1. East Asia’s monetary future: an introduction

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1.1 THE CONFERENCE

Chulalongkorn University is Thailand’s oldest university, and it is among the highest ranked in Southeast Asia. King Rama VI founded the university in 1917. He dedicated the campus – lying in the heart of Bangkok and nearly as big and green as Stanford – to his father, Chulalongkorn, who had been King Rama V from 1868 to 1910.

On 5–6 September 2001, ‘Chula’ – as it is known by insiders – celebrated the 30th anniversary of its Faculty of Economics with an international conference on the prospects for East Asian monetary integration. Organized in co-operation with the universities of Paris-Dauphine and Mannheim, the conference assembled a group of approximately 30 authors and fellow colleagues. It drew approximately 100 participants from the academic, business and policy-making communities as well as a large number of Chulalongkorn students, and was sponsored by the Central Bank of Thailand, the Asian Development Bank, Volkswagen-Stiftung, Thai Airways International and the Kenan Institute Asia.

Over the past decade, applied economic research on East Asia had been concentrating on issues such as the ‘Asian-value’ controversy and the ‘growth miracle’ phenomenon. Monetary issues had been rather insignificant – even among Asian economists. One reason for this lack of interest could have been the previously astonishing performance in price stability within the Asian region (including China) over the foregoing 20 years – in contrast to Latin America and Africa.

With the arrival of the East Asian monetary and financial crisis in 1997, the interest of Asian and Western economists shifted from the ‘real sector’ (including international trade considerations) to the ‘monetary sector’ and, in particular, to

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exchange rate mechanisms. As a matter of fact, under pressure of the ‘external’
crisis event, the ‘crisis’ countries abandoned fixed exchange rates and switched
to the mechanism of floating exchange rates.

The immediate scientific output on the causality of the Thai crisis had been
concerned with country-specific causes of the turmoil, stressing common causes
like ailing banking sectors (‘bad loans’), public sector budget deficits and the
lack of fine monetary tuning under fixed exchange rates. Restructuring of
banking, fiscal discipline and implementation of (free or managed) floating
exchange rates vis-à-vis the US dollar had been among the usual major
recommendations, until recently.

However, global views and analyses on the long-term monetary prospects of
the East Asian region (including China and Japan) are still somewhat lacking.
The global view concerns the intermediate monetary solution and establishment
of ‘currency areas’ within East Asia, or only within Southeast Asia, as a
‘compromise’ between past fixed exchange rate mechanisms pegged to the US
dollar and present floating exchange rate systems – still related to the US dollar
as the international anchor currency.

The conference volume contains 11 contributions that are outlined below.

1.2 CURRENCY AREA FORMATION AND THE EAST
ASIAN REGION (ROBERT MUNDELL)

At the very outset, one should be reminded of the traditional conference codex
that explains the delay between the conference year and the publication year.
Each author has to produce, after the conference, a second version of his or her
paper where he or she has to take into account, if necessary, critical comments
of his or her discussant and of other members of the conference. In principle,
the second version should be better than the first. However, in the case of Robert
Mundell, the procedure is usually different: there is no paper at the very beginning
of the conference, he immediately improvises his introductory oral remarks to
the rather unfamiliar audience, and his paperwork begins several months
afterwards.

Furthermore, besides the various ‘press conferences’ he likes to give, he has
talked to Thailand’s Central Bank (which, by the way, is consistent with his
preferred central bank relationships during the last 15 years) and to 500 alumni
of Chula’s Faculty of Economics during a dinner debate that raised the funds
for the Faculty’s library, while the other participants of the conference had an
excellent supper on Bangkok’s beautiful Chao Phraya River.

His written contribution to the conference is one of his most excellent papers
on applied international monetary economics delivered over the last 10 years. It
is a masterpiece in the field of fixed versus floating exchange rates, and it is for
that reason that we have divided the summary into ‘early Mundell’ and ‘later Mundell’. Indeed, his present paper is a combination of ‘history of economic thought’ and ‘applied economics’.

1.2.1 Fixed Versus Floating: Once Again (early Robert Mundell)

If one compares, over recent time, East Asia with Europe, one could not have imagined a more spectacular contrast in the evolution of their monetary systems. After Southeast Asia’s currency crises, the dogma for fixed exchange rates became an anathema to Asia, while Europe converged to irrevocably fixed exchange rates and a common, single currency. This divergence is unexpectedly revolutionary.

