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Integration of the East Asian Economies and a Step by Step Approach towards a Currency Basket Regime

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Introduction

We have based the discussion in this paper on the assumption that East Asia will have a single regional currency in the long run. In reality, of course, we do not think that it will be materialized in the short run. However, the shocks, which the East Asian economies experienced during the Asian crisis, have resulted in highly intensified intra-regional discussions[1] on how to build financial cooperation in the region. The successful introduction of the euro is an encouraging precedent for a common currency in East Asia.

By taking a step by step approach, first to shift to an individual currency basket and then to move to a common currency basket, East Asian economies would be able to move towards a common currency.

The first question is whether East Asia forms an optimal currency area (OCA) or not. In the eyes of many practical observers, East Asia is more diversified than and politically not as mature as Europe. However, there was a research as to whether East Asia is as shock-symmetric as Europe and its conclusion was that this is indeed the case[2]. As we will see later in this article, trade integration in the region has deepened in the 90s, in spite of the setbacks brought on by the Asian crisis, and if the economic growth of the East Asian economies continues, this tendency will be strengthened. The East Asian economies could open their economies further and deepen the intra-regional economic relationship. FTAs should be arranged so as to speed up the process. Depending on these factors the situation could change dramatically in the future.

In this paper we have examined the trade relationship of each country with others inside and outside the region, and observed how they have changed until recently. This study shows that the economies of the region have a variety of patterns of foreign trade which makes it difficult to introduce a common currency basket in the first stage. A practical way would be for each economy to introduce individual currency baskets in the first stage and then to move on to a common currency basket in the region in the second stage. An individual basket is not the final target and we have to seek a common basket which may lead to a common currency.

By observing the external trade of the region, we have calculated the possible composition of a common currency basket. In order to enable the introduction of a common currency basket, the East Asian economies must make various preparations including the strengthening the financial cooperation.

Finally, we revised the idea of an Asian Currency Unit (ACU) and an Asia Clear. Although

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1 See Asian Policy Forum & Asian Development Bank Institute (2000) *Policy Recommendations For Preventing Another Capital Account Crisis*, The Emerging Markets Eminent Persons Group (2001) *EMEPG Seoul Report Rebuilding The International Financial Architecture*, and IIMA Newsletter No. 6 (2000) *Framework for Regional Monetary Stabilization in East Asia*.

2 See Goto (2002)

there have been various discussions about a common currency basket and financial cooperation among the academics and policy makers in the region, there has not been a strong echo from the practitioners. We think that it would be a useful step for the region to establish an ACU as a concrete common basket and an Asia Clear as a place to settle transactions denominated in such a basket currency. In the EU, the ECU was used to serve as kind of a prototype for the euro. If the East Asian economies could offer such a possibility to their private sectors for their funding or investment operations, a common basket would be easier to realize. The ACU may be at first a common basket with major currencies, namely the US dollar, the euro and the yen. It could later be transformed to a common basket with the yen, renminbi, won and other Asian currencies, depending on how convertible these currencies are and to what extent participants outside the economy could have access to those currencies.

1. *Analysis of co-relationship in East Asia*

In order to figure out the possibility of a currency basket in East Asia, it is essential to make an analysis of the trade relationships of the relevant economies.

We have analysed the trade relationships within the region and with countries outside.

