

The Case for an Asian Currency?

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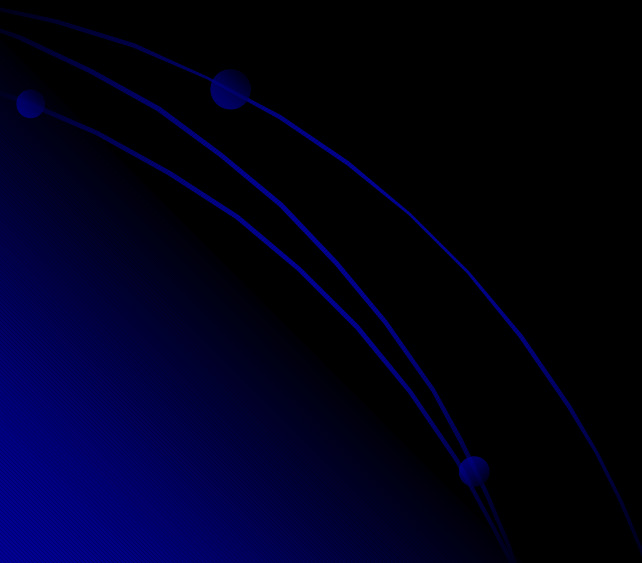
November 12, 2004



Topics

- Lessons from the Euro
 - China and the RMB Issue
 - Is there a Case for an Asian Currency Area?
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1. Lessons from the Euro

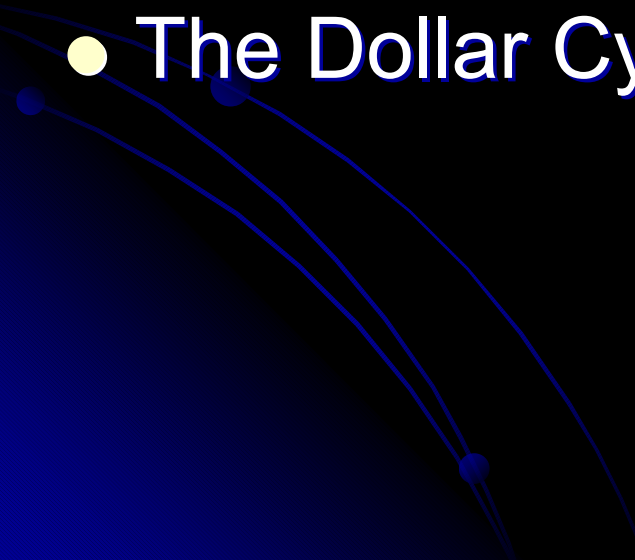


Lessons from the Euro

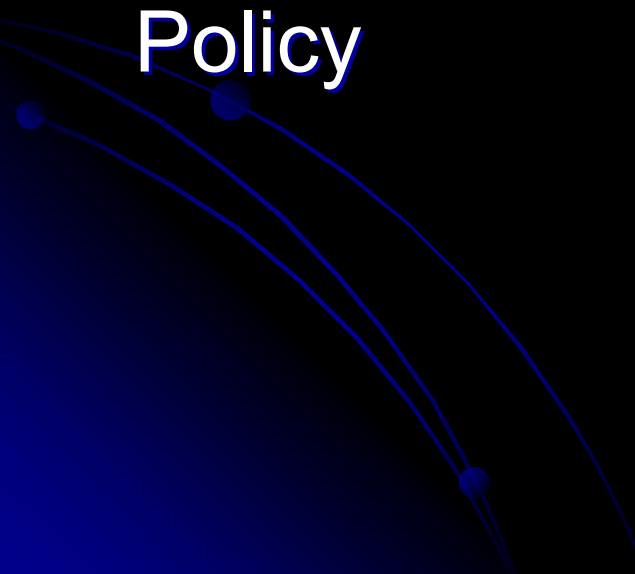
- Hague Summit, December 1969
- EMS, 1978
- Delors Report, 1989
- Treaty of Maastricht, December 1991
- EMI, 1995
- Banking Euro, 1999
- Complete Euro, 2002.

Why did it take so long?


Why did it Take So Long?

- The anchored dollar system.
 - The Nixon Shock. Why did he do it?
 - Smithsonian Dollar Standard
 - Fluctuating Exchange Rates
 - The Dollar Cycle
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Leadership

- From the Grid to the DM Area
 - German-French Confrontation, 1980s
 - EMS Crisis, 1992
 - Determination of Common Monetary Policy
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Weaknesses in EMU System

- Cumbersome Decision-making with Enlargement
 - Immaturity in Short-term Capital Market
 - Need for EU Debt Instruments
 - Decision-Making at Ministerial Level
 - No Defense against Dollar Cycle
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2. China and the RMB Issue



