Asian Monetary integration: A Japanese Perspective

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Outline

1. Introduction
2. Impact of the Global Financial Crisis on Japan
3. Japan’s Exchange Rate Policy
4. Japan’s Strategy for Regional Monetary Integration
5. Conclusion

1. Introduction

Is there a case for regional exchange rate policy coordination in Asia?

- The Asian financial crisis (1997-98) highlighted the value of regional monetary & financial cooperation: CMI, ERPD, ABMI, EMEAP
- Common shocks from the global capital markets (GFC, US QE2 and possible QE3, the eurozone sovereign debt and banking crisis) affect many economies in the region
- Rising regional economic inter-dependence in Asia suggests a case for monetary integration
- What are the lessons from the euro crisis for Asian monetary integration?
- What is Japan’s strategy?

2. Impact of the Global Financial Crisis on Japan

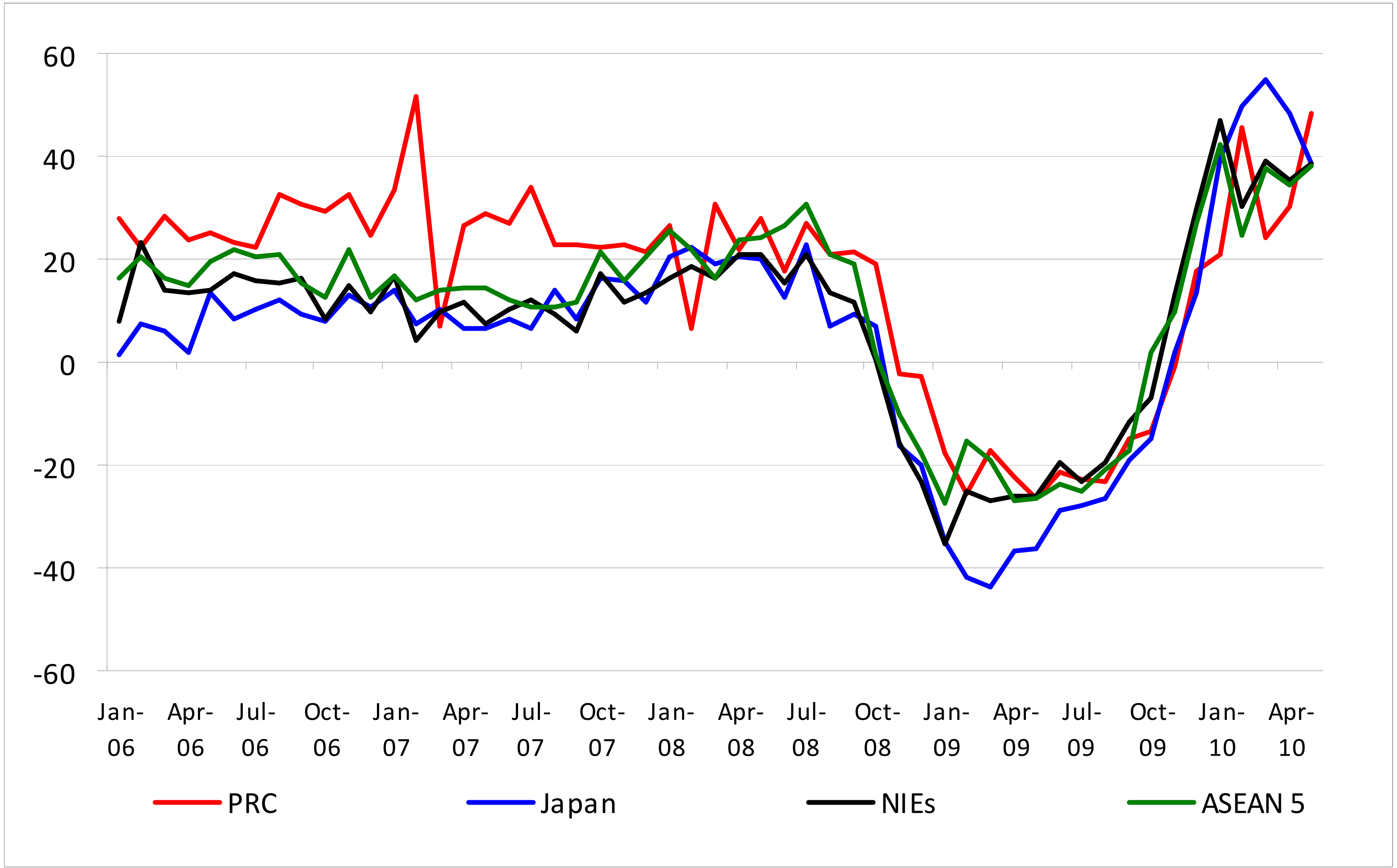
- Real sector impact
- Impact on the yen
- Impact of yen appreciation on the Japanese economy

(1) Real Sector Impact

- The **global financial crisis (GFC)** adversely affected Japan's exports, imports, industrial production and real GDP
  - Japan had negative growth in 2008
  - Japan's exports were affected both in finished products for the US & EU markets and parts and components for the EEA markets
- These impacts were largely similar across East Asia
- The **triple disasters** due to the 3.11 earthquake, tsunami and nuclear plant failures affected the economy significantly
- The economy continued to shrink until 2011Q2; there was a rebound in 2011Q3 and recovery expected in 2012Q4 and in 2012.

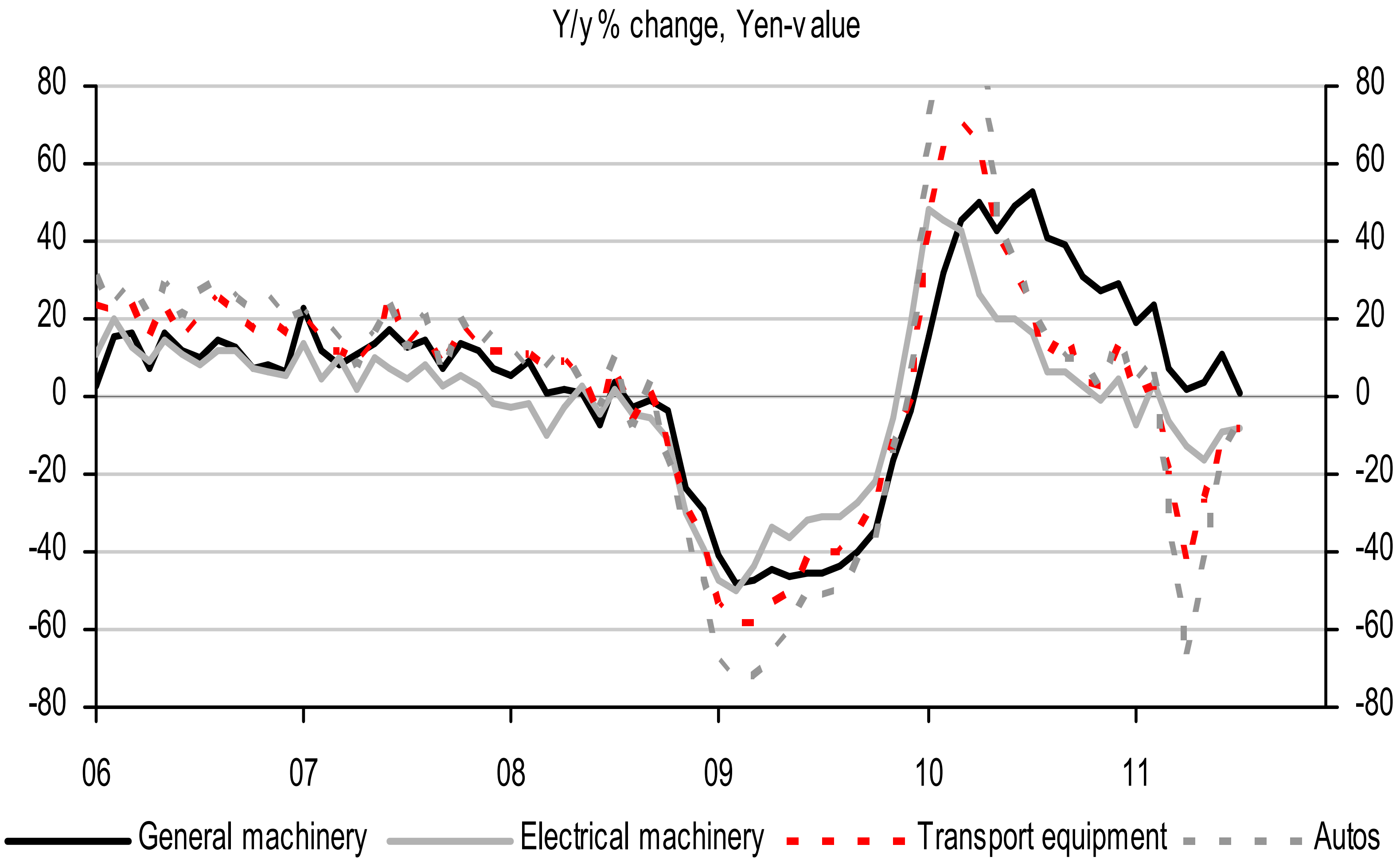
Japan's exports plunged, then rebounded

Export Growth in Japan and emerging East Asia (in %)