Figure 1

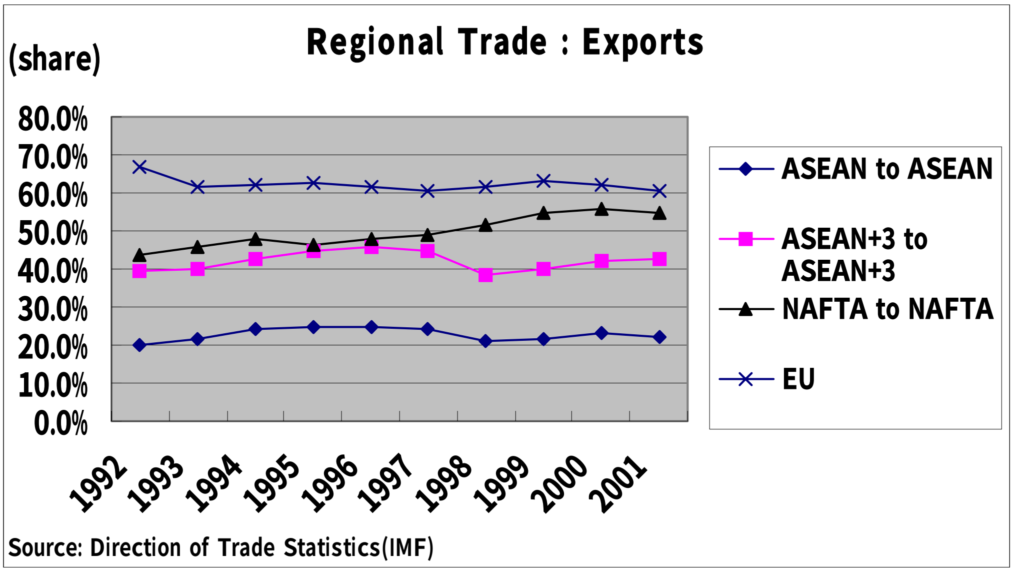


Figure 2

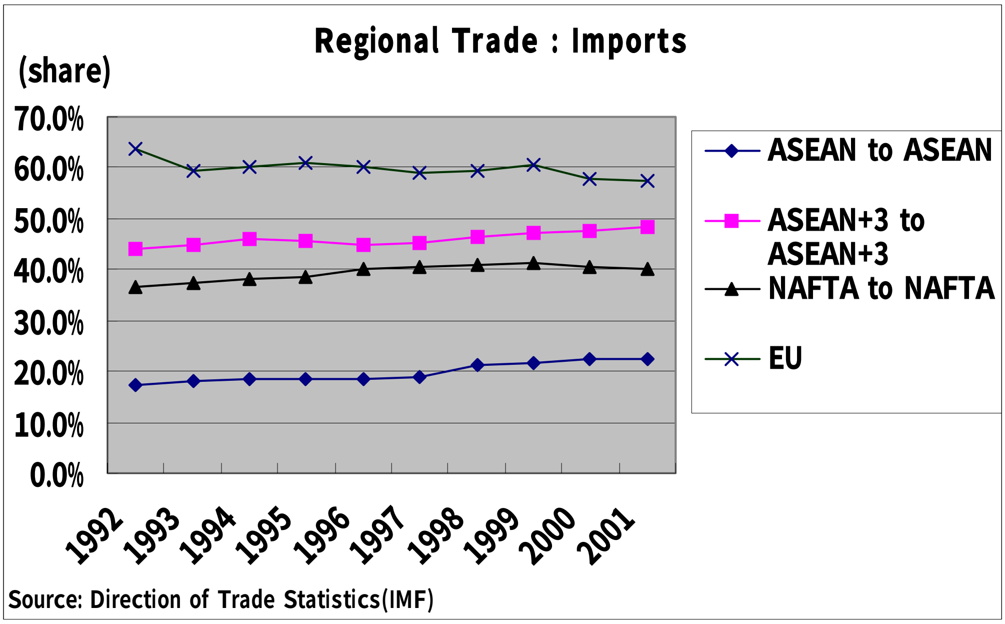


Figure 1 shows the ratio of the regional exports of the three economic regions, the EU, NAFTA and ASEAN+3. The reason for having based the analysis on these three groups is that these groups can form the three major currency areas in the world.

These three groups trade within their own regions and, at the same time, with each other. First, we calculated the ratio of exports and imports within each region to the total exports and imports of each region. We may assume that the higher this ratio is, the higher the intensity of the economic integration of the region, and the higher the possibility of creating a common currency regime. Figure 1 shows the ratio of exports among the regions and Figure 2 that of imports among them. Figure 1 shows that intra-regional exports are highest in the EU with NAFTA next. The EU's intra-regional export share has remained rather constant during the period. NAFTA's intra-regional share is higher than ASEAN+3 but it seems to have peaked in the last few years. The intra-regional exports of the ASEAN+3 fluctuated very much during the Asian crisis, because the economic conditions of the member countries deteriorated during the time, contributing to the abrupt halt of regional trade development. The economic situation of the region started to recover in 1999 and gradually returned to the level before the crisis. Figure 2 shows that regional imports in the EU are again the highest. The second highest is among ASEAN+3 and the ratio within NAFTA is the lowest among the three regions. One important finding is that the ratio of regional imports of ASEAN+3 has increased constantly during the period.

