The Proposed Asian Currency Unit (ACU): Challenges and Prospects

CHAPTER 1: THE EXPERIENCE OF EUROPE BY 1999 AND ITS LESSONS

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The birth and functioning of European Monetary Unit (ECU), as the symbolic tool in the Exchange Rate Mechanism (ERM), had been seen as the most meaningful part of the European Monetary System (EMS) since 1979. Before Euro became the single currency of its member countries in 1999, the ECU was designed to be parallel to the member state currencies as an accounting unit and settlement tool. The section is to examine the effects and limitations of ECU for progressing European monetary integration as well as promoting intra-regional trade and investment. The lessons the European experience could bring to the relevant initiatives in Asia will be addressed in the final part of this section.

The Effects and Limitations of ECU to European Monetary Integration

If the concept of the economic and monetary union could be seen as the model of a full monetary integration, its two component features: the irrevocable fixing exchange rates (or a single currency) and the highly coordinated monetary and fiscal policies among members, could be the main facets of our examination over the European experience.

Suffering from the shock of oil price and the failure of the European 'snake' during the 1970s, the EC members raised the framework of ERM for its major purpose of stabilizing the exchange rate waves among member states' currencies. The criteria of ERM could be summarized as (Molle 1990: chap. 17; Nevin 1990: 275-86): (1) The achieved agreement obliged every currencies to fix to each other within a $\pm$ 2.25 range. And it was a bilateral obligation to sustain any single parity in danger. (2) To defend a given parity, governments had to intervene in foreign exchange markets. The duty of intervention was unlimited before the desirable parity was defended in the face of any threat. (3) Once realignments were needed, it had to be achieved by member states' consensus. (4) The ECU, which comprised currencies of every member state weighed in terms of their respective significance of GDP and trade in Europe, was set to be an anchor for the exchange rate stability. 20% of member states'

foreign reserves were deposited into the European Monetary Cooperation Fund (EMCF) to exchange for ECU.

Compared with the European ‘snake’, the EMS in which the ECU was embedded possessed its major advantages as the exchange rates stabilization is concerned:

1. Using the ECU, rather than the currency of any single state, as the anchor, the ERM presented a more symmetric design. It granted no single currency the privilege of the ‘N’ currency which the US dollar always enjoys in the global scale during most of the post War era.
2. Depart from the European ‘snake’ which lay the duty of sustaining the exchange rate parity of a currency to its issuer only, the ERM obliged both parties to be responsible for stabilizing a parity they involved. And the responsibility was supposed to be unlimited. This mutual binding characteristic of ERM was further enhanced with the provision about the consensus-based realignments when realignments were necessary. All the above implied a strong mutual commitment toward a regional exchange rate regime, which allowed little margin of fluctuation (
Baldwin & Wyplosz 2006: 333-4).

After several realignments in the first half of the 1980s, the EMS started to show its effects on exchange rate stabilization. The frequent realignments allowed member countries to opt for a domestic inflation rate they preferred, however, forced the high-inflation countries to be in permanent trade deficits due to the appreciation of their real exchange rates during the process of realignments (2006: 336-7). Finally, most European countries chose to converge their inflation rates, with German’s low index as their objective. From 1987 to September 1992, there was no any realignment (see table 1). At the same time, the symmetric characteristics of EMS were somewhat lost, since the convergence made the Deutschmark (DM), rather than the ECU, the substantial anchor.

Dates	24.9.79	30.11.79	22.3.81	5.10.81	22.2.82	14.6.82
No. of currencies involved	2	1	1	2	2	4
Dates	21.3.83	18.5.83	22.7.85	7.4.86	4.8.86	12.1.87
No. of currencies involved	7a	7a	7a	5	1	3
Dates	8.1.90	14.9.92	23.11.92	1.2.93	14.5.93	6.3.95
No. of currencies involved	1	3b	2	1	2	2

Table 1 ERM Realignments

a All ERM currencies realigned.

