

What Type of Monetary and Exchange Rate Cooperation do China's Asian Neighbors Want from China?

Maria Socorro Gochoco-Bautista and Raul V. Fabella

Professor and Dean, respectively,
University of the Philippines
School of Economics

ABSTRACT

It is generally taken for granted that China's monetary and exchange rate policy have repercussions on her Asian neighbors and affect the choice set open to them in terms of setting optimal economic policy. At the very least, China's neighbors would like to have a clearer idea of China's plan as regards her monetary and exchange rate policy, specifically how and in what time frame she intends to adjust or exit from the current dollar peg. In a broad sense, China's decision regarding what some might call "national monetarism" will affect the viability of "international monetarism," or the regional or global monetary and exchange rate arrangement, with the yuan playing a key role. Already, many countries in Asia have individually opted to adopt inflation targeting and more flexible exchange rate regimes following the Asian Crisis of 1997. One may question whether indeed adopting inflation targeting cum greater exchange rate flexibility is optimal in the light of current China policy and relative to adopting a regional monetary standard.

From China's perspective, the choice of an optimal monetary and exchange rate strategy is largely contingent on the goals of policymakers there and what they consider to be in China's best interests. From the perspective of China's neighbors in Asia, however, the effects of China's decisions on her monetary and exchange rate policy are likely to have uneven trade and exchange rate effects in the different Asian countries. The differing degrees of complementarity between individual Asian countries and China will give rise to differences in the direction and size of exchange rate adjustment in individual countries. This, in turn, implies that a regional monetary arrangement to address intra-regional fluctuations in response to a change in China's monetary and exchange rate arrangement may not be warranted. The study will try to assess to what extent such a view is valid for some countries in Asia.

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Introduction

The question posed in the title of this study asks what kind of monetary and exchange rate cooperation China's Asian neighbors want from China. The question is relevant because China's decisions and policy actions have profound effects on all of us. In a very short span of time, China has become a very important economic actor in the region and in the world. China today is the major growth engine for the world economy. It is probably the fastest growing economy in the world, with average annual growth rates of between 8 and 9 percent. With the sheer size of its economy, it is able to exert a large influence on the prices of certain commodities and intermediate goods in the world market. For example, China's share of world trade has risen very rapidly from a negligible amount to 6 percent of total world trade by 2004.¹ China consumed 40 percent of the cement in the world, 7.5 percent of the world's crude oil and 25 to 30 percent of aluminum, steel, iron, and coal in 2003.² It accounted for all of the world's growth in demand for aluminum, copper, and steel in 2000-2002.³ Given the greater trade and financial integration of countries with China in the recent period, the decisions and policies adopted by China have repercussions beyond its borders, especially on Asian neighbors who are closely connected to it within a regional production network, producing goods for the global economy. China is increasingly seen as a conduit for trade from Asia to the rest of the world. As a production and export platform, China is able to draw from its vast pool of labor resources, and attract an enviable amount of about \$50B in FDI each year. In 2006, \$60B is expected to flow in. China has become an engine of intra-regional trade growth for the Asian region and is one of the major export markets of countries such as Korea, Taiwan, Malaysia, Singapore, the Philippines, and Japan. By 2002, China had displaced the US as Japan's largest source of inputs.⁴ The prices of many manufactured goods in world markets have declined because of competition from China, to the benefit of the global consumer. Its appetite has also pushed petroleum and commodity prices to levels unknown in recent history.

As regards its monetary framework and exchange rate policy, it seems that the Chinese authorities prefer to slowly evolve the status quo and are reluctant to seriously abandon the dollar peg. A great part of this reluctance is no doubt that this 'exchange rate-centered monetary policy' has served China well up to this point.⁵ Of course, there are those who argue that it is China's good fundamentals combined with capital controls rather than the dollar peg per se that

¹ Presentation by Eswar Prasad in IMF Economic Forum [2004].

² Presentation by Stephen Roach in IMF Economic Forum [2004].

³ McKibbin and Stoeckl [2003], p.1.

⁴ Ibid. Also Fabella [2002]; McKinnon and Schnabl [2004].

⁵ Eichengreen [2004], p. 24, discussing Goldstein and Lardy's 2003 proposal.

are responsible for its success. In any case, it is difficult to argue with success, especially in a region where the other large economy, Japan, which shifted to a flexible exchange rate regime and allowed its currency to appreciate under external pressure in the 1980s, reaped an economic bubble and subsequent stagnation and deflation from which it has only begun to recover. It is a good bet that adjustment will occur in “Chinese time”.

Recent statements from the Chinese authorities themselves recognize that, at some point, China may need to have a more flexible exchange rate regime. External pressures have been brought to bear on the Chinese authorities to revalue the RMB by a large amount, particularly from US officials and from the EU. Some scholars have suggested that the internal conditions in China today make it imperative for the authorities to consider an alternative to the dollar peg. Evidently, the Chinese authorities are torn between the need to be seen to respond to such pressures and their desire not to be seen as succumbing to external pressure on the exchange rate. Premier Wen Jiabao’s stated in May 2005 that, “Reform of the rate of exchange of the RMB is a matter of Chinese sovereignty. Any pressure or media coverage will not help resolve the problem.”⁶ On 21 July 2005, China abandoned the 11-year peg of the currency and allowed the RMB to rise by 2.1 percent to RMB 8.28: US\$1. Henceforth, the RMB is allowed to fluctuate within a narrow band. China also imposed quota (VERs) on its textile exports to EU in an effort to defuse some of the external pressure for a revaluation of the RMB. Very evident is China’s use of its reserves to make strategic purchases of Boeing planes at critical junctures, as well as gradual capital control relaxation. Hu Jintao is said to carry ammunition of \$16B for a shopping spree during his US visit.

It is difficult to see these recent moves by the Chinese authorities as being indicative of a serious desire to exit from the peg in the near future. Even if the official line is that China will eventually adopt more flexibility in its exchange rate regime, the timing, the extent, and the kind of regime it intends to segue into are unclear. Yet the answers to these have important implications on its neighbors and all who are economically connected to China.

