

Asian Monetary Union - Dream or Realistic Prospect?

Norbert WALTER

**Chief Economist, Deutsche Bank Group;
Managing Director, Deutsche Bank Research**

In the middle of the Asian crisis in August 1998, I was quoted in the Singapore Business Times (Aug 19) to have said: "Why should Asia expose itself to the vagaries of third-country currencies?" I pleaded for the establishment of an Asian Monetary Union (AMU) with an Asian single currency along the lines of the model of the European Monetary Union with the euro. And when asked about the time horizon I said the proposal was for the year 2025: "I am not talking about a political project for tomorrow, but a university project for tomorrow". The paper summed up my comment by stating: "The good professor is clearly no subscriber to the theory that in the long run we are all dead." This is a perfectly agreeable summary to my assessment for Asian Monetary Union (AMU) even today, eight years later.

But the establishment of AMU is a political decision that can only be made if the time is ripe, i.e. a number of political and economic pre-requisites are fulfilled. This can only be achieved over a longer period of time. Europe witnessed fifty years of market liberalisation and economic integration and about thirty years of debate about monetary union before EMU was realised in 1999. For Asia two lessons are obvious at this stage: The creation of AMU is more than a vision. It can become reality. AMU is like EMU primarily a political project. It needs strong political will and political leaders that have the vision and act accordingly in order to realise AMU.

In this context many interesting questions are arising ranging from "why AMU" to "the number of participating countries" via "objectives and conditions for a single Asian currency" to "the lessons from Europe for the roadmap to AMU".

1. Why AMU?

I think that there are substantial political and economic advantages. On the political side the bundling of several countries' power will give AMU more clout in a global context, for instance with regard to political influence vis-à-vis the economic superpower USA, the emerging superpower China as well as international organisations such as the IMF. Individual AMU member countries must no longer feel marginalised by global exchange rate developments as during the Asian crisis 1997/98 but can participate in the common AMU decision-making process. Joining AMU would also mean that a country might be spared the politically cumbersome procedure to address the IMF in the event of a balance of payment crisis and to accept its economic policy conditionality for loans.

This brings me to the economic advantages. The irrevocable fixing of exchange rates between AMU participating countries implies the elimination of the exchange rate risks within the club. This makes it easier to live with the exchange rate volatility vis-à-vis the dollar or the euro. In my opinion this is an important argument for Asian countries which have suffered in the past from the volatility of the dollar exchange rate and the impact of the intra-Asian exchange rate development, for instance during the Asian crisis 1997/98. Moreover, the risk that one country tries to escape the impact of a crisis by imposing capital controls - as Malaysia did in 1997 - will no longer be virulent.

AMU will provide greater certainty for trade and long-term investment thus facilitating the exchange of goods and services and capital. It will reduce currency-related hedging costs for companies. This is expected to support intra-Asian trade which has experienced rapid growth since 1999. For example, trade among Asia-10 countries (China, Hong Kong, India, Indonesia, Malaysia, Philippines, Singapore, South Korea, Taiwan, and Thailand) grew by over 150% to reach more than USD 920 bn at the end of 2005. Although this is a much lower level than for intra-EU-15 trade (approx. USD 2.2 tr in 2005), growth rates have been much higher in

Asia. E.g. 1999-2005, intra-EU-15 trade grew by only roughly 60%. It is, however, still true that the US remains the main trading partner of Asian countries. Trade between the above-mentioned Asia-10 and the US is about two-thirds the size of intra-Asia-10 trade.

Let me also mention two further arguments. The introduction of a single currency in Asia will increase price transparency and thus foster competition and growth. It is obvious that consumers can easily compare prices when travelling from one country to another country. But one experience in Europe was that the introduction of the euro is not sufficient to promote growth. It must go hand in hand with the further opening of markets and structural reforms.

Last but not least a single currency will create a large and liquid integrated financial market for the AMU countries. Deeper and better-connected financial markets would benefit Asia. I am fully aware that there is already an intense Asian debate about how to push financial market integration. AMU would offer broader investment and financing opportunities in the single currency. For instance, this will improve the access to bonds markets in order to finance budget deficits and corporate investments.

