

## **CHAPTER 2: CHALLENGES AND PROSPECTS FOR AN ASIAN CURRENCY UNIT**

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At their meeting in May 2006, Finance Ministers of the ASEAN Plus Three (APT) grouping meeting in Hyderabad, endorsed the undertaking of a study on the creation of an Asian Currency Unit (ACU). Together with their agreement to work more closely toward coordinating their foreign exchange policies, enhancing the Chiang Mai Initiative and promoting the development of their bond markets, these were seen in many quarters as tentative steps toward a common regional currency similar to the euro.<sup>1</sup>

While a clear picture of the APT Finance Ministers' collective views on the proposed ACU is yet to emerge, probably in early 2007, there have already been various proposals on the subject. One proposal focuses on its creation with a view toward an Asian monetary system and an eventual monetary union. The latter idea is not a totally new concept, having been previously suggested by former Prime Minister Mahathir Mohamad at the 1997 ASEAN summit,<sup>2</sup> by Nobel economics laureate Robert Mundell at a lecture in Bangkok in 2001,<sup>3</sup> and by Philippine President Gloria Arroyo at the 9th annual Future of Asia conference hosted by Nihon Keizai Shimbun in 2003,<sup>4</sup> among others.

In July 2006, The Network of East Asian Think Tanks (NEAT) proposed the launch of a study on an "East Asian Monetary System." This proposal included elements borrowed from the European Monetary System (EMS), such as establishing a relationship between the currencies of the APT member states and the proposed East Asian currency unit, coordinating exchange rates and carrying out market interventions, as well as the establishment of an Asian Monetary Fund.<sup>5</sup>

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<sup>1</sup> "Asian Finance Ministers Seek Common Currency," The New York Times (May 5, 2006).

<sup>2</sup> "Asian currency unit still a dream," People's Daily Online (November 16, 2006).

<sup>3</sup> "After European, now Asian Monetary Union?" Asia Times Online (September 8, 2001).

<sup>4</sup> "The Future of Asia 2003: Asian leaders talk security, economic integration," The Nikkei Weekly (June 9, 2003).

<sup>5</sup> Report of the NEAT Working Group on East Asian Financial Cooperation (Beijing, July 10, 2006).

A second type of proposal is the creation of an ACU as a parallel currency, as suggested by Professor Barry Eichengreen of the University of California, Berkeley.<sup>6</sup> Rejecting the idea of an Asian monetary system as impractical, Eichengreen proposed that governments create an ACU based on a weighted average of Asian currencies, and allow it to circulate alongside existing national currencies. Official ACUs would be created in exchange for swaps of a portion of participating central banks' international reserves, and ACUs would be used in transactions among member banks, as well as in denominating bond issuances. Monetary unification in this case would be driven by the market rather than politicians, as the ACU gains acceptance as a common regional currency among market participants.

A third type of proposal, much less ambitious than the previous two, is the creation of an ACU that would mainly be an indicator of relative currency values for use in monitoring regional currency movements and possible denomination of bond issues, as initially suggested by the ADB. Under this scenario, the ACU would be a weighted average of Asian exchange rates, with particular criteria such as the size of GDP, trade and capital account openness determining the weights assigned to countries' currencies. Unlike the European Currency Unit (ECU), the ACU also need not have official status nor need it be linked to a monetary system like the EMS.

This third type of proposal allows the ACU to play a role in facilitating a future regional monetary union, by serving as an indicator for monetary authorities in formulating and coordinating their monetary policies to promote convergence of exchange rate systems. While the ACU would at first be a reference currency, Asian countries may eventually adopt it as a common currency replacing their national currencies, when they deem themselves ready for monetary union. However, monetary union is seen here only as a very distant possibility rather than a clear objective to which structure and function of the ACU are oriented.

An interesting possibility is the use of a "private ACU" by exporters, importers and financial market participants to denominate economic transactions, such as in invoicing, deposit-taking, lending, hedging and issuing bonds. This draws from the experience of

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<sup>6</sup> Barry Eichengreen, "The Parallel Currency Approach to Asian Monetary Integration," *The American Economic Review*, Volume 96, Number 2, May 2006, pp. 432-436(5).

the ECU, which was initially adopted in 1975 as the unit of account for the European Community's budget, but which was taken up by market participants, particularly those attracted by opportunities for diversification and regulatory arbitrage. Banks handling ECU deposits of European institutions and governments eventually issued ECU bonds, medium-term notes and commercial paper.<sup>7</sup>

