

## Monetary and Financial Cooperation in East Asia: From the Perspective of Exchange Rate Policy Coordination

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### ABSTRACT

Following the Asian currency and financial crisis, the East Asian countries began to work on regional monetary and financial cooperation. The cooperation for crisis prevention substantially progressed. Chiang Mai Initiative Multilateralization (CMIM), a US dollar liquidity support arrangement among ASEAN+3 (Japan, China, Korea) member countries for US\$120 billion, became effective in 2010.

On the other hand, there has been no cooperation on coordinated regional exchange rate policy. Intra-regional trade and investment has been expanding and Emerging Asia including China has been catching up to Asian NIEs (Chinese Taipei, Hong Kong, Korea, and Singapore) and Japan at a rapid pace. Consequently, intra-regional exchange rate stability has been more important for the economic growth and stability of East Asian economy. In addition, exchange rate regimes of the East Asian economies as a whole have become more flexible and will be more flexible, due to the economic growth and the development of financial system of these economies. Therefore, possible excessive volatilities and misalignments of the currencies of these economies should be reduced by regional exchange rate policy coordination.

From the global point of view, exchange rate policies of the East Asian countries, which could prefer undervaluation rather than overvaluation of their currencies, are important in reducing global imbalances. It could be more important in the future, as the presence of East Asian economy is growing.

This paper explores the way how to prepare for regional exchange rate policy coordination in East Asia by using the AMU (Asian Monetary Unit).

**Keywords:** *regional cooperation, exchange rate policy, Asian Monetary Unit*

### I. INTRODUCTION

Following the Asian currency and financial crisis, leaders of the 10 ASEAN member countries along with the PRC (People's Republic of China), Japan, and Korea started the ASEAN+3 process in 1997. They began to work on regional monetary and financial cooperation for macroeconomic and financial stability.

The cooperation for crisis prevention substantially progressed. The Chiang Mai Initiative (CMI) as the region's currency liquidity support arrangement was launched in 2000. It is useful for crisis prevention and crisis management. The CMI is a network of bilateral liquidity support arrangements among the ASEAN+3 member countries. It was upgraded to the Chiang Mai Initiative Multilateralization (CMIM), a "self-managed reserve pooling" arrangement governed by a single contractual agreement in 2010. It is now a US dollar liquidity support arrangement among ASEAN+3 (Japan, China, Korea) member countries for US\$120 billion.

Although the cooperation substantially progressed, there still remain several challenges. The total size should be increased. It is set at US\$120 billion now. However, it would not be enough, considering the experience of Korea in 2008. US\$ 19.2 billion out of

US\$120 billion is the amount committed to support Korea in the CMIM. However, when the Bank of Korea entered into a currency swap agreement with the US Fed in October 2008 in order to mitigate the adverse effect on their currency and financial markets of the Global Financial Crisis, the size of the agreement was up to US\$30 billion.

In the CMIM, a crisis-affected member requesting liquidity support could obtain financial assistance for the first 20% of the committed amount, and the remaining 80% would be provided to the requesting member under an IMF program. The CMIM is linked to IMF programs in this way. This is due to the lack of the well-functioning regional surveillance mechanism. The Economic Review and Policy Dialogue (ERPD), a surveillance mechanism under the ASEAN+3 process, should be improved further in order to weaken the linkage of the CMIM with IMF programs.

On the other hand, there has been no consensus on coordinated regional exchange rate policy. However, intra-regional trade and investment has been expanding and Emerging Asia including China has been catching up to Asian NIEs (Chinese Taipei, Hong Kong, Korea, and Singapore) and Japan at a rapid pace. Consequently, intra-regional exchange rate stability has been more im-

portant for the economic growth and stability of East Asian economy. In addition, exchange rate regimes of the East Asian economies as a whole have become more flexible and will be more flexible, due to the economic growth and the development of financial system of these economies. Therefore, possible excessive volatilities and misalignments of the currencies of these economies should be reduced by regional exchange rate policy coordination.

