

The Political Economy of Japanese Monetary and Exchange Rate Policy — With Special Reference to Regional Monetary Cooperation in East Asia^{*1}

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Abstract

This study analyzes the political economy of Japanese monetary and exchange rate policy, with particular emphasis on the Japanese position regarding East Asian monetary cooperation and integration. We try to disentangle the factors and interest structures behind the policies taken in order to infer how the Japanese position regarding regional monetary cooperation might evolve over time. The analysis shows that while the current incentive structure within the Japanese economic and political system gives little room for a far reaching commitment of the Japanese government to engage in regional monetary cooperation, a further integration of the Japanese economy into the regional economy and a growing dependency on the East Asian market are likely to shift the equilibrium in favor of regional cooperation.

1. Introduction

Japanese economic policy — including monetary and exchange rate policy —

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has traditionally been unconcerned about regional economic cooperation. With Japan being a relatively closed economy and otherwise being oriented in its exports mostly to global rather than regional markets, monetary policy was primarily focused on domestic economic developments; monetary and exchange rate cooperation with the regional neighbors was not an issue at all. Yet things have changed since the East Asian crisis of 1997–98. At the G7-IMF meetings in Hong Kong in September 1997, just weeks after the outbreak of the crisis in Thailand on July 2, the Japanese financial authorities proposed the creation of an Asian Monetary Fund (AMF) as a framework for financial cooperation and policy coordination in the region. While the plan for an AMF was withdrawn shortly after its proposal because of pressure from Washington (which will be discussed in more detail later on) it marked a notable change in the Japanese policy toward its neighbors.

The crisis highlighted the close economic dependencies within the region and stirred great interest in regional financial and monetary cooperation in Japan as well as the rest of East Asia. The crisis was followed by a continuous policy dialogue and a string of cooperative initiatives in the area of money and finance between Japan, China, South Korea, and the ten member countries of the Association of Southeast Asian Nations (ASEAN)—a grouping that has become known as ASEAN+3. While some progress has been made in East Asia post crisis in the area of financial cooperation, monetary and exchange rate cooperation has not materialized yet. This might be somewhat surprising given the high degree of intraregional trade that ASEAN+3 countries have already achieved. With intraregional trade on average accounting for almost 60 percent of total trade for ASEAN+3 countries, the region is almost reaching levels of real economic integration seen in the European Union (EU). Especially for Japanese corporations, who have invested heavily in the region and established extensive trade-FDI-networks throughout Southeast and Northeast Asia, intraregional exchange rate stability should be paramount. One thus might expect Japanese businesses, and hence the Japanese government, to take an active interest in regional monetary and exchange rate cooperation.

So far, the Japanese authorities' posture regarding regional monetary cooperation has been ambivalent. On the one hand, Japan has so far maintained a distinct position with respect to exchange rate policy in East Asia. While virtu-

ally all other East Asian countries have followed relatively similar exchange rate policies, with their currencies all being effectively linked to the US dollar in the form of soft or hard pegs. Japan has been the only country in the region that did not stabilize its exchange rate against the dollar, except for short periods of intervention (e.g., Spiegel 2003). Thus, while the other East Asian countries have formed what has become known as the informal “East Asian dollar standard” (McKinnon 2001), a system that has provided relative exchange rate stability between these countries, Japan has followed its own singular exchange rate policy, making the exchange rates of Japan vis-à-vis its neighbors vulnerable to swings in the yen-dollar exchange rate.

On the other hand, Japan has launched important initiatives directed toward regional monetary cooperation in East Asia, such as the above mentioned AMF proposal, and played a key role in developing the Chiang Mai Initiative, a network of bilateral swap arrangements among ASEAN+3 countries that provides for mutual assistance in the event of a financial crisis. Also, Japan has been a driving force in other initiatives launched by the ASEAN+3 finance ministers, such as the ASEAN+3 surveillance process and the ASEAN+3 Economic Review and Policy Dialogue. Moreover, the idea of an Asian Currency Unit, now promoted by the ADB, originated in Japan. (The current president of the ADB, Haruhiko Kuroda, who is an ardent supporter of the ACU, is a former high-level Japanese government official.)

The aim of this paper is to understand the political economy of monetary and exchange rate policy in Japan in the context of the regional economy. That is, we try to disentangle the factors and interest structures behind the policies taken in order to infer how the Japanese position regarding regional monetary cooperation might evolve. The position and policy actions of Japan as the largest economy in East Asia and a major actor in regional trade and investment will have great impact on the future course of East Asian monetary cooperation. A better comprehension of the Japanese position with respect to East Asian monetary cooperation is therefore crucial to understanding the perspectives for regional monetary cooperation and integration.

We define international monetary cooperation quite broadly to include, for instance, consultations between policymakers regarding the choice of monetary and exchange rate regimes and the exchange of information among monetary

authorities. With monetary coordination we refer to the agreement by two or more countries to a cooperative set of policy changes, which none of the countries involved would take on their own. Lastly, by monetary integration we mean all forms of coordinated currency stabilization. Besides monetary union, which is defined as an area where a common currency circulates which is issued by a single central bank, monetary integration comprises also less far reaching forms such as coordinated pegging to the same anchor currency or currency basket, and the establishment of a common exchange rate system.

Parts of the information in this paper is based on informal interviews that were conducted with researchers, policymakers, and officials of the Japanese authorities and Japanese business organizations; with representatives of international financial institutions, foreign embassies, governments, and central banks; with journalists; and with Japanese and international academic scholars familiar with the Japanese and regional situation. The interpretation of the information gathered in these interviews is ours alone and should in no way mean to reflect the official point of view of any of the organizations or governments concerned.

The paper is structured as follows. The next section gives an overview of the theoretical literature on the political economy of monetary and exchange rate policy so as to provide the theoretical background for the analysis that is to follow thereafter. Section 3 describes the institutional setting of Japanese monetary and exchange rate policy and the roles of the main actors, most importantly the Bank of Japan (BOJ) and the Ministry of Finance (MOF). Section 4 then turns to Japan's role in East Asian monetary cooperation and integration and scrutinizes the roles of relevant stakeholders and their interests and policies. Section 5 concludes with some predictions of how the Japanese policies with respect to regional integration might develop.

2. Theoretical literature review

There is a rich theoretical literature looking at the political economy of monetary and exchange rate policy. We first review the more general literature looking at how monetary and exchange rate policy might be shaped by the interests of a ruling government and the political business cycle. We then turn to the political economy of monetary integration.

The political business cycle, the time inconsistency problem, and central bank independence

The departure point of the political economy literature is that economic policy decisions are not simply based on the considerations of a benign dictator who takes into account all relevant information and then maximizes the economy's utility function as economic theory in its most simple form assumes. In reality, policy decisions are influenced by the interests of the stakeholders involved. This includes the personal or institutional interests of the policymakers themselves, as well as those of interest groups that will be affected by the outcome of policy decisions, and who might therefore seek to influence the contents of the policies by lobbying the government.

Nordhaus (1975) has developed the model of a political business cycle where the government in a democratic society has an incentive to influence economic behavior in a way that will produce a benign economic environment just before upcoming elections and that will thus favor the government's re-election. One of the assumptions of this model is that there exists a non-vertical Phillips curve in which shifts in aggregate demand generate changes in output and employment, at least temporarily. Moreover, politicians are assumed to be able to instrument fiscal or monetary policy to exploit this situation in order to remain in power. This basic political business cycle model has been extended to include partisan considerations (Hibbs 1977), endogenous election cycles (Chappell and Peel 1979, Lachler 1982), and rational expectations of voters (Alesina 1987).

Kydland and Prescott (1977) and Barro and Gordon (1983) have formalized the time inconsistency problem that arises from a situation where the government (or the central bank) can change its monetary policy stance after firms and workers have concluded nominal wage and price contracts. By an unanticipated monetary expansion—which would bring about surprise inflation—the central bank can create a temporary output expansion. If the central bank misuses its policy repeatedly, agents will take this into consideration and expect a higher inflation rate, hence settling for higher wage and price contracts, which in turn will increase actual inflation. Discretionary central bank policy is thus likely to lead to an inflation bias. Central bank independence is generally viewed as a means to outrule such behavior and solve the dynamic-inconsistency problem.

The institutional independence of the central bank is thus an important determinant of whether monetary policy can be instrumented by policymakers to influence the political business cycle in order to secure their re-election.

The political economy of monetary integration

Henning (1994) maintains that private-sector preferences and government institutions jointly determine the disposition of countries toward international monetary matters. The literature on the political economy of monetary integration highlights the distributional effects of coordination or non-coordination of monetary policies and exchange rates on different groups within an economy (see, e.g., Broz and Frieden 2006; Hefeker 1997). Groups involved in foreign trade and investment are generally predicted to have an interest in exchange rate stability as this is commonly assumed to promote trade and investment. Hence, internationally oriented corporations that import or export a lot and that are heavily exposed to exchange rate risk are expected to prefer stable exchange rates. Groups whose economic activities are more focused on the domestic economy, in contrast, are assumed to prefer a floating regime that will allow the government to use economic policies to stabilize the domestic economy. The latter group typically includes producers of non-tradable goods and firms from the import-competing sector.

Similarly, banks and other financial institutions without substantial international business or foreign asset portfolio will be usually most concerned about domestic inflation, as rising inflation typically reduces the positive spread between the cost of funds and the return on assets, threatening to lower their profitability. They will thus have a preference for the central bank having a strong focus on inflation, i.e., exchange rate policy will not be a primary concern for them (Henning 1994, chapter 2). Banks engaged in international business will typically find it easier than manufacturers to cope with volatile exchange rates, although banks with heavy long-term commitment in foreign fixed assets, e.g., foreign subsidiaries, might as well be adversely affected by exchange rate volatility.

In his sunk cost model Krugman (1989, pp. 44–59) has shown how exchange rate variability is likely to influence exporting firms' international pricing of goods, as well as their international investment behavior.¹⁾ Firms usually price

their goods or services in the currency of the country they sell them in. Due to competition in the foreign market, they are not able to adjust these prices to exchange rate changes, with the result that the exporting firm has to bear the costs of an appreciation of its home currency, and might even accumulate losses. Krugman's (1989) "sunk cost" refers to the investment costs that occur when entering and exiting a foreign market, such as costs for market research or the development of a sales network. The larger exchange rate uncertainty, the higher the risk of a failed investment. This causes potential investors to adopt a wait-and-see attitude toward foreign investment, and, due to exchange rate uncertainty, exporters will only undertake investments that can be expected to reap a higher rate on investment than those in the domestic market. As a consequence, firms are likely to invest less, which implies opportunity costs and bygone profits. For those engaged in cross-border and foreign currency transactions, predictable or completely fixed exchange rates are therefore of high value, and hence interest groups which prefer fixed over flexible rates can be found especially in sectors exposed to international trade.

