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A Political Economic Critique on the Theory of Optimum Currency Areas and the Implications for East Asia

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Contents

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In recent years dynamic debate has emerged on the desirability and feasibility of creating a currency union in East Asia. While the debate has relied heavily on the theory of optimum currency areas, this theory has weaknesses in explaining the actual formation of currency unions. At this point, political economic analysis appears to demonstrate stronger explanatory power. This paper provides a systematic review of the main developments in the literature on optimum currency area theory and of those in the political economy literature on currency union. Additionally, this paper addresses the feasibility of an East Asian currency union, by applying the findings in the two academic strands to the region. It finds that even though East Asia may be to some extent a feasible candidate for a currency union from an economic perspective, the region's political situation does not appear favorable for creation of one.

Keywords: Asian currency unit, currency union, East Asia, monetary cooperation, optimum currency area

JEL Classification: *F33, F59*

I. Introduction

Following the Asian financial crisis in 1997 and the launch of the euro in 1999, debate on the desirability and feasibility of establishing an East Asian currency union has obtained new momentum.[1] While it has not attracted wide public attention yet, this issue is no longer just a matter of academic interest. The ASEAN Plus Three (ASEAN+3) countries have begun to study a "Regional Currency Unit (RCU)," which would be a basket currency similar to the European Currency Unit of the European Commission (EC), by mandating in 2006 that its research group examine how to create and utilize an RCU.[2]

Most discussions revolving around an East Asian currency union address its feasibility mainly within the analytical framework of the economic theory of optimum currency area (OCA), which is generally regarded as *the* theory of currency union. OCA theory indeed provides a useful starting point for studying the desirability and/or feasibility of a particular group of countries' creating a currency union, by offering an

[1] See Eichengreen (2007) for how the crisis and the euro have nourished the idea of an East Asian currency union.

[2] The European Currency Unit was an artificial basket currency consisting of the currencies of EC member countries. It was used as the unit of account of the EC, and was the precursor of the euro.

economic analysis of the aggregate costs and benefits of currency union. Nevertheless, it has a noticeable problem of weak explanatory power relative to actual currency union formation. The political economy literature appears to give more plausible explanations in this respect.

This paper provides a systematic review of the main developments to date in the OCA literature,[3] and also in the political economy literature related to currency union, highlighting the importance of taking political economic considerations into account in analyzing currency union establishment. Additionally, by applying the major findings in the two academic strands to East Asia this study discusses the feasibility of formation of a currency union in the region. This paper does not intend to have the final say on OCA theory nor make a sophisticated analysis of the feasibility of an East Asian currency union. Instead, it aims to present a set of thoughts and questions for further consideration.

[3] In this paper, the terms *OCA literature* and *OCA study* refer to the economic research on OCA theory.

II. Theory of optimum currency areas

OCA theory is the most popular economic theory for analyzing whether or not a particular group of countries should form a currency union. The theory has been developed substantially over the past fifty years, shifting to a more favorable attitude toward currency union creation recently. However, it has a critical problem in that it does not explain well the actual formation of currency unions.

1. Major arguments

OCA theory emerged from the debate on the merits of fixed versus flexible exchange rate regimes during the 1960s, and was pioneered by Mundell (1961).[4] It asks "What is the appropriate domain of a currency area?" (Mundell, 1961: 657), with the term *currency area* referring to either the geographical domain of a single currency, or of several currencies for which the exchange rates are fixed.[5] Implicit in this question is the understanding that there are both costs and benefits to any exchange rate regime.

[4] The theory has been further elaborated by McKinnon (1963), Kenen (1969) and others.

[5] The non-distinction between a fixed exchange rate system and a single currency system in OCA theory is problematic, as the political economic costs and benefits of the two systems can be different.

The benefits of a currency union are mostly realized at the microeconomic level, while its costs have much to do with the macroeconomic management of the economy (De Grauwe, 2003). The benefits arise mainly from the removal of transaction costs associated with the exchanging of national currencies and the elimination of risk stemming from volatile exchange rate movements.[6] These are expected to facilitate trade, reduce investment risk, encourage foreign direct investment, enhance resource allocation, etc. On the other hand, countries belonging to a currency union lose their discretion over monetary and exchange rate policies, which are important macroeconomic policy instruments. As a result, their macroeconomic stabilities may be threatened in times of asymmetric disturbances, if their prices and wages are downward sticky (Mongelli, 2002: 33-34).[7]

On the basis of its identification of the costs and benefits of currency union, the OCA literature presents several “OCA criteria,” which determine conditions

[6] Although hedging can be used against the uncertainty caused by volatile exchange rates, it invariably involves costs, which increase with the duration of a transaction. In addition, there is a great deal of unexplained volatility in currency markets, which makes it particularly difficult to hedge against risk involving smaller countries’ currencies (Broz and Frieden, 2001: 322).

