

Can the Asian Currency Unit Lead to Greater Exchange Rate Co-ordination?

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- Finance ministers of ASEAN+3 economies agreed to make concerted efforts at exchange rate coordination with an objective of creating an Asian Currency Unit.
- The ACU is likely to be an appropriately weighted index of Asian currencies.
- ACU could be used to denominate intra-Asian trade and investment.
- The ACU can be used to devise new instruments that can be easily traded across the border without the underlying exchange rate risk.
- Importers and exporters can denominate intra-Asian trade in ACU.

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- However, the creation of the ACU is riddled with several obstacles including:
 - Economic, Political and Social heterogeneity.
 - Weak multilateral institutions in the region.
 - Lack of political will.
- Given these obstacles is it possible to create an Asian Currency Unit? YES

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Is Asia Ready?

- Seminal contributions by Mundell (1961) and McKinnon (1963) initiated the debate on Optimum Currency Area.
- The main benefits of an OCA were seen as:
 - Reduction in transaction costs involved with international trade in goods, services, labour and capital.
 - Decrease in the uncertainty associated with exchange rates.
 - Imposition of a "discipline" effect on individual countries.
 - Reduces the incentive to undertake uncoordinated policies.
- On the other hand the costs have been identified as:
 - Loss of autonomy to conduct monetary policy.
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Is Asia Ready?

- Frankel and Rose (1998) mooted the idea that several of the OCA criteria can be endogenous.
- If a group of countries exhibit strong political commitment to coordinate monetary and exchange rate policies, then their attempt to form a currency area can be successful as long as they satisfy OCA criteria to some extent initially.
- Asian countries are characterized by high level of trade and FDI integration, speed of adjustment to shock and symmetric supply and demand disturbances.
- Moreover, during the last decade there has been a rapid expansion of intra-regional trade as well as vertical intra-industry trade in manufactured products.
- Based on the existing literature, a case for greater economic and monetary cooperation including a move towards a common Asian Currency Unit can be argued.

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Inclusion of INR

- For the Asian Currency Unit to be truly Pan Asian it can not afford to exclude currencies that exert sufficient regional clout.
- The Indian Rupee has a number of regional currencies closely linked with it.
- India has sought greater integration with other economies of the region.
- India is poised to be the third largest economy in the world and second largest in the region over the next 30 years.
- On its part, India needs to further boost its effort to engage in greater cooperation with East and South East Asia.

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The Asian Currency Unit

- One way to create a regional currency is to have a lead currency that will gain acceptance outside its geographical borders.
- Given the historical and economic sensitivities it would be difficult to envisage such an arrangement.
- A move towards greater Asian integration must involve cohesive efforts involving the big and the small players of the region.
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The Asian Currency Unit

- Formally, an Asian Currency Unit can be defined as a weighted average of the participating currencies.

$$\xi_{ACU,t}^i = \sum_j \psi_j \xi_{j,t}^i \quad (1)$$

where $\xi_{ACU,t}^i$ is the value of the ACU in terms of numéraire currency i at time t ,

ψ_j is the share of currency j in ACU, and

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Outline

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- 5 Institutional Impediments
- 6 Promoting the ACU
- 7 Conclusion

An ACU for ASEAN+3+1

- Typically, the share assigned to individual currencies represent the economic importance or size of the countries.
- Various indicators can be used to measure the economic size of a country like GDP, trade, exports etc.
- We consider the ASEAN+3+1 countries and use the GDP shares of these countries and their export shares to calculate the weights of their currency in the ACU. [▶ Composition](#)
- Choice of Base Year?
- Choice of a Numéraire Currency?

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An ACU for ASEAN+3+1

- **Relative movement of the ACU vis-à-vis the US Dollar.**
- Between 2001 and 2002, the ACU became weaker relative to the Dollar but has significantly strengthened since then. [Graph](#)
- The appreciation has been sharper when weights based on exports are used. [Graph](#)
- Volatility is much more when weights based on nominal GDP are used than when exports based weights are used. [Graph](#)

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Movement of Participating Currencies

- Next we evaluate the movement of participating currencies vis--vis the regional benchmark.
- The exchange rate of participating currencies *vis-à-vis* the ACU is given by the following arbitrage condition.

$$\xi_{i,t}^{ACU} = \xi_{i,t}^{Num} \xi_{Num,t}^{ACU}$$

where

$\xi_{i,t}^{ACU}$ is the value of the currency *i* in terms of ACU at time *t*,

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Movement of Participating Currencies

Definition (Percentage Deviation)

Percentage Deviation is the percent difference between the value of a participating country's currency *vis-à-vis* the ACU in year t and the base year.

$$\text{Percentage Deviation} = \frac{\xi_{i,t}^{ACU} - \xi_{i,0}^{ACU}}{\xi_{i,0}^{ACU}}$$

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Movement of Participating Currencies

