Real and Pseudo Preconditions for an Asian Monetary Union[1]
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1. Introduction

The idea of Asian Monetary Union is again in the air.[2] In May 2004 the *Financial Times* gave front page coverage to a speech at the Asian Development Bank Annual Meetings by Haruhiko Kuroda, special advisor to the Japanese cabinet, laying out plans for a five-stage transition to a single Asian currency.[3] Todao Chino, president of the Asian Development Bank, lent his support to the idea in an interview with the *Wall Street Journal* subsequent to those meetings. On June 6th the lead editorial in the U.S. edition of the *Journal* added its support to the plan. In the words of the *Journal's* editorialist, "The economic advantages are clear to see…A common Asian currency would reduce volatility and currency risk and thus allow for the development of deeper and more diverse financial markets. It would also join the dollar and the euro in anchoring the world's financial system…"[4]

The *Journal* then went on to acknowledge the obstacles to such a step. "Asia is more politically fragmented than today's Europe, and many countries retain an understandable post-World War II skepticism toward Japan, which is still the region's

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[1] For presentation to the Asian Development Bank High-Level Conference on Asia's Economic Cooperation and Integration, Manila, July 1-2, 2004.
[2] As it was in the immediate aftermath of the 1997-8 financial crisis. For example, Xie and Yam (1999) and Chung (1999) mooted this idea in the wake of the crisis. Philippine President Joseph Estrada put the issue on the agenda of the ASEAN summit in Hanoi in 1999.[36] Joseph Yam, head of the Hong Kong Monetary Authority, suggested the creation of a single Asian currency as "a long term possibility" whose "successful implementation would go a long way toward addressing the currency instability we have seen..." Nobel Laureate Robert Mundell called for the creation of an Asian euro at an ADB conference in Manila in February 2001. See Eichengreen (2003) for discussion and citations.
[3] Mallet (2004), p.1.
[4] Wall Street Journal (8 June), p.A16.

largest economy. China is catching up fast, but its financial system continues to be underdeveloped and protected by currency controls." Some, like the present author, are on record as suggesting that the obstacles are even more formidable than this.[5] A single currency for Asia presupposes the creation of a regional central bank. Establishing and operating such an institution would require agreeing on how decisions are taken and on how those taking them will be held accountable. Most immediately this raises the question of how many countries will be represented on the bank's policy board: all of them or only a subset at a point in time? How will their views be aggregated? Will a majority be permitted to override the wishes of a dissenting minority, which would seem essential for a quick response to unfolding events, or will decisions have to be taken by unanimously? Even if day-to-day policy decisions are delegated to an executive board of independent experts with no particular national affiliation, there will still have to be a mechanism for holding policy makers politically accountable for their decisions. In contrast to Europe, Asia possesses no political counterpart to a regional central bank to which those policy makers would have to report and that would be able to rein them in if their decisions are politically and constitutionally unacceptable. That is to say, there is no equivalent of the European Parliament and the European Court of Justice. This is a recipe either for a highly politicized, politically-dependent central bank, whose board members would report directly to their national governments and view themselves as representatives of the national as opposed to the broader regional interest, or for a politically unaccountable central bank whose technocratic leaders would be free to take decisions without regard their broader consequences. The first alternative would be inefficient economically, while the second would be unacceptable politically. The

[5] For example, in Eichengreen (2004a).

question, then, is whether it is possible to create a regional central bank without at the same time pursuing a broader process of political integration for which there is little appetite in Asia. Experience in Europe, where monetary and political integration have gone hand in hand, suggests that the answer is no.

Fortunately, there exists an alternative to monetary union: managed floating backed by inflation targeting. This is the alternative pursued in North America. The three partners in the North American Free Trade Agreement, the United States, Canada and Mexico, are highly integrated with one another, both economically and financially. There is a very large volume of cross-border foreign direct investment in North America. Regional supply chains are highly articulated. Capital accounts are open. U.S. banks are now the dominant players in the Mexican market. Yet not only do the three countries retain their own currencies, but those currencies float against one another with little if any foreign-exchange-market intervention by any of the three national central banks. The monetary policy of each central bank is anchored by a commitment to low and stable inflation. Canada and Mexico are formal inflation targeters, while the U.S. is a de facto inflation targeter.[6] While the fluctuation of their exchange rates is far from negligible, it does not obviously hamper the integration of their economies or undermine financial stability. This is not to imply that currency movements are irrelevant to the calculations of monetary policy makers, especially in Canada and Mexico, which are as open and export dependent as many Asian economies. But the exchange rate figures into their policy decisions only insofar as it affects the prospects for inflation and the output gap, the ultimate policy targets of an inflation-targeting central bank. In practice, the

