An Essay Supplement to Chapter 16

Will East Asia Save the Euro?

The Issue

Viewed from Europe, the dollar is undervalued and steadily going down. But from almost everyone else's vantage point, it is the euro that is well on its way to becoming overvalued. This difference in perspective reveals the quiet evolution of the last few years: It is not just the Latin American countries that tie – whenever they can, and increasingly successfully these days – their currencies to the dollar, but also the most dynamic countries of East Asia. Right now, when the dollar is weak, most of the world's currencies simply follow its lead, leaving the euro alone to play the balancing act.

This explains the anguished signals coming from the Eurosystem – including Mr. Trichet's statement about the "brutality" of exchange rate movements – and the relaxed attitude of the other central bankers, including Mr. Greenspan. The euro is isolated, and the key to breaking this isolation seems to be in East Asia.

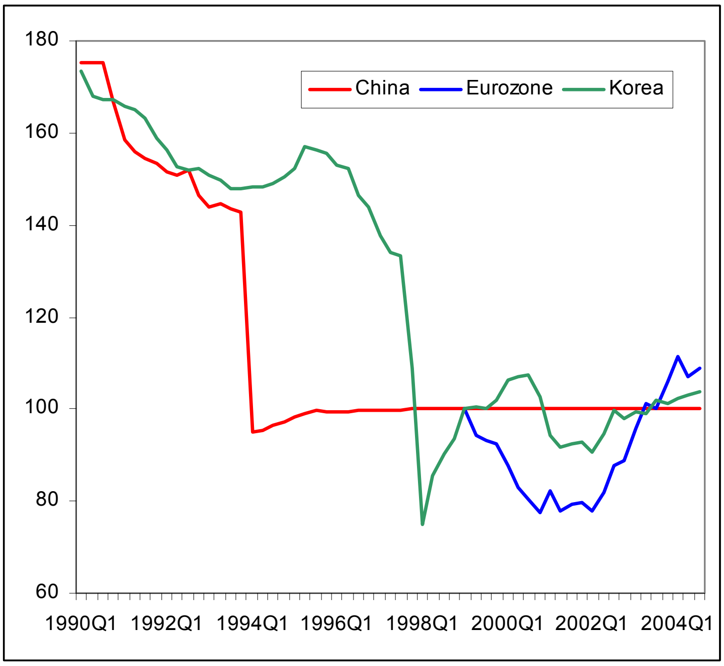
East Asia After the Crisis

In 1997-98, a series of currency crises devastated most East Asian countries. The figure below shows how one of these currencies, the Korean won, lost more than half of its value. Previously, it is China's renminbi that had undergone a massive devaluation. Following these crises, most East Asian countries (but not China, Hong Kong or Malaysia) have officially followed the IMF's advice to let their currencies float. They have stopped announcing exchange rate pegs, but this is just window-dressing.

In practice, they keep their currencies tightly linked to the dollar. They routinely intervene on the foreign exchange markets to avoid "brutal" parity changes, accumulating massive dollar reserves. Since 2000, they have doubled their stocks. Excluding Japan, they have now amassed nearly 2 trillion dollars worth of reserves, about as much as their own combined GDPs. Given that the bulk of these reserves are held in US Treasury bonds, which offer a very low return, this looks like a huge waste of money. It is.

It is no surprise, therefore, that the G7 countries have repeatedly called upon East Asia to let their currencies appreciate vis a vis the dollar and to stop their seemingly senseless accumulation of foreign exchange reserves. So far, their calls have fallen on deaf ears.

Dollar exchange rates (Index: 1999Q1=100)



Source: IMF

One reason for their resistance goes back to the crisis of 1997-98. All of a sudden, the Asian dragons, long described as the economic miracle of the previous two decades and an example for the world to follow, were branded as the basket case of globalization.

They were corrupt, they had badly mismanaged their banks, and they relied on inefficient industrial policies. They had been told to open up their financial markets and now they were facing massive speculative attacks. As their currencies were losing half of their values, they had to accept extraordinarily intrusive conditions set by the IMF in exchange for its support. Poverty exploded and they felt humiliated, not just by the turn of events, but also by their treatment in the hands of the international community, which really means the G7.

