COMMENT ON 'YEN BLOC: TOWARDS ECONOMIC INTEGRATION IN EAST ASIA' BY C.H. KWAN

Gordon de Brouwer

Australian National University

This is an important book. While I think that the argument in favour of a yen bloc is deeply flawed, C.H. Kwan's book is a must-read for those interested in East Asian regionalism and integration. It is one of the clearest and best-written expositions of those who propose deeper financial and monetary integration through the formation of a yen bloc. This topic needs to be debated more, and Kwan provides an excellent start.

He makes two basic points. The first is that regionalism is on the rise in East Asia, manifest not just in political and trade discussions but also in thinking about finance, monetary systems, and exchange rates. The region is becoming more integrated economically. He describes a virtuous circle between interdependence and economic growth in East Asia. Through trade and investment, industrialisation has spread first from Japan to the newly industrialised economies of East Asia

(Hong Kong, Korea, Singapore and Taiwan), and then to ASEAN and China. This has transferred technology, industrial know-how, and capacity. Combined with the waning of ideology, it has enabled countries like China and Vietnam to open their economies and exploit their great advantages in producing and selling labor-intensive goods. The result is an intra-regional growth dynamic and fundamental interdependence, secured by strengthening government ties. Kwan argues that the East Asian financial crisis revealed the need for regional monetary cooperation to support the economic links. Indeed, he senses a new appetite for cooperative exchange rate arrangements in East Asia.

Kwan's second point is that Japan is the biggest economy in the region and it is the natural leader for cooperative exchange rate arrangements in East Asia, focused on the yen. He argues that a yen bloc would be good for Japan, good for East Asia, and good for the world. A yen bloc is good for Japan because it helps internationalise the yen, which helps Japanese firms manage foreign exchange risk, and it promotes Tokyo as a global and regional financial center. Moreover, it puts healthy policy discipline on Japan. A yen bloc is good for East Asia because it provides it with intra-regional exchange rate stability and promotes further integration in the region. While Kwan thinks that Japan has to do more reform in order to lead East Asia, he argues that it has actually made considerable progress, as shown by the 'big bang' of major financial and accounting reforms announced in 1996. He also thinks that a yen bloc would be good for the world because it would provide balance to Europe and, more importantly, the United States in international finance and in policy making. He reckons that an integrated East Asian yen bloc would be the third leg in an emerging tripolar world based on the Americas, Europe, and Asia.

The first point looks right. Policymakers in postcrisis East Asia are thinking about a lot of things, including monetary and exchange rate arrangements. They are interested in better policy dialogue and deeper financial cooperation. The establishment of the ASEAN+3 group is a good way forward in developing policy dialogue in East Asia (although, by excluding nations like Australia and New

Zealand and economies like Hong Kong and Taiwan, its membership is too narrow for it to genuinely represent the region). The Chiang Mai Initiative which sets up a broad system of bilateral swap agreements between ASEAN+3 countries is a welcome first step in more comprehensive regional financial cooperation. Policymakers are also thinking about different monetary and exchange rate arrangements, including cooperative ones, although they are still a long way from accepting the idea and taking steps in that direction.

But I cannot see how the second point is right. There are powerful arguments for deeper monetary and financial integration in East Asia. There is substantial scope for improving regional financial arrangements, especially as vehicles for reducing uncertainty, developing cooperation, and attaining deeper economic integration, although, as is widely recognised, they need to be balanced against the need to maintain policy coherence, consistency, and structural flexibility. But it is naive to think this can be a yen bloc.

The rise of East Asian regionalism is complex: it represents the desire of countries to realise the benefits of deeper economic integration; it is a response to the rise of regionalism in Europe and the Americas; it is a reaction to the exercise of U.S. global power and influence; and it is a manifestation of the intense rivalry that exists between Japan and China in the region, as the current leader and the future leader of the region jockey to assert their interests. As much as Japan plays – and, it warrants emphasizing, will continue to play – a big and leading part in this, it is not the focal point of integration. East Asia is the focus, not Japan.

Kwan's book explores the possibilities of Asian integration through the prism of Japan's interests. This is too narrow a basis. Along with the United States and Germany, Japan is one of the Group of Three (G-3) biggest market economies in the world. It is the biggest and wealthiest economy in Asia. But it is just one country in a region of many, and its interests are not necessarily identical to those of the rest of Asia. The idea of a yen bloc is not just unacceptable to China – and this alone should be enough to put the idea to permanent rest – but to all other countries in the region.