By observing these two figures, we can conclude that the trade intensity of the ASEAN+3 has increased in the last ten years in spite of the turbulent interruption during the Asian crisis.

Figure 3

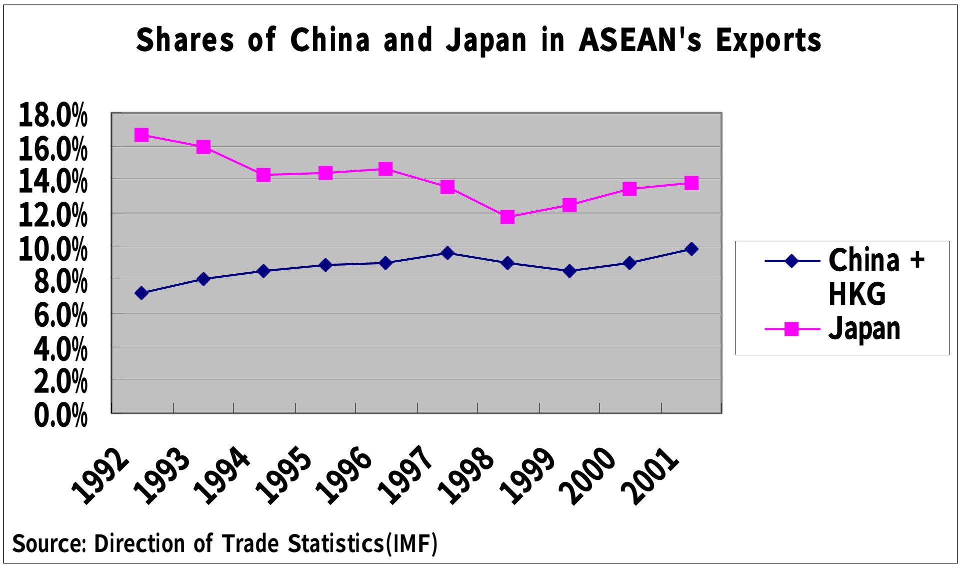
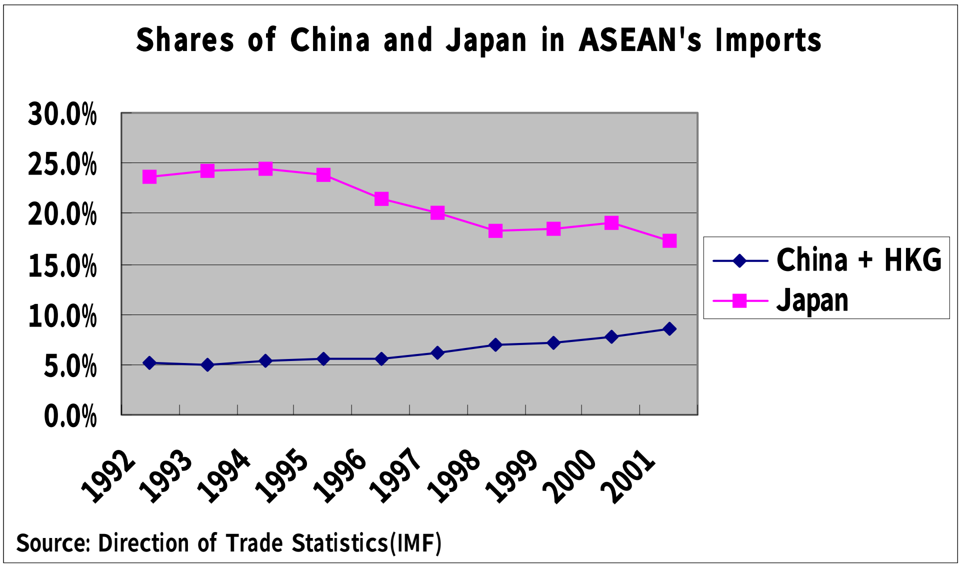


Figure 4



Figures 3 and 4 show the ratios of Chinese (Mainland and Hong Kong) and Japanese trade with the ASEAN countries. They show that it is essential to take the increasing role of China into account when we consider a currency basket in the ASEAN+3 countries.