According to Mundell, the emergence of a ‘non-system’ of managed, flexible exchange rates had become a source of global financial instability – and that phenomenon had taken place not only in Southeast Asia. The shift towards flexible exchange rates had started among the industrialized countries in the early 1970s. After the US relinquished its gold standard, the US dollar became the anchor currency of the world economy (the pure dollar standard).

The case for flexible exchange rates had been put forward by James Meade and Milton Friedman during the 1950s. Meade considered that flexible exchange rates would be a better means for the British socialist government to manage its economy. Friedman argued for flexible exchange rates as a preferable alternative to foreign exchange controls, but he rejected flexible exchange rates for developing countries.

In the recent ‘Nobel Monetary Duel’ between Milton Friedman and Robert Mundell,¹ both ‘adversaries’ arrived at the common conclusion that the real debate is not about fixed versus flexible exchange rates, but should rather deal with the more fundamental issue of ‘currency targeting’ (i.e., exchange rate targeting) versus ‘inflation targeting’ (i.e., monetary targeting). In other words, the debate should be reformulated with respect to the ‘old and new’ question of which monetary system – or which exchange rate system – would be the most adequate to achieve price stability.

However, as one could easily imagine, there are still opposing views. The concerns still voiced mainly deal with the issue of whether the targeting of price stability should be taken from a single country point of view or from a worldwide perspective. Furthermore, price stability targeting, or more precisely, inflation targeting should perhaps be reformulated in a more sophisticated format of ‘inflation forecast targeting’.

According to Mundell – as one might expect – successful implementation of inflation forecast targeting could be achieved with a fixed exchange rate as advocated by him for several decades. The fixed exchange rate has the advantage of being installed rather easily and unambiguously. However, it implies the
existence of a suitable stable anchor currency within the world economy. Furthermore, the anchor currency (e.g., the US dollar) has to follow a successful inflation forecast targeting policy. For that reason, the US dollar cannot be a candidate for proper exchange rate stabilization. Consequently, the US monetary policy has to pursue a rule of benign neglect with respect to its exchange rates; its only aim is to achieve internal price stability.

1.2.2 The Hong Kong Dollar as a Common Currency for East Asia (later Robert Mundell)

The present currency regimes within the East Asian region look divergent, even though all countries share a common international monetary anchor, or reference currency – whether fixed or floating – which is represented by the US dollar (see also McKinnon). Looking at the larger countries, China and Japan, the former strictly follows the regime of a fixed exchange rate (even though accompanied by exchange controls), while the latter belongs to the traditional industrial group of floating currencies. The other side of the scale in terms of size can be illustrated by Hong Kong with its Currency Board and Singapore as a traditional ‘ floater ’ (to which Brunei also belongs as part of the currency union with Singapore, in existence for several decades).

Each country within East Asia still has its proper national currency. Several authors deal with the question, whether East Asian countries (or a group among them) should follow the European example of a single currency (euro) by abolishing national currencies and replacing them with a single, common currency. As a matter of course, the answer by Mundell is fully in favor of the common currency, even though its implementation may be realized only over the very long term. Ignoring the fact that there has not been even the slightest beginning of a customs union within any part of East Asia, Mundell traces the stages of how to implement the ‘Asian Monetary Union’.

His gradual approach consists of the co-existence of two currencies within each country of East Asia, or in a more moderate way, within each country of the smaller Southeast Asian region. His proposal consists of the maintenance of the national currency accompanied by the introduction of an additional money that circulates as a parallel currency with the national currency. This second currency should be simultaneously used, in a later stage, as ‘common’ currency in all other member countries of the future Asian Monetary Union.

According to Mundell, this long-run process could be induced by replacing the Hong Kong dollar with the US dollar, which has a history of stability stretching over the last century second to none. The Hong Kong would fall to New York levels. Hong Kong would become the focal point for an Asian Monetary Fund and ‘Asian dollar’. China would have the advantage of having on its doorstep a region using the most important currency in the world and it
would have access to a world-class capital market and financial center. Mundell’s interesting idea is that in the long run this dollar-based currency area, starting from Hong Kong, including China and – most probably – other Asian countries, could be used as a platform for an independent Asian currency that could become the standard unit of account of an Asian Monetary Fund.

