Joseph Yam: Can the euro be a benchmark for Asian monetary co-operation?

Remarks by Mr Joseph Yam, Chief Executive of the Hong Kong Monetary Authority, at the keynote discussion: “The euro: a stabilising factor of the international monetary system. Can the euro be a benchmark for Asian monetary co-operation?” before the Paris Europlace Financial Forum: the euro markets in a global investment strategy, Hong Kong, 21 March 2005.

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It is a great pleasure to be here this morning to take part in this keynote discussion on the euro hosted by Paris Europlace. One of the great benefits of living in an international financial centre is the opportunity to share something of the life and culture of other parts of the world without leaving one's own city. We have always been fortunate in Hong Kong in our enjoyment of the fruits of European - and particularly French - civilisation. We are currently enjoying, as part of "The Year of France in China", the superb Impressionism exhibition at the Hong Kong Museum of Art: together with all of the excellent performances in our international Arts Festival, and the growing popularity of al fresco dining, this is helping to create a very European atmosphere in Hong Kong this spring. And, from what I see on the streets, I do not get the impression that the strong euro is having any effect on sales of European fashion.

Today's forum therefore seems to fit in very well with the European spirit now sweeping Hong Kong, and I congratulate the organisers on putting together a very lively and topical programme. It is a particular pleasure to be presenting together with Christian Noyer, Governor of the Banque de France. He has made some very thoughtful remarks on the first question for discussion. I intend to comment on the second question: "Can the euro be a benchmark for Asian monetary co-operation?"

But before I address this question, we need to ask another question: how ready is Asia for closer monetary co-operation? We are, I think, all aware of the considerable differences in the political systems, the cultures, the historical backgrounds, and the economic, financial and monetary systems of the countries in this region. I think it is largely accepted that these differences are greater than the differences between the various economies that make up the euro zone. Nevertheless, it is important not to overstate them. Nor should we overlook the regional integration already in progress in the trade, financial and monetary spheres. Let me briefly outline these three forms of integration.

About half of <u>total trade</u> in the Asia region is intra-regional trade. Trade integration has been largely market-driven, and the process has stimulated the signing of various free trade agreements, which will, in turn, encourage further trade integration in the region. Now it is true that slightly over half of trade within non-Japan Asia is processing trade geared towards meeting import demand outside of the region, in particular in the developed economies. But this reliance on demand from the developed economies has been decreasing, and is likely to continue to decrease. Trade integration within the region is therefore likely to grow.

<u>Financial integration</u> in the region shows a more mixed picture, and can be said to be high or low depending on what exactly is meant by financial integration, which is not at all clear. In terms of <u>foreign direct investment</u>, the degree of regional integration seems high if we look at the available figures on the sources and destinations of FDI within the region. The most striking examples are the various economies in the region as a source of FDI for China, and as destinations for FDI from Japan. But in terms of <u>financial intermediation</u> within the region - meaning the flow of savings into investments, other than FDI, through the banking, debt and equity channels - the degree of financial integration is not high at all. The very substantial, and growing, volume of domestic savings invested overseas goes mainly, on a gross basis, to the developed rather than the regional markets. There is, of course, traffic in the other direction, but this is of a much more volatile, potent, demanding, and at times predatory nature, and it can sometimes - as we saw in the late 1990s - be difficult to cope with, to put it mildly.

There is now a common desire among economies within the region to reduce dependence on the recycling of domestic savings through the developed markets, and therefore reduce vulnerability to financial shocks, by promoting greater regional financial intermediation. A number of regional initiatives are being implemented, the most notable of which is the Asian Bond Fund project, a collective initiative of 11 central banks and monetary authorities to develop bond markets in the region. A great deal of emphasis is also being placed on getting one's own house in order, by practising sound macro-economic policies and building robust institutions. Some attempts have been made at financial infrastructure integration: in Hong Kong, in particular, we have been operating US dollar and euro clearing systems and opening linkages with other jurisdictions and international systems. But it has to be said that, so far, these facilities have been serving domestic needs far more than regional needs. This is, I think, a reflection of the rather moderate level of financial system integration in the region. To take banking as an illustration, there may well be quite considerable integration across the borders of immediate neighbours: between Hong Kong and Mainland China, for example, or between New Zealand and Australia. But, for the region as a whole, this kind of integration is less striking than the presence of banks from the developed markets. For example, the number of US and European banks in Hong Kong roughly equals that of banks from the region. Similar observations may be made about the equity markets.

In declining order, we now come to monetary integration. There have, in fact, been some recent efforts at monetary co-operation. These began in 1995 with the collection of EMEAP bilateral swap facilities that provide US dollar liquidity secured against US Treasury securities. In 1997 the idea of an Asian Monetary Fund was aired, but it came to nothing. Then, in 1999, came the collection of ASEAN+3 bilateral swap arrangements under the Chiang Mai Initiative. These cannot be said to amount to efforts towards monetary integration. And, in fact, while ideas may have been thrown around from time to time, there has not really been any formal discussion among Asian authorities that I am aware of towards monetary union.

Why is this the case? I think it is mainly because the obstacles to union appear to be so daunting, and that the special considerations that apply to the Asian case throw up so many difficult questions. These "special considerations" are big matters, and they can be conveniently divided into three broad categories: economic, technical and political. Let me give a brief outline.