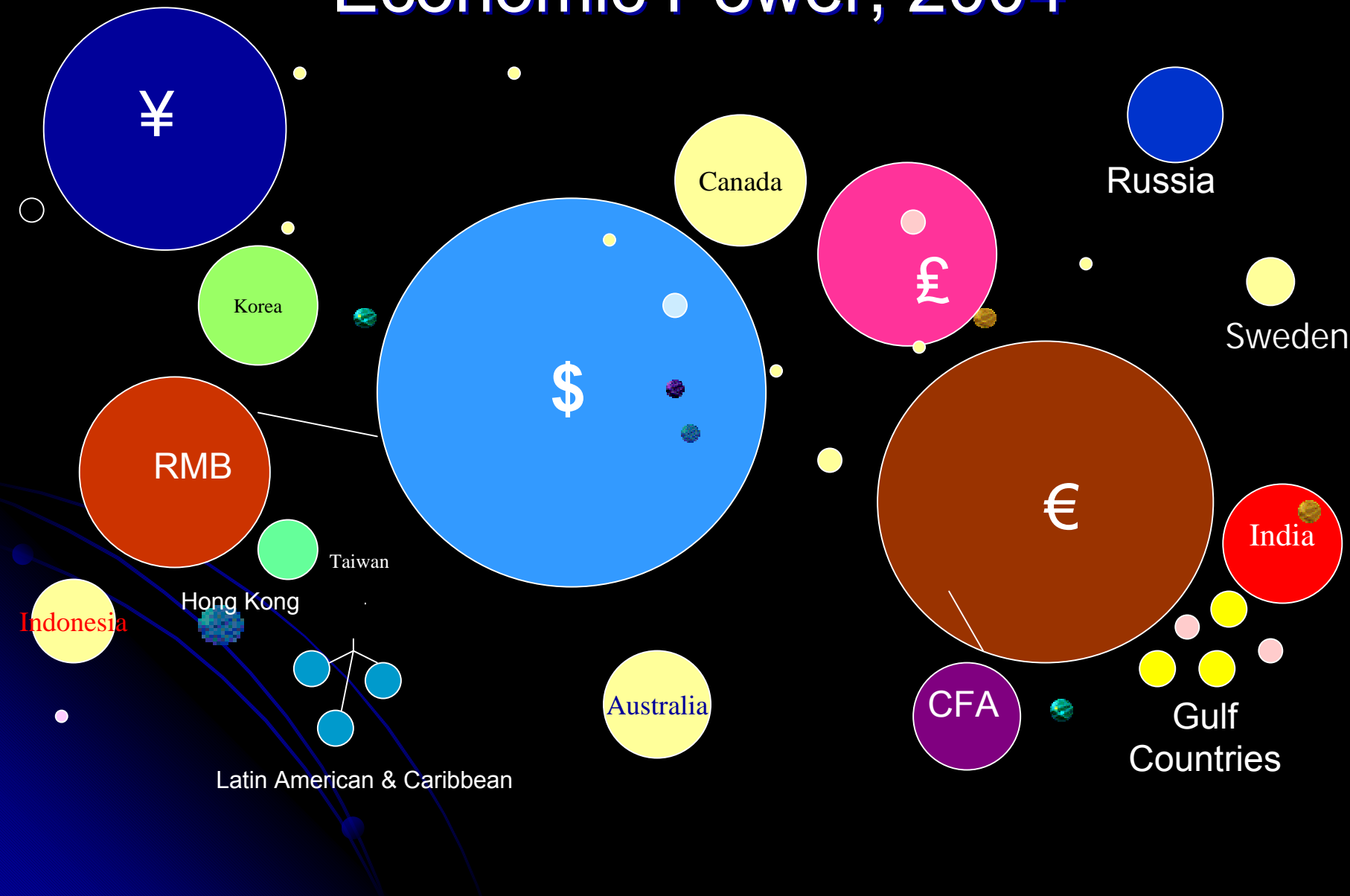
Four Generations of Leaders



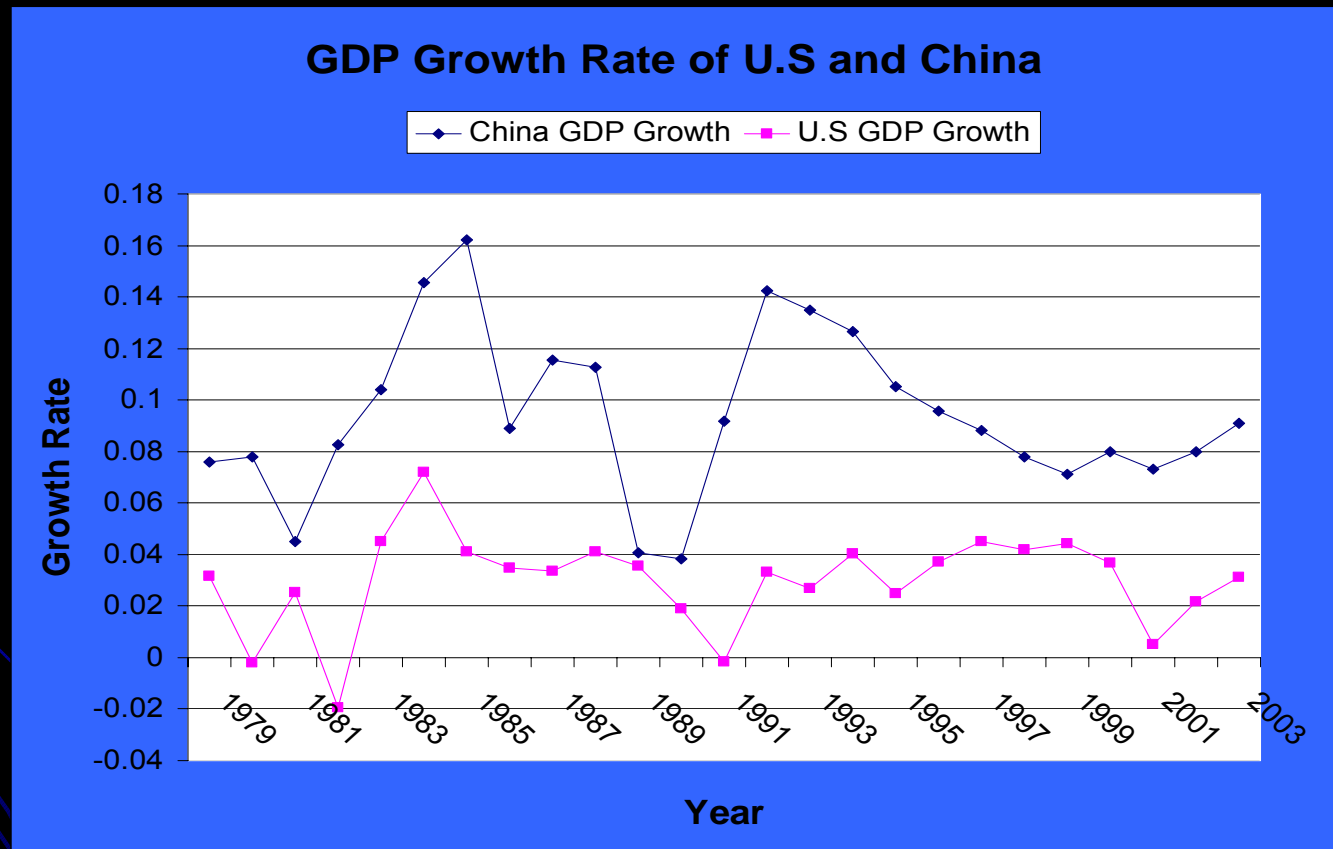
China's Rise

- 26 Years of 9% Growth
 - Exports 6 % of World Exports
 - Stable Price Level and Exchange Rate
 - Annual FDI over \$50 billion
 - Soaring Imports and Exports
 - Foreign Reserves over \$450 billion
 - Soaring Manufacturing Capacity
 - Increasingly Hi-Tech Production
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World Map of Currency Areas and Economic Power, 2004