1.3 ONE COUNTRY, TWO MONETARY SYSTEMS: HONG KONG AND CHINA (SHU-KI TSANG)

Hong Kong, under the framework of ‘one country, two systems’, enjoys full autonomy from China (including monetary autonomy) except in two areas: defense and diplomacy. After all, it is one of China’s Special Administrative Regions (SARs). Both currencies circulate as parallel currencies in Mainland China as well as Hong Kong: the Hong Kong dollar in China and the renminbi (RMB) in Hong Kong. While the renminbi is not yet a fully convertible currency (exchange controls), the Hong Kong dollar has achieved the status of a respectable currency. In Mainland China, the Hong Kong dollar is exchanged with the renminbi close to parity (one Hong Kong dollar being equal to one renminbi), even though the Hong Kong dollar is pegged to the US dollar at the rate of 7.80, while the renminbi’s exchange rate against the US dollar has been ‘floating’ around 8.20–8.30 since 1995.2

In fact, Hong Kong is not eager to form a monetary union with Mainland China – at least for the moment – through official currency unification between the Hong Kong dollar and the renminbi; nor is the latter. The phenomenon of a Hong Kong dollarization could be conceived through the mechanism of spontaneous competition. Furthermore, as Tsang emphasizes, the Hong Kong dollar as a parallel currency is already used widely in the Pearl River Delta, but it declines rapidly when one moves further north. A spontaneous and gradual implementation might be a signal for Mundell’s proposal as the means to bring about a Hong Kong dollarization within East Asia or, more modestly, within Southeast Asia plus China and probably without Singapore.3

1.4 THE ROLE OF THE YEN IN EAST ASIA (TAKATOSHI ITO)

Did the yen become an important international currency over the last 10 years within the world economy and, in particular, within East Asia? Ito’s empirical answer is no. By presenting elementary statistics until the arrival of the euro in January 1999, he shows that the share of the yen within total foreign exchange reserves held by other central banks amounted only to 5 percent, while the
US dollar attained the top level of 57 percent. By looking at the international bond market, bond issues from Japan and other countries denominated in the yen, amounted equally to 5 percent. Thus Japan, as an ‘economic giant’, which, in addition, has an impeccable history of price stability, seems to be a dwarf among key international currencies.

A particular talisman of Japanese economists – but also shared by other East Asian economists – seems to be the notion of a ‘basket currency’, indicating their belief in the need to regard or even influence the ‘effective’ exchange rate. This concept describes the weighted average, in the case of Japan, of the yen with respect to the dollar, the euro, British pound, China’s renminbi, and to the Hong Kong and Singapore dollars, etc.; this ‘multilateral exchange rate’ is necessarily expressed by an index. The index therefore indicates the average volatility of the yen with respect to Japan’s most important trading partners.

In a generalized world of floating exchange rates, the effective exchange rate fluctuates less ‘wildly’ than bilateral rates. Consequently, the concern of monetary policy, if it addresses exchange rates, could be to manage this multilateral exchange rate indicator. However, from a one-country point of view, the effective exchange rate can only be influenced by one bilateral exchange rate, which – in the case of Japan – is the yen-dollar rate.

As a matter of course, Takatoshi Ito knows this simple rule of arithmetic for exchange rate policy. Nevertheless, what he has in mind is co-operation between central banks to intervene collectively in foreign exchange markets in order to avoid ‘competitive’ depreciations. If one considers the triangular yen–euro–dollar relationship, and if one assumes that Japan’s central bank wants only a depreciation of the yen–dollar rate, Japan would have to persuade the European Central Bank to intervene equally in the euro–dollar market to bring about a similar depreciation of the euro–dollar exchange rate, such that the yen–euro relation would not be affected.

1.5 THE DOLLARIZATION DEBATE: IS IT OVER? (RICARDO HAUSMANN)

An apparently opposing view to Mundell’s proposal could be derived from Hausmann’s chapter, which classifies countries by virtue and vice. Virtuous countries do not need fixed exchange rates for realizing price stability because they would also have price stability under floating exchange rates. In opposition to them are vicious countries that are so hopelessly inflationary that they need fixed exchange rates as a credible institution for import price stability; the most often quoted country of this type had been Argentina, which installed a Currency Board in 1991 in order to seek an end to its inflationary nightmare. However, Argentina of the 1970s and 1980s cannot be compared with
contemporary Southeast Asian countries that have introduced floating rates (since the crisis of 1997), because they realized over the last decade reasonable price stability.

