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DOES ASIA NEED A COMMON CURRENCY?

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It is a great pleasure for me to be here. The first order of business is to congratulate you on this generous, wonderful collection of papers that are in the sessions. To think of seven universities getting together and collaborating in this way for the first time is nearly something like a miracle. I have looked over some of the papers and I found the topics extremely interesting and I look forward to hearing some of them afterwards and reading the rest on my way home.

There are six key elements in the world economy today that we should pay attention to. One is the New Economy. The New Economy underlies the big change in the United States that made possible a sudden jump – up from a 2½ percent average sustainable growth rate that most economists thought was the maximum, to something in the order of 5 percent growth rate. The New Economy is affecting every aspect of our life. With a little exaggeration I could say that it is like a combination of the electricity revolution and the printing revolution at the same time. It is very equalising because it lowers the cost of information all over the world. For the poor countries that can get over the access hurdle – getting wired – it is a godsend that will enable them to tap sources of knowledge and information that offer new hope for prosperity.

The second factor is globalisation, and at once we should say that this can be good or bad. Globalisation comes and goes with its cousin, integration. A century ago there was a kind of globalisation with a high degree of free trade, migration, capital mobility and the gold standard. The dramatic decline in transportation and communication costs in recent years has been combined with a new degree of international political stability.

The role of political stability should not be ignored in the current wave of globalisation. It was the political stability of *la belle époque,* loosely managed, we might say as a kind of shorthand, under a *pax Britannica*, that enabled globalisation in that other era to thrive. In a similar vein, we can say that it was the breakup of the Soviet Union and the end of the Cold War, leaving one remaining superpower, that provided the preconditions of international political stability in the form of the *pax Americana*, which have created the preconditions for globalisation in our decades to flourish.

The third factor is the rise of the US economy over the past 18 years as the motor of the world economy. We have seen a spectacular increase in growth and employment – more than 40 million new jobs created since 1982 in the US economy. This equals the entire labour force of the third largest economy in the world – Germany's. Tremendous growth was triggered by the supply side revolution in the 1980s, which saw income tax rates falling from 70 percent at the federal level to 28 percent when Ronald Reagan left office in 1988, and corporate tax rates falling from 48 percent to 34 percent. Coupled with a cut in capital gains taxes, that made the American economy the most efficient in the world. The US became a place in which everybody wanted to invest. A consequence of this development is the big current account deficits that the United States has had ever since.

It has been ten years since the US has experienced a recession. It started in the middle of 1990 and lasted 9 months. Since the spring of 1991 the United States has been in a great expansion, the longest boom in US history. Two facts give this expansion even great significance. One is that US is the largest economy in the world, representing some 20–25 percent of the world economy (depending on the exchange rates at which one measures world output). The other is that US economic growth leapt upward in 1995, doubling with the New Economy. These facts have been particularly important at a time when both the European and especially the Japanese economies have been caught in a prolonged period of sluggish growth or stagnation.

If the US economy slows – and this seems likely at present – the world will face quite a bit of a problem. The dollar will peak and sooner or later the $420 billion current account deficit will be a drag on the dollar. Unlike in the 1980s when large current account deficits were combined with a strong (but weakening) net creditor position, the United States has now become the world's biggest debtor. If the dollar falls dramatically it will not be good news for the United States economy or any other economy in the world.

The fourth factor is China, whose share of world trade has risen dramatically, from less than 1 percent of the world exports in 1978 to 4 percent. Boosted by China's influence, Asia, with half the world's population, will eventually overtake Europe as the second largest economic region of the world. We will see a convergence in size of the American, European and Asian economies.

The fifth factor is that suddenly, propelled by the emergence of new economies and globalisation, the optimum size of the firms and banks has grown larger. Firms now have to compete at a global scale so our anti-trust and competition laws have to reflect that trend. The massive movement toward major mergers of banks and corporate restructuring is likely to continue for some time.

The last factor – and it is more directly relevant to my topic today – is the advent of the euro. Well, why is the euro important? How important is it? It has been said that the emergence of the euro in the world's currency market is the most important development since the breakdown of the fixed exchange rate monetary system in 1971 or 1973.