The point has been made that a country’s optimal monetary policy is dictated by its economic reality. The monetary framework that China chooses for itself presumably puts more weight on the Chinese authorities’ perception of what is best for China. In the end, it is more likely that China’s own internal political and economic demands rather than external political and economic pressures will dictate the timing and course of action adopted. This perception is clearly a battleground in the coming years. China’s neighbors and all who are interested in what China is going to do need to put themselves in China’s shoes. China’s neighbors likewise have to consider what is in their best individual interests. Collectively perhaps rather than individually, the actions of China’s neighbors also have effects on China as well. Deciphering all these is important for China’s neighbors to be able to plan ahead and respond in a way that will allow them to mutually benefit. We examine the academic literature, writings of some scholars in the region, and conduct interviews with some government officials involved in regional economic issues to arrive at some possible answers.

This study will attempt to address several issues:

What appears to be in China’s best interest? What does this imply about the kind of monetary framework China should optimally adopt, and if different from the current system, the timing of its adoption? How about the interests of China’s neighbors? Is there a fair amount of mutuality of

⁶People’s Daily [2005].

interests between China and China's Asian neighbors? What does this imply about how China's neighbors might want China to act? Is there an emerging consensus among scholars and policy makers in the region about a new regional monetary arrangement given the increasing degree of economic integration between China and the rest of the region? What role would China play in such an arrangement?

We review the literature on the economic relations between China and the countries in the region or sub-groups of countries in the region, examine how trade patterns have shifted over time, the degree of complementarity or competitiveness of industries in these countries or sub-groups, the degree of synchronization of output growth of countries in the region and the effects, if any, of China's output fluctuations on those experienced by countries in the region or vice-versa. We then examine the implications of all these on the degree of mutuality of interests between China and her neighbors and how these might condition how China's neighbors want China to act.

Based on the writings of some scholars in the region about a new monetary framework for the region that we examined, we note that there are very few things mentioned explicitly about a role for China in a prospective new regional financial framework. Instead, these scholars mention the need to enhance regional financial integration by considering the adoption of some variant of a basket peg system, enlarging and possibly multilateralizing the Chiang Mai Initiative (CMI), greater and more meaningful regional surveillance, deepening capital markets in the region through initiatives such as the Asian Bond Fund (ABF), while putting the idea of forming a common currency area in the backburner for the moment. All of them agree that the latter is not politically feasible at this time.

Policymakers emphasize that the bottom line is this: the interests of countries in the region are better served by having China grow than otherwise. Two sub-points are related to this: First, East Asia cannot be regarded as a monolithic group. Different countries have different interests and these interests do not lie in one direction. Hence, East Asia may not speak with one voice as they are dissimilarly affected by China's actions. This has implications on the viability of a regional monetary arrangement based on a single currency or basket of currencies, or the need for homogeneity in monetary policy frameworks in general across countries in the region. A second point relates to why Asia has been largely quiet in the debate about the need for China to revalue etc. so popular in the US and the EU. From the political perspective, perhaps the US is already speaking on Asia's behalf, hence, many of the Asian countries see no need to incur the ire of a (large) neighbor; and/or because Asia will have more to lose economically, not only from incurring its neighbor's ire, but also because the revaluation of the RMB with a concomitant growth slowdown à la Japan in the 1980s is, on balance, expected to have adverse effects on the region.

China and East Asia: Mutual Interests

A major insight obtained from reading the literature or listening to the view of policymakers on the relationship of China and East Asia is that one cannot speak of East Asia as a homogenous group. There are countries that are favorably affected by China's rapid growth while others are less favorably affected. Growing trade and investment linkages with China mean that the fortunes of countries in Asia are more dependent on economic developments in China and this entails some degree of risk.

Ahearne et al. [2003] investigate the degree to which China's economy and those of its emerging Asia neighbors are complementary or competitive with each other. The trade patterns characterizing China and her neighbors have been shifting in the period between 1989 and 2002. Consistent with a 'flying geese' pattern, China and the ASEAN 4 (Thailand, the Philippines,

Indonesia, and Malaysia) have been displacing the NIEs in the production of products on the higher end of the value-added chain as the NIEs did the US previously, and have gained market share in the US market while the share of the NIEs has fallen. China's share of exports to the US from the three groups doubled while that of ASEAN 4 also increased. The NIE share dropped from 59% to 44%. Between 1993 and 1997, the shares of both China and the ASEAN 4 increased at the expense of the NIEs. In 2000 to 2002, China's share grew from 40% to 49% at the expense of *both* ASEAN 4 and the NIEs. Thus, it is in the most recent period that degree of competition between China and its Asian neighbors has intensified.

Zhang and Zhang [2005] use a panel data analysis on China's 37 manufacturing industries over the period 1991-2002 based on the Solow-Swan growth model and find negative correlations between China and its neighboring countries, both NIEs and Southeast Asian developing countries. This suggests a more competitive rather than complementary relationship between China and these country groups. The main source of China's strong competitiveness in these industries, however, stems mainly from increasing total factor productivity, particularly increasing labor productivity, rather than the level of the exchange rate. Zhang and Zhang's findings are compatible with those of Ahearne et al. [2003] at the industry level. According to the latter, at the industry level, China and ASEAN 4 are comrades to a weaker degree than previously found overall. Eichengreen, Rhee, and Tong [2004] point out that China's exports tend to crowd out the exports of labor-intensive consumer goods in major markets for consumer goods and hence, tend to be competitive with less-developed Asian neighbors. Nevertheless, Ahearne et al. show that cases in which the export shares to the US of both China and countries such as the ASEAN 4 increased are equally likely as cases in which they both declined.

Some studies, such as Heferker and Nabor [2004], also find that China's trade patterns and those of the NIEs are complementary at the moment but competition is expected to increase as China's exports rise along the value-added chain. China appears to be the increasingly dominant player. Zhang and Zhang report that China's export share rose in 42 industries while that of the NIEs only showed increases in five industries between 1989 and 2002. Be that as it may, China has become important as a production center for the NIEs and has increased NIE exports of intermediate products to China for processing and export elsewhere. China imports mostly capital goods from its NIE neighbors (and raw materials from the less developed Asian neighbors). There is also a great deal of mutual benefit between China and the NIEs who are shifting production to China to take advantage of lower costs there.