Hausmann pleads neither for floating nor for fixed exchange rates, but for dollarization. He starts with the observation that economic history has shown very little floating, particularly among emerging countries. What explains their ‘fear of floating’, and what makes some countries even want to dollarize their economy?

To the various prerequisites for a credible fixed exchange rate belongs fiscal solvency. In Argentina’s winter of 2002, its exchange-rate system broke down not because of its proper Currency Board system, but because the former (historically) richest country (in terms of natural resources) among Latin American nations allowed itself to become fiscally insolvent. Fiscal insolvency, or even the slightest doubt about a possible future fiscal misalignment, aggravates the consequences of the ‘original sin’ to which developing and transition countries are exposed, namely, the ‘default risk premium’ on international credit markets. The phenomenon of the original sin implies exorbitant interest rates (comparable to ‘usurious’ levels) on their treasury bonds, even if they are denominated in dollars, yen or euros. Consequently, the public debt burden could become rapidly unsustainable: under fixed exchange rates, a currency crisis could emerge; and under floating exchange rates, the exchange rate could overshoot.

There is no redemption from the original sin. Nevertheless, Hausmann proposes the following ‘holy’ solution. The concerned ‘sinner’ country should adopt the currency of those neighbor countries with highest credibility, not by fixing but by ‘dollarizing’. For Latin America, it is the US dollar, and for East Asia, it may be the yen, the Singapore dollar or the Hong Kong dollar. At any rate, the default risk on credit markets cannot be eliminated. There is no absolute redemption. But the default risk premium can be minimized by dollarization, which at least avoids exchange rate risk.

1.6 THE EAST ASIAN EXCHANGE RATE DILEMMA AND THE WORLD DOLLAR STANDARD (RONALD MCKINNON)

By proposing an alternative pragmatic option to Ricardo Hausmann’s dollarization, McKinnon chooses a less dramatic solution for East Asia’s exchange rate dilemma by simply proposing a traditional fixed dollar peg.

A common currency for East Asia like the euro is not foreseeable in the near future for two reasons. First, East Asia still does not have the degree of economic integration that the countries in the European Union had, where the Single
European Market – with free movement of goods, services, capital and labor – had existed since 1993. Secondly, East Asia is far away from having the necessary political cohesion for introducing an independent regional currency similar to the euro.

The other extreme of monetary integration, namely dollarization (as discussed by Hausmann) is also not an adequate solution for East Asia. Unlike most countries in Latin America and Africa, countries in East Asia – with the possible exception of Indonesia – have collectively exhibited sufficient fiscal discipline to secure regional monetary stability, i.e., they do not need to use the inflation tax for fiscal reasons, or to ‘suffer’ from the subsequent currency depreciations.

McKinnon favors an East Asian monetary standard. The objectives of such a regional monetary standard, far from the euro model, should promote: (1) greater long-run exchange rate stability among East Asian economies; (2) a common and highly credible monetary anchor against inflation risk and default-risk fear in the East Asian debtor countries, as well as against Japan’s deflation risk and fear; and (3) mutual understanding toward more appropriate policies for regulating banks and international capital flows. To reach these objectives, McKinnon proposes an East Asian Dollar Standard. The East Asian countries, including Japan, should fix their currencies to the US dollar, that is, they should use the US dollar as their monetary anchor.

However, there are two important question marks related to his proposal. First, why should smaller East Asian countries fix their currencies to the dollar and not to the yen, given the fact that Japan is by far the largest economy in East Asia? McKinnon gives a twofold answer. The dollar, and not the yen, had been used before the 1997 crisis; at that time, smaller East Asian countries had a *de jure* dollar peg, and after the crisis, most of the smaller East Asian countries implemented a *de facto* dollar peg. Therefore, fixing to the dollar (and not to the yen) makes these operations work more effectively. Furthermore, the problem with fixing East Asia’s currencies to the yen is that the yen is not an international currency (see the chapter by Ito). For a decade, Japan has been unable to get rid of its ongoing price deflation and economic slump. Thus, other East Asian countries, by pegging to the yen, would not be well advised to import deflation, implying near zero interest rates as Japan experiences them for the moment.

