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EMU: A role model for an Asian Monetary Union?

The Asian crisis 1997/98, the launch of the euro in 1999 and the global financial crisis 2007/8 have stimulated monetary cooperation in East Asia and debate about an Asian Monetary Union (AMU). The success story of the euro can serve as a role model but special features in East Asia have to be taken into account.

Like EMU in Europe, AMU is expected to provide substantial advantages. Politically, AMU is likely to avoid dependence on the IMF and strengthen the clout of Asian states in international fora. On the economic side, AMU will foster intra-Asian trade and investment and stimulate financial market integration.

The central bank of AMU should be independent and focus on price stability, similar to the ECB. In addition, monetary policy should support growth and financial market stability. A centralised monetary policy requires the backing of sound (national) fiscal policies.

Given the heterogeneity of East Asian countries in terms of size, per capita income and trade integration **ASEAN-5 might serve as the nucleus for an AMU**, which should be open for new member states.

AMU requires convergence criteria for entry and rules for monitoring and coordinating monetary, fiscal and economic policies thereafter. The criteria should ensure a high degree of convergence. The creation of an ASEAN single market by 2015 will be an important milestone on the road to AMU.

AMU is likely to require an institutional and legal framework that goes beyond the structure currently in existence in ASEAN. AMU entry can be based on a Maastricht-like treaty which specifies the conditions for AMU entry and the framework for policy cooperation in AMU.

AMU is likely to promote financial market integration. A special feature is the development of bond markets in order to use ample domestic savings and reduce vulnerability to maturity and currency mismatches, which had been an Achilles heel during the crisis of 1997/98.

The launch of an Asian Currency Unit (ACU) could be a helpful intermediate step for the development of the bond markets in East Asia. An ACU could also be a useful anchor for the creation of an Asian Exchange Rate Mechanism.

Given the current state of economic and monetary integration and cooperation as well as institutional infrastructure in ASEAN and ASEAN plus 3 it is likely to **take at least another two decades before AMU can be launched.**

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1. Introduction

Three drivers for AMU debate

The Asian crisis in 1997/98 and the launch of the euro in 1999 sparked a lively debate about reshaping the exchange rate regime in East Asia and the creation of an Asian Monetary Union (AMU) with a single currency along the lines of the successful model of European Economic and Monetary Union (EMU)[1]. Following the collapse of the dollar peg in the Asian crisis, most East Asian states[2] have faced large fluctuations of the dollar exchange rate and of intra-Asian exchange rates. This problem has even been accentuated by the global financial crisis 2007/8[3], which is likely to intensify the debate about AMU. The stabilisation of intra-Asian exchange rates is a key aim in order to avoid competitive distortions.

The monetary debate in East Asia also focuses on alternative currency regimes, just for the simple reason that it will be a long way to reach AMU. East Asian states have implemented different and more flexible exchange rate regimes in which the dollar has still played a key role. The exchange rate options range from basket-based floating via the establishment of an intra-Asian exchange rate mechanism[4] to the creation of a dollar-based currency board or even a yen or a yuan peg. Some of these options could also serve as intermediate steps on the road to AMU.

EMU experience — relevant for East Asia

This study aims at analysing the lessons which East Asian states could learn from the successful economic and monetary integration in the EU and the introduction of the euro, which celebrates its 10th anniversary on January 1, 2009. EMU is so far the only existing monetary union between sovereign countries which could be used as a role model for East Asia. The issue of creating a monetary union is also on the political agenda of the Arab states of the Gulf[5].

Key questions are why, when and under which conditions can the creation of an AMU be expected? What are the objectives? Which countries will participate? While the intra-Asian trade and FDI flows have been prospering for a decade, monetary and financial market integration is low but an important political goal. The creation of an Asian Currency Unit (ACU) may play a role on the road to AMU, e.g. as a means of issuing bonds and a yardstick for exchange rates.

2. Why AMU?

Advantages of AMU

The arguments in favour of EMU played a key role in ensuring the acceptance of the project in the general public and in the financial markets. Like EMU, AMU is expected to provide substantial political and economic advantages which are worthwhile to be considered. ASEAN, for instance, is an emerging economic bloc with growing economic and financial clout. Thanks to the dynamic economic growth it may become another global growth centre. An AMU is expected to solidify this role.

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1 Norbert Walter (1998). An Asian Monetary Union? Singapore Business Times, August 19.

2 They usually comprise ASEAN plus 3: ASEAN (Association of Southeast Asian Nations) comprises 10 member countries. It was founded by Indonesia, Malaysia, the Philippines, Singapore and Thailand in 1967. Brunei Darussalam, Cambodia, Laos, Myanmar and Vietnam joined by the end of the 1990s; plus 3 include China, Japan and South Korea.

3 This is, for instance, illustrated by the fall by 40% of the South Korean won against the yen between early September and early November 2008.

4 This could be similar to the European Exchange Rate Mechanism (ERM) I of the European Monetary System (EMS) from 1979 to 1998.

5 The countries of the Gulf Cooperation Council plan to establish a monetary union by 2010 with Oman joining at a later date. The GCC comprises Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates.

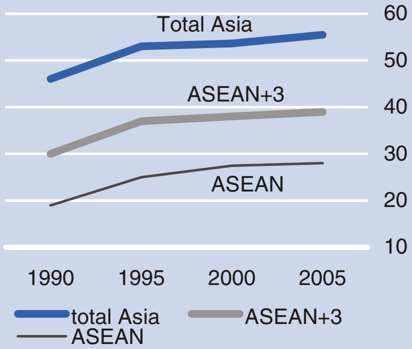
More international clout

On the *political side*, a key argument was to bundle the political power of Europe and to speak with one voice in order to increase the EU's and EMU's clout in international fora such as the G7 and the IMF. By the same token AMU could serve as means to strengthen the common voice of the AMU states and thus give them more clout on the international stage, e.g. in the IMF, as well as vis-à-vis the superpower USA and the emerging superpower China.

Furthermore, Germany's European partner countries were politically concerned during the D-mark times about being dominated in their monetary policy by Deutsche Bundesbank without being able to participate in decision-making. While the pre-EMU Europe had only one "économie dominante", Germany, there is no dominant economy in ASEAN but two economic giants in East Asia, namely China and Japan. Nevertheless, the essential dominant currency in East Asia is still the dollar, whereas the yen has a role as a vigorous regional currency and the yuan has the potential to become an anchor currency in the future. An AMU with a common Asian central bank is expected to establish a vigorous regional currency so that individual AMU member countries must no longer feel marginalised by Federal Reserve System (Fed) dominance. Instead they can participate in the common decision-making process of a common central bank. Contagion effects – e. g. as seen in the severe simultaneous pressure on the national exchange rates during the Asian crisis 1997/98 – are expected to be mitigated by large and liquid financial markets in AMU.

Interregional trade in Asia

Share in total exports, in % of GDP



Source: IMF Direction of Trade Statistics, DIW

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However, the political argument that joining AMU might spare a country the cumbersome procedure of asking the IMF for help in the event of a national balance-of-payments or financial crisis has lost relevance in East Asia. The reason is the accumulation of large foreign exchange reserves in most East Asian countries in recent years, which are likely to enable them to cope with a crisis without going to the IMF and accepting its conditionality. Nevertheless, East Asian states responded to the global financial crisis 2007/8 and will explore the idea of establishing an Asia fund for mutual support by June 2009 in order to cushion the possible impact of the financial crisis (See also chapter 10).

On *the economic side*, a prominent argument in favour of EMU was that the irrevocable fixing of exchange rates between participating currencies would eliminate the exchange rate risks and exchange-related transaction costs. It would save costs for companies and

Euro plays small role in East Asian trade invoicing

	Exports					Imports				
	Euro	Dollar	Yen	Pound	Other	Euro	Dollar	Yen	Pound	Other
Japan	8.9	55.0	34.0	0.1	1.3	5.6	65.7	27.6	0.1	1.1
Korea	7.6	84.6	5.3	0.9	1.6	6.1	78.3	14.0	0.6	1.0
Indonesia	1.8	93.2	1.5	0.1	3.3	4.3	83.6	4.1	0.2	7.7
Malaysia [1]	4.9	66.0	6.8	1.0	21.3 [2]	n.a.	n.a.	n.a.	n.a.	n.a.
Thailand	3.5	80.7	6.2	0.5	9.1 [3]	n.a.	n.a.	n.a.	n.a.	n.a.

[1] Data refers to total trade, whithout the breakdown for exports and imports

[2] Includes Malaysian ringgit and Singapore dollar (17.8% and 3.5% respectively).