The importance of the euro cuts in a different dimension. It relates to the power configuration of the international monetary system. During World War I the dollar replaced the pound sterling as the most important currency in the world, and it has kept and increased its dominance ever since. The breakdown of the Bretton Woods arrangements in 1971 and the movement toward floating in 1973, far from undermining the dollar, reinforced its position. Under floating, the dollar was even more unique and necessary.

Partly by way of digression, I want to say something about the move to flexible exchange rates, which led to the Second Amendment of the Articles of Agreement of the International Monetary Fund. Few events in international monetary history have been more poorly prepared. There was virtually no theory existing on the subject and nothing that hinted at the role of dominant currencies in a world of flexible exchange rates. Imagine a world of, say, 200 currencies each of which represented economies of approximately equal size. What a calamity for international trade and payments. Very quickly national self interest would lead to larger currency areas or even an agreement on a world currency, probably linked to gold. But the presence of the dollar, the currency of a supereconomy, gave the world monetary system a coherence it would have otherwise lacked. As long as countries were willing to use the dollar as the international currency, they would have a virtually universal unit of account, and no need for a world currency.

Patterns of dominance, however, led to frictions, resistances and counter-alliances. Vexing under the dollar standard, the Europeans created their own alternative, the euro, which would allow Europe to capture some of the profits from international money-creating. The significance of the euro lies in the fact that it has the potential to change the power configuration of the international monetary system and to vie with the dollar as an alternative unit of account and reserve currency. In this sense it might be more important than the breakdown of the system in the early 1970s.

Instantly upon its creation, the euro became the number two currency in the world. By the middle of 2002 it will replace the currencies of the twelve countries that make up the euro area, countries with a combined GDP of \$7 trillion. I think we can be sure that the three countries that had opted to stay out will eventually go in. The Blair government of the UK wants to bring the euro in but they will have a referendum first. The governments of the other two countries, Sweden and Denmark, have said that it's not a question of 'if' but 'when.' When they enter, the EMU will have a combined GDP of more than \$8.5 trillion, close to US GDP, especially if the dollar weakens against the euro. In addition, the accession countries will probably mean another dozen countries added to the euro area, not to mention 13 CFA franc countries of West Africa that are already tied to the euro through their former connections with the franc.

Counting a few other countries that are likely to tie their currencies to the euro zone in the coming decade, we could expect that as many as 40–50 countries with a population approaching 500 million, with a GDP perhaps 30 percent larger than the United States, would be in the euro zone within the next decade. This will ultimately produce a sea change in the power configuration of the system. Although the dominance of the United States will remain, taking into account its military power and centralised government (at least relative to the European Union), it will no longer have things its own way in the field of trade policy and the international monetary system. A multi-polar power system will develop.

Some say that estimates of the future strength and importance of the euro are exaggerated. The fall in the value of the euro is one indication of its weakness that has captured wide attention. But this weakness has blinded people to its long run significance. The euro is a political necessity for Europe. Whenever factors tend to make it weak, countervailing forces will work to help it recover. That has happened time and again over the past three decades since the process of monetary integration began. Despite the difficulties, the EU has confirmed the commitment to expand into Central and Eastern Europe. The European Union is going to become bigger and more important for the world economy.

By 2012 the importance of the dollar and euro will be about equal and countries will want to hold about equal proportion of dollars and euros. What are the implications? Given that most of the existing reserves are now in dollars, a balance between dollars and euros would mean little, if any, growth in demand for dollars over the next decade but a substantial demand for euros. If the past is any indication, the global demand for reserves will double over the next dozen years, say from \$1.6 trillion to \$3.2 trillion. With, say, three-quarters of reserves in dollars today and in 2012, there would be no room for dollar growth but a demand for euros of \$1.2 trillion, or \$100 billion a year. With unchanged capital movements this would involve a substantial turnaround in current account and trade balances, with the United States generating a smaller and Europe a larger deficit or smaller surplus. Most likely the change in reserve would be split between changes in current accounts and capital movements. In any case it would involve downward long-run pressure on the dollar and a factor making for the long-run strength of the euro.