Another important question concerns Japan’s proper exchange rate policy. Why should it be in the interest of Japan to take part in the East Asian Dollar Standard? McKinnon argues that fixing the yen to the dollar (instead of the present float) and using the dollar as a monetary anchor by Japanese monetary authorities would end the threat of an ever higher yen (appreciation) and of an ongoing internal deflation that would not help to overcome Japan’s prolonged economic slump. Fixing the yen to the dollar would be a huge economic advantage, not only to Japan, but also to all other East Asian countries, because of their strong economic links with Japan.5
It should be emphasized that McKinnon’s East Asian Dollar Standard would only be successful under two assumptions. First, the anchor currency, namely the US dollar, would have to be stable and expected to remain stable in the future (in full harmony with one of Mundell’s preconditions of a worldwide dollar standard). Second, East Asian countries must be willing and able to conduct a free market-orientated economic policy. If these conditions are fulfilled, and if East Asia, especially Japan, is ready and willing to accept the US dollar as the monetary anchor, then the implementation of McKinnon’s East Asian Dollar Standard would undoubtedly contribute to the needed monetary integration in East Asia and would be compatible with Mundell’s Asian dollar proposal since his proposed Hong Kong dollar as parallel currency is fixed with respect to the US dollar, as well.

1.7 CAUSES OF THE CURRENCY CRISIS: INDONESIA, KOREA, MALAYSIA, THE PHILIPPINES AND THAILAND (CHAYODOM SABHASRI, JUNE CHAROENSEANG AND PORNKAMOL MANAKIT)

There could be some doubt whether there had been an ‘Asian’ crisis since it was limited to five countries – namely Thailand, Indonesia, South Korea, Malaysia and the Philippines. Countries like Singapore, Hong Kong, China, Taiwan and Japan had been bystanders, and had not been affected, fundamentally. The latter five ‘happy few’ had three stability factors in common: large foreign exchange reserves, low external debt and a successful anti-inflationary monetary policy, even though Japan over-reacted by gliding towards the deflationary syndrome.

The Southeast Asian crisis started on 2 July 1997, when Thailand left its fixed currency exchange rate, which signaled a different future for Asian economies. Already, during December 1996 to July 1997, the baht had come under speculative attacks.

The reader should notice that the three Thai authors analyze, in an extensive and fascinating survey, the crisis scenarios not only for Thailand, Indonesia and Korea (as in the following chapter by Peter Warr), but they address, in addition, the same issue for Malaysia and the Philippines.

After the float, Thailand’s monetary policy shifted to the ‘modern road’ of an inflation targeting framework by letting the currency float from its pre-crisis level of 25 baht to 40 baht per dollar over recent time (2003). Thailand’s success story has been based on a rather constant price level for non-tradable goods, whereas prices for tradable goods adjusted smoothly to the depreciation of the baht.
However, as one could have expected, Thailand’s ‘conservative’ monetary policy under floating exchange rates had been challenged continuously by ‘excessive’ budgets deficits. The fiscal package had been considered as a necessary stimulus to recover the economy from its poor economic stance, even though the risk of large budget deficits could also enhance devastating long-lasting outcomes. On the other hand, there had been doubts about the ultimate independence of Thailand’s central bank despite the new ‘Bank of Thailand Act’, whose successful implementation still remains to be seen, since credibility has to be built *inter alia* on past performance.

1.8 EXCHANGE RATE POLICY AND THE ASIAN CRISIS: THAILAND, INDONESIA AND KOREA (PETER WARR)

Thailand, Indonesia and Korea had been outstanding economic performers prior to the financial crisis of 1997. Each considered the fixed exchange rate as the cornerstone of its macroeconomic stability. The currency crisis (rapid outflow of financial capital in anticipation of devaluation) occurred first, and financial crisis (collapse of domestic banks) resulted from the float. The economic crisis (loss of output) arose from the combined effects of both. This scenario of the three types of crises took place in all three countries. Thailand was the first to be hit by the loss of confidence, and the other two followed with similar breakdowns, which could be explained by the ‘contagion’ phenomenon of currency crises.