[6] With some, like Governor Bernanke, arguing that it should contemplate moving toward a formal inflation targeting regime.

operation of this monetary regime implies fairly considerable fluctuations of the three currencies against one another, fluctuations that are seen as playing a useful stabilization role. And there is little sign that these currency movements are fanning political tensions or hampering economic and financial integration in the region.

To be sure, there are obstacles to the adoption of inflation targeting in a number of Asian countries. The operation of an inflation targeting regime presupposes the existence of an independent central bank, the absence of fiscal dominance (large ongoing deficits or contingent fiscal liabilities that the central bank might come under pressure to finance), and well-defined transmission channels running from the central bank's policy instruments to a market determined interest rate. China, which will soon be the dominant economic power in the region if it is not so already, possesses none of these attributes.[7] But an increasing number of other Asian countries do. And it is important to bear in mind that these same arrangements – central bank independence, market determined interest rates, the absence of fiscal dominance – would also be prerequisites for monetary union, not just in particular countries but uniformly across the region.

It will now be clear that, knowingly or not, the Asian Development Bank stacked the cards against the case for monetary union when it asked me to serve as an outside expert for this meeting. Nonetheless, in the interest of balance I will attempt to suspend my own disbelief and take a more positive approach. I will start by analyzing in more detail what Asia must achieve over the next quarter century in order to achieve a monetary union by, say, 2030. I will then go on and identify what is not needed – that is

[7] The absence of central bank independence and market determined interest rates is self evident. The potential problem of fiscal dominance lies in the extent of nonperforming loans in the banking system and the insolvency of important state enterprises, which imply fiscal liabilities whose precise magnitude is unknown but which are certain to be substantial.

to say, a number of additional desiderata that arise in discussions of monetary union but are not essential preconditions for that step. My analysis is informed by Europe's experience with monetary union, which has important lessons for other regions. But some of my views of Europe's monetary union are unconventional.[8] And I challenge the belief that Europe's particular approach to establishing and operating a monetary union is easily transplanted to Asian soil, where economic and political conditions are different

In the conclusion I return once more to the medium-term prospects for monetary union in Asia.

2. Preconditions

European experience points to following preconditions for monetary union.

A. The capacity to delegate monetary policy to an international institution. Monetary union, as already noted, entails a single currency whose supply is determined by a regional central bank. The essence of monetary unification is therefore agreement to establish an international institution to which the participating national governments are prepared to delegate the relevant policy prerogatives. The first and most basic question is thus: what economic and political conditions must be satisfied by this limited compromise of national sovereignty?

Standard political theory points to four.[9] First, the institution in question must be *accountable.* Technocrats must be answerable to elected officials, and elected officials must be answerable to the citizenry. Second, it must be *representative.* Representation ensures that various interest groups, including but not necessarily limited to nation states,

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[8] See Eichengreen (1997).
[9] Here I draw on the framework developed in Berglof et al. (2003).

have their interests adequately taken into account. Third, the institution in question must be *efficient* in the sense that it is capable of reaching decisions that find the best common denominator among diverging opinions and interests. That is, policy outcomes should be pareto optimal in the sense that it is not possible to make some interests better off without at the same time making other worse off. Fourth, the institution in question must be *effective.* This means that it should have the ability to implement decisions without damaging delays.

Concretely, this implies a need to agree on decision making rules and arrangements like those enumerated in the introduction. In the Asian context, doing so will require addressing some difficult political decisions and tradeoffs. Will Asia's monetary union be a union of states or a union of their citizens? In a union of states, representativeness might imply a decision making board constituted on a one-country-one-vote basis. But does it really make sense for China and Myanmar to have the same weight in the decisions of an Asian Central Bank? A union of Asia's citizens, on the other hand, implies weighted voting with more weight for more populous countries. Taken literally this would imply giving China more weight than all the other participating countries combined, which may not be palatable either. There may be tradeoffs, moreover, between representativeness and effectiveness. A board on which every country has seats and votes would be more representative of the participating states than one on which only a subset of countries is seated at a point in time and countries periodically rotate on and off, but such a large board would be unwieldy and might find it hard to respond quickly to unfolding events, something that may be critical in periods of financial instability.