A further incentive for entering a monetary arrangement such as a regional monetary system relates to the time inconsistency problem described above. Monetary integration can be used to instrument economic reform and buy credibility to overcome the time inconsistency problem. The time inconsistency literature was able to show that monetary credibility of a country with high inflation rises through the entry into a currency area because policy makers get their "hands tied" (Giavazzi and Pagano 1988). The strategy of tying one's hands aims at the import of stability, because an exchange rate target requires the subordination of national economic policies and currency devaluations cannot be used to compensate for inflationary price and wage policies. The assumption is that national governments would not be able to see through such a policy course on their own. Recent contributions have particularly discussed how a stabilization of exchange rates can induce changes in the labor and factor markets or changes in the monetary policy regime that suppress inflationary

1) See also Collignon (1999).

wage and price setting and that bring about a convergence of inflation rates.²⁾

3. The Japanese institutional setting and policy record to date

To understand the political economy of Japanese monetary and exchange rate policy, it is important to be aware of the institutional setting in which policy is being conducted. The two most important actors are the BOJ and the MOF.

The BOJ is responsible for conducting Japanese monetary policy, as specified in the BOJ law, whereas the MOF is in charge of exchange rate policy. The BOJ law was rewritten in 1997 and came into effect in April 1998. Under the old law, which was written during World War II, the BOJ had little *de jure* independence.³⁾ The new law significantly strengthened the BOJ's institutional and policy independence.

Article 1 of the new BOJ law (BOJ 1997) defines “[t]he objective of the Bank of Japan, as the central bank of Japan, [...] to issue banknotes and to carry out currency and monetary control. In addition [...], the Bank's objective is to ensure smooth settlement of funds among banks and other financial institutions, thereby contributing to the maintenance of an orderly financial system.” Article 2 of the BOJ law stipulates as the principal objective of currency and monetary control that “[c]urrency and monetary control shall be aimed at, through the pursuit of price stability, contributing to the sound development of the national economy.”

Monetary policy decisions are made by majority vote at the BOJ's Monetary Policy Meetings (MPM) of the Policy Board. The board consists of nine members: the governor, two deputy governors and six experts on monetary affairs and economics. The new BOJ law states that members of the Policy Board are appointed on the basis of their expertise.

2) Schelkle (2001a) maintains that especially structural inflation might only be overcome by a policy of monetary integration. This might have been a main reason for Italy's membership in the EMS, even though it meant a complete departure from past economic policies (Giavazzi and Pagano 1988). The convergence of interest rates was also one of the Maastricht criteria, and the convergence that was achieved illustrates the structural change in national economic policies that was made possible by the political decision to join EMU. For a comprehensive treatment of the interaction between wage bargaining and monetary policy in the European Monetary and Economic Union see Dullien (2004).

3) For a detailed account of the Japanese monetary policy up to the mid 1990s, i.e., the time before the BOJ law was rewritten, see Cargill, Hutchison and Ito (1997).

The BOJ's institutional independence and the transparency of monetary policy decisions were greatly enhanced under the new BOJ law. The process of drafting the new BOJ law, however, was rather coincidental. The amendment came about as a political compromise in the aftermath of the burst of the asset bubble in late 1990s, when the reputation of the MOF as a supervising authority over the financial sector had been shattered—more so than the reputation of the BOJ which is often blamed for leaving the bubble growing too long. The trigger for BOJ reform came from outside politically as part of the MOF reform after the *jusen* (housing loan finance companies) crisis in 1996. According to Shigeru Ito, the then Vice President of the Social Democratic Party (one of the ruling coalition parties at the time) and head of the MOF reform project team, the reform plan for abolishing the MOF's Banking and Securities Bureau and the decoupling of treasurer and financial supervision functions caused immense resistance from the MOF (cf. Tokyo Shinbun 2007). To shift attention away from the MOF reform, it was decided to amend the BOJ law. Although the MOF wanted to keep the BOJ under its control it compromised in order to keep itself out of the fire. In July 1996 then Prime Minister Ryutaro Hashimoto appointed Yasuhiko Torii, then president of Keio University, to head an advisory Central Bank Study Group.

The MOF opposed to the Study Group's original draft which did not include government representatives in the BOJ's Policy Board and succeeded in allowing two non-voting government representatives “when necessary, [to] attend and express views at Board meetings for monetary control matters” (Article 19.1) as well as the right to “submit proposals regarding monetary control matters, or request that the Board postpone a vote on monetary control matters until the next board meeting of this type.” (Article 19.2) Moreover, Article 4 of the new law stipulates that the BOJ “shall always maintain close contact with the government and exchange views sufficiently, so that its currency and monetary control and the basic stance of the government's economic policy shall be mutually harmonious.”

Nevertheless, the new BOJ law meant a great advancement in terms of independence when compared with the previous law.⁴⁾ In the assessment of Ito

4) Cargill, Hutchison and Ito (2000, chapter 4) provide a detailed comparison of the changes to the BOJ law.

(2006, pp. 106–7), “[t]he Bank of Japan Law of 1998 is in every sense a state-of-the-art modern central banking law. The central bank is given a mandate of price stability (Article 2), and there is no mention of aggregate demand or full employment as part of its objective. Institutional independence is guaranteed in the sense that Governors as well as Policy Board members will not be dismissed unless physically or mentally incapacitated; their terms of appointment are five years; government officials attend Board meetings only as non-voting members.”⁵⁾

Cargill, Hutchison and Ito (2000) use the rating method developed by Cukierman, Webb and Neyapti (1993) as the most detailed and recent among available methods for rating the degree of independence of the BOJ on a *de jure* basis. Table 1 compares the rating of the BOJ during 1980–89 as evaluated by Cukierman, Webb and Neyapti (CWN) and that of the BOJ under the new law, evaluated by Cargill, Hutchison and Ito (CHI). As can be seen in Table 1, the score of independence rose substantially with the new BoJ law from 0.18 to 0.39.⁶⁾ The new rating now compares favorably with those of other advanced economies, placing the BOJ in the middle of a ranking of central bank independence of advanced countries, compared to 20th out of a group of 21 advanced countries before the reform (cf. Cargill, Hutchison and Ito 1997, p. 184).⁷⁾

An episode that illustrates the BOJ’s newly gained monetary policy independence after the reform of the BOJ law is recounted by Ito (2006, p. 112):

5) Moreover, under the new law transparency of monetary policy decision-making was greatly enhanced. Under the old regime the monetary policy board was often described as rubber-stamping decisions that were already made beforehand by the MOF and there was no disclosure of minutes or transcript. The BOJ under the new law, in contrast, announces its decisions on the day of meeting, followed by a press conference by the governor within a few days. Detailed minutes are publicly disclosed several weeks after the meeting (cf. Ito 2006).

6) Cargill, Hutchison and Ito (2000) point out that due to a wrong assessment in item 1c, CWN’s rating value of 0.83 under the old law is apparently a mistake because the governor was subject to dismissal under any conditions. Therefore the overall rating under the old law should have been 0.0415, lower than 0.18.

7) Cargill, Hutchison and Ito (2000, p. 111) emphasize that despite its low *de jure* independence the BOJ’s inflation record was the lowest with an average inflation rate of 3.31 percent for the period 1975–96 in a sample of 19 industrial countries. They argue that the Japanese tradition of a “long-lived” and highly autonomous government bureaucracy and the resulting strong institutional standing of the MOF might have de-linked the MOF and thus also the BOJ from the political business cycle, helping the BOJ to achieve price stability.

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Table 1 Independence of BOJ before and after reform of the BOJ law

Item	Adjusted weight (2)	Japan's score		Japan's weighted score		
		CWN (3)	CHI (4)	CWN (2)x(3)	CHI (2)x(4)	
1. Chief executive officer (CEO)						
a. Term of office	0.05	0.05	0.5	0.5	0.025	0.025
b. Appointment	0.05	0.05	0.25	0.75	0.0125	0.0375
c. Dismissal	0.05	0.05	0.83	0.83	0.0415	0.0415
d. Joint appointment in government offices	0.05	0.05	0.5	1.0	0.025	0.05
Subtotal					0.104	0.154
2. Policy formulation						
a. Formulation of monetary policy	0.05	0.05	0.67	1.0	0.0335	0.05
b. Authority on resolution of conflict	0.05	0.05	0	1.0	0	0.05
c. Role in government's budget process	0.05	0.05	0	0	0	0
Subtotal						
3. Objectives						
a. Stated objectives do not include price stability						
b. Price stability is one goal, with the others compatible	0.15	0.15	0	0.6	0	0.09
c. Objectives include stable banking system					0.0335	0.10
4. Limitations on lending to government						
a. Advances for nonsecuritized lending	0.15	0.1765	0	0		
b. Securitized lending	0.1	0.1765	0	0		
c. Terms of lending	0.1	0.1765	0.33	0.33	0.033	0.033
d. Potential borrowers from bank	0.05	NA				
e. Limits on central bank lending	0.025	NA				
f. Maturity on loans	0.025	0.0294	0	0		
g. Interest rates on loans	0.025	0.0294	0.25	0.25	0.006	0.066
h. Buying or selling government securities in the primary market	0.025	0.0294	0	0		
Subtotal					0.039	0.039
Total = 1 + 2 + 3 + 4					0.18	0.39

Source: Cargill, Hutchison, Ito (2000), Table 4.3, pp. 108–9.

“When Governor Hayami and some Board members started to suggest in the spring of 2000 that ZIRP [the BOJ’s Zero Interest Rate Policy] might be terminated soon, many economists and government officials questioned the basis for early tightening. The economy was only on a fragile recovery path, and the internal and external environment was turning worse, as the IT stock bubble had burst. The US economy was slowing down due to the collapse of IT stock prices. Domestic consumption and investment were also slowing down. However, the Bank of Japan pushed the agenda. It is said that the Bank wanted to raise the interest rate in the July MPM, but that this was pushed back by one month because it feared a negative impact of the failure of the Sogo Department Store. As the department store failure turned out to be not so negative for the overall economy, the motion was tabled in the MPM of August 2000. In the 11 August MP meeting, the government officials who attended the meeting without voting power argued that it would be too early to raise the interest rate. The government officials [...] submitted a motion to delay the voting on the interest rate hike by one month. This was the maximum resistance and show of displeasure that the government could make against the independent central bank. The delay motion was voted down by the votes of 1 in favour to 8 against. Then, the motion for an interest rate hike was passed by 7 in favour and 2 against.”

In summary, one can say that the BOJ maintains a fairly high degree of monetary policy independence today, also compared with other central banks. Yet, the already mentioned division of labor between the BOJ and the MOF with respect to monetary policy and exchange rate policy leaves room for potential discord: the MOF’s responsibility for the external value of the yen stands in conflict with the BOJ’s independent conduct of monetary policy.

The Foreign Exchange and Foreign Trade Law stipulates that the “Minister of Finance shall endeavor to stabilize the external value of the yen through foreign exchange trading and other measures” (Article 7.3). Moreover, “the Minister of Finance is legally authorized to conduct intervention as a means to achieve foreign exchange rate stability. The Bank of Japan, as the agent of the Minister of Finance, executes foreign exchange intervention operations in accordance with the directions of the Minister of Finance.”⁸⁾ (BOJ 2000) The BOJ (2000) is thus keen to emphasize on its website that it “might therefore be misleading” to speak of “Bank of Japan Intervention”, as is often done in the media.