Last year we saw a phrase of “international currency war” gathering attention. The currency markets in the world as well as in East Asia has continued to be unstable, due to the Global Financial Crisis triggered by the US subprime mortgage crisis and the European sovereign debt crisis. The recent exchange rate issues would be really one of the most important challenges we should address seriously.

This paper attempts to explore the effectiveness of the Asian Monetary Unit (AMU) as a means to minimize the misalignment of exchange rates, i.e. the deviation from their equilibrium rates and also their volatilities among the countries in East Asian region.

## II. AMU FOR EXCHANGE RATE POLICY COORDINATION

The AMU is a basket currency unit consisting of Asian currencies. This is an Asian version of the ECU (European Currency Unit) that consisted of European currencies and served as a predecessor of the Euro. It is also called an Asian Currency Unit (ACU), however this paper adheres to the name of the AMU hereafter.

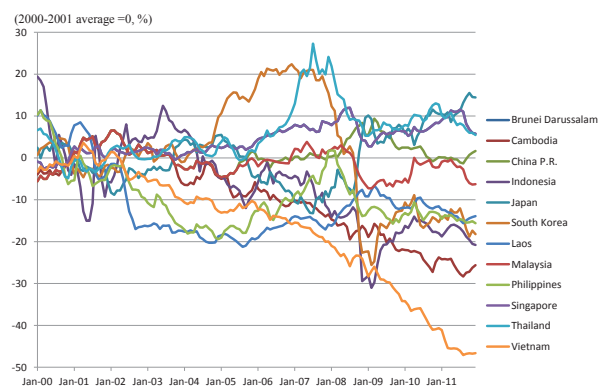
With Prof. Takatoshi Ito of the University of Tokyo as a leader, a group of professors, namely, Prof. Eiji Ogawa of Hitotubashi University and Associate Prof. Junko Shimizu of Senshu University, has been calculating and releasing the AMU. This is a basket currency unit consisting of 13 Asian currencies such as 3.08 Chinese Yuan, 1.96 Thai Baht, 26.58 Japanese Yen, 124.15 Korean Won, etc.<sup>1</sup>

Exchange rates of the AMU against the US dollar and the euro and its changes against its each component currency are shown on the website of the RIETI, with a monthly renewal of the data. This group of professors has proposed monitoring the AMU in the framework of a regional surveillance of Asia.

First of all, the AMU is very useful for monitoring the exchange rate developments of Asia currencies. Since the AMU is a currency unit with a weighted average of

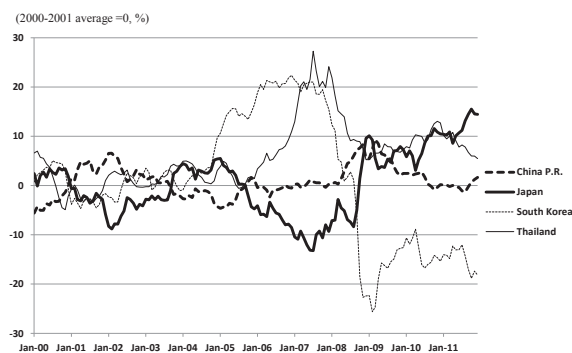
Asian currencies, by watching the exchange rate of each Asian currency against the AMU, you can see whether each of the basket currencies is appreciating or depreciating in Asia as a whole.

Chart 1 and Chart2 shows the deviations of the exchange rates of the major Asian currencies against the AMU from their average rates of 2000-2001 respectively. This is called the AMU Deviation Indicator (AMU DI). If the AMU DI rises for a certain currency, it means the currency is appreciating against the AMU, i.e. against the weighted average of the Asian currencies. Conversely, if the AMU DI of a currency falls, it shows the currency is depreciating against the average of the Asian currencies.



(Note) The AMU DIs are the percentage deviations of the exchange rates of Asian currencies against the AMU from their average rates in 2000-2001.