[7] In fact, the earlier OCA literature rarely discussed the benefits of a currency union, but focused mainly on its macroeconomic costs. The European Commission’s (1990) “One Market, One Money: An Evaluation of the Potential Benefits and Costs of Forming an Economic and Monetary Union” was one of the first major efforts to draw attention to the benefit side. For more detailed discussions of the benefits and costs of currency union, see Mongelli (2002: 33-34).

decreasing the costs and/or increasing the benefits of a currency union, and thereby provides a framework for assessing whether a certain group of countries are feasible candidates for one. Traditional OCA criteria include price and wage flexibility, mobility of labor and other factors of production, financial market integration, economic openness, diversification in production and consumption, similarity in inflation rates, fiscal integration, similarity of shocks, political integration, etc.[8] The higher the degrees of these properties, the more feasible formation of a currency union.

Recently, some significant albeit mostly controversial arguments have been proposed, that alter the traditional cost-benefit analysis of currency unions. Firstly, it is argued that in a world of free capital mobility the exchange rate is not an effective instrument for correcting external disequilibria; rather, it is a target of destabilizing speculative capital movements and thus a source of large asymmetric shocks (Mundell, 1973). Secondly, monetarism argues that since activist monetary policies are only sources of instability in the long run, governments do not have the capacity to stabilize their economies through monetary policies in the first place (De Grauwe, 2006: 715). Thirdly, it is claimed that a currency union integrates the capital markets of its member

[8] For the details of the OCA criteria, see Ishiyama (1975), Tavlas (1993), Mongelli (2002) and Willett *et al*. (2007).

countries, thereby providing the countries with an insurance mechanism against asymmetric shocks (Mundell, 1973). Finally, it is pointed out that a country's monetary policy credibility can be enhanced by attachment of its monetary policy to that of a country with a low-inflation anchor currency in the currency union (Tavlas, 1993: 673-77).[9] All of these arguments suggest creation of currency unions to have fewer costs or more benefits than previously believed.

Another important novel strand in the literature is the notion of "endogeneity of OCAs," which owes much to Frankel and Rose (1997; 1998). It argues that countries joining a currency union can satisfy OCA criteria *ex post* even if they do not do so *ex ante*. In other words, even if a currency union was not an OCA at the time of its creation, it can afterwards turn into one over time. This argument attracted great attention with the start of the European Economic and Monetary Union (EMU) in 1999. However, most empirical research in this field faces serious problems, such as an inability to clearly distinguish between the effects of the euro *per se* and those of broader European Union (EU)-wide initiatives (Willett, 2006). As De Grauewe (2006:

[9] For more on this issue, see McKinnon (2004: 695) and De Grauwe (2006: 715). Also note the argument by Sandoholtz (1993), that a shift in European policymakers' economic beliefs to the anti-inflation discipline during the 1980s was a precondition for establishment of the euro.

719) indicates, we need more time to properly assess the importance of the endogeneity effect of currency unions.

2. Limitations

Despite these substantial developments, OCA theory is frequently criticized for its weak explanatory power with regard to the actual formation of currency unions. Indeed, at around the time of the agreement on the Maastricht Treaty in 1992, much economic research based on OCA theory suggested that the euro area as a whole was not an OCA, even though its particular subgroups may have met the OCA criteria.[10] Even recently, Rogoff (2005: 443) has commented: "Right now, Europe may be an optimal monetary area from a political point of view, but it certainly does not appear to be one from an economic one." Also, Goodhart (1995: 449) questions: "How many argue that certain small nations using the dollar, such as Liberia and Panama, belong optimally to the US currency area?" These examples suggest that satisfying OCA criteria alone has little to do with the actual formation of currency unions. Likewise,

[10] See, for example, Eichengreen (1990), De Grauwe and Vanhaverbeke (1991), Bayoumi and Eichengreen (1992) and Neumann and von Hagen (1992). At that time, most academic economists' views were based on the earlier OCA literature (De Grauwe, 2006: 715).

even though OCA theory can be also used to study the sustainability of existing currency unions, the theory does not in practice explain it, either (Cohen, 1994; De Grauwe, 2006: 720-21).

The limitations of OCA theory in explaining the actual formation of currency unions may be partly due to the fact that it does not provide a framework that unifies all of the diverse OCA criteria. There is no consensus on the weight of each OCA criterion, and this leads to the "problem of inconclusiveness" (Tavlas, 1993). As a result, one may draw different borders for a currency union by referring to different OCA criteria (Mongelli, 2002: 11). In fact, most OCA studies tend to focus only on a small number of the OCA criteria and based upon them draw strong conclusions about the economic suitability of countries to join a currency union (Willett *et al*., 2007: 2).[11]

A more critical problem, however, is that OCA theory does not encompass political considerations.[12] This may be a natural consequence of its being an economic theory. However, it is interesting to note that even most OCA studies

[11] In the recent OCA literature, emphasis on patterns of shocks and on the degree of synchronization of business cycles as the primary criteria has become popular, partly due to the easy availability of relevant data and of applicable statistical techniques (Willett, *et al.*, 2007: 4).