8) The BOJ law stipulates that the BOJ buy and sell foreign exchange “as the agent of the government [...], when its purpose is to stabilize the exchange rate of the national currency” (Article 40, Section 2). The Foreign Exchange Fund Special Account Law stipulates that “the Minister of Finance may entrust operations involving the Foreign Exchange Fund that are stipulated in the Article 5 to the Bank of Japan (Article 6, Section 1).” (BOJ 2000)

The practice that the BOJ has to administer foreign exchange interventions if asked to do so by the MOF has serious implications for its monetary policy. When official intervention is non-sterilized, the purchase (or sale) of foreign currency is matched by an increase (or decrease) in net foreign assets and an equivalent increase (decrease) in the monetary base. Non-sterilized intervention has therefore the same effect on the central bank's monetary liabilities as an open market operation. If the BOJ is ordered by the MOF to intervene in the foreign exchange market, its monetary policy is hence directly affected. Theoretically, the BOJ will always be able to sterilize foreign exchange intervention to neutralize the effects on monetary supply. Sterilization usually involves selling or purchasing domestic bonds or currency bills to offset the effects of a change in official foreign asset holdings on the domestic monetary base. There are, however, two problems with sterilization. First, sterilization is likely to weaken or even offset the intended effect on the exchange rate, which in the Japanese setting could cause discord between BOJ and MOF.⁹⁾ Second, heavy and frequent intervention in the foreign exchange market inevitably constrains the central bank in adopting an effective monetary policy (e.g., Obstfeld 1982). Excessive purchase of foreign exchange will make it increasingly difficult for the central bank to mop up domestic liquidity, endangering price stability.

An example of this quandary was given in summer/autumn 1999. At the time the Japanese economy was in recovery after a long period of zero interest rate policy and expansionary fiscal policy under the Obuchi administration. As the government feared that the appreciating yen would choke off the recovery, the MOF instructed the BOJ to intervene in the foreign exchange market by selling yen and buying US dollar. In this situation the markets paid a close attention to whether the BOJ would respond by sterilizing (Yamada 2007). In its Monetary Policy Meeting on September 21, 1999, the BOJ made clear its “price stability first” position by not only deciding to sterilize, but also announcing that

“[t]he foreign exchange rate in itself is not a direct objective of monetary policy. One of the precious lessons we learned from the experience of policy

9) The effectiveness of official intervention in the foreign exchange market is hotly contended among economists. See, e.g., Sarno and Taylor (2001), Fatum and Hutchison (2003), Domingues and Frankel (1993a, 1993b).

operations during the bubble period is that, monetary policy operations linked with control of the foreign exchange rate runs a risk of leading to erroneous policy decisions. Having said this, it does not mean that monetary policy is pursued without any consideration to the development of the foreign exchange rate. The Bank considers it important to carefully monitor the development of the foreign exchange rate from the viewpoint of how it affects the economy and prices.” (BOJ 1999, §7)

With this announcement, the yen continued to appreciate, making the intervention effectless.

Fatum and Hutchison (2005) investigate the effect of foreign exchange intervention on the yen exchange rate and Japanese monetary policy for the period 2003–04. They find that intervention was somewhat effective in influencing the yen’s external value over short periods of time (several days), but less so over longer periods. They associate the limited effectiveness of intervention with a high degree of sterilization and suggest that “from a technical perspective the BOJ has not allowed MOF intervention decisions to influence the day-to-day conduct of monetary policy” (Fatum and Hutchison 2005, p. 259), again underlining the BOJ’s claim for institutional and policy independence.

4. Japan and East Asian regional monetary cooperation

4.1 Regional monetary and financial cooperation initiatives since the Asian crisis

Already during the Asian crisis, attempts were made to establish a regional scheme for financial cooperation. In August 1997, only weeks after the outbreak of the crisis in Thailand, the Japanese government proposed the creation of an AMF as a framework for financial cooperation and policy coordination in the region. The AMF, which was to be endowed with USD 100 billion of central bank reserves, was intended as a lender to countries in financial distress and a complementary means of defense against financial crises in Asia. Kwan (2001, p. 35) describes the endeavor to build an AMF “as an attempt by Asian countries to escape domination by Washington and to achieve financial independence.” It is therefore not surprising that the AMF—which was endorsed by South Korea and several ASEAN countries—was averted by the objection of

the US government and the IMF.¹⁰⁾

The idea of an AMF—even though under a different name—was revived when the ASEAN finance ministers met with their counterparts of China, Japan, and Korea on the sidelines of the annual meetings of the Asian Development Bank on May 6, 2000, in Chiang Mai, Thailand, where they agreed to establish a system of bilateral short-term financing facilities within the group. This agreement, called the Chiang Mai Initiative (CMI), provides for mutual assistance consisting of swap arrangements in the event of a financial crisis.¹¹⁾ The CMI consists of an expanded ASEAN Swap Arrangement (ASA) that includes the ASEAN countries and a network of Bilateral Swap Arrangements (BSAs) among ASEAN+3 countries. The ASA is now USD 2 billion in size, while 16 BSAs have been successfully concluded among 8 countries with a combined total size of USD 83 billion. While the amounts available to potential borrowers under the CMI are small in relation to most East Asian countries' foreign exchange holdings, the swaps nonetheless exceed borrowers' quotas at the IMF by several multiples (Henning 2005). In May 2007, at the 10th ASEAN+3 Finance Ministers' Meeting in Kyoto the ministers agreed to further develop the CMI and in particular seek to multilateralize it (ASEAN+3 2007). A year later, in May 2008 the finance ministers of the ASEAN+3 countries reaffirmed on the sidelines of the annual meeting of the ADB in Madrid to multilateralize the CMI, i.e., to set up a pool of foreign exchange reserves (Volz 2008). They decided that at least USD 80 billion of the region's foreign reserves are to be funneled into a regional fund to protect regional currencies against speculative attacks and provide countries in crisis with liquidity. 20 percent of the funds are to be provided by the ASEAN members and the remaining 80 percent by the "Plus Three" countries.

Another important regional initiative in the field of money and finance is the

10) The role of the US in preventing the AMF will be discussed in detail in Section 4.2.2.

11) The wording of the declaration of the ASEAN+3 Finance Ministers (2000) at Chiang Mai diplomatically depicts the region's desire for reducing dependence on the IMF: "In order to strengthen our self-help and support mechanisms in East Asia through the ASEAN+3 framework, we recognized a need to establish a regional financing arrangement to supplement the existing international facilities. As a start, we agreed to strengthen the existing cooperative frameworks among our monetary authorities through the "Chiang Mai Initiative"." On the CMI see Henning (2002) and Park and Wang (2005).

ASEAN Surveillance Process, which the ASEAN finance ministers agreed on in Washington in October 1998. The objective of the ASEAN Surveillance Process is to strengthen cooperation by (1) exchanging information and discussing the economic and financial development of member states in the region; (2) providing an early warning system and a peer review process to enhance macroeconomic stability and the financial system in the region; (3) highlighting possible policy options and encouraging early unilateral or collective actions to prevent a crisis; and (4) monitoring and discussing global economic and financial developments which could have implications on the region and proposing possible regional and national level actions (ASEAN 1998). A similar scheme is ASEAN+3's Economic Review and Policy Dialogue (ERPD), which has been in place since May 2000. Under the ERPD, finance ministers and deputies meet semi-annually to discuss economic and financial developments in the region. In 2001, the ASEAN+3 finance ministers also agreed to exchange data on capital flows to facilitate an effective policy dialogue.

A third field of cooperation directly resulting from the crisis experience is the development of regional security markets. For instance, ASEAN+3 countries have developed the Asian Bond Market Initiative (ABMI), which was originally proposed by Japan in 2002. The aim of the ABMI is to develop efficient and liquid bond markets in Asia in order to enable a better utilization of Asian savings for Asian investments and to avoid the currency and maturity mismatches in financing that exacerbated the financial crisis. The ABMI includes efforts to modify existing regulations to facilitate the issuance of and investment in local currency denominated bonds, as well as the development of new securitized debt instruments, credit guarantee and investment mechanisms, foreign exchange transactions and settlement issues, and rating systems. In May 2008, the "New ABMI Roadmap" was endorsed. The four key issues in the New ABMI Roadmap are (i) promoting issuance of local currency-denominated bonds (supply-side); (ii) facilitating the demand of local currency-denominated bonds (demand-side); (iii) improving the regulatory framework; and (iv) improving related infrastructure for bond markets and will be addressed by separate task forces (cf. Schou-Zibell 2008).

Complementary activities are the launch of the Asian Bond Funds (ABF) I and II by the Executives' Meeting of East-Asia and Pacific Central Banks

(EMEAP).¹²⁾ ABF I and II are aimed at promoting greater regional financial integration particularly in bond markets to help financing private sector investment in the region. For ABF I, which was launched in 2003, EMEAP central banks pooled USD 1 billion of their foreign reserves to purchase a basket of USD-denominated bonds issued by East Asian sovereign and quasi-sovereign issuers. In 2005 ABF II was established to invest a total of USD 2 billion in East Asian bonds denominated in local currencies. ABF II consists of a Pan-Asia Bond Index Fund and eight single-market funds investing in eight EMEAP bond markets and is also open to private investors.

While the initial focus after the crisis was on financial cooperation, there have been also intensive discussions about exchange rate cooperation. Although no actual steps have been taken in exchange rate coordination hitherto, the ASEAN+3 countries have established a research group to explore the possibility of a regional exchange rate arrangement for East Asia and, more recently, the possibility of creating regional monetary units (see ASEAN+3 Research Group 2004). Moreover, several ASEAN leaders have repeatedly mentioned the option of creating a common currency for ASEAN (see, e.g., Estrada 1999, Severino 1999, Yong 2004, Siazon 2005).¹³⁾ At the sidelines of the ADB meeting in Hyderabad in May 2006, the finance ministers of Korea, Japan, and China pledged to enhance the existing cooperation framework to defend regional currencies against speculators and announced that they will “immediately launch discussions on the road map for the system to coordinate foreign exchange policy” (Giridharadas 2006).

The most recent initiative in monetary and exchange rate cooperation was started by the ADB, which proposed the launch of an Asian Currency Unit (ACU) (see Kawai 2009). The ACU is envisaged as a virtual basket currency similar to the ECU that the Western European countries created in 1979 as part of the EMS. While it is not clear whether the ACU could become a forerunner of a common East Asian currency—indeed it still is unclear if and when it will

12) EMEAP includes Australia, China, Hong Kong, Indonesia, Japan, Korea, Malaysia, New Zealand, the Philippines, Singapore, and Thailand. On the ABFs see Ma and Remolona (2009).

13) In the Hanoi Plan of Action of December 1998, the ASEAN heads of state and government agreed to “Study the feasibility of establishing an ASEAN currency and exchange rate system” (ASEAN 1998b, Section 1.4.1).

be launched—it is undeniable that the region has developed a dynamic in regional integration that cannot be ignored.

