Asian Regional Economy in a Multilateral Setting

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A Preview

- Long-Term Global Economic Trends
- The Emergence of an East Asian Economic Region
- The Prospects of an East Asian Free Trade Area
- Mechanisms for International Exchange Rate Coordination and Cooperation
  - Maintenance of Fixed Relative Multilateral Real Exchange Rate Parities;
  - Multilateral Mutual Assistance Agreements;
  - Acceptance of Non-Convertible Currencies;
  - An East Asian "Gold Standard"
- An East Asian Economic Community?

Long-Term Global Economic Trends: De-Verticalization or Fragmentation of Production

- "De-Verticalization" or "Fragmentation" means the vertical division of labor—the physical and often geographical separation (with or without out-sourcing) of design, manufacturing, marketing, inventory, transportation and distribution functions of a firm both within and across national boundaries.
- Successful de-verticalization depends on
  - (1) the possibility of standardization (uniform grading), existence of common platforms (degree of precision, resolution, communication protocol, software and other compatibility requirements), etc.;
  - (2) accurate, precise, reliable and timely communication;
  - (3) quality assurance (possibly by impartial third parties) and timely performance--reputational capital is key here.
- The "Information and Communication Technology (ICT) Revolution" greatly facilitates and encourages de-verticalization (and out-sourcing), division of labor and specialization.
- However, a long-term collaborative relationship is still indispensable in sectors with rapid innovation (repeated game)

The Concept of De-Verticalization is NOT New

- Vertical division of labor--subcontracting
  - e.g., the construction industry in developed market economies--all the "trades" (services) are traditionally performed by specialist subcontractors.
- "Original Equipment Manufacture" (OEMs) in developing economies
  - Nike, Polo, Dell, Compaq, brand name products, all use contract manufacturers in developing economies.
- "Fabless" semiconductor companies and contract manufacturing
  - e.g., Taiwan Semiconductor Manufacturing Corporation, Solectron, Flextron
- "Original Design and Manufacture" (ODMs)
- Outsourcing of services
  - e.g., processing of credit cards (many credit card issuers are nominal issuers only); information processing for financial institutions; call centers.
- Just-in-time inventory system has been used very effectively by Japanese manufacturers and their (mostly captive) suppliers.
- What is new is that the transactions costs have come way down and that one can "de-verticalize" globally rather than just locally, thanks to the "information and communication technology revolution."

Long-Term Economic Trends: Rising Globalization and Growth of World Trade

- Falling barriers (legal, technical, and institutional) to movements of goods, services and factors (particularly capital (including foreign direct investment), but also human capital); more expeditious and impartial cross-border resolution of commercial disputes.
  - Reduction and/or elimination of tariff and non-tariff barriers
  - WTO, European Union, NAFTA, ASEAN Free Trade Area, other free trade areas
- Falling costs of (international) communication and transportation
- Falling transactions costs in terms of both money and time brought about by the information and communication technology (ICT) revolution
  - The rise of English as a global medium of communication
- The increasing acceptance of the concept of national treatment for foreign direct investment
- Benefits of economies of scale create large global niche players.
- Global competition has also brought down the costs of relocation/out-sourcing.

Global Out-Sourcing Draws New Players into the Global Market (China, Russia and India)

- Re-alignment of comparative advantages
  - Both existing and new players can benefit
  - Comparative advantages will change
  - Adjustments will be necessary
  - There should be sufficient gain for everyone to more than compensate all the losers
- There will be increased demands for goods and services (aircrafts, cell phones, computers and tourism services)
- There will be little upward pressure on the wage rate of unskilled labor for many years to come

Implications of Rising Globalization

- A new impetus for the growth of world trade
  - The finer division of labor increases the gross volume of world trade, even if total value-added grows much more slowly
  - Over time, both exports and imports as percentages of GDP will tend to rise worldwide; however, net exports, and value-added from exports as a percent of GDP will tend to rise much more slowly
  - Trade in "Intermediate Inputs," "Semi-finished Goods" and "Services" rather than finished "Products"
    - A substantial proportion of world trade is intra-firm and intra-industry trade
  - Many services not previously traded have become tradable—e.g., back office work, call centers.
  - Tourism is one of the few non-tradable services left because it is location-specific
- An expansion of potential world output

Implications of Rising Globalization

- The importance of large markets
  - Leveraging intangible capital--economies of scale in the utilization of intangible capital implies that the rate of return depends on reaching as large a market as possible
  - Standardization and standard setting and establishment of brand names generate market economies of scale (the higher the market share, the higher the profit margin)
  - Leaving large markets alone gives potential competitors an opening to establish themselves
- The importance of openness—global subdivision of the production process implies that an economy must be ready to take any link or links of the global supply chain in which it has a comparative advantage—sometimes a product may have to go in and out of the same economy four or five times undergoing different processing before being shipped to the final consumers (import quotas and arcane country of origin rules have much to do with back and forth movement of goods in process across economies). A free trade policy on both the export and the import side helps enterprises rationalize and optimize their position(s) in the global supply chain.

The Complementarity of De-Verticalization and Globalization

- Specialization in tasks rather than products by firms—finding a niche in the global supply chain that maximizes value-added based on "core competence"; higher-value-added parts of the supply chain have much less competition (Intel, Microsoft, TSMC)
- Specialization in tasks enables the realization of economies of scale and learning by doing effects—It is more efficient for firms to expand horizontally (to supply multiple customers around the globe) rather than to integrate vertically

East Asian Economies: ASEAN + 3 (including Hong Kong, Macau & Taiwan)