b In addition, two currencies (sterling and lira) leave the ERM

Source: Adapted from Baldwin and Wyplosz 2006: 334

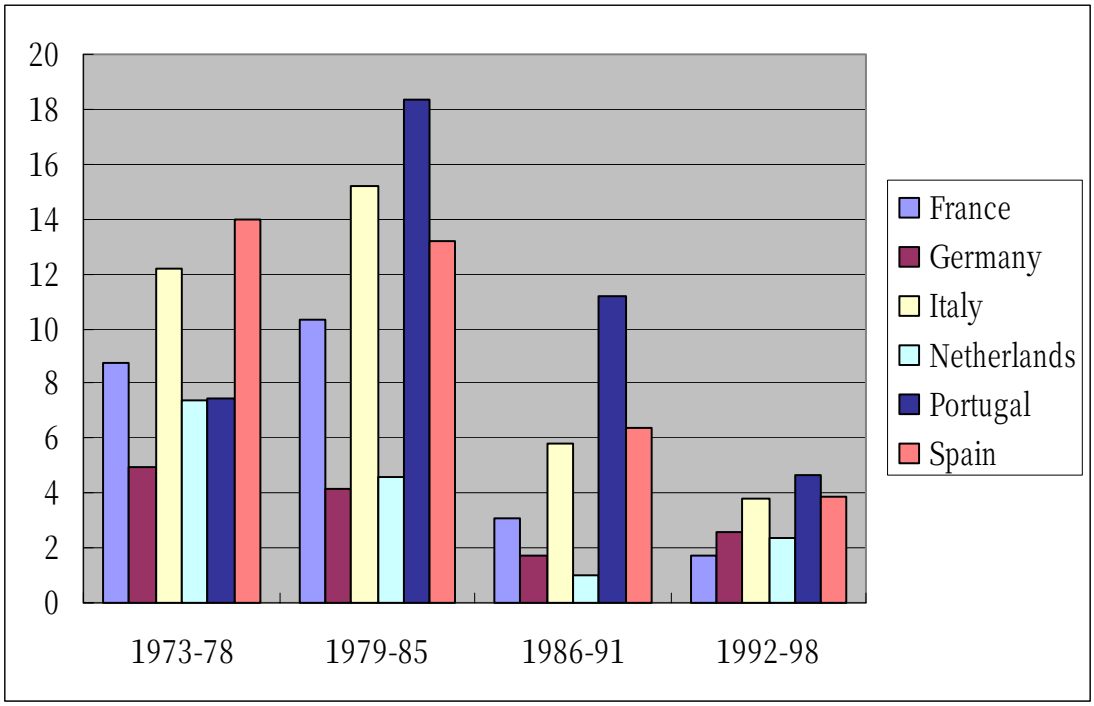
The Crisis of ERM from 1992 to 1993 revealed the limitations of the EMS and its ECU in a lack of a proper coordination over monetary and fiscal policies among members. Ultimately, this brought the efforts for stabilizing the exchange rates in danger.

Several reasons contributed to the burst of the Crisis (2006: 337-9). First, the convergence of inflation rate was not completed, especially in the cases of Italy, Spain and Portugal (see figure 1). Since 1987, there was no any realignment, and in the cases of Spain and Portugal, this implied an overvaluation of the real exchange rate of the two currencies in terms of consumer price index or labour cost (Anderton, Barrell and Veld 1992: 5-10). This had set the competitiveness of Spain and Portugal in disadvantage. Suffering from this setback, the two countries felt difficult to impose a rigid monetary policy and discipline, which was necessary for disinflation, to their national economy (Gros & Thygesen 1998: 207-218; Buiter, Corsetti and Pesenti 1998: 43-48; Larre and Torres 1992). Second, the unification of East and West Germany heightened inflation rate, which incurred German central bank's austerity response. For the purpose of depressing inflation rate, a series of tight monetary policies were adopted by the German central bank. Third, the liberalization of capital control in Europe since the late 1980s left the European central banks little choice but to follow the tight monetary policies of the Bundesbank, due to the impossible trinity[1].

[1] The impossible trinity indicates that it seems unrealistic to hold simultaneously fixed exchange rate, full capital mobility and monetary policy independence for any country. In the face of free capital mobility, the European countries pursuing fixed exchange rates felt pressured to give away their

Forth, the global recession during the early 1990s made the effects of the austerity programs even more unbearable than expected. Markets anticipated that the austerity programs might not last long enough and there would be space for speculation. Finally, the voted down of the Maastricht Treaty by Denmark in 1992 enforced markets' expectation that the progress of European monetary integration might be stuck, and provoked a wave of speculation in the weak currencies. Germany's retreat from the unlimited commitment to intervene in the foreign exchange markets directly resulted in the withdrawal of the lira and the pound from the ERM (Buiter, Corsetti and Pesenti 1998: 54-8).

Figure 1 Inflation in Europe



Source: IMF.

After the 1992 shock, the EMS dramatically widened the range of bilateral parities wave. This made it more like a floating exchange rate regime. Without a proper coordination over monetary and fiscal policies among members, the symmetric design of ECU could be set aside by the dominance of few leading currencies, which implies threats to exchange rate stability when the relevant conditions matured.

autonomy on monetary policies. In this case, the central bankers had no choice but to follow the Bundesbank's policy.