As Padoa-Schioppa (2005, p. 31) notes, “these initiatives are more than just a first step towards greater cooperation, they have also created important fora for an ongoing policy dialogue at the level of finance ministers and central bank governors.” And indeed, they would have been unthinkable without the changes in East Asian policymakers’ attitudes toward regional cooperation brought about by the Asian crisis.

4.2 Stakeholders, interests, and policies

4.2.1 National actors

State actors

The actor most directly concerned with monetary policy in Japan is obviously the BOJ. The strengthening of BOJ independence through the BOJ law reform has rendered the BOJ in a much more powerful position. From an institutional perspective, the BOJ will have all incentive to defend its recently gained independence. Therefore, the incentive to join regional monetary and exchange rate cooperation which would constrain its policy autonomy will be limited.

As outlined in Section 3, the primary duty of the BOJ is to maintain price stability and safeguard a smooth functioning of domestic financial markets. The bank’s focus is therefore on internal developments, especially inflation. Given the BOJ’s mandate, together with the fact that Japan is a large and still fairly closed economy where the degree of exchange rate pass-through to Japanese imports and the domestic price level is limited (Otani, Shiratsuka and Shirota 2003, Fujii 2004), the exchange rate becomes a concern to the BOJ only to the extent that it influences the domestic price level.¹⁴⁾

Moreover, the experience with the Plaza and Louvre accords, where the world’s leading economies “agreed” on an adjustment of exchange rates, with the Japanese yen appreciating rapidly after the 1985 Plaza communiqué, left a bitter taste for exchange rate cooperation among Japanese policymakers and

14) Cf. the BOJ (1999) statement quoted in Section 3.

central bankers in particular.¹⁵⁾ The massive yen appreciation is commonly regarded in Japan as setting the stage for the bubble economy, which after its burst threw Japan into what is frequently referred to as the lost decade. The conclusion that is often drawn from this episode is that the BOJ should focus exclusively on domestic monetary policy and ignore the external value of the yen as long as it does not hurt the Japanese economy.¹⁶⁾

However, while regional monetary and exchange rate cooperation has not been a prime concern for the BOJ, it has been involved in regional monetary cooperation—albeit on a low scale—since 1991, when EMEAP was inceptioned. Initially, EMEAP only held executive-level meetings twice a year to informally discuss economic and financial developments in the region, but since 1996 EMEAP holds also annual governor’s meetings. The same year EMEAP established two working groups (one on financial market development and one on central banking operations) and one study group on banking supervision. Within the financial market development working group the BOJ was actively involved in the creation of the ABF-initiative and contributed USD 100 million to ABF I and USD 200 million to ABF II (BOJ 2003 and 2004).

In November 2005 the BOJ’s International Department established the Center for Monetary Cooperation in Asia (CeMCoA), which is “aimed at promoting monetary cooperation in Asia and taking stock of information and know-how accumulated at central banks in Asia” (BOJ 2005). The BOJ describes CeMCoA’s main responsibilities as advancing monetary cooperation in the region; conducting joint research on Asia within and/or together with researchers outside the central banking community; and strengthening technical cooperation and training of central bank staff from neighboring countries. The creation of CeMCoA can be interpreted as the BOJ’s reaction to an ever increasing importance of the regional economy to Japan and an attempt to step up its own visibility in the regional arena.

The BOJ is also involved in the ASEAN+3 Finance Ministers Meetings, which have been held since 1997, but the lead here is on the side of the MOF, with the BOJ consulting and supporting the ministry. Among all government

15) On the politics behind the Plaza and Louvre accords and the pressure on Japan to appreciate the yen see Funabashi (1988).

16) Again, cf. the BOJ (1999) statement in Section 3.

bodies, the MOF clearly has been the most active in initiating or taking part in regional monetary and financial cooperation initiatives. For instance, the AMF proposal during the East Asian financial crisis was developed and launched by the MOF. According to Eisuke Sakakibara (2000), then MOF Vice Minister for International Affairs, the MOF started to seriously work on the AMF proposal following a Tokyo conference on August 11, 1997, at which a group of neighboring countries met under Japanese leadership to provide support to crisis-hit Thailand. The meeting, according to Sakakibara, created a sense of “unity of Asian countries” and led Sakakibara and Haruhiko Kuroda, then Director of the International Bureau of the MOF (and later MOF Vice Minister for International Affairs), to flesh out the AMF plan, an idea they had both been considering since the Mexican peso crisis (Blustein 2001).¹⁷⁾ Frustrated with the US and IMF response (or lack thereof) to the crisis, Japan was willing to provide half of the suggested USD 100 billion endowment for the AMF.

After the AMF plan failed (the reasons of which will be discussed in Section 4.2.2), the MOF in October 1998 unveiled the “New Miyazawa Initiative”, a USD 30 billion aid package for the five most affected East Asian crisis economies (Indonesia, Malaysia, the Philippines, South Korea and Thailand), named after then Japanese Finance Minister Kiichi Miyazawa.¹⁸⁾ In total, Tokyo committed more than USD 80 billion under the New Miyazawa Initiative. Under Miyazawa’s leadership, the MOF also endorsed the CMI. It is noteworthy that the funds Japan has pledged under the CMI stem from the MOF’s “Foreign Exchange Fund Special Account”, which consists of foreign currency and yen funds which are also used for intervention in the foreign exchange market by the BOJ as the agent of the MOF (BOJ 2000).¹⁹⁾ The BOJ is involved in the CMI only in an operational way, i.e., it provides technical advice to the MOF on pay-

17) For a narrative of the background of the Japanese AMF proposal see Lipsy (2003) and Blustein (2001). Lipsy highlights that the MOF had a strong interest in providing liquidity to Thailand (and later the other crisis economies) because Japanese banks’ exposure to Thailand was very high at the time, amounting to USD 38 billion, which was equivalent to about 25 percent of their total lending to developing countries. According to BIS data, 80 percent of short-term loans to Thailand came from Japanese banks.

18) See Castellano (2000).

19) More than 95 percent of Japan’s foreign exchange reserves are held by the MOF, with the BOJ giving assistance in the management of these holdings. The remaining 5 percent of Japanese reserves are held by the BOJ.

ment modalities or legal issues.

The MOF has shown a keen interest in promoting the development of regional capital markets. Within the ASEAN+3 Finance Minister's grouping it has nurtured the idea of developing regional bond markets, which contributed to the creation of the aforementioned ABMI. The MOF has assigned the Japan Bank for International Cooperation (JBIC), Japan's governmental financial aid institution, to work toward the goals of the ABMI.²⁰ In particular, the MOF enhanced JBIC's guarantee operation rights, so that it can not only issue local currency bonds in East Asia itself, but also guarantee those of Japanese firms within the region. The MOF's interest in developing regional bond markets is threefold. First of all, the idea behind the ABMI is to contribute to regional financial stability by mitigating the problem of currency mismatches that arises if firms finance in foreign currency, a problem that significantly contributed to the crisis as the forced devaluations of East Asian countries during the crisis made it increasingly difficult for companies that had borrowed in dollar to pay back their debt. Second, more developed regional bond markets will help meet the local currency financing needs of Japanese companies undertaking FDI in the region, thus improving their competitiveness. And third, regional bond markets will provide new opportunities for Japanese financial investors. Against the backdrop of a rapidly ageing society, overseas investments in regional capital markets can provide an important insurance mechanism, i.e., help financing retirement fund schemes for an ever increasing number of Japanese pensioners.

Other important state actors in the arena of regional economic cooperation include the Ministry of Foreign Affairs (MOFA) and the Ministry of Economy, Trade and Industry (METI), neither of which are directly concerned with monetary or exchange rate policy. MOFA and METI (as is the Ministry of Agriculture), however, are directly involved in the negotiation of regional economic cooperation/free trade agreements. As monetary cooperation is only one aspect of economic cooperation, one should expect for repercussions from one area of integration to others. METI is generally known to be much in favor of regional

20) JBIC was established in 1999 under the JBIC law out of a merger of the Export-Import Bank of Japan and the Overseas Economic Cooperation Fund.

trade integration (and sees its proposals for FTA agreements frequently compromised by the Ministry of Agriculture, which tries to protect Japanese farming interests). Recently, then Japan's Economy, Trade and Industry Minister Toshihiro Nikai made an offer at the World Economic Forum in Tokyo in June 2006 of setting up a FTA in East Asia comprising ASEAN+3 plus India, Australia and New Zealand, now known as ASEAN+6. He also suggested a new regional policy coordination body modeled on the Organization for Economic Cooperation and Development (OECD), with ASEAN as a motor (World Economic Forum 2006).²¹⁾ While METI has no official position on exchange rate policy, its generally favorable attitude toward regional economic integration converts also to this area, without making METI a driving force of monetary integration itself.

Although it is hard to find any evocative statement from the MOFA regarding regional economic, let alone monetary and exchange rate cooperation, MOFA is understood to take a strategic approach to international economic policy to secure a meaningful position for Japan in any regional initiative. A major concern seems to be the fear of Chinese domination within the region and the worry to be pre-empted by China. The situation presents itself as a strategic game with China, where both countries are afraid that the other will assume the leadership role in the region. The final part of this section will come back to this.

The private sector

As discussed in the theoretical section, one would expect internationally-oriented businesses to be in favor of monetary cooperation, whereas domestically oriented corporations will prefer a policy that is tailored to domestic developments. Given that Japanese corporations have been heavily involved in regional markets—not only as importers and exporters, but also as investors (e.g., Tachiki 2005)—one would expect them to be vocal in support of regional exchange rate cooperation. Indeed, European businesses that were involved in

21) The idea led to an agreement among ASEAN+6 of establishing the Economic Research Institute of ASEAN and East Asia (ERIA) at the third East Asian Summit in November 2007. ERIA's secretariat has been established in Jakarta.

regional operations were very supportive of moves toward European monetary integration (e.g., Collignon and Schwarzer 2003). Tables 2 and 3 show that Japan's most important trading partners today are to be found within the region: about 40 percent of Japanese trade is conducted within the region. Moreover, Table 4 shows that Japanese FDI in the region has reached significant amounts. Surprisingly, however, Japanese businesses appear to be rather mute on issues of regional monetary and exchange rate cooperation.

