Exchange-Rate Arrangements and Financial Integration in East Asia: On a Collision Course?

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Summary

Policy makers in East Asia see economic integration in the region as one way to consolidate growth and to prevent a recurrence of instability due to the perceived stop-go nature of international capital flows. Substantial integration of trade in goods has in fact already occurred as documented in a number of studies. Although financial integration in East Asia less advanced, it is being actively pursued and will in due course lead to substantial mobility of capital between economies in the region.

The increased trade integration among economies in the region has led to calls for coordination of exchange rate policies lest competitive depreciations lead to artificial distortions in competitiveness, disruptions of trade, and dislocation of production. Not infrequently, the experience of Europe is used to argue that such exchange rate cooperation is desirable in a transition period towards full monetary union.

This paper argues that the adoption of common exchange rate policies in East Asia may be dangerous in the context of highly integrated financial markets as it may recreate conditions that brought about currency crises in the past. An alternative approach is proposed where independent central banks coordinate their monetary policies through the adoption of common objectives and by building an appropriate institutional framework. When this coordination process has progressed to the point where interest rate developments are similar across the region, and if in the meantime the required institutional infrastructure has been build, the next step towards monetary unification can be taken among those central banks that so desire. The claim is that this transition path is likely to be robust and will limit the risk of currency crises.