Their recovery was surprisingly fast, an indication that not everything was rotten, but deep scars remain. Chief among them, is the determination to never ever be in the position of having to ask for IMF support. The massive reserves that they have accumulated now far exceed the money committed by the IMF, much of which was never disbursed. The cost of holding these reserves may be huge; to the East Asians it is the insurance that they will not “go to the IMF” any more. This may well be pie in the sky – determined speculators can scoop up much of these 2 trillions in a few days – but it is an unshakable belief.

The other reason why the East Asians are unwilling to unhook their currencies from the dollar is related to the redistribution of power within the region. China’s GDP is already the sixth largest in the world. With an annual growth rate of close to 10%, China is quickly climbing the ladder. It has become the main trading partner of most East Asian countries. More importantly perhaps, it has become their chief competitor. With one fifth of the world population and salaries that are a fraction of those in the region, China seems able to produce almost any of the goods that have propelled the Asian tigers to the world league. Already many East Asian firms are busy moving their production facilities to China. "What will be left for us to manufacture?" is a question commonly heard in the region. Of course, China is transforming itself not just into a major producer, but also into an avid consumer, but there is no doubt that a deep restructuring is under way. As a result, the East Asian countries watch their exchange rates vis a vis the renminbi as a key strategic parameter. At this stage, they are not going to appreciate vis a vis the renminbi. Since the renminbi is kept rigidly tied to the dollar, the whole region is locked.

Asian Plans

This is all very defensive, and the East Asians are keenly aware of it. They have tried to imagine all sorts of plans to establish a high degree of regional economic cooperation. With the Chiang Mai initiative, they have decided to pool some of their exchange reserves to build up an alternative to IMF support. They are now studying the "Asian bond initiative", a plan to establish a common financial market and lessen their dependence on borrowing from outside the region. They have agreed to sign free trade agreements to further develop regional trade. But for all the noise around these manoeuvres, they are really going nowhere.

Officially, they regard Europe as a role model. They would like to have a Common Market and a Single Currency, but they are decades away from such goals. All their agreements are strictly bilateral, not multilateral as in Europe. There are tens of country-to-country reserves pooling and free trade agreements in place or under negotiation, each one different from the others. It is not just messy and inefficient, but it keeps the dream of deep regional cooperation away. They have not even started to build up a common institution that could resemble the European Commission. Why?

The current economic leader is Japan. Nothing much is possible without Japan and Japan is eager to assume some regional leadership, but history has left a deep mistrust – to put it mildly – towards the former empire. The next leader is China, but China is not really a market economy, its Communist regime is watched with deep suspicion and it is so big that every country fears that it will dominate the region, a prospect that they would rather slow down. The next two economically large countries are Korea and Taiwan, but the future of Taiwan is very much in doubt. To make things worse, the mounting competition between China and Japan for regional leadership could turn nasty, very nasty.

What next?

The plot is now in place. Outside of the US and Europe, the main economic powers of the world are in East Asia. The East Asians could join Europe in dealing with the US deficits and the weak dollar, but they would have to first agree among themselves. They are not ready to do so and, for the time being, they tie their currencies to the renminbi, which is pegged to the dollar. China is the key, therefore. Can it be convinced to let its currency fluctuate or, at least, to appreciate vis a vis the dollar? The G7 tried, and keep trying, but China is not a member of the club, so why should it do the G7 a favour? In fact, keeping the renminbi pegged to the dollar is not a good idea for China itself since undervaluation eventually translates into inflation. So it is a good bet that the Chinese will eventually step aside from their current exchange rate policy. But beware: when they lessen the link with the dollar, they may well decide to diversify their holdings of foreign exchange reserves. If they just sell 10% of their dollars, worth some 50 billions, to buy up euros, Mr. Trichet might discover what brutality really means.

Questions

1. Do the East Asian countries satisfy the optimum currency area criteria?
[An interesting analysis is in:
Barry Eichengreen (1997) "International Monetary Arrangements: Is There a Monetary Union in Asia's Future?", http://emlab.berkeley.edu/users/eichengr/policy/asiamone.pdf
See also:
Charles Wyplosz (2002) “Regional Exchange Rate Arrangements: Lessons from Europe for East Asia”, http://hei.unige.ch/~wyplosz/adb.pdf]

2. This is an early indication of the difficulties for the euro to share the dollar’s role as a world currency. What would be the situation had the East Asian countries decided to peg informally to the euro instead of the dollar?

3. Imagine that China indeed allows the renminbi to appreciate and at the same time rebalance its foreign exchange reserves, replacing some of its dollars with euros. What would happen, in your view?