Indeed, the surging imports by China are perhaps even more important than its exports. Net FDI into China comes from Japan and other Asian countries from which China imports goods.⁷ It has been pointed out, as was observed about S. Korea's surplus with the US, that China's bilateral trade surpluses with the US and the EU have been matched by increasing trade deficits that China runs with other Asian countries.⁸ Eichengreen, Rhee, and Tong [2004] point out that China's exports have not adversely affected the share of capital goods exports by more advanced economies in Asia, i.e., the NIEs, in which machinery and equipment are a significant factor of exports. In 2003, for example, 43 percent of Japan's export growth was accounted for by China, as was 45 percent of Korea's, 68 percent of Taiwan's, compared with 21 percent of the US' and 28 percent of Germany's.⁹

⁷ Rajan and Subramanian [2004].

⁸ Presentation by Eswar Prasad, IMF Economic Forum, op. cit., [2004].

⁹ Presentation by Stephen Roach, IMF Economic Forum, op. cit., [2004].

The fact that the exports of China and those of some Asian countries, viz., NIEs tend to move together suggests that common factors, such as growth in major trading partners, world prices of key exports such as semiconductors etc., rather than competition with China drive exports. Indeed, a variance decomposition of real export growth in Ahearne et al.'s [2003] study shows that income effects rather than relative price effects account for a larger percentage of the variance of real export growth. Specifically, over the last two decades, income growth in major trading partners has been the primary driver of export growth for the major Asian exporters. Changes in the level of the RMB such as, say, a small revaluation, for example, may not be sufficient to overcome the effects of important common factors as well as fundamentals such as increasing total factor productivity that drive real export growth.

Eichengreen and Tong [2005] point out that greater investment in Asian countries like Singapore and Indonesia is encouraged by growing FDI to China as they are part of a global production network and are suppliers raw materials and intermediate goods to China. Beyond Asia, this seems to be the case with Latin America as well due to China's demand for raw materials from that region. But the DFIs are more likely to be extractive and de-industrializing.

Increasing economic integration, particularly growing intra-industry trade between China and her neighbors, is expected to give rise to more synchronized business cycles. The Optimum Currency Area (OCA) theory suggests that this would make countries less reluctant to give up an independent monetary policy and form a monetary union unless they want to respond idiosyncratically to common shocks for their own reasons. It also limits the viability of resorting to beggar-thy-neighbor policies.¹⁰

McKinnon and Schnabl [2003] find evidence of a common business cycle in the smaller East Asian countries using data for the period 1981-2001. The evidence is stronger for the group including Hong Kong, Indonesia, Malaysia, Korea, Singapore, and Thailand, and to a lesser extent for Taiwan and the Philippines. Japanese output changes have a significant impact on the output of Hong Kong, Indonesia, Korea, Taiwan, and Thailand, while the business cycles of the Philippines and Singapore do not seem to be linked to Japan's. They find that China's business cycle seems to be relatively uncorrelated with those of other countries in Asia. Output fluctuations in the US, Japan nor the other East Asian countries do not significantly influence output fluctuations in China and conversely.

Gochoco-Bautista [2005] estimates the common component of output growth of the original ASEAN 5 + 3 countries using a methodology due to Lumsdaine and Prasad [2003] and monthly industrial production growth from 1994 to 2004. The results are similar in some aspects to those obtained in McKinnon and Schanbl's [2003] study. The actual growth rates in industrial production in each country exhibit a positive correlation with the common component in all cases. Japan, Korea, and Singapore's correlations with the common component, 0.55, 0.53, and 0.54, respectively, are the largest and reflect their higher average weights in the construction of the common component. The Philippines has the lowest correlation with the common component, 0.16, and in some way reflects findings elsewhere that this country is somewhat of an outlier in the region. While the graphs of cumulated actual growth in industrial production in each of these countries generally display a similarity to the graph of the cumulated common component of industrial production across countries, Japan's graph is the most similar to the cumulated common component. McKinnon and Schnabl's [2003] study suggests that China seems to be relatively immune from exogenous shocks originating abroad. China's graph of the

¹⁰ Of course, if the countries compete in third country markets, the temptation to use a beggar-thy-neighbor policy would not be eliminated.

cumulated output growth in Gochoco-Bautista [2005] is very different from that of the cumulated common component for the region. Of course, part of this may be due to data quality which is rather severe in China's case.¹¹ McKinnon and Schnabl [2003] explain that China's being seemingly immune to external shocks may be because China is a large continental economy whose degree of openness to trade in goods and services is only beginning to increase and whose capital controls still continue to insulate it from shocks abroad. Since their study uses data only up to 2001, this is entirely possible. The earlier evidence from other studies seems to indicate in fact that China's significantly more important role in the region and the world is of more recent vintage.

In contrast with McKinnon and Schnabl's [2003] findings that the fluctuations of the smaller East Asian countries have no measurable impact on China business cycle and vice-versa, however, Gochoco-Bautista [2005] finds a significantly positive coefficient on the common component of output growth in a regression explaining China's industrial production growth. This means that common output movements in the ASEAN 5 + 3 affect China's output growth. While the common component of output growth likewise significantly affects Japan's output growth as well, the size of the coefficient on the common component in the China regression is much larger than that in the Japan regression. This would seem to imply that in the more recent period, at least including data beyond 2001, China and the ASEAN 5 + 3 region affect each other to a greater degree than do the ASEAN 5 + 3 region and Japan.

Girardin [2005] uses quarterly data over the 1978:3-2002:4 period and examines the similarities of GDP growth cycles in ten East Asian countries including China's using Markov regime-switching techniques. During growth-recession regimes corresponding to negative growth rates in all countries except China, the growth cycles of Japan, Korea, and Taiwan, i.e., the NIEs, are similar to China's although the latter's mean growth is much larger than those of the NIE countries. China's economy evidently belongs to the NIE club. Hence, its growth may tend to be more complementary with those of the smaller countries in the region rather than with the NIEs. Indonesia and Malaysia experience sharply negative growth rates, while moderately negative growth rates prevail in Thailand and Singapore. Under a normal-growth regime of between one and two percent per quarter, China's mean growth is about the same as growth in the rapid-growth regime in other countries, except the Philippines whose growth rates are lower.¹² In the rapid-growth regime, China and Hong Kong experience accelerated growth, Singapore and Thailand experience rapid growth, and the Philippines experiences moderate growth. These results suggest that growth in China is good for countries in the region as it is largely accompanied by growth in the neighboring countries, although the others do not grow at the same relative rates.