GDP Growth Rates: U.S. and China

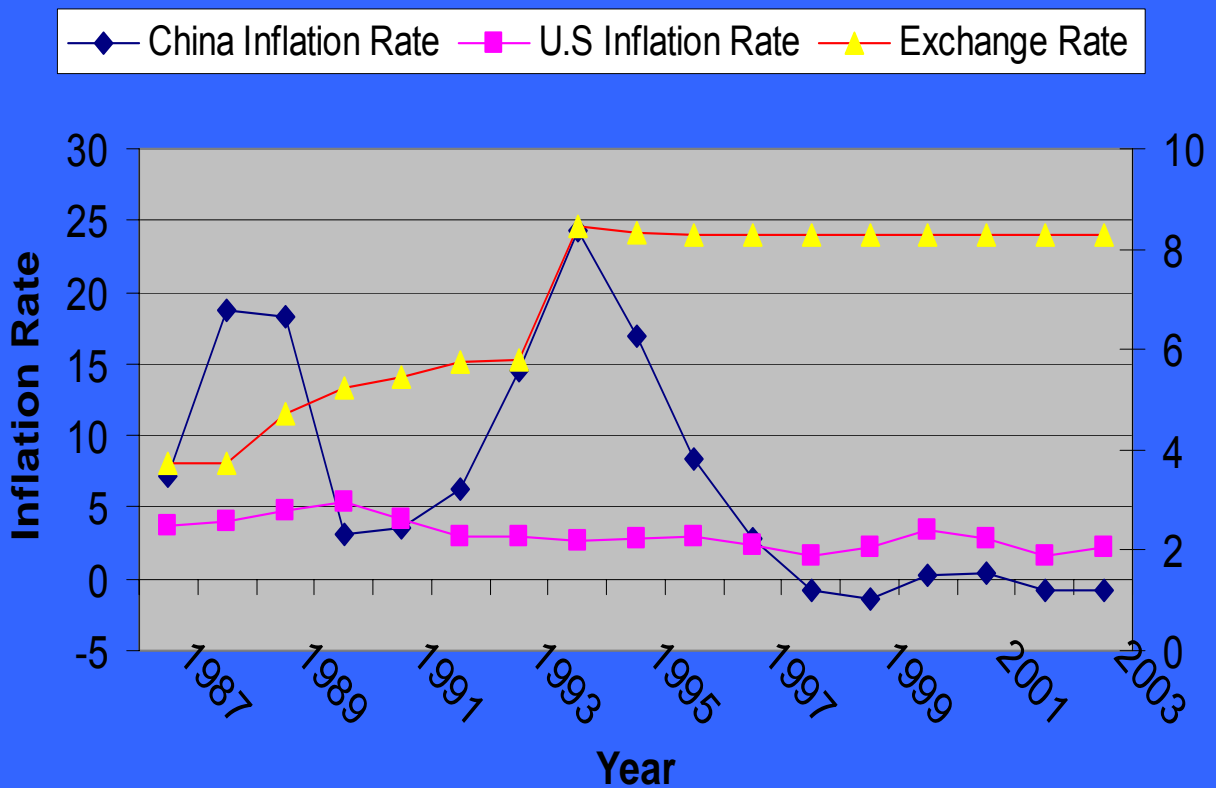


Pressure on China to Appreciate or Float

- Japan's Charge of Deflation
- Charge of "Manipulation"
- US Bilateral Deficit with China
- Overheating Issue
- Dalian Conference
- IMF Managing Director
- G-7 Pressure

RMB Stabilization in 1994 Brought Price Stability to China, Managing Money Growth to Bring about a Soft Landing!

Inflation Rate Comparison




Discussion points

- No manipulation: RMB/\$ fixed since 1994
- China not the cause of US deficits
- China cannot export deflation to countries on flexible exchange rates.
- Flexible Rates removes the anchor for monetary policy and is thus the opposite of a policy.
- Alternative for China could be inflation targeting but China has stabilized prices better by fixing to the dollar.

Effects of Substantial Appreciation on China

- Delay Convertibility
- Cut down FDI
- Lower economic growth from 7.5% perhaps to below 4% (disaster level).
- Aggravate problem of Non-Performing Loans in Banks
- Create Deflation in Rural China
- Destabilize South-East Asian economies

Effects of Appreciation on Rest of World

- No effect on US current account deficit
 - No effect on Japan's deflation rate
 - No effect on US employment
 - Possibility of another Asian Crisis
 - Derail growing consensus on Asian currency area.
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Conclusion about Substantial Appreciation

- Great Damage to China
- Trivial Benefit to U.S.
- No Benefit to Japan
- Damage to Southeast Asia
- Destabilization of the World Economy
- Souring of International Relations, APEC, etc.

Query?

- Is it more important to keep a national basket of goods stable or to keep a wider international basket of goods stable?
- Should China keep its currency stable in terms of its local basket, 4% of the world economy, or its current basket, 33% of the world economy?
- Should Japan stabilize its local basket of 12% of world economy, or a wider basket of $12\% + 33\% = 45\%$ of the world economy?

Defects of Inflation-Forecast Targeting

- China, no experience with inflation-forecast or monetary targeting in past thousands of years.
- Inflation-forecast targeting would make monetary policy a political football in China, between regions, town and country
- Aggravation of Speculative Capital Movements
- Instability of Real Exchange Rate

Defects of Inflation-Forecast Targeting, Cont'd

- Reduction in Asian role of RMB
- Reduction in confidence in RMB for savings accounts.
- Dollarization of asset prices, undermining role of RMB
- Reduction in Growth Rate
- Increase interest rates and unemployment
- Delay in convertibility

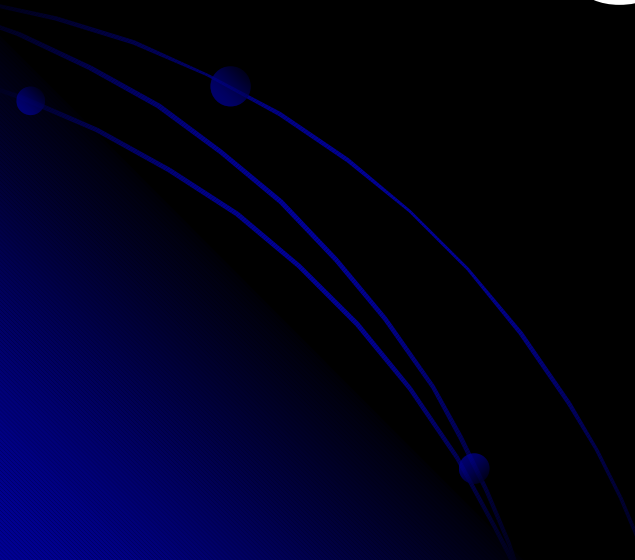
Conclusion About Floating

- Convertibility (on current account) into the dollar provides confidence in the yuan for savers.
- Floating would subject China to more continuous pressure than fixed, as in the case of Japan in the 1980s and 1990s and 2000s.
- As long as the dollar is stable in terms of the US price level, China should maintain its current policy.

