Towards an Asia/Pacific Economic Community

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A Potential Asia/Pacific Community

- ASEAN (Association of Southeast Asian Nations)—Brunei, Indonesia, Khmer Republic, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand, Vietnam
- + 3 (China Japan, South Korea)
- Hong Kong, Macau and Taiwan
- Australia and New Zealand
- The role of the United States (are the interests of the U.S. aligned with those of ASEAN + 3)?--inclusion but no veto
- Canada, Mexico and Chile

ASEAN + 3 (including Hong Kong, Macau and Taiwan)

- In 1960, the GDP of ASEAN + 3 was approximately 40% of US GDP
- In 2000, the GDP of ASEAN + 3 was approximately equal to that of US GDP
- Within ASEAN + 3, Japan contributed more than 50% of total GDP, followed by China (Mainland only), which contributed more than 10%
- South Korea, and Hong Kong, Macau, and Taiwan combined each contributed somewhere between 5% and 10%
- Thus, ASEAN + 3 is also comparable to the Zone Euro in terms of the magnitude of its GDP

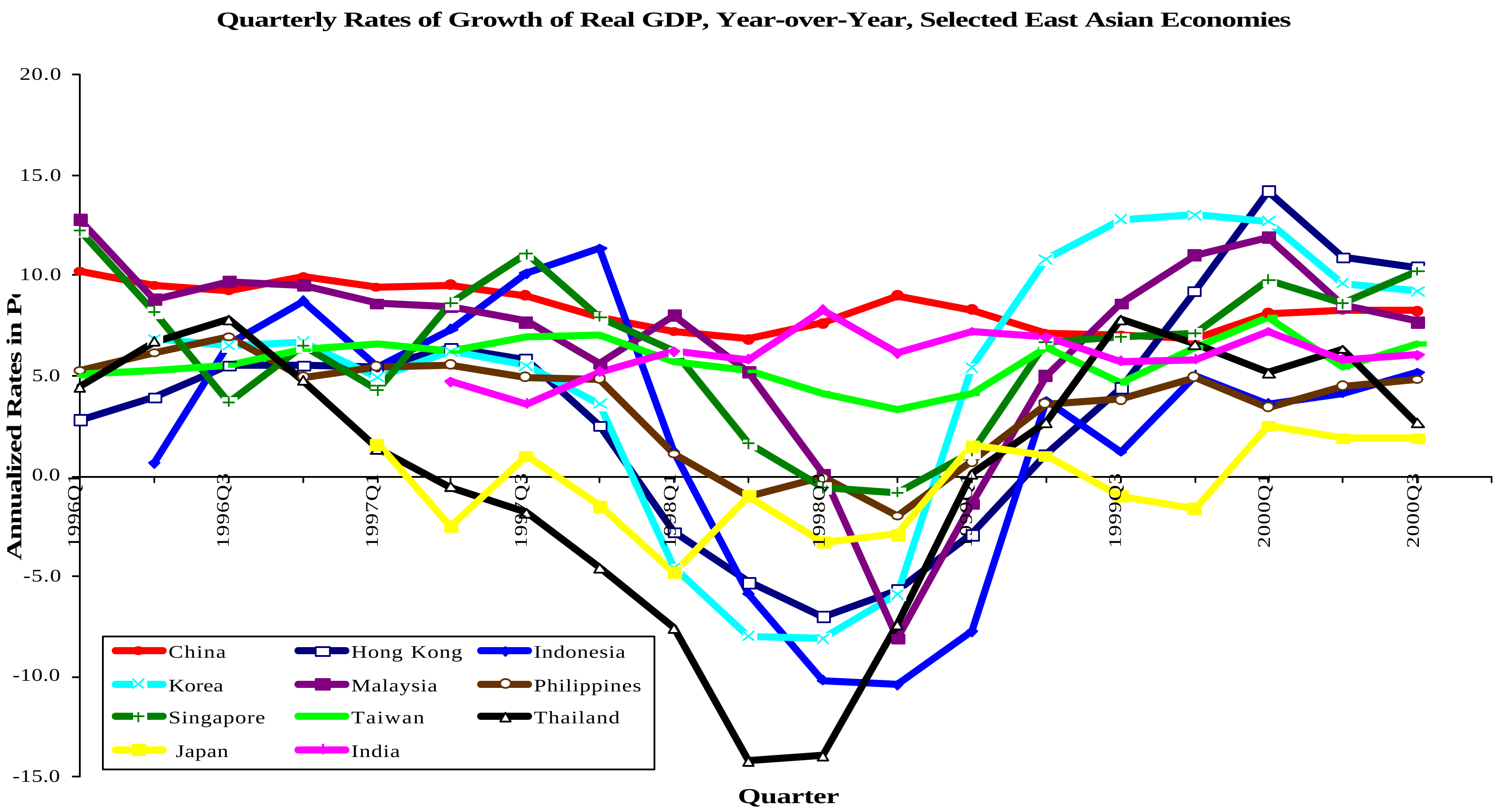
Historical Precedent—The Evolution of the European Union, a 50-Year Process