The contagion theory is a panic theory that is well known in the literature on self-fulfilling bank runs. An alternative term for contagion would be ‘vulnerability’, as Peter Warr suggests. According to this less dramatic concept, economies are vulnerable without the necessity of crisis – meaning currency crises – occurring; they are only susceptible to currency crisis. There are three indicators that assess a country’s vulnerability to a currency crisis: adequacy of international reserves compared to the volume of volatile capital, financial sector fragility and real exchange rate misalignment.

The unorthodox message of Peter Warr’s paper is that all three IMF bailout countries showed the same three vulnerabilities, and that the contagion hypothesis is misleading, since the currency crisis in Thailand, Indonesia and Korea could be explained sufficiently as if each country had been isolated from the other two. In each of the three countries, the financial crisis (breakdown of the domestic banking system) and the economic crisis (absolute decline in output) would not have taken place without the currency crisis.
1.9 INFLATION TARGETING AFTER THE CURRENCY CRISIS: THE CASE OF THAILAND (CHAYODOM SABHASRI, JUNE CHAROENSEANG AND PORNKAMOL MANAKIT)

Several East Asian countries that have suffered from the crisis have turned to new macroeconomic policy management aimed at economic recovery and prevention of further economic and financial crisis in the future. Some countries like Thailand have altered their monetary policy framework from nominal exchange rate anchors or monetary aggregate targeting to inflation targeting. Inflation means the anchoring of the domestic (internal) value of money. Furthermore, one should learn from the experience, industrialized countries and some Latin American countries have had already in the adoption of inflation targeting. The case of Thailand – which is among the newest countries to employ inflation targeting – is analyzed in this chapter to see whether the new framework will be able to accommodate recovery from the economic decline. In particular, the policy mix (monetary fiscal policy) is reviewed in the context of whether a sharp turnaround in the economy had been possible with an excessive budget deficit without facing that parts of the deficit are financed by money creation leading to an inflation level that lies above its proper target.

1.10 RETHINKING CAPITAL CONTROLS: THE CASE OF MALAYSIA (MASAHIRO KAWAI AND SHINJI TAKAGI)

During colonial times, and until June 1967, Malaysia and Singapore shared a common monetary history in terms of their Currency Board, established in 1897. The Straits dollar circulated in the Straits Settlements (Singapore, Pulau Penang and Melaka) and in all Malay States, and was renamed the Malayan dollar in 1938. By 1950, new members had joined the Malaysian currency area: the Borneo territories of Sarawak, British North Borneo (now Sabah) and Brunei.

On 12 June 1967, a currency split took place between Malaysia and Singapore. Malaysia replaced its Currency Board with the Bank Negara Malaysia, while Singapore issued its own currency with the Currency Board of Singapore. The outcome was three new currencies, namely the Malaysian ringgit, the Singapore dollar and the Brunei dollar. However, during the next six years each country’s currency circulated as a parallel currency in the other’s economies at a strict par of 1:1.

That currency interchangeability arrangement between Singapore and Malaysia was officially terminated in May 1973, together with the split in their
common stock market. One month later, in June 1973, Singapore decided to let its dollar float. The next day, Malaysia followed the same policy.

Even though the exchange rate of the Malaysian dollar with respect to the Singapore dollar was maintained roughly within the range of 1:1 throughout the remainder of the 1970s, Malaysia’s monetary ‘independence’ or ‘sovereignty’ became obvious in the 1980s, when its external currency value depreciated progressively with respect to the Singaporean dollar. During the first half of the 1980s, there was still the dogma in the Bank Negara Malaysia to stay within a 10 percent-margin of the Singaporean dollar. From 1985 onward, the Singaporean dollar was completely abolished as a nominal anchor.

When the Thai baht began to float, Malaysia followed the same floating exchange rate policy as Thailand did. Between July 1997 and early January 1998, the Malaysian ringgit depreciated 80 percent with respect to the US dollar – as did the baht. Furthermore, both floating currencies appreciated 20 percent in the period January to August 1998. On 2 September 1998, Kuala Lumpur decided to fix the exchange rate at 3.8 ringgit to one dollar (while the Bank of Thailand continued to float) and implemented a ‘moratorium’ for financial capital outflows. As Kawai and Takagi formulate it, Malaysia wanted to recover ‘under a capital account umbrella’, where the country attempted another ‘salutary’ safeguard, replacing the financial bailout by the IMF.