The economic issues concern the viability of an Asian monetary union. This would involve the replacement of regional currencies with a single one, implying a single monetary policy for participant states. A key concern, therefore, is whether it would work. Or whether the pressures would be so intense as to make an Asian monetary union unworkable from the outset. At the heart of this question is the degree of real economic convergence between potential members. Using the Maastricht criteria as a reference point for the degree of nominal convergence among Asian economies suggests that Asia is far from ready to cope with a single monetary policy. In 2003 only six Asian economies were able to keep their budget deficits below 3% of GDP, and only five had government debt levels of less than 60% of GDP. Only five economies had inflation rates within 1.5% of the three economies with the lowest rates. As for long-term interest rates, only six had bond yields within 2% of the three economies with the lowest interest rates.

Perhaps more fundamentally, the degree of real economic convergence among Asian economies is a lot lower than it was between European economies prior to the formation of monetary union. One measure of this is income dispersion, in 2003, the per capita GDP of Japan was about US$34,000, while that in the Philippines was less than US$1,000. Real convergence matters because complementarity and similarity in production and economic structure reduces the likelihood of so-called "asymmetric" shocks, or shocks that hit all member states in a different way calling for different monetary policy responses - something that is not possible under a monetary union. For emerging market economies, financial disturbances are an increasingly prevalent source of asymmetric shocks: the best illustration of this in recent years is the Asian financial crisis, and the differing effects - and the variety of responses - among the economies in the region may, for some, be the main argument against union.

It is tempting to conclude that the lack of nominal and real convergence among Asian economies is a serious barrier to a viable Asian monetary union. However, it has been suggested that full convergence is not a necessary pre-requisite to successful monetary union, and that the act of forming a monetary union will, by itself, force greater convergence among its members. As Governor Noyer has just said in his presentation, the introduction of the euro has increased the correlation between the business cycles of European economies, and has led to a more homogenous monetary transmission mechanism.

While the lack of economic convergence among Asian economies may make an Asian Monetary Union a more challenging prospect, it is interesting to note that quite a number of governments in this region have already chosen to sacrifice some monetary policy autonomy for exchange rate stability. Hong Kong, Mainland China, and Malaysia choose to fix their exchange rates against an external currency, the US dollar, while other regional economies operate managed floats. There are indications that some economies are considering using the renminbi as a reference currency in their currency regimes, although a hard peg to renminbi is still not possible until full convertibility is achieved. It might also be the case that, while Asian economies are more diverse than European economies, they are flexible in ways that can compensate for the loss of independent monetary policy, for example, in their high degree of price flexibility and fast adjustment to economic shocks.

It may seem premature to turn now to the technical issues surrounding Asian monetary union, but the devil is in the detail.

The first set of technical issues involves the exchange rate arrangements themselves, including the transitional arrangements prior to the introduction of a single currency. For example, would Asia adopt a basket peg or choose an anchor currency? If a basket, what would be the weights for individual currencies, and would the basket include external currencies, such as the US dollar? If a regional currency is chosen as the anchor, in the same way that the deutschmark was effectively the anchor for exchange rate arrangements leading up to European monetary union, would this be the yen or the renminbi?

Alternatively, could Asia move straight to a single currency? It is increasingly argued that, in a world of liberalised markets, the only viable exchange rate system is either a hard peg (like Hong Kong's Currency Board) or a free float. Soft pegs by their nature are vulnerable to self-fulfilling speculative attacks, as was demonstrated in Europe in 1992, Mexico in 1994-5, and Asia in 1997-8. Europe was able to move gradually to a system of fixed exchange rates with capital controls prior to the introduction of a single currency. But the high degree of capital mobility in a number of key Asian economies would make gradual transition in this way more difficult.

A further set of technical issues concerns the setting up of, and mandate for, an Asian central bank. This would require agreement on the monetary policy objective, country representation, and decision-making process of the central bank. Most important, the institution would need to be designed so that national interests are kept in check in order to deliver efficient monetary policy making at the regional level. The lesson from Europe is that agreement can be reached, but I have to say that the issues are quite daunting.

Related to this is the question of whether Asian governments have the political will to devolve monetary policy to a single central monetary authority. Asia is more disparate than Europe in its political systems, and it has often been noted that there is less of a tradition of cross-border institution-building here than there is in other regions. It is quite striking, for example, that the approach to free trade agreements so far has been rather piecemeal, where in Europe they have grown and developed from a strong and centralised common market. Indeed, one serious political obstacle that has often been pointed out is the lack of embryonic supranational bodies within Asia from which to launch Asian monetary union efforts. These disadvantages must, of course, be recognised. But, on the other hand, it should be remembered that European monetary union has been a unifying force - a common interest that has brought countries together.

All of these "special considerations" point to the conclusion that Asia is not yet ready to implement monetary union. In the process of discussing them, it may well turn out that Asian monetary union is a non-starter. But that does not mean that we are not yet ready to talk about monetary union. After all, it took Europe about half a century to move from the idea of monetary union to the reality. Despite the general consensus that the obstacles to union in this region now are greater than they were for Europe 50 years ago, I have a feeling that Asia will not take quite so long. I am not offering to make a bet on this, mainly because I do not think that many of us in this room will be around long enough to see how many years it really does take. But one reason that makes me think that Asia will not take so long is that we have a successful model to look to, which brings me to the main question: "Can the euro be a benchmark for Asian monetary co-operation?". My answer to this question is a resounding "yes". The creation of the euro has shown that effective monetary union can be achieved in a voluntary and co-operative way by countries with different economic, political and cultural traditions. While, as I have suggested in the discussion about "special considerations", there may be different ways of achieving a similar goal in Asia, the euro provides a precedent, a point of reference, a large realm of experience and expertise, and - I would certainly agree - a benchmark for any enterprise in monetary co-operation that we might wish to embark on in this region.