[3] Includes Thai baht (6.7%)

Source: Bank of Indonesia; Ministry of Finance, Japan; Bank of Korea; Bank of Thailand

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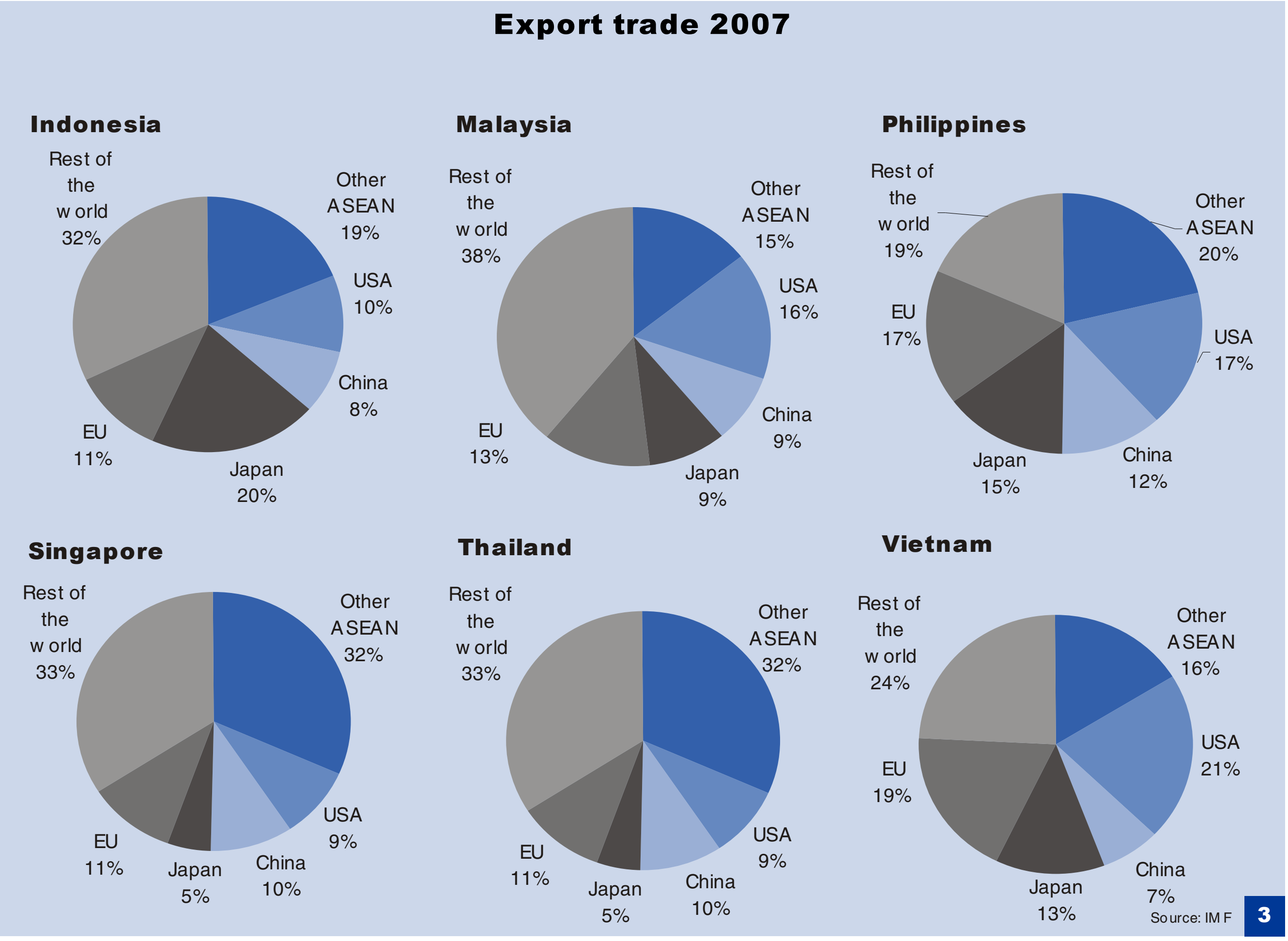
AMU to promote trade and investment

improve the investment climate (including FDI). This would be also true for AMU participants. AMU would facilitate cost accounting of intra-Asian trade and investment in comparison with the current practice of dollar invoicing which always involves exchange rate risk. A single Asian currency is likely to support the expansion of intra-Asian trade and investment as the euro has done since its launch in 1999. This argument is gaining in importance with rising levels of intra-Asian economic integration and the declining role of the US market. However, there is still one key difference between EMU and ASEAN: the US export share of most ASEAN states is about 10-17%, i.e. it is substantially higher than the US share of most EMU member states (e.g. Germany 7.6%; France 7.2%). The latter is due to intense European integration even before the introduction of the euro.



More transparency

A further argument in Europe was that the introduction of a single currency would increase price transparency and thus foster competition and growth. It is obvious that consumers can easily compare prices when travelling from one EMU member country to another. A further advantage is that travellers in Europe are spared the cumbersome and costly task of buying foreign exchange at national borders by simply using the euro. This will also be a valid argument with regard to AMU. However, far-reaching expectations in Europe that more competition between EMU member states would stimulate structural reforms and growth have been disappointed.

Boost to financial market integration

Both economic theory and empirical evidence suggest that financial market integration fosters economic growth. It is a big advantage that the euro has been a catalyst for financial market integration in Europe. The euro has raised market transparency and made it easier for investors to compare prices and returns on financial market products in the euro area. EMU broadened the spectrum of liquid investment opportunities involving no exchange rate risk. The creation of efficient financial markets is desirable in order to transfer some of the benefits of the euro to the real economy. It is not only the financial services industry and its clients that benefit from well functioning financial markets; the economy as a whole does, too, because growth and competitiveness are strengthened by a more cost-efficient supply of financial products and services. Various studies have concluded that successful financial market integration can boost GDP in the EU by 0.5 - 1.1%.

Greater scope for absorbing shocks

Last but not least the creation of AMU will provide a large single market with a single currency of regional importance. AMU is likely to offer the opportunity to act jointly with more clout on the international scene and allow more flexibility to adjust to the impact of US developments. It would, however, be an illusion to believe that AMU member countries would become completely independent from the ups and downs of the US business cycle and US interest rates. The European Central Bank (ECB) is independent of the Fed to a large extent but it has to take into account in their conduct of monetary policy that there is a time-lag of two quarters to two years compared with the US business cycle.[6] AMU is also likely to provide more scope to absorb asymmetric shocks than the status quo. The risk that a country will go it alone in case of a shock – as Malaysia did in the Asian crisis 1997/98 by imposing capital controls – will no longer be virulent.

3. Objectives of AMU may be similar to those of EMU

AMU objectives to be specified

East Asian countries which are willing to join AMU must define the objectives of a monetary union. The objectives of ASEAN are specified and likely to be also relevant for AMU. ASEAN is to (1) "accelerate economic growth, social progress and cultural development in the region and (2) to promote regional peace and stability through abiding respect for justice and the rule of law in the relationship among countries". In 2003, the ASEAN leaders resolved that an ASEAN Community shall be established on the following three pillars: Economy, Security and Socio-Cultural issues. The creation of an Economic Community deserves special attention as it is a key complement of a monetary union.

In contrast, the objectives of AMU are not yet specified. The creation of AMU requires, however, a definition of aims and principles. In this respect, the EU and EMU could serve as a role model. Its aim is not only to foster growth, investment and trade by complementing the single market with a single currency but most importantly to ensure price stability. To effectively achieve this with sound fiscal policies are to be guaranteed.

Prime aim of monetary policy: price stability

As regards *monetary policy*, the statutes of the European Central Bank (ECB) deliver a blueprint for a sound monetary policy and an attractive currency. As in the case of the ECB the prime objective of a common central bank in East Asia should be *price stability* and the

[6] Norbert Walter and Werner Becker (2008), US – euro area interdependence in monetary policy. Does the ECB follow the Fed? Deutsche Bank Research, EU Monitor 59. Frankfurt am Main.

central bank should be independent. The ECB has a good track record regarding the inflation rate since the start of EMU in 1999. The inflation rate came to only 2.1% on average in the period from 1999 to 2007.

Independence and accountability are essential

The other side of the coin of *independence* is, of course, the *accountability* of the common central bank vis-à-vis national parliaments and governments of AMU member states. Accountability is deemed to be essential to create confidence in the general public and in financial markets. Regarding accountability, the ECB might serve as a role model. The ECB has been right in taking accountability very seriously. Accountability comprises a variety of instruments including the publication of annual and monthly reports, regular monthly press conferences, public speeches and interviews of the ECB management and regular testimonies of the ECB president before the European Parliament.

Nevertheless, several Anglo-American observers have repeatedly criticised a lack of accountability because the ECB does not – unlike the Fed and the Bank of England – publish the minutes of the Governing Council meetings. The ECB has rightly rejected this practice since the disclosure of the voting procedure could easily lead to political pressure on individual Governing Council members and jeopardise the ECB's independence. The ECB seems to be the better role model for a common central bank in East Asia than the Fed or the Bank of England given the broad-based accountability approach and the fact that it is a supra-national central bank representing a union of sovereign countries.