[12] As mentioned above, political integration is identified in some OCA studies as part of the OCA criteria. However, the OCA literature generally does not provide a systematic analysis of political factors.

recognize the importance of political factors in determining the establishment of currency unions.

The political economy literature, meanwhile, has made substantial progress recently in studying the formation of currency unions. The next section introduces its major findings.

III. The political economy of currency unions

Politics can affect the formation of a currency union, at both the international and the domestic levels. At the international level, symmetry of influence among member countries, regional leadership, linkage politics, and regional community identity appear to be important factors. At the domestic level, the distributional effects of the currency union and the political institutions may affect currency regime choice (whether or not to join a currency union).[13] The domestic and the international factors interact in complex ways, of course, but for ease of analysis it is useful to address

[13] There are other political economy approaches that analyze exchange rate regime choice. One popular example is the class-based partisan approach, which focuses on partisan influences on exchange rate choice. However, empirical evidence does not appear to support this approach strongly (Broz and Frieden, 2001: 328-29).

them separately.

1. International politics

Prior to discussing international political factors that may affect the establishment of a currency union, it should be noted that the OCA literature rarely explicitly distinguishes between currency unions relying on *unilateral* pegging to an existing dominant currency and those relying on *cooperation* among their member countries. Yet, unilateral action and cooperative action have different political and economic implications in terms of the distributions of the costs of operating currency unions, with these costs likely to be more evenly distributed among member countries in cooperative unions. The discussion in this section focus mainly on international political factors that may influence cooperation among national governments to achieve a currency union.

A. Systemic symmetry

Where countries are able to exercise largely symmetrical influences in a currency union, its creation and sustenance is more likely. Insofar as a currency union's member countries can effectively voice their interests in its collective operation, their monetary sovereignty is not completely lost, but rather pooled together at the union-wide level. Accordingly, the countries' costs of joining the currency union decrease. Of course, for a country that has played a predominant role in the regional monetary system, creation of a symmetric currency union requires a willingness on its part to allow its influence to decrease to some extent in the currency union.[14]

One example that supports this argument may be the creation of the EMU. In the European Monetary System (EMS), the Deutsche mark served as its anchor currency, and this forced other countries to adapt their monetary policies to Germany's. As a result, EMS countries except for Germany effectively lost monetary sovereignty, and the burdens of adjustment to maintain exchange rate parities fell predominantly on them. This asymmetry in the EMS generated conflicts between Germany and the other EMS countries, in particular France. The creation of the EMU was partly an attempt by those countries to regain some monetary sovereignty, as they would have equality with Germany in the European Central Bank (De Grauwe, 1993: 655-56; Sandholtz, 1993: 27-30). Notably, Wyplosz (2001: 141) argues that the EMS would never have been created had it been built as an asymmetric arrangement based upon the Deutsche

[14] The participation of such a country in a symmetric currency union can be encouraged through linkage politics, which will be discussed later.

mark; the EMS was formally a set of identical bilateral arrangements with no center currency, with intervention rules that were explicitly symmetric, and the emergence of the Deutsche mark as the system's anchor currency over time was an unplanned – and perhaps unforeseen – outcome.

The non-creation of currency union in North America can serve as another example. The desirability of currency union has often been discussed in Canada. However, the United States has no willingness to share its monetary policymaking with Canada, which leaves unilateral adoption of the US dollar by the country as the only option for establishing a currency union. Such a union is certainly not acceptable to Canada, as it would then have no say over monetary policy (Helleiner, 2004: 31-33).

B. Benign leadership

In a study of six historical formal currency unions,[15] Cohen (2003) argues that the presence of a regionally dominant country – a leader, or "hegemon" – committed to using its influence to keep a currency union functioning effectively, on terms agreeable to all, is critical to sustainability of the currency union.[16] The underlying

[15] The Latin Monetary Union, the Scandinavian Monetary Union, the Belgium-Luxembourg Economic Union, the CFA Franc Zone, the East Caribbean Currency Area, and the East African Community

[16] Cohen (2003: 278) also emphasizes the presence of community identity, which will be discussed later.

logic of this argument is that sovereign governments need strong incentives to stick to bargains that might, at some point, turn out to be inconvenient, and that such incentives may derive from the encouragement or discipline supplied by a powerful country. Likewise, the role of a leader could be substantial in creation of a currency union, as strong political leadership can foster coherence among member countries having divergent interests through mediation among and provision of necessary support for them. Indeed, the existence of a small group of large nations willing and able to take the lead in monetary relations has been an important element in most successful fixed exchange rate systems (Broz and Frieden, 2001: 339).