Figure 3 shows that Japan’s share of ASEAN’s exports decreased in the first half of the 90s, though it started to recover after the Asian crisis. Japan increased its imports of manufactured products from the ASEAN countries recently and this contributed to the recovery of the Japanese share. China has increased its share of ASEAN’s exports and it may increase further if China’s economy grows even further in the coming years.

Figure 4 shows that Japan’s share of ASEAN’s total imports has decreased constantly during the period. The decline may be explained partly by the increasing production of Japanese companies in the ASEAN countries and partly by the increase of China’s share. The increasing oil bills of the ASEAN countries due to higher oil prices may also be a cause of the decline of Japan’s share.

Figure 5

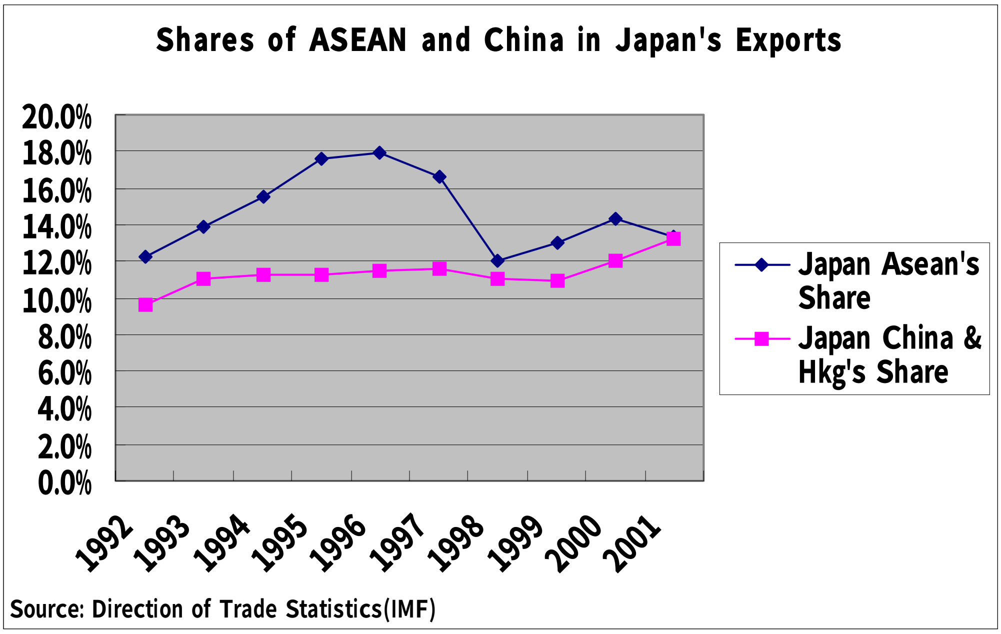
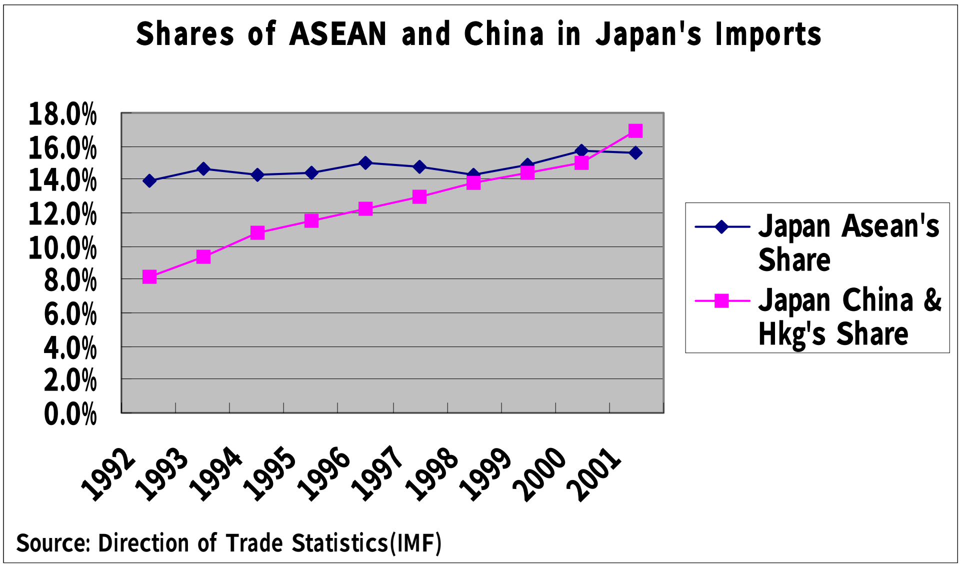