Monetary policy tasks beyond price stability

Other important objectives

The ECB also has other important objectives which should be taken into account when designing a common East Asian central bank, namely supporting growth, ensuring financial market stability as well as managing the exchange rate.

First, the ECB has the task to *support general economic policy within the Community* insofar as this is compatible with price stability. Such a task is also recommendable for a common central bank in East Asia. It should also imply that a common central bank should be given appropriate room for manoeuvre to respond flexibly to adverse trends in the business cycle. The ECB for its part has shown a relatively high degree of flexibility in the business cycle so far. For instance it reacted to the deflation debate in the years 2002/2003 with lower key rates and did so again in autumn 2008.

Lender of last liquidity

Second, the financial crisis in 2007/8 underpinned the central banks' key role in contributing to *financial market stability*, in particular by acting as lender of last liquidity.[7] The ECB has done a good job in liquidity provisioning since the outbreak of the sub-prime crisis in August 2007 when the inter-bank money market collapsed because of a lack of confidence among banks. The worldwide impact of the financial crisis made it necessary for the ECB to closely cooperate with other important international central banks such as the Fed, the Bank of England and the Swiss National Bank. However, the mandate and possible actions of the ECB in the event of a financial markets crisis are formulated rather vaguely. The underlying rationale is to avoid moral hazard. Nevertheless, effective action is

[7] The ECB's function of lender of last liquidity is a must in the event of a liquidity crisis. The task of lender of last resort in case of a systemically relevant solvency crisis must not be assigned to a common central bank but has to be shouldered by government, i.e. taxpayers.

essential in case of need. A common central bank in East Asia is likely to play an important role in contributing to financial stability and acting as an international partner for the Fed and the ECB.

Role in exchange rate policy to be defined

The third task of the ECB concerns *exchange rate policy*. Here, the ECB is responsible for the day-to-day business including interventions in the foreign exchange market, while the governments of participating countries are in charge of deciding the exchange rate regime. The latter means that governments of EMU member states have to decide on flexible or fixed exchange rates vis-à-vis major currencies. If governments agree on a fixed exchange rate regime, e.g. vis-à-vis the dollar, then a conflict of interest between the objective of price stability and defending a certain exchange rate vis-à-vis the dollar could arise. A fixed exchange rate with narrow fluctuation margins between the dollar, the euro or the yen seems, however, to be unlikely as it can hardly be defended successfully in global foreign exchange markets with a daily turnover of USD 3,210 trillion.[8] Therefore, flexible exchange rates vis-à-vis important currencies are probable[9].

4. AMU implications for fiscal policy

Fiscal discipline is important

Monetary union with a centralised monetary policy and a decentralised fiscal policy requires some rules to ensure a degree of budgetary discipline both upon entry into monetary union and thereafter for the following reasons:

Firstly, a monetary union needs an appropriate "mix" between monetary and fiscal policy. Budgetary discipline is to prevent strains on monetary policy caused by overly lax fiscal polices on the national level. This risk exists if excessive national budget deficits fuel inflationary expectations within EMU, forcing the ECB to hike rates (or limiting its scope to lower rates), which would dampen business activity in the whole monetary union. The risk is likely, in particular, with regard to a large country but the same rules should be applicable for all member countries in order to ensure equal treatment.

Secondly, fiscal policy has to prevent a "free-rider" problem since budget offenders can no longer be penalised through a devaluation of their currencies and/or higher interest rates, and the repercussions of unsound policy would spill over to the monetary union as a whole in the form of higher inflation and interest rates.

Some fiscal rules are needed

A key question is how to ensure effective fiscal discipline among sovereign states in a monetary union. One handicap is the fact that the importance of fiscal policy as a policy tool will actually rise when a country enters a monetary union because it loses the policy instruments of a national monetary and exchange rate policy. Given the free-rider problem it seems unlikely that complete freedom to conduct national fiscal policy is compatible with ensuring fiscal

[8] Equivalent to about one quarter of US GDP! BIS, Triennial Central Bank Survey of Foreign Exchange and Derivatives Market Activity in 2007 – Final results December 2007. This does, however, not rule out international exchange rate agreements. There were two important agreements of the G7 during the 1980s. The Plaza Accord in 1985 on jointly lowering excessively high dollar exchange rates was relatively successful whereas the Louvre Accord in 1987 (aiming at stabilising dollar exchange rates "around current levels") was not. However, such an event could happen again, for example, in order to correct a massive overshooting of the dollar exchange rate (which reached a low of USD 1.60 per EUR in July 2008) or to stabilise the dollar rate around a certain much higher level.

[9] Nevertheless, policy makers should be aware that exchange rate changes can easily override changes in productivity in the sector of tradable goods and distort competitiveness.

discipline. Therefore, a mechanism of binding rules for all member states of the monetary union should be installed.

EMU agreed on a stability and growth pact

In EMU the Stability and Growth Pact (SGP) was established to find an appropriate policy mix between centralised monetary and de-centralised fiscal policy. The aim in AMU should be to avoid an overburdening of monetary policy through excessive national budget deficits. The SGP was a conditio sine qua non for German participation in EMU. Before the start of EMU in 1999 there were concerns especially in Germany that budgetary discipline could disappear once the convergence test for EMU participation had been passed in 1998. The SGP consists of a regular coordination and monitoring of national budget policies. Budgetary offenders with a deficit of more than 3% of GDP p.a. are subject to an "Excessive Deficit Procedure" aiming at reducing the deficit by agreeing on a flexible adjustment path. In the event of tenacious budget deficits even sanctions can be imposed on a country (amounting to up to 0.5% of GDP).[10]

SGP reformed in 2005

The adoption of the SGP has left a lot to be desired so far. The SGP was in a "stress phase" between 2002 and 2005 with increasing evidence of an erosion of public finances in several EMU states including Germany and France. The original SGP was criticised to be a straitjacket leaving not enough room for fiscal stabilisers over the cycle. Therefore, a profound reform became necessary in 2005 to provide more fiscal flexibility over the cycle. The corrective arm of the pact was improved e.g. by allowing longer adjustment periods to correct an excessive budget deficit of more than 3% of GDP. By the same token, stricter rules were agreed with regard to the preventive arm of the pact, for instance by the strict obligation to consolidate in good economic times. Bad fiscal performers with a general government debt of more than 60% of GDP should even have a budgetary surplus during a boom.

An Asian SGP?

Assuming the establishment of an independent common central bank in AMU and the absence of a common central budget of AMU member states there should be a certain degree of fiscal policy coordination among member states on the basis of an "Asian stability and growth pact". The fiscal rules for AMU member states could be designed similar to those of the reformed SGP of EMU. Fiscal rules should take into account two important aspects:

Consolidation in good times provides flexibility

First, a certain degree of flexibility of fiscal policy is necessary over the business cycle as monetary and exchange rate policies are no longer available as national policy tools and shock absorbers. This implies that the automatic fiscal stabiliser must be allowed to work in a downswing. This in turn requires consistent fiscal consolidation in good times.

[10] ECOFIN Council (2005), Code of Conduct, specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes.

Secondly, the race to qualify in the run-up to monetary union initially strengthens budgetary discipline; this was a positive element among the EMU contenders, with budget deficits falling from 6% of GDP in 1993 to 2.6% in 1997, the reference year for EMU participation. This was associated with lower interest rates for the former high-interest countries and interest rate convergence among the member states. This in turn reduced the debt service of government debt to a considerable extent. Even the yield for German government bonds fell below the level experienced during D-mark times. Interest rate convergence in the run-up to AMU may also be an issue to be taken into account.