Wyplosz (2001: 141-42) indicates that leadership should not be seen as threatening, considering the German case in the creation of the EMU. Due to its historical experience during World War II, Germany has accepted a subdued role throughout the post-war period, trying to develop its influence only within the context of a united Europe. This has largely removed other EC countries' fears of German dominance in Europe, fostering European cooperation.[17] Cohen (2003) also shows

[17] In practice, Europe has been driven by the joint leadership, or partnership, of Germany and France, and their disagreements have been regarded as a guarantee that leadership will be balanced. In addition, their influences have been mediated through institutions, decreasing their capacities for coercion of smaller countries (Wyplosz, 2001: 141-42).

that the CFA Franc Zone, in which France played the role of benign hegemon, was more successful than the Latin Monetary Union, in which France's dominant role was less benign.[18]

C. Linkage politics

International cooperation to form a currency union can be enhanced through "linkage politics." Linkage here means the tying together of two otherwise unconnected issue areas, which allows the agents to an agreement to give concessions in one area in return for receiving concessions in the other. Thus, one country may give in to joining a currency union, even though it does not inherently favor it, in order to attain other objectives. Such a decision is reasonable if the perceived benefits of the other objectives exceed the costs of the former (Eichengreen and Frieden, 1994: 11). Therefore, where many potential areas for cooperation exist outside the monetary realm, a currency union is more likely to be established. Where supranational or international institutions are well developed, as in Europe, the range of areas subject to linkage will be broader.

For instance, Germany's support for the EMU may be explained by linkage

[18] The Latin Monetary Union was formed by Belgium, France, Italy and Switzerland in 1869, and was formally dissolved in 1927 (Cohen, 1994: 152-53).

politics. The establishment of the EMU was seen as likely to mean a loss of German power to determine monetary affairs in Europe, as the European Central Bank would represent the interests of all member countries (De Grauwe, 1993: 655). Thus, on purely monetary grounds, Germany's motives for pursuing the EMU may appear puzzling.[19] Yet, Germany, along with many other European countries, had a broad foreign policy goal of binding itself to its European neighbors, and used the EMU as a crucial means of doing so. In short, Germany's agreement on the EMU may be explained by its support for European integration (Sandholtz, 1993: 31-34).

D. Community identity

Where countries have developed a strong sense of regional community, aversion to a transfer of policymaking authority from the national to the regional level will be lower. In this situation, the creation of a currency union is likely to be easier. The development of formal or informal regional institutions in diverse issue areas can be expected to boost trust among countries and eventually strengthen feelings of regional community, and thus work favorably for creation of a currency union. In contrast, the presence of strong desire for national independence may have a negative effect on

[19] In fact, the German monetary authorities voiced doubts about the EMU and insisted on strict prior conditions (Sandholtz, 1993: 31).

currency union establishment.

Recent studies (Jonung and Vlachos, 2007; Jupille and Leblang, 2007) on the 2003 Swedish referendum on adoption of the euro support these arguments.[20] Those who believed that the EU would undermine Swedish democracy and those who believed that Swedish sovereignty was very important were more likely to vote "no," while those who voted for the euro were more positive toward the idea of increased European political integration.[21]

2. Domestic politics

Even if the international political environment is favorable to creation of a currency union, its realization is difficult without strong domestic support for it within the potential member countries. Where a proposed currency union member country does not enjoy strong domestic support for it, its commitment to a currency union can be threatened. Thus, domestic politics in the countries concerned have significant effects on currency union creation and sustainability. However, the OCA literature focuses

[20] In the 2003 Swedish referendum on joining the euro, public views on the euro were formed on the basis of the traditional OCA approach (Jonung and Vlachos, 2007: 60).

[21] Cohen (1994) also argues that community identity was important for the successes of the Belgium-Luxembourg Economic Union, the East Caribbean Currency Area, and the Scandinavian Monetary Union.

mainly on aggregate economic efficiency, adopting the assumption that policymakers conduct currency policy with the aim of maximizing aggregate social welfare (Willett, 2003: 5). This would be a useful starting point for gauging the attractiveness of a currency union in terms of national welfare. Yet, there is little reason to believe that currency policy is formed any less politically than are other economic policies (Broz and Frieden, 2001: 325). In fact, decades of theoretical and empirical work in political economy do not support such a theoretical proposition (Frieden, 2007: 346).

A. Distributional issues

In the macroeconomic framework of OCA theory, the domestic distributional aspects of currency unions are left out of the picture.[22] However, a policy that is optimal for a country as a whole may not be optimal for particular groups within the country, since the choice of currency regime does have distributional consequences. Thus, domestic actors may have diverse opinions regarding a currency union, dependent upon their own cost-benefit analyses (Broz and Frieden, 2001: 322-25).