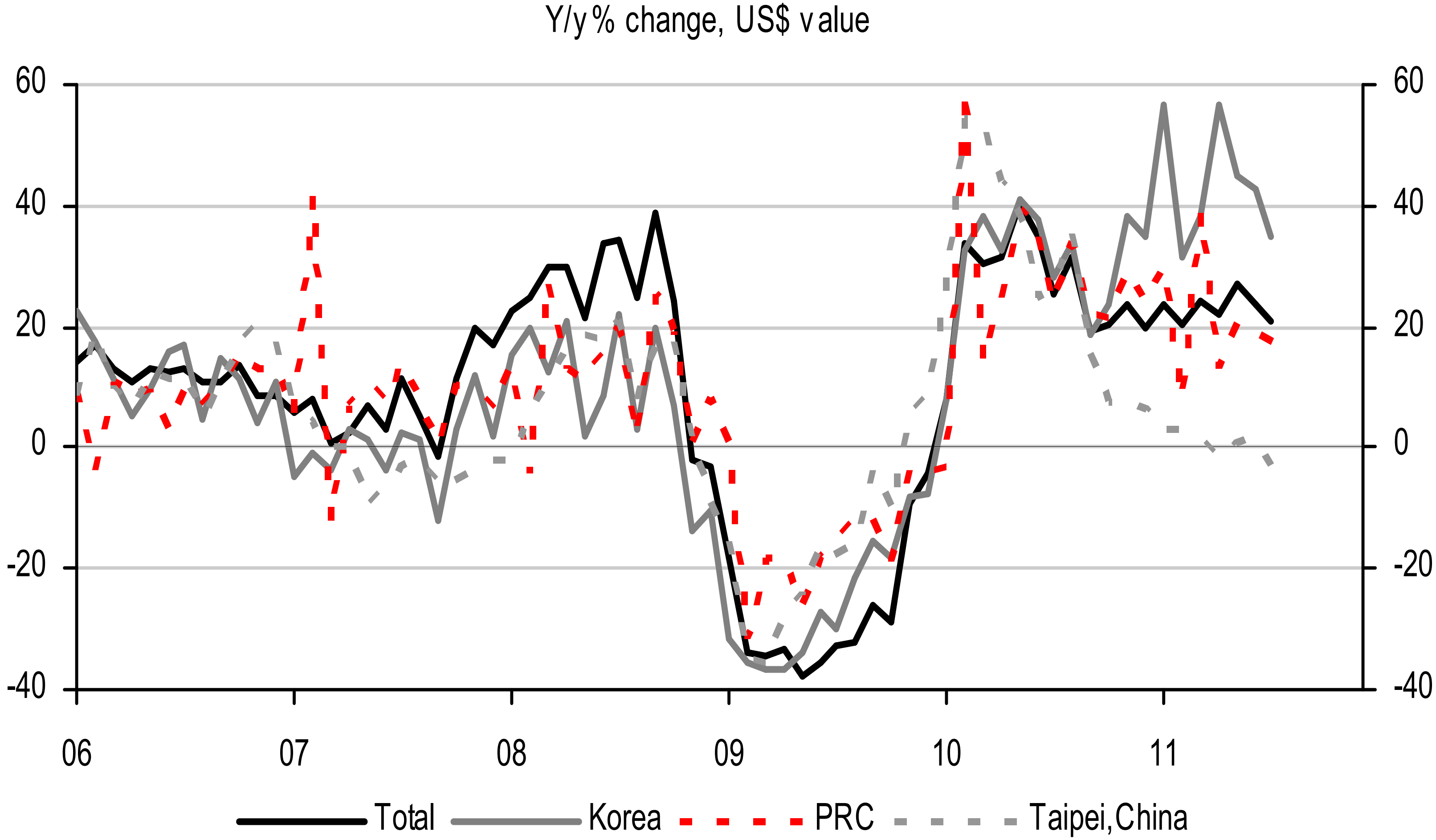
Source: CEIC database

Japan exports by sector:
Autos hardest hit, but now rebounding



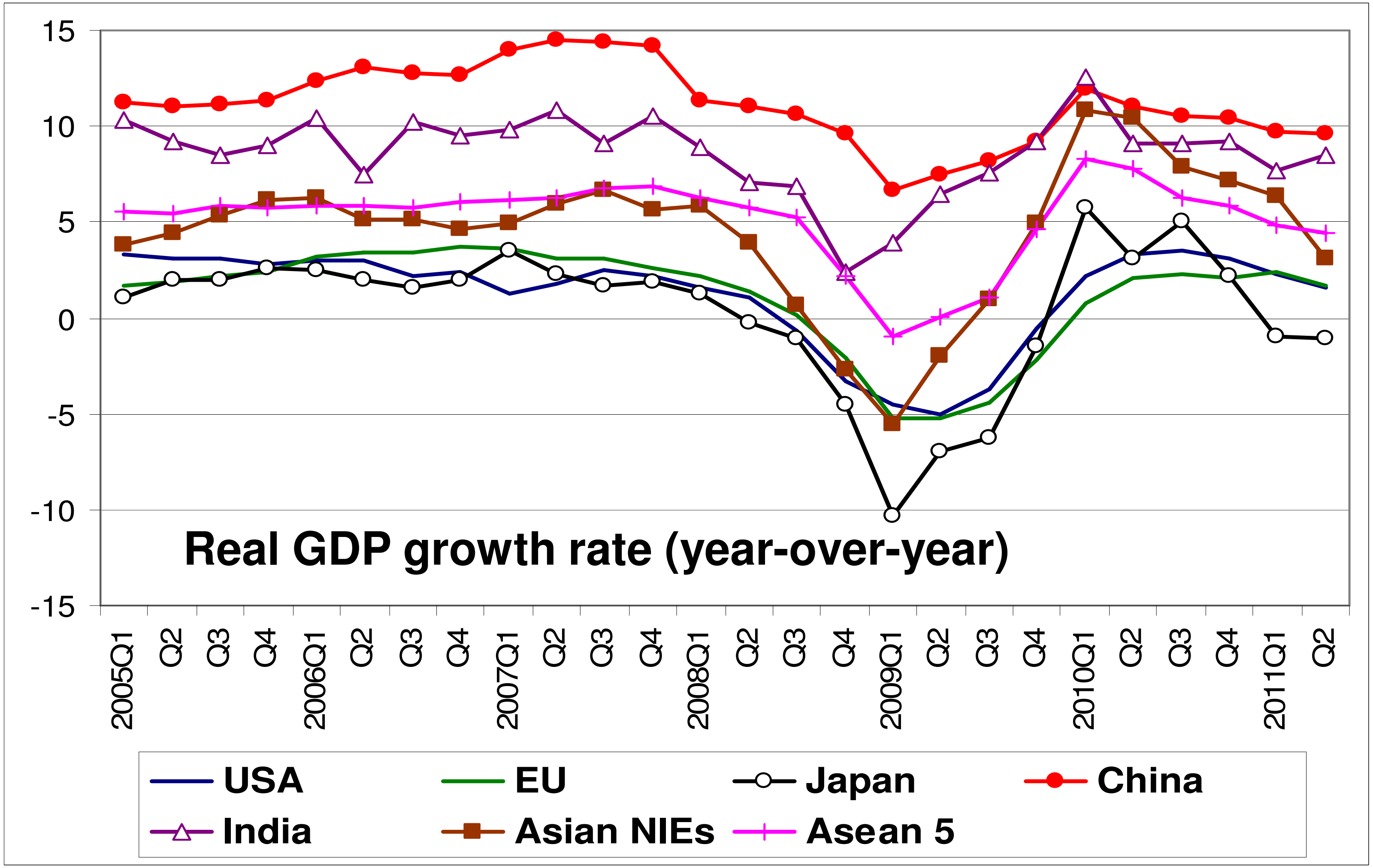
Source: CEIC Database Co.

Japan import growth remained firm, except from Taipei,China



Source: CEIC Database Co.

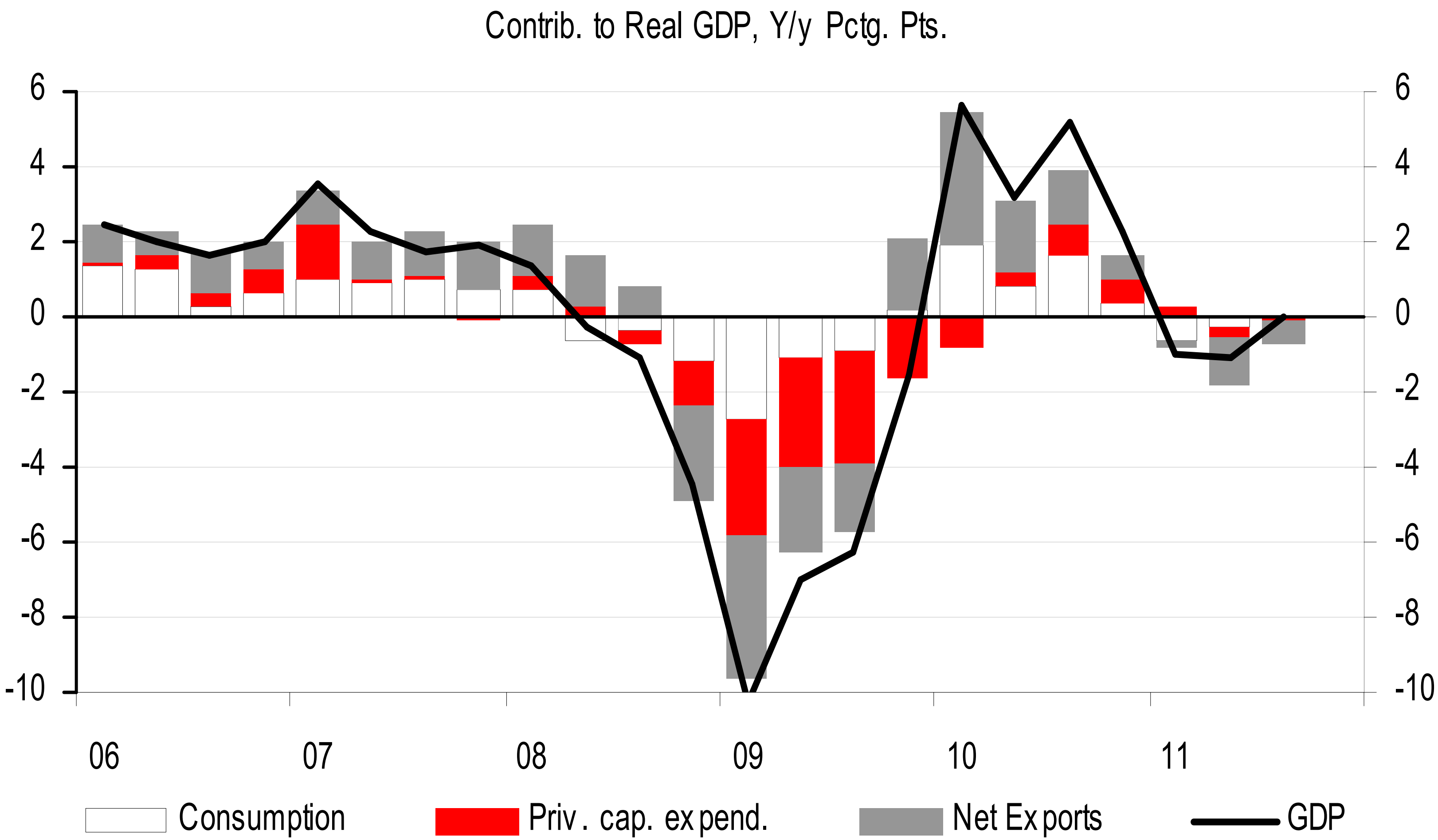
Japanese economy contracted sharply due to the global financial crisis



Source: IMF, *International Financial Statistics*, CD-ROM; Eurostat

GDP rebounded in 2011Q3

GDP growth (y-o-y, %)



Source: Cabinet Office

Japan’s economic growth forecasts

Consensus forecasts for Japan real GDP (% change)

	2011	2012
Median	-0.4	2.8
Mean	-0.5	2.8
Capital Economics	-0.2	2.5
Daiwa Institute of Research	-0.7	2.5
UBS	-0.4	2.9
CITIC Group	-0.2	2.4
Nomura Securities	-0.3	3.1
JPMorgan Chase	0.0	--
Morgan Stanley	-1.2	2.9
BNP Paribas	-0.8	2.1
Credit Agricole	-0.7	2.9
Itochu Corp	-0.3	2.8
Japan Research Institute	-0.9	3.3
Mitsubishi Research Institute	-0.4	2.4
Mitsubishi UFJ Research and Consulting	-0.8	3.4
Reference		
IMF	-0.7	2.9
OECD	-0.9	2.2

Source: Bloomberg accessed on 9 September 2011, IMF (2011), OECD (2011)

(2) Impact on the yen

- The **global financial crisis (GFC)** caused the yen to appreciate, rather than depreciate, unlike in many other economies

  - Massive repatriation of the US dollar back to the US markets, driven by cash-short US financial firms

  - Korea saw rapid capital outflows and a mini won crisis

  - Japan's yen appreciation partly due to the unwinding of carry trades

- Following the **triple disasters**, the yen began to appreciate with the expectation of Japanese insurance firms' repatriation back home
- The nominal value of the yen continued to appreciate, breaking the historical record reached in April 1995

  - Monthly average rate: 76.84 yen/$ (Sep. 2011) vs. 83.67 yen/$ (April 1995)

Why yen appreciation?

