without limit.

Expanding imbalance in the European System of Central Banks

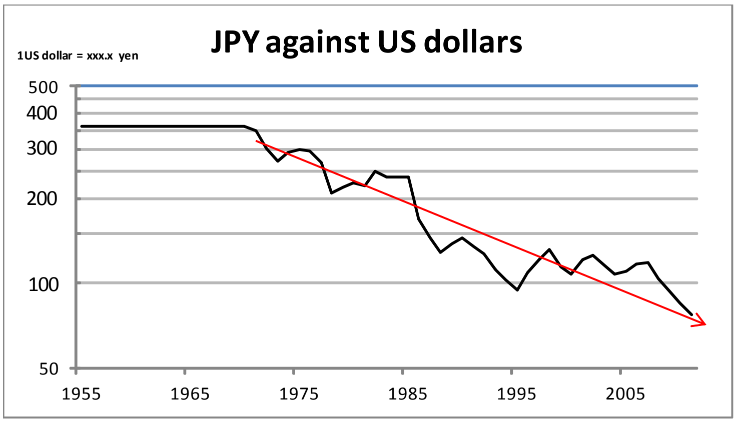


(Source) Bundesbank, Central Bank of Greece, Central Bank of Portugal

2. Japan's experience

(1) Long term trend of the yen appreciation

Now, let's see Japan's experience. Japan has a history of continuous appreciation trend of the yen against the US dollar since it took a floating system in 1973. This historical trend can be explained by the inflation gap between the yen and the US dollars. Future trend can be also explained by the same factor.



(Source) IMF

(2) Positive and negative sides of the appreciation of the yen

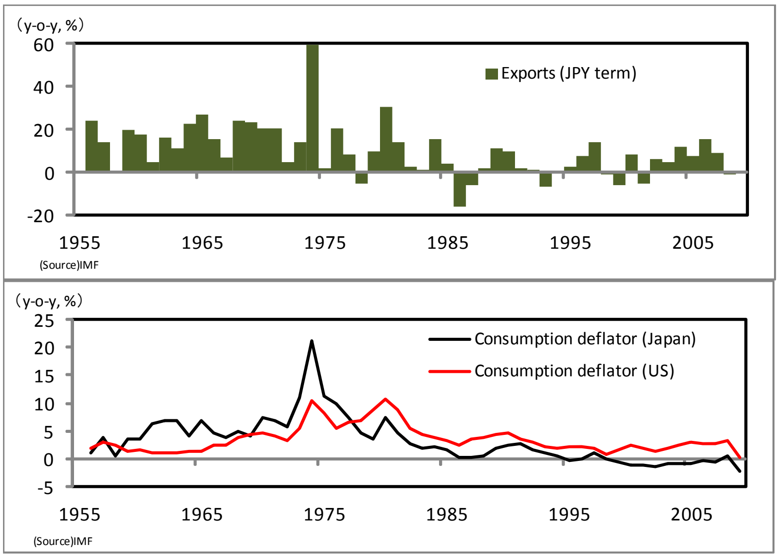
What has the yen appreciation brought to Japan? In general, the appreciation of a local currency does have a negative impact on exports. The employment of manufacturing sector might shrink in the short term because of the appreciation of the currency. Actually, the average export growth rates were very high in the days of fixed exchange rate and lower after Japan taking the floating system when the yen started to appreciate.

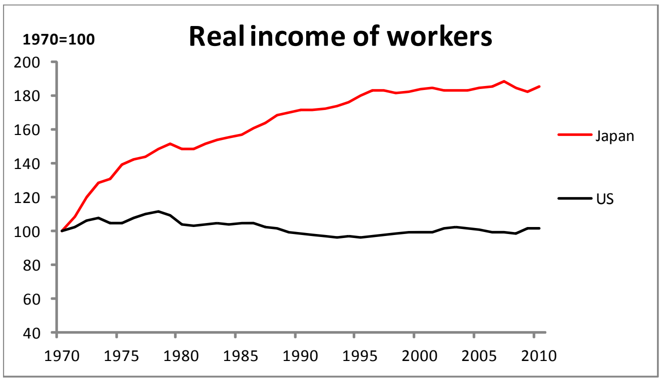
But there was a positive side, too. Several years after Japan took the floating system, the relative inflation rates of Japan and US got reversed. Since then Japanese economy showed a solid growth supported by a stable price development. Thanks to the price stability, to which the appreciation of the yen has played a big role, Japan could enjoy a widely spread growth of real income in the household sector. In other words, the benefit of the economic growth was not concentrated on a few sectors or industries but shared broadly by the middle class.