Focusing on the tradeoff between exchange rate stability and independent

[22] Recently, a few studies by economists attempt to relate distributional issues with OCA theory. See, for example, Willett (2003) and Jonung and Vlachos (2007).

monetary policy, a simple manifestation of the division between economic actors may be made as follows. First, for those whose businesses are fully domestic, exchange rate stability is insignificant, while domestic business conditions and the government's ability to control national monetary conditions can affect their interests substantially. They will therefore prefer national monetary independence to the stability of exchange rates.[23] Those heavily engaged in international trade and investment, on the other hand, attach great importance to predictability of exchange rates, as this has a major impact on their economic performance.[24] Indeed, to the extent that they can easily move production or sales from home to foreign markets, they care more about the currency values than about domestic conditions. In short, all else being equal, domestically-oriented producers place heavier weight on a flexible exchange rate, and internationally-oriented ones on a fixed exchange rate (Frieden, 1991; 1994; 2007).[25]

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[23] This category mainly includes the nontradables sectors – such as services, construction, and transport – as well as import-competing producers of tradable goods (Frieden, 1991).

[24] This group mainly includes producers of exportables, foreign direct and portfolio investors, and international merchants (Frieden, 2002: 326).

[25] This proposition is consistent with the long-term neutrality of money and the efficiency of forward markets, given that the tradeoff is politically relevant in the short and medium term, while the abilities of forward markets to protect agents far into the future are limited (Frieden, 2002: 839). Of course, this simple assertion needs more qualifications. For example, the degree to which an export industry is sensitive to currency volatility may depend upon its ability to "pass through" the costs arising from

In fact, the distributional analysis of exchange rate regime choice does not say much directly about the actual policy outcomes (Frieden, 1994: 98). To be sure, actual policy outcomes are largely influenced by political institutions that affect the political power of different domestic groups.[26] Nevertheless, distributional analysis can provide clear predictions of the exchange rate regime preferences of economic groups, which may be critical to the country's currency regime choice. Indeed, a good number of studies on the adoption of the euro by member countries suggest that distributional issues took center stage.[27]

B. Political institutions

Political institutions may shape the choice of currency regime by affecting the electoral incentives of politicians. This view is distinct from the distributional approach in that it focuses directly on the government sector, while distributional analysis puts principal emphasis on the preferences of private sector actors. In fact, institutional studies tend to focus only on analyzing the choice of exchange rate

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currency volatility to consumers, in the form of price changes (Frieden, 2002).

[26] To analyze distribution of political power, scholars may use proxies such as an economic sector's share of gross domestic product as a measure of its influence, or take distributional arguments to the individual level of analysis using the available public opinion data on currency regime preferences and voting behavior (Broz and Frieden, 2001: 327-28).

[27] See, for example, Gabel (2000), Kaltenthaler and Anderson (2001), Banducci et al. (2003), Gabel and Hix (2005), Jonung and Vlachos (2007) and Jupille and Leblang (2007).

regime – between flexible and fixed rate – rather than currency regime choice. It can, however, also be extended to address currency regime choice.

One representative study based upon this view is Bernhard and Leblang's (1999) analysis of the exchange rate regime choices of twenty industrial democracies from 1974 to 1995. They argue that the configuration of electoral and legislative institutions conditions the choice of exchange rate regime by politicians, who are presumed to have interest in maintaining their positions in office. In the majoritarian electoral system with low opposition influence, the costs of losing an election are very high, and as a result ruling politicians have strong incentives to retain their ability to manipulate monetary policy so as to generate support prior to elections. Accordingly, they favor floating exchange rate regimes. In the proportional representation system with high opposition influence, in contrast, elections are not very decisive; ruling politicians therefore show less unwillingness to lose policy discretion through adopting fixed exchange rates. In addition, while coalition governments are common in the proportional representation system, a fixed exchange rate may help coalition bargaining by providing a focal point for parties with diverse interests concerning monetary and economic policy.[28]

IV. East Asian currency union

What does OCA theory tell us about East Asia? And by comparison, what implications does political economic analysis of currency unions carry for the region?

1. An OCA analysis

There are a good number of OCA studies of the feasibility of currency union in East Asia. Watanabe and Ogura (2006: 11-12) review fourteen recent OCA studies of this subject, and find that all but two take a positive view, at least for certain subgroups of East Asian countries.[29] Eight of the twelve studies which consider Japan show that it and its Asian neighbors make a feasible combination for a currency union. Five of the

[28] Bernhard and Leblang (1999) also contend that electoral timing affects the governing party's incentives relative to the exchange rate regime. Competing studies in political institutional analysis point, as key explanatory variables, to the number of veto players in the political system, such as subnational governments and party veto players (Hallerberg, 2002), to the degree of transparency in the political system (Broz, 2002), etc.

