

Revisiting the Shocking Aspects of Asian Monetary Unification

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Summary

This paper revisits the question whether economies in Asia are likely to be good candidates for pursuing similar exchange rate policies and ultimately joining together in a monetary union. A number of authors have investigated this question before typically using some variant of the methodology originally used by Bayoumi and Eichengreen (BE) to study the same question for countries that were potential candidates to form common currency area in Europe. It is the contention of this paper that this methodology is flawed because it fails to identify properly the aggregate demand and aggregate supply shocks in each economy and hence cannot adequately address one of the central issues in determining the suitability of two or more countries joining a monetary union. To remedy this deficiency in the existing literature we propose an alternative methodology to identify structural shocks. We will therefore be able to revisit the debate about monetary integration in Asia based on more solid empirical foundations.

The results show that these modifications do matter for the cross-country correlation of these shocks. In particular, aggregate demand shocks among the relatively smaller economies of Asia appear to be more highly correlated with the larger or more advanced economies in the regions such as Korea, Hong Kong, Singapore, and Japan, than they are amongst themselves when we rely on the standard BE methodology. When an alternative approach is used we conclude, for example, that aggregate supply shocks remain most highly correlated between China, Hong Kong and the remainder of the economies in our sample while Japan and Singapore, most notably, seem more 'disconnected' with the rest of the region.

Taking explicit account of foreign shocks not only prevents them from erroneously being confounded with domestic shocks as in the conventional methodology, it also makes it possible to evaluate the desirability of a common monetary policy response to common external shocks. Our results show that this can have an important bearing on assessing the desirability of forming a monetary union among the economies in the region. With respect to the implications for monetary unification in Asia our results do not clearly identify a group of countries for which shocks are unambiguously highly correlated and which therefore would be able to perform well with a common monetary policy.