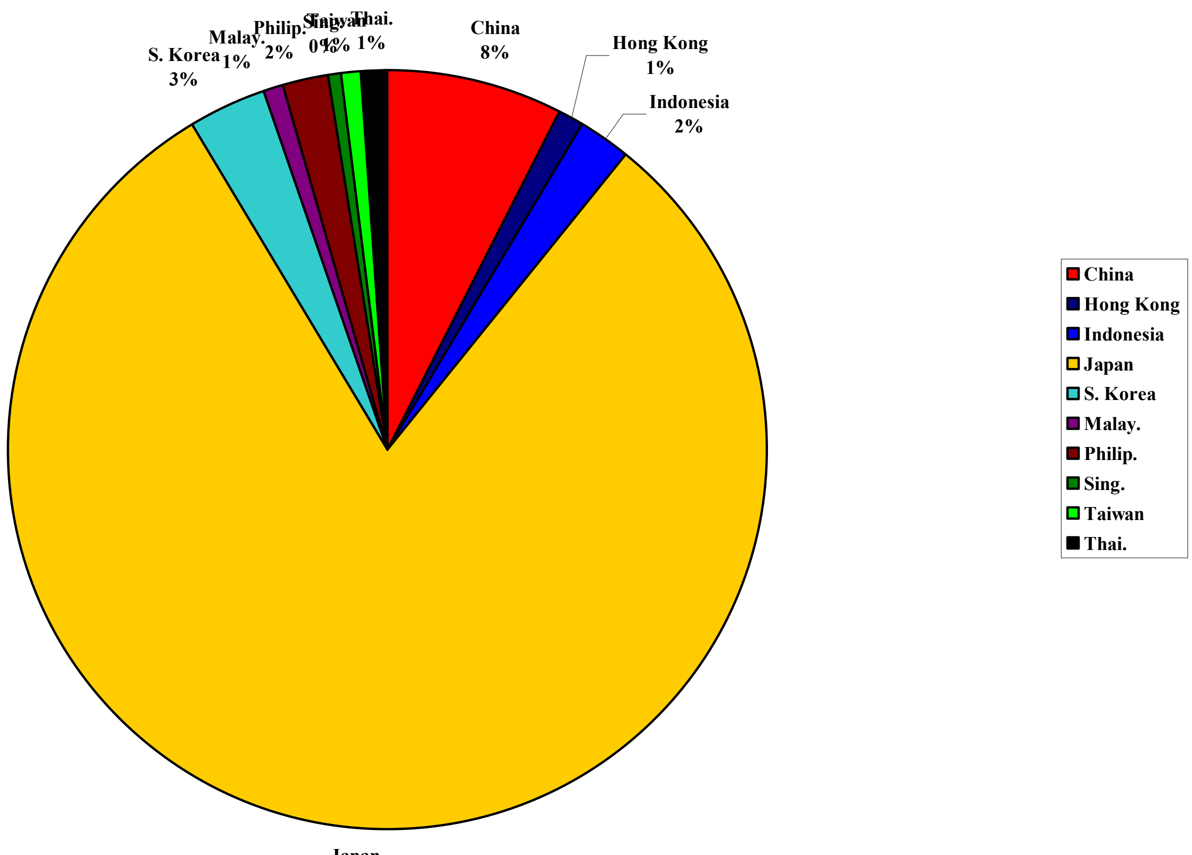
- ASEAN (Association of Southeast Asian Nations)—Brunei, Indonesia, Khmer Republic, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand, Vietnam
- + 3 (Mainland China, Japan, South Korea)
- + Chinese Economic Areas (Hong Kong, Macau and Taiwan)

The Levels of Real GDP and Real GDP per Capita in East Asian Economies

- In 1960, the GDP of ASEAN + 3 was approximately 40% of US GDP, with Japan contributing more than 80% of total East Asian GDP, followed by China (Mainland only), with not quite 8%.
- In 2000, the GDP of ASEAN + 3 was approximately 75% of US GDP, with Japan contributing more than 60% of total GDP, followed by China (Mainland only), which contributed somewhat more than 15%.
- South Korea, and Hong Kong, Macau, and Taiwan combined, each contributed between 5% and 10%.
- Thus, ASEAN + 3 is also comparable to the Zone Euro in terms of the order of magnitude of its GDP.
- The GDP of Japan is larger than the GDP of all of the other East Asian economies combined. If purchasing-power-parity (PPP) exchange rates are used, the GDP of Japan will be smaller, but will still be the largest among all East Asian economies.
- Japan also leads in GDP per capita among East Asian economies, with almost US$50,000 in 2000 (at market exchange rates), followed by Singapore at US$30,000. In contrast, Mainland China's GDP per capita was less than US$900 in 2000.
- These figures and percentages are sensitive to the exchange rates used for the conversion, but the general conclusions that (1) The contribution of the rest of East Asia to total GDP has increased significantly and (2) Japan remains the leading economy within East Asia in both aggregate and per capita terms are inescapable.