[29] The papers covered by the study are Bayoumi *et al*. (2000), Loaza *et al*. (2001), Yuen (2001), Baek and Song (2002), Chow and Kim (2003), Lee *et al*. (2003), Kawai and Motonishi (2004), Kwak (2004), Zhang *et al*. (2004), Girardin (2004), Sánchez (2005), Tang (2006), Ogawa and Kawasaki (2006) and Huang and Guo (2006).

eleven studies that include China suggest that an East Asian currency union encompassing it would be possible. Ten of the thirteen studies that consider South Korea show the feasibility of an East Asian currency union including it (see the Appendix).

These findings, however, can be interpreted as answering either “yes” or “no” to the question of whether East Asia is an OCA. Firstly, there is no strong evidence that East Asia as a whole is an OCA, although certain subgroups of East Asian countries do appear to meet some OCA criteria. Secondly, as Willett (2007: 4) points out, there is considerable variability across studies as to the composition of the subgroups.[30] These two points may seem to deny the feasibility of an East Asian currency union. This is not necessarily so, however; many OCA studies have not assessed the entire euro area as an OCA, either. Ultimately the findings of the existing OCA studies of East Asia can provide economic grounds sufficient to support either positive or negative positions toward an East Asian currency union. In this circumstance, a critical issue is whether countries in the region are actually willing and able to pursue currency union. And it is at this point that political factors come to the fore.

[30] This should not be surprising, given that the methodologies applied across the studies vary.

2. A political economy observation

Systematic analysis of the political economy of an East Asian currency union requires in-depth research on the region. Such a comprehensive study is beyond the scope of this paper.[31] Instead, this study presents a preliminary analysis, by applying the discussed major findings in the political economy literature on currency unions to the region.

A. The regional level

The international political situation in East Asia does not appear to encourage hopes for emergence of a currency union in the region. Firstly, the likelihood that either Japan or China, the region's two most important powers, can exercise leadership effectively in a way accepted by other East Asian countries is not high. Japan is still strongly denounced for its reluctance to resolve historical tensions with its East Asian neighbors,[32] while the perception of a "China threat" seems to remain strong in the

[31] There is little comprehensive political economic research related to the issue of an East Asian currency union.

[32] According to a public opinion survey conducted by the Pew Research Center in 2006, more than 80 percent of Chinese respondents believed that Japan had not apologized sufficiently for its military actions during the 1930s and 1940s, while about 40 percent of Japanese respondents agreed.

region. If the two countries were to provide joint leadership by cooperating with each other, it would reduce other countries' fears about dominance by either, thereby working to favor formation of an East Asian currency union. Such a possibility appears to have increased to some extent recently, as both Japan and China have been cooperative in development of the Chiang Mai Initiative, a network of swap arrangements among ASEAN+3 countries to provide short-term liquidity assistance (Chey, 2007). However, the current situation surrounding the RCU, which will be discussed later, suggests that expansion of such cooperation to other areas of monetary cooperation will not likely be easy. In addition, China is willing to see the renminbi appreciate to at least a limited extent to prevent its economy from growing too fast, while Japan is happy with depreciation of the yen as a way of boosting exports; under these circumstances, it would be hard to expect the two countries to embrace a common monetary policy (Eichengreen, 2007: 90).

Community identity in East Asia also does not appear to have developed much, at the public level at least, despite the 1997 Asian financial crisis. For example, a public opinion survey by the Japanese government in 2007 showed that more than 80 percent of Japanese respondents not feeling affection for other Asian countries, with the ratio having in fact increased slightly in recent years. It is also worth noting that Japanese public opinion of China has worsened in the past few years, with more than 60 percent of the survey respondents expressing non-affection for China. Meanwhile, in a public opinion survey by the Pew Research Center in 2006, more than 70 percent of Chinese respondents expressed unfavorable views of Japan. The responses to these surveys contrast vividly with the more than 70 percent of European respondents in the *Eurobarometer*, a public opinion survey by the European Commission, who expressed support for European unification and the EC in the early 1990s (European Commission, 1992).[33]

In addition, it should be asked whether China and Japan would intend to build a symmetric currency union. This question may be addressed by considering their current attitudes toward creation of an RCU.[34] Determination of the weights of currencies to be included in an RCU is an issue critical to its creation.[35] Yet, the

[33] A number of scholars also argue that creation of an East Asian currency union would require commitment on the part of member countries to political integration, but this is almost completely absent in the region. See, for example, Eichengreen (2007).

[34] Also note that even though Japan and China support development of the Chiang Mai Initiative, they appear to intend exploiting it as a means of increasing their own influences in the region, in particular, to promote internationalization of the yen (Chey, 2007), and the renminbi, respectively.

[35] The weights of currencies in an RCU will affect the adjustment burdens of member countries if an EMS-like system is introduced. Simply speaking, all else being equal, the more symmetrical the weights are, the more equally the adjustment burdens will be distributed to member countries.