Chart 1. AMU Deviation Indicators (AMU DIs) for the ASEAN+3 member countries' currencies.



(Note) The AMU DIs are the percentage deviations of the exchange rates of Asian currencies against the AMU from their average rates in 2000-2001.

Chart 2. AMU Deviation Indicators (AMU DIs) for several Asian currencies.

Several facts are observed in these charts. First, it is clear that the yen tended to appreciate outstandingly among the major currencies since around 2007. On the other hand, the Korean won depreciated a great deal during the same period, only recovering some of the plunge

<sup>1</sup> 1AMU=0.0040 Brunei dollar + 6.2017 Cambodian riel + 3.0765 Chinese renminbi + 472.2701 Indonesian rupiah + 26.5817 Japanese yen + 124.1471 Korean won + 9.4017 Laos kip + 0.1729 Malaysia ringgit + 0.0208 Myanmar kyat + 0.9247 Philippine peso + 0.1165 Singapore dollar + 1.9639 Thai baht + 298.7892 Vietnamese dong  
For further information, please see the following URL.  
<http://www.rieti.go.jp/users/amu/en/>

in the recent years. In the last 3 years or so, the Chinese RMB continued to depreciate against other Asian currencies, although it appreciated slightly most recently.

By utilizing the AMU, we can observe the changes of the international competitiveness of the Asian countries in the region. There will be various arguments for what kind of exchange rate policies we can and should adopt from such observations, however at least it gives us an important suggestion for contemplating exchange rates policies in East Asia.

It is important for the present East Asia to monitor the developments of exchange rates in the region, because the Asian countries have been fairly integrated economically. The share of intra-regional trades in Asia (hereinafter referred to the 48 regional member countries of ADB) reached 59.3% in 2009 and therefore the stabilization of the exchange rates in the region has a significant meaning.

It is true that the share of intraregional trades of finished goods is currently much lower than that of the raw materials and intermediate goods which are used to produce exports goods shipped to outside the region such as the United States and Europe. However, as the economic growth continues in East Asia, it can be expected that the share of intraregional trades of finished goods will also rise. That will further enhance the importance of the stability of exchange rates within the region.

Secondly, since the AMU is a basket currency unit of Asian currencies, it provides useful information to judge whether the Asian currencies as a whole are appreciating or depreciating against the currencies of outside the region. Chart 3 shows that from 2000 to 2007 the Asian currencies continued to appreciate against the US dollar but to depreciate against the euro while since 2008 they have appreciated against both the US dollar and the euro. This fact provides useful information in forecasting the future of the global imbalances.



Chart 3. Exchange rates of the AMU against the US dollar and the euro

Thirdly, it is also useful to monitor the AMU when we try to stabilize the effective exchange rates of the East Asian countries. Effective exchange rates represent the index of exchange rates of a currency that are weighted by its trade weights against major trading partners' currency. In order to promote an economic growth and stability of a country, it is necessary to monitor the effective exchange rates, rather than just focusing on such bilateral exchange rates as against the dollar. Watching the values of the AMU against the currencies outside the region and also the value of each currency against the AMU is almost equivalent to monitoring the effective exchange rates of a currency.

### III. EQUILIBRIUM EXCHANGE RATES OF ASIAN CURRENCIES MAY CHANGE

East Asian countries are in a wide range of development phase and therefore it will be expected that the desirable levels of their exchange rates, i.e., the equilibrium exchange rates, will change as time passes. Therefore, if the monetary authorities try too hard to stabilize the exchange rates in the region, or give too much focus on lowering their volatility, it, despite their intentions, will expand the misalignments and destabilize the economy as well. This point should be fully taken into consideration.

In Europe of the 1980s and 90s, volatility of the exchange rates was restrained by the parity grid system that set the margin for bilateral exchange rate fluctuations among the currencies. This is not the situation, however, of present Asia where equilibrium exchange rates can move quickly and widely. Therefore, it will be a first step toward stability that we monitor the developments of the exchange rates of East Asian currencies by using the AMU.