Key figures 2007 of ASEAN plus 3

	Population	GDP	Per capita income	Exports (goods and services)	Imports (goods and services)	Total public debt	General budget surplus/ deficit	Current account balance
Unit	**m**	**USD bn**	**USD**	**% of GDP**	**% of GDP**	**% of GDP**	**% of GDP**	**% of GDP**
Indonesia	231.6	413.3	1,420	29.3	25.3	40.2	-1.2	2.5
Malaysia	26.6	187.2	5,620	110.2	89.9	48.3	-3.2	14.0
Philippines	88.0	144.1	1,390	41.0	41.8	73.3	-0.2	4.4
Singapore	4.4	168.7	28,730	230.9	202	96.2	3.4	24.3
Thailand	63.9	251.2	3,050	73.3	65.7	36.9	-1.2	6.1
Brunei	0.4	12.4	26,930	74.9	25.5	6.4	26.2	57.3
Cambodia	14.4	8.8	490	71.9	77.6	52.2	-3.0	-0.9
Laos	5.9	4.0	500	32.3	34.9	n.a.	-2.7	-23.1
Myanmar	48.8	13.7	230	34.8	22.1	48.3	-3.0	4.0
Vietnam	87.4	71.4	700	78.3	83.2	45.6	-1.5	-9.6
China	1,328.6	3,376.2	2,000	40.9	31.5	45.0	0.7	11.1
South Korea	48.2	962.7	17,690	45.6	44.8	33.3	3.8	0.6
Japan	128.0	4,372.5	38,630	17.6	16.0	180.3	-2.4	4.9
EMU	318.5	8,900	27,900	21.6	20.9	66.6	-0.6	+0.3
USA	299.8	10,100	33,700	11.9	17.0	63.4	-1.2	-4.8

Source: IMF 4

5. Which countries should become AMU members?

Incentive to consolidate in the run-up to EMU

East Asia does not have a community of states with an institutional framework comparable to that of the EU. Nonetheless, there are several groups of states which cooperate closely in stimulating trade and investment. The largest group is APEC[11] consisting of 15 East Asian countries and six states from the Americas and Oceania. However, the 15 East Asian countries included in this group are too heterogeneous to form the core of monetary integration.

ASEAN plus 3 plays a role

When it comes to monetary integration, there is usually talk about ASEAN plus 3. One might think that this group could be the basis for monetary integration since it comprises all main players in East Asia and has a large economic potential both in terms of market size and economic dynamics. It would have the economic and political clout in order to play a role in the international monetary arena. At the

[11] Asian-Pacific Economic Cooperation is a forum for facilitating economic growth, trade and investment in the Asian-Pacific region. 15 countries are stemming from East Asia (including Russia). The other six member states are the US and Canada, Mexico and Chile, Australia and New Zealand.

same time, however, this group is also characterised by great heterogeneity in terms of country size and per capita income.

China and Japan are political and economic heavyweights. Both countries could act as dominant regional economic powers. An important question is, however, whether such a regional power is really interested in becoming a member of a monetary union implying economic and fiscal constraints. By the same token, it has to be clarified whether the membership of an economic and political powerhouse would meet the acceptance of other potential AMU members.

EMU overcame dominance of the D-mark

Looking at Europe there was a similar feature regarding Germany: The dominant role of the D-mark until 1998 was also deemed to be a political problem for many EU countries and one of the arguments for the creation of the ECB.[12] In Europe, the inclusion of Germany in EMU resolved the problem. In contrast, East Asia has two dominant economic players. The yardstick for monetary policy is, however, the US central bank. In any case, it cannot be easily assumed that China and Japan are ready to give up their national currency in order to participate in an AMU. It is more likely that both countries are reluctant to join AMU and accept a single Asian currency.

South Korea is a special case

Possible burden of unification to be taken into account

South Korea – the third economic powerhouse in East Asia – deserves special attention. Close monetary cooperation between South Korea and ASEAN-10 would be helpful and welcome. However, Korea is – as Germany was until 1989 – a divided country. Nobody knows whether and when the possibility of unification would be given. Nonetheless, the issue has to be taken into account given the fact that participation in AMU is a long-term project. It is evident that the economically highly developed South Korea has to shoulder a substantial financial burden in case of unification because the disparity of income between North and South Korea is much larger than it was between East and West Germany.[13]

In the event of unification South Korea would have to face higher interest rates, a weaker won exchange rate and a rising risk premium on sovereign debt in the initial stage. Higher fiscal burdens and larger borrowing needs would also contribute to higher interest rates. Thus, South Korea is expected to maintain a high degree of flexibility of monetary and exchange rate policy so it can absorb economic shocks of unification as smoothly as possible. This implies retaining a national monetary and exchange rate policy instead of participation in AMU. This does, however, not rule out an AMU membership at a later stage.

ASEAN expected to be the nucleus for AMU

Starting point could be a "small AMU"

Against this backdrop, it seems to be much more appropriate to concentrate on the group of ASEAN-10 as a catalyst of the monetary integration process. Here, a network of political and economic cooperation has been established over the past decades. A common East Asian identity could also emerge under this umbrella as has been the case in the European Union. But even among ASEAN-10

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[12] In the Governing Council of the ECB the governors of all national central banks of EMU member states sit around the table when it come to monetary decision-making, while prior to 1998 Germany's European partner countries had to accept the decisions of Deutsche Bundesbank without having a seat in its Governing Council.

[13] Syetarn Hansakul (2008), South Korea, The quest to stay a high-performing OECD economy, Deutsche Bank Research, Current Issues Asia, July 24.

there is considerable heterogeneity, not only between the five founding members and the other five countries but also within the group of the five founding member states, for instance regarding size of countries and per capita income. It is obvious that the greater the heterogeneity of countries the more difficult it will be to agree on launching an AMU.

Therefore, the option of a small AMU comprising only the five founding member states of ASEAN is also being discussed.[14] ASEAN-5 is an attractive destination for business, trade and investment with a combined economy worth of USD 750 bn, comparable to India, and a total population of 420 m people, not significantly lower than in the EU-27. They have witnessed a period of about forty years of economic integration and developed a good set of institutional structures.

Thus, the five founding states of ASEAN may be considered as the potential nucleus of an AMU. Although it is evident that AMU can start with a small group there should be the prospect of new member states joining AMU, increasing its economic and political weight and providing regional or even some global clout. This argues for a model ASEAN-5 plus X.

6. Is AMU an optimum currency area?

Challenging criteria ...

In *theory,* an optimum currency area (OCA)[15] exists if the participating economies fulfil the following criteria: a high degree of convergence (e.g. in terms of growth and inflation rates) and of openness in external trade (exports and imports of goods and services in relation to GDP), similar economic structures, flexible factor prices for labour and capital as well as a high degree of factor mobility. The OCA criteria shall ensure smooth functioning of a monetary union and improve the absorption of asymmetric shocks, e.g. a steep oil price hike which affects oil-exporting and oil-importing countries differently.

... need not be met in full

In *practice*, there would probably be no monetary union at all – even within national boundaries – if all the conditions had to be fulfilled concurrently and in full. Therefore, the creation of a monetary union and the introduction of a common currency usually diverge from the theory of the OCA in some areas and ways. In addition, it has to be taken into account that the establishment of a monetary union with a single currency is likely to stimulate trade integration and thus improve ex post the conditions for a monetary union.[16] In practice, countries that are highly integrated with each other in terms of trade and other economic relationships are likely to constitute a monetary union. EMU has already become a classic case in point. The interesting question is whether ASEAN-5 could be the starting point for forming an East Asian monetary union on the basis of the criteria of an OCA. In this context it might be helpful to ask to what extent the experience of EMU could be a benchmark for East Asia.

[14] David Kim (2007). An East Asian currency union? The empirical nature of macro-economic shocks in East Asia, Journal of Asian Economics 18, pp.847-866; Frank Strobel (2007), Southeast Asian monetary integration: a real options perspective, Applied Economics 39, pp. 759-763.

[15] Robert Mundell (1961). A Theory on Optimum Currency Areas, The American Economic Review. November 1961.

[16] Jeffrey A. Frankel (2000). On the euro – the first eighteen months. Deutsche Bank Research. EMU Watch No. 87. Frankfurt am Main.

EMU met several essential conditions of an OCA when it started in 1999. It was established on the basis of a high degree of convergence, measured by the famous Maastricht criteria[17], a considerable degree of openness, very close economic ties and freedom of capital movements. At the same time, however, it was, and still is, obvious that EMU is still some way from being an optimum currency area regarding such important elements as flexible prices for the production factor labour as well as the degree of movement of labour. The former implies that several EMU countries still have more or less rigid wage regimes. With regard to the latter one has to see that cross-border labour mobility among European countries is low due to many cultural and language barriers as well as the fact that not all EU countries have implemented the freedom of movement of labour.

Rising degree of openness
Exports plus imports of goods and services, % of GDP

	Indonesia	Malaysia	Philip-pines	Singapore	Thailand	Vietnam	China	South Korea	Japan
1995	37.8	166.9	80.5	344.2	79.5	83.9	41.2	58.6	13.8
2000	70.6	189.4	119.6	355.8	112.0	110.7	38.2	78.1	17.2
2001	71.1	172.0	107.3	347.1	112.7	109.3	37.1	72.9	17.0
2002	67.5	171.0	110.6	345.5	108.8	117.4	41.3	68.9	17.8
2003	68.8	163.6	107.7	399.8	112.4	126.8	50.2	73.4	18.7
2004	88.6	179.5	108.2	431.8	122.4	141.9	57.9	83.2	20.6
2005	99.7	180.9	100.0	449.3	132.9	143.6	61.7	81.8	22.9
2006	93.8	181.4	95.7	465.1	128.5	152.2	64.3	84.6	26.3
2007	106.0	165.2	85.1	433.0	125.9	168.8	64.3	90.2	28.6

Source: DB Research 5

ASEAN-5 no optimum currency area

Imperfect preconditions for an OCA are even more evident in the case of forming a monetary union with ASEAN-5 despite the observed progress with regard to some indicators such as the increase in intra-Asian trade and a growing degree of openness (exception: Philippines).