- The Bank for International Settlements
- The European Coal and Steel Community
- The European Common Market
- The European Economic Community
- The European Union—the Euro

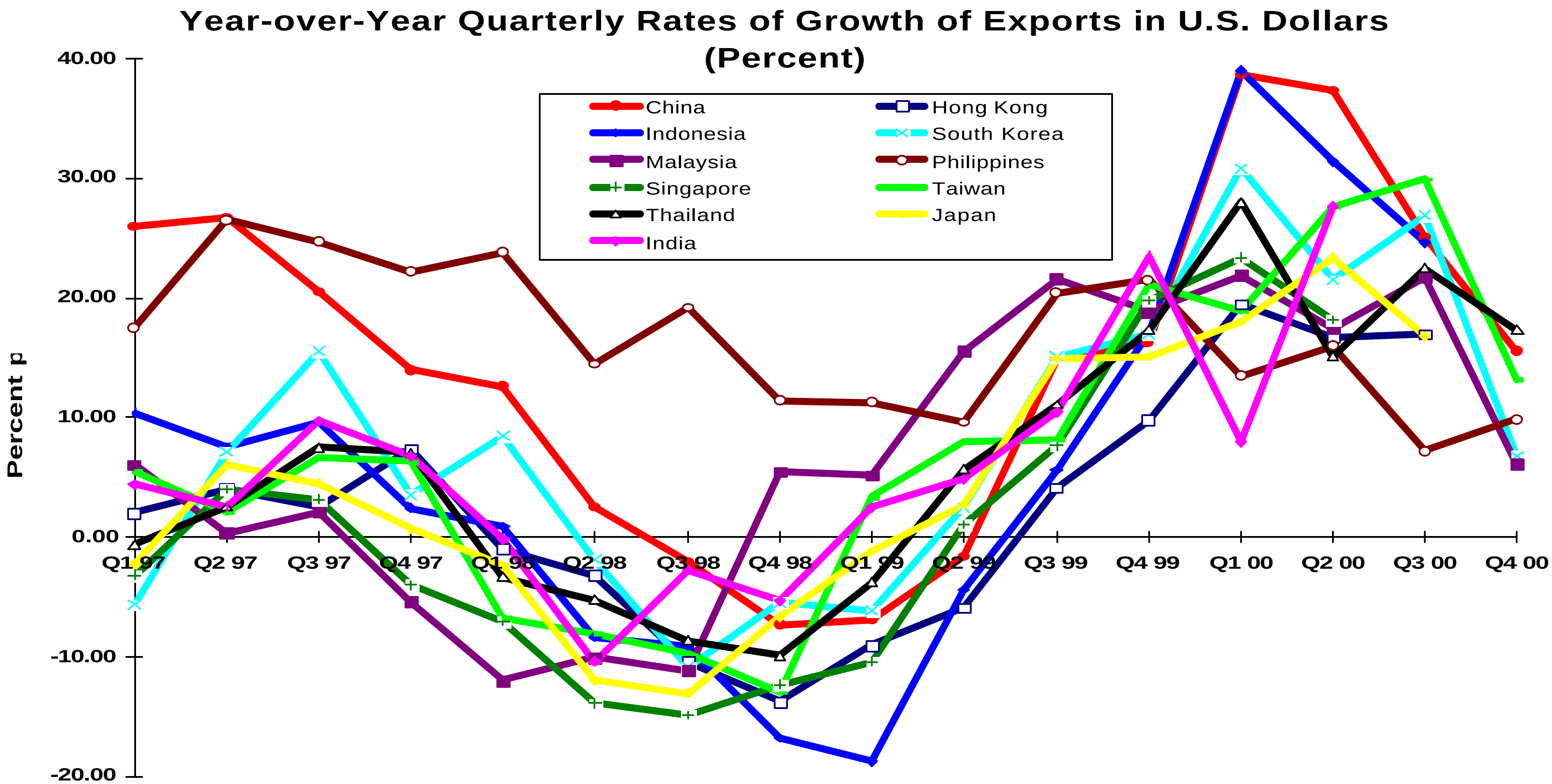
Rising Intra-East Asian Interdependence from Trade and Capital Flows