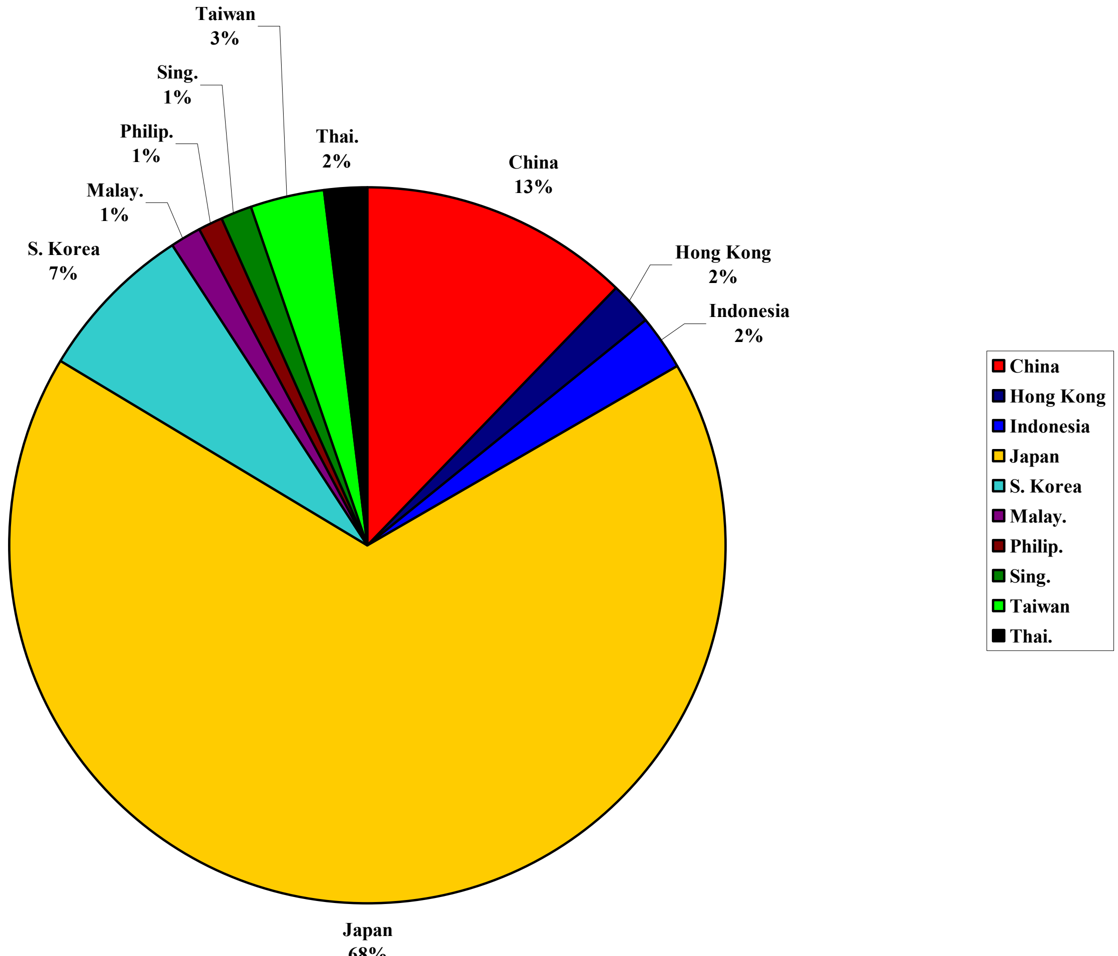
Composition of East Asian GDP, 1960

Figure 2.1: Composition of East Asian GDP, 1960

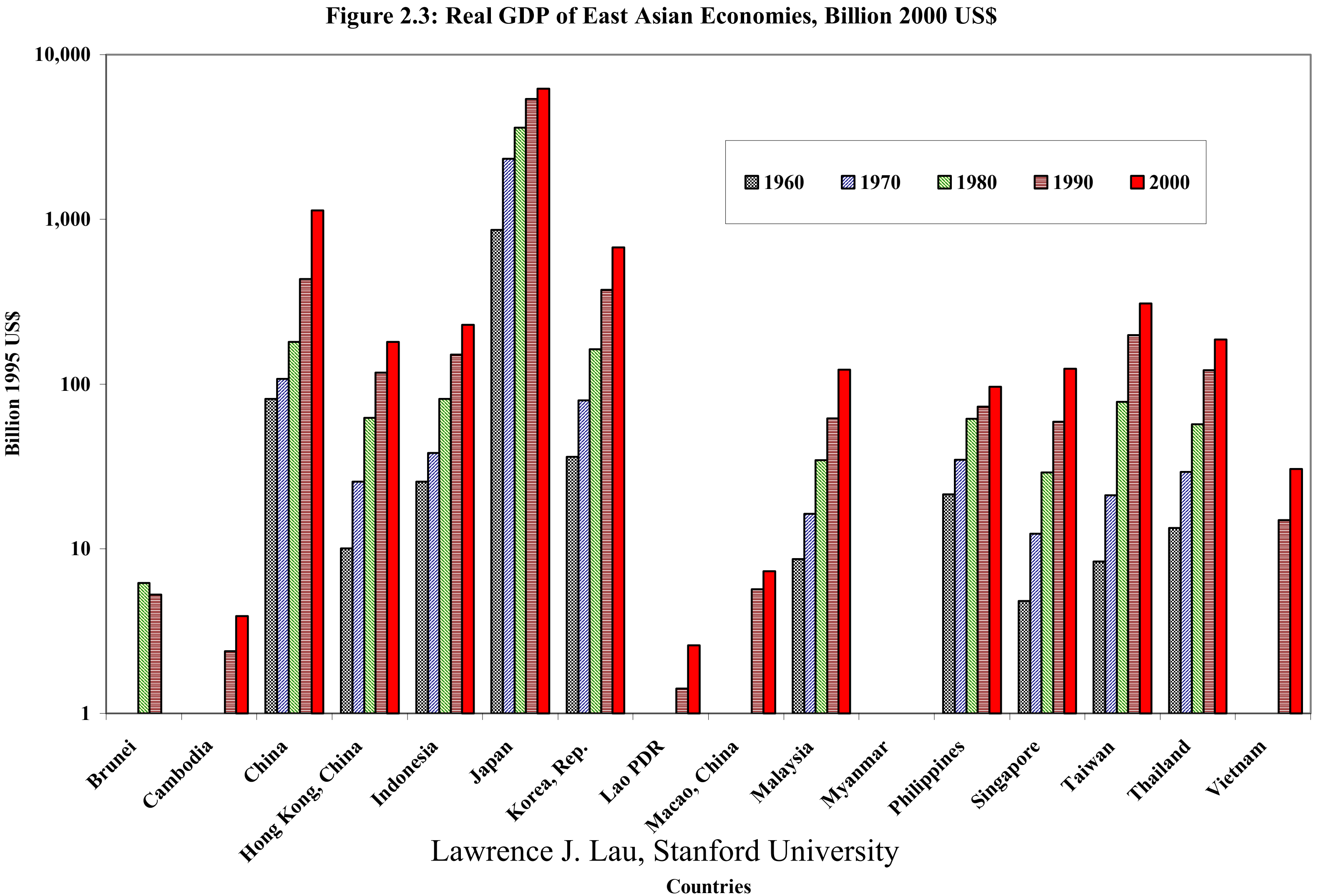


Composition of East Asian GDP, 2000

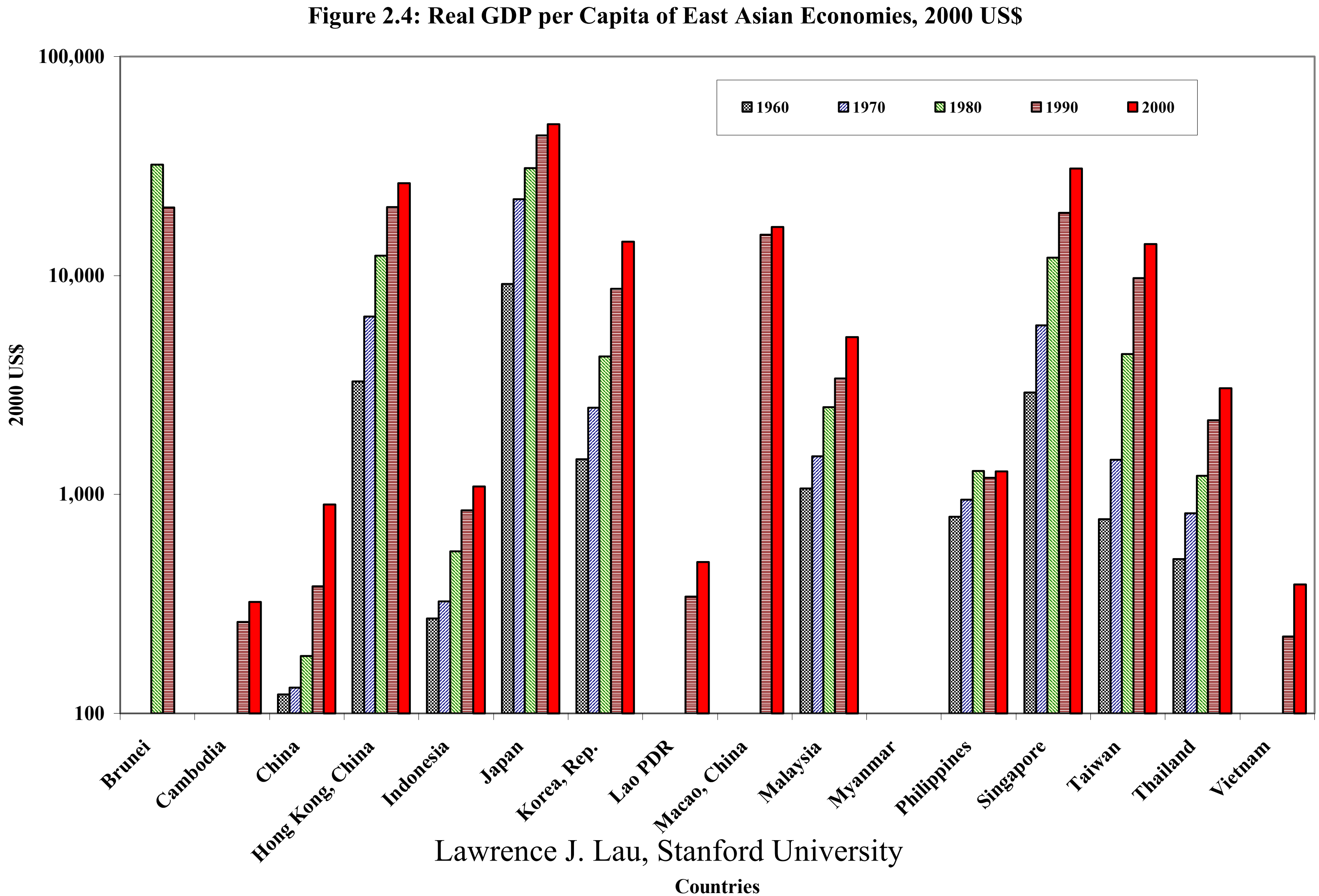
Figure 2.2: Composition of East Asian GDP, 2000