The use of the ACU as a component of an Asian Monetary System similar to the role that the ECU played within the EMS is an attractive concept in Asia for a variety of reasons. It is seen as a possible way to limit the effects of financial contagion that has resulted from the deepening of economic interdependence within the region. It would provide a mechanism to prevent largely export-oriented Asian countries that compete in international markets from engaging in competitive devaluations. It would help minimize transaction costs arising from the need to hedge against exchange rate volatility.<sup>8</sup>

However, the establishment of an Asian Monetary System similar to the EMS faces a number of challenges. One of these is the difficulty of choosing an optimal exchange rate regime, in view of the divergence in living standards and differences in economic structure, which are much larger in Asia today than in Western Europe during the 1980s and 1990s.<sup>9</sup> Large differences in potential growth and inflation performance and relatively low correlation of business cycles within Asia, as compared to Europe, would make it difficult for Asian economies to manage such a system.

Eichengreen notes two preconditions for successfully defending a system of currency pegs given high capital mobility: close convergence of policies and the maintenance of confidence. Although a system of swap lines and credits under the Chiang Mai Initiative has been recently expanded, it still remains to be seen whether Asian countries are ready

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<sup>7</sup> Clifford Damers and Robert N. McCauley, "Basket weaving: the euromarket experience with basket currency bonds," *BIS Quarterly Review* (March 2006), pp. 79-92.

<sup>8</sup> Deok-ryong Yoon, "Is Asian Common Currency Feasible?" *The Korea Times* (September 22, 2005).

<sup>9</sup> Estimates put the standard deviation of living standards in Asia at about three times that in Europe, see Hew McKay, "An Asian currency – a bridge too far," *Asia Times Online* (September 29, 2006).

to subordinate other policies to the maintenance of the system and to provide extensive financial support in times of crisis.<sup>10</sup>

The establishment of an ACU that would serve as a parallel currency circulating alongside the existing national currencies would avoid the necessity of stabilizing the currencies in the basket. However, there are some serious challenges, as acknowledged by Eichengreen.<sup>11</sup>

One is the currency mismatch problems that may arise from banks or firms holding more ACU liabilities than assets and the consequent heightening of credit and liquidity risks. While these could be addressed through prudential supervision and regulation, the quality of regulation and enforcement may not yet be adequate in a number of developing Asian countries to successfully contain these risks to financial stability.

Another would be the limitations on the use of the ACU arising from restrictions that would be necessary to prevent currency mismatch problems. Limiting banks' abilities to incur ACU liabilities would restrict the issuance of ACU-denominated bonds as well as the growth of transactions in ACU claims and liquidity in secondary markets, thus making the spread of the parallel currency a slow and lengthy process.

The most important challenge is the difficulty of gaining political acceptability, as the parallel currency would have to be given full legal tender status for domestic transactions, and would be competing not just with the dollar internationally, but also with existing Asian currencies domestically. For this reason, despite its technical merits, it is unlikely that an ACU in this form would be established in the foreseeable future.

The introduction of an ACU serving as an accounting unit without an accompanying Asian Monetary System would be a useful indicator for monetary authorities in formulating and coordinating their exchange rate policies, by allowing them to monitor the collective movement of Asian currencies against the US dollar and the euro, as well as the movement of individual currencies against the regional average.

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<sup>10</sup> Eichengreen (2006).

<sup>11</sup> Eichengreen (2006).

The experience of Europe with the use of currency baskets in denominating bonds, notably the European Unit of Account (EUA), the eurco, the Special Drawing Rights (SDR) and the ECU, points to official use and definition of the basket as a necessary (though by itself not sufficient) condition for wider use by market participants.<sup>12</sup> However, if the ACU is to be used more widely in the market, a number of important issues need to be addressed.

One is related to the impact of ACU-denominated bonds on the liquidity of bond markets. Governments issuing in ACU would result in decreasing issues and liquidity in their local currency bond markets. Domestic bond market issuances of ECU bonds in France, Italy, Spain and the U.K., which reached the equivalent of US\$63 billion at the end of 1991, had resulted in less liquid markets by dividing the government bond market into two currency sectors.<sup>13</sup> The impact of similar practices on the liquidity of less developed Asian bond markets would likely be much larger.

A second issue is whether an ACU would be able to attract a critical mass of users in the region. While intra-East Asian exports has grown to take up 50% of the region's total exports in 2005, the level of regional economic integration in Asia still falls behind those of Europe and North America.<sup>14</sup> In addition, with a very significant portion of intra-Asian trade accounted for by components and conditioned by international production networks and supply chains, Asia is still very much linked to other regions, particularly North America.