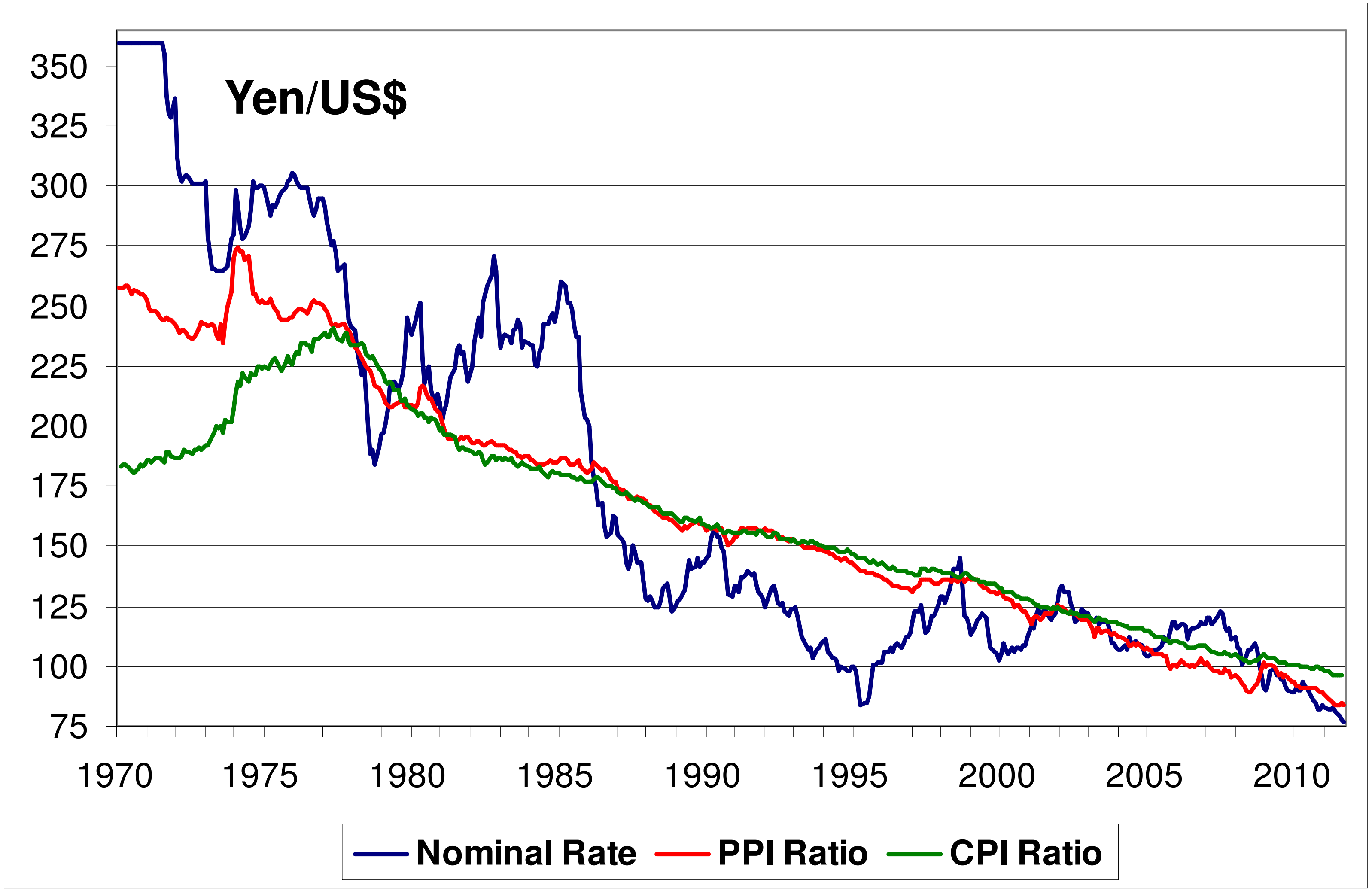
Despite the aging pressure and rising public debt, the yen remains strong

- One fundamental reason is price deflation in Japan, that sets the long-term trend of nominal yen rates
- Another reason is persistent current account surpluses
- The third reason is a safe haven effect; The Japanese economy is not growing, but its growth prospect is better than those of the US and Europe given the latter's problems

  - Sovereign debt and banking crisis in the eurozone

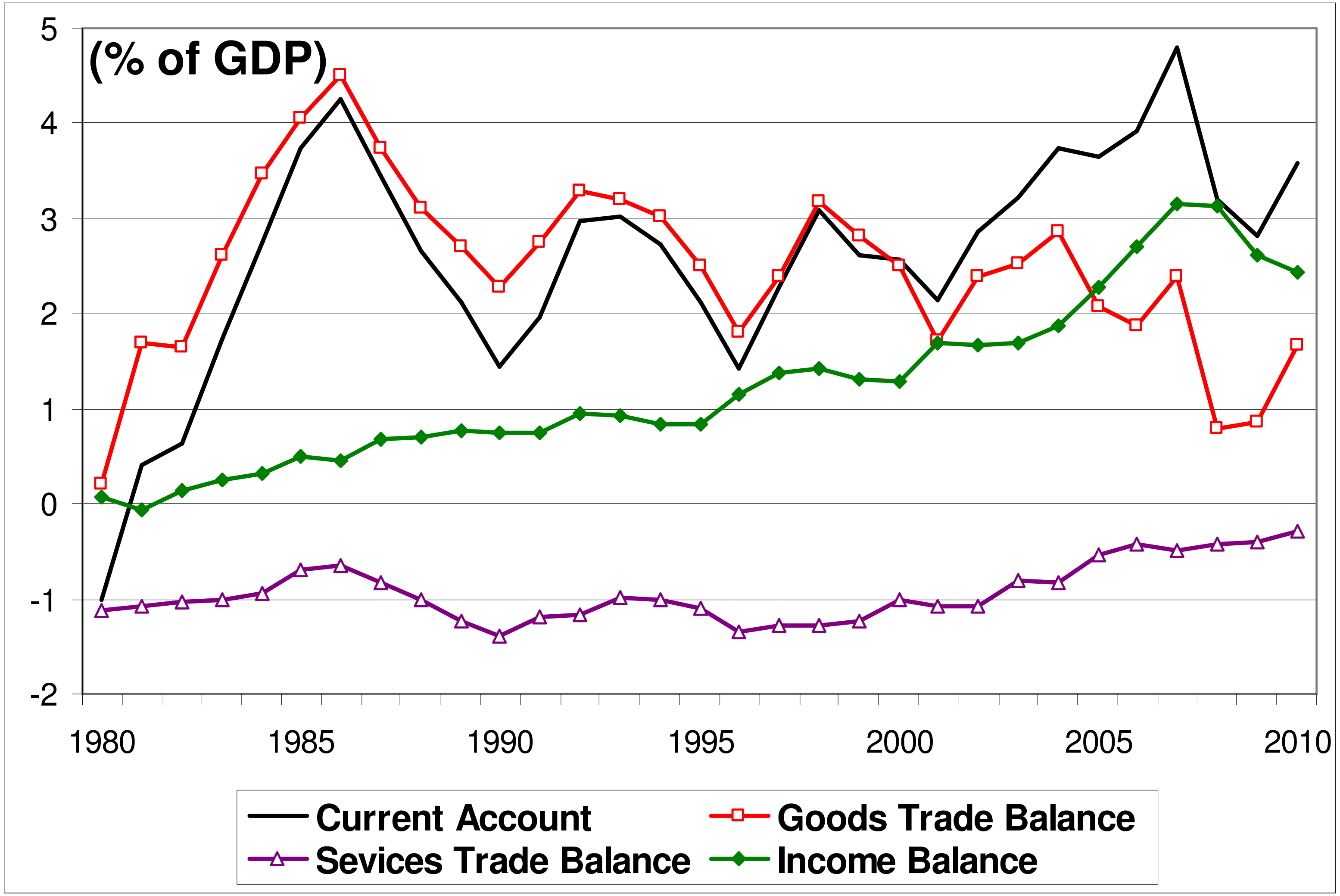
  - Rising public debt, high unemployment, uncertain property prices, and potential for QE3

Nominal yen appreciation driven partly by Japan's price deflation



Source: International Monetary Fund, *International Financial Statistics*, CD-ROM

Japan's current account is still in surplus



Source: IMF, *International Financial Statistics*, CD-ROM

(3) Impact of yen appreciation on the Japanese economy

- The yen's overall real effective exchange rate (BIS REER), based on relative CPIs, is still about 30% lower than in the previous peak in 1995
- But the REER for the automobile sector suggests that the level is about the same as the 1995 level