Real GDP of East Asian Economies Billion 2000 US$



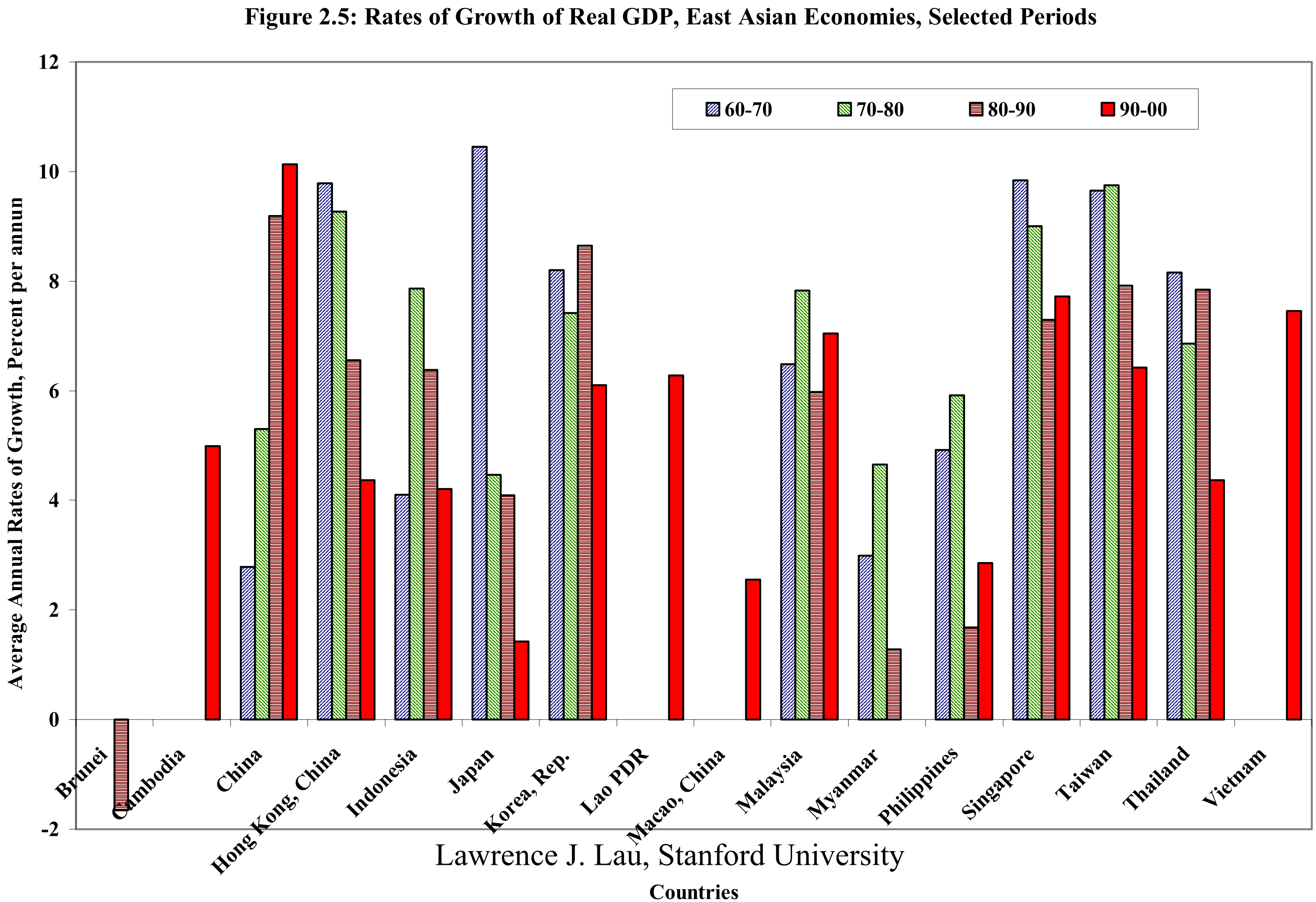
Real GDP per Capita of East Asian Economies, 2000 US$



The Rates of Growth of Real GDP in East Asian Economies

- Japan achieved an average annual rate of growth of real GDP in excess of 10 percent during the decade of 1960-1970 (in fact, between 1955 and 1975). However, due to the two oil shocks, the average annual rates of growth in the two subsequent decades declined significantly to less than 5%. And since 1990 the average annual rate of growth has been below 2%.
- The rest of East Asia, with the exceptions of Brunei, Macau, Myanmar and the Philippines, have been able to grow significantly faster than Japan in the decades of the 1980s and 1990s, despite the considerable slowdown in the Japanese economy during the past decade. In particular, China was able to achieve an average annual rate of growth of almost 10% over the past two decades, a performance comparable to that of Japan between 1955 and 1972.
- Notwithstanding the East Asian currency crisis of 1997-1998, the other East Asian economies, with the aforementioned exceptions, still achieved respectable average annual rates of growth ranging between 4% and 8% in the decade of the 1990s.