Girardin finds that East Asia's contemporaneous correlations of smoothed probabilities with China have been much stronger than with Japan during growth-recessions, while during rapid growth periods, the countries which were correlated with Japan in the 1980s have become linked with China in the 1990s. Over the entire sample period, the contemporaneous correlations of smoothed probabilities of the growth-recession and rapid-growth regimes show that China is

¹¹ A consistent and long time series on industrial production growth for China is not available. In large part, this is because the industries surveyed change in different periods.

¹² As has perhaps become apparent by now based on earlier findings, the Philippines tends to be somewhat of an outlier in the region in terms of growth rates. It is also less connected to China in terms of trade and being part of a regional production network than its neighbors. The US remains its major market and political ally.

substantially correlated with both Indonesia and Thailand, and is also correlated with Hong Kong, Korea, and Malaysia. Singapore and Taiwan are correlated with Japan. In the 1990s, however, all countries correlate more with China than Japan with the exception of Taiwan. During rapid-growth regimes, China is correlated with South Korea and Thailand. Since the 1980s, there has been a shift away from Japan towards China for countries like Indonesia, Singapore, and Thailand.

Girardin runs a regression of the probability of growth-recession in China on the probability of the same regime in another country using a measure of cycle independence by Harding and Pagan. He finds that for the entire sample period, independence vis-à-vis China can be rejected for Hong Kong, Indonesia, and Thailand while in the 1990s, it cannot be rejected for all countries except Korea, the Philippines, and Taiwan. By and large, therefore, a majority of the economies in the region are connected to China. The finding that cross-country correlations obtained are larger during growth-recession regimes compared with those obtained during rapid-growth regimes is important as it implies that any deceleration of growth in China will hurt its neighbors more than an acceleration of growth in China will help. Both China and its neighbors thus have reason to be very concerned about anything that affects China's growth, more particularly, anything that would lead to a deceleration of growth in China.

In general, therefore, there is a fair amount of shared interests between China and her neighbors. While China has been making great strides in world markets, it has not been completely at the expense of her neighbors, certainly not of the smaller emerging countries in the region. Overall, China and the non-NIEs in the region have a fairly complementary relationship. Greater intra-industry trade and investments to and from China have led to similar effects and higher growth in countries in the region to varying degrees. Indonesia and Malaysia have benefited from higher oil and other commodity prices. Thailand and Vietnam benefit as food (rice) exporters. As China belongs to the NIE club, there is less complementarity between China and the NIEs in the production of goods at the higher end of the value-added chain, than between China and the other economies in the region. Nevertheless, from a global production standpoint, China is an important buyer of intermediate inputs from the regional NIEs as well and therefore, they have mutual interests. The smaller Asian countries will find it harder to move up the value-added chain particularly in the manufacturing sector.

China's comparative advantage arises from her vast pool of low-cost but adoptable labor resources and rising total factor productivity. To a certain extent, the story of China maintaining a deliberately undervalued RMB and using a mercantilist policy to corner the world export market is exaggerated. The greater degree of trade integration, particularly through intra-industry trade, has given rise to more synchronous business cycles among China and her neighbors. Studies show that more recently, China is increasingly affecting and being affected by fluctuations in output growth in the region, in contrast to the earlier period in which Japan was the single most important economy in the region. Furthermore, there are indications that a deceleration of growth in China would hurt its neighbors more than an acceleration of growth in China would help. Apart from recognizing the increasingly important role of China in the region, and the possible repercussions of China's actions on the region, countries in the region seem to be more apprehensive about a deceleration of growth in China.

A New Monetary Framework for the Region?

In the face of more recent economic realities in the region such as greater intra-industry trade, more synchronous business cycles, complementary export growth etc. that indicate and increase the degree of economic integration, it would seem that a new monetary framework for the region is an idea whose time has arrived. In 2003, the ASEAN Secretariat commissioned two sets of

studies by scholars/research institutes from the region to examine (1) the current process and future prospects for regional financial and monetary cooperation and (2) different proposals for regional exchange rate arrangements. The reports were presented at an ASEAN + 3 Research Group Workshop and Meeting at the Asian Development Bank in March 2004. The various researchers and institutes involved in (1) included Danareska Research Institute (DRI Indonesia), Korea Institute for Economic Policy (KIEP), the Thailand Development Research Institute (TDRI), and the Institute of World Economics-Chinese Academy of Social Sciences (IWE-CASS), with Institute for International Monetary Affairs (IIMA Japan) as the lead institute. Those involved in (2) included the Korea Institute of Finance (KIF), Malaysian Institute of Economic research (MIER), Professor Tan Kim Song of Singapore Management University, UPECON Foundation (Philippines), and IWE-CASS, TDRI, with Japan Center for International Finance (JCIF) as the lead research institute.

Under the regional financial architecture theme (1), the existing financial architecture in the ASEAN + 3 framework is first reviewed. All of the studies note the developments under the Chiang Mai Initiative (CMI) and the existing state of the ASEAN Surveillance Process. Although the CMI process is appreciated, IWEP-CASS states that CMI lacks a clear vision and objective, while KIEP is cautious about the prospect of developing CMI into a full-fledged regional financial organization. All the studies suggest a strengthening of the surveillance process in ASEAN + 3. The IIMA proposal is for the surveillance process to be patterned after the G-7 and OECD processes. IIMA, TDRI, and IWEP-CASS see the importance of the development of the Asian Bond Fund to reduce currency mismatch problems, deepen and help capital market development, and help prevent future financial crises.

Ways to deepen regional financial integration include trade and financial macro integration, domestic financial reform, and institutional harmonization in terms of collection of statistics, banking and capital market supervision, and real sector harmonization. The IIMA study presents empirical evidence that suggests that the original ASEAN countries and Korea would be a good candidate for a common currency area with a common currency basket as the anchor currency. It is interesting to note that this proposal does not include China explicitly and gives no special or anchor role to the RMB. TDRI expresses concern about global imbalances and the need to bring about adjustments. Seeing that most of the world's foreign exchange reserves are held by East Asian economies, TDRI proposes careful management of these financial resources because the global financial system could be destabilized otherwise. While obviously China is indirectly referred to because it does hold most of the world's foreign reserves today, the proposal does not mention China explicitly nor map out exactly what role China might have in trying to resolve global imbalances.