There is another feature of the euro to consider. The euro will have a tremendous demonstration effect, changing the way people think about flexible exchange rates and currency areas. Consider the fact that the International Monetary Fund (IMF) and the United States have together been preaching for two and a half decades to countries throughout the world about the importance of having flexible exchange rates, and the calamities visited on countries that fix their currencies to another currency. Together, the United States and the IMF have been completely negative on fixed exchange rates or currency board systems for smaller countries. But suddenly the euro emerges, as a great success. Instead of the fixed exchange rates in the euro zone creating speculative capital movements, they became instead a dead letter; hedge funds can't make a dime in the euro zone. Interest rates, which in several countries were between 10 and 15 percent, suddenly dropped to 5 percent. Europeans suddenly had a capital market of continental dimensions and a currency that promises to be the number two currency in the world. The success of the euro zone has made smaller countries look freshly at the exchange systems foisted on them by the United States and the IMF.

If the euro is right for 11 (now 12) most advanced countries in the world, why not for other countries? If it is right for Europe to scrap its national currencies, why is it wrong for other countries to do the same thing? Why indeed? To understand the convention wisdom, which looks upon fixed exchange rates as at best an aberration, it is necessary to glance at a mistake that has permeated international economics for more than two centuries. This mistake is the idea behind what was called the 'price-specie-flow mechanism.' This is the mechanism attributed to David Hume, the 18th century economist who was instrumental in developing (if not exactly originating) the immensely important doctrine of the self-adjusting international mechanism under specie (gold or silver) standards.

Starting with equilibrium, Hume would postulate some disturbance, such as an increase in the quantity of money, and then show that the consequent outflow of specie would be self-correcting. Later writers interpreted Hume to mean that domestic prices would rise, shift expenditure onto foreign goods, create a balance of payments deficit, which would reduce the money supply, and thus correct the initial disturbance, with opposite effects occurring in the foreign country. This came to be known as the price-specie-flow mechanism.

This interpretation of Hume cannot, however, be correct because Hume was careful to insist upon the inviolability of the 'law of one price'. Prices at home could not rise above prices abroad. To save the idea, theorists then interpreted the change in relative prices to mean a change in the terms of trade. But this idea could be quickly refuted: what about a country that was too small to change the terms of trade?

It was only in recent years that the problem was cleared up. The fact is that price changes were not required to make the mechanism effective. An increase in the quantity of money would simply increase expenditure, and thus worsen the balance of payments at unchanged prices. Price changes were not essential to the mechanism and incidental changes could go in either direction. Yet the harm had already been done to generations of economists brought up on the defunct economics of their teachers. It was a simple step for those economists who man the international institutions to reject fixed exchange rates as an evil force that imposed deflation on deficit countries and inflation on surplus countries. This is one case where practical businessmen have had greater insights into policy than the faculty of the economics profession.

Taking a look at the world today, we have three islands of stability: the dollar area, the euro area and the yen area, and these three areas make up 60 percent of the world economy. We can say approximately that by the decade of the 1990s, inflation has been stopped in all three areas. In the past decade there has been no inflation in the United States, no inflation in Europe and no inflation in Japan. But we have hugely unstable exchange rates. If we have price stability in each area why do we need unstable exchange rates? If we look at the DM/dollar rate, which can be looked on as the predecessor of the euro/dollar rate, we find that in 1975 the dollar was at DM3.5. Five years later, in 1980, it was half that, at DM1.7. Five years later, in 1985, the dollar had doubled to DM3.4. Seven years later, in the exchange-rate-mechanism crisis of 1992, the dollar had fallen to DM1.35. Now it is DM2.20! What violent instability! If it were matched by the dollar-euro rate in the future, it would crack Euroland apart.

Alternatively, look at the yen/dollar rate, more familiar in Hong Kong. In 1985 the dollar was at 250 yen; 10 years later, in April 1995, it was 78 yen;

3 years later, in June 1998, it was 148 yen. Speculators said it was going up to 200 yen. Instead it fell to 105 and then recovered to 125. The rise of the dollar and the depreciation of the yen between 1995 and 1998 was a major cause of the Asian crisis. For all kinds of subtle reasons the impact was not just the increased competitiveness of Japan. Whenever the yen goes down, foreign investment from Japan dries up. That happened in 1997 and it was a great blow to many of the economies of Southeast Asia.