Dysfunctional International Monetary System

- Three Islands of Stability: \$-€-¥ Areas:
- Exchange Rate Instability
- Cause of Asian Crisis
- The Need for Stable Exchange Rates in Developing Countries
- World Currency Map 2004

3. ASIAN CURRENCY



Which Anchor for Asia?

- Yen? **Is it too deflationary for Asia?**
- RMB? **Is inconvertibility a barrier?**
- ACU (Asian Currency Unit) basket?
- Dollar? **Will it remain stable?**
- Euro? **Is it too unstable?**
- Gold? **Not feasible unless a large country fixed it?**
- SDR? **$\$.45 + \text{€}29 + \text{¥}.15 + \text{£}.11$.**
- **Gold not feasible unless a large country fixed it.**

Possibility of a Basket Anchor

- Basket anchors only useful if they are simple and easy for the public to understand.
- The Special Drawing Rights Basket was too complicated. It started off with 16 currencies some of which were inconvertible.
- Since then the IMF has improved the SDR basket. It now has four currencies.

The SDR Basket

- 45% \$ + 29% € + 15% ¥ + 11% £
- Not a bad basket now and would be improved if Britain entered the euro zone.
- But it is still too complicated for general use. And unnecessarily complicated.

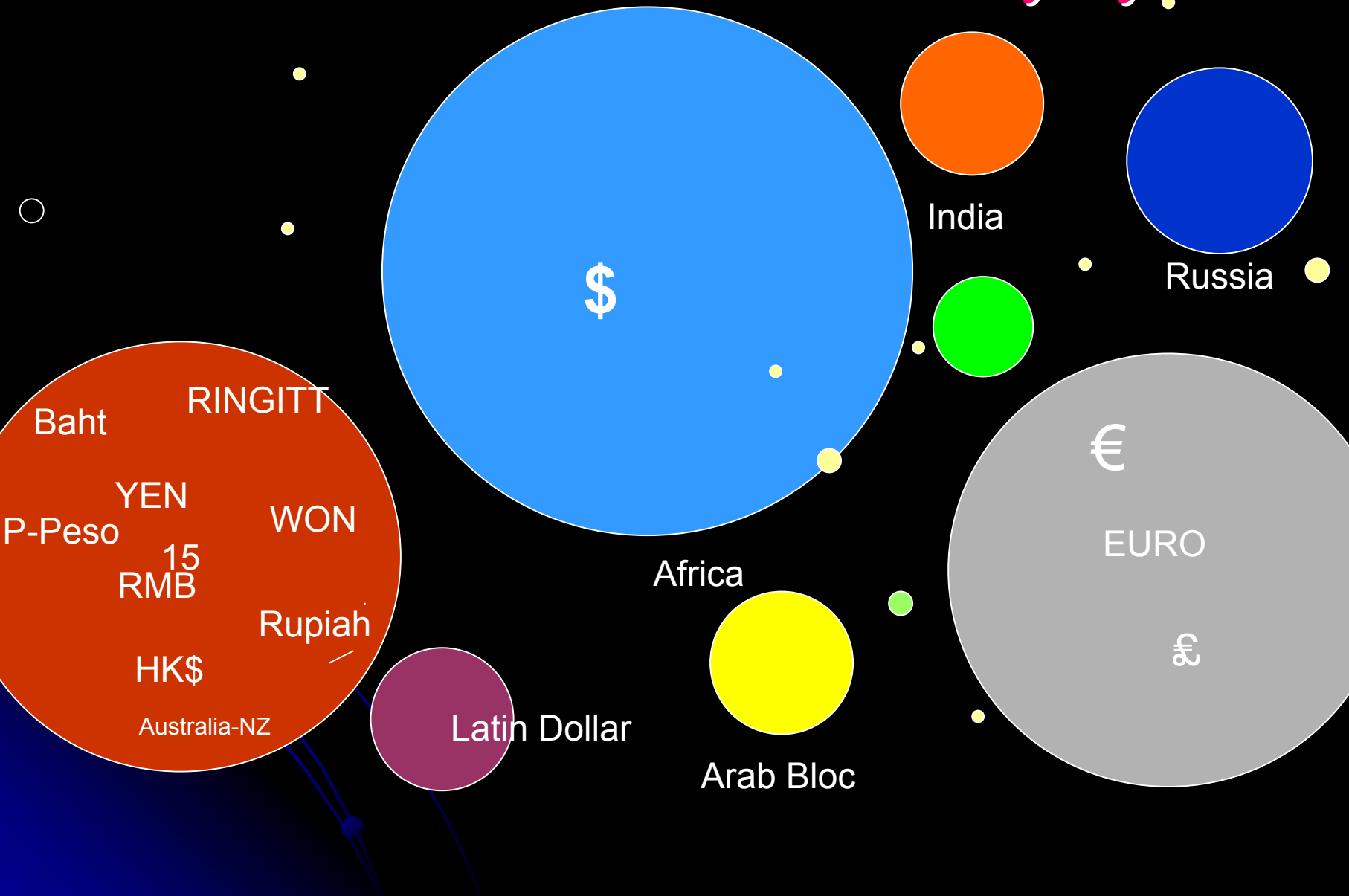
Currency Areas and Power Centers

- United States—New York
- European Union—London
- Japan—Tokyo
- China—Shanghai-HongKong
- What would be the financial center for the Asian Monetary Area?