- Over the last decade, the proportions of East Asian exports to other East Asian economies have been increasing rapidly
- By the late 1990s, approximately 50% of the exports of the East Asian economies are destined for other East Asian economies
- Synchronization of economic cycles--all East Asian economies, with the exception of China, Japan and Taiwan, experienced rises in the rate of interest and downturns in economic activities at the same time, which in turn caused significant reductions in the demands for one another's exports, further exacerbating their recessions
- However, the simultaneous upturns also allowed the recovery in the East Asian economies to be extraordinarily and unexpectedly rapid, with the rising import demands of each economy feeding into rising export demands of its trading partners

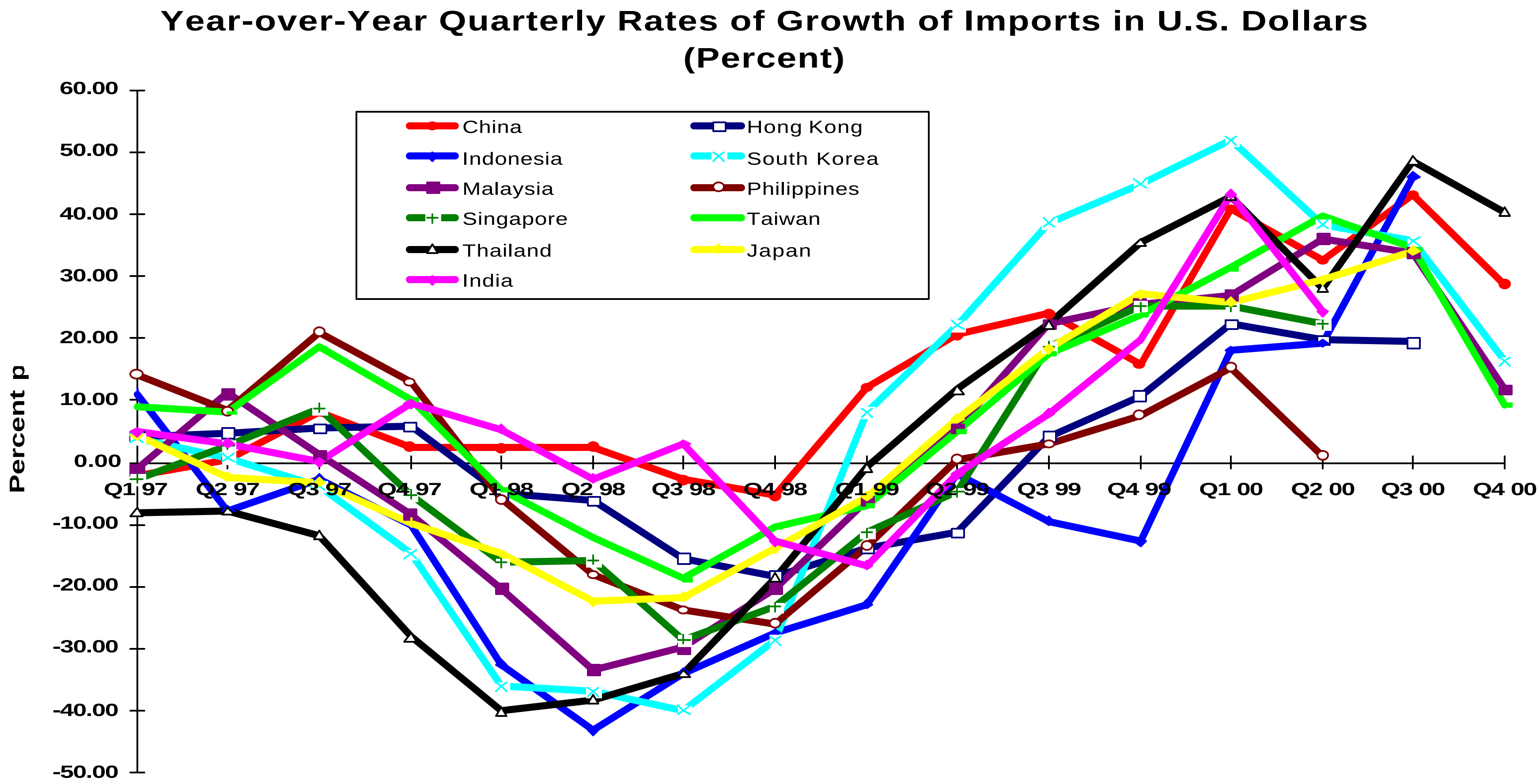
The Synchronization of Downturns and Upturns