Nippon Keidanren (Japan Business Federation), the all-powerful and influential lobby group of Japanese business, has occasionally issued statements urging the Japanese government to foster regional economic cooperation. Most of them, however, were concerned with trade issues rather than monetary or exchange rate matters. There have been only a few statements of Keidanren that have addressed monetary and exchange rate matters. For instance, in a statement in 2001, Keidanren (2001) highlighted that “[t]he Asian currency and financial crisis in 1997 demonstrated eloquently that currency stability is essential to the economic development of Asian countries. As a result, an increased attention is being paid to a shift away from excessive dependence on the USD toward exploration of a new currency stabilization system and the role the JPY should play therein.” Keidanren (2001) bemoans that the “use of the yen has not progressed relative to the speed of Japanese business becoming international” and therefore “Keidanren renews its recognition for the yen’s role in Asia and recommends its enhanced international use through public-private cooperative” by “[s]trengthening economic partnership and regional cooperation in Asia”. In the same statement Keidanren endorses the Japanese government for advocating a regional currency swap, the creation and use of a common Asian currency basket and further AMF initiatives. It maintains that “[f]or these efforts to bear fruit, the use of JPY in international transactions must be expanded. In addition, while EU and NAFTA strengthen their respective regional ties, Asian countries need to strengthen their economic partnership through expanded trade and investments and move forward their regional monetary cooperation toward currency stability within Asia. The JPY is expected to play its role in such cooperation as a major regional currency. As a result, it is desirable for the stability of the global economy to have a tri-polar currency system consisting of USD, JPY and euro.” (Keidanren 2001) This and similar statements (e.g., Keidanren

Table 2 Japanese imports from ... as percent of total imports, 1980–2006

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	
Brunei	2.31	2.03	2.00	1.88	1.61	1.46	1.02	0.79	0.61	0.51	0.54	0.63	0.58	0.59	0.43	0.40	0.40	0.42	0.37	0.34	0.44	0.49	0.45	0.48	0.42	0.44	0.39	
Cambodia	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.04	0.00	0.00	0.00	0.00	0.01	0.01	0.01	0.02	0.02	0.02	0.02	0.02	
China	3.08	3.70	4.06	4.02	4.37	5.01	4.49	4.96	5.26	5.29	5.12	6.02	7.29	8.54	10.05	10.69	11.56	12.35	13.20	13.86	14.53	16.55	18.33	19.73	20.74	21.05	20.47	
China+HK	3.48	4.17	4.53	4.55	4.98	5.60	5.33	6.00	6.39	6.34	6.05	6.89	8.17	9.37	10.83	11.50	12.29	13.01	13.82	14.43	14.97	16.97	18.75	20.08	21.10	21.35	20.74	
Hong Kong	0.41	0.47	0.47	0.53	0.62	0.59	0.85	1.05	1.13	1.05	0.93	0.87	0.88	0.83	0.78	0.81	0.74	0.66	0.62	0.58	0.44	0.42	0.42	0.42	0.35	0.36	0.30	0.27
Indonesia	9.36	9.28	9.09	8.25	8.18	7.81	5.79	5.63	5.12	5.23	5.42	5.40	5.25	5.19	4.70	4.22	4.35	4.31	3.85	4.06	4.31	4.26	4.20	4.27	4.10	4.03	4.18	
Korea	2.15	2.38	2.49	2.69	3.09	3.17	4.18	5.42	6.31	6.17	4.99	5.23	4.98	4.86	4.93	5.16	4.57	4.31	4.32	5.19	5.39	4.93	4.60	4.68	4.85	4.74	4.73	
Lao	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.01	0.01	0.01	0.01	0.01	0.01	0.00	0.00	0.00	0.00	0.00	0.00	0.00	
Malaysia	2.48	2.04	2.28	2.47	3.23	3.33	3.12	3.19	2.53	2.43	2.30	2.73	2.81	3.18	2.99	3.14	3.36	3.36	3.09	3.52	3.82	3.67	3.31	3.29	3.10	2.85	2.69	
Myanmar	0.05	0.04	0.04	0.04	0.02	0.03	0.04	0.02	0.02	0.02	0.02	0.02	0.02	0.02	0.03	0.03	0.03	0.03	0.03	0.03	0.03	0.03	0.03	0.03	0.04	0.04	0.04	
Philippines	1.39	1.20	1.19	1.03	1.04	0.96	0.97	0.91	1.09	0.98	0.91	0.99	0.99	1.00	0.97	1.04	1.29	1.48	1.57	1.71	1.89	1.84	1.93	1.84	1.81	1.50	1.37	
Singapore	1.07	1.36	1.38	1.16	1.30	1.23	1.16	1.38	1.25	1.40	1.52	1.44	1.33	1.50	1.69	2.04	2.10	1.73	1.68	1.75	1.69	1.54	1.48	1.43	1.38	1.30	1.29	
Thailand	0.80	0.74	0.79	0.81	0.76	0.79	1.10	1.20	1.47	1.70	1.77	2.22	2.55	2.70	2.98	3.01	2.94	2.82	2.91	2.86	2.79	2.97	3.12	3.10	3.10	3.02	2.94	
Vietnam	0.03	0.03	0.03	0.03	0.04	0.05	0.07	0.10	0.10	0.16	0.25	0.28	0.37	0.44	0.49	0.51	0.58	0.64	0.62	0.63	0.69	0.75	0.75	0.81	0.85	0.88	0.93	
ASEAN	17.51	16.72	16.80	15.67	16.19	15.66	13.25	13.23	12.19	12.44	12.74	13.73	13.93	14.66	14.30	14.40	15.05	14.81	14.14	14.92	15.69	15.57	15.30	15.28	14.82	14.09	13.86	
ASEAN+3	22.73	22.79	23.34	22.39	23.65	23.84	21.92	23.60	23.76	23.89	22.85	24.98	26.19	28.06	29.28	30.24	31.18	31.47	31.66	33.97	35.61	37.05	38.22	39.69	40.41	39.87	39.06	
ASEAN+4	23.14	23.26	23.81	22.92	24.26	24.43	22.76	24.64	24.88	24.95	23.78	25.85	27.07	28.89	30.06	31.06	31.92	32.13	32.28	34.54	36.05	37.47	38.64	40.04	40.77	40.18	39.33	
EU	6.31	6.63	6.38	7.27	7.73	7.61	11.64	12.39	13.53	13.99	15.58	14.16	14.10	13.28	13.68	13.99	13.64	13.57	14.21	13.98	12.57	13.05	13.30	13.08	12.76	11.44	10.33	
USA	17.39	17.69	18.38	19.60	19.75	20.00	23.04	21.18	22.54	23.02	22.45	22.66	22.62	23.14	22.99	22.57	22.85	22.43	24.04	21.73	19.10	18.25	17.38	15.64	13.98	12.70	11.98	

Source: Own calculations with DTS data.

Note: ASEAN+4 includes ASEAN+3 and Hong Kong.

The Political Economy of Japanese Monetary and Exchange Rate Policy

Table 3 Japanese exports to ... as percent of total exports, 1980–2006

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	
Brunei	0.07	0.06	0.10	0.06	0.04	0.05	0.03	0.02	0.03	0.03	0.03	0.04	0.05	0.04	0.03	0.03	0.03	0.04	0.02	0.01	0.01	0.01	0.01	0.08	0.02	0.02	0.02	0.02
Cambodia	0.02	0.01	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.07	0.01	0.02	0.02	0.01	0.01	0.01	0.01	0.01	0.01	0.02	0.01	0.01	0.01	0.01
China	3.92	3.35	2.53	3.35	4.24	7.10	4.71	3.60	3.58	3.09	2.13	2.73	3.52	4.78	4.73	4.95	5.30	5.15	5.20	5.59	6.35	7.67	9.59	12.18	13.06	13.45	14.35	
China+HK	7.58	6.84	5.93	6.94	8.09	10.81	8.14	7.47	8.00	7.26	6.69	7.92	9.63	11.07	11.24	11.21	11.46	11.61	10.99	10.87	12.03	13.43	15.69	18.52	19.32	19.50	19.98	
Hong Kong	3.67	3.49	3.40	3.60	3.85	3.70	3.42	3.87	4.42	4.18	4.55	5.19	6.11	6.29	6.51	6.27	6.16	6.47	5.79	5.28	5.68	5.76	6.10	6.34	6.26	6.05	5.63	
Indonesia	2.66	2.72	3.07	2.42	1.81	1.24	1.27	1.30	1.15	1.20	1.76	1.78	1.64	1.67	1.94	2.25	2.20	2.42	1.11	1.17	1.59	1.59	1.50	1.52	1.60	1.57	1.14	
Korea	4.13	3.72	3.52	4.09	4.25	4.04	5.01	5.77	5.83	6.00	6.08	6.38	5.23	5.29	6.16	7.06	7.14	6.19	3.97	5.50	6.42	6.27	6.86	7.38	7.82	7.85	7.78	
Lao	0.01	0.01	0.01	0.01	0.00	0.01	0.01	0.01	0.01	0.01	0.01	0.01	0.01	0.01	0.01	0.01	0.01	0.01	0.01	0.00	0.01	0.00	0.00	0.00	0.00	0.00	0.00	
Malaysia	1.59	1.59	1.80	1.89	1.69	1.23	0.82	0.95	1.15	1.50	1.92	2.43	2.39	2.67	3.13	3.79	3.73	3.45	2.40	2.66	2.90	2.73	2.64	2.38	2.22	2.12	2.04	
Myanmar	0.16	0.16	0.17	0.12	0.11	0.10	0.10	0.08	0.07	0.04	0.04	0.03	0.03	0.02	0.04	0.06	0.05	0.05	0.04	0.04	0.05	0.03	0.03	0.02	0.02	0.02	0.02	
Philippines	1.30	1.27	1.30	1.19	0.63	0.53	0.52	0.62	0.66	0.86	0.87	0.85	1.04	1.33	1.49	1.60	2.04	2.06	1.87	2.09	2.14	2.03	2.03	1.91	1.70	1.54	1.39	
Singapore	3.01	2.94	3.15	3.03	2.71	2.20	2.19	2.62	3.14	3.35	3.73	3.88	3.82	4.59	4.96	5.19	5.05	4.81	3.81	3.90	4.35	3.65	3.40	3.15	3.18	3.11	3.01	
Thailand	1.48	1.48	1.37	1.71	1.42	1.15	0.97	1.29	1.95	2.48	3.18	3.00	3.05	3.39	3.72	4.45	4.45	3.47	2.41	2.71	2.85	2.94	3.17	3.40	3.58	3.79	3.54	
Vietnam	0.09	0.07	0.07	0.08	0.07	0.08	0.09	0.08	0.07	0.06	0.07	0.07	0.13	0.18	0.16	0.21	0.28	0.30	0.34	0.39	0.41	0.44	0.51	0.56	0.56	0.60	0.64	
ASEAN	10.38	10.31	11.04	10.49	8.49	6.60	5.99	6.96	8.22	9.52	11.61	12.08	12.22	13.92	15.48	17.58	17.86	16.61	12.03	12.99	14.32	13.45	13.38	12.98	12.90	12.79	11.82	
ASEAN+3	18.43	17.38	17.08	17.92	16.97	17.74	15.71	16.32	17.63	18.61	19.82	21.19	20.97	24.00	26.37	29.58	30.30	27.95	21.20	24.09	27.09	27.39	29.83	32.54	33.78	34.09	33.94	
ASEAN+4	22.10	20.87	20.48	21.52	20.83	21.45	19.14	20.19	22.05	22.79	24.37	26.38	27.09	30.29	32.88	35.85	36.46	34.42	26.98	29.37	32.77	33.15	35.93	38.88	40.04	40.14	39.57	
EU	14.68	13.61	13.66	13.95	12.47	12.54	15.43	17.35	18.69	18.20	19.42	19.31	18.58	15.67	14.73	15.03	14.57	15.97	18.92	18.23	16.85	16.54	15.31	16.01	15.80	14.63	14.55	
USA	24.46	25.66	26.39	29.48	35.59	37.62	38.86	36.74	34.05	34.20	31.66	29.27	28.45	29.46	30.02	27.53	27.50	28.09	30.85	31.04	30.10	30.41	28.84	24.87	22.73	22.86	22.76	

Source: Own calculations with DTS data.