The ASEAN-5 are dynamic economies which are poised to achieve 4-6% GDP growth annually in the medium term, i.e. more than double the rate of the EU or EMU. There is a significant degree of convergence between four ASEAN countries in terms of growth while convergence on inflation rates is less extensive.[18]

However, there are also some important weak spots regarding the OCA criteria, in particular concerning flexible prices for the production factor capital as well as the freedom of movement of capital and labour. The single market project 2015 is only aiming at dismantling most cross-border capital restrictions (although full liberalisation of capital movements would be required) and the free movement of skilled employees (while all workers should be included). Thus, the factor mobility requirements of the ASEAN-5

[17] The Maastricht convergence criteria require low inflation and interest rates, a stable rate of exchange versus the euro, and solid public finances in terms of general government budget deficits and debt. Italy only managed to take the 3% of GDP budget hurdle thanks to a Europe tax and much lower interest rates in the process of convergence.

[18] Only the Philippines are missing. Bacha, Obiyathulla Ismath (2008). A common currency area for ASEAN? Issues and feasibility, Applied Economics, 40, pp. 515-529.

Maastricht Treaty definitions in order to qualify for EMU

1. The inflation rate (CPI) in the year before the examination may not be more than 1 ½ percentage points above the average rate of the three best-performing EU member states. The latter is the so-called reference value. There must be a sustainable degree of price stability.
2. Short-term interest rates may not exceed the level in these three countries by more than 2 percentage points. Again, this is called the reference value.
3. The annual budget deficit of general government may not exceed 3% of GDP unless either the ratio has declined substantially and continuously and reached a level that comes close to the reference value; or, alternatively, the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value.
4. The general government debt ratio may not exceed 60% of GDP unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace.
5. A country's currency must have participated in the European Exchange Rate Mechanism (ERM), and remained within the standard bandwidth, for at least two years; it must not have been de-valued on the initiative of the EMU candidate.

Inflation rates ASEAN-5 1999-2008

%

Source: DB Research 6

single market are lagging behind those of the EU at the time of establishing EMU. Unfortunately, factor mobility between countries and even within countries is relatively low (apart from the attractiveness of high-per-capita-income Singapore). Nevertheless, the single market and ASEAN Economic Community (AEC) goal of 2015 is expected to boost the mobility of capital and labour, thus increasing economic efficiency and productivity. It should not be overlooked that ASEAN-5 is also quite different in terms of size (small Singapore vs. large Indonesia), per capita income as well as economic structures.

The latter 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 sound infrastructure, strong rule of law and high governance standards make it a natural choice as regional hub and financial centre.

The review of several OCA criteria suggests that it is far too early to argue in favour of the creation of a monetary union within ASEAN in the foreseeable future.[19] On the other hand, AMU is likely to foster some OCA criteria such as trade integration. A further study comes to the conclusion that East Asia is not inferior to Europe in meeting the OCA conditions.[20]

7. A Maastricht convergence check for ASEAN-5

The establishment of AMU does not only require a strong political will but also qualification in economic and monetary terms. This follows the insight that a monetary union can only work smoothly in the long term if a degree of convergence is realised even before the start. Therefore, the criteria for an entry into AMU should be concrete and verifiable.[21] Meeting a set of convergence criteria – similar to EMU – seems to be indispensable for AMU membership.

EMU entry was dependent on meeting the following convergence criteria: low inflation rates, interest rate convergence, stable exchange rates and sound fiscal policies with regard to general budget deficit and public debt. Assuming that ASEAN-5 will be the nucleus for creating AMU this analysis undertakes a hypothetical Maastricht convergence test on the basis of current data for the member countries of ASEAN-5.

This convergence test produces some interesting conclusions. Only two out of five countries, namely Malaysia and Thailand, meet all five convergence criteria. A major dilemma involves the inflation rate. The reference value of 5.3% is far too high to launch an AMU as price stability is not given with such a high inflation rate. Much depends on the choice of the reference period which, in our case, comprises the 12 months to June 2008. The first half of 2008 is characterised by an extraordinary world-wide hike in inflation rates

19 Frank Strobel (2007). Southeast Asian monetary integration: a real options perspective, Applied Economics 39, pp. 759-763.

20 W. Moon, D.R. Yoon and Y. Rhee (2002). Asian Monetary Cooperation: A Search for Regional Monetary Stability in the Post Euro and Post Asian Crisis Era, Quarterly Economic Analysis, 6 (2), pp. 165-216.

21 The criteria for an OCA are too vague. The same is true for the five self-defined economic tests which the British government has announced to meet in addition to the Maastricht convergence criteria. The five tests comprise cyclical convergence between the UK and EMU, flexible absorption of asymmetric shocks without own monetary policy, attractiveness for FDI, beneficial effects on the "City of London", long-term positive effects on employment and growth.

due to soaring oil and food prices. Therefore, it is not surprising to state that inflation rates were too high, anyway, in 2008/09 to allow AMU entry. Looking back, the year 2006 would have offered a more favourable period for meeting the inflation criterion. This implies that the period chosen is crucial for the outcome of the inflation convergence test.

Regarding the interest criterion, several ASEAN-5 states already have relatively low (nominal) interest rates. In general, ASEAN-5 shows a relatively good performance with regard to the fiscal convergence criteria for the budget deficit and the stock of public debt. It is also interesting to note that China, Japan and South Korea are also not meeting all five convergence criteria. Thus, the time is not yet ripe for a successful convergence test in East Asia.

Convergence criteria[1] for a hypothetical entry test for monetary union

	Inflation	Interest rates[1)]	Fiscal balance	Public debt	Exchange rate regime[2)]	Number of criteria fulfilled
	Avg. 12 months to June 08	Avg. 12 months to June 08	% of GDP 2007	% of GDP 2007		
Reference value	5.3	4.7	3	60		
Indonesia	7.4	8.2	-1.8	40.2	met	**3**
Malaysia	2.3	3.5	-2.8	48.3	met	**5**
Philippines	4.7	5.5	-0.2	73.3	met	**3**
Singapore	5.0	1.4	2.7	96.2	met	**4**
Thailand	3.9	3.3	-1.2	36.9	met	**5**
China	7.1	4.0	0.7	45.0	met	**4**
South Korea	3.4	5.0	3.8	33.3	met	**4**
Japan	0.6	0.5	-2.4	180.3	met	**4**

1) See box on Maastricht Treaty definitions

2) Regarding the exchange rate criterion, it is assumed that the above-mentioned East Asian countries meet the exchange rate criterion if the nominal exchange rate vis-à-vis the US dollar has moved mostly in the middle of a wide fluctuation band of +/- 15% and there was no devaluation, on balance, towards the dollar in the two years before the convergence test.

Sources: Eurostat, DB Research **7**

8. EMU: What political lessons for East Asia?

From the very beginning of the European monetary union debate EMU has not only had an economic but also a political dimension. Therefore, a brief review of the history of economic and monetary integration in Europe is given in order to get some clues about the timing and the political decision-making process for AMU. Before EMU was launched in 1999 Europe had witnessed a long period of more than forty years of intense economic integration following the Treaty of Rome in 1957 which aimed at political objectives (e.g. peace-keeping function of economic integration) and economic goals (e.g. growth and rising income). European economic integration was stimulated by the creation of a free trade area and the liberalisation of FDI.

Some milestones have been the establishment of a customs union with common tariffs vis-à-vis third countries and a common trade policy by the end of the 1960s. The next big event was the announcement of the single market project in the late 1980s which started in 1993 and aimed at the free movement of goods, services, capital and labour ("four freedoms") as well as the freedom of cross-border establishment. It focussed on dismantling non-trade barriers and introduced the mutual recognition of standards (instead of full harmonisation). Nevertheless, the single market is an ongoing construction site with regard to several aspects, for instance the completion of a single market for financial services.

European integration started with six countries

European integration started with six core countries in 1957.[22] The six proved to be the nucleus for the European Union (EU) which has become a "snowballing" community now comprising 27 member states after six enlargement rounds. However, only 16 EU member states have joined EMU.[23] The tandem of France and Germany served as a political, economic and monetary integration engine for decades. The integration process has been stimulated and monitored by setting up an institutional framework including the European Council as main decision making body and the European Commission as monitor of the treaty and initiator of ongoing integration.