Quarterly Rates of Growth of Exports



Quarterly Rates of Growth of Imports



Intra-East Asian Capital Flows and Technology Transfer

- The wild geese flying pattern of East Asian economic development (Kaname Akamatsu (1962))
- Japan, Hong Kong, Singapore, South Korea and Taiwan have become major direct investors in the East Asian developing economies

Economic Complementarity

- Within the prospective Asia/Pacific Economic community, there exist significant economic complementarity between the developed economies (principally Japan) and the developing economies (China and the ASEAN with the exception of Singapore)—there is very little overlap between what Japan on the one hand and China and the ASEAN without Singapore export on the other hand
- The Newly Industrialized Economies (NIEs) of Hong Kong, South Korea, Singapore and Taiwan are actually competitive with the developed economy, Japan, on their high ends and with the developing economies on their low ends (and with one another)
- The largest potential gains from the economic complementarity is therefore a (China-Japan-ASEAN) combination
- An Asia/Pacific Economic Community without the participation of both China and Japan is unlikely to be successful

Identifying a Pareto-Improving Sequence of Implementable Measures

- Separation of economics and politics, at least initially
  - Dual leadership (China and Japan)
  - Inclusivity
- Free trade per se is likely to face domestic opposition everywhere—in principle, the losers can be compensated; in practice it is difficult to do so
  - World Trade Organization membership is almost universal among the potential members of the Asia/Pacific Economic Community
  - Free trade can be promoted on the grounds that it increases the size of the regional market and hence is an attraction to foreign direct investors
  - Free trade can also be promoted if there is an adequate mechanism for compensating the displaced workers
- Harmonization of standards and facilitation of exchangeability
- Coordination and stabilization of exchange rates can provide potential Pareto improvement to all economies
  - Distinguishing liquidity problems from solvency problems
- Coordination of foreign direct investment policies
- Coordination of capital market policies
- Common issues on trade

Harmonization of Standards and Facilitation of Exchangeability

- Technological standards—e.g., mobile telephones, television, data transmission, financial data protocols
- Grading, inspection and certification standards for commodities
- Software standards
- Certification standards
- Harmonization of rules and regulations for e-commerce

Co-Ordination and Stabilization of Intra-East Asian Exchange Rates

- Competitive devaluation can lead to great instability, both for the individual countries and for the region as a whole (as well as globally)
- Predictability and stability of the exchange rate over the medium to long term facilitate investment and economic growth
- Timely intervention can make a significant difference for all
  - Prevents over-shooting adjustments with their irreversible negative effects
  - Prevent/minimize contagion and hence a vicious cycle of competitive devaluation

Problems of Exchange Rate Stabilization for a Small Economy

- A thin market--total volume small relative to the size of hedge funds and other pools of hot money (estimated to total 100s of billions of US$)
  - E.g. the average daily net turnover of foreign exchange trading in April 1995 in Hong Kong was US$90 billion compared to US$1,460 billion for the world as a whole
  - At the time Hong Kong had foreign exchange reserves of US$ 55 billion
  - Shorting the Hong Kong $ for 6 months require only a 4% premium
- Possibility of market manipulation due to lack of regulation and transparency
- Central bank/monetary authority has to assume the role of market-maker
- A credibly adequate level of foreign reserves (and/or standby commitment from an international or regional stabilization facility) is necessary to insure stability