Note: ASEAN+4 includes ASEAN+3 and Hong Kong.

Table 4 Japanese FDI stocks abroad (in hundred million USD)

	1996	1997	1998	1999	2000	2001	2002	2003
China	86.34	228.17	157.63	65.78	92.75	108.65	118.13	141.13
Hong Kong	100.29	56.03	37.47	35.20	38.01	39.45	35.98	52.46
Indonesia	183.31	84.91	101.58	39.66	50.80	54.41	53.20	62.17
Malaysia	61.31	50.57	39.06	32.42	42.69	46.69	37.48	36.53
Philippines	30.52	22.62	21.18	17.55	21.68	22.60	28.28	29.16
Korea	36.94	89.08	81.07	55.68	69.76	59.57	52.09	46.82
Singapore	121.65	118.12	83.56	75.05	94.39	110.23	99.28	90.66
Thailand	167.95	61.45	50.32	41.37	50.82	66.12	59.85	70.58

Source: UNCTAD WID country profile.

2000) suggest that regional monetary cooperation would need to center on the yen. Indeed, from a Japanese perspective, regional monetary cooperation or regional exchange rate stabilization for long seemed to be understood as a system in which the yen would be the anchor currency to which the others peg their currencies—similar to Europe where the smaller economies grouped around the German mark.²²⁾ However, Keidanren's calls for an internationalization of the yen have abated (the 2001 statement was the latest we could find on this topic), probably a realization that the idea of a yen bloc simply does not appeal to and will not win the support of the neighboring countries. With no more hope for a yen bloc, the topic of regional monetary cooperation seems to have slipped the minds of Japanese business leaders.

So why is the Japanese business community mute in demanding exchange rate cooperation with its biggest export and investment markets in East Asia? At least three reasons seem plausible. First, Japan is still a relatively closed economy. Even though Japan is one of the world's largest exporters, its export to GDP ratio was only 14.8 percent in 2006, markedly lower than that of Germany for instance, which stands at 38.1 percent. The picture is similar when taking figures for total trade (imports plus exports) as percent of GDP as in Table 5. With 28.7 percent, Japan's degree of openness is way below that of all other

22) The idea of a yen bloc gained prominence in the 1980s at the height of Japanese economic power. One of the most ardent supporters of a yen bloc is Kwan (2001).

Table 5 Total trade (imports plus exports) as percent of GDP, 1980–2006

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006		
Brunei	88.75	87.71	100.65	90.87	92.05	91.79	91.25	96.64	151.24	162.86	148.05	134.09	140.49	137.13	106.52	84.34	76.46	83.04	86.77	87.89	87.89	86.77	87.89	87.12	76.61	75.84			
Cambodia						6.94	16.24	11.69	20.98	10.87	5.93	37.58	51.45	50.53	56.45	55.30	51.44	66.42	65.08	69.73	69.03	73.77	75.14	79.85	88.39	90.03			
China	12.24	14.81	14.58	14.45	16.43	22.87	25.26	25.73	25.69	24.95	30.06	33.45	34.67	31.85	42.30	38.62	33.89	34.12	31.79	33.29	39.58	38.52	42.73	51.87	59.78	63.40	66.59		
Hong Kong	147.45	151.78	139.12	155.64	172.81	171.08	173.20	192.24	213.40	211.47	214.28	224.03	233.74	228.17	231.17	253.98	238.47	224.88	214.66	216.45	246.26	235.11	249.43	288.14	320.15	331.37	343.26		
Indonesia	34.34	34.83	35.87	37.90	35.26	28.55	27.54	34.18	33.69	34.46	37.93	39.14	40.08	37.32	36.88	38.54	37.01	39.91	72.25	46.97	57.78	54.33	45.22	39.84	45.94	49.95	56.60		
Japan	25.65	25.19	24.84	23.13	24.29	22.69	16.86	15.76	15.39	16.44	17.26	15.97	15.20	13.94	14.05	14.77	16.41	17.83	17.28	16.66	18.38	18.37	19.21	20.19	22.15	24.36	28.07		
Korea	61.72	66.34	60.43	59.91	64.24	63.46	59.77	63.05	59.94	52.38	53.90	50.02	48.58	47.62	48.11	51.52	51.58	54.76	64.90	59.17	64.99	60.49	57.39	61.25	70.20	68.92	65.13		
Lao	0.00	15.60	17.91	4.90	3.54	3.83	5.76	11.35	26.71	30.70	24.43	23.02	30.72	50.71	56.10	50.25	54.20	34.16	78.96	86.31	62.30	61.90	60.55	57.99	63.45	67.96	79.91		
Malaysia	95.41	91.76	89.65	89.71	88.62	87.24	87.86	95.23	106.79	122.64	133.09	144.83	136.34	138.66	158.85	170.39	155.35	157.70	162.62	189.58	199.69	183.59	181.49	180.50	194.84	194.59	195.47		
Myanmar	19.19	20.16	12.58	9.85	8.06	7.98	6.69	4.32	3.10	2.06	38.61	67.10	64.43	68.32	60.15	64.51	77.92	85.77	54.14	46.20	56.36	81.62	84.41	57.26	61.29	59.68	62.20		
Philippines	43.40	39.83	35.76	38.54	36.95	32.43	33.55	38.06	41.46	44.38	47.98	48.08	46.06	53.18	56.15	60.48	62.14	76.88	88.65	86.98	95.78	91.56	91.96	92.59	96.31	89.78	83.79		
Singapore	371.06	350.05	321.13	287.88	280.95	277.42	267.32	298.66	327.78	313.72	308.79	290.78	272.91	274.23	282.34	287.84	277.17	269.13	256.71	273.36	294.10	278.23	274.45	320.95	345.79	368.15	386.55		
Thailand	48.59	48.74	42.28	41.58	42.66	42.14	41.88	48.64	58.72	63.05	65.96	69.48	66.86	68.58	70.15	80.82	72.23	80.78	88.59	88.76	106.65	110.07	105.28	109.47	118.16	129.57	125.72		
Viennam	0.00	5.10	3.33	2.21	1.61	16.90	8.69	7.87	16.33	87.47	82.92	61.13	60.25	52.42	60.69	67.42	76.04	79.63	75.96	81.18	96.55	96.10	103.70	114.56	128.33	130.85	141.35		
ASEAN	58.75	62.02	58.83	58.68	53.33	55.91	51.29	58.89	71.54	78.01	87.67	89.58	87.84	89.50	94.81	101.78	96.27	103.00	126.77	117.13	132.89	126.76	119.21	121.28	133.43	138.35	138.75		
ASEAN+3	29.17	30.08	29.78	28.39	29.25	28.79	22.91	22.69	23.01	24.57	27.01	26.15	25.68	24.43	26.20	27.99	30.31	32.63	31.96	31.08	35.26	35.18	37.30	40.94	46.43	50.84	56.26		
ASEAN+4	31.17	32.16	31.80	30.42	31.64	31.23	25.17	25.35	25.93	27.77	30.51	29.93	29.90	28.55	30.50	32.43	35.06	37.74	37.14	35.64	40.25	40.20	42.47	46.26	51.97	56.60	62.21		
ASEAN*	61.20	60.61	55.85	51.26	58.64	58.42	58.69	64.54	71.83	81.13	84.18	84.61	90.65	95.77	97.99	101.08	100.78	101.25	107.08	104.88	111.54	110.95	110.76	113.62	121.21	125.55	129.75		
ASEAN+3*	54.74	54.80	50.64	46.93	53.18	53.32	52.98	57.69	63.03	69.62	72.54	72.74	77.30	80.86	83.41	85.82	85.36	86.10	91.14	89.07	95.26	94.37	94.38	97.65	104.94	108.63	112.10		
ASEAN+4*	61.36	61.73	56.96	54.69	61.73	61.74	61.57	67.30	73.77	79.75	82.67	83.54	88.47	91.38	93.97	97.83	96.30	96.01	99.96	98.17	106.04	104.42	105.45	111.26	120.31	124.55	128.61		
European Union	45.49	45.97	45.35	45.12	47.96	48.73	43.18	42.58	42.71	44.86	43.71	41.80	40.07	39.73	42.70	45.13	45.53	48.99	49.27	50.93	57.61	57.13	55.05	54.52	56.82	59.29	62.94		
Germany	46.10	48.91	49.44	48.15	51.47	53.53	47.54	45.96	46.82	50.22	48.85	43.71	40.12	34.61	36.87	37.75	39.25	43.82	45.90	46.58	55.05	56.17	54.68	54.71	59.29	62.73	69.27		
USA	17.14	16.22	14.36	13.31	14.22	13.63	13.55	14.29	15.27	15.63	15.68	15.53	15.78	16.06	16.99	18.31	18.43	19.10	18.58	18.77	20.48	18.87	18.11	18.51	20.04	21.21	22.41		

Source: Own calculations with data from DTIS and WEO.

Note: *denotes unweighted average. ASEAN+4 includes ASEAN+3 and Hong Kong.

neighboring countries and also much lower than the openness of the EU, which is 62.9 percent (73.7 percent for the euro area). Japanese trade openness, however, has increased significantly in the past couple of years, and is projected to increase further (METI 2007, p. 204). A shrinking home market will increasingly force Japanese firms to look for new markets abroad (e.g., Euromoney 2007). With increasing openness of the economy, and ever growing linkages with China and the rest of East Asia, Japanese business is likely to put more emphasis on exchange rate developments with other East Asian countries.

Second, the Japanese export sector is highly concentrated. Whereas the export sector in most European countries, as a comparison, to a large degree constitutes small and medium enterprises (SMEs), Japanese exports are mainly conducted by large multinationals. Indeed, over 30 percent of Japanese exports are exported by the ten largest exporting companies, which include well known household names such as Toyota, Honda, Canon, Sony and Panasonic (Tanaka 2004). These corporations have formed extensive production networks in East Asia, but they are also producing in the US and in Europe. Moreover, these firms, which are partly larger in economic size than the least developed countries in Southeast Asia, all have their own financial infrastructures, including banks, and financial know-how to hedge exchange rate risk, making Japanese exchange rate policy a secondary matter of importance to them. In a sense they are too big and too globally oriented to seriously worry about Japanese exchange rate policy, although of course large exchange rate swings such as those triggered by the recent financial crisis have significant impacts on their operations.

Smaller Japanese firms typically use specialized trading firms (*shosha*) as intermediaries for their exports.²³⁾ These trading companies are specialized in importing and exporting and have substantial expertise in managing currency risk. Hence smaller export-oriented firms often do not interact directly with their counterparts, and, because the management of exchange rate risk is delegated to trading companies, they will tend to worry less about it. While the trading companies certainly demand their share in the transactions they carry out, they also offer other valuable services like financing and marketing to

23) See Yoshino and Lifson (1986) and Wichmann (1997).