Europe may be a model case here. The introduction of the euro has provided a strong stimulus to joint financial legislation and market integration. The experience of Europe is encouraging so far with regard to the establishment of a single money and bond market. The euro bond market is also tapped by a variety of sovereign and corporate issuers from Asia. But there are still several construction sites in European financial markets such as retail banking and asset management regulation. Here strong differences in national laws and traditions still prevail. But problems have been recognised. Europe has still to do a lot of homework regarding financial market integration even seven years after the introduction of the euro.

What are the conclusions for Asia? European integration and the introduction of the euro is one element of the European reply to globalisation. Asia is even more exposed to exchange rate risks vis-à-vis the dollar than Europe as the dollar is also used for invoicing the rapidly growing intra-Asian trade. The Asian dependence on the vagaries of US economic, monetary and exchange rate policies and increasingly fewer possibilities of a natural hedge speak a clear language: an Asian currency as a solution is preferable. Money, currency, is the incarnation of trust. Before money is widely accepted, it must convince by its quality over quite some time. Therefore, any Asian answer to the challenge will start with the question of how to provide the quality and trust that is the precondition to accepting paper money. Thus, an AMU with a single currency can only be established and designed as a "stability union". EMU can be seen as a case model for AMU.

2. The objectives of AMU may be similar to those of EMU.

As regards monetary policy, the European Central Bank statute delivers core elements of a sound monetary policy and a stable currency. The prime objective of monetary policy of a common Asian central bank is supposed to be ensuring price stability as the basis for sustainable growth. This certainly requires an independent status of the common central bank. The complement of independence is, of course, accountability of the common Asian central bank vis-à-vis the elected national parliaments and governments of member states. Accountability is essential to support confidence as we have learned in fierce debates about a presumed lack of accountability of the ECB. The ECB takes accountability very seriously. Accountability comprises a variety of instruments including the publication of annual and monthly reports, public speeches and interviews of the ECB management and regular testimonies before the European Parliament.

The common central bank should support growth if the target of price stability is not at stake. That means it also needs the appropriate room to respond flexibly to trends in the business cycle.

But there are some issues that play a special role in the current debate on AMU in Asia. One important task of a common central bank is to ensure financial stability. If so, the common central bank's role in banking supervision and its role as lender of last resort have to be clarified. The ECB has also the task to secure financial stability. But the mandate and possible actions in the event of a financial markets crisis are formulated rather

vaguely. However, there should be the clear message to market participants and national governments that incurring risky businesses is not sanctioned through a bail-out by the common central bank in case of a bankruptcy.

A second issue is the responsibility for the exchange rate policy vis-à-vis third currencies. Here, the ECB is responsible for the day-to-day business including interventions in the forex market while governments of the participating countries are in charge of the exchange rate regime. The latter means that governments decide whether the ECB has to operate in an environment of flexible or fixed exchange rates. If governments agree on a fixed exchange rate regime then a conflict of interest between the objective of price stability and defending a certain exchange rate e.g. vis-à-vis the dollar may arise. In globalized markets such a situation seems to be unlikely at the first glance. But an international agreement on exchange rates (like Plaza 1985 or Louvre 1987) may emerge, for instance if there is a massive overshooting of the dollar (to 1.50 USD per EUR or so) triggered by the huge current account deficit.

With regard to fiscal policy the aim should be to establish an adequate policy mix between monetary and fiscal policy. Assuming the establishment of an independent common central bank in AMU there should be a certain degree of fiscal policy coordination among member states on the basis of an "Asian stability and growth pact". The objective of fiscal policy coordination must be to avoid an overburdening of monetary policy by a too lax fiscal policy that could end up in a more restrictive monetary policy (than otherwise necessary) later on. The aim is to avoid a free-rider problem.

3. Which countries should become member countries of AMU?

There is no institutional framework in Asia comparable to that of the EU. Nevertheless, it is quite obvious that the process of Asian monetary integration can start from existing institutions. The group of APEC is, however, out of question as it is too large (21 countries including also the US and Australia) and an Asian identity would probably not emerge under this umbrella. ASEAN-10 would be much more appropriate as a fertiliser of the process as a network of political and economic cooperation has been established over the past decade. Of course, the heterogeneity among the ASEAN-10 is big not only between the 5 founding members and the other 5 countries. This is illustrated by a brief look at the comparative advantages. Labour costs are attractive especially in Indonesia and the Philippines. Malaysia and Thailand have comparative advantages in industries such as electronics and automobiles due to their relatively educated workforce and reasonably competitive wages. Singapore's famous infrastructure, strong rule of law and high governance standards make it a natural choice as regional hub and financial centre.