The Size of the Global Foreign Exchange Market

- According to the Bank for International Settlements data, London is the largest foreign exchange market in the world with average daily turnover of approximately $650 billion in 1998
- London is larger than the New York and Tokyo markets combined
- Total worldwide average daily turnover is probably on the order of US$2 trillion, approximately two-thirds of the trade are conducted through the interbank market
- Private capital flows to developing countries increased from US$40 billion in 1990 to US$290 billion in 1997
- There are between 3,000 and 4,000 hedge funds, at a conservative estimate of US$100 million of equity capital each, with an estimate of aggregate capital of between US$300-400 billion
- Large and well known funds such as Quantum Fund (Soros) and Tiger Fund had approximately US$20 billion worth of capital
- With leverage, the hedge funds can collectively undertake transactions as high as US$10 trillion (Total U.S. stock market capitalization is US$12.5 trillion)

Post-Currency Crisis Options for Exchange Rate Regimes: Large Markets and Currency Areas

- The impossible trinity--countries cannot have simultaneously all three of the following:
  - Capital mobility
  - Independent monetary policy
  - Fixed exchange rate
- Large and deep individual markets--United States, Japan
  - Stabilization of a freely-floating currency is difficult unless it has a large and deep market relative to the short-term capital flows
- Currency areas
  - The Euro--even before the Euro there was the EMS "snake" pegged to the DM (German Mark)--evidence that small and shallow markets for individual currencies can be too volatile even for developed economies such as Austria, Belgium and the Netherlands
  - World monetary union—A "group of three" monetary union advocated by Robert Mundell, Nobel Laureate in Economics

Post-Currency Crisis Options for Exchange Rate Regimes: Capital Control

- Capital control--Japan before 1980, China, Malaysia
  - Current account convertibility, long-term capital convertibility, limited short-term capital convertibility
  - Some forms of capital control, especially on short-term flows, may make sense to prevent exchange rates from being moved around excessively by short-term capital flows as opposed to by real factors of competitiveness
  - For small economies, it is not possible to have a stable floating exchange rate without some kind of control over short-term capital flows--this is because the potential short-term capital flows can overwhelm the flows generated by exports and imports of goods and services and long-term capital flows in the determination of the exchange rate

Post-Currency Crisis Options for Exchange Rate Regimes: Dollarization

- True dollarization (Panama) and quasi-dollarization (Hong Kong, Argentina) through a currency-board arrangement
  - True dollarization implies that the U.S. dollar will be legal tender for all obligations and contracts can be denominated in U.S. dollars
  - Hong Kong and Argentina with a fixed U.S.$ peg are not quite truly dollarized but is very close to being so
  - Benefits:
    - Insulation from exchange rate volatility
    - Promotes long-term FDI as well as foreign portfolio investment
    - The rate of interest and the rate of inflation will be at U.S. levels if credible
    - Facilitates foreign trade
  - Costs:
    - No more monetary policy (neither money supply nor interest rate can be independently controlled)
    - Fiscal policy constrained by the ability to issue US$ denominated government notes and bonds
    - Loss of seigniorage from currency issuance

A Multilateral Currency Swap Framework with Bilateral Agreements

- The ASEAN (Brunei, Indonesia, Malaysia, Myanmar, Khmer Republic, Laos, Philippines, Singapore, Thailand and Vietnam) + 3 (China, Japan, Korea) have approved, in principle, bilateral standby swap arrangements for the support of the exchange rates of individual economies
- It is also possible to have bilateral agreements on settlement of transactions in the currencies of the countries instead of the U.S. dollar (up to a maximum amount if necessary), thus conserving foreign exchange reserves and freeing them up for potential use in emergencies
- The same result can also be achieved through an East Asia-wide multilateral agreement

A Foreign Exchange Lender of Last Resort: A Cooperative Asian Currency Stabilization Fund