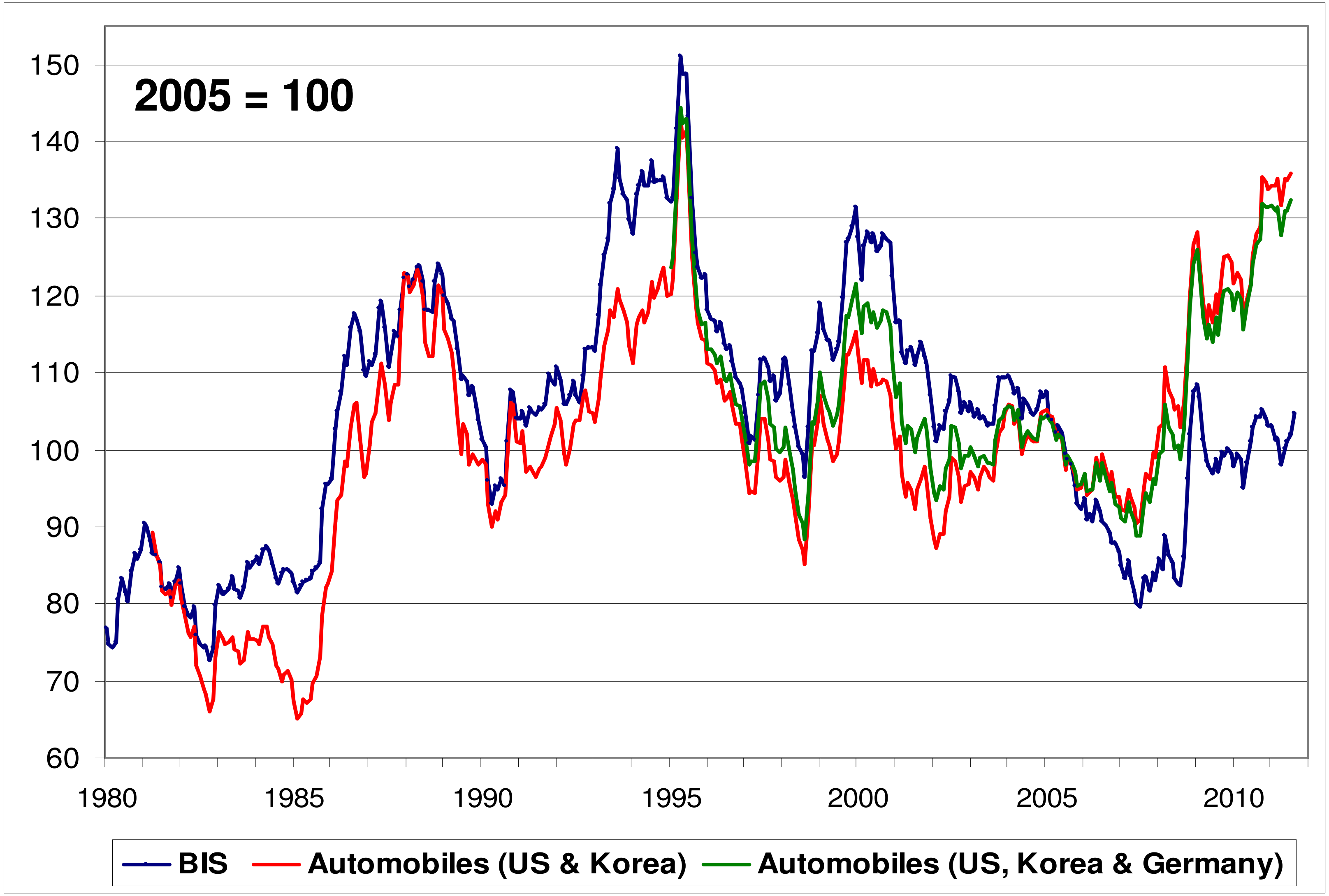
  - Large negative spillover effects on the auto-related sectors (steel, tires, glass, electronics, etc)
- Business concern over the hollowing-out of Japanese manufacturing

  - Sectors which have exited Japan are less affected

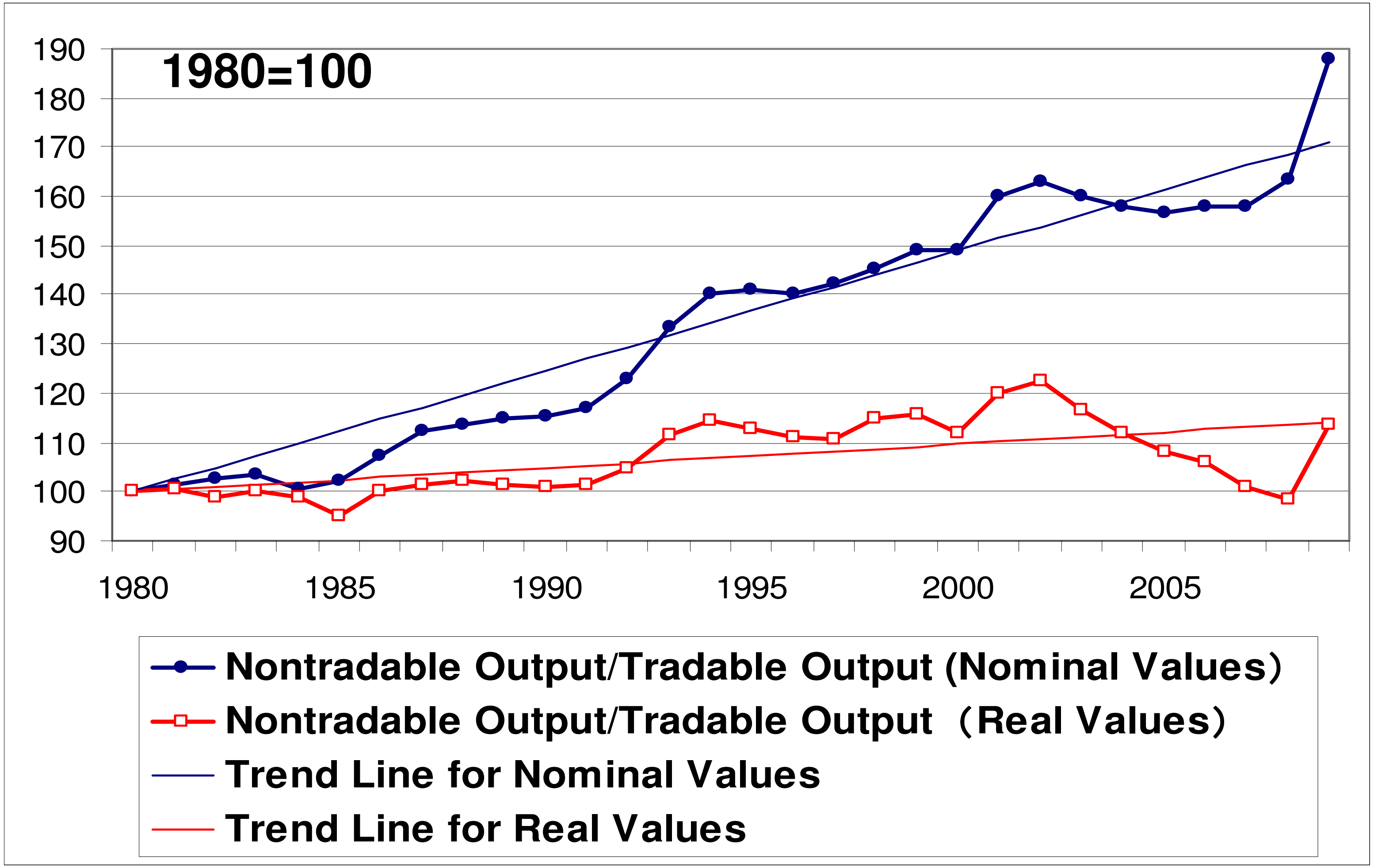
  - Competitive sectors, like automobiles and technology & knowledge intensive sectors, are now severely affected

  - Some evidence of a shift towards nontradables

Real effective exchange rates of the yen, BIS data and for automobiles



Production of nontradable goods relative to tradables goods (nominal & real), 1980＝100



Note: Tradable goods are those produced in agriculture, mining and manufacturing, and nontradable goods are those produced by other sectors

Source: Constructed from data published by Cabinet Office, Government of Japan

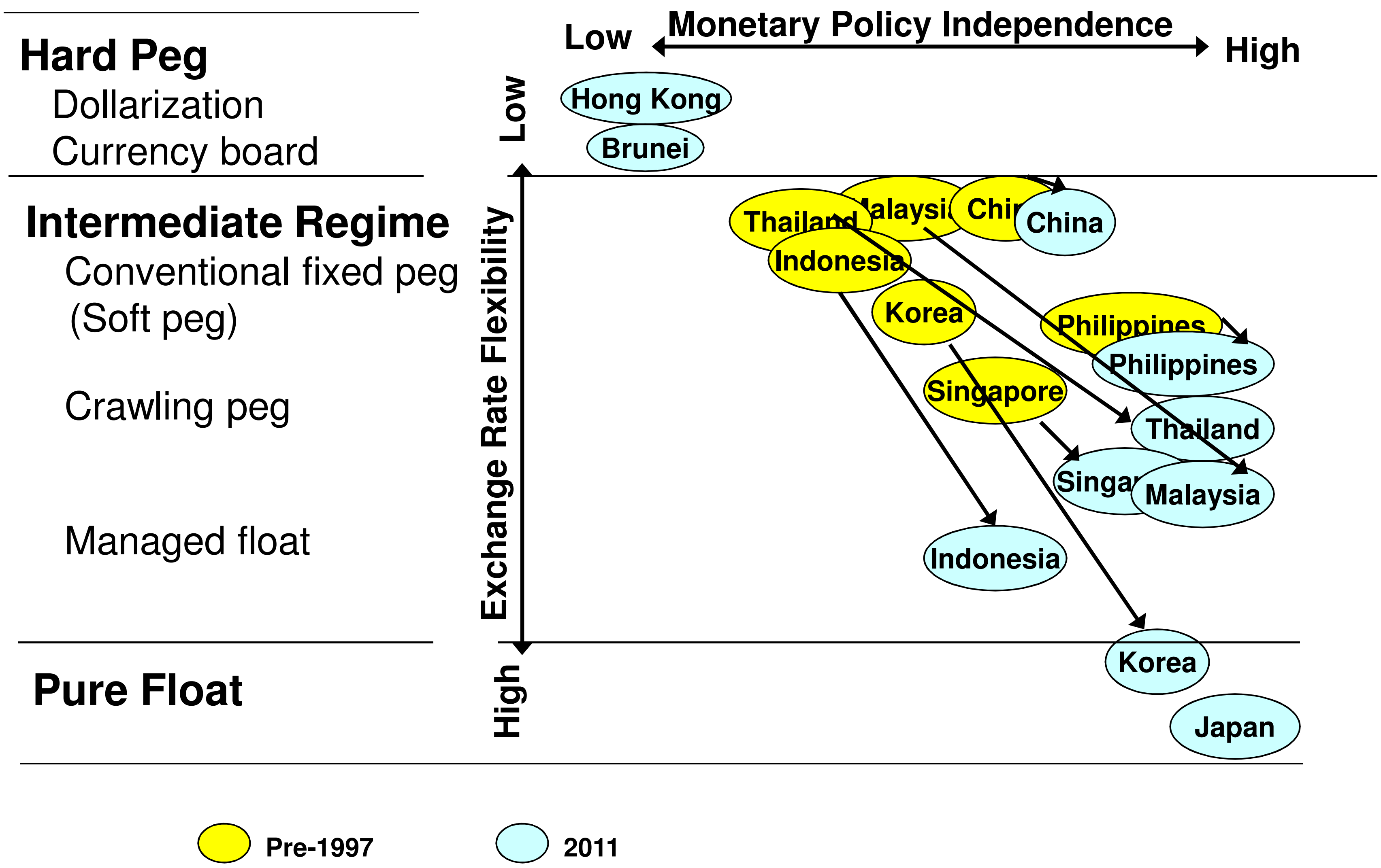
3. Japan’s Exchange Rate Policy

- Japanese yen as a freely floating currency
- Foreign exchange market intervention
- Support of emerging Asia’s exchange rate stability

(1) Japanese yen free floating

- Japan fully liberalized its capital account in the 1980s, and adopted free floating in order to pursue monetary policy independence
- This is different from emerging East Asian economies which are either financially under-developed so that they have to maintain some capital controls, or they are small and open (Hong Kong, Singapore) so that they attempt to stabilize their exchange rates against outside currencies
- As a result exchange rate regimes in Asia are diverse, although there has been some convergence towards greater exchange rate flexibility, except in China
- Degrees of intra-regional exchange rate fluctuation are often large