DRI and IWEP-CASS mention the need to improve and strengthen domestic financial systems in individual countries in Asia as these would form the basis for a stable regional economy. The IIMA points to the goal of "full financial integration as a medium-term objective for the region", "requiring financial and capital account liberalization on the part of all ASEAN + 3 members."¹³ Again, the two obvious countries being referred to, China and Malaysia at least, are not explicitly mentioned, although it appears that this position is not necessarily shared by the other research institutes/scholars.

The proposal for a new regional financial architecture includes strengthening the ASEAN + 3 process, creating a new regional financing arrangement, issues regarding exchange rate policy

¹³ IIMA [2004], p. 5.

coordination, and a long-term vision toward an East Asian economic community and monetary union.

DRI and KIEP propose the possibility of reserve pooling in the future to ensure that sufficient resources are available in the region for investment, to stave off crises, and as a way to go beyond CMI. Again, although China and Japan are not explicitly mentioned, the presumption is that any such proposal is really directed at them. However, beyond proposing a newly-created ASEAN + 3 Secretariat as the institution to handle this, it is unclear exactly what the role of China and Japan would be in such a scheme beyond being willing to surrender a lot of foreign reserves. The same applies to the KIEP proposal to increase the number and amounts of bilateral swaps or the TDRI and IWEP-CASS proposals to increase the size of liquidity support of CMI.

IIMA explicitly proposes exchange rate coordination through policy dialogues and surveillance over their individual exchange rate policies. Specifically, IIMA would like countries in East Asia to “stabilize the exchange rates against a G-3 currency basket (the US dollar, the euro, and the Japanese yen) because they have strong economic relationships with not only the United States but also Japan and the EU.”¹⁴ This is seen as helping to resolving what IIMA regards as a “coordination failure” with respect to exchange rate coordination in the region. Glaringly absent is any mention of China or any role for the RMB in the basket.

TDRI sees maintaining the yen/dollar within some band and the greater utilization of regional currencies for transactions within the region in the meantime that a common peg or common currency is not realistic. Neither proposal mentions China or the RMB explicitly. IWEP-CASS likewise mentions a desire for a greater of intra-regional exchange rate stability, but sees a cost to shifting to a common exchange rate arrangement, especially in countries in which sophisticated financial markets are absent.

Under the forms of regional arrangement theme (2), the summary report first notes that there are diverse exchange rates prevailing in East Asia currently, with differences in the way individual regimes are categorized on the one hand, and the way exchange rate policy is actually implemented in individual countries. The report also states that, “To complicate matters still further, the exchange rate framework has recently been associated with a monetary policy framework.”¹⁵ This statement is intriguing since it would seem that economists tend to view the choice of a country’s optimal exchange rate regime in the context and not independent of a monetary framework that serves as a credible anchor. Otherwise, it may be difficult for the authorities to resist conducting monetary policy in a way that does not allow the breaching of rules compatible with the chosen exchange rate regime. In any case, one might ask if there might be anything seriously wrong or discomforting with the current system of having different exchange rate systems in East Asia.¹⁶ Given the initial statements from the report cited above, one can infer that JCIF has some level of discomfort with the current exchange rate systems prevailing in East Asia, similar to the position of IIMA mentioned earlier regarding “coordination failure” in East Asia.

All the studies under this research theme agree that it is currently both politically and economically infeasible to establish a monetary union in East Asia, a point made by policymakers

¹⁴ Ibid., p. 9.

¹⁵ JCIF [2004], p.i.

¹⁶ Of course, as pointed out earlier, others, such as McKinnon, for example, see East Asian countries as following a de facto peg, rather than having different exchange rate regimes.

we interviewed as well. There are two conflicting aspects: economic integration and economic diversity in East Asia currently. Nevertheless, all the studies see regional monetary union as a goal worth attempting to reach in the long run. In view of this, most of the studies make proposals for an interim exchange rate arrangement, emphasize that the current policy dialogue and financial markets be strengthened, in order to reach a level of East Asian economic intensity that will “ultimately need exchange rate coordination.”¹⁷

IWEP-CASS proposes the formalization of exchange rate policy dialogue and information exchange first, followed by the announcement of regional exchange rate stability as a policy objective in the region, the establishment of regional financial integration arrangements and a regional investment bank. There is no specific proposal regarding how to promote exchange rate stability beyond announcing it as a regional policy objective.

MIER agrees with proposals for a basket currency peg system with varying weights on the euro, dollar, and yen, to limit exchange rate volatility. Similar to the previous proposals for a basket peg enunciated by the two Japanese research institutes, the proposal does not explicitly include China or a role for the RMB in the basket. In addition, the MIER proposal calls for consultations among countries especially with respect to macroeconomic policies. We are unsure about how deeply committed countries in the region are to public discussions of their individual macroeconomic policies, although this is clearly necessary to strengthen the regional surveillance process.

In contrast to the previous proposal, Professor Tan Kim-Song of Singapore is skeptical of proposals for a common basket peg because of the difficulty of defending the peg and having shared policy objectives among countries such as stability in the real exchange rate, which may come in conflict with individual country considerations such as inflation targets, debt repayment, etc. He suggests that East Asian countries take a loose approach towards exchange rate coordination, build up supporting institutions first, and adopt something like Singapore’s managed float within a band in the interim period. His is the only proposal that talks of the need to have a leader in the region.

The KIEP and UPECON proposals are similar. The KIEP proposal is the adoption of a wide array of floating exchange rate arrangements by countries in the region to be followed by sub-regional monetary union based on OCA criteria, and finally, assimilation of the various monetary sub-unions. KIEP cites Korea’s own experience after the Asian Crisis of 1997 when it shifted to a floating exchange rate regime. While there were some negative effects initially, such as a decline in the investment by firms, there have been more beneficial effects. These include the use of monetary policy for internal balance purposes, and the reduction in extraordinary exchange rate movements in the post-crisis period. Hence, the KIEP proposal is akin to open economy inflation targeting. Note that the proposal is for individual countries to adopt a monetary framework that addresses their internal concerns first, in tandem with more flexibility in their exchange rates, and only subsequently and when more of the OCA criteria are fulfilled, should sub-regional monetary unions formed. Also, exchange rate stability is an outcome rather than being part of the operational aspects of the policy process.