- A multi-country cooperative currency stabilization fund may have a useful role to play by augmenting the potential foreign exchange reserves perceived to be available for the defense of any single currency. (Timely intervention in the currency markets of certain countries, such as Indonesia, would have helped to reduce the misery significantly.)
- In order to avoid moral hazard, countries must meet certain prescribed rules of liquidity and solvency in order to avail themselves of the facility
- The facility is dedicated to the stabilization of the exchange rate only and cannot be used for other purposes

Reducing Vulnerability to Speculation: An Adequate Level of Foreign Exchange Reserves

- An adequate level of foreign exchange reserves should be maintained, taking into account not only trade flows but also short-term and long-term capital flows. A conservative estimate of foreign-currency needs would be three months of imports plus the stock of foreign portfolio investment plus the stock of short-term foreign-currency denominated bank loans plus debt service on long-term foreign-currency denominated debt. If foreign exchange reserves, plus available lines from international organizations and other counties, are perceived to be less than the estimated foreign currency needs, a run on foreign exchange may ensue.

The Importance of Timely Action with Decisive and Overwhelming Force

- Sudden increase in variance (riskiness) encourages flight to safety
- Maintaining the confidence of domestic citizens is the most critical, especially for countries without capital control
- Successful stabilization requires “decisive and overwhelming force”
- Perceived commitment is more important than
  - the actual value of the exchange rate (the Hong Kong (1983) and Chinese (1993) examples) or
  - the actual amount of foreign exchange available (the Mexican example)
- Intervention is intended to change expectations--prevention of contagion and a vicious cycle in competitive devaluation

New Channels for Contagion!

- The speculative attacks on the New Taiwan Dollar (10/17/97) and the Hong Kong Dollar (10/23/97) show that even **ECONOMIES WITH SOUND FUNDAMENTALS ARE NOT IMMUNE!**
- Traditional channels for contagion (through trade)
  - Competitive devaluation
  - Nervous domestic traders and investors (Prof. Jeffrey Sachs's "rational panic")
- New channels for contagion (through short-term capital flows)
  - Predatory speculation by hedge funds
  - Domino effect of cross-country lending and re-lending (e.g., by Korean banks and chaebols)
  - The confidence factor--withdrawals by indiscriminate investors of developing (emerging) countries equity and debt; reduction of outstanding credit by multinational banks

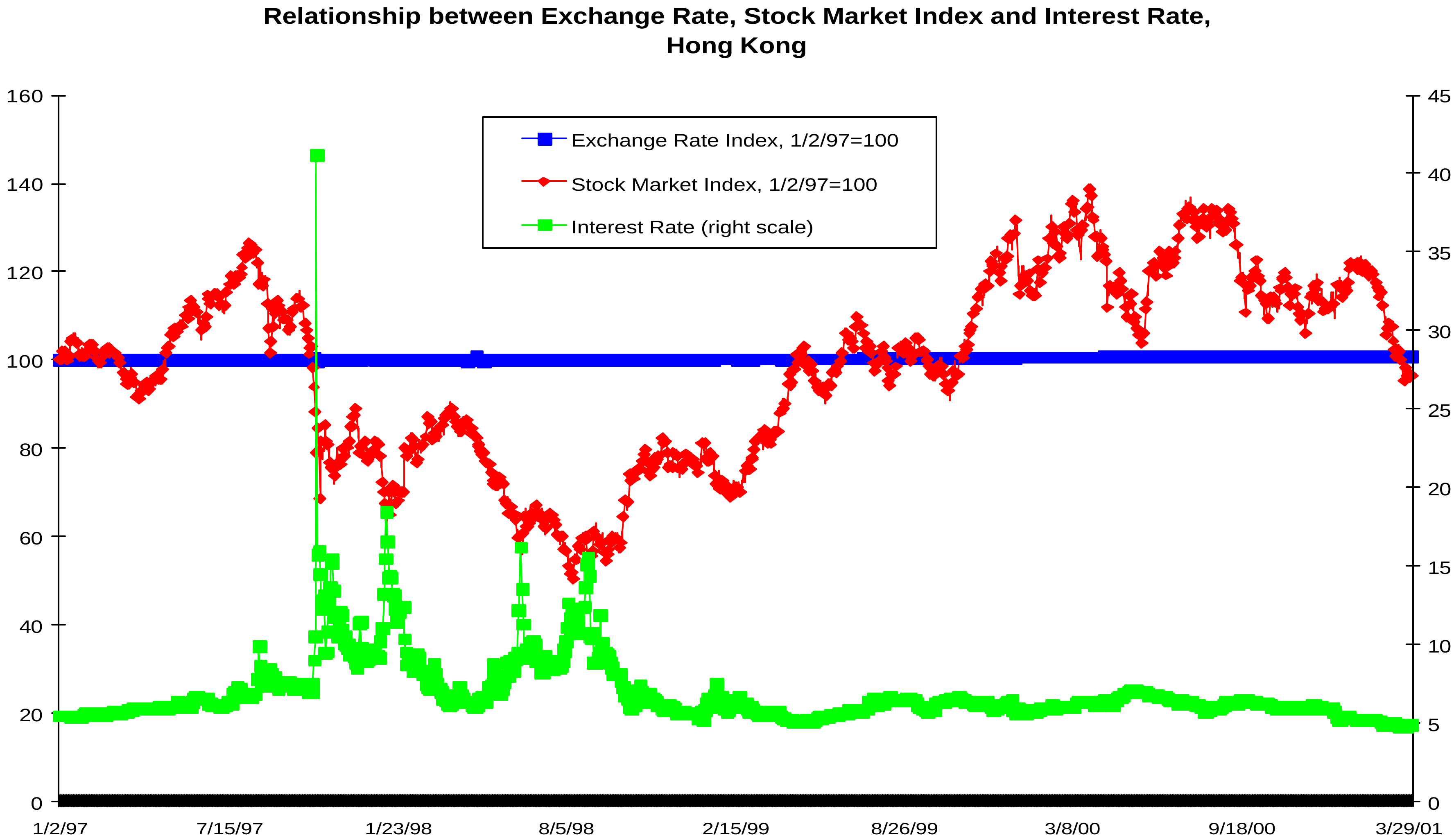
Predatory Speculation (1)