ASEAN founded only 10 years after EC

ASEAN has also witnessed quite a long history. The nucleus for economic integration in East Asia was the foundation of ASEAN in 1967, i.e. only 10 years after the signing of the Treaty of Rome. However, the speed of intra-Asian economic integration only gained momentum in the late 1990s. The main reason was the strong focus of the corporate sector on the large US market under the umbrella of the dollar peg.

The debate about AMU was put on the political agenda by the ASEAN Summit in December 1998 by submitting the proposal to study a monetary union. However, most East Asian countries continued to follow the typical pattern of "trade first, money later". Therefore, it is not surprising that there has been little progress in monetary integration so far.

Four political lessons

Against this backdrop four *political* lessons from European integration can be drawn for the creation of an AMU:

AMU is a long-term project

First, *the creation of AMU will be a long-term project*. It requires not only several decades of economic and monetary integration including the establishment of a single market. As regards trade integration East Asian countries have made substantial progress in recent years as the rising degree of openness underpins. But the establishment of a single market, which is scheduled to be realised by 2015, is a necessary condition for monetary union. Progress in integration also involves a permanent political debate in order to ensure acceptance of the general public. Progress followed by setbacks has also been a "normal feature" in the European integration process. There might be ups and downs in economic and monetary integration in East Asia, too. This should, however, not discourage governments of East Asian countries from pursuing the goal of AMU. European governments' tenacious attitude eventually paved the way to EMU.

Political will is crucial

Second, *AMU is primarily a political project*, which requires a strong political will. Eleven out of 15 EU member countries proved to have such a strong will – and met the convergence criteria – in order to launch EMU in 1999 after the convergence test in 1998 (on the basis of the reference year 1997). Yet, it remains to be seen whether

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[22] France, (West)Germany, Italy, the Netherlands, Belgium and Luxembourg.
[23] See chapter 9.

and when East Asian countries will produce the necessary political will. If they do so, AMU is more than a vision. It can become reality like EMU.

AMU should be open for new members

Third, like EMU[24], an *AMU is expected to be designed as an open club*. Not all countries in East Asia that participate in economic integration are likely to join AMU from the very beginning. Countries which prefer to stay out of AMU should be given the right to opt in, similar to the opt-in approach of the UK and Denmark with regard to EMU. At the same time all AMU member countries should be fully aware that AMU membership is a long-term commitment because the exit of a country and the reintroduction of a national currency are extremely difficult and costly. It will involve severe economic and political problems for the country concerned and, if a key country is willing to leave AMU, it may also be a political challenge or a threat to the cohesion of the monetary union as a whole. In contrast, the global financial crisis 2007/8 has also shown the disadvantages of not being a member state of EMU. For instance, Denmark and Hungary have suffered, for different reasons, in terms of greater volatility of exchange rates and higher interest rates.

Integration fostered by institutional framework

Fourth, *market-based progress* in economic and monetary integration was promoted in the EU by an *institutional framework as well as common rules, guidance and monitoring*. European integration has benefited from a sophisticated institutional framework of common policies, rules and institutions including the European Council, the European Commission and the European Parliament.[25] The question is, however, to what extent ASEAN needs common rules and common institutions in order to ensure efficient political, economic and monetary cooperation and to boost the ongoing market-driven process of regional economic integration.

Tailor-made institutions needed

The EU's institutional framework can, of course, not simply be copied by ASEAN as member states need to take account of the specific regional aims and circumstances. A basic question is whether ASEAN as a nucleus for integration will predominantly pursue economic goals or whether it also aims at progress in political unification as the EU has been doing de facto. With regard to the institutional framework ASEAN have made some progress in recent years, for instance, by holding summits on a regular annual basis and establishing a permanent Secretariat. It remains, however, to be seen whether the current institutional framework will be sufficient for the creation of an AMU.

9. Economic and monetary policy conclusions for East Asia

ASEAN's economic and monetary integration has developed much slower than in the case of the European Union. The intra-Asian trade ties were weak in the starting period from 1967 to the early 1990s because most member countries were developing countries

[24] EMU started with 11 member states in 1999 but will have 16 member states in early 2009 when Slovakia will join.

[25] In political terms the EU is neither a federation of states nor a confederation but an entity "sui generis". The EU does not have a government but a Commission is charged with executive tasks. In contrast, the European Council has mainly legislative tasks. It co-decides with the European Parliament on many issues. The EP is directly elected but not a fully-fledged parliament. The co-decision power of the Council and the EP covers most EU directives and the expenditure side of the EU budget (amounting to only 1% of GDP). The EP does, however, not have the right to levy taxes or sanctions to incur public debt on the EU level. The aim of the pending Lisbon Treaty is to streamline the institutional framework of the enlarged EU in order to strengthen its decision-making process and its ability to act.

at that time with limited purchasing power and absorption capacity. East Asian countries in general and ASEAN in particular had a strong focus on the huge US market.[26] Although ASEAN was founded in 1967, regional economic integration was weak until the early 1990s while economic integration in Europe was given priority right from the start. However, things in East Asia have changed since then.

AFTA stimulated trade integration

Some milestones to date were the establishment of an *ASEAN Free Trade Area (AFTA)* in 1992 and the sector-by-sector liberalisation of regional services which have paved the way for rapidly growing intra-ASEAN economic ties since the mid-1990s. Despite the implementation of a free trade area for goods and many services ASEAN did not establish a customs union with common tariffs vis-à-vis third countries. It is, however, likely that the issue of a custom union will be put on the political agenda in due course as ASEAN is aiming at the creation of an Asian Economic Community (AEC) and a single market by 2015. A single market requires de facto common custom tariffs vis-à-vis third countries in order to avoid market distortion, for instance, trade diversion effects through the implementation of different national custom tariffs on imports.

ASEAN single market 2015 is essential

The project of an *ASEAN single market 2015* is aiming at free movement of goods, most services and investment flows within ASEAN[27]. A further goal is to provide more freedom for the movement of skilled labour. However, the ASEAN single market concept is obviously lagging behind the EU concept, which is based, as mentioned above, on the “four freedoms” for goods, services, capital and labour. In particular, the EU’s complete liberalisation of capital movements in the early 1990s was an essential step on the road to EMU. In this area, ASEAN still has to do some homework. The creation of a fully-fledged single market is a key economic complement to AMU with a common currency.

Exchange rate regimes in East Asia

Status: September 2008

	Currency (ISO code)	Exchange rate regime	Capital controls
Indonesia	Rupiah (IDR)	float	no
Malaysia	Ringgit (MYR)	basket peg	yes 1)
Philippines	Peso (PHP)	float	yes 2)
Singapore	Dollar (SGD)	managed float	no
Thailand	Baht (THB)	float	no
China	Renminbi Yuan (CNY)	basket peg	yes 1)3)
South Korea	Won (KRW)	float	no
Japan	Yen (JPY)	float	no

1) Inter alia limits for foreign ownership of companies
2) Inter alia limits for offshore investments of local companies
3) Controls on resident's holding of foreign exchange

Source: DB Research 8

26 In Europe, there was a similar phenomenon with regard to the new EU member states in Eastern Europe. Their main market in the 1990s was the old EU-15 while intra-trade was minor. However, intra-trade has risen in the catching-up process of dynamic growth in the course of this decade.

27 There are two main principles: all industries are to be opened up for investment and national treatment is granted immediately to ASEAN investors with only a few exceptions.

EMU debate launched in 1970

There was a phase of about thirty years of monetary integration and debate on the creation of EMU. It started with the Werner Report in 1970 and was stimulated by the collapse of the global fixed-exchange rate system of Bretton Woods in 1973. Important mile-stones were the creation of the European Monetary System (EMS) in 1979 – characterised by fixed but adjustable exchange rates – as well as the launch of EMU with the single currency euro in 1999.

Close monetary cooperation required in East Asia

In contrast, *monetary cooperation* within ASEAN as well as between ASEAN and China, South Korea and Japan is still in its infancy. East Asia is now at a similar stage as Europe in the late 1970s. The collapse of the Bretton-Woods system and its impact for Europe can be compared with the period after the Asian crisis 1997/98. In both cases the dollar peg collapsed. European as well as East Asian governments discussed ways to stabilise the exchange rates between regional currencies. The EU came up with the creation of the EMS in 1979 with fixed but adjustable exchange rates. In ASEAN, there is no similar monetary system in the offing so far.

If one compares, in general, the EU and ASEAN with regard to the current state of economic and monetary integration, ASEAN is economically less interlinked than the EU. Therefore, it is likely that ASEAN or ASEAN plus/minus X countries will need at least another two decades before there is any realistic chance of an AMU being launched.