Rise of Asia as an Economic and Monetary Force

- Recovery of Japan
- The Future of China
- Asia's role in IMF
- Asian Currency Developments

An Asian Currency by 2015?



Implications of a Successful Asian Currency

- Avoidance of unstable exchange rates between Asian countries.
- Gains from a fixed exchange rate zone in Asia.
- Capturing of seigniorage.
- Reduction of US deficit.
- Increased trade and capital movements in Asia.
- Fall-back anchor if U.S. ejects countries (e.g., China) from dollar area.
- Increased power for Asia
- Mitigation of Exchange Rate Conflicts

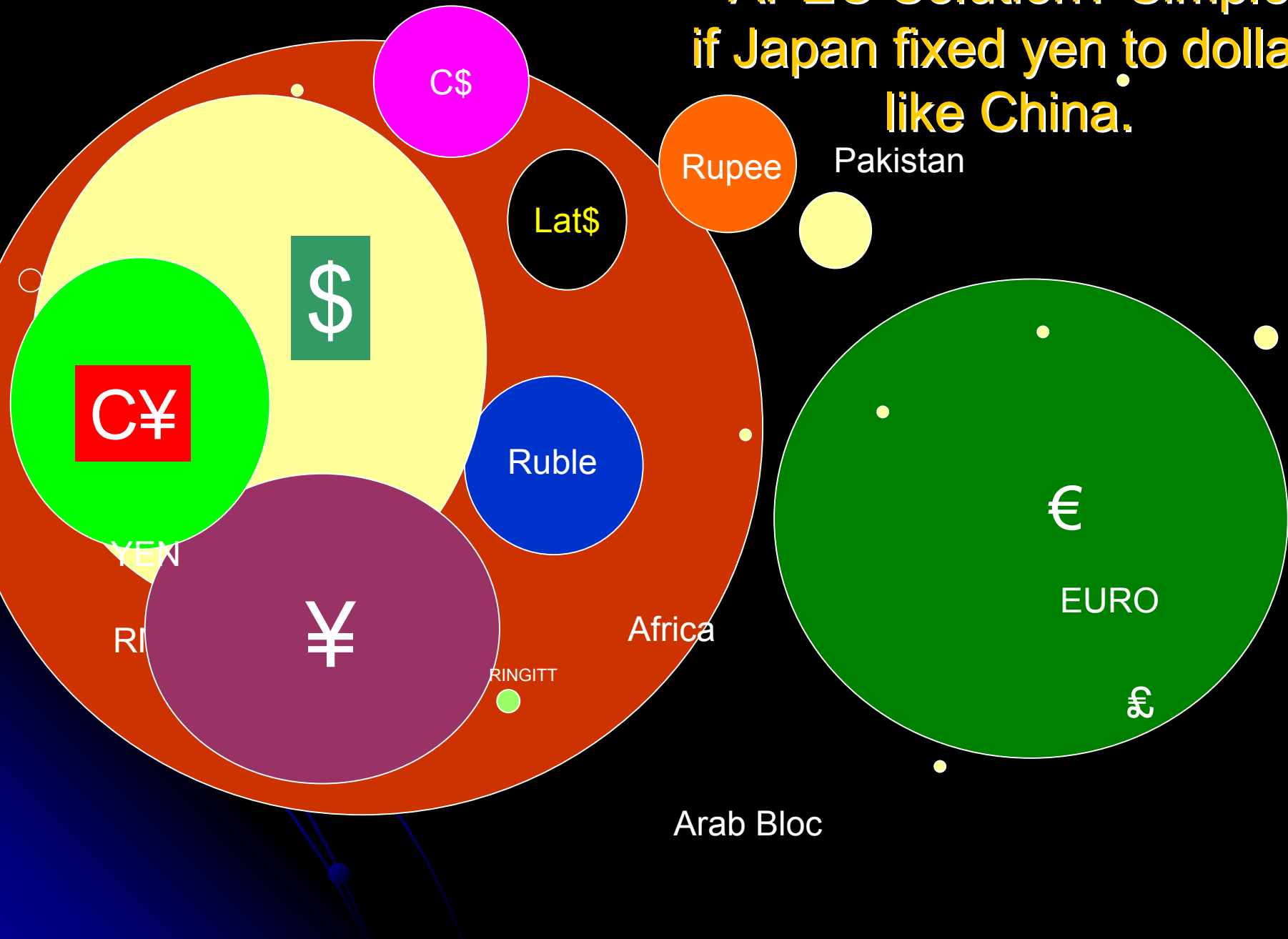
Problems

- A currency area is a power center
- Japan and China both power centers
- Location of headquarters?
- What anchor? Inflation targeting?
- Importance of US anchor?
- Need for war-free Security Area
- Implications for US alliance?