- Large pools of hot money (3,000-4,000 hedge funds with aggregate capital of US$300 billion+) that can move (small) markets
- Formulae for almost risk-free profits, especially in economies that are expected to defend their exchange rates (transactions must be large enough to be a credible threat to the exchange rates)
- (Short) Sales of large quantities of local currency induce purchases by local central bank or monetary authority
- Such purchases by the central bank or monetary authority cause the local money supply to contract and liquidity to tighten, sending the short-term rate of interest up
- The local central bank or monetary authority may also raise the rate of interest directly to discourage the conversion of local currency-denominated assets into foreign currency-denominated assets

Predatory Speculation (2)

- For example:
  - Simultaneous shorting of currency and going long on interest rate futures (Attack on the British Pound, 1992)
  - Simultaneous shorting of currency and stock (or stock index futures), in either spot or forward markets or both (Attacks on Hong Kong)
  - Shorting the stock market and then selling the domestic currency proceeds for U.S. dollars
  - Simultaneous longing of currency and stock or stock market index
- Predatory speculation can occur and succeed <u>independently of the economic fundamentals</u> if the resources of the speculators are sufficiently large relative to the size of the market
- Short sales of forward contracts in the local currency will have the same effect through arbitrage (Buyers of forward contracts will sell short in the spot market)
- Predatory speculation has the effect of depressing the exchange rate and increasing its volatility and hence the interest rate risk premium

An Example: Hong Kong



Containing Contagion

- Predatory speculation by hedge funds should be monitored and controlled --through mandatory disclosure of large positions (similar to what New York Stock Exchange requires of individual stock holdings) and imposition of margin requirements on purely speculative (non-current account-related) spot, forward or future currency transactions thereby reducing the degree of leverage and hence potential profitability of such transactions—these requirements should be made region-wide so as to reduce gaming on the part of the hedge funds
- Exchange rate policy coordination among countries of the region can prevent contagion leading to unexpected and unintended changes in the exchange rate alignments
- The existence of a region-wide currency stabilization facility can actually discourage speculation and help stabilize the exchange rate

Is There Room for a Common East Asian Currency?

