

The Chinese Crux of Monetary Union in East Asia

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There are few precedents for maintaining the high degree of separation between internal monetary arrangements that still prevails between Hong Kong and Mainland China. This paper anticipates the erosion of this separation and considers the economics of the different forms which monetary unification of China could take. It argues that achieving such a unification without resort to capital controls or expropriation is a precondition for developing a second major international currency in East Asia, rivaling the yen. Until the renminbi, hopefully by another name, has established itself as an international currency inside a unified financial system that is up to Hong Kong's current standards, there can be no progress toward a regional monetary union in East Asia. The goal of such an internal union is to emancipate the region from the dollar standard. (JEL F33, F41)

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Summary

There are technical and market-driven pressures for currency consolidation all over the world (see von Furstenberg, 2002). In the Western Hemisphere, more and more countries have given up trying to resist these pressures and are dollarizing formally. The terms dollarization and euroization denote unilateral approaches to monetary union by which a country, at its own initiative and without benefit of international treaties, adopts another country's currency – U.S. dollar or euro – as its legal tender, replacing the local

currency. European Monetary Union (EMU) exemplifies an alternative, multilateral, form of monetary union that is based on a network of agreements and treaties among its members. In Europe, some countries still choose to stand aside from EMU but others, in Central and Eastern Europe, are clamoring to get into the euro area or euroizing under pressure from the dominant currency in the region. But what about East Asia, another region with a collection of small, medium-size, and large countries at different levels of development? How could pressures for currency consolidation be accommodated there so that the smaller countries in the region may be spared future currency crises and the resulting economic and financial mayhem?

This chapter offers five tentative responses to these questions:

- 1) Monetary union in continental East Asia, although desirable in principle in view of the area's revealed fear of floating, is not achievable until perhaps the second decade of this century.
- 2) Chinese Monetary Union (CMU), in particular between Hong Kong and Mainland China, is a precondition for any wider monetary union in the region.
- 3) To avoid impairing the value of Hong Kong Dollar (HKD) claims in the process leading up to CMU, all HKD-denominated financial assets and currency should be converted to U.S. Dollars (USD), an operation which Hong Kong's high level of international reserves can easily support. Conversion to USD should be at the 7.8 HKD/USD currency-board parity.

- 4) After CMU has been accomplished in this way, the sole surviving Chinese currency must be allowed to float freely against USD and all other major international currencies (euro, yen) whose ranks it will have joined.
- 5) Whether the CMU area will expand because neighboring countries choose to join unilaterally, or whether a multilateral monetary union including Japan will eventually become feasible remains to be seen. However, any attempt to develop such a union without first a) overcoming China's own internal monetary division, and b) then decoupling the sole surviving Chinese currency from USD will be futile.

Introduction

The latest IMF (2002a, p.3) Country Report on the People's Republic of China – Hong Kong Special Administrative Region (SAR) describes the growing ties between Hong Kong and Mainland China since Hong Kong's return to China's sovereignty this way:

Integration between the two economies has deepened notwithstanding the Asian crisis: Mainland-related entrepôt trade has continued to increase; a large share of China's foreign currency financing is raised in Hong Kong SAR financial market; a growing range of economic activities are integrating across the border; and

Hong Kong SAR business has become increasingly centered around China-related activities.

Such a situation would seem to cry out for a common currency because separate currencies act like a strong barrier to trade (see Rose, 2003, for an appraisal of the central estimates of the monetary union effect on trade). This paper discusses how best to achieve the monetary unification of China. The purpose is not only to strengthen internal trade and hence economic growth (see Frankel and Romer, 1999; Chou and Wong, 2001) but also to banish currency crises between Hong Kong and China and at the same time for the whole of China and its single money with the outside world. The achievement of CMU without continuing to peg to the U.S. dollar would also meet one of the essential prerequisites for a wider monetary union on the continent of East Asia down the road.

Premises. In a short paper it is not possible to justify all the premises and judgments on which it is based. Yet they must at least be stated at the outset to help explain the broader contextual view underlying the limited areas considered in detail.