There are also arguments that the ASEAN-10 is too small and that it would be highly welcome if the heavyweights of the region are also included. There is talk about ASEAN+ 3 (Japan, China and South Korea) or even about ASEAN+ 4 (i.e. including India). This implies that heterogeneity would increase. I do not wish to speculate about the size of AMU but two things are evident when launching AMU:

On the one hand, AMU needs an appropriate economic (and political) weight in order to gain global clout. This argues for a model ASEAN-10 plus X. On the other hand, it is obvious that the greater the heterogeneity of AMU the more difficult it will be to agree on launching AMU. Thus ASEAN-10 (or even ASEAN minus X) could become the nucleus for AMU.

Membership in AMU needs qualification in economic and monetary terms following the insight that a monetary union can only work in the long-term if a degree of convergence is realised before the start of monetary union. Therefore, meeting a set of convergence criteria - similar to EMU - seems to be indispensable for an entry into AMU as well. But AMU should remain a club with open membership. Countries that qualify for membership at a later date should also be welcome. EMU has started with 11 member states in 1999, Greece joined in 2001 and Slovenia will do so in 2007.

4. Conditions for establishing AMU.

One assumption is that AMU is established for a very long period of time and should work smoothly. There are, then, a variety of political and economic conditions for the creation of AMU. The political will to push economic and political integration is essential. It seems to be given as the message of the Philippine foreign secretary Alberto G. Romulo to the first meeting of the 40th ASEAN Standing Committee on September 7, 2006 indicates: "it is upon our shoulders that rest the tremendous responsibility of carrying on and realizing the dream of a community whose diverse peoples live side by side, with respect and understanding, and enjoy the fruits of peace and development." It is interesting to see that the ASEAN "ministers have acknowledged the vital role of the ASEAN Standing Committee (ASC), which serves as a focal point for coordination of ASEAN activities, ensures the effective implementation of approved priority projects, and monitors ASEAN's external relations with its ten dialogue partners and the incoming development partners." But political will must go hand in hand with institutional arrangements and the further liberalisation of markets and the dismantling of remaining cross-border restriction to trade and capital flows.

If ASEAN is chosen as a nucleus for creating AMU the existing institutional elements do probably not suffice, i.e. they most probably have to be strengthened or extended. For instance, cooperation between governments has to be installed in order to launch a coordination process regarding economic, fiscal and monetary policy. Policy coordination must also be monitored. This requires a set of legislative, executive and judicative arrangements and bodies. Clear tasks have to be assigned regarding the coordination of fiscal policies and the establishment of a common central bank for AMU.

From the political point of view, an appropriate communication is key in order to launch a promising AMU project. Europe has delivered the model case with the introduction of the euro in 1999. The wheel must not be reinvented. Asia can learn some lessons from Europe but should adapt them to the specific circumstances of Asia.

On the economic side the establishment of a Monetary Union also requires a relatively high degree of liberalisation and integration of product markets as well as flexibility and mobility of labour and capital. The implementation of AMU will trigger tough political decisions to further open markets and to establish a "single market" with the free movement of goods, services, capital and persons ("four freedoms"). ASEAN policymakers have made substantial progress in liberalising trade and capital flows. I have already mentioned that intra-Asian trade integration has substantially risen in recent years. Policy makers have also launched several initiatives to deepen domestic financial markets. In many countries, capital account restrictions do no longer stand in the way of cross-border financial flows. Nevertheless, further steps are necessary to foster the development of financial markets by means of strengthening the issuers, broadening the investors base and build market infrastructure (including clearing and settlement system).

We have seen in Europe that the creation of the single market is an important intermediate step towards AMU. The European single market was announced in 1986 and started in 1993 while EMU was politically decided in 1991 with the Maastricht treaty and realised in 1999.

One condition for a smooth functioning of monetary union is a certain degree of economic convergence. This implies that its member economies are as similar as possible in terms of economic structures as well as cyclical developments. In a monetary union individual monetary and exchange rate adjustments are no longer available to its constituent member states. Asymmetric economic developments inside the union, e. g. a decline in competitiveness in a particular sector or region, have to be absorbed by the real economy, i. e. may lead e. g. to higher levels of unemployment, or have to be evened out by fiscal redistribution or better by factor mobility or factor price flexibility between the member states.