This is a problem with which Europe is currently grappling and whose urgency will grow as more new EU members ready themselves for accession to its monetary union. While the ECB has recommended moving to a rotation system, there is some reluctance on the part of the member states to take this step. As a result, the rotation system that has been devised would require member states, and large member states in particular, to rotate off the board only very occasionally. The resulting policy board would still be very large (with as many as 19 members, far more than any national central bank), raising doubts about the continuing effectiveness of policy. Some commentators have suggested that it would be preferable to dispense with national representation and delegate decision making authority to a small committee of monetary experts without national affiliation, perhaps a six member monetary policy committee selected on the basis of expertise similar to that employed at the Bank of England.

But this effectiveness-enhancing reform is resisted on the grounds that it is not clear to whom this committee of monetary technocrats would be accountable. In the British system, the Bank of England answers to the British Parliament, which holds it accountable for its actions. If its policies are politically unacceptable to the country's citizens, who are represented by their members of Parliament, then the statutes under which the Bank operates can be changed. In the U.S. presidential system, the Board of Governors of the Federal Reserve System is accountable to both the U.S. Congress and Executive. If the decisions of the Board are politically unacceptable to the country's citizens, then the president can demand the resignation of the Fed chief and seek to appoint someone he and his constituents like better. The Congress can threaten changes in the Fed's statute that limit its independence. These are not things that happen frequently, but the fact that they can is a source of discipline and accountability.

Resistance in Europe to delegating decision making power to an independent monetary policy committee derives, in part, from the fact that there is no political analog to the U.S. executive and legislative branches. There is no single, powerful European head of state to demand the resignation of the president of a renegade ECB, but rather 25 heads of individual member states, none of whom speaks for the citizenry as a whole.[10] The European Parliament does not possess the power to alter the statute of the ECB, which is embedded in an interstate agreement (the Treaty on European Union) whose modification would require the unanimous consent of the signatory governments.

National representation on the central bank board, on the other hand, provides a conduit for political accountability. National representatives, who are the governors of the national institutions (together with the ECB) comprising the European System of Central Banks, are answerable to their governments through traditional channels. This is a weaker mechanism for accountability than in the traditional case of a national central bank that executes its own monetary policy, since only the individual board member and not the institution as a whole can be held accountable in this way. Still, this explains why member states are reluctant to give up their seats at the board table even for limited periods.

In turn, this suggests that monetary policy will be less effective in a monetary union of sovereign states than in a setting where the domains of money and politics coincide. The weaker are regional political institutions, in other words, the less ready

[10] While the EU's draft constitution, by reducing the frequency with which the chair of the Council rotates between member states, will represent a modest step in this direction, it is still fair to say that there will be no European analog to the U.S. executive.

will be the participating member states to delegate responsibility, and the larger, more unwieldy and less effective will be the policy making board. One reading of the recent Constitutional Convention in Europe is as a recognition of the need to enhance the powers of the European Parliament and at the same time to create a more powerful European Executive precisely in order to address these inefficiencies.[11] From this point of view, it is no coincidence that a constitutional convention followed shortly on the heels of the creation of the European Central Bank.[12]

B. A culture of monetary policy transparency. A second prerequisite for effective management of a single Asian currency (and for that matter any currency) is a culture of monetary policy transparency. Increasingly transparency is recognized as an essential attribute of effective monetary policy making.[13] It is a way of constraining the discretion of policy makers in a world where simple rules are inefficient but unfettered discretion gives rise to problems of time inconsistency and inflationary bias. A pegged exchange rate rule would presumably be no more appropriate for an Asian Central Bank than it is for the European Central Bank or the Fed; standard optimum currency area theory argues against pegged rates for such large, relatively closed continental economies.[14] Given the limits of our knowledge of the economy, it is unlikely that any other simple, pre-specified rule would perform much better. The rule would have to be updated as our knowledge of the economy was updated; as that procedure was repeated ad infinitum we would then be back in a world of discretion. And as recent research on