The UPECON proposal is premised on the idea that a country’s exchange rate policy must be compatible with its monetary framework. Because a country’s monetary framework is relative to its economic reality, an inflation targeting monetary strategy combined with a more flexible

¹⁷ JCIF [2004], op. cit., p.viii.

exchange rate policy in individual countries is a good starting point for a regional monetary framework. By allowing countries to pursue their national interest and concerns explicitly first and foremost, monetary policy has a greater chance of delivering desired results. Such will contribute to regional economic stability and greater convergence in important variables such as inflation rates and rates of output growth. As more of the OCA criteria are fulfilled, the idea of a regional monetary union becomes more politically and economically viable.

It is apparent that there is no unanimity among the different scholars/research institutes in the region about whether the fact that there are different exchange rate systems in the region currently is a problem, whether there is a need for an interim regional exchange rate arrangement, and if so, the form of such an exchange rate arrangement. No explicit mention is made of China's or the RMB's role in proposals for a new regional exchange rate system. Some of proposals pointedly do not include the RMB but include the currencies of Japan, the US, and the EU.

Some senior officials involved in the ASEAN+ 3 Finance Ministers dialogue process whom we interviewed said that proposal for an ASEAN common currency that was made at the 1998 ASEAN Summit Meeting was "buried in Jogjakarta in 2005." In other words, at the policymakers' level, nothing like a full monetary union is currently being seriously discussed. Such topics are seen as being politically and economically infeasible at the current time. Discussing it without the political will to take meaningful actions to effect it, according to officials interviewed, could actually delay the process and the attainment of monetary union in the region in the future. Hence, officials focus on less contentious things, such as the development of the Asian Bond Fund which was an initiative of the region's central bank governors through their group called EMEAP, and others that incrementally push forward the agenda of greater financial and economic integration.

What this suggests is that discussions about a new regional financial architecture or a regional monetary and exchange rate arrangement are largely academic in nature, with the notable exception of Japan, in which the topic is discussed by policymakers and academics alike.

What Should China Do?

For the Chinese authorities and scholars as well, the answer to this question lies in their perception of what is in China's interest. At the moment, the Chinese authorities are facing increasing pressure from certain US and EU officials, in particular, to revalue the RMB. A lot has been written about this in the literature and popular press, how it may or may not be in China's interest to do so, and to a lesser extent is the question of how this may affect China's neighbors in the region. Another perspective from the literature is that what China needs to do is not simply to change the level of the exchange rate, but instead, to adopt an entirely different exchange rate regime. Others assert that China should continue to maintain the fixed peg. While there are different suggestions made, almost all the studies have as their basis the idea that China's interest must be seen from the reality of China's internal political and economic conditions.

The rationale for China to undertake a revaluation of the RMB and by how much differs depending on where the suggestion to revalue is coming from, and the reason why a revaluation would be in China's interest. The demand by certain US officials for China to revalue by a large amount, i.e., in excess of 20 percent, for example, seems to be largely driven by domestic political considerations in the US. The US (and the EU) run very large trade deficits vis- a-vis China, with

data for the US showing a trade deficit against China in 2004 of about US\$162B.¹⁸ The phenomenon of outsourcing and the supposed loss of American jobs to the Chinese have become more politically hot recently, especially in the face of upcoming congressional elections in the US this November. The intellectual support for this position comes from those who see China and the US in some type of “Revived Bretton Woods” system.¹⁹ This system says that China’s strategy is to deliberately undervalue the RMB and accumulate massive dollar reserves by drawing out its vast pool of cheap labor from the countryside (140 M workers with about 11 M added each year) while attracting FDI and furthering its own industrialization. Others see China’s massive dollar reserves (over US\$860B based on the latest information) as being at the heart of the world’s global imbalances, presumably because of China’s mercantilist policy and hence, China is obligated to participate in the solution.

There are some problems with these positions. As Obstfeld [2005] points out, it does not make sense to argue that China’s participation in such a “Revived Bretton Woods” system underlies the US deficits for as long as the world is willing to lend to the US. Many likewise put forth the position that revaluing the RMB will not solve the trade deficit of the US (or EU).²⁰ There are several reasons for this: The problem of the US is a structural one of an imbalance between saving and investment in the US which revaluation of the RMB against the dollar cannot solve; and China accounts for only about 10 percent of US total trade (and only 3 percent of EU total trade). Hence, even a drastic 50 percent revaluation of the RMB against the dollar would only reduce the dollar’s effective value by 5 percent.²¹ Furthermore, US, Japanese, and European companies that rushed to outsource in China will be hurt by higher costs arising from the RMB’s revaluation. Evidently, 70 percent of Japanese firms and 50-60 percent of US firms believe that they would be hurt by RMB appreciation.²² In 2004, 57 percent of China’s total exports were accounted for by foreign-invested enterprises, compared with only 15 percent in 1990.²³ The inflation in the US, already under pressure from the war spending in Iraq, would worsen. Stiglitz, for example, estimates that a 10 percent revaluation of the RMB would raise the cost of US imports by about 3 percent.²⁴ Inflation rates in countries that buy goods made in China would rise and the global consumer would be hurt. It seems that very few scholars believe that a revaluation is in China’s interest. Even though there are many scholars who believe that the RMB is undervalued, a shift to more flexible exchange rates in which the RMB would naturally appreciate rather than a revaluation under a peg is generally favored.²⁵

Numerous scholars, and Chinese authorities themselves, do not believe that a significant revaluation is in China’s interest. The magnitudes of desired revaluation vary depending on the proponent, but generally, any rate under 20 percent is considered “moderate.” The fact that the Chinese authorities revalued initially by 2.1 percent basically says that they do not want to revalue the RMB. Instead, their current game plan seems to be to find ways to stay the course while placating those in Washington and others who insist on revaluation by engineering only a

¹⁸ See, for example, Greenspan’s [2005] comments.

¹⁹ Dooley, Folkerts-Landau, and Garber [2003].

²⁰ Greenspan [2005], op. cit.; Henke and Connolly [2005]; Stiglitz [2005].

²¹ Laurenceson [2005], p. 4.

²² See Sakakibara’s [2003] comments.

²³ Laurenceson [2005], op. cit., p. 3.

²⁴ See Stiglitz’ [2005] comments.

²⁵ Frankel [2005].

symbolic revaluation and promising further incremental changes, as well as offering other substitutes like putting VERs on textile exports from China.²⁶ The strategic timing of commercial airplane orders bears this out.