- The percentage deviations of the participating countries' currencies' again show that the region has experienced severe misalignments over the last seven years. [▶ Graph](#)
- The Lao Kip depreciated by more than 22% in 2005 against the ACU but since then has recovered slightly.
- In contrast, the Vietnamese Dong and Cambodian Rial weakened by 18% and 13% respectively, in 2008 relative to their base year value. [▶ Graph](#)
- Brunei Dollar and Singapore Dollar became weaker relative to the ACU from 2002 to 2005, but have experienced significant strengthening since then. [▶ Graph](#)
- Both Malaysian Ringgit and the Chinese Renminbi become weaker by 8% against the ACU till middle of 2005. Since then both currencies have significantly strengthened. [▶ Graph](#)

Movement of Participating Currencies

- Both Japanese Yen and Indonesian Rupiah witnessed a great deal of cyclical fluctuations, and in 2008 were considerably stronger than the base year value. [▶ Graph](#)
- The Thai Baht has also gained considerably against the ACU. Most of this gain has come since 2005 as the Thai Baht gained more than 28% against the ACU. [▶ Graph](#)
- The Philippine Peso became weaker by more than 20% in 2004 from its benchmark value but recovered smartly in the next few years, and in 2008 was stronger by nearly 10%. [▶ Graph](#)
- The Indian Rupee has been one of the most stable currency of the region and exhibited the least amount of volatility relative to the ACU. [▶ Graph](#)

Institutional Impediments Towards a Common ACU

- Undoubtedly, the creation of the ACU will play a significant role in stabilizing exchange rate volatility and enhance intra-regional trade and promote an Asian bond market.
- Participating countries will have to make extra efforts to promote the ACU as they will have to overcome the historical inertia associated with the use of national currencies.
- Typically it is unattractive for any particular agent to move towards ACU, abandoning the historical means of exchange, unless sufficient number of agents have already done so.
- A successful move towards an Asian Currency Unit will have to overcome a number of institutional impediments associated with greater economic and monetary integration.

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Economic, Historical and Political Heterogeneity

- Asian countries differ widely in terms of economic structure and level of development.
- In 2007, Japan and Singapore's per capita GDP in PPP terms was nearly 15 times that of Lao PDR.
- Several countries like China and the newer ASEAN members have an extensively regulated financial system.
- A number of countries in the region have historically unsettled issues with their neighbours.
- Widespread divergence in political systems and institutions in the region (e.g. non-democratic governments in China and Myanmar and mature democracies in India, Japan and Korea) are a deterrent to generation of political will in the region.

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- Several countries like China and the newer ASEAN members have an extensively regulated financial system.
- A number of countries in the region have historically unsettled issues with their neighbours.
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Diverse Exchange Rate Regime

- From the European experience it can be seen that pursuit of region wide exchange rate stability, played a key role in evolution of greater monetary cooperation.
- Asian countries follow a diverse range of exchange rate regimes.

Exchange Rate Arrangement	Countries
Currency Board	Brunei Darussalam
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Managed Floating with No Predetermined Path	India, Lao PDR, Malaysia, Singapore Cambodia, Myanmar and Thailand
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Inadequate Surveillance in the Region

- **Effective regional surveillance of national policies is a prerequisite for countries attempting to adopt a singular currency.**
- The ASEAN+3 countries have an existing system of surveillance process with technical assistance from the REMU.
- The process includes the preparation of a confidential staff report by ADB, which is reviewed by the policy makers of the member countries and thereafter discussed at the finance minister's meeting and brought out as an agreed ministerial document.
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Chiang Mai Initiative

- The Chiang Mai Initiative (CMI) was developed to provide an institutional support against speculative attacks on countries.
- Under the mechanism Japan, China and South Korea signed bilateral agreements with the original five ASEAN member countries establishing a network of bilateral swap agreements (BSAs). ▶ CMI
- At present the CMI is primarily bilateral in nature and the use of BSAs require approval from each lender.
- The size of the swap facility has only marginally increased the financial resources available to the country to help them in their liquidity need and is inadequate to prevent a financial crisis like the one in 1997.
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Strategies to Promote ACU

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 - ① Creation of certain institutional safeguards as well as strengthening the existing ones to promote greater regional cooperation.
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Exchange Rate Cooperation

- Given the present state of development among Asian countries a system as tight as the ERM will not be feasible.
- Williamson (1999) proposed an alternative rule of exchange rate management.
 - Adoption of a common currency peg vis-à-vis the Dollar, Euro and Yen.
 - Member currencies have a common set of weights based on the regional trade shares and the members announce a central parity.
 - The central parity and the band is allowed to drift in response to changes in the fundamentals.
 - Allows the coexistence of the various exchange rate regimes prevailing in the region.
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Strengthening the Chiang Mai Initiative

- At the Istanbul meeting in 2005 number of steps were decided on how to strengthen the CMI
 - Develop an effective regional surveillance.
 - Adopt a collective decision making mechanism as a first step towards multilateralization.
 - Expand the size of the bilateral agreements.
 - Increase the amount a country can draw without having an IMF program.
- Barring, an increase in the amount a country can draw without being subject to an IMF program from 10% to 20%, not much progress has been made on the other issues
- Invite newer members like India, which has over \$300 billion as reserves, into the arrangement.
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Greater Integration of Goods and Services Market