[11] As anticipated in the preceding footnote.
[12] It is similarly revealing that in the Southern Cone, where there have been desultory discussions of a single currency for Mercosur, there is now discussion of the possibility of a Mercosur Parliament to provide for the necessary political accountability (Eichengreen 2004).
[13] See for example King (2000).
[14] Pegging to the dollar or the euro would also force Asia to forego the monetary autonomy that the aspiring architects of an Asian Monetary Union seek to acquire for the region (that is effectively one of their principal motivations).

the time inconsistency of optimal monetary policy has shown, discretion is an equally inefficient basis for policy formulation.[15]

Transparency is a way of constraining discretion while at the same time permitting limited flexibility. It is a way for central banks to make credible commitments that ameliorate their time-inconsistency problem and enhance the efficiency of monetary policy. It is a better approximation to the optimal state-contingent rule than either simple non-contingent rules or unconstrainted discretion. The central bank specifies its policy objective, typically an inflation target. It describes how its tactics translate into achieving that goal, typically by publishing an inflation forecast and describing the model linking its instruments to market outcomes. If the target it missed, it explains why in its *Inflation Report* and in testimony before the relevant deliberative bodies. Thus, the central bank has discretion over its targets, but discretion that is constrained by the targets, forecasts and model that it announces and publishes.

In addition to enhancing efficiency, another function of central bank transparency is as a mechanism for accountability. The central bank's mandate can be defined by the politicians in general terms, by embedding it in the central bank's founding legislation, or more specifically by assigning to the government the task of selecting the inflation target, perhaps in conjunction with the annual budget round. Requiring the central bank to defend and justify its actions in press conferences, reports and testimony also holds it accountable in the court of public opinion. This mechanism for accountability would be particularly important for an Asian Central Bank that could not be held accountable through standard political means.

[15] The classic reference here is Kyland and Prescott (1977).

Not all of these points are uncontroversial among theorists.[16] But among practitioners transparency is increasingly seen as a vital attribute of efficient central banking.[17] Policy decisions taken by regional groupings in Asia are not renowned for their transparency. The question is thus whether and, if so, how this requirement can be met.

C. Open capital accounts. A common currency with a value that is uniform throughout an integrated economic area implies the removal of geographical restrictions on financial transactions.[18] That is to say, Asian countries will have to remove their remaining controls on capital account transactions in order to form a monetary union, just as Europe removed its remaining capital controls in the decade leading up to the establishment of the ECB and issuance of the euro. Recent experience, not least with the financial crisis of 1997-8, provides important cautions regarding the prerequisites for capital account liberalization. Thus, before China, to pick a case not entirely at random, removes its remaining capital controls, at a minimum it will have to do the following: (i) recapitalize and commercialize its banks, (ii) strengthen prudential supervision to prevent the banks from assuming excessive risk, (iii) improve corporate governance to prevent the same excessive risks from simply being shifted to the corporate sector, and (iv) develop deeper and more liquid domestic financial markets in order to enable minority

[16] See for example Geraats (2002) for discussion.
[17] A point documented in the survey resulted reported by Fry et al. (2000).
[18] To be sure, it is possible to imagine an Asian currency unit that traded at different prices in different Asian countries because of the persistence of capital controls, but it is hard to see what the advantages of such an arrangement would be. The exchange rate between Chinese ACUs and Korean ACUs would presumably differ from unity if China maintained capital controls, but neither the Chinese nor the Korean authorities could control that exchange rate, rendering the latter of questionable utility from a policy point of view. And the other putative advantages of monetary union would not obtain under such a regime. Since that exchange rate would presumably still vary, the advantages of reduced costs of cross-border trade and investment would be foregone. The advantages of the stimulus to financial development afforded by the greater scale of the integrated monetary area could not be obtained.

shareholders to vote with their feet if they see management following imprudent policies. These preconditions are formidable. They remind us that full capital account liberalization will not and cannot be the norm across Asia anytime soon.

