



## **Regional Monetary Unit for Minimizing Misalignment and Volatility of Exchange Rates in the Region<sup>1</sup>**

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Recently we have been hearing more often the phrase “currency war.” The exchange rate issues are really one of the most important challenges we should address. Today, I would like to speak about the effectiveness of Regional Monetary Units in minimizing the misalignment of exchange rates, i.e. the deviation from their equilibrium rates as well as exchange rate volatility among APEC member economies, specifically in East Asia.

### **What is an AMU?**

Instead of the more general term “regional monetary unit,” I will use “Asian Monetary Unit,” or AMU, since we will focus on Asian exchange rates. The AMU is a basket currency unit consisting of Asian currencies. Some people like to call it an Asian Currency Unit, but I will use the term AMU. This is an Asian version of the ECU (European Currency Unit) that consisted of European currencies and served as a predecessor of the euro.

Prof. Takatoshi Ito of the University of Tokyo, Prof. Eiji Ogawa of Hitotubashi University, and Associate Prof. Junko Shimizu of Senshu University have been calculating the several kinds of AMUs. They are basket currency units consisting of

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<sup>1</sup> This paper is based on the author’s presentation at the Finance and Economics Working Group meeting in ABAC (APEC Business Advisory Council) on 9th November, 2010.

Asian currencies such as the Chinese Yuan, Indonesian Rupiah, Japanese Yen, Korean Won, and others, with their respective weights.<sup>2</sup>

Exchange rates of the AMU against the US dollar and the euro and its changes against each component currency are shown on the website of the Research Institute of Economy, Trade and Industry (RIETI), a research institute in Japan, and updated monthly. This group of professors has proposed monitoring the AMU under the framework of regional surveillance in Asia, and IIMA researchers are supporting that proposal.

### **The AMU is useful in surveillance of intra-regional exchange rates in Asia**

First of all, the AMU is very useful for monitoring exchange rate developments among Asian 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 currency is appreciating or depreciating within Asia as a whole.

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

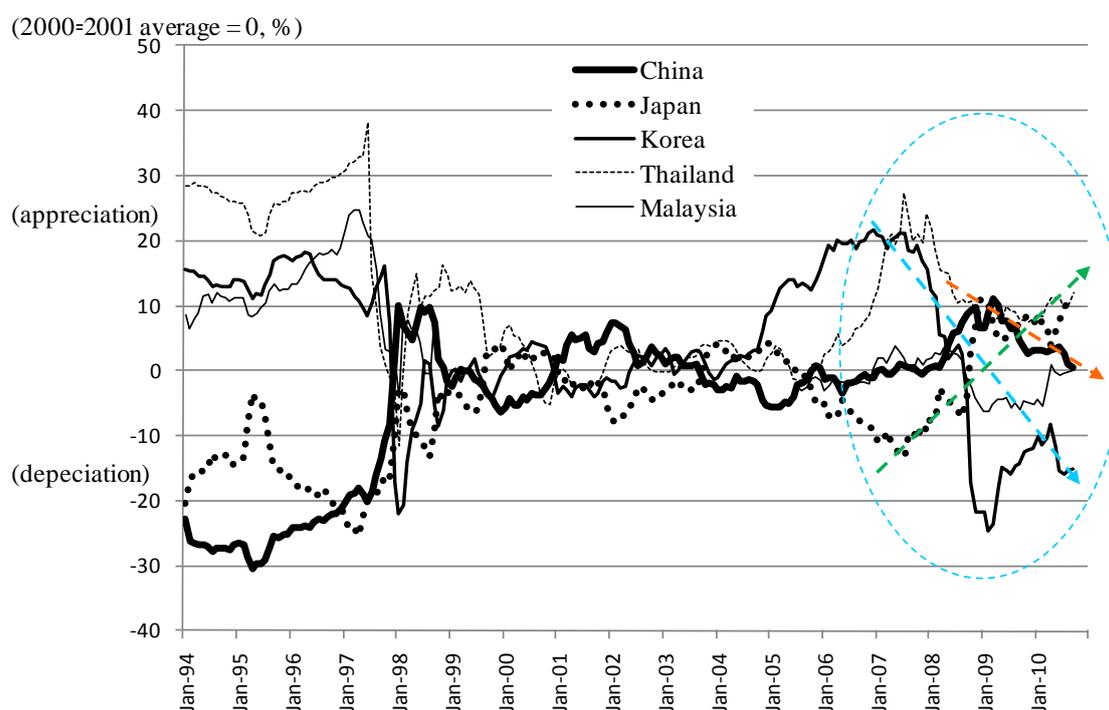
We can observe several facts from this chart. First, it is clear that the Japanese yen tended to appreciate significantly vis-a-vis major currencies since around 2007. On the other hand, the Korean won depreciated a great deal during the same period, only recovering some of the plunge in the past year. In the last 2 years or so, while the Chinese RMB remained relatively stable against the US dollar, it continued to depreciate against other Asian currencies. This reflects the fact that although many Asian currencies have substantially appreciated against the US dollar, the appreciation of the RMB has been limited. This trend is even accelerating these days.