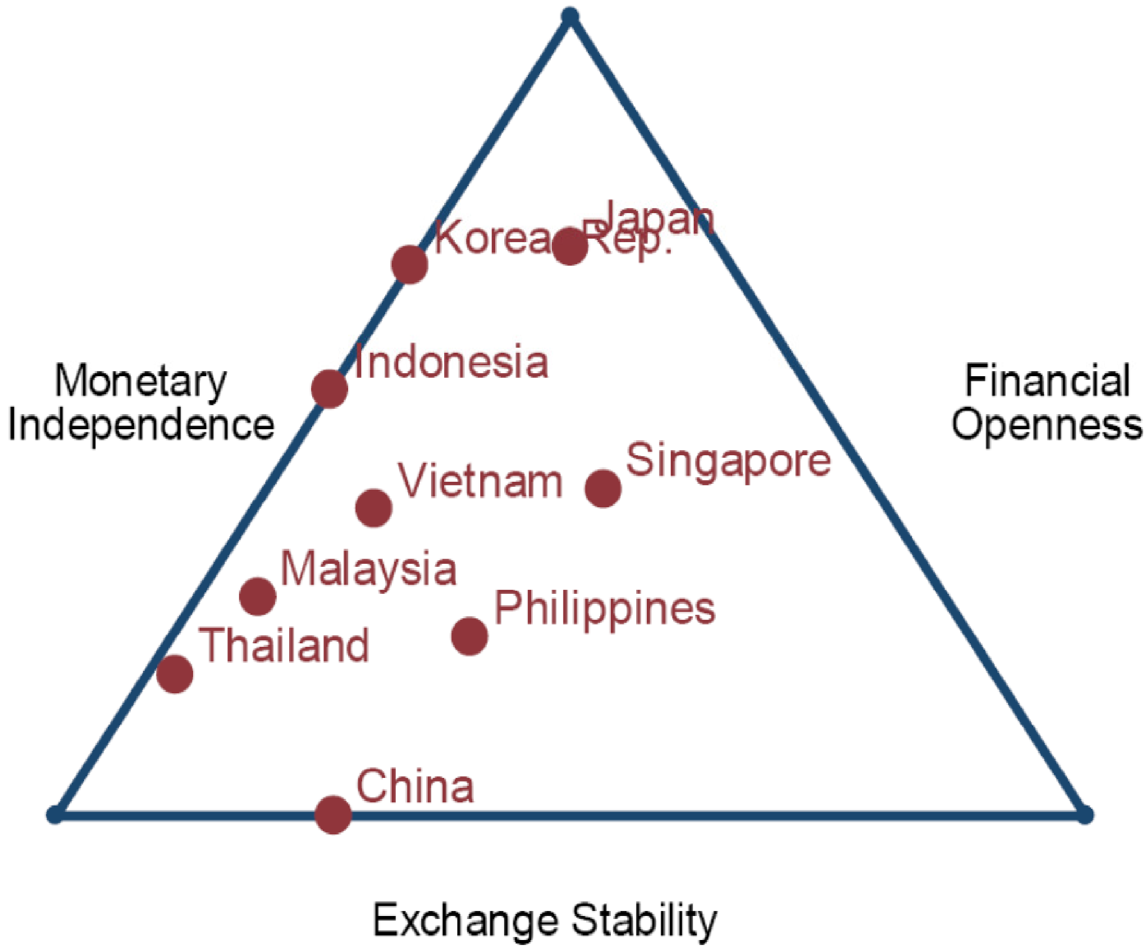
Japan adopts free floating while exchange rate regimes in East Asia are diverse



Source: Author

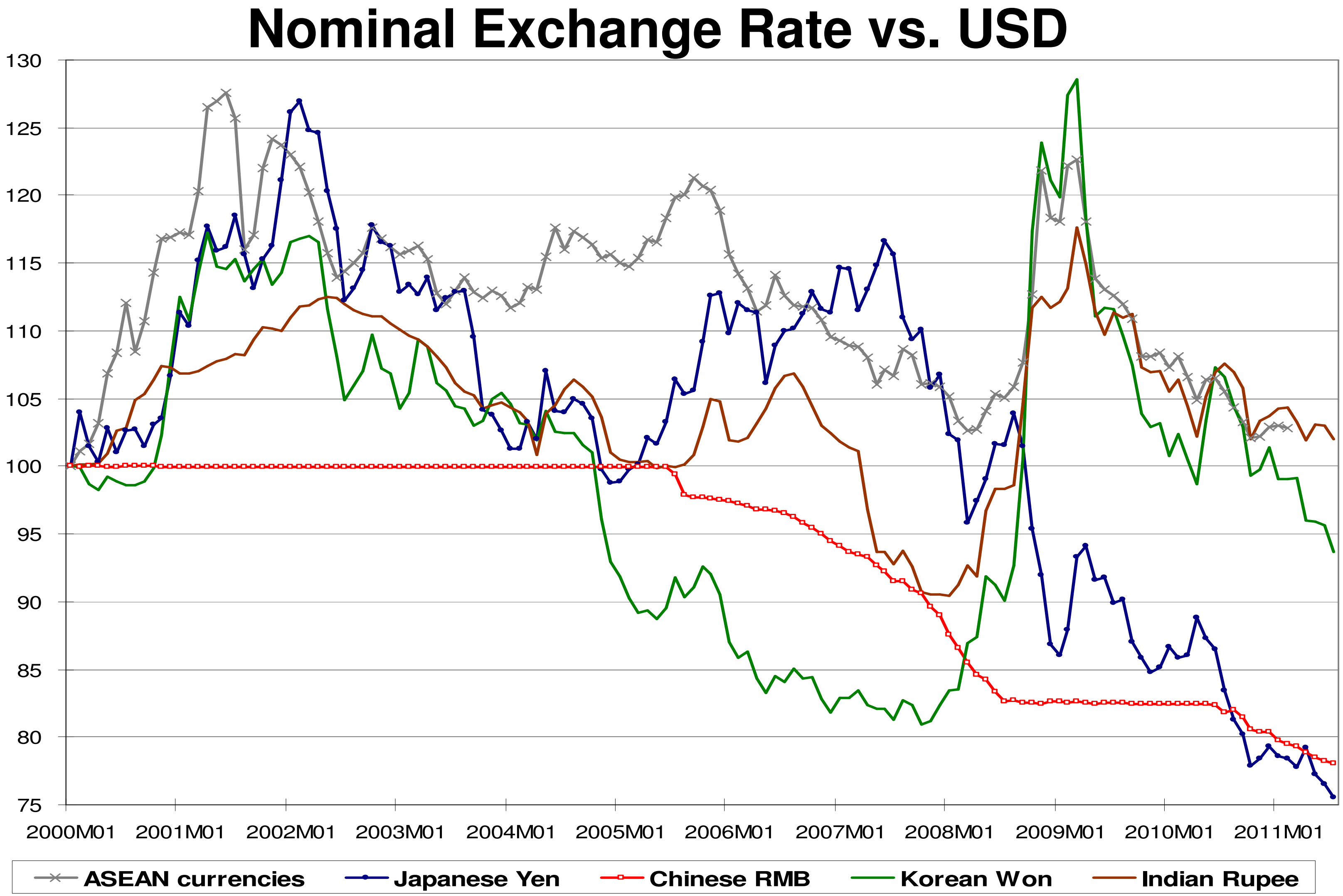
Impossible trinity in East Asia

ASEAN3 Economies, 2009



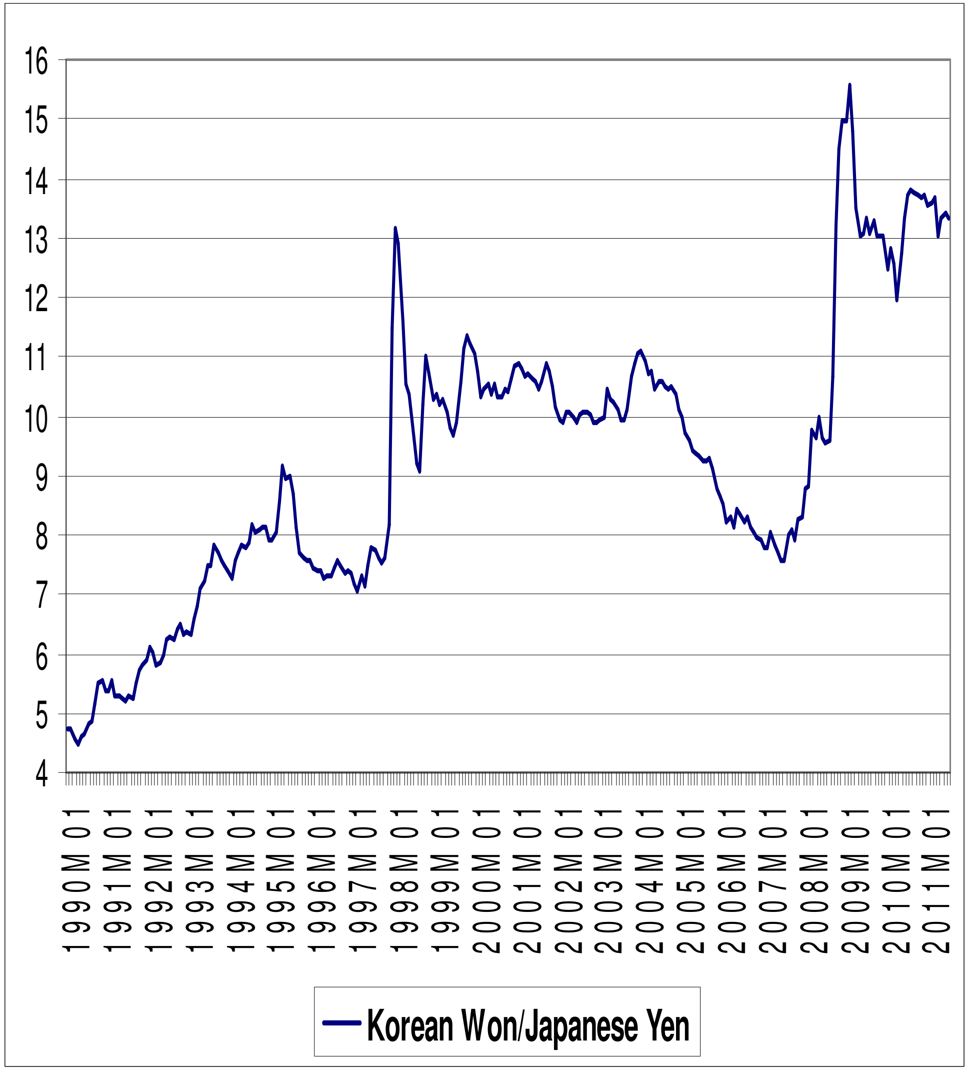
Source: Ito, Hiroyuki and Masahiro Kawai (2011)