As far as financial transactions are concerned, financial liberalization has resulted in East Asia's closer integration with global financial markets, but very little regional financial integration so far. East Asians have maintained a preference for borrowing from and investing in markets outside the region, while US and European financial institutions have come to play dominant roles in key areas of the region's financial markets.<sup>15</sup> In this

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<sup>12</sup> Dammers and McCauley (2006).

<sup>13</sup> Dammers and McCauley (2006).

<sup>14</sup> Pacific Economic Cooperation Council, State of the Region, 2006-2007 (2006).

<sup>15</sup> East Asian investors are largely oriented toward markets outside the region, particularly the US and European markets, with less than 3% of total East Asian long-term bond investments going to the region in 2003. Were Japanese investors to be excluded, the share of the region in total investments from the nine

context, the preference for the US dollars in the Asian region will likely continue to be strong.

The attractiveness of an ACU for market participants in the region will also depend on technical factors. It will more likely find acceptance in the region's business sector to the extent that it represents Asia's current economic configuration and financial structure. Table 1 provides figures for selected Asian economies with respect to three criteria that are relevant to the calculation of the ACU: GDP, exports and outward foreign direct investment.

Based on this table, market participants would likely be attracted to an ACU that includes among its components the currencies of a number of the following key economies: China, Hong Kong, Indonesia, Japan, South Korea, Malaysia, the Philippines, Singapore, Taiwan and Thailand. An ACU that includes currencies outside East Asia may also well include the currencies of Australia, New Zealand and India.

There are technical issues that pose problems in the use of trade data in calculating the ACU, including the limitations of trade statistics with respect to the measurement of trade in services, which is growing rapidly, the difficulty of measuring trade in value added terms (rather than in gross value terms) to reflect the impact of international vertical specialization, and the challenges of capturing re-exports, especially in the case of trade involving regional trading centers like Hong Kong and Singapore.

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East Asian economies would be 14%. See J.C. Parreñas, "Current Trends in Financial Liberalization and Integration in East Asia and Prospects for Regional Cooperation," *Asia-Pacific Today*, Volume 5 (2006).

**TABLE 1: GDP, FDI and Exports**

Country	GDP (PPP), 2005 in US\$ billion	FDI outward stock, 2005 in US\$ billion	Exports (f.o.b), 2005 in US\$ billion
<u>Brunei*</u>	6.8	0.6	4.5
<u>Cambodia</u>	34.1	0.3	1.0
<u>China</u>	8,883.0	46.3	762.0
<u>Hong Kong</u>	234.3	470.5	289.0
<u>Indonesia</u>	869.7	13.7	84.6
<u>Japan</u>	4,025.0	386.6	595.0
<u>Korea, South</u>	1,101.0	36.5	284.0
<u>Laos</u>	12.3	0.0	0.5
<u>Malaysia</u>	287.0	44.5	140.9
<u>Myanmar</u>	80.1	0.0	3.8
<u>Philippines</u>	412.5	2.0	39.9
<u>Singapore</u>	126.5	110.9	229.6
<u>Taiwan</u>	630.0	97.3	197.8
<u>Thailand</u>	550.2	3.9	110.0
<u>Vietnam</u>	235.2	0.0	32.0
<b>Total E.Asia</b>	<b>17,487.7</b>	<b>1213.1</b>	<b>2774.6</b>
<u>Australia</u>	635.5	159.2	106.0
<u>New Zealand</u>	102.0	11.1	21.7
<u>Bangladesh</u>	305.9	0.1	7.2
<u>India</u>	3,666.0	9.6	99.5
<u>Pakistan</u>	395.2	0.8	16.1
<u>Sri Lanka</u>	86.1	0.2	6.4
<b>Total</b>	<b>22,678.4</b>	<b>1394.1</b>	<b>3031.5</b>

\*2003 estimate for GDP and 2004 for Exports

Sources: National statistics; UN World Investment Report 2006; IMF International Financial Statistics November 2006

In conclusion, among the various types of proposals for an ACU, the most viable option is the least ambitious one of an indicator for monetary authorities in formulating and coordinating their monetary policies to promote convergence of exchange rate systems. There are technical and political challenges that would make it very difficult to develop a structure similar to the EMS as well as to launch a parallel currency in Asia.

While an ACU that is primarily an accounting unit may also have the potential to promote regional integration by providing a basket currency that can be used to denominate economic transactions, its success in this regard would be dependent on

whether it is structured in a way that responds to the needs of the market. Nevertheless, a number of technical issues related to statistical data still need to be addressed.