Average Annual Rates of Growth of Real GDP of East Asian Economies

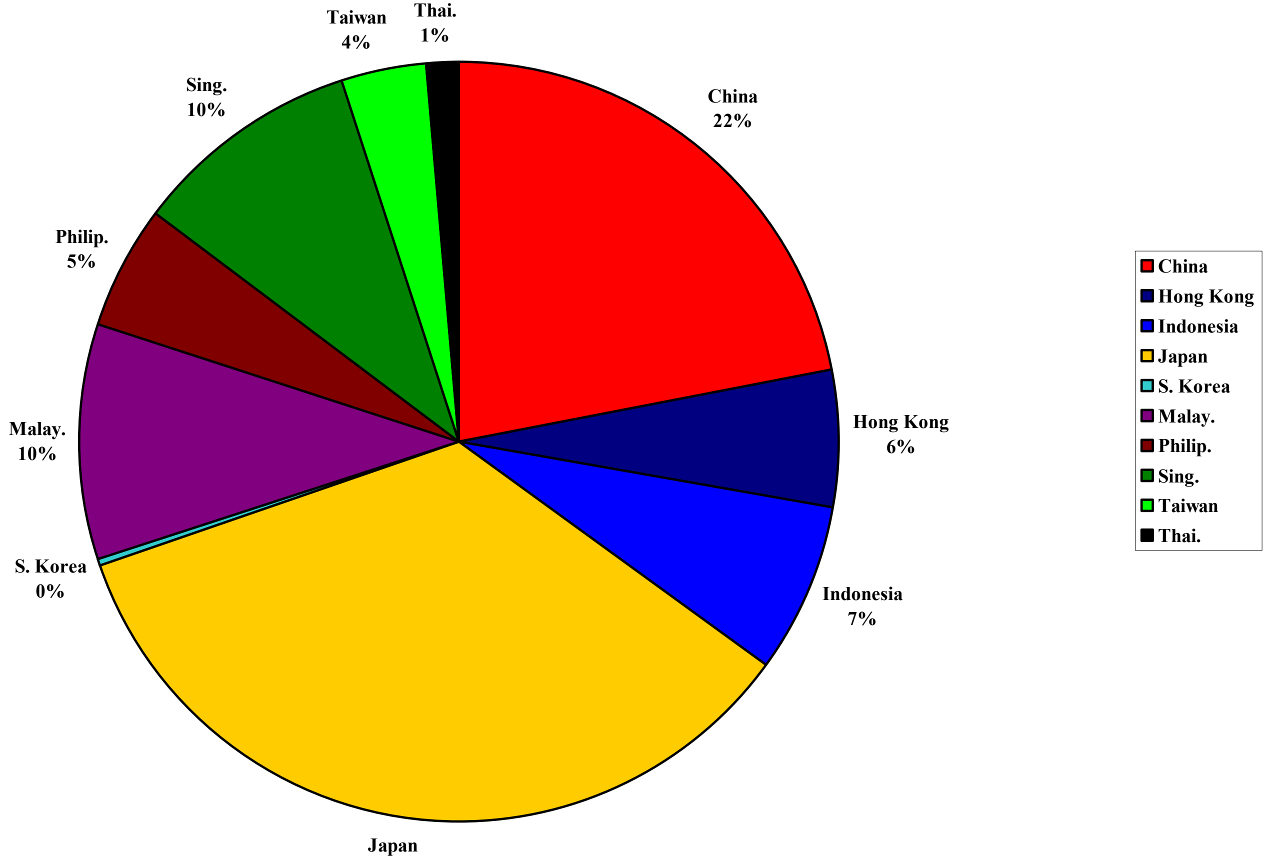


Rising Intra-East Asian Interdependence from Trade and Capital Flows

- Over the last two decades, the shares of exports of East Asian economies destined for other East Asian economies have been increasing rapidly. The share of Japanese exports for East Asian rose to 40% in 2001. Similarly the share of East Asian exports in Japanese imports also rose to 40% in 2001.
- By the late 1990s, approximately 50% of the exports of the East Asian economies are destined for other East Asian economies. The increasing shares are a manifestation of the increasing economic interdependence.
- With the possibility of synchronization of economic cycles as, for example, during the East Asian currency crisis, East Asian economies may experience simultaneous downturns in economic activities at the same time, which in turn may cause significant reductions in the demands for one another's exports, further exacerbating their recessions. However, it is also possible that the economic recoveries may be accelerated by simultaneous upturns, with the rising import demands of each economy feeding into rising export demands of its trading partners, as actually occurred during the East Asian currency crisis.
- The emergence of the Chinese economy on the global market was the one important new development during the past two decades. China-Japan trade reached US$101.91 billion in 2002 (exports of US$48.44 billion and imports of US$53.47 billion). Japan has been China's largest trading partner for ten years and China became Japan's largest source of imports in 2002.