Of course, there were other factors that contributed to the growth of real income in Japan such as technological developments and managerial innovations. But lower inflation was certainly one of the elements that could explain it.

Unfortunately Japan has been in a continued deflation phase and many people wish for a more positive price development. But it is worth remembering of the good side of low inflation.

Export growth rate of Japan, Inflation in the US and Japan



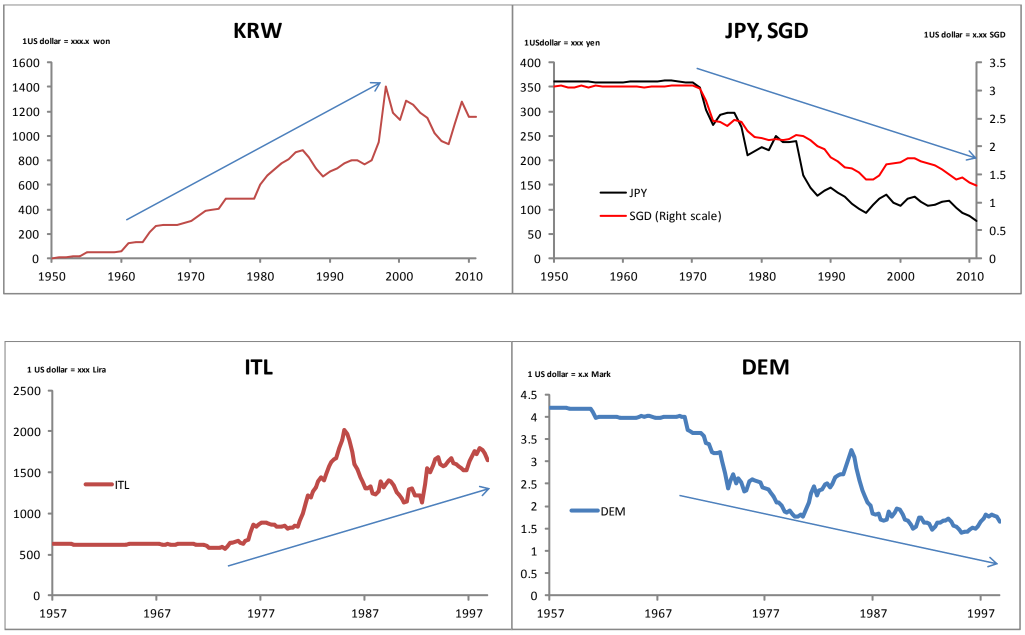


(Source)IMF

Many people think that the appreciation of a currency inflicts hardship on export sector and manufacturers are forced to shift their factories to overseas. They say, this means a reduction of domestic employment and leads to lower economic growth. But is it true?

Regarding how conditions and circumstances affect and transform the economies, it should be noted that short term result and long term result are not always the same. Currency appreciation often encourages exporters to invest to improve their non-price competitiveness. Long time accumulation of such investments will make the exporters more competitive. Competitive exporters will help form a competitive economy which in turn will result in a currency appreciation that they can bear. If you look at the long term development of several economies, you can at least say there is no convincing evidence that the countries with appreciating currency perform worse in trade than the countries with depreciating currency.

Long term trend of exchange rates in several countries



3. Conclusion

From the experience of the Euro, it is seen a stable exchange rate regime does not guarantee a stable development of real economies in the long run. On the contrary, it might bring more harm than good to a regional economy.

From the experience of Japan, there is few convincing evidence that currency appreciation is an obstacle to the development of economy or currency depreciation supports the development of economy. On the contrary the yen's appreciation might have contributed a long term development of Japan, where the inflation was relatively well controlled and the middle class has relatively enjoyed the growth of real income.

So long as the exchange rates are moving in line with the development of fundamentals, they should be left as they are. Even if they are volatile reflecting the uncertain sentiment of the market, there should be some reasons for it and we should address the causes instead of seeking for a superficial stability in nominal terms. Overshooting in the financial markets should be avoided. But instability should be taken as a warning sign that something wrong is going on underneath the surface.

In this globalized world where exchange rates move rapidly reflecting the policy failures of the countries, what is needed is not an artificial systematic mechanism to keep the exchange rates stable within a certain range but closer surveillance of the economic fundamentals and enhanced multi-governmental communications so that policy co-ordinations can be made when we observe overshooting in markets or large discrepancy between market perception and fundamentals.

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