The capital controls consisted mainly of a complex bureaucratic system to prescribe which capital outflows were permitted to leave the country and which potential capital outflows had to stay within the country. As one could imagine, the general scheme had been guided by the ‘principle’ of not discouraging new future capital inflows (including mainly trade credit and foreign direct investment). Consequently, profits on former investments (realized before September 1998) were allowed to be transferred to foreign countries, while their principal had to remain, accompanied by a gradual differentiation to limit short-term capital outflows and to liberalize long-term capital outflows.

As the authors correctly emphasized, once a country has introduced capital controls for a while, even for a very short period, foreigners will remember the experience of the possibility of ‘currency inconvertibility’. Or in other words, capital controls are remembered by future generations.

1.11 SINGAPORE AND BRUNEI: LESSONS FOR MONETARY CLUSTERS WITHIN EAST ASIA (NGIAM KEE JIN)

Within East Asia, there are two special geographical entities belonging to the group of ‘industrialized nations’, namely Hong Kong and Singapore. Both are
the birthplace of Currency Boards, where, in addition, two national currencies
circulate as parallel currencies at a fixed parity.

Hong Kong–Mainland China is the first example. As we already mentioned
in the paper on Hong Kong, since the establishment of Hong Kong’s Currency
Board in 1982, the renminbi had been used increasingly as a means of payment
and a store of value within Hong Kong and, in a similar way, the Hong Kong
dollar within South China. In addition, both currencies are linked to the US
dollar by fixed pegs.

In contrast to the Hong Kong–Mainland China area, the Singapore dollar has
been floating since 1973, as did the currencies of many other industrialized
countries. As mentioned in the context of Malaysia, the official currency area
of Singapore–Malaysia broke down in 1973, but the monetary ‘cluster’ of
Singapore–Brunei remained intact, despite all subsequent worldwide crises.
The use of Brunei’s banknotes in Singapore and the circulation of Singaporean
banknotes within Brunei (where one Singapore dollar is equal to one Brunei
dollar) has been such a common tradition that the two currencies have grown
up ‘as if’ they were a single currency. However, from a monetary policy point
of view, only the ‘Monetary Authorities of Singapore’ are responsible for
‘managing’ the floating exchange rate with respect to the US dollar.

Ngiam’s contribution uses the traditional method of cost–benefit analysis of
optimum currency areas, even though this specific currency area is called a
monetary ‘cluster’ within the region of Southeast Asia. The disadvantage of
any currency area (which is a specific case of a regional exchange rate peg) is
the emergence of adverse shocks, namely asymmetrical ones, hitting – in our
present case – either the Singaporean or Brunei economy. The likelihood of
such an event is rather high within the Singapore–Brunei area since the
dissimilarity of their production structure is a ‘masterpiece’ of extremes.
Ninety percent of Brunei’s exports are concentrated in oil and gas, while
Singapore’s trade consists mainly of industrial goods and financial services.

Nevertheless, Brunei did not glide into the trap of the ‘Dutch disease’, which
had been the case for so many other countries producing primary commodities.
Singapore’s most important feature of monetary policy had been the maintenance
of the regime of floating rates with respect to the US dollar. Consequently,
it could strictly follow the target of higher price stability in a better shape than its
US counterpart, with the result that the Singapore–Brunei dollar has experienced
a long history of a steady and smooth appreciation with respect to the US dollar.

The main advantage of the ‘Monetary Union between Brunei and Singapore’
as the author calls it, lies on the side of Brunei having chosen the Singapore
dollar as its monetary anchor (one Brunei dollar is identical with one Singapore
dollar). Between 1967 and 1997, Brunei’s mean inflation rate had been 3.07 percent
and Singapore’s rate had been at the higher level of 3.81 percent; meanwhile,
Malaysia’s mean inflation rate stayed at 3.93 percent, which had also been an
East Asia’s monetary future

excellent score. However, Thailand having never been a member of any currency area, realized an average inflation rate of 5.30 percent, despite its fixed peg to the US dollar. Its inflation rate ‘overshot’ the permissible limit and provoked, over the long run, the breakdown of its fixed exchange rate system.