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<sup>2</sup> 1AMU=0.0004 Brunei dollar + 3.6969 Cambodian riel + 2.2780 Chinese renminbi + 0.2635 Hong Kong dollar + 352.8940 Indonesian rupiah + 35.3024 Japanese yen + 186.1856 Korean won + 1.8342 Laos kip + 0.1459 Malaysia ringgit + 0.0031 Myanmar kyat + 1.4001 Philippine peso + 0.0675 Singapore dollar + 1.6196 Thai baht + 116.4928 Vietnamese dong

This is based on a weighting scheme reflecting the contributions to the Chiang Mai Initiative Multilateralization (CMIM). On the website of the Research Institute of Economy, Trade and Industry (RIETI), several kinds of AMUs based on other kinds of weighting schemes are released. For further information, please see the following URL. <http://www.rieti.go.jp/users/amu/en/index.html>

(Chart 1) AMU Deviation Indictors (AMU DIs) for several 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.

### Importance of the exchange rate stability among the intra-regional currencies

By utilizing the AMU, we can observe changes in price competitiveness among Asian economies. This is important, as the share of intra-regional trade in Asia today is more than 50 percent. There will be various arguments for what kind of exchange rate policies we can and should adopt from such observations, but at least it gives us an important suggestion, I believe, for contemplating exchange rates policies in Asia.

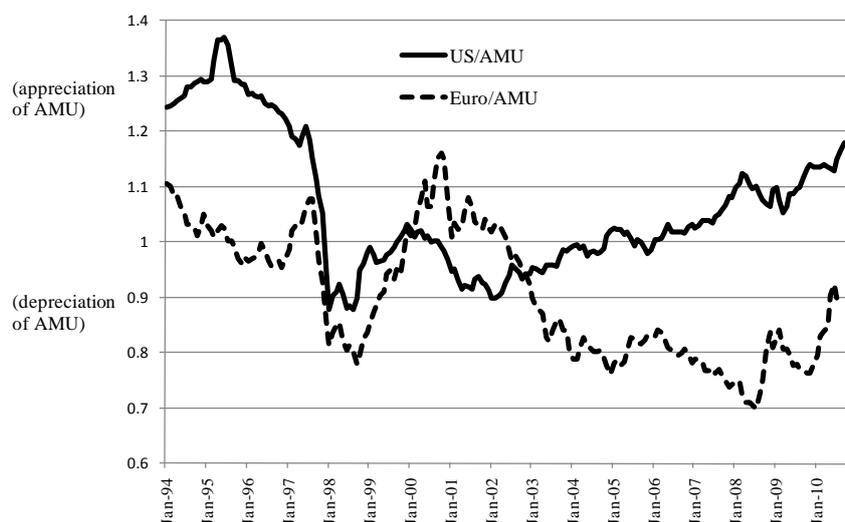
It is important for the present Asia to monitor the developments of exchange rates in the Asian region, because the Asian countries have been fairly integrated economically. The share of intra-regional trades in Asia (hereinafter referred to the 48 regional member countries of ADB) reached 56% in 2008 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. But as the economic growth continues in 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.

### **The AMU is useful for monitoring the exchange rates of Asian currencies against the extra-regional currencies**

Secondly, since the AMU is a basket currency unit of Asian currencies, it provides useful information to judge whether Asian currencies as a whole are appreciating or depreciating against currencies outside the region. Chart 2 shows that from 2000 to 2007 Asian currencies continued to appreciate against the US dollar, but depreciated 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 global imbalances.

(Chart2) 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 Asian countries. Effective exchange rates represent the index of exchange rates of a currency that are weighted by its trade volumes against major trading partners' currencies. 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 of the values of each currency against the AMU almost equals to monitoring the effective exchange rates of a currency.

### **Equilibrium exchange rates of Asian currencies may change along with the economic growth**

As you know, East Asian economies vary widely in terms of development stage and therefore it is expected that the desirable levels of their exchange rates, i.e., the equilibrium exchange rates, will change as time passes. Therefore, if we try hard to stabilize exchange rates in the region, or focus too much on reducing volatility, we could end up expanding the misalignments and destabilizing the economy as well. We have to take this risk fully into our consideration.

Let me give you an example. Despite the appreciation of the AMU exchange rate against the US dollar, current account surpluses of emerging Asian economies substantially increased in the last decade. This indicates that the equilibrium exchange rates of Asian currencies against the dollar were rising as a whole during this period.

In Europe during the 1980s and 90s, exchange rate volatility was restrained by the parity grid system that set the margin for bilateral exchange rate fluctuations among currencies. However, this is not suitable for Asia today, where equilibrium exchange rates can fluctuate widely over time.

#### **AMU is not connected to the currency/monetary union**

The AMU has another function. That is a function as a denomination of transactions. As the AMU is a basket currency unit of the Asian currencies, financial products denominated in AMU will provide a useful means for diversification of exchange risks and the weighted average interest rates in Asia. This means that if a person in high interest rate country raises funds in AMU, he will be able to spread the exchange risks and at the same time get the fund at a lower interest rate than in his country. On the other hand, people of the low interest rate country can invest their money at a higher interest rate. If these transactions expand, they will help facilitate the development of capital and financial markets in Asia.

Some people may see the introduction of the AMU as a harbinger of the Asian Monetary Union, but the recent financial and fiscal crisis in Europe 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. So I do not recommend that we promote the introduction of the AMU in relationship with the monetary union.

What I would like to emphasize is that monitoring developments of Asian currencies' exchange rates by using the AMU would be a first step in promoting stability. It is all the more important today in view of the prospects of a "currency war" and in light of growing Asian economic integration.

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