- Cooperation between China and Japan is absolutely essential for the emergence of a common East Asian currency
- An East Asian snake similar to the former EMS snake?
- The volatility of the Yen/US$ exchange must be significantly reduced in order for an East Asian snake or more permanent arrangement to be viable

Coordination of Foreign Direct Investment Policies

- Investment protection
- Tax treaties—elimination of double taxation and exchange of information
- Harmonization of investment benefits for foreign direct investors (differentiation by host countries can be permitted based on real GDP per capita)
- Elimination of export requirements on foreign direct investment
- Common policy for the free movement of employees of foreign direct investors (on residence, tax, pension and other related matters)

Coordination of Capital Market Policies

- Adoption of common accounting standards (e.g., requiring all assets and liabilities be marked to market)
- Adoption of common rules of transparency, disclosure and corporate governance
- Adoption of common regulations for securities markets—manipulation, insider trading, treatment of minority shareholders, corporate governance, etc.
- Harmonization of margin and other trading rules
- Harmonization of listing requirements with a view to eventually facilitating cross-listing (the role of demographics)
- An East Asia-wide market for securities in terms of depository receipts denominated and traded in U.S. Dollars

More Timely and More Accurate Financial Information

- Financial institutions and enterprises should be required to mark their financial accounts to market at the end of each quarter so that the true state of their financial condition is known
- Such a requirement will encourage greater prudence, greater use of hedging instruments and more careful risk management

Reduction of Information Asymmetry

- Enforcement of disclosure of holders with large positions in individual stocks, bonds, options, currency contracts and other instruments
- Disclosure of pledges of securities as collateral for loans, in addition to sales and purchases, by directors and officers
- Enforcement of the "real names" system
- Piercing the corporate veil—greater use of recourse rather than non-recourse debt

Reduction of Excessive Leverage in the Stock Market

- High leverage in the stock market can eventually make the government hostage to the stock market. A high leverage implies that a collapse of the stock market will adversely affect the health of the financial institutions that have provided directly or indirectly the financing of the stock purchases. Thus the government will be motivated to try to support the stock market (Japan and Taiwan are examples). However, government support of the stock market encourages moral hazard—speculators will realize that they will never lose money but can only make money—this in turn encourages even more margin purchases, further increasing the leverage. The government will find itself in a position that it cannot extricate itself.
- The margin requirements for stock purchases should be kept relatively high, e.g., 50%. The government should maintain the flexibility of increasing (or decreasing) the margin requirement, on the margin, i.e., for new purchases, if the price/earnings ratio in the stock market becomes too high (imposing a higher margin requirement only on new purchases minimizes the downward pressure on the stock market) or too low; increasing the margin requirement is similar to increasing the tax rate on short-term capital gains relative to long-term.
- Another advantage of a lower leverage in the stock market is that when the stock market falls (or when the bubble bursts), there will not be as severe a social disturbance as if all the shareholders wind up owing huge amounts of money to the financial institutions. The market collapse of 1992 in Taiwan did not lead to any social disruption largely because there was little use of margins.

Common Issues on Trade

- Rules of origin incompatible with the global trends for de-verticalization (fragmentation) and out-outsourcing
- Dumping and anti-dumping rules
- Labor standards
- Environmental standards
  - Global warming and carbon dioxide emissions
- Environmental protection and pollution—the possibility of internalization
- Internalization of costs of adjustment (exporting textile machinery in exchange for increased imports of textiles)

An Asia/Pacific Free Trade Area: Is There a Pareto-Improving Approach?

- Domestic compensation for displaced workers to be paid monthly through a fund financed through tariffs at existing rates, or by equivalent tariffs corresponding to existing quotas, for a fixed period (5-10 years) for workers above a certain age, say, 50
- Tariffs to be phased out completely when the value of the fund is equal to the present value of the liabilities for the displaced workers
- Younger workers will be retrained at government expense
- Older workers will be encouraged to retire

Is There the Political Will to Move Towards an Asia/Pacific Economic Community?

- Is each of the East Asian economies ready to trade increased exports for increased imports, thus realizing the gains from specialization and economies of scale?
- Are the East Asian economies as a group ready to restrain nationalistic sentiments and support the rise of global companies by facilitating the free movement of long-term capital and direct investment?
- Can Japan and the other East Asian countries put their historical enmity behind them and enter a new era of mutual cooperation?
- The choice for Japan: East Asia’s West Germany or East Asia’s United Kingdom?