Yen and emerging East Asian currencies often move in opposite directions



Source: International Monetary Fund, *International Financial Statistics*, CD-ROM

The yen-won rate is often very volatile



Source: IMF, *International Financial Statistics*, online

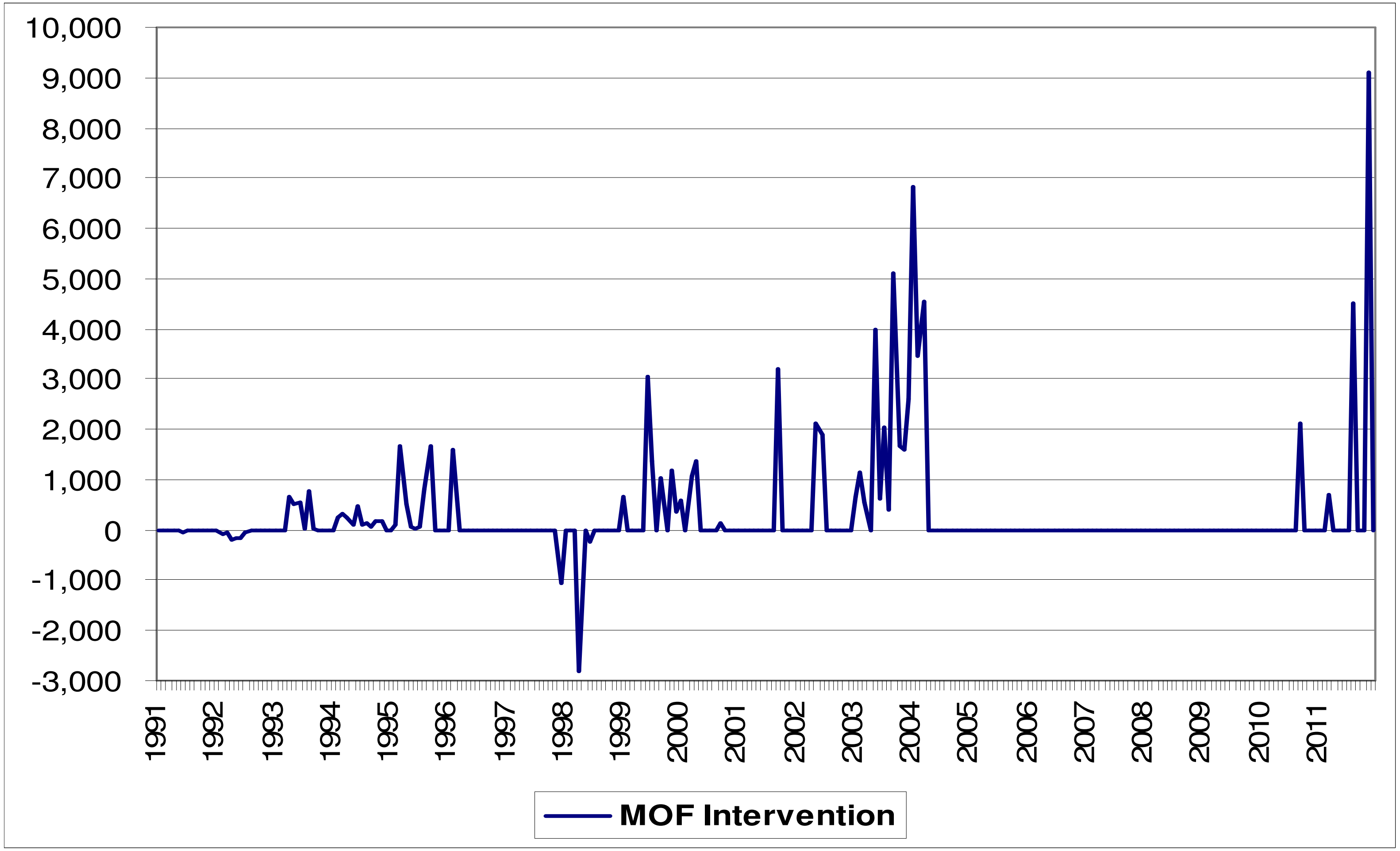
Large yen/won volatility

- The won was strong before the global financial crisis but, following the Lehman collapse, depreciated sharply from 907 won/$ (Oct. 2007) to 1,483 won/$ (Nov. 2008)
- The won/yen rate moved from below 8 won/yen in mid-2007 to above 15 won/yen at end-08 and early 09
- Such a large volatility of exchange rate is counterproductive to trade and investment

(2) Foreign exchange market intervention

- Japan intervened heavily in the past on some specific occasions, particularly to prevent rapid yen appreciation such as during 2003-04
- The most recent intervention in November 2011 was a record high in terms of monthly intervention volume
- Intervention was often, but not always, sterilized
- Intervention was sometimes, but not always, coordinated with the US and other authorities
- Impacts of intervention have been limited in stopping currency appreciation, but, it likely
  - Lessened the speed of yen appreciation
  - Avoided a free fall of the US$ vs. the yen

Japan MOF intervention in the foreign exchange markets



Note: Positive numbers indicate purchases of foreign currency with the yen, and the negative numbers indicate sales.
Source: Japan Ministry of Finance, official website

Coordinated intervention

Period	# Days	Episodes
February 1987	1	Yen appreciation (Louvre Agreement)
January - February 1992	3	Yen depreciaiton together with low performance in the stock market
April - June 1993	4	Yen appreciation due to Japan-US trade friction
May - June 1994	2	Yen appreciation due to Japan-US trade friction
November 1994	2	Yen appreciation due to Japan-US trade friction
March - May 1995	4	Yen appreciation due to the Mexican currency crisis and Japan-US trade friction
July - August 1995	3	Yen appreciation due to the Mexican currency crisis and Japan-US trade friction
November 1997	5	Rupia depreciation due to spread of the Asian currency crisis
June 1998	1	Yen depreciation due to Japan's nonperforming loan problem
September 2000	1	Euro depreciation
March 2011	1	Yen appreciation in the aftermath of the Great East Japan Earthquake

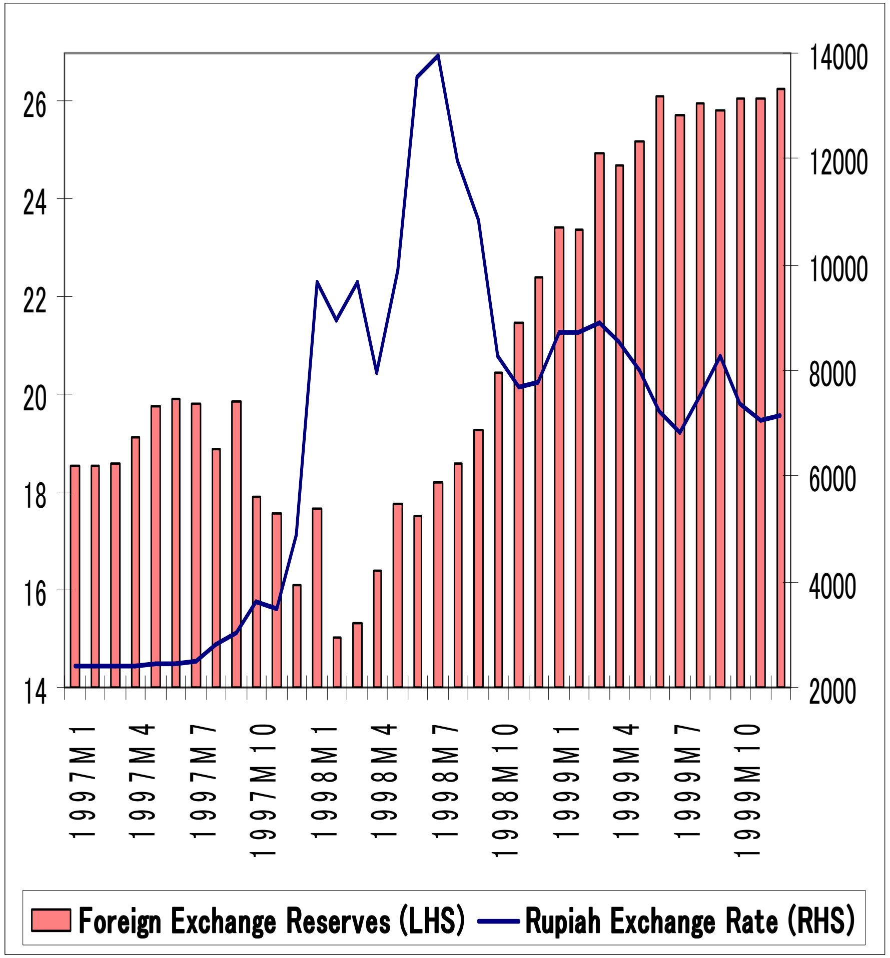
(3) Support of emerging Asia's exchange rate stability

Japan regards emerging Asia's currency and financial stability as vital

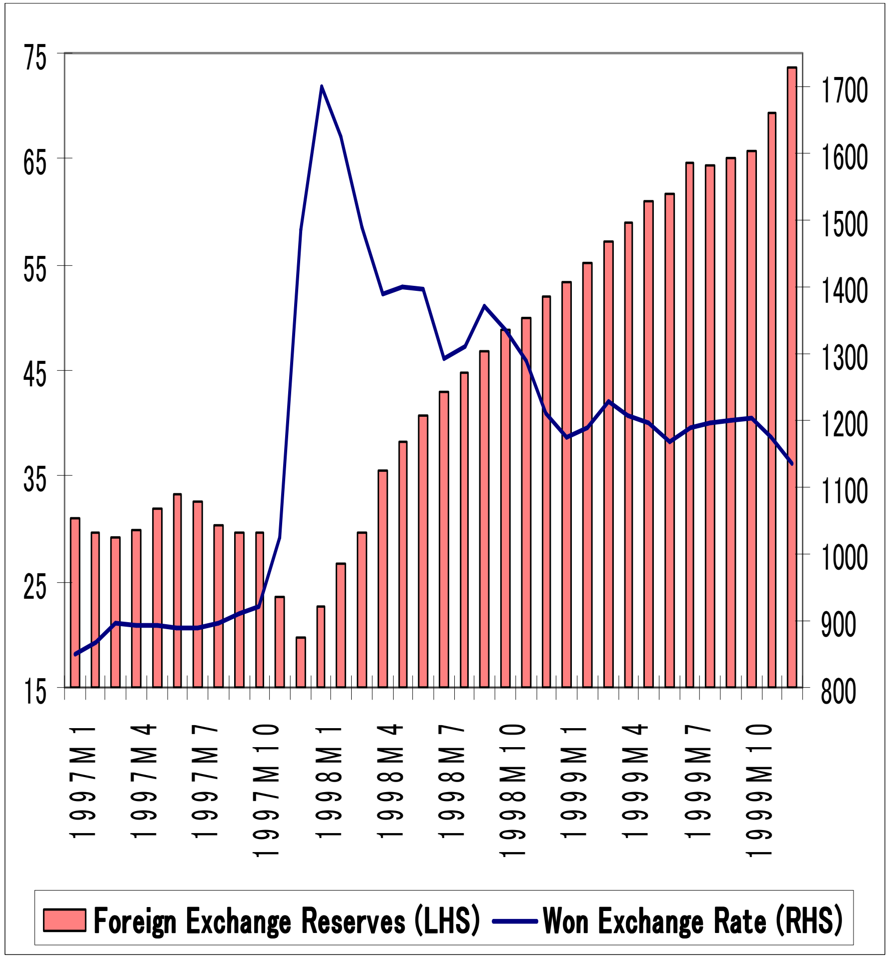
- Japan took initiatives to support crisis affected countries during the Asian financial crisis of 1997-98
  - Currency intervention to support the rupiah in 1997
  - Thailand, Indonesia, & Korea which went to IMF
  - Malaysia which did not go to IMF, but went to WB
- Japan proposed the creation of an Asian monetary fund (AMF) in 1997
- Japan took lead in creating ASEAN+3 processes
  - CMI/M, ERPD, ABMI, AMRO, CGIF
- During the GFC, Japan expanded currency swaps and supported Indonesia
- Japan did this while maintaining a free float