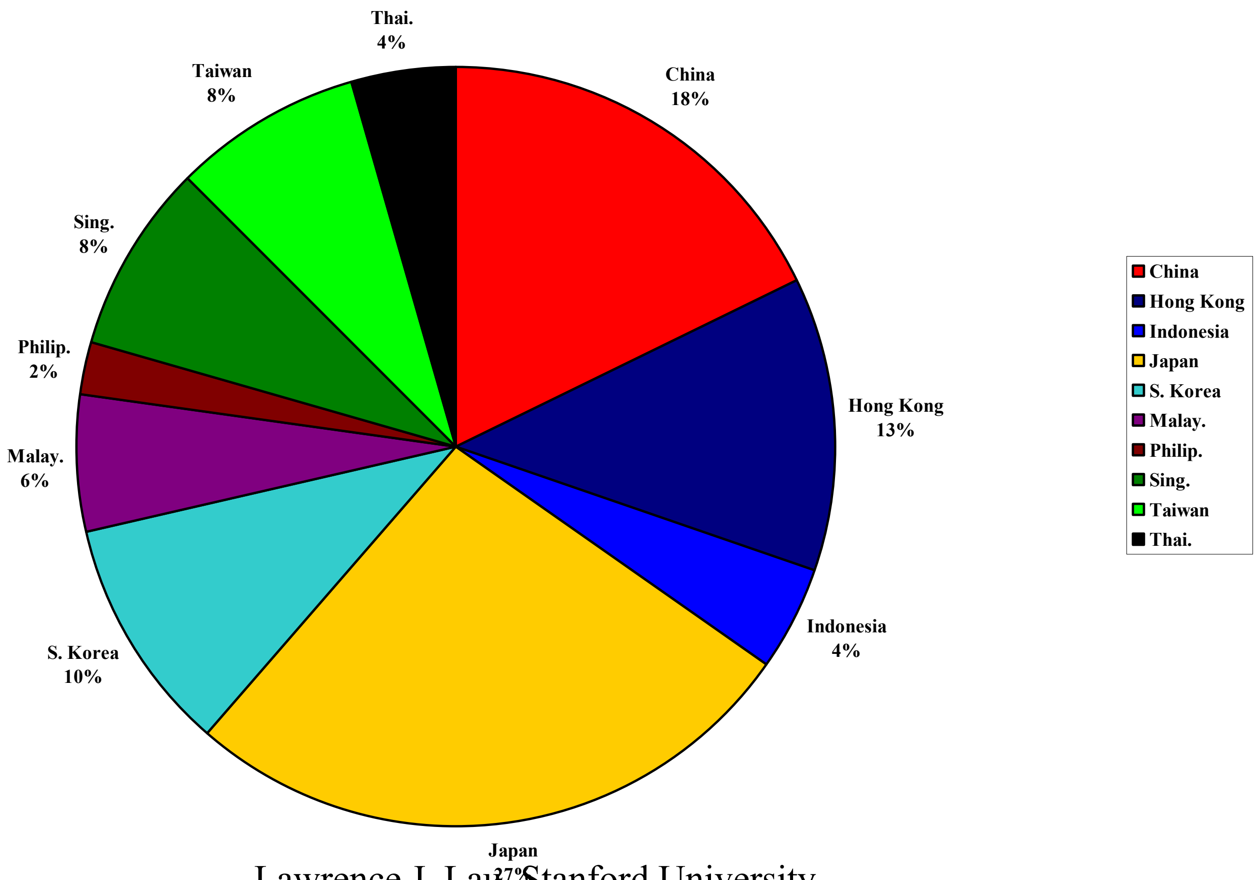
Composition of East Asian Exports, 1960

Figure 3.1: Composition of East Asian Exports, 1960



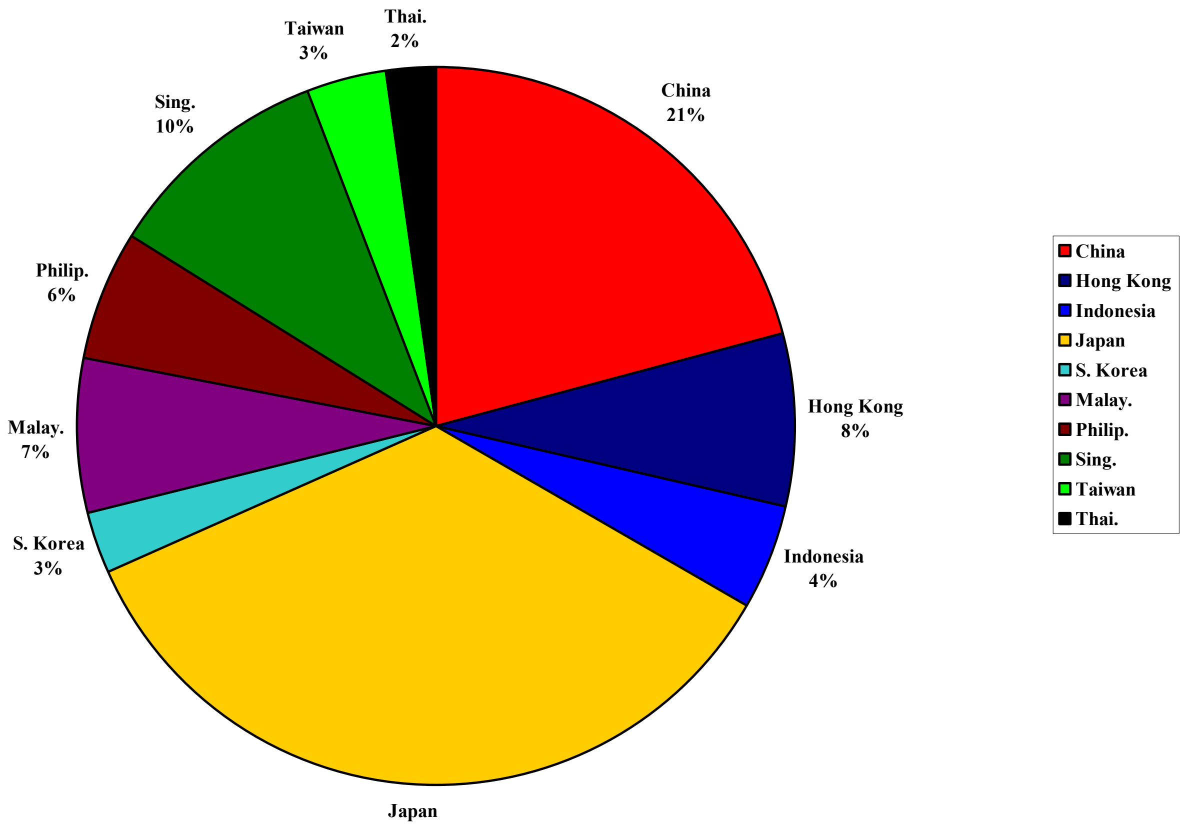
Composition of East Asian Exports, 2001

Figure 3.2: Composition of East Asian Exports, 2001

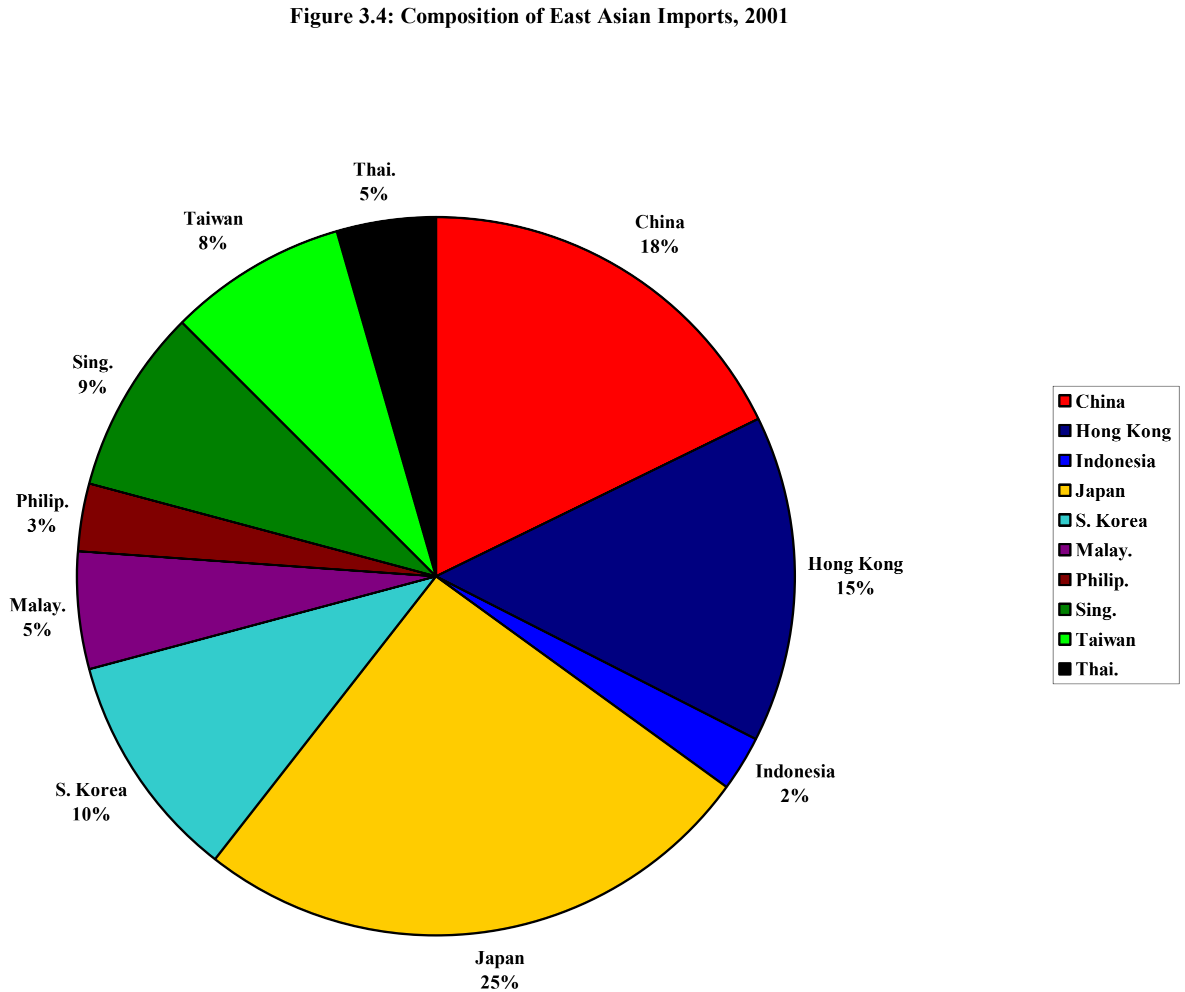


Composition of East Asian Imports, 1960

Figure 3.3: Composition of East Asian Imports, 1960



Composition of East Asian Imports, 2001



Shares of Exports to East Asia

Table 3.1: Shares of Exports to East Asia

	Japan	China	Hong Kong	Taiwan	S. Korea	ASEAN	U.S.	E.U.	R.O.W.	Total
1980	0.22	0.36	0.62	0.30	0.31	0.47	0.23	0.05	0.16	0.14
1990	0.26	0.54	0.72	0.42	0.35	0.51	0.36	0.08	0.16	0.20
2001	0.40	0.58	0.63	0.53	0.42	0.62	0.30	0.10	0.14	0.24

Export Ranks of China, Japan and the U.S. for East Asian Economies

Table 3.2: Ranks of China, Japan and the U.S. as Destinations of East Asian and U.S. Exports