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Promoting the Use of the ACU

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- The recent financial turmoil and the ever burgeoning trade deficit of the United States *vis-à-vis* many Asian countries strengthens the belief that the U.S. Dollar is likely to further depreciate in the near future.
- Create the right incentives to induce importers and exporters to take and give credit in ACU.
- The Asian countries could also denominate significant amount of debt instruments in the ACU.
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- The recent financial turmoil and the ever burgeoning trade deficit of the United States *vis-à-vis* many Asian countries strengthens the belief that the U.S. Dollar is likely to further depreciate in the near future.
- Create the right incentives to induce importers and exporters to take and give credit in ACU.
- The Asian countries could also denominate significant amount of debt instruments in the ACU.
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- There is a strong need for the development of a parallel currency in the region to ensure greater trade and financial linkages.
- Such a move will also give the central banks of the region a viable alternative in which they can park their reserves.
- There are several obstacles like the political, economic and historical differences among the member countries.
- Presence of relatively weak multilateral institutions in the region.
- Most of these difficulties are surmountable provided that there is strong political will in the region.

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- 8 Appendix
 - Composition of ACU

Composition of ACU involving ASEAN Plus 3 and India

	1	2	3	6	7
	National Currency per \$ (2001)	GDP Nominal		Exports	
		Weights (%)	Units	Weights (%)	Units
Brunei Dar.	1.79	0.081	0.001	0.282	0.005
Cambodia	3916.33	0.057	2.237	0.138	5.393
China	8.28	19.063	1.578	20.412	1.69
India	47.19	6.818	3.218	4.107	1.938
Indonesia	10260.9	2.312	237.2	4.282	439.353
Japan	121.53	58.965	71.66	32.23	39.169
Korea	1290.99	6.935	89.532	12.188	157.352
Lao PDR	8954.58	0.025	2.27	0.031	2.8
Malaysia	3.8	1.266	0.048	6.986	0.265
Myanmar	6.68	0.093	0.006	0.189	0.013
Philippines	50.99	1.025	0.523	2.44	1.244
Singapore	1.79	1.23	0.022	10.18	0.182
Thailand	44.43	1.662	0.739	5.318	2.362
Vietnam	14725.2	0.468	68.869	1.218	179.325

▶ ACU

Movement of Asian Currency Unit

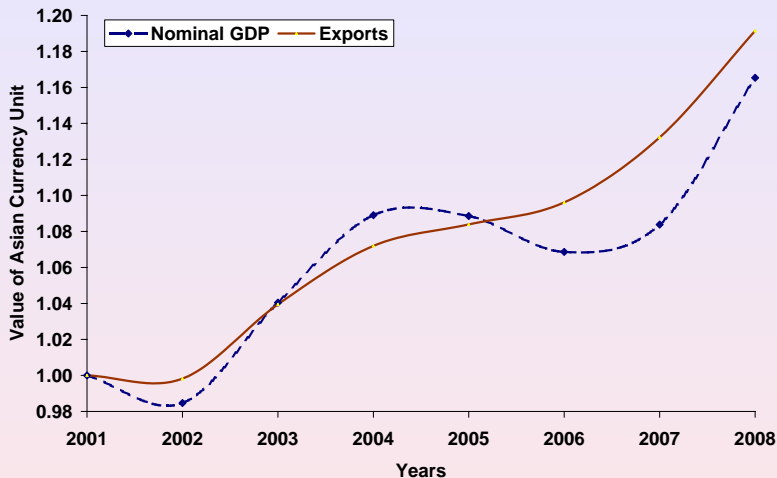
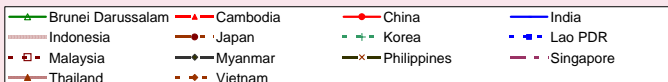
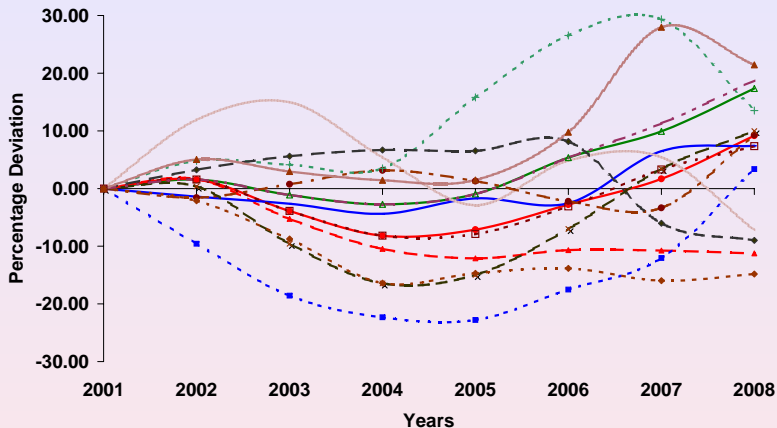


Figure: Trend *vis-à-vis* the US Dollar

Deviation of Participating Currencies



Chiang Mai Initiative