1. We accept Rogoff's (2001) considered conclusion that "into the foreseeable future, it would not be desirable to aim for a single world currency, and that from an economic point of view, it would be preferable to retain at least, say, three to four if not n [major independently floating] currencies." "The optimum currency area is not the world" according to Mundell's (1961, p. 659) original judgment as well. A new continental East Asian currency, born of Chinese monetary union,

- that floats against U.S. dollar and euro permanently and against yen at least temporarily ultimately is essential for a region that is integrating internally.
2. On account of a latent banking and debt crisis in Japan (see Fukao, 2002), the yen is becoming progressively less suitable for providing the standard of monetary integration for continental East Asia. With partial exceptions like Singapore (see Borensztein et al., 2001) that region has looked to the U.S. dollar (USD) as the common external anchor and not to the yen. The dollar anchor is likely to become unsustainable once capital-account convertibility in the main countries of the region, in particular Mainland China, has progressed. Instead, an internal anchor must arise from the monetary unification of China. Thus a fourth major international currency, in addition to USD, euro, and yen, will have to crystallize in continental East Asia before its monetary emancipation can progress.
 3. As in Europe, where the United Kingdom has kept aloof from European Monetary Union (EMU), Japan will be standing aside from any China-based monetary union. Such a union will involve the monetary unification of just a single country before unilateral accessions or multilateral transformation may occur. If and when China's currency, after monetary unification, develops into a major international denomination rivaling the yen, it could become one of the two pillars of a multilateral monetary union with most other East Asian (and some Southeast Asian) countries. Assuming political compatibility, that union eventually could include Japan should the economic and financial integration of China and Japan continue to grow and their banking and financial systems be reformed to the point

of reaching internationally accepted standards of soundness, provisioning, and transparency.

Section Outline. This chapter will consider only the modalities that could lead to a major international Chinese currency, initially through monetary union between Hong Kong and Mainland China. In other words, we will be dealing mostly with point 2 of the scenario outlined above. To provide some guidance, Section II reflects on salient features of monetary unification processes observed in Britain's American colonies and later in Italian history. From this history Section III draws inferences about how best to accommodate pressures for currency consolidation that arise inside a country such as China. Section IV analyzes the extent to which different plans for achieving Chinese monetary union apply these lessons and hold the promise of evolving a major international currency for all of China that would float against USD. Section V concludes and reminds of the broader context in which this development is set.

II. Lessons from Monetary Disunity in American-Colonial and Italian History

Monetary history holds some interesting lessons about how monetary disunity arises in a country or region and how it tends to be resolved. Start with colonial Northeastern America and its 13 separate British colonies. These colonies referred the value of their money to two external silver currencies, sterling and the Spanish peso (peso de ocho reales) that was known in the colonies as piece of eight and then dollar. The piece of eight having 422.9 grains (less than one troy ounce of 480 grains) of 0.935 fine silver was valued at 4s6d, or at a little under a quarter pound sterling based on its silver

content. It appears to have served as the decisive monetary standard in that “intercolonial exchange was effected at par based on the comparative values of the piece of eight of the two colonies involved rather than on the comparative commercial rates of exchange on London at the time of the transaction” (McCusker, 1978, p. 159). Obviously when neither arbitrage nor price information could be instantaneous, it mattered in practice what was the monetary standard on which all cross rates were calculated for transactions in Northeast America. Just as the piece of eight, i.e., the silver dollar, was always the standard in England’s North American colonies, the U.S. dollar is that standard in Southeast Asia currently as it has been, with minor interruptions, for over three decades (McKinnon, 2001). This is why it has a special role to play in the discussion of alternative routes to the monetary unification of China.