D. A common transmission mechanism. A final precondition for monetary union is a market-determined interest rate and reasonable convergence of the monetary policy transmission mechanism across the participating countries. A change in the central bank's instrument setting that has very different effects on economic and financial conditions in different parts of the monetary union could give rise to serious strains and inefficiencies. The standard example is when the central bank raises interest rates in response to a union-wide inflationary shock. If the consequences of this monetary contraction differ from country to country, either in terms of the timing or the impact on real variables, then the output cost of maintaining price stability will be unevenly spread across the monetary union. It might be higher on balance than in the more uniform case. Hence, convergence of the monetary transmission mechanism across regions is advantageous for the operation of a monetary union.

This argument should not be overstated. Full uniformity of the monetary transmission mechanism is not required; even within Europe's monetary union, there is evidence of differences in the monetary transmission across participating countries.[19] But if, in Asia, those differences were pronounced, the implications could be serious.

There is a fairly substantial literature concerned with these issues. One explanation for differences in monetary transmission is the so-called financial structure hypothesis. This is based on the lending view of monetary transmission, according to which monetary policy actions first affect the reserves available to the banking system,

[19] For evidence see Arnold (2001), Barran, Coudert, and Mojon (1997), and the references cited therein.

thereby affect bank lending, and ultimately affect the behavior of bank-dependent borrowers. It follows that countries in which firms are more bank dependent and banking systems are less healthy will be more sensitive to decisions to change interest rates.

Indeed, there is considerable evidence, for both Europe and Asia, that countries with many small banks, less healthy banking systems, and poorer direct capital market access display greater sensitivity to monetary policy changes than countries with big, healthy banks and deep, well-developed capital markets. The question is why financial structure tends to differ in these ways. Cecchetti (1999) attempts to test whether these aspects of financial structure are mainly a function of regulation or of the legal system. His main finding is that countries with better legal protection for shareholders and debt holders have financial structures in which the lending channel of monetary transmission is less potent, even after one controls for the effects of taxation and regulation. The implication is that these aspects of the law must be harmonized (preferably at high levels) for reasonable convergence of the transmission mechanism.

The point is that some convergence of financial structure across countries will be needed for reasonable uniformity of the transmission mechanism, which will in turn require strengthening and harmonizing measures to protect creditor rights. The specific problem in Asia is that legal protections for shareholders and other creditors have been relatively weak. Reform efforts are underway, but starting points are different, and differential rates of progress are not obviously leading to greater harmonization and thus similarity of monetary transmission across the region.

Summary. This somewhat unconventional review thus points to three key prequisites for monetary union. First, a degree of *political solidarity* that permits the delegation of monetary policy to an international institution without entailing unacceptable compromises of representativeness, accountability, and policy effectiveness. Second, a commitment to *transparency and openness* that allows for the efficient formulation and conduct of policy. Third, measures to *strengthen, develop and harmonize the structure of financial systems* so as to permit the opening of capital accounts and provide for reasonable uniformity of the transmission mechanism throughout the monetary union.

3. Pseudo Preconditions

These are not, of course, the only preconditions for monetary union identified in scholarly literature and popular discussion. But I regard the others as pseudo preconditions – that is, as superfluous and, in some cases, counterproductive.

A. Fiscal transfers between member states. Students of the U.S. economic and monetary union have long observed that its smooth operation is facilitated by America's federal fiscal system.[20] Resources are transferred from booming to depressed regions through the operation of the federal tax and transfer system. When activity in an individual state declines, there is a proportionate decline in the taxes it pays into the federal budget in support of programs that extend over the whole of the monetary union. At the same time there is a rise in the transfers it receives to help to defray the costs of, inter alia, payment of unemployment benefits. This transfer of purchasing power buffers the effects of idiosyncratic shocks and limits regional divergences placing pressure on the common central bank. Early studies motivated by the prospect of European monetary union suggested that the U.S. tax and transfer system offsets a third to half of regional

[20] See for example Sachs and Sala-i-Martin (1993).

demand shocks.[21] The implication, seemingly, is that Asia will not be ready for monetary union until it too is prepared to establish a federal fiscal system.

There are several grounds for questioning this conclusion. First, recent research on the extent to which idiosyncratic shocks to U.S. states are offset through federal taxes and transfers has yielded major downward revisions of the estimated magnitude of the effects. Second, Europe has shown itself to be fully capable of operating a monetary union in the absence of such a system. The EU budget is little more than one per cent of EU GDP, providing limited scope for stabilizing cross-state transfers. The vast majority of that budget is devoted to spending on the Common Agricultural Policy and Structural Funds, the distribution of which is only loosely related to cyclical fluctuations in the individual member states.