The basic rationale of those against a revaluation of the RMB is that it would be bad for China. By extension, this would be bad for China's neighbors and all those who depend on China's prosperity for their own prosperity. Mundell, on many occasions, has vigorously stated that a substantial revaluation of the yuan would cut FDI to China, cut China's growth rate, delay convertibility, increase bad loans, increase unemployment, cause deflationary distress in rural areas, reward speculators, set in motion more revaluation pressures, weaken the external role of the yuan, undermine China's compliance with WTO rules, and destabilize Southeast Asia. In other words, a significant revaluation would lead to severe deflation in China. Given the rapidly increasing economic integration of East Asia with China, maintaining the status quo which allows China to grow is beneficial to East Asia as well.

What are realities of China's internal economic conditions? What are the challenges that it faces? Despite all the strides China has made economically, it is still a country with a tremendous amount of rural poverty, growing income inequality between the rich and the poor which tends to dramatically increase social tensions, low domestic consumption (54 percent of GDP in 2003, which is very low for a major country)²⁷ and an imbalance between consumption and investment, large investment inflows but mostly of the speculative kind that have created booms in the non-tradeable goods sector such as real estate, a banking system saddled with huge NPLs that will cost, by some estimates, the equivalent of nearly 50 percent of GDP even as about US\$ 500B has already been spent by government to try to clean up the NPLs²⁸, an economy that is overheating with inflation on the rise as foreign exchange reserves build up faster than authorities can sterilize capital inflows given the shallowness of financial markets, etc. In short, China is a large, poor country with an overheating economy.

How would a significant revaluation of the RMB likely affect China's internal conditions? A significant revaluation of the RMB would severely hurt the vast majority of the poor in the rural areas by encouraging the importation of agricultural output which they produce. It would make it difficult for the poor farmers to find work in manufacturing in urban areas because wages would increase and discourage foreign investments in manufacturing. This would exacerbate income inequality and raise social tensions. It would further lower domestic consumption. Speculators betting on a revaluation will be rewarded. Depending on what happens to capital controls, this encourages more speculative capital to come in, inflation will be more difficult to tame as base money further increases even though a revaluation may also temper inflation by making domestic goods more expensive. The prospect of bubbles in the non-tradeable goods sector with the revaluation with such speculative inflows will worsen and reduce flows to or divert flows away from the tradeable manufacturing goods sector. Recall that the yuan devaluation in 1994 defused emerging bubbles then. This is the real danger.

²⁶ Interestingly, the Bank Paribas [2005] study suggests that China may be offering VERs on textiles to shift attention away from electronic goods that constitute a much larger proportion of its exports compared with textiles.

²⁷ Presentation by Stephen Roach, IMF Economic Forum, op. cit., [2004].

²⁸ This was pointed out by Guonan Ma during his presentation at the Asian Economic Panel Meeting in Seoul in March 2006.

Substantial revaluation would hurt foreign investors, including many US companies that outsourced to China, but will now face higher costs of producing there. If export growth were to slow down, the volume of FDI would also slow down. Revaluation would worsen the NPL problem, as credit is likely to be misallocated, and thereby undermine the stability of the banking system. In other words, the Mundell scenario. A significant revaluation of the RMB is a different story. Park's [2005] simulation shows that a 20 percent or greater appreciation of the RMB against the dollar risks a hard landing for China as output is nearly halved. Mundell estimates that a yuan appreciation by 40 percent will cause economic growth in China to decline by 5% or even lower and aggravate NPL problems.²⁹ Eichengreen [2005] foresees that rising unit labor costs will induce a faster shift away from the production of unskilled, labor-intensive goods into the production of goods such as finished capital goods in which labor costs matter less.

Indeed, the only seeming "benefit" to a sizeable revaluation of the RMB is the cooling down of the economy by deflation. Faced with a tradeoff between cooling down an overheating economy to worsening poverty and income inequality, bad loans etc., the Chinese authorities clearly have a delicate balancing act to perform internally. It is not surprising that they are hesitant to do anything drastic that may lead to massive dislocations in the economy. To the extent that China's neighbors understand that they are dependent on China's prosperity for their own, they are sympathetic with China's status quo position.

How might a moderate revaluation of the RMB affect China? McKibbin and Stoeckl [2003] and Park [2005] use their own forecasting models to examine the effects of a 10 percent revaluation of the RMB on China. McKibbin's G-cubed model finds essentially very little change in China's current account since China's saving-investment balance does not change much. Effects are generally confined to the short-term, such as cooling off of the economy and lower rates of inflation. However, this revaluation has little impact on long-run variables. Similarly, Park [2005] using the Oxford Forecasting model, finds that a 10 percent revaluation of the RMB would suppress inflation and cool the Chinese economy. Hence, both models see cooling the Chinese economy as the main effect of a moderate RMB revaluation against the dollar. Both models show that a moderate revaluation will have very little impact on China's external account balance. Its effects on price competitiveness of Chinese exports will be low because of the structural reasons for low production costs in China. Eichengreen [2005] suggests that the large imported-input component of Chinese exports would result in a small impact on exports if the RMB were to be revalued.

How might a moderate revaluation of the RMB affect China's neighbors? The same models above can also be used to examine the effects of a 10 percent revaluation of the RMB on China's neighbors. Assuming that the other Asian countries are essentially following their current exchange rate regimes, McKibbin's G-cubed model finds small changes in the total exports of the neighboring countries given changes in real exchange rates; Taiwan's currency depreciates and picks up export share as China's expense; Hong Kong loses competitiveness and exports relative to China. There are few repercussions on net trade or capital flows for China's neighbors, although their currencies depreciate initially by small amounts. This is compatible with the views of officials we interviewed about the likely effects of a moderate revaluation of the RMB on them. Park finds that a revaluation of the RMB induces an appreciation, albeit very small amounts, of the other Asian currencies. China is able to buy more from its neighbors but a reduction in China's growth would also constrain import demand. Countries that have complementary endowments and strong trade links with China will experience a fall in net exports and slower

²⁹ Mundell, quoted in People's Daily, November 4, 2005.

income growth. The converse case applies. For some countries like Indonesia and Thailand, and those whose goods compete with China in export markets, domestic investment is encouraged as their export competitiveness is enhanced.