Another striking lesson comes from the obvious striving of colonial moneys to be accepted as substitutes for each other at a fixed rate so that payment in the currency of one colony could be readily accepted in a neighboring colony. The network externalities which currencies afforded determined whether they were used just inside their native colony or also outside it as happened in the case of New Jersey. According to a 1740 account quoted in McCusker (1978, pp. 169-170), “New York bills, not being current in Pennsylvania, and Pennsylvania bills not current in New-York, but Jersey bills current in both, all payments between New-York and Pennsylvania are made in Jersey bills.” Because the Hong Kong dollar and the U.S. dollar are viewed as close substitutes in Mainland China, it would not be quite correct to analogize the above quotation by claiming that the renminbi, not being current in Hong Kong, and the Hong Kong dollar not very current in Mainland China, but U.S. dollars current in both, most payments

between Hong Kong and Mainland China are made in U.S. dollars. Nevertheless, there is more than a grain of truth in this analogy.

Colonial moneys strove to be accepted as substitutes for each other at precisely fixed levels that became customary rates of colonial interchange. Without first achieving internal monetary union, calls to float the renminbi against the U.S. dollar and hence against the HK dollar or to establish an appreciable band around its central rate ignore the compelling expedient of a fixed rate of equivalence in internal exchange. As indicated in the quote below, in the American colonies, fixed cross rates could be taken for granted and required no particular vigilance or market checking of the conversion rate with pound sterling in London. Hence different colonial moneys had to compete with characteristics of usefulness, including designation as legal tender for public and private debts, *other* than stability of value relative to each other.

The evidence comes, again, mostly from the period after 1750, but it clearly shows the existence of customary rates of intercolonial exchange... The accepted ratio between New York currency and the Lawful Money of New England was £133.33 to £100. £100 Maryland or Pennsylvania currency cost £106.67 New York currency, at least from 1762 on. Earlier it seems to have varied somewhat, but in 1768 the Chamber of Commerce officially adopted the £106.67 rate.

(McCusker, 1978, p. 159)

Not sharing the Anglo-Saxon fondness for numbers ending in odd fractions like $1/3$ and $1/15$, the integration of various coinage systems in Germany and Austria during the

period 1834-1857 involved simpler, but equally precise, equivalences fixed by treaty, such as 1:1.5 and 1:1.75 (Bordo and Jonung, 2000, pp. 20-21).

Moneys anchored in perfect substitutes, such as silver content, can coexist confidently inside and outside their original jurisdiction at a perfectly fixed exchange rate because they have the law of arbitrage on their side. There are several instances in history of formal arrangements for mutual acceptance based on coins of equal precious-metal content in which coins issued by one country were legal tender in other countries and vice versa. By contrast, exchange rates fixed by statute between gold and silver quantities, such as 1:15.5, under bimetallism, as well as a fixed exchange rate between commodity money and unbacked paper money, invariably trigger operation of Gresham's Law. As the relative price of the two types begins to deviate from the officially decreed price relation, the cheaper of the two legal means of settlement is chosen, and the higher-valued form of money is driven from circulation.

Obviously, therefore, if underlying market values are not maintaining a fixed relation, the only way to keep different moneys in joint circulation is to allow the exchange rate between them to vary also. Then those moneys that are weakest commonly, and hence conveniently, would be used for payment services, while stronger moneys would be used as stores of value. Hence different moneys would be preferred for different services that could all be provided more efficiently by a single, superior money. These differences are well brought out in the quote that follows.

When a country goes from a gold standard to a system of inconvertible paper money, metal currency will not necessarily disappear. In general, a dual price

system develops in the market: higher prices for payments effected with paper money and lower ones for those made with metal money. A clear example is given by the so-called greenback period in the United States ... In such a situation metal money was not melted down or transferred abroad, because the authorities did not impose a single level of prices which would have indirectly devalued the coins. In the case of Italy, however, article 3 of the decree passed on 1 May 1866 ‘provided’ that one gold lira should have the same purchasing power as one paper lira. This legislation therefore forced the metal out of the market. (Fratianni and Spinelli, 1997, pp. 76-77)

The last part of the quote above already indicates that there is an important final issue about changing monetary arrangements relative to an outside standard, be it gold, sterling, or a Hong Kong dollar fixed to the U.S. dollar. It is bound up with respect for property rights, the sanctity of intertemporal contracts, and time consistency. In the American colonies it expressed itself this way:

Debts due in sterling could sometimes be lawfully paid in the colonies with a sum notionally equivalent to but really less than what was owed. While such abuses were infrequent, they pandered to the fears of the merchants of London...