The Effects and Limitations of ECU for Promoting Intra-regional Trade and Investment

The process of European monetary integration is gradual, which was preceded by the establishment of the European Custom Union, and accompanied by the individual endeavors for deregulation in capital control. In additions, the expected return of investment in European countries varied due to a variety of reasons. These made it difficult to determine to what extent the ECU had benefited the development of intra-regional trade and investment in Europe. However, the amount and percentage of pro-European trade and investment (including portfolio investments) denominated in ECU should suggest the trends developed during the two decades. The following discussion will focus on the adoption of ECU in the public and private sector respectively. It concludes that though the private ECU had developed much better than ECU's adoption in the public sector, the proportions of ECU denominated transactions in the private sector were relatively small. The private ECU's effect on intra-regional financial market integration was limited.

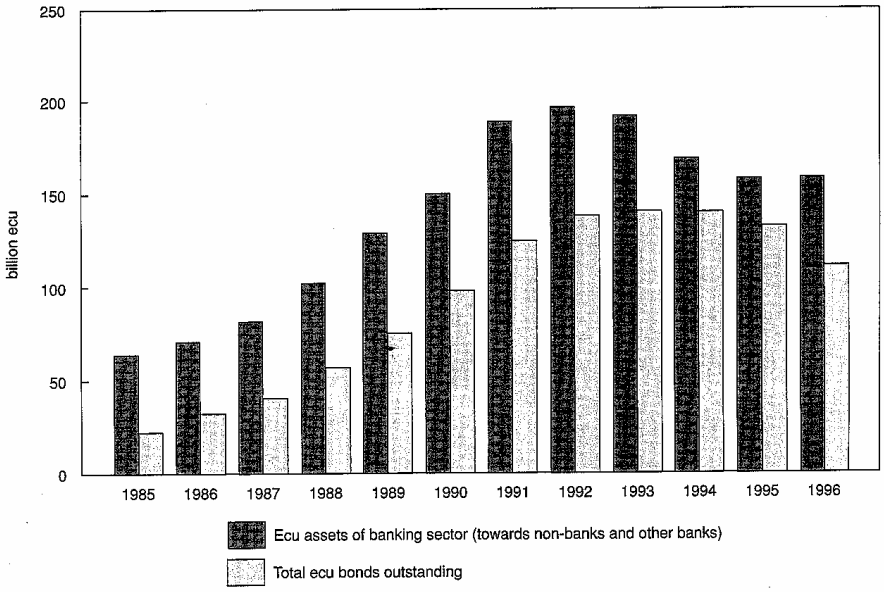
The official ECU was designed to be the official accounting unit of the Community and should be used to settle all the official transactions. However, the idea of having a real monetary union was a premature one against the reality when ECU was borne. To avoid the ECU from acting as the real currency of a monetary union, there was no physical existence of ECU. More importantly, the central banks did not conduct any transaction in ECU, except for exchanging gold and hard currency reserves for ECU under the European Monetary Cooperation Fund (EMCF). There were two more possible ways to take advantage of the official ECU: to issue large credits to the needed through EMCF, and to connect the official ECU with the private one (Gros and Thygesen 1992: 208-9). The former was impeded by the lower rate of remuneration by the middle of 1980s, and later ruled out due to the abundant supply of short-term financial resources in the global capital markets. The latter was not realized because of concerns over its effects on the expansion of credits outside the central bankers' control. Nevertheless, the prospect of a single currency in Europe implied that the two circuits of ECU would merge anyway.

Distinguishing from the absolutely passive role of official ECU, the private ECU experienced a quite vivid development during the two decades (though fluctuations remained).

The private ECU could be seen as a basket of currencies mobilized in the private transactions. Its compositions is exactly the same with the official ECU, which means

that any change of the composition of the official ECU would be precisely followed by the private one.

Figure 2 The ECU in International Finance



Note: Data for 1996, end of March.
Source: BIS. Adapted from Gros and Thygesen 1998: 246.

In the capital markets, the use of the ECU in the international bond market grew from the very tiny to almost 150 billion ECU in 1993 at its peak. Compared with all European national currencies in the bond market, the ECU had become the third biggest one. In the banking market, the amount of the ECU assets in the European banks' foreign currency positions increased from about zero in 1984 to near 200 billion ECU in 1993 (see figure 2). Researchers identified several factors that contributed to this explicit development of private ECU:

1. For both investors and debtors, the ECU is a good choice in terms of diversifying exchange-rate risk, especially when the fluctuation of exchange rates was obvious in the first half of the 1980s. And specifically for the debtors who run their businesses across Europe, the growth of intra-regional trade made them more willing to issue ECU denominated debts for the same reason.