Southeast Asia does not see itself as an appendage to Japan (and, besides, it wants to get as much out of China-Japan rivalry as it can). Given the occupation of 1910-45, the idea of Korea basing its monetary system on the yen is fantasy. Along with Japan and Malaysia, Korea has been leading the regional debate on financial and monetary cooperation; its think tanks have argued for an Asian Currency Unit for East Asia's developed economies in preference to Japan's common basket peg to the dollar, yen, and euro for non-Japan East Asia because it sees the latter as too Japan-centric.

The protagonists for centering East Asian exchange rate arrangements on Japan evoke the example of Germany, its G-3 colleague, in European monetary integration. Germany may have played a central role in European monetary integration and created the European Central Bank (ECB) in the image of its Bundesbank, but it gave up its monopoly on deciding European monetary policy. The ECB is European, not German, as shown for example by the fact that its managing director is, by custom, not German. The euro is not simply the deutsche mark rebadged, and will become even less so if and when the European Union expands to Eastern Europe.

Even if the politics and strategic positioning permitted it, there are two economic reasons why East Asian monetary cooperation cannot take the form of a yen bloc. First, Japan's weak economic performance over the past decade makes a pure yen bloc infeasible. Despite its wealth and core elements of manufacturing and technological brilliance, Japan is in a state of decline relative to the rest of the region. This is the result of rapid aging, population decline and low productivity growth, as well as ongoing problems, despite some reforms, with structural rigidity, inflexibility in parts of its bureaucracy, and a political system compromised by sectional interests, especially in the agriculture and construction industries.

Japan has plenty of economic clout in East Asia, through its sheer size, the investment of its firms, and its aid program. But it has declining economic authority because of its poor economic management. Japan has dealt badly with the rise and fall of its asset price bubble, corporate (and now public) debt overhang, the endemic weakness of its financial system, and the financial operations of its postal system. As a result, its institutions are losing respect and authority in East Asia. The rivalry between, and within, some institutions is also notorious, and viewed outside Japan as an impediment to national and regional policymaking. How can Japan expect to lead the region when its institutions are seen as divided and indecisive?

Second, the economic structural differences between Japan and the rest of East Asia also make a pure yen bloc infeasible. The domestic and external economic structures of non-Japan East Asia are much too complex to be adequately represented as extensions of the Japanese economy, as the notion of a yen bloc implies. Consider just three dimensions to this.

In the first place, East Asia's trade and investment structures are diverse and globally oriented. As trading partners, the United States and Europe are at least as important as Japan to non-Japan East Asia. Intraregional trade within non-Japan East Asia is also increasing, although this partly reflects increasing intrafirm and intraindustry trade and belies the region's dependence on outside markets. To fix to just one of a set of important currencies would expose the domestic currency to variation in the rest of the set. Countries are well aware of the problems created by implicit pegging to the dollar before the East Asian financial crisis, so why should they now do the same to the yen? Indeed, the Japanese authorities recognise this and have instead proposed that East Asian countries instead target a basket of the dollar, yen, and euro.

If a country is going to target its currency to maintain export competitiveness (which is certainly a preoccupation of many East Asian countries), it will target its currency to a country against which its exports most closely compete. As it turns out, apart from Korea, non-Japan East Asia's exports have become more, not less, similar to those of the United States and European Union, not Japan. This implies that exchange rate stability against the dollar and euro is becoming more important to most of the region.

Using the optimum currency literature as a guide, countries will seek a common exchange rate if, among other things, they have similar economic structures, including whether international disturbances have common effects on the set of countries considered. Real exchange rates are an endogenous price variable in an economy, reflecting the confluence of economic structure and the disturbances affecting the economy. As it turns out, the real exchange rates of most of non-Japan East Asia react very differently to external shocks than does Japan's. Fixing to the yen may force more adjustment to output and employment, which is something the region does not need.

Japan is a very big and very wealthy economy. It is East Asia's leading economy and it will remain central to the rest of the region. But that does not mean that East Asia is a yen bloc. The word 'bloc' connotes ownership but East Asia does not belong to anyone. Japan's best strategy in exercising and maintaining influence in East Asia is to reform and grow its own economy and cooperate as a partner with the rest of the region.

The notion of the world collapsing into three blocs, which C.H. Kwan supports, is a highly unlikely one. Even if global cooperation is being undermined somewhat by American unilateralism and European insularism, Asia's fundamental economic and strategic interests will ensure that the region remains outward focused, even if the rhetoric runs a bit the other way at times. East Asia - especially China - has far too much to lose by closing in on itself. While it may be appealing to chauvinistic elements in Japan, a 'yen bloc' as such would not secure economic stability and growth in East Asia and is unattractive to the rest of the region. That said, there are clear gains from, and growing support for, deeper financial and economic integration in the region. Japan is a leader in this debate and has much to contribute.