A different story applied to China. In 1998 there were widespread speculations that China would devalue its currency. The black market rate, reflecting speculation against the RMB, rose to more than 9 RMB. With the RMB about to be devalued, why would businesses in Japan want to invest in China. How much better to pick up bargains after the devaluation! Thus investment in China dried up and the speculation against the RMB almost proved to be self-justifying. The lesson is that exchange rate uncertainty can be just as damaging as the reality of exchange rate changes.

Let me elaborate here somewhat on recent proposals from the IMF that China widen its exchange margins; depending on whether the balance of payments was in surplus or deficit, the currency might initially appreciate or depreciate. But the ultimate result is inevitable: depreciation. Given the inconvertibility of the RMB on capital account and exchange controls, widening the margins would aggravate uncertainty about the commitment to parity and be looked upon as a prelude to devaluation.

There are special features of the monetary situation in China that need to be allowed for. China has an unusually high ratio of money to GDP (using a broad definition of money that really includes quasi-money). That ratio is not just huge, it is growing rapidly. Remember that people in China cannot look upon land as owned wealth; land can be held not on the basis of ownership but only of lease. Some other outlet in which to invest their saving is needed. The stock market can take some of it but it is not suitable for vast numbers of small savers who do not have ready access to the knowledge needed to manage stock portfolios. In any case stock market capitalisation is still not large enough to absorb much of the deposits that are put into banks. Money, therefore, represents the most important abode of saving. But if the currency starts to depreciate, confidence in this outlet for savings will be undermined and there will be a flight from money into hoarding in the countryside of the type that led to such a panic in the late 1980s. It would be especially disturbing in the poorer western part of China that has not by any means shared fully in the prosperity of the coastal regions. A policy of devaluation or even a widening of the exchange margins would be looked upon as movement away from China's commitment to monetary stability and create grave uncertainty about the future.

Yet another argument against devaluation – or widening the margins as a prelude to it – is that the United States – China's main market – with its large trade deficit with China might retaliate by imposing quotas on China's exports. This would be especially likely if the US economy weakens and moves into a recession.

While in Korea last March at a meeting of the APEC Study Group Commission I heard a new phrase: the 'Asia-IMF crisis'! Both adjectives need to be justified: Was it an Asian crisis? Was it an IMF crisis?

It wasn't really an 'Asian' crisis. The real crisis was restricted to four countries: Thailand, Malaysia, Indonesia and South Korea. There was no real crisis in Singapore, Hong Kong, China, Taiwan China, or Japan except, of course, for the fact that bystanders are never unaffected by the plight of their neighbours. The countries that avoided the crises had two things in common. The first feature they had in common was large foreign exchange reserves and relatively low (or at least manageable) external debts so they didn't have to draw on the IMF or follow its policy prescriptions. The speculators had no interest in taking on these countries. The second feature they had in common was a clear-cut, specific target for monetary policy. Singapore has a currency basket (with unspecified weights) target that worked almost like inflation targeting. Hong Kong had a currency board system. (To be sure, Hong Kong got into a little trouble when the newly-created Hong Kong Monetary Authority threatened to depart from the rules of the system in order to support the stock market, but the punishment in the form of outward speculation was severe and it quickly corrected its mistake.) China had a fixed exchange rate coupled with exchange controls. Both Taiwan and Japan had commodity basket targets.

Was it an IMF crisis? The IMF had programs in each of the countries at the epicentre of the crisis but little or no exposure in the other countries. But this doesn't prove causation! There are a lot of sick people in hospitals too! A serious case, however, could be made that IMF policies have led to the rejection of fixed exchange rates as an anchor without replacing that monetary rule with an equally satisfactory alternative anchor.

I now must turn to the question that is the focus of my comments. Does Asia need a common currency? The answer depends on what the alternative to it is. If the alternative is the present system then my answer is 'yes, Asia needs a common currency'. The present system has serious flaws. If, however, the alternative to it is a global currency, which I think would be the best solution, then my answer is Asia does not need a separate common currency.