	China Export Rank				Japan Export Rank				U.S. Export Rank			
	1980	1990	2000	2001	1980	1990	2000	2001	1980	1990	2000	2001
Japan	5	12	4	2					1	1	1	1
U.S.	17	18	11	9	2	2	3	3				
China					2	2	3	3	3	3	1	1
Hong Kong	4	1	1	1	5	4	3	3	1	2	2	2
S. Korea	N/A	31	3	2	2	2	2	3	1	1	1	1
Taiwan	N/A	183	8	4	2	3	3	3	1	1	1	1
Brunei	N/A	10	8	7	1	1	1	1	2	7	4	3
Cambodia	N/A	13	5	8	3	4	6	4	N/A	N/A	1	1
Indonesia	64	6	6	5	1	1	1	1	2	2	2	2
Laos	N/A	2	11	11	N/A	3	6	10	N/A	20	9	13
Malaysia	13	11	10	7	1	3	3	3	3	2	1	1
Myanmar	17	4	4	4	2	5	5	7	26	9	1	2
Phillippines	19	17	12	12	2	2	2	2	1	1	1	1
Singapore	14	14	6	5	3	3	4	4	2	1	2	2
Thailand	13	19	6	5	1	2	2	2	3	1	1	1
Vietnam	N/A	22	2	5	N/A	2	1	1	N/A	50	5	3

Shares of Imports from East Asia

Table 3.3: Shares of Imports from East Asia

	Japan	China	Hong Kong	Taiwan	S. Korea	ASEAN	U.S.	E.U.	R.O.W.	Total
1980	0.26	0.53	0.25	0.20	0.30	0.53	0.22	0.03	0.18	0.15
1990	0.30	0.65	0.42	0.34	0.34	0.51	0.27	0.06	0.21	0.19
2001	0.40	0.48	0.51	0.51	0.45	0.56	0.24	0.07	0.17	0.22

Import Ranks of East Asian Economies in China, Japan and the U.S.

Table 3.4: Ranks of East Asian Economies and the U.S. as Origins of Imports of China, Japan and the U.S.

	China Import Rank				Japan Import Rank				U.S. Import Rank			
	1980	1990	2000	2001	1980	1990	2000	2001	1980	1990	2000	2001
Japan	1	2	1	1					2	2	3	3
U.S.	2	3	3	2	1	1	1	1				
China					8	4	2	2	36	9	4	4
Hong Kong	6	1	5	5	32	20	36	37	14	13	21	24
S. Korea	N/A	26	2	3	13	5	3	3	16	8	7	8
Taiwan	N/A	N/A	12	10	15	10	4	8	10	5	8	9
Brunei	N/A	80	75	61	12	32	37	35	70	86	81	80
Cambodia	N/A	104	76	86	135	132	84	75	N/A	N/A	65	65
Indonesia	55	13	10	16	3	2	5	4	13	24	21	20
Laos	N/A	72	109	111	120	126	125	138	141	164	156	170
Malaysia	14	11	7	7	10	12	8	7	23	19	11	11
Myanmar	N/A	39	59	63	63	87	69	69	126	118	75	74
Phillippines	38	40	23	24	16	22	13	13	29	25	18	19
Singapore	16	12	8	9	22	17	15	18	28	12	12	15
Thailand	23	17	11	12	24	15	11	11	39	17	14	14
Vietnam	N/A	94	33	33	73	41	28	25	N/A	N/A	67	62

Intra-East Asian Trade Flows

- Over time, China has become increasingly an important destination for the exports of other East Asian economies; however, Japan remains more important than China for most of the East Asian economies (in terms of their export ranks), with the notable exception of South Korea—China has supplanted Japan as the second most important export destination for South Korea (the U.S. remains the most important destination for South Korea).
- The share of imports from East Asian economies has risen considerably for Japan, to 40% in 2001, and has remained high for China, at 48% in 2001. These shares have risen for all other East Asian economies (Hong Kong, Taiwan, South Korea and the ASEAN). The ranks of East Asian economies in both the China and Japan have also been rising (that is, becoming higher in rank and lower in number) over time.
- In contract, the share of U.S. exports destined to East Asian economies as well as the share of U.S. imports originated from East Asian economies have declined slightly during the last decade.

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. More recently, Chinese enterprises have also begun to make direct investments abroad.

Economic Complementarity or Competition

- Within East Asia, there exist significant economic complementarity between the developed economies (principally Japan) and the developing economies (China and the ASEAN without Singapore)—there is very little overlap and hence competition between what Japan exports on the one hand and China and the ASEAN without Singapore export on the other hand. Japan is still the premiere source of capital goods and technology within East Asia. This complementarity is borne out by the trade statistics at the disaggregated commodity level.
- 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).
- Moreover, the bulk of the Japanese exports as well as exports from the East Asian Newly Industrialized Economies consists of intra-industry and intra-firm trade, which reflect that the exports are mostly based on long-term supplier-user relationships and/or direct investment by Japanese parent firms. Globalization of supply chains and the concomitant de-verticalization of production and outsourcing have accounted for much of the expansion of intra-industry and intra-firm trade.
- The largest potential gains from the economic complementarity is therefore a (China-Japan-ASEAN) free trade area (FTA). The continued economic development and growth of East Asian economies, including China, therefore present enormous economic opportunities for Japan's capital and technology goods industries.

The Formation of Free Trade Areas The ASEAN Free Trade Area (AFTA)

- Intra-ASEAN tariff rates have been lowered to 5% on Jan. 1, 2002 with the inauguration of the ASEAN Free Trade Area (AFTA) among Brunei, Indonesia, Malaysia, Philippines, Singapore and Thailand. The goal is to reach zero tariff rate within AFTA by 2010. The reduction in tariffs applies to 90% of products provided the ASEAN content of the product exceeds 40%.
- Khmer Republic, Laos, Myanmar and Vietnam are expected to join AFTA in 2006 and reach zero tariff rate within AFTA by 2015.
- Specific protection on manufactured and agricultural products still remains.

The China-ASEAN Free Trade Area

- Chinese Premier ZHU Rongji first proposed in Brunei in November, 2001 a new free trade area, covering China and the ASEAN (Brunei, Indonesia, Khmer Republic, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand and Vietnam), to be created within ten years.
- A 3 trillion US$ market and 1.7 billion consumers
- Complementarity (primary raw materials) and competition (light manufactures)
- Opening the economies for trade—China will become a major export market for the ASEAN and vice versa
- The free trade area will promote foreign direct investment in the ASEAN region itself through the enlargement of the potential market.
- Further agreement was reached in a second meeting in Phnom Penh, Khmer Republic in November, 2002 at which a framework agreement for the establishment of the China-ASEAN Free Trade Area was signed.
- Negotiations to be completed by 2004 with "early harvest" for ASEAN countries in the reduction of tariffs on agricultural and food products. Full free trade between China and Brunei, Indonesia, Malaysia, Philippines and Singapore by 2010; full free trade extended to Khmer Republic, Laos, Myanmar and Vietnam by 2015/

Japan-Singapore Free Trade Agreement

- Japan and Singapore concluded a free trade agreement in 2003.