10. What progress have East Asian countries made in monetary cooperation?

Two lines of action

Before the Asian crisis 1997/98 the dollar peg had dominated East Asian monetary and exchange rate policies for decades so there had been no necessity for close regional monetary co-operation until the late 1990s. Yet, the Asian crisis produced two lines of monetary action, which were initiated by the fact that several countries affect-ed by the Asian crisis heavily criticised the adjustment programmes of the IMF.[28]

Huge foreign exchange reserves

First, East Asian countries started to accumulate huge foreign exchange reserves so they could weather a financial crisis without submitting to traditional IMF conditionality.

Bilateral swap arrangements

Second, East Asian central banks launched the “Chiang Mai Initiative” by agreeing on bilateral swap arrangements in May 2000 in order to provide dollar liquidity in case of an attack on a country’s currency. The hotly-debated proposal to create an “Asian IMF” was, however, buried.

ASEAN plus 3: emergency fund agreed

In the meantime the global financial crisis 2007/8 also has implications for East Asia although the impact is less pronounced than in the US and in Europe so far. Nevertheless, ASEAN-plus-3 countries responded in October 2008 by exploring the idea of creating a USD 80 bn emergency fund[29] (i.e. a shared pool of foreign-exchange reserves) by June 2009 in order to support countries in the region facing liquidity problems. This is a small amount relative to combined huge foreign exchange reserves of about USD 4.3 trillion in these countries.[30] However, there are still open questions, e.g. regarding the structure of capital endowment and the degree of “conditionality” for disbursements. The ASEAN-

[28] Those IMF programmes were based on traditional demand-restricting recipes and not deemed to be appropriate to cure the structural problems in the late 1990s.
[29] It will replace the bilateral swap arrangements agreed in May 2000.
[30] About two-thirds of this amount is held by China and Japan alone.

plus-3 agreement also underpinned the necessity of closer co-operation of monetary and supervisory authorities in the region.

Proposal of an Asian IMF problematic

It cannot be ruled out that the old proposal of an Asian IMF might return to the political agenda in the wake of the reform debate triggered by the global financial crisis. A main feature of the proposal was not to impose conditionality, which used to be a cornerstone of IMF adjustment programmes. This is, however, not unproblematic as it may undermine economic policy and market discipline and run counter to the political objective of strengthening the role of the IMF as a "policeman" for financial stability. Any dilution of macroeconomic conditionality is likely to weaken a debtor country's ability to redeem a credit, implying a substantial default risk for the liquidity-providing emergency fund.

11. AMU: Stimulus for financial market integration

Euro pushed financial market integration

The introduction of the euro in 1999 has stimulated financial market integration in EMU. However, other factors, such as the international process of deregulation and globalisation of financial relations as well as leaps in information and communications technologies have also played a significant role. European financial integration has been primarily market-based. Yet, EMU paved the way for a broad-based programme of joint financial market legislation in the EU.[31] Thus, it was also a catalyst for the implementation of common rules and regulations for the creation of a single financial market which is an essential part of the single European market.

The financial services industry and its clients benefit from well-functioning financial markets and the availability of a broad range of efficient financial products and services. A case in point is the integration of securities business throughout the EU. The investment universe without exchange rate risks has been extended to the entire monetary union. This has led to dynamic growth in cross-border portfolio investment, with regard to both bond and equity markets, over the past years and reduced the focus on the home market ("home bias"). Despite substantial progress further integration steps are necessary to complete the EU single financial market above all in the areas of retail banking, professional asset management and the Europeanisation of the supervisory structures.[32]

Model case for East Asia

All in all, the integration of European financial markets can be considered a model case for East Asia. The European experience is, in particular, encouraging with regard to the establishment of integrated bond markets and a single money market.[33] For instance, large and liquid bond markets have emerged, not only for government bonds but also for corporate bonds. German government bonds have the role of the benchmark. The euro bond market is also tapped by a variety of sovereign and corporate issuers from East

[31] The EU launched the Financial Services Action Plan (FSAP) in 1999 covering both EMU and non-EMU countries within the EU. The FSAP comprised 43 joint legislative projects including securities and payment services. The legislation was passed by 2005 and is now in the phase of implementation.

[32] Norbert Walter and Bernhard Speyer (2007). Towards a new structure for EU financial supervision. Deutsche Bank Research. EU Monitor 48. Frankfurt am Main.

[33] This is true despite the fact that the single money market in the euro area has not functioned properly with unsecured funds, since the outbreak of the financial crisis in August 2007. There is money market turbulence also in the US, the UK and elsewhere. The euro money market worked smoothly right from the beginning of EMU and is expected to do so again once confidence in the reliability of counterparties is restored.

Asia. It has also gained increasing importance for institutional investors from Asia including central banks and sovereign wealth funds.

Benefits of financial market integration

The prospect of AMU is likely to intensify the debate in East Asia about how to push financial market integration. AMU countries are also expected to benefit from the creation of deeper and better-connected financial markets under the roof of a single currency. Indeed, AMU would offer broader investment and financing opportunities in the single currency for institutional and private investors. This will further boost the bond market but also other financial market segments including equities.

Focus on Asian features

The process of Asian financial market integration also has to take into account some East Asian peculiarities on the road to AMU. For a long time the dynamic East Asian economies have been characterised by relatively high savings ratios and savings amounts available for efficiently financing growth. Nevertheless, the Asian crisis 1997/98 showed that East Asian states had been vulnerable to volatility in short-term capital movements through maturity and currency mismatches. Prior to the crisis, banks in East Asia incurred maturity mismatches by obtaining short-term funds which they lent out as long-term loans. By the same token, Asian banks collected funds in a foreign currency in order to lend in the local currency, resulting in currency mismatches.

Dismantling of capital controls is essential

Therefore, ASEAN-10 plus Japan and South Korea have launched some important initiatives in order to reduce weak spots in the financial sector. They aimed, in particular, at promoting financial integration by liberalising capital accounts and financial services and by developing the Asian bond markets. Since 2003 the Asian Bond Initiative has sought to intensify the development of regional bond markets. It aims at reducing the dependence of East Asian states on short-term foreign-currency-denominated financing by boosting government and corporate finance in local currency and thus making more efficient use of the substantial local savings. The process of dismantling capital restrictions should also pave the way for greater diversification of the assets of institutional and private investors within East Asia. AMU could – similar to EMU – stimulate such a process and reduce the home bias of asset allocation.

12. Intermediate steps to AMU

Although the time is not ripe for launching an AMU in the foreseeable future there are a number of intermediate steps which might be helpful to pave the way to AMU.

One political issue pertains to the institutional arrangements of AMU. AMU membership has a variety of political, economic and monetary implications which require building a minimum legal and institutional framework. This could imply that the existing institutional elements and arrangements have to be strengthened or complemented.

AMU needs a Maastricht-like treaty

A Maastricht-like treaty is necessary between AMU member and candidate states in order to define the objectives of AMU, the statute of the common central bank, the convergence criteria for AMU entry as well as the framework for cooperation and coordination of economic, fiscal and monetary policies. A legal framework is also necessary to determine the rules of transition and the timetable for implementation of AMU. The rights and duties of member states as well as the responsibilities and tasks of institutions have to be established. For instance, a forum for regular cooperation between governments has to be installed in order to bring about an appropriate policy mix between a centralised (independent) monetary policy and a decentralised fiscal policy. There should also be a separate common institution commissioned to monitor economic and fiscal policy performance and coordination. A smooth working of policy coordination and monitoring in an AMU requires a set of legislative, executive and judicative arrangements and bodies. For instance, within the EU and EMU the European Commission not only has executive tasks but it is also initiator for new legislation and the guardian of the EC Treaty.

Good communication is crucial

One big problem in the run-up to AMU is communication with the general public, companies and banks in order to win broad acceptance for the project. Moreover, good communication is crucial in paving the way for the credibility of the common Asian central bank and a common currency. Until such a high-flying 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, studies and an exchange of views 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 experience with EMU.

Beyond the current state of affairs the monetary and financial co-operation in East Asia could help to intensify the preparatory work for monetary integration.

ECU: Role model for ACU

The ECU (European Currency Unit) was an artificial "basket" currency consisting of the weighted average of ten EU currencies. The weights of the ECU were determined by a country's shares in GDP and international trade. They were checked and corrected every five years. One reason for a change in weights was exchange rate movements. Appreciating currencies led to increasing weights and depreciating currencies to decreasing weights. The ECU was used by EU institutions as a unit of internal account (as of 1975) and as a yard-stick for fixing the parities and fluctuation bands for the market exchange rates within the Exchange Rate Mechanism (ERM) of the EMS. The ECU also played an important role on financial markets as a unit of account and a store of value, for instance for issuing government and corporate bonds. Interestingly, the ECU was converted at a rate of 1:1 into the euro. This implied that investments in ECU had experienced legal continuity when the single currency euro was actually introduced. The ECU had a certain symbolic character on the road to the introduction of the euro in 1999. The ECU may also serve as a role model for the envisaged Asian Currency Unit.