To form an idea of the needs of Asia in the field of currency reorganisation, we need to form a view of the outlook for Asia and its prospects in the world economy as it could conceivably evolve. I have written in the 30 March 2000 issue of the *Asian Wall Street Journal* on a plan for building a world currency on the platform of a three-currency (G-3) monetary union of the dollar, euro and yen areas. I don't have time today to go into the details but you can think of achieving it with the five steps leading up to the euro area (without the third phase in which national currencies are scrapped). The five steps are as follows: (1) establish a common inflation target for the G-3 area; (2) establish a common price index to measure inflation in the area; (3) lock exchange rates; (4) form a monetary policy committee to establish the common monetary policy; and (5) develop an arrangement to share seigniorage. Given the high degree of inflation convergence among the three currency areas, making monetary policy decisions should not be more difficult than for the European Central Bank inside the euro area. If that could be achieved it would be a relatively simple matter to use the dollar-euro bloc as the platform for a world currency produced by the members of the IMF.

Notice the great advantages of such a monetary union for the world economy. Instead of having to cope with unstable exchange rates among the dollar, euro and yen, the rest of the world would have the option of stabilising its own currencies relative to the mainstream of the world economy.

Of course, it is possible – some might say extremely unlikely – that an agreement to lock exchange rates and conduct a common monetary policy could be worked out among the United States, the EMU countries and Japan. The day is long past when all the major central banks – as in the post-war era – believed in a fixed exchange rate monetary system as an act of faith. The current fashion is to go the opposite extreme and praise policies of benign neglect of the exchange rate. For that reason Asia should not indulge in wishful thinking but find (possibly second-best) alternatives.

It is here that I think the solution is an Asian currency. I have to say very quickly here that I do not mean a *single* currency for Asia. When I speak of the desirability of a world currency I am not talking about a *single* currency. The distinction between a common currency and a single currency has given rise to difficulties elsewhere, so to avoid misinterpretation I want to underline the distinction.

Some of you may have seen a debate, 'The Nobel Monetary Duel', conducted by email between Milton Friedman and myself and appearing in eight issues of the *National and Financial Post* of Canada. In the final episode, Friedman accused me of advocating a single world currency. But I have never suggested a single currency for the world and, moreover, I have several times suggested there would be problems with it. Assuming the political conditions were appropriate, the optimal and equilibrium solution is for each (sufficiently large) country to retain their national currencies but keep them fully convertible into the world currency.

In my model for the world economy, every country can keep its own currency. All that is needed is for the currencies to be produced as if there were a single currency. What model would this be? Well, it could be the model of the Belgium-Luxembourg monetary union. Belgium and Luxembourg formed a monetary union in the 1920s. The Luxembourg franc has existed along with the Belgium franc all this time but monetary policy was (before the advent of the euro) conducted by Belgium. Luxembourg had no independent monetary policy but there are nevertheless a lot of Luxembourg francs kicking around, just as there have been Scottish pounds kicking around since the Act of Union with Britain in 1707. The equilibrium is stable as long as the supply of each national currency is kept below the global demand for it at the fixed parity by a margin large enough to squash speculation.

So, to get back to the main theme, Asia needs a common currency but it is not possible or desirable for it to have a single currency. Each state can keep its own currency but it should be kept convertible into the common currency organised and run by a consortium of relevant states. Such an arrangement would be highly desirable to avoid a repetition of the currency storm that struck several countries in Asia in 1997–98, from which one or two countries have not yet recovered.

Remember the meeting of the IMF in Hong Kong in September 1997? At that time Japan proposed the organisation of an Asian Monetary Fund. This proposal was decisively rejected by the United States Treasury. Apparently the fear was that an Asian Monetary Fund would take decision-making power away from Washington. What a pity! There followed in just a few weeks the so-called Asian crisis. Policy responses with an Asian solution could hardly have been worse than the solutions concocted in Washington.