Despite the appreciation of the AMU exchange rate against the US dollar, current account surpluses of the emerging Asian countries showed a substantial increase in the 2000s. This may prove the evidence that the equilibrium exchange rates of the Asian currencies against the dollar are rising as a whole in this period.

From the global point of view, exchange rate policies of the East Asian countries, which could prefer undervaluation rather than overvaluation of their currencies, are important in reducing global imbalances. It could be more important in the future, as the presence of East Asian economy is growing.

### IV. THE ASIAN MONETARY UNION SHOULD NOT BE A POLICY OPTION

Some people may see the introduction of the AMU as a harbinger of the Asian Monetary Union. However, the recent European sovereign debt showed that the premature monetary union will rather cause many problems unless there are ample economic and political cohesions among the union members. Even the more integrated

Europe experienced the hardships and it is clear that the present diversified Asia does not qualify the conditions for monetary union. Therefore, I do not recommend that we promote the introduction of the AMU in the context of the monetary union.

In October 2009, it was discovered that the fiscal data had been manipulated in Greece and the budget deficits were larger than those released. The EU and the IMF announced financial assistance to Greece in May 2010 for reducing the default risk on Greek sovereign debts. They announced assistance to Ireland in December 2011 and to Portugal in May 2011 for the same reason. Further deterioration of these crises and further crisis contagions to other countries cannot be ruled out now.

These crises should be attributed not only to the lack of fiscal discipline but also to the problems caused by the Economic and Monetary Union (EMU) itself. When a country without EMU membership faces the risk of default on its sovereign debts denominated in its own home currency, it can avoid default by buying back the debts, issuing its own currency as a last-resort measure. However, if an EMU member country faces the risk of default on its sovereign debts denominated in Euro, it can be difficult to avoid default by buying back the debts, issuing Euro as a last-resort measure. This is because issuing Euro for buying the debts is not easily permitted by the other member countries, as the right of issuing Euro is not retained independently by each member country but is retained collectively by all the member countries.

In addition, nominal GDP growth rates exceeded the interest rates in some countries having introduced Euro, leading to the economic and financial bubble. It accumulated the risks of financial turmoil and might have caused the lack of fiscal discipline.

Interest rates of the member countries converged, as the financial and capital markets ignored the differences of credit qualities among the member countries. On the other hand, the economic growth rates and price inflation rates in the lower income (productivity) countries were higher than those in the higher income (productivity) countries, because the former countries were catching up to the latter countries. Consequently, nominal GDP growth rates exceeded the interest rates in the lower income countries.

The fact that nominal GDP growth rates exceeded the interest rates induced the following phenomena in these countries.

It increased investment in tangible and financial assets, excessively stimulated the economy as a consequence. It was one of the factors which gave rise to the house price bubbles in these countries.

It also induced the lack of budget discipline, as it has a downward pressure on the ratios of government debt to nominal GDP even without budget deficit reductions.

The lack of fiscal discipline excessively stimulated the economic activities in these countries.

During the global financial crisis in 2007-09 triggered by the US subprime loan crisis, the house price bubble collapsed, the economy fell into recession, and the budget deficit and government debt swelled significantly in these countries.

Thus, the introduction of Euro can be seen as a cause of the recent European sovereign debt crisis. Therefore, the introduction of a single currency should not be a policy option in East Asia, not only in the short term but also in the long term.

## V. CONCLUSION

With respect to the monetary and financial cooperation in East Asia, the cooperation for crisis prevention advanced significantly and the CMIM was established, although there still remain several challenges to be tackled with. However, there is no consensus for exchange rate policy coordination. It should be recommended to monitor the development of the AMU in order to minimize the misalignment and volatility of the exchange rates in the Asian region. Its importance is all the more increasing in the light of the progress of economic integration in East Asia as well as growing presence of East Asian economy in the world.

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