Japanese reports (IIMA, 2007) in the 2006 ASEAN+3 research group study of the RCU include suggestions biased toward increasing the weight of the yen in the basket currency. This could be interpreted as indicative of a Japanese wish to see the yen evolve over time into the anchor currency in the system, as the Deutsche mark did in the EMS. Meanwhile, China is reluctant to discuss an RCU, expecting that the renminbi will naturally become a dominant currency in East Asia as time passes. Given these circumstances, it may be difficult to expect that China and Japan will agree to creating a symmetric currency union. On the other hand, an asymmetric currency union, either a yen bloc or a renminbi bloc, might face difficulty gaining acceptance from their East Asian neighbors.[36]

If there is much room for emergence of linkage politics, joint leadership by Japan and China, or cooperation by a larger number of East Asian countries, might be an easier way to go. However, the number of regional issues that can be used in international bargaining in connection with creation of a currency union is limited,

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[36] There is a view that an existing regional anchor currency would be helpful to the creation of a cooperative exchange rate arrangement in East Asia. See, for example, Glick (2005). This may be plausible from an economic perspective, but it is not so from a political viewpoint for the reasons discussed above.

partly because of the underdevelopment of regional institutions in East Asia.[37] Moreover, note that for an international bargain to take place in exchange for formation of a currency union, there need to be issues that are of importance similar to that of currency unification. At this moment, however, there are few such important regional issues requiring broad international cooperation.

Finally, it should not be forgotten that the US policy position is another significant variable that can affect creation of an East Asian monetary union. The United States has traditionally been opposed to the emergence of East Asian regionalism, including the creation of a yen bloc. A telling example was the strong US opposition to Japan's proposal in 1997 for an Asian Monetary Fund, which the United States regarded as a threat to dollar hegemony in the region (Chey, 2007). Recently, the United States has seemed to act as an onlooker with regard to East Asian monetary cooperation (Chey, 2007). However, its actual position is not yet clear. Moreover, if the establishment of a currency union were to lead East Asian countries to reduced purchases of dollar-denominated assets, the hegemonic position of the dollar in the international monetary system could be seriously challenged, and the United States

[37] For an analysis of East Asian regionalism during the post-crisis period, see for example Bowles (2002), Dieter and Higgott (2003), Hamilton-Hart (2003), Hund (2003), McDougall (2002) and Pascha (2007).

might endeavor to prevent this happening.[38]

B. The domestic level

Examining Japan and China, the domestic political situations do not appear very favorable for creation of a currency union, either. In the case of Japan, the share of intra-regional trade (with ASEAN+3 countries and Hong Kong) in GDP is quite low, reaching only about 10 percent in 2005.[39] In this regard, domestic support in Japan for exchange rate stability vis-à-vis its East Asian neighbors is not expected to be strong; discretionary monetary policy is likely to attract more domestic support. On the other hand, the Japanese electoral system is a combination of the majoritarian and the proportional representation systems.[40] This makes it difficult to forecast whether the electoral system might be for or against a currency union. Nonetheless, given that Japan has maintained a floating exchange rate for a long time without serious domestic challenge, a high level of domestic support for currency union does not seem likely in the country.

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[38] Whether the United States would be able to effectively block East Asian countries' cooperative efforts to establish a currency union is an issue that needs more research.

[39] In 1992, the share of intra-regional trade in GDP was higher than 20 percent for most member countries of the European Union, with Italy's 17 percent the lowest.

[40] Two-thirds of the total seats in its House of the Representatives are elected by a majoritarian system, and the remaining by a proportional representation system.

As for China, the share of its intra-regional trade (with ASEAN+3 countries and Hong Kong) is higher than Japan's, amounting to 26 percent in 2005. In this sense, Chinese domestic support for an East Asian currency union is likely to be higher than that in Japan. As China is not a democracy, political institutional analysis based upon its electoral or legislative systems is not applicable. Discussion of whether the current Chinese political regime will or will not support a currency union is possible, however, and in this regard it is the view of this paper that the Chinese government may need to achieve high economic growth to maintain acceptance of the current socialist political regime's legitimacy. This may give the government strong incentive to retain monetary policy independence as a tool for managing domestic economic conditions.

To sum up, it may be fair to conclude that the domestic political situations in Japan and China do not provide strong foundations for emergence of an East Asian currency union.

V. Conclusion

This study has reviewed the OCA literature and the political economy literature on currency union, and discussed the likelihood of an East Asian currency union emerging. OCA theory has an important limitation in that it is not effective in explaining the actual formation of currency unions. It is at this point that the political economy literature makes substantial contributions. Application of the major findings in these two academic approaches to East Asia suggests that even though the region seems to some extent a feasible candidate for currency union from the economic perspective, political conditions in the region may hinder creation of an East Asian currency union.