One milestone will be the realisation of the ASEAN single market project by 2015. It should be accompanied by the gradual dismantling of the remaining controls of capital movements. The aim should be complete liberalisation of the capital account. An important part of the single market project is the creation of a single financial market which is likely to promise growth stimuli. The global financial crisis 2007/8 should be taken as an occasion to create appropriate regulatory and supervisory structures in financial markets.

In the field of monetary integration, there is a plan, namely the launch of an Asian Currency Unit (ACU), and one proposal, i.e. the creation of an Asian Exchange Rate Mechanism (ERM).

Do not wait too long with an ACU

An Asian Currency Unit (ACU) was scheduled to be launched in 2006 but then postponed indefinitely. The Asian Development Bank was commissioned to design the ACU as a weighted basket of East Asian currencies. Similar to the ECU in Europe the ACU could serve the following purposes:

1. Unit of account for intergovernmental and private financial market transactions within ASEAN (plus 3) as well as with third countries;
2. Unit of account, medium of exchange and store of value on financial markets, for instance for issuing bonds in participating countries[34];

[34] Many governments, public agencies and companies in the region borrow in dollars or euros, thus incurring a considerable exchange rate risk. Investing in ACU assets and taking up ACU liabilities only implies a minor exchange rate risk. It will only materialise to a relatively small extent in case of a devaluation of a country's currency vis-à-vis the other currencies which are components of the ACU basket. See also: Clifford R. Dammers, Robert N. McCauley (2006), Basket weaving: the euromarket experience with basket currency bonds, BIS, Quarterly Review, March.

EMS was an important intermediate step to EMU

The European Monetary System (EMS) was established in 1979 and disappeared with EMU's start in 1999. It called for fixed but adjustable exchange rates. The idea was to counter inflation among member states and stabilise intra-European exchange rates in order to provide a sound costing basis for the rising intra-European trade and investment. Its most important part was the **Exchange Rate Mechanism (ERM)**, which defined, on the basis of the ECU, a system of bilateral parities ("parity grid") with fluctuation bands in which the market exchange rates could move. The borders of the bands were described by the upper intervention point and lower intervention point. In general, the bandwidths were 2.25% to each side, with a wider margin for the Italian lira (± 6%). When a market exchange rate reached either of these intervention points, central banks were compelled to support these rates indefinitely through interventions in the foreign exchange market. In case of a fundamental disequilibrium, the country in question had to accept a de-valuation. There were 17 realignments of EMS parities from 1979 to 1998.

However, the D-mark was de facto the anchor currency of the EMS, and not the ECU. The D-mark's image of price stability was also reflected in its international role as an important trade, investment and reserve currency well behind the dollar but as the key European counterpart to the dollar. After the currency crisis in 1993, the bands were widened to 15% on each side, while the exchange rate fluctuations were kept within a relatively narrow band.

The EMS paved the way to EMU. Its successor was the **ERM II** between the euro and the currencies of several non-EMU EU member states on a volunteer basis. Membership in ERM II is an important intermediate step on the road to EMU. Smooth participation in ERM II for least two years is necessary in order to fulfil the convergence criterion for a stable exchange rate. Four countries were members of ERM II before they entered EMU and four other countries are using the ERM II as a waiting room on the road to EMU: Denmark, Estonia, Latvia and Lithuania.

3. Yardstick for the definition of parities of an ERM for an Asian Monetary System (similar to the ERM of the EMS).

The launch of the ACU will require governments in East Asia to make several technical decisions regarding the selection of currencies to be included in the basket, the nature of the basket, the determinants of the weights, and the criteria and the timing of revisions etc.[35] Beyond these technical issues there are two important experiences from Europe:

- The ECU had a certain symbolic character on the way to the euro's introduction in 1999. The ACU may play a similar role on the road to AMU. However, a different question is the name of a future single currency in East Asia. It has to be discussed in due time. In Europe the name of the single currency became euro and not ECU.[36]
- A currency basket is not a single currency, i.e. a single currency cannot be achieved by making the ACU simply a parallel currency circulating in addition to national currencies in East Asia.[37] That would blur the responsibility for monetary policy and create uncertainty regarding combating inflation and providing liquidity in case of emergency. A single currency needs a clear definition of responsibility (which should be allotted to a single central bank) in order to gain confidence and credibility in the population and on financial markets.

Exchange Rate Mechanism in East Asia to be considered

A further intermediate step could be the establishment of an Asian Monetary System with an Exchange Rate Mechanism (ERM) between those East Asian countries that are willing to become an AMU member state. The EMS could serve as a role model. An East Asian ERM could fix bilateral fluctuation margins for the development of the market exchange rates of participating currencies. The partner countries have the obligation to strengthen their economic fundamentals by good governance. There could also be an obligation to defend the national currency through foreign exchange interventions if it is weak and threatens to leave the fluctuation margin. An Asian ERM should have wide fluctuation margins (e.g. ±15% as the EMS as of 1993) in order to prevent speculation at the margin. The market exchange rate should be kept close to the parity. In case of divergent economic fundamentals realignments of exchange rate parities should be carried out quickly. Such a mechanism – similar to the ERM in Europe – has two functions.

An Asian ERM should help to stabilise the exchange rates in the run-up to AMU and the irrevocable fixing of the exchange rates at

[35] Eric Girardin and Alfred Steinherr (2008). Regional Monetary Units for East Asia: Lessons from Europe, ADB Institute Discussion Paper No. 116, September; Asian Development Bank Institute (2008), Road map for the market-based development of the store of value ACU.

[36] Werner Becker (1995), EU Summit in Madrid: results and unresolved issues, Deutsche Bank Research, EWU Watch No.4.

[37] In Europe there was the hard ECU proposal of the British government as an alternative to the Maastricht Treaty concept of a single currency. The hard ECU should be issued by a currency board as a currency in its own right and brought into circulation as a parallel currency to the national currencies. The hard ECU had some severe flaws. As a parallel currency it would not have saved transaction costs — on the contrary. Responsibilities for monetary policy are not clearly defined between the currency board and national central banks. The hard ECU would have circulated in addition to the basket unit ECU. Stefan Collignon and Daniela Schwarzer (2003), Private Sector Involvement in the Euro, The Power of Ideas, Routledge advances in European politics.

the start of AMU. It will pave the way for meeting the convergence criterion for the exchange rate.

After the start of AMU an ERM can serve as a waiting room for late-comers on the road to AMU. Countries that are unwilling to join AMU right from the beginning can integrate their currency into the ERM and use the single currency as an anchor.

In contrast to Europe, East Asia does not (yet) have one dominant currency like the D-mark but – as mentioned above – two dominant currencies, the yen and the yuan. Assuming that ASEAN-5 is the nucleus for AMU there are three options for anchoring an Asian ERM.

First, the yen could be used as an outside anchor. However, the yen never did play an anchor role for other Asian currencies for political reasons although it has been an important international reserve and investment currency for some decades. But the international role of the yen is receding. The same is true of the share of Japan in ASEAN's exports. Making ASEAN exchange rate regimes dependent on the volatile exchange rate of the yen is not considered to be a real alternative to the dollar peg.

Yuan has the potential for an anchor currency

Second, the yuan could serve as anchor. But the yuan is not yet a fully convertible currency. It is, however, gaining international importance given the dynamic growth of China for many years and the fact that China is an economic and political powerhouse. There are some arguments in favour of pegging ASEAN currencies to the yuan. This would take into account the rising importance of China for ASEAN exports. A positive element is also that the fluctuations of the yuan vis-à-vis the dollar have been much less pronounced than those of the yen. However, there is some uncertainty concerning the future exchange rate policy of China towards the dollar. In the end, a pegging towards the yuan would be a political decision.

ACU is an anchor option

The third option is using the ACU as an anchor. The ACU could either consist of ASEAN currencies only or comprise the currencies of ASEAN plus 3. In this case the yuan, the yen and the won would also be components of an ACU and exercise a strong implicit external impact on the yardstick for an Asian ERM.

13. And what answer for now?

Even dynamic East Asia is affected by the global financial crisis 2007/8 and the downturn of the world economy, but it will continue to grow albeit at a somewhat slower pace. It is likely that East Asia will be able to cope better with the economic problems than most of the rest of the world. Intra-Asian economic integration is expected to remain on the rise. Nevertheless, the US market still plays a crucial role for East Asia. Thus, East Asia will remain exposed to the risks of the US economy and the dollar exchange rate. AMU and a single Asian currency are an appropriate response to these risks. Thus the debate on AMU should continue and even intensify. 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 ASEAN will be able to run an internal market by 2015.

The introduction of a single currency requires strong political will as well as the building of institutions, a legal framework and trust. Economic and monetary integration in ASEAN may be similar to the EU's situation in the 1970s. Therefore, it is likely to take at least another two decades before AMU can be launched.

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