Why there has not been more pressure to create a European system of fiscal transfers is clear. Unlike the U.S., where the majority of taxes are paid to Washington, D.C. and the majority of public expenditure is undertaken by the federal authorities, in Europe the member states themselves collect the taxes and undertake the spending. This allows them to do their own countercyclical stabilization. When one member of the monetary union experiences an unusually severe recession, it allows its budget to move into deficit, thereby taking steps on its own to buffer the negative demand shock without the need for help from its monetary union partners. This is what we are seeing at the moment, for better or worse: slowly growing member states such as Germany are using their own very substantial budgets to counter the stagnation of demand.

[21] Ibid.

Thus, so long as the members of the monetary union are free to vary their fiscal stances as they choose, there will be no need for a union-wide system of federal taxes and transfers.[22] Fiscal federalism is not then a precondition for monetary union.

B. Deficit ceilings, sanctions and fines. Sound fiscal policies have long been one of Asia's strengths. The importance of fiscal soundness for stability, prosperity and growth is appreciated by policy makers in the region. Sound fiscal policies make for stronger economic performance, and stronger economic performance will ease the transition to and operation of a monetary union. But this is all quite distinct from the question of whether monetary union requires a system of numerical ceilings, sanctions and fines like those provided for by Europe's Stability and Growth Pact.[23]

Indeed, Europe's unsatisfactory experience with the pact suggests that this is not an example to be emulated. The greater the passage of time, the firmer the realization that the case for constraints on national fiscal autonomy is weak. The idea that excessive deficits at the national level will drive up real interest rates union-wide, creating an investment-unfriendly policy mix, is tenuous at best. Real interest rates are determined in global capital markets, not in the capital markets of the monetary union alone. Then there is the idea that the members of a monetary union are prone to excessive deficits because when they get in to trouble they can expect an inflationary debt bailout from the common central bank that effectively shifts the costs onto the rest of the monetary union. In practice, however, the injection of liquidity to stabilize the markets in response to such an event would be temporary. As in the case of the Fed and Long-Term Capital

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[22] Thus, von Hagen and Eichengreen (1996) argued that strict enforcement of restrictions on the budgetary autonomy of EU member states could eventually lead to pressure for the creation of a federal fiscal system in Europe, but in the absence of such restrictions no such system was likely to emerge. In its first five years, Europe has indeed opted for the first of these two alternatives.
[23] Even some strong supporters of the Pact (e.g. Issing 2004) inadvertently make this point.

Management in 1998, it could be reversed out subsequently with few discernible inflationary consequences. Ultimately, the costs of any debt default would be borne by national taxpayers or their creditors, in some proportion, with no monetary free riding involved. Similarly, if a debt default leads to runs on banks that had been stuffed full of government paper, as in Argentina, the costs of bank recapitalization would be borne by the offending country and paid out of its fiscal resources. Thus, the idea that fiscal externalities in a monetary union give rise to free rider problems that could potentially undermine the central bank's commitment to monetary stability turns out to be relatively weak. Indeed, one reading of Europe's experience with the Stability and Growth Pact is that the continent has disregarded its sanctions against these forms of fiscal "misbehavior" with no adverse consequences for monetary stability.

In addition, Europe's experience with the Stability and Growth Pact has shown that constraints on fiscal policy are difficult, if not impossible, to enforce. Public spending is the basis for the national defense, and the distributional consequences of public programs are often quite prominent. For these and other reasons, outside interference with the contact of national fiscal policies is strongly resisted. When the European Commission attempts to invoke the Excessive Deficit Procedure against large countries like France and Germany, the latter simply tell the Commission to go away. This gap between the letter and application of the rules damages the credibility and even-handedness of the regional surveillance process. This problem would be even worse in Asia, given the region's tradition of nonintervention in national affairs, which translates into a low-key approach to surveillance.[24] In other words, can one really imagine a system in which an international committee of technocrats decided that China's deficit

[24] See Manzano (2000).

was excessive and compelled that country to pay substantial fines to its partners in the monetary union?