Indonesia and Korea were severely affected in 1997-98

Indonesia

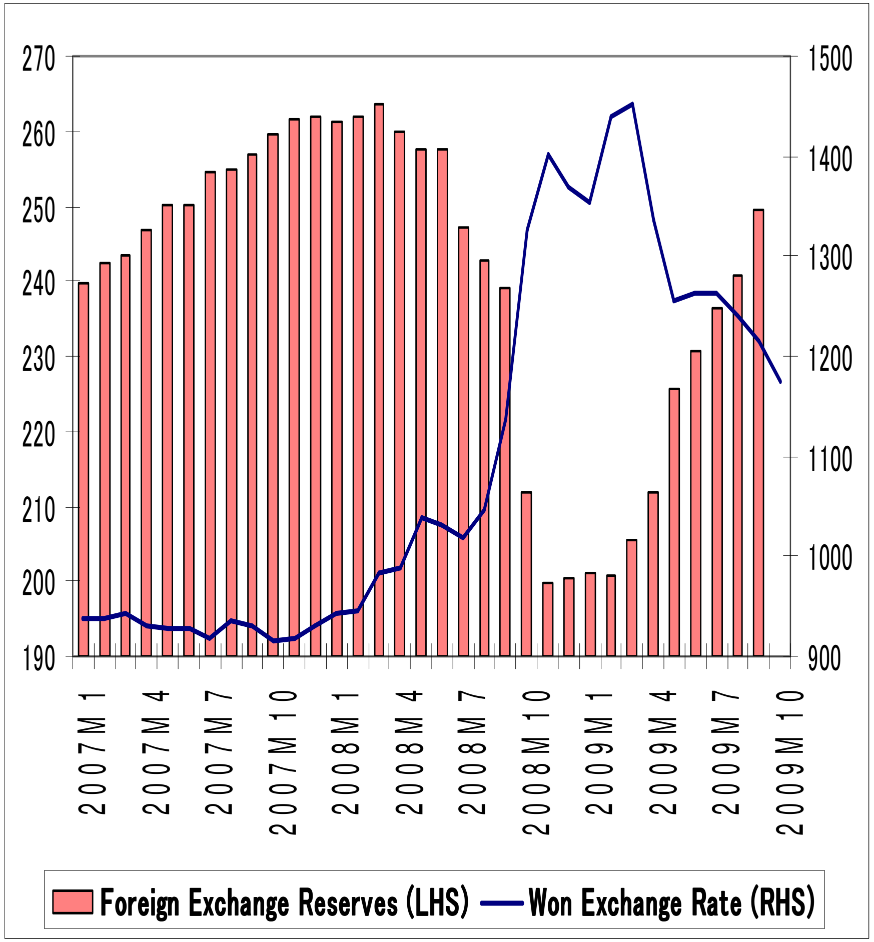


Korea

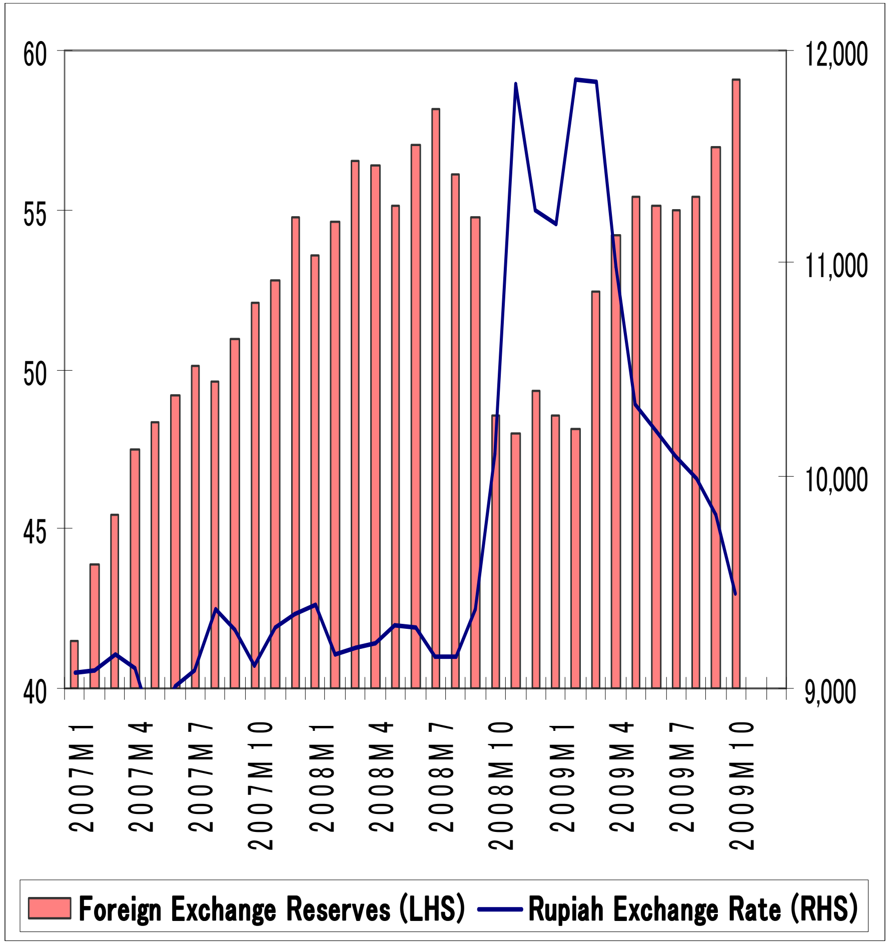


A rapid (temporary) loss of reserves and won & rupiah depreciation in 2008-2009

Korea



Indonesia



Source: IMF, International Financial Statistics, online

4. Japan's Strategy for Regional Monetary Integration

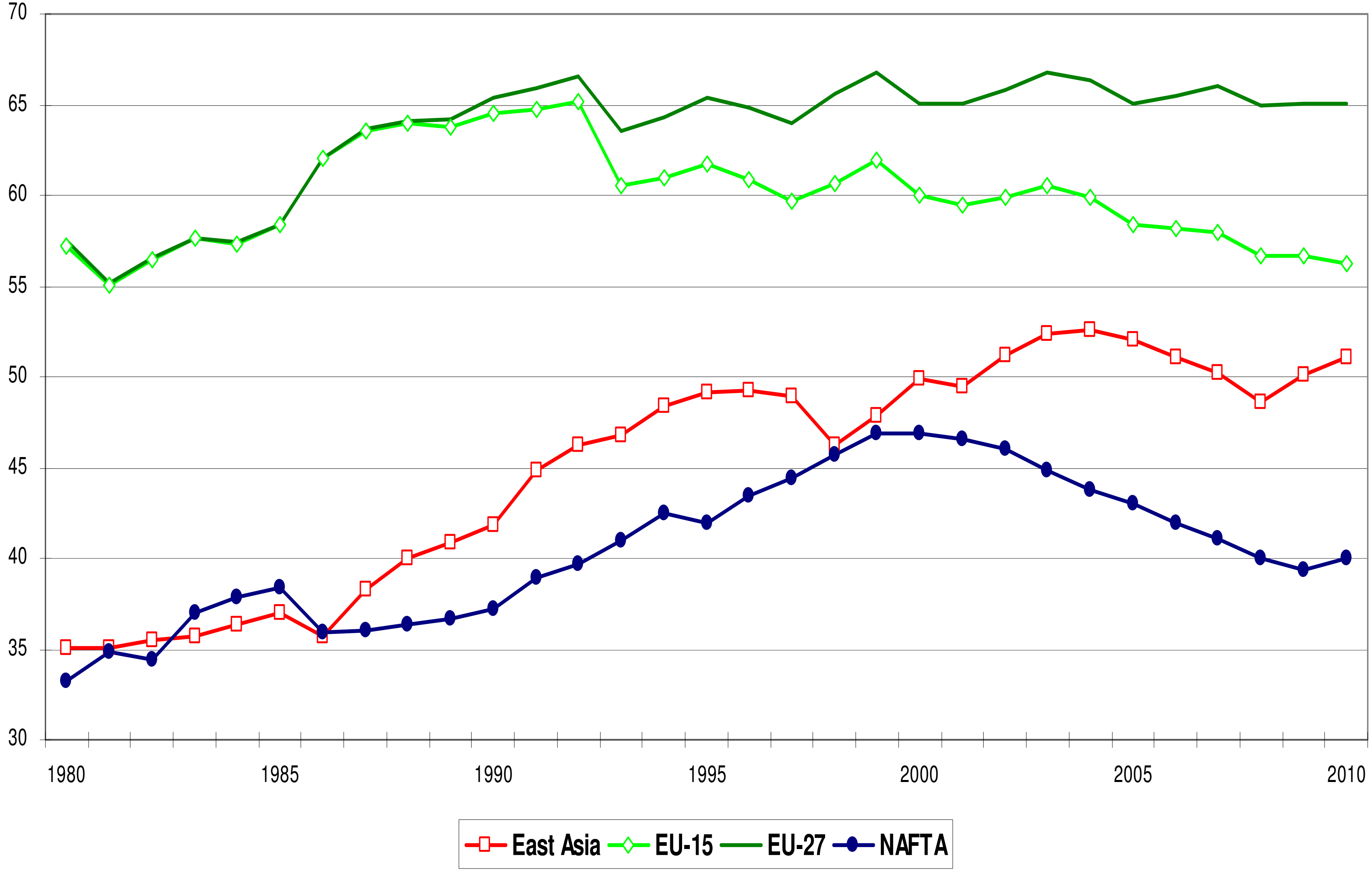
- Why Asian monetary integration for Japan?
- Prerequisites of monetary integration
- Step by step approach

(1) Why Asian monetary integration for Japan?