1.12 COSTS AND BENEFITS OF A COMMON CURRENCY FOR THE ASEAN (SRINIVASA MADHUR)

Madhur compares the suitability of the ASEAN countries (Association of Southeast Asian Nations) for a common currency to the suitability of the EU countries. The integration process in Europe – from its beginning with the Treaty of Rome in 1957 until the introduction of the euro in 1999 – took a long and stony path. According to Madhur, this tedious long-run process over 40 years should not be an argument for being pessimistic about a faster monetary integration process within the ASEAN.

First, the East Asian capacity for time compression should not be underestimated. During the last few decades, these countries have produced economic achievements at an unprecedented speed. Secondly, the ASEAN can use the European experience to great advantage. Thirdly, politicians in the ASEAN countries will come to realize that a stable common monetary framework is a precondition for higher economic growth within Southeast Asia.

There are nevertheless serious constraints to introducing a common currency in the ASEAN. Madhur discusses four of these constraints: (1) the diversity in the level of economic development; (2) the weakness of the financial sectors in the various countries; (3) the lack of a regional-level resource pooling mechanism, plus the absence of institutions required for forming and managing a currency union; and (4) the lack of political preconditions for monetary cooperation and, in particular, for a common currency.

1.13 SUMMARY

By summarizing the 11 contributions to this volume, East Asia’s monetary future may be described as a bundle of ‘futurist’ scenarios. An enlarged Singapore–Brunei currency area could be a possible avenue for monetary integration. Another alternative, going beyond Southeast Asia, could be the Hong Kong–China area increased by Taiwan, named a ‘Greater China Monetary Bloc’. As the participants of the Bangkok conference suggested, monetary imagination is endless: even a ‘Northeast Asian Bloc’ (Japan–Korea) is conceivable. Finally, by referring to the guest country of the conference, a monetary ‘cluster’ of
Cambodia and Laos around the Thai baht could be a realistic option, since the baht circulates in these two neighbor countries already for many years as a parallel currency, and the Thai currency is accepted as readily as the US dollar, despite the latter’s worldwide use as the nearest currency substitute.

Among the possible future monetary outlines, one should not forget the initial Japanese proposal suggested at the outbreak of the Southeast Asian currency crisis in late 1997. Japan had been prepared to contribute 50 billion US dollars (out of its present reserves of 300 billion US dollars, held by the Central Bank of Japan) to a new institution to be called the Asian Monetary Fund as a parallel and competent competitor to the IMF.

### NOTES


2. ‘Foreign exchange certificates’ (FECs), expressed in US dollars, used by China. They were abolished in 1995. It is interesting to note that an ‘outsider’ within Southeast Asia, namely Myanmar (former Burma, with 45 million inhabitants, and since 1997, a member of the Association of Southeast Asian Countries, ASEAN) has recently increased the use of this instrument as a third currency beside the US dollar and the domestic kyat. Like in China previously, the parity between FECs and the US dollar is 1:1. As a matter of course, the heavy foreign exchange controls, together with a high inflation tax rate on domestic currency, brought about a black market exchange rate on the kyat to the US dollar of about 1,000:1 where 1 is the official exchange rate. The obvious reason for the existence of FECs is the seignorage gain to be absorbed by Myanmar or by its military authorities.

3. Singapore can be compared with another industrialized country, namely Switzerland, having a stable (floating) currency and not being a member of the euro currency area.


5. McKinnon’s proposed East Asian Dollar Standard has still another advantage. A credible long-term exchange rate peg keeps the purchasing power of domestic bonds fairly constant so that the risk premium between bonds at the center of the system (USA) and at the periphery (small East Asian countries) should become smaller (in analogy to Ricardo Hausmann’s ‘original sin’ hypothesis). This reduction in the monetary asymmetry between the center and periphery is extremely important for the development of a long-term bond market in the small East Asian countries.

6. However, the currency union continued to exist until present time for Singapore and Brunei (see Chapter 11 by Ngiam Kee Jin).

7. The econometric technique of cluster analysis examines the similarities and dissimilarities of the economic structure and groups of countries according to various sets of criteria. Its aim is to obtain membership co-efficients indicating the degree of ‘belongingness’. The highest coefficient would indicate the group (or ‘cluster’) to which this country is most likely to belong.