(McCusker, pp. 125-126)

Violating property rights jeopardized the reputation of a currency with “the merchants of London” then as surely as it would with global financial centers now.

III. This History's Principal Lessons for Internal Monetary Unification

Going back at to the 18th and 19th centuries, the history of internal monetary unification in Colonial America and Italy suggests that it is not ultimately sustainable for a single country to have two or more currencies, each of which has legal tender status in one part alone. Monetary integration is a gradual process that starts with mutual convertibility and getting used to each other's money in an ever denser web of transactions. Eventually it becomes possible to deal confidently and at low transaction costs with the moneys issued by separate jurisdictions of economically integrating units that later become a single country. An essential prerequisite is that the differences in value between the bills and coins of various denominations circulating side by side are fixed precisely and permanently to a standard of value not subject to the jurisdiction of the issuers. Hence, as long as the Hong Kong dollar (HKD) is credibly fixed to the U.S. dollar (at 7.8HKD per USD), the renminbi (RMB) must be fixed just as precisely (at 8.28 yuan per USD) and not in a band with an appreciable spread that would disturb the application of a fixed and customary exchange-equivalence rule, such as $7.80 \text{ HKD} = 8.28 \text{ yuan} = 1 \text{ USD}$, for retail transactions.

To maintain Chinese monetary integration prior to having a common currency, any change in the RMB/USD exchange rate would have to be mirrored simultaneously and equi-proportionately in the HKD/USD currency-board parity, and vice versa, so that the first of the two equalities above would be maintained. However, preserving the monetary integration of China in this way would violate the promise of the Hong Kong currency board arrangement that 7.8 Hong Kong dollars can always be turned into 1 USD. Since many intertemporal economic and financial arrangements and contracts have

been predicated on that firm pledge, not honoring it would involve a breach of the implicit contract between the authorities and the public. There would also be partial expropriation of investors and creditors for the benefit of debtors, including a self-serving government, to the extent depreciation against USD would ensue.

The IMF (2002b, pp. 12-16) supports, or cites with approval, “Hong Kong SAR’s commitment to the linked exchange rate system” while at the same time recommending a policy -- a wider renminbi trading band -- that would tend to undermine it. In making this recommendation, the Fund continues to be oblivious to the destruction that following its advice would entail of what has been de facto an almost completely fixed exchange rate between HKD and RMB. Four consecutive years of deflation since 1999 and low investment, falling asset prices, and no or low growth in the last two years indicate the vulnerability of Hong Kong’s currency-board peg to USD. The market’s perception of the likelihood, that the current level of that rate will be maintained, surely will be adversely affected once the RMB/USD rate is allowed to move, up or down, in a wide range. Hence dollarization of the Hong Kong economy is the appropriate fulfillment and exit strategy from its currency-board commitments.

The government of Argentina’s reckless trampling on property rights in the deep financial and economic crisis of 2002 has cast a long shadow over the prospects of that country and of any national currency it may seek to sustain. Forced pesification of USD-denominated deposits in Argentine banks devalued them greatly. To avoid any lasting loss of reputation due to a lack of contract fidelity, the monetary unification of China thus cannot prudently be achieved by simply hitching the Hong Kong dollar to the renminbi by requiring conversion and then letting the surviving currency rise or sink when it is left

to “float.” Appreciation of the unified currency against USD would mean that debtors (or those with short positions) who had contracted in HKD lose as the USD cost of their debts would rise, while depreciation would hurt HKD creditors (and those with long positions) relative to what they originally had bargained. Instead of initiating partial expropriation of one side or the other in this way, the Hong Kong dollar’s currency board must be given a property-rights-preserving exit. Argentina’s currency board arrangement could have been safely converted in 1999 by quickly gearing it to a similar endpoint, formal dollarization. Once trouble with Argentina’s exchange relations with its neighbors had started while fiscal disorder continued, the currency-board peg needed to be hardened to formal dollarization to withstand the added financial and economic pressure coming from escalating default and currency risk. Hence, while internal monetary union is imperative if complete integration of the economic and financial markets of Mainland China and Hong Kong SAR is intended, it can be achieved safely only by a circuitous route. That route involves temporarily strengthening the role of the USD in the Chinese monetary system before cutting the exchange-rate tie with the dollar as explained in greater detail below.