Eichengreen [2004] points out that a stronger RMB induces China to move up faster along the value-added chain and away from the production of less unskilled labor-intensive goods. This means that the more advanced neighboring countries will face a greater imperative to move up the technology ladder as well. If they are unable to attract foreign investment or are fiscally-constrained to invest in human and physical infrastructure, then they will be unable to do so. The advanced countries in the region, the NIEs, who compete with China will feel positive effects in the short-run but rising negative effects. Meanwhile, the less developed countries in the region such as Vietnam, Cambodia, and Laos, and others such as Sri Lanka, Bangladesh, and Pakistan, who compete with China in the production of unskilled, labor-intensive manufactured goods, will benefit as China's unit labor costs rise and China veers away from producing such types of goods. In short, a strengthening of the RMB against the dollar has uneven effects on different countries and their ability to move up the tech ladder in the production of higher value-added goods. If they feel unprepared to meet this challenge because of their own internal constraints and because of China's enormous natural advantages to begin with, they will also prefer that China maintain the status quo.

It appears that very few academic economists think that a revaluation of the RMB is welfare-improving from China's perspective. At the same time, the debate has shifted to whether China should maintain the peg or shift to a more flexible exchange rate regime. Here there appears to be some uneasy consensus: China should shift to a more flexible exchange rate regime. Frankel [2005], for example, points out the benefits of a flexible exchange rate regime in helping China attain its internal goals: cooling down the economy and ease inflationary pressure; it has sufficient dollar reserves and does not need to acquire more US treasury securities that do not pay much if it does not have to sterilize large capital inflows; easier to achieve adjustment via a change in the exchange rate rather than price flexibility; a good time to exit from the peg when times are good, plus the usual argument for flexible exchange rates which is that it allows for the operation of an independent monetary policy to address internal problems, that it shields the economy from external shocks, and that it prevents speculative capital inflows due to a one-way bet.

On the other hand, Mundell takes issue with those who preach the virtues of flexible exchange rates as: having lost sight of the unit of account property of money; misunderstanding the adjustment mechanism under fixed exchange rates or between different regions of the same country; neglecting the costs of exchange rate fluctuations; an inability to identify a common currency area; and believing in the myth that it automatically gives monetary authorities an extra degree of freedom.³⁰ Others point out that China does not suffer from the "irreconcilable trilemma" of capital mobility, a fixed exchange rate, and independent monetary policy since it has maintained a closed capital account. Although there may be some increasing porosity in the capital account over time, this has not prevented the maintenance of the peg in China. Also, as mentioned earlier, the peg has served China well and this is in sharp contrast with Japan's experience.

Eichengreen [2004] proposes that the question be viewed not as a debate between the relative virtues of fixed versus flexible exchange rates, but rather, a question of what the goals of

³⁰ Mundell's speech in Busan, South Korea in October 2005.

monetary policy in China are. Here he recognizes the need for the Chinese to look inward and find a monetary framework that addresses their internal needs rather than focus on the exchange rate regime per se. As an alternative to a so-called exchange-based monetary framework, he suggests a form of open economy inflation targeting in which monetary policy is used to attain inflation and growth targets, and a very heavily managed float, in which intervention is used to limit exchange rate fluctuations, which may adversely affect the attainment of inflation and growth targets. The inflation targeting part is very familiar to countries in the region that have recently adopted inflation targeting as a monetary framework, including the Philippines.³¹ Eichengreen does not suggest rapid liberalization of the capital account in China. His views on this agree with other scholars who suggest that China go slow on capital account liberalization so as not to undermine the ability of authorities to better control the monetary base and contain inflation while reducing the temptation to misallocate credit and worsen the state of the banking system.

While his suggestion makes sense, it is unclear when the authorities in China will see it his way. They seem to worry a great deal, in particular, about the sorry state of the banking system, which could explode if the RMB's tendency to appreciate is allowed under a more flexible exchange rate regime. Hence, they seem to be waiting for the right conditions to emerge inside China, i.e., substantial progress on cleaning up the NPLs and strengthening institutions and regulatory supervision etc. before taking this big leap. In other words, the timing of any change to the monetary framework and exchange rate regime is conditioned on a satisfactory reading by the Chinese authorities that the internal conditions are ripe for such a change. That of course is a very difficult thing to figure out, and perhaps even the authorities in China do not know when this will come. But they do think that today is not the time. Eichengreen points out that delaying the adoption of a more flexible exchange rate regime in China will also tend to induce more expectations of currency appreciation, which will fan greater speculative capital inflows. But the specter of the Japanese bubble and subsequent stagnation will not go away easily.

CONCLUSION

Sufficient mutuality of interests between China and East Asian neighbors exists but East Asia is not a monolithic group so uneven effects on them will ensue from anything that China does.

China's interests defined from her internal conditions will drive her actions. China views herself as poor and in a catch-up orbit and the NIEs continue to be its plausible role models. East Asia understands this and therefore some sort of tacit agreement is implicitly at work.

Scholars in the region have no unanimity as far as a regional financial architecture is concerned. The same goes for regional exchange rate coordination. Most popular are incremental steps like Asian Bond Fund etc. to help integration and more trade (bilateral FTAs for example) to attain OCA criteria. Only the Japanese are pushing very hard for currency basket with the yen in there. Proposals do not seem to mention an explicit role for China or RMB to play in new regional financial framework. Policymakers downplay it because they feel the time isn't right to.

Substantial revaluation is generally not seen to be in China's interest nor that of her neighbors, although there may be some benefits for less developed neighbors who produce labor-intensive goods and are trying to climb up the value chain.

³¹ However, these countries which had earlier liberalized their capital accounts have opted to follow a more flexible exchange rate regime. In any case, the ability of countries like the Philippines, Indonesia, or Thailand to support a heavily-managed float is constrained by the small size of their foreign reserves.

On the fixed versus flex ER debate, Eichengreen's position is cogent. But the Chinese favor Mundell's and many East Asians implicitly do so. If countries are able to better attain some degree of convergence in inflation and growth rates across the region, there is better chance of forming MU. But the latter is not the compelling issue.

China's timing in adopting change is uncertain because of her internal conditions. To the extent that her actions and state of the economy affect us, we want to know what and when. But we understand that China can't be rushed because the results might be disastrous for us all. We need to prepare ourselves to face new challenges just like China. Not all of us are equipped to do so.

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