The Prospects of an ASEAN + 3 Free Trade Area

- A voluntary and co-operative version of the "Great East Asia Co-Prosperity Sphere."
- An East Asian Economic Community without the participation of both China and Japan is unlikely to be successful.
- Specialization in accordance with comparative advantage
  - Japanese strengths:
    - Capital goods production
    - Complex manufacturing processes
    - R&D capability
    - Quality assurance
  - Newly industrialized economies
    - Manufacturing of heavy industrial goods
    - High-technology flexible manufacturing
    - Development capability
    - Finance and other services
  - China and the ASEAN without Singapore
    - Mass manufacture of light industrial goods
    - Processing and assembly

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 East Asian developing economies
  - 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
- Publicly funded compensation for displaced workers in all countries:
  - Domestic compensation for displaced workers to be paid monthly through a fund financed with tariffs at pre-existing rates, or by equivalent tariffs corresponding to pre-existing quotas on above-quota imports, for a fixed period (5-10 years) for workers above a certain age, say, 45
  - 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

Identifying a Pareto-Improving Sequence of Implementable Measures

- 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

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)

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)

Exchange Rate Movements among Major Currencies Caused by Capital Flows

- The exchange rate movements among the major currencies (the U.S. Dollar, the Euro and the Japanese Yen) are caused mostly by capital flows, particularly short-term capital flows, rather than by trade flows or by relative price movements.
- There is a large and persistent discrepancy between market exchange rates and the "Purchasing Power Parity (PPP)" exchange rates. For example, the Japanese Yen is over-valued relative to its purchasing power parity.

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 real relative exchange rates over the medium to long term facilitate international specialization and division of labor, cross-border direct investment, and economic growth.
- Thus, the importance of maintaining relative real parity among the East Asian economies, particularly the developing ones.
- Exchange rate policy coordination among East Asian economies can prevent contagion that may result from unexpected and unintended changes in the relative exchange rate alignments.
- 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

Maintenance of Fixed Relative Multilateral Real Exchange Rate Parities

- Fixed relative real parities facilitate de-verticalization and global relocation and out-sourcing, and in particular, intra-firm and intra-industry trade, and flows of foreign direct investment, which is primarily long-term in nature.

Maintenance of Fixed Relative Multilateral Real Exchange Rate Parities

- Even in the absence of significant trade between two countries, it may still be advantageous for them to maintain a relatively fixed exchange rate parity between them if they compete in the same export markets.
- The rationale for a fixed relative parity is the same as that for price fixing between two competitors. It maintains the terms of trade of both countries. It prevents ruinous competition. In particular, it can prevent the outbreak of intentional competitive devaluation.
- Exchange rate reaction functions are asymmetric. If a country devalues its currency, it can expect that its competitors are likely to match its devaluation, thus negating any pricing advantage that may have been gained by its exports through devaluation. If a country revalues its currency, it can expect that its competitors are unlikely to match its revaluation, and hence it is likely to lose competitiveness and market share to its competitors. (In other words, it faces a "kinked demand curve".
- Consequently, very few countries are willing to revalue, unless they can be assured that their competitors will match its revaluation so that it is not likely to lose market share.
- Thus, exchange rates are likely to be "sticky"—there is everything to lose with a revaluation and nothing to gain with a devaluation—and moreover is probably more "sticky" upwards than downwards. And that is why a fixed relative parity agreement may actually help to make the exchange rates among blocs of currencies more flexible, since the aversion of each country to a revaluation is significantly reduced.

Maintenance of Fixed Relative Multilateral Real Exchange Rate Parities

- The East Asian economies fall into two groups—the industrialized and newly industrialized economies of Japan, Republic of Korea, Taiwan, Singapore and Hong Kong—and the developing economies of China, Indonesia, Khmer Republic, Malaysia, Laos, Myanmar, Philippines, Thailand, and Vietnam.
- Moreover, the economies in the two groups compete in their exports only with economies within the same group (Singapore and Hong Kong, being city-states are actually not major exporting economies in any case). The exports of economies in one group do not compete with the exports of the economies in the other group.
- Thus, it makes sense for the economies of each group to maintain relative real exchange rate parities among themselves. If the relative real parities are relatively fixed, the exchange rates of the entire bloc vis-a-vis the major currencies of the U.S. Dollar and the Euro can more readily adjust in response to any significant changes in the relative fundamentals between the East Asian economies and the U.S. or the European Union.
- To the extent that there is significant intra-firm and intra-industry trade between the two groups of economies, it also makes sense for the two groups of economies to maintain a stable relative real exchange rate parity between them.

Exchange Rate Mechanism: Long-Term Prospects

- It is desirable for the continued stable development of both trade and foreign direct investment, outbound as well as inbound, among East Asian economies, to maintain stable relative real exchange rate parities, thus avoiding "beggar thy neighbor" policies of competitive devaluation.
- Such a system of stable relative parities can be the beginning of an Asian currency "snake" and wider monetary cooperation among East Asian economies.

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 regional 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
- The mere existence of such a region-wide currency stabilization facility can actually discourage speculation and help stabilize the exchange rates of smaller East Asian economies.

Is There Room for a Common East Asian Currency?

- The reduction in exchange risks promotes cross-border trade and direct investment much more than the reduction in tariff and non-tariff trade barriers.
- An East Asian snake similar to the former EMS snake? It can begin with the East Asian developing economies (including Cambodia, China, Indonesia, Laos, Malaysia, Myanmar, Philippines, Thailand and Vietnam) maintaining stable relative parities with one another. Japan, South Korea and Taiwan can also maintain stable relative parities among themselves. Hong Kong is pegged to the U.S. Dollar and Singapore is pegged to a basket of currencies.
- Cooperation between China and Japan is absolutely essential for the emergence of a common East Asian currency.
- The volatility of the Yen/US$ exchange rate must be significantly reduced in order for an East Asian snake or more permanent arrangement to be viable
- One of more countries must be prepared to provide the liquidity (and earn the seigniorage). Other countries must be able to acquire the currency, by running export surplus vis-à-vis the country(ies) providing the currency, and accepting the currency as payments in return.
- A gradual change in the currencies used for invoicing and settlement in intra-East Asian trade. This can begin with the East Asian economies accepting the (possibly non-convertible) currencies for settlement of their exports. In the interim, the economies accepting these currencies can be granted options to redeem the currencies for gold at a pre-agreed fixed parity (An East Asian "Gold Standard"). In time substitute currency(ies) to the U.S. Dollar will emerge.

An East Asian Economic Community Will Take Decades to Get Off the Ground

- Historical Precedent—The evolution of the European Union has been a more than 50-year process, beginning with the Bank for International Settlements and proceeding progressively to the European Coal and Steel Community, the European Common Market, the European Economic Community, and now the European Union and the Zone Euro.
- The support of the United States and the pressure of the Soviet threat helped to overcome internal political differences.

Is There the Political Will to Move Towards an East Asian FTA/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, China and the other East Asian countries put their historical enmity behind them and enter a new era of mutual cooperation?
- Japan can play a leading role in the economic future of East Asia. It may even be a stimulus for renewed economic growth in Japan. The choice for Japan: East Asia's West Germany or East Asia's United Kingdom?