Changes in monetary arrangements often involve selective elements of expropriation, for instance, by allowing debts incurred in one currency to be discharged in a debased or devalued currency that is declared to be its legal successor or equivalent. Any selective expropriation on the way to monetary unification would mar the reputation of the new currency and keep it from acquiring a major international role. Once formal Chinese monetary unification has been achieved, the hopefully new common currency, introduced at the rate of 1:1 with “the people’s money,” RMB, but shedding its socialist

image and nomenclature, should not be legal tender for claims and obligations incurred originally in HKD. Instead, HKD currency and all HKD claims should be converted into USD at the currency-board parity to avoid selective expropriation unless alternative currency arrangements are made privately and voluntarily by the contracting parties involved.

Decoupling the Hong Kong dollar from the U.S. dollar under a speculative attack that appears too costly to resist and then letting it depreciate against USD would constitute an implicit breach of promise to those who contracted in HKD with official assurances that the currency board arrangement was sacrosanct and secure. Floating the RMB prior to formal conversion of all outstanding HKD claims and obligations to USD quickly would doom Hong Kong's currency-board arrangement as well and cause the HKD to be pegged to the RMB as a prelude to monetary union on the Mainland's terms. In any case, requiring Hong Kong dollars to be turned in for renminbi at a fixed rate without insuring the dollar value of the renminbi counterpart would either risk or seal partial expropriation by lowering the USD-value of HKD claims. By contrast, replacing the Hong Kong dollar (and the Taiwanese dollar, not further discussed here) by the U.S. dollar would achieve monetary unification of China -- in the sense of leaving only one Chinese currency when one ignores the Taiwan dollar and assumes that the pataca goes the way of the Hong Kong dollar -- without selective expropriation. These are the two approaches to monetary unification considered further in this paper.

IV. A Market-Based Transition to Chinese Monetary Unification

Currently the RMB is still far from having achieved full capital-account convertibility. Yet, liberalization of financial markets in the Mainland has progressed. Steps in that direction have been prodded in part by China's 2001 accession to the WTO with a transition period of only five years and in part by China's ambitious plans to develop a financial services industry beyond the confines of Hong Kong, particularly in Shanghai. The on-going liberalization makes it highly unlikely that fixed exchange rates with USD are fundamentally compatible with the monetary unification of China and with the eventual emergence of the unified Chinese currency as an international currency widely used in international trade and finance. Hence, while the *achievement of* monetary unification of China will benefit greatly from the maintenance of a tight dollar peg and fixed equivalence between HKD and RMB, trying to maintain an explicit hard USD peg, or any other external peg, after that unification is unnecessary -- even dangerous. Such pegging is bound to invite a major currency crisis eventually that may result in a sharp movement of the exchange rate with USD, either up or down. Instead, monetary unification should be followed either immediately or within a period of months rather than years by public abandonment of a dollar peg even though a modest amount of managed floating, official market-making for foreign exchange, and attempts at short-run smoothing of the exchange rate with USD may, of course, continue.

The first step needed for Chinese monetary unification without confiscation, formally dollarizing the HKD, already also has been recommended by Mundell (2000, pp. 12-13). However, he envisions the dollar as an excellent permanent anchor for the Asian currencies and looks forward to the formalization of a dollar-based currency area

in East Asia, including China and Hong Kong, in the long run. As a sop to national monetary identity, formal dollarization could be combined with intramarginal amounts of dollar-equivalent stand-in currencies being issued by the dependent members of the currency union, analogous to the Scottish Pound for Pound Sterling.