The worst of all such systems would be one based on numerical ceilings for deficits and debts. Such ceilings are arbitrary: there is no coherent economic model in which deficits of 3.1 per cent of GDP are a problem but deficits of 2.9 per cent of GDP are not. There is no a priori reason for thinking that dire economic consequences will follow if the 3 per cent rule is violated or that all will be well if the deficit comes in just below that level.[25] This numerical threshold is not well grounded in theory. Whether it implies a sustainable public debt depends on the real interest rate, the real growth rate, and other variables that vary over time, unlike the 3 per cent reference value, which is set in stone. It is this fact – that the 3 per cent ceiling of the Stability and Growth Pact is arbitrary, capricious, and not grounded in a clear conceptual framework – that robs it of political legitimacy and explains why member states and their constituents are able to successfully resist the European Commission when the latter attempts to enforce it. They can always say "We are a fast growing accession economy with high real growth rates and low real interest rates; hence a deficit in excess of 3 per cent does not imply the same problems of debt sustainability as in other countries." Or "We have fewer unfunded pension liabilities than other countries; there is therefore no reason to be worried about this year's 3 per cent deficit." These and other arguments are credible. An arbitrary 3 per

[25] Buiter, Corsetti and Pesenti (1993) noted that 3 per cent was the typical level of public investment spending in Europe and that the golden rule on which German fiscal policy was based stated that deficits that did not exceed public investment were permissible, since they posed no threat to financial stability. They noted further 60 per cent was in fact the EU-wide debt/GDP ratio in 1992, when the Maastricht Treaty was ratified, and that a deficit/GDP ratio of 3 per cent stabilizes a net debt/GDP ratio of 60 per cent when nominal income growth is 5 per cent (close to the 1980s and 1990s norm in Europe). This is one explanation for why the framers of the Maastricht Treaty settled on these particular indicators. Whether these same assumptions about growth rates, real interest rates and public investment rates are valid for Europe now, or in the future, is more questionable. Whether they have any relevance to Asia is more questionable still.

cent ceiling is not. Debt ceilings make more sense, since they permit more flexibility over the cycle for countries whose debts are low, but why should such flexibility be enjoyed by countries when their debt/GDP ratios are 59 per cent but not when they are 61 per cent?[26]

My own view is that fiscal surveillance should focus not on symptoms – whether the deficit is above or below 3 per cent – but on the underlying sources of chronic fiscal problems.[27] In fact, we know quite a lot about what kinds of institutional arrangements and budgeting procedures produce good and bad fiscal outcomes. When central governments raise the revenues but subcentral governments do the spending, chronic deficits tend to result, since the states and municipalities are allowed to spend now and to go running to the central government for financial assistance later. In contrast, when each fiscal jurisdiction has its own source of revenues that are proportional to its spending obligations, chronic deficits are less. Deficits tend to be less where pension systems have been reformed, so that there will be no spending explosion in the future. They tend to be less where labor markets and unemployment entitlements have been reformed, so that unemployment is not a constant drain on the budget. They tend to be less where state enterprises have been privatized, hardening budget constraints and minimizing the danger of fiscal skeletons in the closet.

None of this is to say that peer pressure for fiscal reform is undesirable. But it makes more sense for peer pressure to focus on the fundamental institutional sources of chronic deficits rather than on some arbitrary numerical ceiling. It is important to recognize that this is essentially an arm-twisting and information-sharing exercise, not

[26] The preceding footnote which explains how the 60 per cent debt ceiling was chosen reinforces this point.
[27] For elaboration see Eichengreen (2003).

one that can be grounded in a system of sanctions and fines whose application will not be credible. And the argument for such surveillance is equally relevant whether countries join together in a monetary union or not.