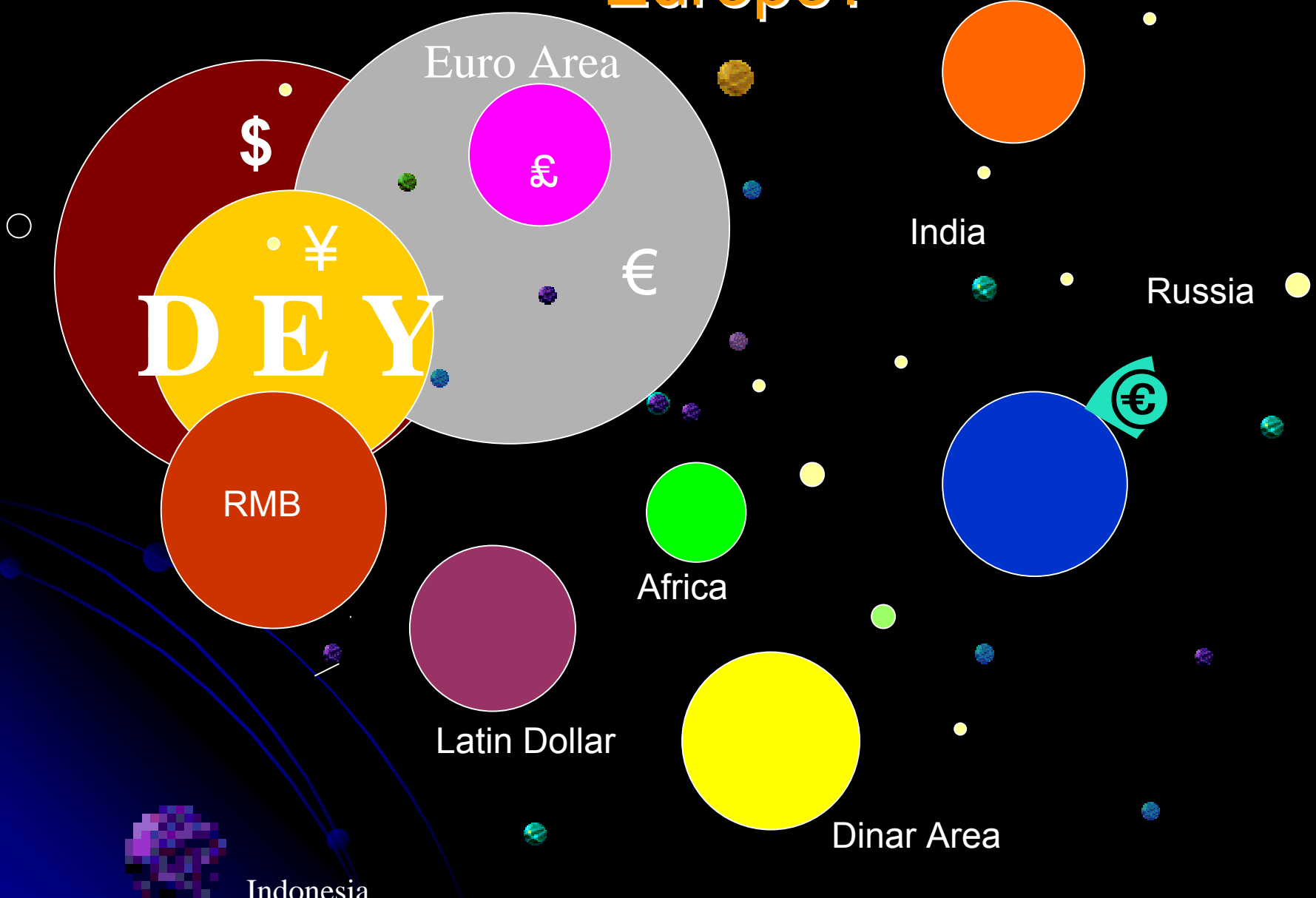
Next Steps?

- Currency Stabilization Agreement—Japan, China, Korea, ASEAN
- Would Japan accept a Common Anchor with Dollar as the initial pivot for convergence.
- Asian Monetary System (AMS) modeled after EMS.
- Is an Exit Strategy Necessary?

