No. 23 May 2006

RIS Policy Briefs

The Case for an Asian Currency Unit:

Need for a Broad-based Approach

Ever since the currency and financial crisis of 1997-98 there has been a great deal of interest in enhancing regional monetary economic cooperation in Asia. The motivation for this is multi-dimensional. First it was the financial crisis of 1997-98 and perceived inadequate response to it from extra regional players. Second are the ongoing concerns about under-representation of Asia in IMF quota distribution and Asia's apparent lack of voice in international monetary affairs, along with the belief that Asia has ample resources for regional self-help. Third have been the significant external developments in regionalism, particularly the deepening and broadening of the European Union (EU). Fourth has been the growing *de facto* economic interdependence (so-called "market driven regionalism") as well as the regional nature of spillovers (so-called "contagion").

Notwithstanding early suggestions for major reform of the regional financial architecture, including the creation of an Asian Monetary Fund (AMF) and a single Asian currency *a la* the Euro, in reality, progress in regional cooperation in Asia has been one of muddled incrementalism. This is understandable in view of the region's acute heterogeneity and lack of either political will or strong and credible leadership in promoting ambitious regional initiatives.

A recent noteworthy initiative — initially proposed by the ADB but since taken over by the ASEAN plus Three (APT) countries — is an "Asian Currency Unit" or "ACU". In a general sense the ACU is a weighted average of regional currencies *a la* the European Currency Unit (ECU). It is expected that the weights will be determined on the basis of regional country GDP and trade shares, with China, Japan and Korea expected to dominate the weighting scheme.

At the micro-level the rationale for an ACU is to afford regional economic agents the opportunity to invoice regional financial and trade transactions in the ACU, hence reducing the region's dependence on the US dollar and other external currencies. As is commonly noted, Asia as a whole holds the bulk of the world's savings. The excess of savings over investment along with quasi-managed exchange rates has given rise to large current account and overall balance of payments surpluses. Historically, the lack of sufficiently liquid financial instruments has led to much of Asia's savings being rechannelled outside the region, especially to the US. If successful, intra-regional intermediation of savings may be promoted, in the process possibly reducing the region's exposure to external shocks.

However, in reality, it is unlikely that the ACU will be used on a widespread basis for some time to come in the early stages. The experience of Europe is instructive in this regard. The initial creation of the ECU in 1974-5 did not lead to a widespread use of the unit. Even in the 1990s until the actual creation of the Euro, the vast majority of intra-European financial and trade transactions were not in ECUs but in US dollars primarily, as well as other sovereign national European currencies.

So it is not just the creation of the ACU that is important; there has to be a coordinated agreement by regional bodies to start transacting in the new unit, failing which no one will want to take the first step. This inertial effect of existing currencies (i.e. advantage of incumbency) is based on the concept of "network externalities"

RIS Policy Briefs are prepared to communicate results of RIS research on specific policy issues to the policy makers.

This Policy Brief is based on a draft prepared by Dr. Ramkishen S. Rajan, Associate Professor of Public Policy at George Mason University in Virginia, USA and an Adjunct Fellow of RIS.

or "lock in" effects, whereby there are limited incentives for economic agents to unilaterally take on a new currency (particularly for invoicing transactions).

It has also been suggested that the ACU could be used as a means of enhancing *internal* exchange rate stability if the regional central banks begin to stabilize their respective currencies to the regional unit (i.e. helping reduce the possibility of regional competitive devaluations). The notion of stabilization vis-à-vis an internal basket *a la* Europe's Exchange Rate Mechanism (ERM) is distinct from stabilization vis-à-vis an external unit which would require that the ACU in turn be pegged in some way to external currencies such as the US dollar or Euro, or some weighted average thereof. Of course, internal stability does not require the latter and in fact may exacerbate external currency stability. This may occur if regional countries substitute the use of external currencies for the ACU, hence being less concerned about fluctuations of their currencies relative to the external currencies.

Conversely, effective *external* stability requires *internal* stability, in the sense that, if regional central banks do not explicitly or implicitly manage their currencies against the ACU, it is irrelevant whether the ACU per se is managed against the external currencies, as the proposed ACU will remain purely a theoretical construct. Indeed, the stated aim of the ADB at this stage is for the ACU to serve mainly as a means of benchmarking the extent of currency movements/deviations.

Focussing on the notion of stabilization vis-à-vis an internal basket (i.e. regional currencies benchmarking movements to the ACU), while the potential microeconomic benefits noted above does not require internal stabilization, such stabilization could promote the more widespread use of the ACU. This is so as the regional central banks will automatically begin to use the ACU more extensively as a reserve and possibly even intervention currency, thus providing an additional inducement for private agents to also intensify use of the unit in invoicing and transactions.

The long-term viability of internal stabilization in an era of open capital markets requires that there be an enhancement of regional surveillance, a degree of policy coordination, and an augmentation of regional liquidity arrangements.

The ACU has a far better chance for success (in terms of becoming a significant regional vehicle currency) if a larger set of countries is included in the basket. In this regard it is imperative that the ACU be broadened from the proposed ASEAN plus Three (APT) countries to also include India, Australia and New Zealand [the other members of the inaugural East Asian Summit (EAS)], all of which have significant financial market depth. It is myopic for monetary and financial regionalism to be limited to only the APT economies while excluding the large and dynamic Indian economy and a mature and well-developed Australian economy, both of which, along with New Zealand, are consciously looking to integrate themselves with the rest of East Asia and have been doing so on a *de facto* basis.

In particular, India has integrated her economy with East Asian countries consciously as a part of her Look East Policy pursued since 1991. East Asia has emerged as India's largest trade partner in the region accounting for more than 30 per cent of her trade. India is evolving comprehensive economic cooperation arrangements with ASEAN, South Korea, Japan and China, Singapore, Thailand and Malaysia. The Indian economy of US$ 700 billion has been growing at more than 8 per cent per annum for the past few years and enjoys robust medium and long-run outlook. The Indian rupee is fully convertible on current account and is moving towards full capital account convertibility. The exchange rate of rupee is determined by a managed float and has a much greater degree of flexibility than some other East Asian currencies including the Malaysian ringgit and the Chinese yuan. The more inclusive and broad based overage will enhance the potential effectiveness and significance of the ACU.

RIS Reports, Discussion Papers, Policy Briefs, New Asia Monitor and *RIS Diary* are available at RIS Website: www.ris.org.in

RIS
Research and Information System for Developing Countries

Core IV-B, Fourth Floor
India Habitat Centre
Lodhi Road, New Delhi-110 003, India.
Ph. 91-11-24682177-80
Fax: 91-11-24682173-74-75
Email: dgoffice@ris.org.in
Websites: http://www.ris.org.in
http://www.newasiaforum.org