McKinnon (2001), on the other hand, advocates USD as the common monetary standard and not as the common currency for the region. He emphasizes the benefits of introducing official dollar parities that are treated as long-term obligations to which the government is committed after any crisis. “Then, with regressive exchange rate expectations and the future price level more secure in the face of any mishap forcing the (temporary) suspension of the fixed exchange rate commitment, the authorities could seriously encourage lengthening the term structure of domestic and foreign finance in the bond market” (p. 237). In other words, if the anchor chain ever snaps, it must be reattached after the storm without lifting or dragging the anchor from its place.

Local financial structures are opening up and will eventually strengthen in Mainland China, and the relative importance of the U.S. market to Mainland China and Hong Kong has started to shrink. That market took about 25 percent of their exports and supplied 10 percent of their imports in 1999 (IMF, 2000, pp. 163, 166). In the near-universal economic slowdown of 2001-2002, China has proved itself as an engine of regional economic growth accounting for a growing share of East Asia’s trade. Hence we do not share the view that maintaining a U.S. dollar peg, particularly with the yen-dollar rate on the loose, would continue to bring the blessings of stability to a continental East Asian monetary area far into the future. Permanent USD dependence and a permanent lack of financial and political emancipation by a fast-growing and increasingly confident,

though still far too rigged, intransparent and statist, region containing over a third of the world's population would be a historical anomaly. East Asia's combined real GDP soon may come to exceed that of the United States if capital formation, productivity growth and technology catch-up continue at a rapid pace. It will be difficult to defend politically that maintaining fixed nominal exchange rates with USD in open capital markets should command repeated sacrifices from the region once it is well on its way to building an internationally fit non-inflationary monetary and financial order of its own.

Regarding any region-wide hard peg to USD as a way to achieve stable cross rates internally, it is questionable that equally reliable dollar fixes could be delivered by all the countries in the region. There is uncertainty about how a successful speculative attack on one might affect the security of the peg by others, and why a politically and economically costly defense against any such attack would necessarily be successful and hence credible. As Wyplosz (2002, p. 143) has noted, if pegging comes without any institutional backup, it solely relies on the separate decisions by individual countries. There would be little else to defeat speculative attacks since USD-based regional swap arrangements, such as the Chiang Mai Initiative of May 2000 between the ASEAN countries plus China, Korea, and Japan, not including the United States, have inherent limitations. Rajan (2002, pp. 42-48) sees some development potential in this regional system of providing loans of foreign exchange reserves to each other. However, such an exchange intervention financing system may be used to support an ultimately not credible cause such as defending the wrong set of parities.

McKinnon (2001) also does not attempt to demonstrate that scrambling back to the old parity if it were ever lost would be a politically credible proposition in all

countries that had to deviate from that dollar parity. In fact he envisions committing East Asia to an arrangement stronger than that imposed in many countries under Bretton Woods: Fixed exchange rates with USD for each of them and hence fixed exchange rates with each other, with the former condition, but not the latter, suspendable. What this means is that all countries in the region, and hence the region as a whole, may devalue or revalue by a uniform percentage against USD, but only temporarily and in an emergency. How a uniform exchange-rate realignment, on and off, might be negotiated *en bloc* within the group of East Asian countries or by that group with the United States is not explained either. Eichengreen's (1997, p. 2) prediction, that "schemes to peg the dollar, the yen, and the deutschmark [now euro] against one another, as had been the practice until the Bretton Woods international monetary system collapsed in the early 1970s, will prove unavailing," could apply to a unified international Chinese currency of tomorrow as well.

