

International Monetary Arrangements
Is There a Monetary Union in Asia's Future?

Barry Eichengreen

During 1995-96 the yen-dollar exchange rate endured a cycle of violent fluctuation. From 100 yen at the beginning of 1995 the dollar fell to 80 yen in April. At that point worried central bankers in Japan, the United States, and Europe intervened and halted the dollar's decline. By September of 1995 the dollar had risen to 104 yen; by this past November, to 115 yen. Alarm then grew that an undervalued yen would fan conflict over the U.S.-Japan current account balance, and a cautionary word from the Japanese Ministry of Finance dropped the dollar to 111 yen, apparently ending the cycle.

Such dramatic exchange rate fluctuations can present serious problems for the economies of the nations affected. [THIS PARAGRAPH NEEDS AMPLIFYING.] The tradables sector is most directly affected. An overvalued currency puts the squeeze on exporters, an undervalued one, on importers. Profit margins suffer from currency volatility, which also complicates investment planning.

The 1995-96 yen-dollar dustup elicited the predictable calls for international monetary reform. If the major industrialized countries that make up the Group of 7 could only agree to establish a new system of pegged-but-adjustable currencies or exchange rate target zones, observers argued, these painful exchange rate fluctuations could be avoided. And if the seven could not reach agreement as a group, then the countries whose currencies were being affected should establish a bilateral target zone.

The matter, unfortunately, is not so simple. Stabilizing exchange rates through establishing a new international monetary system of pegs, bands, or target zones would require significant compromises of domestic policy autonomy. Intervention by central banks is effective only if it sends credible signals of future shifts in monetary and fiscal policies--that is, when there

is no conflict between domestic and international economic policies.

But in today's world, conflicts between domestic and international economic objectives are inevitable, and they will inevitably defeat efforts to maintain currency pegs. The removal of controls on international capital movements and the development of modern information-processing technologies over the past several decades permit billions of dollars to be traded across borders at the stroke of a key. The domestic policy independence that capital controls once afforded national monetary and fiscal authorities has become a thing of the past. Currency traders, no longer limited by controls, are free to attack an exchange rate as soon as they begin to suspect that the government is less than totally committed to defending it--a practice that can greatly increase the cost of defending the currency peg. With the end of the Cold War and the disintegration of dominant political coalitions in countries like Italy and Japan, governments are necessarily fragile and hesitant to put the domestic economy through the wringer to defend the exchange rate at any cost. Weak governments find it infeasible to pursue the international economic policies needed to maintain a durable currency peg.

Thus schemes to peg the dollar, the yen, and the deutschmark against one another, as had been the practice until the Bretton Woods international monetary system collapsed in the early 1970s, will prove unavailing. Exchange rates between these currencies will continue to float against each other.

For United States and Japan, large countries that remain relatively closed to international transactions, this arrangement, while painful, is bearable. For small open economies, where a larger share of production is typically sold on international markets, the dislocations caused by exchange rate swings can be excruciating. Because the financial sector is small relative to global financial markets, a shift in market sentiment or in interest rates in the United States can elicit a flood of capital inflows that lead to a dramatic real appreciation or massive outflows that cause the exchange rate to depreciate alarmingly.

Whether these small open economies are in Europe, Latin America, or East Asia, they find it exceedingly difficult to live with exchange rate fluctuations. They are thus prepared to take drastic steps to limit exchange rate volatility. In Western Europe, such steps include the effort to establish a monetary union among the members of the European Union. Monetary unification banishes exchange rate volatility by abolishing the exchange rate. But it requires the participants to share responsibility for their common monetary policy. Conveniently for the small open economies of Europe, the larger partner they wish to join in monetary union, Germany, may be prepared to compromise its monetary autonomy in return for reacquiring a foreign policy role in the context of a European Union foreign policy.

The question for the 21st century is whether analogous monetary blocs will form in East Asia and in the Western hemisphere. With the dollar, the yen, and the single European currency floating against one another, other small open economies will be tempted to link up to one of the three. But the linkage will be possible only if accompanied by radical changes in institutional arrangements like those contemplated by the European Union. The spread of capital mobility and political democratization will make it prohibitively difficult to peg exchange rates unilaterally. Pegging will require international cooperation, and effective cooperation will require measures akin to monetary unification.

The day when the countries of the Western Hemisphere are prepared to join the United States in a monetary union or when the countries of East Asia including Japan will be prepared to create a single Asian currency remains far away. The political preconditions for monetary unification are not in place. Operating a monetary union requires some pooling of political responsibility. History provides very different prospects for this in Western Europe and East Asia. Proponents of European integration can trace their antecedents back for hundreds of years. Jeremy Bentham advocated a European assembly, Jean-Jacques Rousseau a European federation, Henri Saint-Simon a European monarch and

parliament. By the middle of the 19th century intellectuals like Victor Hugo could speak of a United States of Europe. In the 1920s, the Pan-European Union lobbied for a European federation and attracted the support of Aristide Briand and Edouard Herriot, future premiers of France. Konrad Adenauer and George Pompidou, two leaders of the postwar process of European integration, were members of the Pan-European Union. The ideal of European integration is intimately connected with the liberal and democratic principles of the European Enlightenment and has roots in centuries of European history.

East Asia, in contrast, lacks comparable political solidarity. It lacks a Jean Monnet or Paul Henri Spaak to speak for regional integration. In part this reflects the ideological distance between China's communist government and market-oriented regimes elsewhere in East Asia. By contrast, in postwar Western Europe, variants of the social market economy were embraced by virtually all the members of the present-day European Union.

At a deeper level, East Asia lacks a Benthamite\Rousseauian\Saint Simonian heritage of collective democratic governance through integration. As FIRST NAME? Katzenstein puts it, "the notion of unified sovereignty . . . central to the conception of continental European states, does not capture Asian political realities." Not only in China do the regions resist the attempts of the center to exercise its political WHAT through the operation of political and legal institutions. The idea of a centralized state with a monopoly of force that regimented its citizens through the superimposition of a common set of institutions is a European conception, not an Asian one. Asian civil society is structured by ritual, ceremony, and economic networks as much as by force and law.

Consequently, integrationist initiatives in Asia have proceeded not through the creation of strong supranational institutions but by establishing loose networks of cooperation. It is revealing that APEC, which is essentially just a consultative forum, has succeeded where initiatives to create smaller, more cohesive Asian analogues to the EEC or EFTA have not.

Gazing far into the 21st century, one can imagine the development of a single Asian currency analogous to the Euro. In a world of open international capital markets and politicized domestic policy settings, that will be the only alternative to floating exchange rates. As the economies of East Asia grow still more open and interdependent, pressure will build to work toward this goal. But as yet the political preconditions are not in place. An Asia monetary union is at best a very distant prospect.