If there is to be an Asian plan – solution is too strong a word – for an Asian currency, it is natural to ask: what currency and what anchor? As already emphasised, the European model of a single currency would not work in Asia now because a single currency requires a substantial degree of political integration, much more than exists in Asia now or in the foreseeable future. The Asian currency would have to be a common parallel currency, used for international trade within Asia and with the rest of the world.

What would be the anchor for a parallel currency in Asia? At least at the beginning it would have to be based on one of the existing global currencies. The relevant choices are the dollar, euro and yen, and possibly the RMB. But the RMB would not suffice at the present because it is not a convertible currency. If China continues to grow as it has in the past, the RMB will be an increasingly important currency in Asia but it would be a step backwards to use an inconvertible currency as an anchor, and this rules out the RMB as the anchor for the next several years.

What about the yen? Japan basically has a very strong economy. It is the world's largest creditor nation, a position it has built up with a high savings rate that has led to huge current account surpluses. Japan also has been more successful (one could even say *too* successful!) than any other country in recent decades in keeping inflation under control.

But against these advantages the choice of the yen as anchor has severe problems. Japan has not put its macroeconomic house in order. A first problem is that its banking system is in grave trouble, a problem that stemmed from deflation in the form of the excessive appreciation of the yen in the late 1980s. A second problem was that its mix of monetary and fiscal policy has been wrong for several years: fiscal expansion coupled with a high degree of capital mobility and a flexible exchange rate (a straightforward conclusion, if I may say so, of the Mundell-Fleming model!). A third, related problem concerns the secular tendency of the yen to appreciate, reflected in long-term interest rates less than 2 percent. Until these problems are corrected the yen could not be used as the basis for a currency area. In addition to these difficulties, there is widely perceived to be unfinished business left over from Japan's role in World War II.

Because the euro is not a serious contender as an anchor for the Asian currency at the present, we are left with the dollar – or a basket of the dollar, yen and euro. But a basket of the three currencies, however, useful as a long-run unit of account, would not make a good medium of exchange. As long as the dollar, euro and yen rates fluctuate against each other, its value would be uncertain and it would not be an interesting anchor for the national Asian currencies.

We are left, of course, with the dollar. US GDP is, at current exchange rates, somewhat less than 2½ times that of Japan and 10 times that of China. The dollar would be an excellent anchor for the Asian currencies. China already uses the dollar as its anchor as does Malaysia and of course Hong Kong.

Let me conclude with a comment on Hong Kong. This region has become an important feature of the economy of Southeast Asia and outside Tokyo it has the largest foreign exchange market in Asia. Even so, its policy could, in my opinion, be improved by a policy change that would be better for itself, mainland China and the rest of Asia.

I am thinking of a reform that would replace Hong Kong dollars with US dollars! What would be the costs and benefits?

Start with Hong Kong. There are about $HK100 billion in circulation that would have to be replaced, at the current exchange rate of $HK7.80 = $US1.00, by about US$12 billion. With Hong Kong's vast reserves of about $100 billion, it would be a simple matter to finance. The only cost to Hong Kong would be the interest receipts foregone on this $US12 billion. The benefits to Hong Kong would be enormous. The Hong Kong public would suddenly get a currency that is the most important in the world, with a history of stability stretching over the last century, second to none. Interest rates in Hong Kong would fall to New York levels. And Hong Kong would continue to get the rate of inflation of the United States, modified by a secular productivity-change factor. Hong Kong's finance centre would suddenly dominate the rest of Asia.

China would benefit. The RMB has been fixed to the US dollar since 1994. China would have on its doorstep a region using the most important currency in the world and she would have access to a world-class capital market and financial centre. The continued existence of the Hong Kong dollar is completely unnecessary for China. Other advantages would be that Hong Kong would become the focal point for the Asian Monetary Fund and the Asian dollar. The existence of a great financial centre based on the dollar and with dollar interest rates would be of immense benefit for the rest of Asia. The transformation of the Hong Kong currency into a rock of stability for all Asia would have far reaching – and beneficial – implications for the currency reorganisation of the world.

In the long run, the formation of a dollar-based currency area in Asia, including China, Hong Kong and most Asian countries, could be used as the platform for an independent Asia currency that could become the standard unit of account of an Asian Monetary Fund.