Schemes to peg such a currency of the future to a basket of currencies consisting of the full set, or a subset (Tsang, 2001, pp. 7-15), of the four currencies currently included in the SDR -- USD, euro, yen, and pound sterling -- will be equally unavailing and spurned in open financial markets. Although direct interbank clearing in the first three major currencies is being introduced in Hong Kong (IMF, 2002b, p. 14), basket pegging would be ill-advised from the beginning as it would introduce cumbersome hedging requirements for the prevailing USD claims. These are obligations that, in Hong Kong at least, currently do not need to be hedged against the local currency. Without the pressure from basket pegging, other countries in East Asia in general would have no compelling reason to hedge USD claims against exchange risk with euro, pound and yen

because the greatest risk comes from the breakdown of their own currency arrangements however their respective parity is expressed. As long as financial instruments for hedging exchange rate exposure in their own currency have not fully developed, continental East Asian countries are obliged to rely on balance-sheet hedging and direct currency matching of prospective flows of payables and receivables. Even though Hong Kong's derivatives market is the fifth largest in the Asia-Pacific region, basket pegging would only complicate that task. Reaction to the announcement of former Finance Minister Domingo Cavallo's 2001 contingency plan to change the peso's currency board parity from 1 USD to 0.50 USD and 0.50 euro is instructive in this regard: It instantly weakened confidence in Argentina's scheme of currency-board pegging.

Once firm exchange-rate commitments are made, the political temptation is to try to keep them as long as possible for reputational reasons even when they are seen to be wrong in retrospect. It would be better, of course, to avoid post-unification fixed exchange-rate commitments with USD, or with USD, yen, and euro combined, supported by indefinite retention of capital controls, in the first place. McKinnon (2001) considers that, in the long run, the formation of a dollar-based currency area in Asia, including China, Hong Kong and most Asian countries, could be used as a platform for an independent Asia currency. However, in the end he repeats his earlier judgment (2002, p. 50) that "[b]ecause no region-wide 'Asian euro' exists or is in prospect, the dollar is the only plausible anchor for creating an East Asian zone of monetary stability in price levels and exchange rates." If the message is that a dollar-based currency area with fixed exchange rates and rationally regressive (i.e., fixed) exchange-rate expectations will have to be maintained successfully for quite some time before it can serve as a platform for an

independently floating currency, then McKinnon's condition should be cut short: China should move toward independent floating, like the euro, right after achieving monetary unification. Discovery of the appropriate scope and timing of monetary union in East Asia over an extended period thereafter would be based on learning how well the actual and prospective behavior of the Chinese and Japanese exchange rates with other major currencies, and of any common monetary standard they might develop between them, might suit the East Asian countries.

In our view, Chinese monetary union and managed floating that is free of long-term commitments to a fixed external exchange rate would have to be achieved before regional monetary union could possibly be considered seriously. Hence there need to be four major international currencies, including two in Asia, before there can ever be as few as three in the world. The preferred approach to Chinese monetary unification is first to U.S.-dollarize the Hong Kong economy by making the U.S. dollar the legal successor currency to the Hong Kong dollar, and then to declare the U.S. dollar nonexclusive tender in Hong Kong together with the renamed renminbi so as to permit currency competition.

In practice this would mean that the Hong Kong Monetary Authority and its management of the payment and settlement system and of clearing balances with eligible banks would be conducted in USD for some time during which the development of RMB-denominated business at Hong Kong banks would be phased in. At the end of 2000, two dozen branches of Mainland banks were already operating in Hong Kong (IMF, 2002a, p. 6), and this might facilitate the eventual introduction of banking business denominated in RMB. Already in the first half of 2002 there were hints from both the Governor of the People's Bank of China and from the Hong Kong Monetary Authority

that licensed banks in Hong Kong could begin to accept RMB deposits which would initially have to be hedged by RMB-denominated loans made to clients on the Mainland. Once the HKD has disappeared through dollarization, loans denominated in the sole surviving Chinese currency are likely to be demanded by Hong Kong applicants as well. The growth in renminbi-denominated assets and liabilities of Hong Kong banks would then occur at a market-determined pace to take advantage of any growing network externalities with Mainland China in which the yuan, and not USD, currently is the dominant transactions currency. Hong Kong's nonfinancial businesses that account for most production and consumption activities thus might eventually choose to settle predominantly in the unified Chinese currency. This would be done for the convenience of customers and as a way to reduce currency risk given the close economic integration of Hong Kong with the Chinese Mainland noted in the introduction and elaborated by Wan and Weisman (1999). International financial business done in Hong Kong would continue to be conducted mainly in USD, as elsewhere in the world.