- Asia (eg, ASEAN+3) will be the largest economic bloc by the second half of the 2010s and will continue to grow, while achieving greater economic and financial interdependence
- Such a large, integrated region will have its own currency, and if so it would be Japan's interest to influence the process of monetary integration
- Creation of a stable monetary zone is anyway beneficial to Japanese MNCs
- It is Japan's interest to promote the Japanese yen as Asia's important international currency, at least in an Asian currency basket

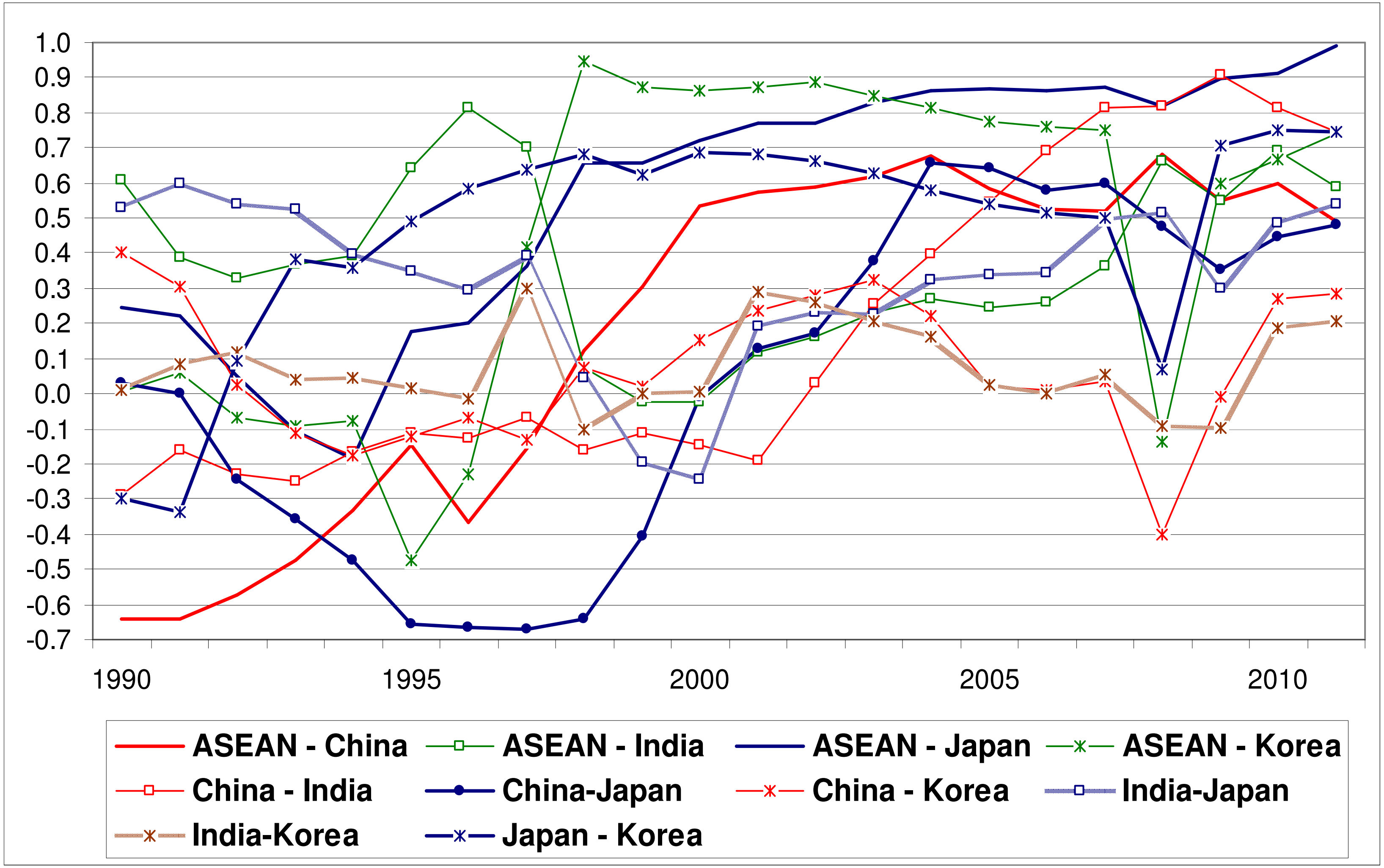
Question: Is Japan ready to accept its cost?

East Asia's intra-regional trade dependence rising over time



Source: International Monetary Fund, *Direction of Trade Statistics*

GDP growth rate correlations are rising between Japan and ASEAN, China, Korea,..
(10-year moving windows)



Source: International Monetary Fund, *World Economic Outlook*, database

Fear of RMB dominance?

- Another driving force behind Japan's interest in Asian monetary integration may be a fear of RMB dominance
- Given that China's economic growth will continue and the authorities promote RMB internationalization, some Japanese fear that ASEAN and even Korea may become part of a RMB bloc in the not-so-distant future
- Hence, Japan should play a proactive role in creating an Asian monetary zone in a way that is consistent with Japan's commercial and economic interests
- From this perspective, ACU (a basket of ASEAN+3 currencies plus HK dollar) is an attractive option for Japan as it allows the yen to play a role in the basket
- Another option is for Japan to become the UK in Europe; this is hard and may not be beneficial

No dominant currency for a while…

Dollar, yen or yuan as an anchor for East Asia?

- Relying solely on the US$ is not feasible in the LR
- The yen (failed internationalization, size relatively declining) or the yuan (inconvertible, weak prudential supervision, non-independent central bank) alone cannot assume a nominal anchor currency role
- The yen, the yuan and other important currencies can share the nominal anchor role for East Asia

Currency basket system

- SDR-plus currency basket (dollar, euro, pound, yen plus Asian currencies): Singaporean model
- ACU-based system: complex and hard to establish internal anchor for now, but potentially a useful starting point

(2) Prerequisites of monetary integration

- High degrees of economic and financial integration (a region-wide FTA, customs union, regulatory harmonization, competition policy, capital account liberalization)
- Macroeconomic convergence (inflation, fiscal policy, public debt, exchange rates)
- Structural convergence (per capita income, financial sector development, human capital development,..)
- Institutional coordination (credible central banking, financial sector regulation, fiscal discipline,…)
- Lessons of the euro crisis: Avoidance of domestic financial imbalances, coordination of fiscal policy, crisis management system

Asia has a long way to go

- East Asia has not achieved macroeconomic or structural convergence
- For many emerging and developing economies, the first priority is to pursue macroeconomic institutional reforms so as to strengthen macroeconomic policymaking to promote sound macroeconomic performance
- The next priority is to continue to pursue structural reforms so as to strengthen domestic economic and structural fundamentals and help achieve convergence towards developed country levels
- Achieving a fiscal union or a social union is out of the question at this point in Asia; **Asia should aim to achieve a limited monetary union in the long run** without a fiscal or social union

(3) Steps for closer exchange rate policy coordination

Progress	Exchange rate policy	Supporting institutions	Trade-investment
Current State	Uncoordinated exchange rate arrangements	CMIM, AMRO, regional surveillance	Fragmented, overlapping FTAs
1. Intensive policy dialogue on exchange rates	Intensive policy dialogue on exchange rates; use of an ACU index for surveillance	AMRO as a powerful secretariat for ERPD and CMIM	Coordination of rules & provisions among FTAs
2. Informal coordination (exchange rate regime choice)	Greater exchange rate flexibility vs. US$; A wider currency basket (SDR plus) as loose reference	Asian monetary fund	An East Asia-wide FTA (ASEAN+3 or +6); East Asian Investment Area
3. Formal but loose coordination (exchange rate policy)	A wider currency basket system with clear rules for intraregional rate stability	Very short-term liquidity facility	Asian customs union, Asian single market (goods, services, capital)
4. Tight coordination (monetary policy)	ACU-based system: Asian Snake" or "Asian ERM"	ACU clearing and settlement system	Asian regulatory policy integration
5. Full coordination	Asian monetary union	Asian central bank	Fully integrated institutions & policy

Step 1: Intensive policy dialogue

- Cultivate a culture that views exchange rates (including misalignments) as regional matters
- Introduce an Asian currency unit (ACU) index as one of the tools of regional economic surveillance
- Expand capacity & resources of AMRO as an independent secretariat for ERPD and CMIM, with participation of both finance ministers & central bank governors
- Support collective currency appreciation in the event of rapid capital inflows
- Continue to develop and deepen local-currency bond markets
- Make further efforts to internationalize regional currencies

Step 2: Informal coordination (regime choice)

- Greater exchange rate flexibility vis-à-vis the US dollar, based on a wider currency basket (such as SDR plus, or a basket of dollar, euro, pound, and ACU [= yen plus emerging Asian currencies])
- Significant macroeconomic and structural convergence not required for informal stabilization of exchange rates against the SDR-plus basket
- Creation of an Asian monetary (cooperation) fund (AMF) by delinking the CMIM from IMF and strengthening AMRO and ERPD
- Promotion of ACU as international reserve assets
- Real side integration desirable through the consolidation of various, overlapping FTAs into a single East Asia-wide FTA (EAFTA, CEPEA)

Step 3: Formal but loose coordination (exchange rate policy)

- Adoption of an SDR-plus currency basket with well-defined rules for intraregional exchange rate stability
  - Greater macro and structural convergence required
  - Possibility of Japan's participation once sufficient convergence is achieved
- Regional financial integration to be achieved
- The need for the AMF to provide very short-term liquidity financing for frequent interventions
- Goods, services and capital market integration and formation of an East Asia-wide customs union
- Institution building to coordinate policies within the region

Step 4: Tight coordination (monetary policy)

- Tightly coordinated intraregional exchange rate stability—a la Asian Snake or ERM using ACU as a reference—supported by close monetary policy coordination and a short-term liquidity facility
  - Japan as a full member
- AMF as a clearing house of frequent currency interventions (due to short-term liquidity finance) for settling balances among the central banks, and issue official ACUs
- Limited fiscal policy coordination, with sovereign debt restructuring mechanisms in place
- Selection of a regional anchor country/currency through central bank competition for credibility
- Complete exchange rate and monetary policy coordination feasible, if ever, only in the LR

(4) Next practical steps

Regional surveillance (AMRO & ERPD)

- Provide sufficient resources for AMRO
- Strengthen policy dialogue on exchange rate policies among the finance ministers and central bank governors in the ERPD (and CMIM) process

CMIM (and an eventual AMF)

- Increase the size of the fund substantially
- Introduce flexible, precautionary instruments, like IMF's FCL & PLL
- Reduce its link with IMF over time, ultimately to zero, by strengthening ERPD

Practical suggestions

- Create an ACU, use its index for surveillance, and promote its assets as international reserves
- Support RMB internationalization and its flexibility

5. Conclusion

- For Japan, maintaining exchange rate stability in and with emerging Asia is critical
- Asian monetary integration will be a long process as it requires macroeconomic and structural convergence in Asia as well as significant fiscal policy coordination
- Japan needs to work hard with other ASEAN+3 members to initiate much deeper policy dialogue to achieve relatively stable intraregional exchange rates against external financial shocks
- The current global financial conditions should provide impetus toward such initiatives

Thank you
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