Japanese firms, many of which are constrained in their international outreach due to language problems.

Third, Japanese businesses, like those in the rest of East Asia, have gotten used to the East Asian dollar standard, an informal exchange rate arrangement in which the dollar has assumed the role of anchor currency for a majority of East Asian countries. This system has been also referred to as Bretton Woods II (Dooley, Folkerts-Landau, and Garber 2004), invigorating the post-World War II arrangement of fixed pegs to the dollar. While the system of dollar pegging was interrupted in most countries through the Asian crisis, basically all East Asian countries with the exception of Japan still stabilize their exchange rates with the dollar today. These dollar pegs have, at large, served the region pretty well. The common pegging or soft pegging to the same external anchor has resulted in a high degree of intraregional exchange rate stability, which helped secure a rapid growth of intraregional trade and the development of an extensive trade-FDI-network throughout East Asia—with Japanese firms being among the most active in the region.

For Japan, the East Asian dollar standard has effectively reduced the number of relevant foreign currencies to two: the US dollar and (on a much lower degree of importance) the euro. In 2001, 52.4 percent of Japanese exports and 70.7 percent of Japanese imports were invoiced in USD (Goldberg and Tille 2005, p. 20). With the BOJ at times intervening in the foreign exchange market, trying to limit exchange rate volatility vis-à-vis the dollar, Japanese firms have come to live quite well with the present system, giving them few reason to ask for changes.

But as was the case with the Bretton Woods I system which became increasingly fragile with a weakening dollar and a high US current account deficit in the late 1960s, the success of the Bretton Woods II system is built around the strength and credibility of the dollar, both of which seem to decline by the day. Indeed, several East Asian countries have recently allowed for more flexibility toward the dollar, letting their currencies appreciate vis-à-vis the dollar. It is therefore foreseeable that the East Asian dollar standard will come to an end. Like in Europe almost forty years ago, today's real economic ties in East Asia are too tight as to allow for a non-cooperative approach or a move toward freely floating rates throughout the region. The region will therefore have to

find a new arrangement, and Japan's government will have to consider whether to stay outside a new regional monetary and exchange rate arrangement, or whether it wants to shape the agenda. When a reassessment of East Asian monetary relations becomes due, the Japanese corporate sector will also have to express its preferences.

Turning to the financial sector, financial lobby groups, such as the Japanese Bankers Association (*Zenginkyo*), have been quiet in demanding the government to engage in regional monetary and exchange rate cooperation, just like Japanese manufacturing sector. The reason here is straightforward: the burst of the bubble economy threw the Japanese financial sector into an existence-threatening crisis. Corporate defaults left banks saddled with huge debts and in need of government rescue packages. The banking crisis caused a massive consolidation, which brought the number of so-called "city banks" (dominant banks in Japan serving urban population) down from 13 to three. In addition to domestic troubles, the East Asian crisis hit Japanese banks' activities in the region, further weakening their position and causing them to curtail their international and regional exposure.

The Financial Times (2008) observed that "[w]hile US and European financial institutions have been busily scooping up acquisitions in Asia, Japanese banks are conspicuous by their absence. Japanese banks have made just half a dozen acquisitions in Asia in the past three years, according to Thomson Financial, spending slightly more than \$1 billion on total overseas acquisitions in that period. That is a fraction of the \$22.5 billion spent by their western peers in Asia. This is an odd trend for Japan to buck. After all, Japanese banks have operated in China—where they continue to have modest branch networks—since the 19th century and Asia is on their doorstep." Given this abstinence from the regional market, it is not surprising that regional cooperation was no big topic for Japanese bankers.²⁴⁾

But things are bound to change: Japanese banks have consolidated their balance sheets, and, in the judgment of the Financial Times (2008), today "they have the wherewithal to spend, being well-capitalised and boasting far more deposits than loans." Moreover, "sluggish lending growth and shrinking demo-

24) As mentioned earlier, Japanese banks were indeed heavily exposed in the region until the East Asian crisis—in contrast to US and European rivals who have taken opportunity post-crisis.

graphics mean sticking to home base is not really an option in the long term.” (ibid.) Indeed, pressure is building on Japanese banks to take advantage of the investment opportunities abroad: “With a shrinking domestic market, expanding their overseas businesses is one of the few paths to growth left” (Nakamoto 2008). Like in the corporate sector, increasing exposure to the regional economy will increase the financial sector’s stake in regional cooperation.

4.2.2 International actors

While the domestic scenery is a key determinant in shaping a country’s international monetary policies, policy options and choices are also influenced or constrained by the actions and decisions of other countries.²⁵⁾ China, South Korea, and the ASEAN countries are obviously factors of influence for Japan’s choice regarding involvement in regional cooperation, as are the USA.

Washington

Japan, being a close political and military ally of the United States since World War II, has traditionally been compliant to the US government’s policy stance. As Pempel (2007, p. 1) puts it, “Japan’s postwar foreign policy behavior has continually reflected an ongoing deference to America’s power position, and Japanese policymakers have consistently structured their nation’s foreign policies with at least one eye constantly attuned to Washington’s preferences and changing priorities.” With the US disapproving of regional integration in East Asia—especially if built around institutions or fora that explicitly exclude the US from participating—the Japanese government has persistently tried to keep a balance between its regional ambitions and US interests. To this end, Japan traditionally sought to ensure regional economic and financial, rather than political, cooperation and promoted open regionalism that would also include the US and other non-East Asian countries such as Australia, Canada or New Zealand.²⁶⁾

The US government, in turn, has always made sure that the Japanese administration was aware of its interests and, in case of conflict, concede to the US

25) Hamada (1974, 1987) models international monetary cooperation as a strategic game.

26) Examples are the Pacific Basin Economic Council (PEBEC) and the Pacific Economic Cooperation Council (PECC). See Langdon (1997) for details.

position. The US has frequently deployed Japan as its closest ally in East Asia to secure its regional interests. For instance, when former Malaysian Prime Minister Mahathir Mohammed proposed the creation of an East Asian Economic Caucus, a multilateral grouping of exclusively East Asian countries, the US (and Australia) vehemently opposed to this. With US pressure, the Japanese quietly tried to dismiss the idea, while the Australians promoted a more inclusive Asia-Pacific Economic Cooperation Forum (APEC) forum as an alternative, which was then established in 1989 (cf. Fukuyama 2005).²⁷⁾

The Asian crisis caused a big stir in the US-Japanese relationship. Seeing its economic interests in the region in danger and the US not willing to support the East Asian crisis economies, Japan launched the AMF plan, without seeking US approval, or even informing the US in advance. According to Blustein (2001, pp. 165–6), MOF Vice Minister for International Affairs Sakakibara sent an unofficial outline of the AMF plan to South Korea, Malaysia, Hong Kong, Singapore, and Indonesia on September 10, 1997. Although not intended for American eyes, the Treasury quickly got hold of the plan. US officials, to whom sending the proposal to the Asians without involving Washington seemed a rude departure from the normal conduct of the US-Japanese alliance, were enraged. The Treasury responded immediately after obtaining information on the AMF plan and actively opposed it.²⁸⁾

27) Besides the US, China, Japan, Korea, Taiwan, and the ASEAN countries, APEC also includes Australia, Canada, Chile, Mexico, New Zealand, Papua New Guinea, Peru, and Russia.

28) In his memoirs Sakakibara (2000, p. 185) reports that then Deputy Secretary of the Treasury Larry Summers called him directly at his residence at midnight and angrily shouted “I thought you were my friend.” During an intense two-hour phone conversation, Summers allegedly criticized the AMF plan for excluding the US and sidelining the IMF. Summer’s telephone call to Sakakibara was only the first of several conversations in which senior US officials expressed indignation to their Japanese counterparts that the rules of American-Japanese engagement had been violated. On September 17, Secretary of the Treasury Robert Rubin and Fed Chairman Alan Greenspan sent a letter to their Asia counterparts, followed up with visits to East Asian capitals by Tim Geithner of the Treasury and Ted Truman, the Director of the Fed’s Division of International Finance, to lobby against the AMF plan. While Tokyo won support of several East Asian countries, including Malaysia, the Philippines, and Thailand, Chinese officials told Japanese emissaries that China could take neither a positive nor negative position, which, in effect, was nothing but a Chinese veto (Blustein 2001). According to Lipsy (2003), there is indication that the US lobbied China to oppose the AMF plan by highlighting the threat of “Japanese hegemony”.

The US Treasury's main criticism focused on two points: moral hazard and duplication of institutions. The AMF would only create an incentive for East Asian countries to delay necessary structural adjustments and add little to the pre-existing system centered on the IMF (cf. Lipsy 2003). Interestingly, Michel Camdessus, the then managing director of the IMF, initially welcomed the AMF proposal (he only disliked that it should be called "Fund"), but later retracted his endorsement in the light of objections of the US Treasury. With European support Washington made considerable efforts to wreck the Japanese proposal, arguing that the AMF would be an agency of potential conflict with the IMF, so that Japan, which was unwilling to risk an outright confrontation with the US, abandoned the plan. The Treasury also responded to the AMF proposal by providing for faster activation of IMF facilities, offering bilateral funds to crisis countries, and by initiating the IMF's Supplemental Reserve Facility (cf. Henning 2002 and 2005).

Admitting defeat of the AMF plan, Eisuke Sakakibara is reported to have said: "We were taught a valuable lesson on the influence the United States wields in Asia" (Blustein 2001, p. 168). Henceforth, Japanese policymakers have been cautious not to risk a clash with the US again. When the CMI was discussed, for instance, the ASEAN+3 finance ministers made sure that the CMI was not perceived in Washington as a threat to the IMF. To soothe concerns that the IMF's role would be undermined through the CMI, the ASEAN+3 finance ministers agreed to include an "IMF link", which required that beyond the first 10 percent of each bilateral swap arrangement, borrowers must agree to an IMF program and its conditionality.²⁹⁾

Apparently, the non-confrontational strategy worked much better. While the US Treasury had been largely responsible for the rejection of the AMF proposal in autumn 1997, it took a softer though noncommittal line in the spring of 2000 (Henning 2002). Edwin Truman, Under Secretary for International Affairs who represented the Treasury at the ADB meeting where the CMI was negotiated, stated that regional initiatives such as the CMI could well be constructive in principle and that greater cooperation among Asian countries was "perfectly

29) In 2005 the non-linked portion of the swaps was quietly increased from 10 to 20 percent. Cf. Henning (2005).

appropriate”. He nevertheless reserved final judgment, cautioning that “[t]he devil is in the details. If they are supportive of prompt financial and economic adjustment, then I think they are to be commended, but we don’t know yet what will happen” (cited after Henning 2002, p. 13).