As estimated by Tsang (2001, p. 9), even without legal tender status, almost 40 percent of the total Hong Kong dollar issue appears to be held and used in Mainland China but mainly in the Pearl River Basin in the proximity of Hong Kong. Replacing HKD claims with USD claims would not require making USD legal tender in Mainland China. However, the stipulation of any settlement currency, including a foreign currency, in private contracts would be free. The renamed unified Chinese currency would be legal tender in both Mainland China and Hong Kong, but only for claims contracted earlier in renminbi or contracted since unification in the new currency unit introduced at par with it. Use of the U.S. dollar in business and finance should be subject to few, if any,

restrictions not only in Hong Kong as now, but also in Mainland China. The eventual achievement of full (or “total”) convertibility would allow open currency competition. This would pressure the renamed Chinese unified currency to develop its reputation and usefulness so as to defend and expand its hold and to capitalize on the network externalities available to it in China’s vast internal market. Successful inflation targeting would be an essential complement to letting the sole surviving Chinese currency float against other major international currencies whose ranks it would have joined.

This approach is likely to leave Hong Kong’s world-class international financial business, which is now conducted mostly in USD, less disturbed than a forced exchange of Hong Kong dollars for renminbi that could be accomplished, for instance, by making the renminbi legal tender for discharge of HKD-denominated obligations at a fixed rate. In the latter event, the renminbi would become the exclusive legal tender in all of China but with a dubious international reputation. If the withdrawal rate for HKD were set at 1:1 with RMB, it would imply an immediate devaluation of the SAR currency. In addition, a further effective devaluation of Hong Kong dollar claims in terms of USD might be involved if the renminbi subsequently is depreciated against USD. The net effect would be to betray the trust engendered by the Currency Board Arrangement to the detriment of the international reputation of the renminbi and of the governance of its financial system.

V. Conclusion

Chinese monetary unification and the way it is done will determine whether there will be an international Chinese currency in the not too distant future. Such a currency

decades later could come to serve as one of the pillars of an East Asia monetary union including Japan, or it could continue to exist on its own with perhaps some unilateral accessions from the region. Although there may be political imponderables, Taiwan, Singapore, and Malaysia could perhaps become interested in such a unilateral monetary union with China on economic grounds, but other sub-groups may also be envisaged (see Ling, 2001; Bayoumi and Mauro, 2001). Most importantly, however, if Chinese monetary unification is achieved without selective expropriation and without preventing currency competition, particularly from USD, it may lay the foundation for an international currency that will can float safely against all the other major currencies.

A second major international currency, and not an East Asian dollar standard, thus needs to crystallize in East Asia before there ever can be just one such currency through monetary union in the region. The main obstacle in the path of such a development is the unresolved state of bankruptcy of much of the Mainland Chinese banking and financial system (Zhu, 1999, lays out some of its pathology) whose non-performing loans are still near 40 percent. In this regard, waiting until all the conditions are right for Chinese monetary union may not be realistic. Rather, such a union could be precipitated at almost any time by a financial crisis, such as the collapse of Hong Kong's Currency Board Arrangement (CBA), or an appreciable change in the USD value of RMB.

With no time to complete the loan workout for the mostly still government-owned financial system of Mainland China, its monetary union with Hong Kong would then precede the emergence of an international money, rather than give birth to it. Even then the most important principle to be followed is this: Before the CBA is destroyed or the RMB/USD near-fix is abandoned, HKD claims and obligations must be converted to

USD. Waiting until pressures on the 7.8 HKD/USD and or the 8.28 RMB/USD rate have become intolerable will not permit this. Hence moving toward Chinese monetary union, even if imperfect, may not safely be deferred lest its terms become confiscatory for Hong Kong residents, and other users of HKD, under pressure of events.

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