Regarding convergence I would like to touch briefly on the EMU experience. In order to avoid painful adjustments and to provide a solid basis for the single currency, much emphasis in the run-up to the introduction of the euro was placed on the economic convergence of the future member states of EMU. Indeed, the great

efforts the EU member states had made throughout the 1990s to meet the EU-Treaty's convergence criteria largely paid off in May 1998 when the first-round participants of EMU were selected. Eleven countries met the convergence criteria which aimed at low inflation rates, interest rate convergence, stable exchange rates and sound fiscal policies (for instance the budget deficit should not exceed 3% of GDP in the years of the convergence test).

I do not want to bother you with all these convergence criteria. Instead I would like to focus on interest rates. The convergence of long-term interest rates had been a remarkable feature of the pre-EMU qualification period. This trend continued beyond the 1997 reference period, leading to the reduction of interest rate spreads among ten-year EMU government bonds to around 20 to 25 basis points from 1999 to 2006. The Euroland yields are still low in international comparison with a differential of more than 100 basis points below US Treasury bonds, reflecting a rather homogeneous stability culture in the Euro area.

Economic coherence among the member states is an important prerequisite for the success of the AMU. Thus, similar convergence criteria should be chosen to create the conditions for a successful AMU.

5. Intermediate steps for a roadmap to AMU

One big issue in the run-up to AMU is communication with the citizens, companies and banks in order to win broad public acceptance for the project and pave the way for the credibility of the common Asian central bank.

Until such a grand project gets off the ground it would, therefore, be highly welcome if institutions with a special interest in the issues were to promote related debate, study and exchange about AMU. For instance series of conferences could be arranged by the respective governments and national central banks. Universities and research institutes should take up the issue. Lively debates about the advantages of a common currency should be initiated. European scholars should be invited to report about the experience with EMU. The academics who addressed the issue of dollarisation in Latin America should also be invited to present their thoughts on why they approach the currency issue in such a way.

A second line of action could be an intensification of monetary and exchange rate cooperation well beyond the Chiang-Mai-Initiative which established a network of bilateral swap arrangements between Asian countries in the aftermath of the Asian crisis 1997/98. An intermediate step could be the establishment of an Exchange Rate Mechanism (ERM) between those Asian countries that are willing to - later - become member of an AMU. An ERM is to establish bilateral fluctuation margins for the development of the exchange rates of participating currencies. The partner countries have the obligation to intervene if the exchange rate of a currency is weak and threatens to leave the fluctuation margin. Realignment of exchange rates at this stage of integration remain possible if economic fundamentals between participating currencies are diverging widely. Such a mechanism - similar to the European Exchange Rate Mechanism - has two functions:

- The ERM should contribute to stabilise the exchange rates in the run-up to AMU and the irrevocable fixing of the exchange rates at the start of AMU.
- After the start of AMU an ERM can serve as a waiting room for latecomers on the road to AMU. Countries that are unwilling to join can use the ERM as an anchor for their currency.

An interesting approach is the plan to launch an Asian Currency Unit (ACU) which should obviously be designed as a weighted basket of Asian currencies. The aim is to develop regional bond markets and promote monetary cooperation. Europe also developed such a currency unit called ECU. It played a certain role on financial markets in particular for issuing bonds. The ECU was the official unit of account of the European union in the run-up to the euro. The ECU had a certain symbolic character on the road to the introduction of the euro. Interestingly the ECU was converted at a rate of 1:1 into the euro.

Last but not least AMU will need a legal framework, an Asian Maastricht Treaty in order to launch the project and give it a clear perspective. A legal framework is also necessary to fix the core elements of AMU, the rules of transition and the timetable for implementation.

6. And what answer for now?

Asia is a fast growing region. Intra-Asian economic integration is on the rise. But the US market still plays a crucial role for Asia. Thus, Asia will remain exposed to the risks of US economy and the dollar exchange rate. AMU and a single Asian currency are an appropriate response to these risks. Given the current heterogeneity of Asian countries the exchange rate orientation will remain dominated by a mixture of dollar-pegged and (managed) floating schemes for the time being. But there is some hope that Asia will be able to run an internal market with its own currency by 2025. For this institution building and trust building is of the essence. Initiatives by smaller countries are probably crucial. At the end of the day however it will depend upon the giants willingness to share monetary responsibility that decides whether AMU stands a chance to fly. China must not only cooperate with Japan and India, it must repeat the contributions of Singapore and the Phillipines if AMU should become a success.