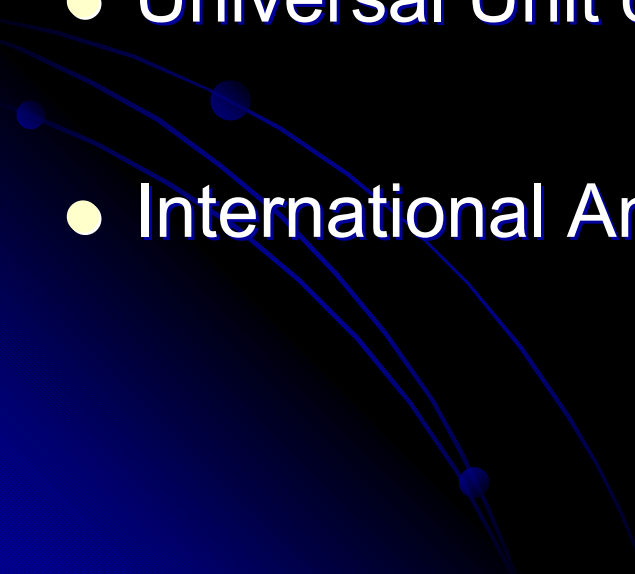
APEC Solution? Simple if Japan fixed yen to dolla like China.



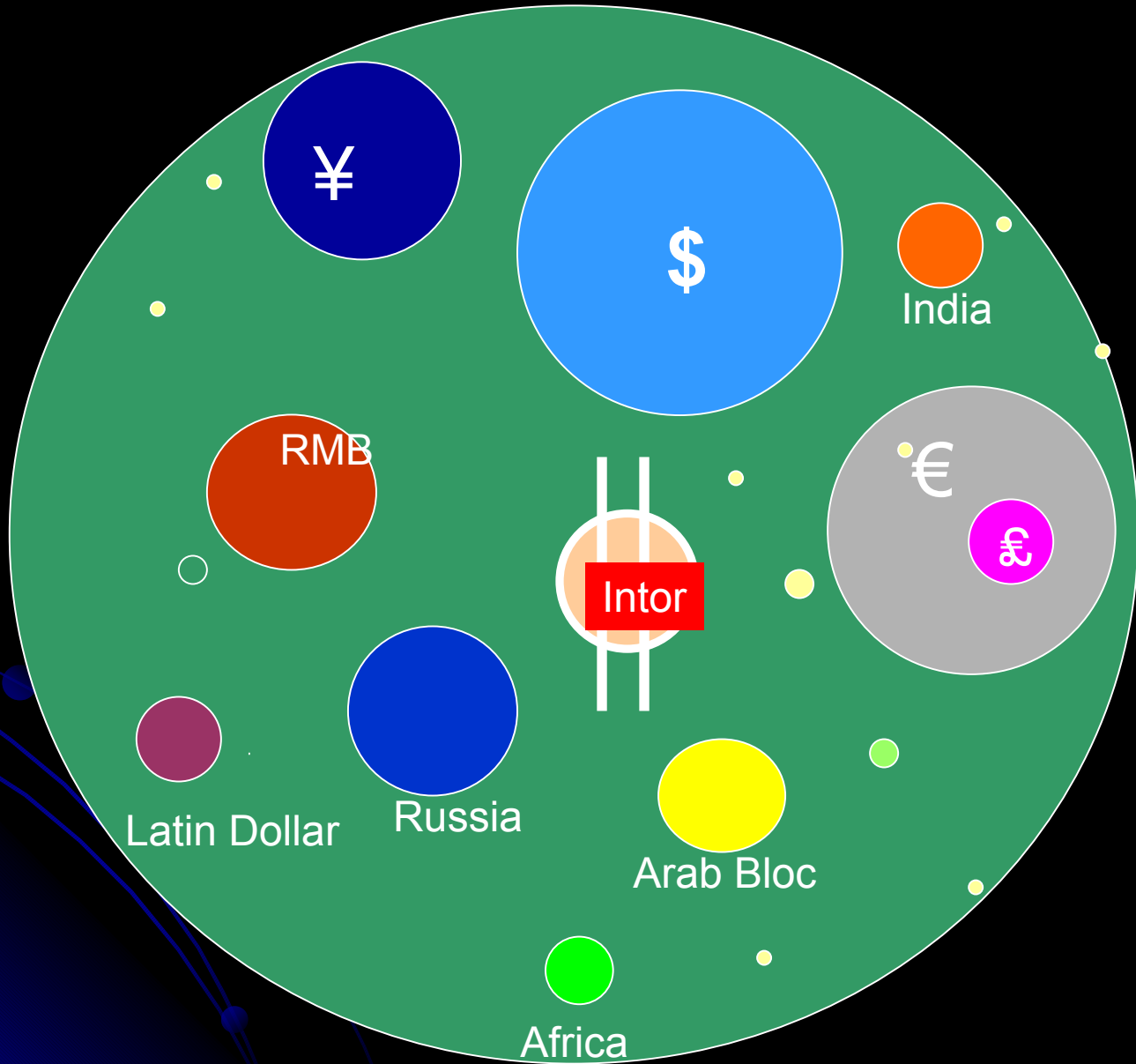
Alternative Scenario: AFEC + Europe?



Need for a Better International Monetary System

- Need for a viable international monetary system
 - Universal Unit of Account
 - International Anchor for National Currencies
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Global Solution?



アリガトウ