2. When wide capital controls were incumbent by late 1980s, the use of ECU could be based on the motives of 'regulation arbitrage' (Dammers 2006: 84-6). That is, to

gain more yield by eluding the national regulations. For example, the German financial authorities' reluctance to internationalize its currency made room for more ECU bond issuance.

3. Motivated by political considerations, European countries encouraged the issuance of the ECU denominated debts, and expected them to substitute the DM denominated ones (Gros and Thygesen 1992: 214-5).

4. Due to their commitment to a more integrated Europe, the EC and certain European giant financial institutions supported the use of ECU in the financial markets (1992: 215).

5. The market anticipated that there would be a 'through-train relationship' between the ECU and the coming European single currency, and this would become the reality by the end of the 1990s. This partially explained the new surge of demand in ECU by the late 1990s (Dammers 2006: 87).

However, the use of ECU in the over all trade and investment activities was still the small minority. As summarized by Eichengreen (2006: 433):

> *'In the 1990s, only about one percentage of trade within the Community was invoiced in ECUs. At their height, ECU-denominated claims still amounted to less than 10 percent of the nondollar foreign currency claims of banks reporting to the Bank for International Settlement. ECU bonds never accounted for much more than 20 percent of all nondollar Eurobonds. Medium-term ECU notes accounted for barely 15 percent of the non-US dollar market in such notes, and the ECU commercial paper for only about 10 percent of all euro commercial paper.'*

Observed in the early 21st Century, the concentration in the European banking sector is still a trend developing within borders and few trade of banking service is offered across boundaries. The integration of governmental and private bond markets is far from completed even after the birth of Euro. The achievement that ECU had made for promoting intra-regional portfolio investment exceeds not much than in the field of trade.

In fact, the ECU was under severe competitions from both sides: the national currencies (the DM in specific) as well as the hegemonic US dollar in the global financial world (2006: 433). In a lack of legal tender status granted by European

governments, it was difficult for the ECU to antecede the national currencies, especially during the time when the European exchange rates volatility was tamed to certain extend. A currency that most people use could create its ‘network externalities’ that forms a natural barrier to competitive new entry. And the ECU had to conquer the cultural, political and identical drives that made people attach to their respective national currencies. These drives had made the ‘network externalities’ enjoyed by the national currencies even more solid. At the same time, the ‘advantage of incumbency’ of the US dollar will not disappear in the foreseeable future. The prospect of ECU as a new global currency was under the shadow of this pre-eminence of US dollar. Taking this advantage as given, the fluctuation of US dollar transmitted its impact on individual European currencies. They received pressure of different levels accordingly, due to the individual European countries’ economic constitution and their trade relationship with US. This seduced the individual EC countries to have their own response to the floating US dollar (Nevin 1990: 282-3). The ECU could not be immune from the impact and pressure. The construction of Euro in 1999 could be seen as a once-and-for-all response to the above situations.

Lessons

What are the lessons that the Asia pacific region can learn from the experience of ECU, if an Asian Currency Unit (ACU) is to be constructed?

1. In an era of global finance where capital control is dismantled, it is almost impossible to sustain monetary policy autonomy for any single country when a stabilized foreign exchange rate is pursued. In the experience of the ECU, the stable currency parities could not be maintained without a proper framework of coordination between national monetary and fiscal policies of member states. The coordinated monetary and fiscal policies have to put the different economic conditions of individual member states into consideration. Therefore, the coordinated policies are de facto political compromises between members.

2. The absence of this framework for policy coordination is inclined to lead to a dominance of the strongest currency, considering the competitiveness pressure that the members with higher different inflation rates would feel. This dominance will not only undermine the systemic symmetry of the regional monetary regime, but also lead the stabilized currency parities to crisis when the relevant conditions are ready.

3. In addition to the growth of intra-regional trade, the imposition of capital control measures and certain unilateral favorable policies of governments can help to motivate the use of a parallel currency like the ECU. However, the network externalities of money determine that it would be difficult for a newly constructed parallel currency to win its competition with the national currencies, as legal tender status granted by member states are unavailable. And the hegemony of the US dollar comprises another challenge to a wider adoption of the regional currency. In the experience of Europe, the birth of Euro was a response to these difficulties.

4. Again, either the grant of legal tender status or the establishment of a single currency in the region, it implies that the member states alienate their sovereignties on monetary and fiscal affairs to the coordinations among them, or to a super-state authority. This requires strong political wills of all members and has its economic price to pay (at least in the short term). In Europe, the relevant debates continue in the beginning of the 21st century. Are Asian countries ready in this sense?

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