This study does not argue that OCA theory is meaningless. The OCA literature provides a systematic analysis of the economic costs and benefits of currency unions, and such analysis does carry significant implications for policymakers, as economic conditions tend to constrain the possible sets of policies they can choose. It should also not be forgotten that there are caveats to political economic analysis of currency unions as well. For example, the political economy literature makes few attempts to answer the salient question of whether or not countries should join a currency union. In addition, just as the OCA literature disagrees on the relative significance of economic factors, there is no consensus in the political economic literature on which political factor is most important in currency union establishment. Nevertheless, political economic analysis is critically important in practice, since policies framed in ignorance of their political economic implications will face serious problems during their implementation phases. Ultimately, inputs from both the economic and the political perspectives are required if the study of currency unions is to become more systematic and realistic.

This paper concludes by highlighting three points where these two different academic strands may be effectively linked. Firstly, given that the OCA literature carries strong implications as to the domestic distributional effects of currency union, it can provide a useful foundation for political economic analysis focusing on such effects (see also Jonung and Vlachos, 2007; Willett, 2003).[41] Secondly, the political economic research based on functionalism has frequently discussed the spillover effects of cooperation in the process of European integration, and this discussion has strong analytic similarities with the endogenous OCA analysis of policy response to currency union formation (Willett, 2006: 27-28). Finally, OCA endogeneity may be

[41] The findings of political economic analysis focused on the domestic distributional effects of currency union, which were mentioned earlier, may be extended to argue that more open economies are more likely to favor a currency union, which is quite consistent with OCA theory (Willett, 2003: 20-21).

affected by the motivations for creation of the currency union (De Grauwe and Mongelli, 2005; Frankel and Rose, 1997: 29). Thus the political economic analysis of such motivations may provide significant insights for the study of OCA endogeneity. This paper would suggest all three of these areas to be rich in possibilities for future research.

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Appendix. Identified Optimum Currency Areas in Asia

	China	Hong Kong	Taiwan	Japan	South Korea	Singapore	Malaysia	Indonesia	Thailand	Philippines	Other ASEAN countries	Australia and New Zealand	India
Bayoumi *et al.* (2000)													
Loaza *et al.* (2001)													
Yuen (2001)													
Baek and Song (2002)													
Chow and Kim (2003)													
Lee *et al.* (2003)													
Kawai and Motonishi (2004)													
Kwak (2004)													
Zhang *et al.* (2004)													
Girardin (2004)													
Sánchez (2005)													
Tang (2006)													
Ogawa and Kawasaki (2006)													
Huang and Guo (2006)													

Source: Watanabe and Ogura (2006: 12)

Notes: 1. Shaded boxes indicate inclusion of countries in the OCAs identified in the papers concerned, and boxes marked with diagonal lines indicate non-coverage of countries in respective studies.

2. The OCA criteria adopted by the fourteen studies are not identical. For instance, Kwack (2004) examines trade openness, trade and foreign direct investment directions, similarities in economic structures and in responses to common shocks, and factor mobility, while Tang (2006) mainly analyzes the symmetry of, the size of, and the speed of adjustment to shocks.

< Abstract in Korean >

최형규*

1997년 아시아 외환위기가 발생하고 1999년에 유로화가 출범하자 동아시아 통화동맹 설립의 적절성과 실제 수립 가능성에 대한 논의가 활발히 전개되어 왔다. 그러나 이러한 논의 대다수가 기반하고 있는 최적통화지역(OCA) 이론은 역내 국가의 정치적 역학관계 등 비경제적 요인을 고려하지 않아 통화동맹의 실제 수립 가능성 여부를 충분히 제시하지 못하고 있다.

본 논문은 통화동맹과 관련하여 OCA 이론 연구와 정치경제학 연구를 이슈별로 조사하고 시사점을 도출하고자 하였다. 조사 결과 동아시아 통화동맹 설립 가능성을 보다 체계적으로 분석하기 위해서는 정치경제적 요인들에 대한 종합적인 접근이 필요한 것으로 나타났다. 통화동맹 설립에 영향을 미치는 주요 요인들로는 우선 국제정치적 요인인 통화동맹 참여국 영향력의 균형도, 역내 리더십, 통화동맹 협상과 연계될 수 있는 여타 협력분야의 존재, 지역공동체 의식 등이, 국내정치적 요인인 통화동맹 지지집단과 반대집단의 정부 정책결정에 대한 영향력, 선거제도와 같은 정치제도 등이 있는 것으로 조사되었다.

기존의 OCA 이론 연구와 정치경제학 연구의 주요 결과를 동아시아에 적용하여 평가해 본 결과, OCA 이론 연구결과는 부정적·긍정적 어느 쪽으로도 다분히 자의적으로 해석될 가능성이 있으나, 역내 국제정치적 상황 및 주요국의 국내정치적 상황은 통화동맹 수립에 덜 우호적인 것으로 평가된다.

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