C. Numerical convergence criteria. Monetary unification in Europe was preceded by a lengthy prequalification period in which candidates for participation were supposed to demonstrate their readiness by satisfying four convergence criteria having to do with the level or stability of their fiscal policies, interest rates, inflation rates and exchange rates. This is another precedent that should not be emulated. The exchange rate criterion – that the candidates should remove their capital controls and hold their currencies stable against their partners for up to two years – is a recipe for disaster. If anything goes wrong – if there is the least uncertainty about the outcome – the result can be a massive speculative attack, given the absence of capital controls. Inflation and interest rates are endogenous. They will come down smoothly in response to (expectations of) the country's acceptance into the monetary union.[28] There is no reason why the country should have to demonstrate its ability to reduce them in advance. Moreover, subjecting all countries to the same inflation criterion is perverse insofar as fast growing countries starting out far from the technological frontier are naturally subject to additional (Balassa-Samuelson) inflation. These criteria are even more dangerous in combination than separately, a point which becomes clear once one observes that requiring countries to stabilize both the exchange rate and inflation implies requiring them to stabilize the real exchange rate and therefore closes off scope for relative price adjustment. Not only are the fiscal criteria arbitrary, as already noted, but success at bringing the deficit below the critical ceiling in the period leading up to the membership

[28] See inter alia de Grauwe (2004).

decision is no guarantee that it will remain there once that decision has been taken and the pressure is off, as Europe has learned to its chagrin.

The relevant preconditions, as already noted, are neither purely financial nor purely numerical. Rather, they are institutional reforms that ensure reasonable uniformity of the monetary transmission mechanism, that lead to deepening and development of financial markets, and that promise the absence of chronic fiscal imbalances. Criteria like these are harder to operationalize than simple numerical thresholds for debts, deficits, interest rates, inflation rates, and exchange rates. But they are more relevant.

4. Conclusion

The following conclusions flow from this analysis. First, the important preconditions for monetary union in Asia are political as well as economic. It is well known that Asia comes as close as Europe did in the late 1980s and early 1990s to satisfying the classic optimum currency area criteria.[29] And at least some of those criteria are endogenous: they develop in response to monetary union.[30] The political solidarity needed to ensure the representativeness, accountability, effectiveness and efficiency of the monetary union is another matter. Europe has shown that it is possible to establish a monetary union without first moving to political federation. At the same time its experience underscores that the less the degree of political integration, the more difficult the tradeoffs between representativeness, accountability, effectiveness and efficiency, and the less satisfactory is likely to be the outcome. Asia's experience with the International

[29] See Goto and Hamada (1994).
[30] A point made by Frankel and Rose (1998) for the conformance of business cycles.

Monetary Fund, which is criticized in the region for its inadequate accountability and representativeness, suggests that its citizens care deeply about such matters. Replacing dependence on an inadequately representative, accountable, and effective IMF with dependence on an inadequately representative, accountable and effective Asian Central Bank would not be an improvement. The question is thus whether Asia is prepared to proceed with political integration as well as monetary integration, and if not whether it can find another way of cracking this nut.

Second, monetary union presupposes significant convergence of economic structures, monetary and financial structures in particular, across the participating countries. Specifically, there is a need to strengthen investor rights and for greater uniformity of those rights across the region in order to ensure reasonable uniformity of the monetary transmission mechanism. There is the need to strengthen and develop financial systems in order to limit the pressure on the central bank for last-resort lending and to provide a system of market determined interest rates. There is the need to strengthen prudential supervision and regulation in order to facilitate capital account convertibility. There is the need for full central bank independence where this does not already exist and for a culture of policy transparency to facilitate efficient policy making and strengthen accountability. This is different from saying that there has to real income convergence before monetary union is possible; although there has been considerable per capita income convergence in Europe in the lead-up to monetary union, the essential convergence is in the structure of monetary and financial institutions and markets, not per capita incomes. The further development of financial markets and strengthening of financial institutions are already high on the policy agenda in Asia, but these processes has further to run before the region is ready for monetary union.

Third, and finally, many of these same desiderata are preconditions for effective and efficient monetary policy in one country. Asian countries will have to move in the direction of greater central bank independence, greater policy transparency, and stronger financial markets and institutions whether they opt for monetary union or not. This suggests that the prospects for moving to monetary union are likely to grow brighter with the passage of time.

But monetary unification requires all of the participating countries to move in this direction simultaneously and all of them to have reached certain minimal levels of achievement before proceeding to a single currency and single central bank. One can imagine a process like Europe's in which the regional monetary union starts with a subset of countries that have satisfied the relevant preconditions, and in which these pioneers are joined subsequently by additional members. The problem is that of all major Asian countries, China has the furthest to go in meeting the relevant preconditions. And a monetary union that does not include China would have relatively little appeal. This fact, together with the political obstacles, suggests that Asian monetary unification will not be achieved anytime soon.

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