The Treasury maintained a critical stance also when the ADB announced plans for launching an Asian Currency Unit (ACU) in spring 2006. The ACU was envisaged as a weighted index of currencies for ASEAN+3, and was modeled upon the European Currency Unit (ECU), which later developed into the euro. Haruhiko Kuroda, an ardent supporter of East Asian monetary integration who in the meantime had become President of the ADB, had pledged to propose the creation of an ACU at the ADB meeting in Hyderabad in May 2006, but reportedly held back in light of opposition from the US, who together with Japan is the largest shareholder in the bank, each with a 12.85 percent stake.³⁰⁾ China was reportedly also at unease with the ADB’s plans, as it strongly disliked the idea of including currencies such as the New Taiwan and Hong Kong dollars in the currency index (Rowley 2006). Moreover, the fact that the proposal originated from the ADB, which across the region is widely regarded as the long arm of the Japanese MOF, automatically raised suspicion in the other East Asian capitals (not least Beijing) (Johnson and Wolf 2006). In the end, the ADB was forced to put the ACU on hold.³¹⁾ The ASEAN+3 Finance Ministers, however, picked up the idea of an ACU and decided to further explore it in study groups.

In the light of ongoing discussions by East Asian countries—including Japan—to step up regional monetary cooperation efforts and its own diminishing

30) Timothy Adams, then Treasury Under Secretary for International Affairs, actually denied that the US had expressed concern about an ACU, telling the International Herald Tribune at the ADB meeting: “We don’t oppose it. I have no concerns about this issue.” (Giridharadas 2006) People familiar with the situation, however, maintain that the US did exert pressure on the ADB, arguing that its role was in poverty reduction, not encouraging regional integration. Volker Ducklau, the ADB’s executive director for Germany and Britain, was quoted in the press as saying: “From the Americans there was an outcry, seeing it [the ACU] as a danger to the dollar” (ibid.).

31) Japan’s Vice Finance Minister for International Affairs, Hiroshi Watanabe, concluded that the debate is likely to take “some time” before any agreement can be reached. He described “[t]he ACU [as] one good example of regional cooperation [but] it is very political and will require much closer discussion” (Rowley 2006).

influence in the region (a result of the tarnished reputation with which the US government and the IMF came out of the East Asian crisis), the US appears to have accepted that a confrontative opposition to East Asian regionalism would only further decrease its policy weight in the region. In a much-noted speech at the World Economic Forum in Tokyo in June 2006, Timothy Adams, Under Secretary for International Affairs signaled that the US Treasury would no longer fight efforts to create an ACU, “turning the page on more than a decade of largely consistent opposition to Asian monetary integration” (Guha and Mallet 2006). In his speech, Adams (2006) described regional economic integration as “an important factor contributing to [...] regional dynamism” in East Asia and that “we therefore support regional cooperation that is consistent with multilateral frameworks.”³²⁾ With respect to the ACU, Adams spoke of “some confusion about the U.S. position on this topic” and stated that “[w]e do not see the ACU as a competitor to the dollar”. He also remarked that the US is “open-minded” on “currency cooperation within the region” and that “[w]e view proposals for Asian currency cooperation with interest”. Adams underlined that “we support outward-oriented Asian regional economic integration” and that “we think it’s important that Asian regional financial initiatives complement and strengthen the multilateral framework.”³³⁾ In a press meeting back in Washington, Adams told reporters the US government hopes to be “intimately involved” in any steps toward fostering deeper economic cooperation among East Asian countries and that regional integration is “a way to keep rapid economic growth in the region on track, and to bring about greater stability in the region” (Schroeder 2006). He even suggested that such integration could include a single Asian

32) Directed at the CMI, Adams (2006) said that “we see room for further clarity [...]. Too little is known by the markets or by borrowers about amounts available absent IMF adjustment programs, and the conditions, if any, CMI creditors would impose. More clarity on these issues would aid an assessment of the CMI’s compatibility with the international system.”

33) In his speech Adams said: “I also wish to emphasize our position that Asia, along with other regions contemplating integration initiatives, must not tear down intra-regional walls only to erect new ones that exclude the rest of the world. Closed regionalism would have negative implications for the region, given the continued importance of the extra-regional economies—particularly the United States—to trade and capital flows in the region. Open regionalism can—and is clearly more likely to—benefit regional and extra-regional actors alike.”

currency, akin to the euro (*ibid.*).³⁴⁾

While Adams presented his notes as a clarification rather than a shift in US policy, US officials admitted that the US is perceived in East Asia as being hostile to regional monetary and financial integration in principle, and wants to change this image (Guha and Mallet 2006).³⁵⁾ Dieter (2006, p. 49) views this policy shift rather as “a belated acceptance of America’s inability to bloc the emergence of monetary regionalism in Asia than an expression of a new willingness to constructively engage America in a new form of financial governance in the region.”

In any case, the US government’s change from a negative to a more neutral attitude toward East Asian monetary integration will presumably make it easier for Japan to take part in such initiatives.³⁶⁾ Outright confrontation with the US is still no option for Japan, as the alliance with the US is too important. On the other side, the US will be able to exert more influence on regional integration if Japan is involved—the alternative would most likely be an East Asian grouping dominated by China, with even less US sway.

Regional actors

For long Japan has been the undisputed economic leader in East Asia, and as such did not feel the need to seriously engage in regional economic cooperation. A sluggish economic performance since the burst of the bubble and the simultaneous rise of other economies in the region, most significantly China, have increasingly undercut Japan’s economic leadership. China has rapidly developed into a regional economic hub, and is courting Southeast Asian coun-

34) In the same meeting Treasury spokesman Tony Fratto said the US is not against deeper economic ties among Asian countries, including a single currency, and that the US Treasury is “not opposed, right now, to any particular aspect of greater integration [...]. If done the right way, it would be very beneficial to the region and the global economy” (Schroeder 2006).

35) Masahiro Kawai, then head of the ADB’s Office of Regional Economic Integration (and former MOF official) who developed the ACU idea with ADB President Kuroda told the Financial Times that he was “pleasantly surprised” by what he saw as a new US approach to East Asian monetary integration (Guha and Mallet 2006).

36) As the Financial Times put it: “The green light from the US is a big fillip for Japan, which has been pushing the idea of an Asian currency unit [...] in face of considerable regional scepticism. It comes at a time of growing diplomatic closeness between Washington and Tokyo.” (Guha and Mallet 2006)

tries with economic partnership agreements. The emergence of China as a regional and global power, both politically and economically, constitutes a formidable challenge for Japan.

Like Japan, China doesn't seem to have developed a coherent regional strategy. Rather, they both appear to be involved in a strategic game. Both China and Japan regard Southeast Asia as their own backyard, with both being eager to maintain or increase their influence in the region. At times, the result appears to be a "competition for regional cooperation". As an example, China's agreement in November 2004 with ASEAN to create the world's largest FTA by 2010, with more than 1.8 billion people (ASEAN and China 2004) prompted Japan to launch its own formal trade negotiations with ASEAN about a similar ASEAN-Japan FTA.³⁷⁾ And while the Chinese government was first wary of associating itself with the Japanese AMF-proposal in 1997, it was the Chinese foreign minister who proposed regional financial cooperation to the ASEAN+3 finance ministers two years later (Henning 2005). Indeed, the fear to be pre-empted by the other country seems to be a driving force for both China and Japan to engage in regional cooperation.

ASEAN countries are well aware of the Sino-Japanese rivalry. With its early role played in regional trade liberalization, ASEAN is certainly to be regarded as a driving force in regional integration. This is not to say that ASEAN member countries all have the same ambitions and vision for regional integration. Indeed, motivations appear quite different in part. And yet, what all ASEAN countries have in common is their relative economic insignificance if contrasted to the two main regional players China and Japan, or even Korea. The rise of China in particular has created a feeling across ASEAN capitals that regional economic integration is imperative to maintain competitiveness and remain attractive destinations for foreign investment (Volz 2006).

Moreover, the Asian crisis created a feeling in the affected economies of "being alone together". It also nurtured resentment against the US, whose slow

37) See Wall Street Journal Europe (2004) and Jopson (2004). The two agreements have come into effect by the end of 2008. A trading arrangement has also been concluded also being negotiated between ASEAN and Korea. These arrangements are envisaged as building blocks for the possible establishment of an East Asia Free Trade Area (EAFTA) involving all ASEAN+3 countries. On the race for FTAs in East Asia see Munataka (2006, chapter 7).

crisis response was seen in stark contrast to the quick and generous support it had given Mexico a few years earlier. The Japanese support during the crisis, even though driven by the self interest to secure investments of Japanese firms and recover lending of Japanese banks, helped boost Japan's standing across the region considerably. In a similar fashion, the Chinese decision during the crisis not to suspend its dollar peg contributed to restoring stability in the currency markets and won Beijing praise. Indeed, the progress in regional financial and monetary cooperation, as slow as it might have been, would have been unthinkable without the crisis.

And yet the dynamics of regional economic cooperation that has transpired so far cannot obscure that neither ASEAN nor ASEAN+3 has a clear vision or integration agenda.³⁸⁾ Moreover, the rivalry between China and Japan runs deep and will encumber economic, including monetary and exchange rate, cooperation. Both countries remain, despite their regional and international economic exposure, essentially inward-looking. Monetary and exchange rate cooperation is certainly less important for them than for the smaller Southeast Asian economies. Still, if the strategic aspect of regional leadership is added to the storyline, it is not unconceivable that the integration process develops its own momentum.

5. Summary and conclusions

Regional monetary and exchange rate cooperation is a topic that has been attracting growing interest in Japanese academic and policy circles. At present, however, the voices demanding regional monetary and exchange rate cooperation are mostly limited to academic circles and pockets within government. Japanese industry and finance has been remarkably mute on this topic, despite the heavy involvement of Japanese firms in the regional trade-FDI network. The reasons are threefold: first, Japan is still a relatively closed economy, despite its role as one of the world's largest exporters. Second, the Japanese export sector is highly concentrated, with exports mainly being conducted by large internationally oriented firms which all have their own financial infrastructures,

38) For instance, the Charter that ASEAN leaders signed at the 13th ASEAN Summit in Singapore in November 2007 exposed the sharp divisions persisting among the signatories (e.g., Arnold 2007).

including banks, and financial know-how to hedge exchange rate risk. They therefore do not have a strong incentive to lobby for regional exchange rate stabilization. Third, Japanese firms, as elsewhere in East Asia, have gotten used to the East Asian dollar standard.

The situation, however, is likely to change, suggesting more demand from the side of the business community for regional cooperation. International—and especially regional—trade is expected to become more important for the Japanese economy, with a growing number of small and medium firms getting more exposed to international transactions. Moreover, there is increasing unease within the region about the dollar's role as anchor currency, especially after witnessing its declining reliability in the financial crisis, suggesting a regime shift in the rest of East Asia rather soon. Given that the Japanese government appears to be involved in a strategic game with other East Asian countries, most notably China, Japan is likely to respond to changes in the regional financial architecture to preempt Chinese dominance with the region. Finally, the US has recently changed its stance to East Asian monetary and financial cooperation to a more neutral position, giving more room for the Japanese government to engage in regional initiatives without threatening its special relationship with the US.

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