Figure 6



Figures 5 and 6 show the weight of ASEAN and China (Mainland and Hong Kong) in Japan's exports and imports.

ASEAN's share of Japan's exports showed a strong fluctuation before and during the Asian crisis. It grew to 18% of total exports before the crisis and then dropped to 12 % during the crisis before recovering slightly after the crisis. China's share remained around 11 % throughout the 90s. However, it increased to 13% in 2001, almost equal to that of the ASEAN.

ASEAN's share of Japan's imports remained rather constant at around 14% during the crisis. China's share had increased consistently in the 90s and it surpassed ASEAN in 2001 for the first time.

These two figures show that it is essential for Japan to regard China as an important player in considering the currency regime.

We also observed the ASEAN+2[3] exports and imports from the world. If we assume a currency basket pegged to the three major currencies of the world, then we need to study the trade pattern of ASEAN plus China and Korea.

3 In this paper, "ASEAN+2" means "ASEAN+3" minus Japan. It would make sense for our research to make a separate analysis on ASEAN+2 and Japan.

Figure 7

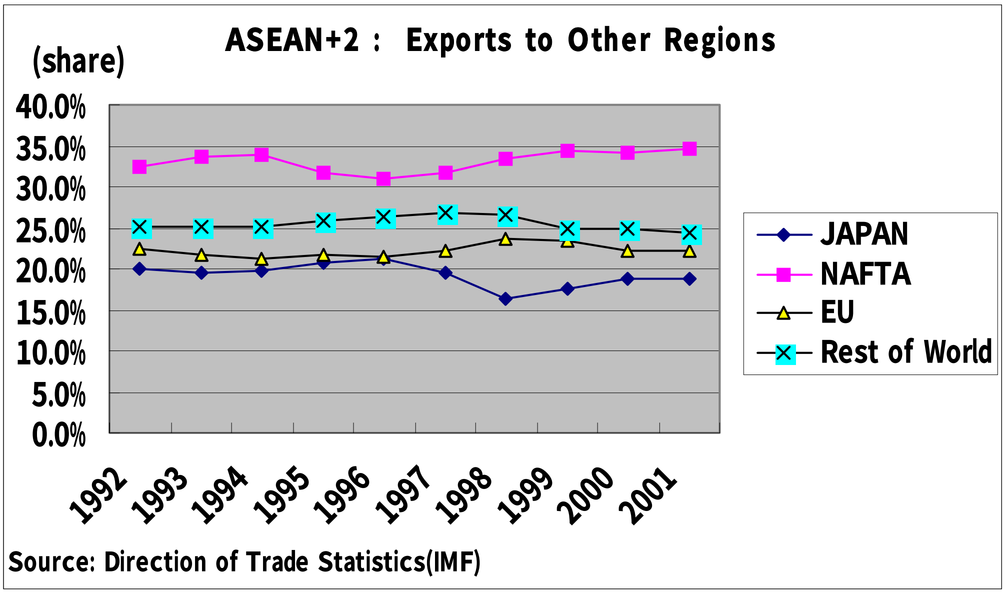


Figure 8

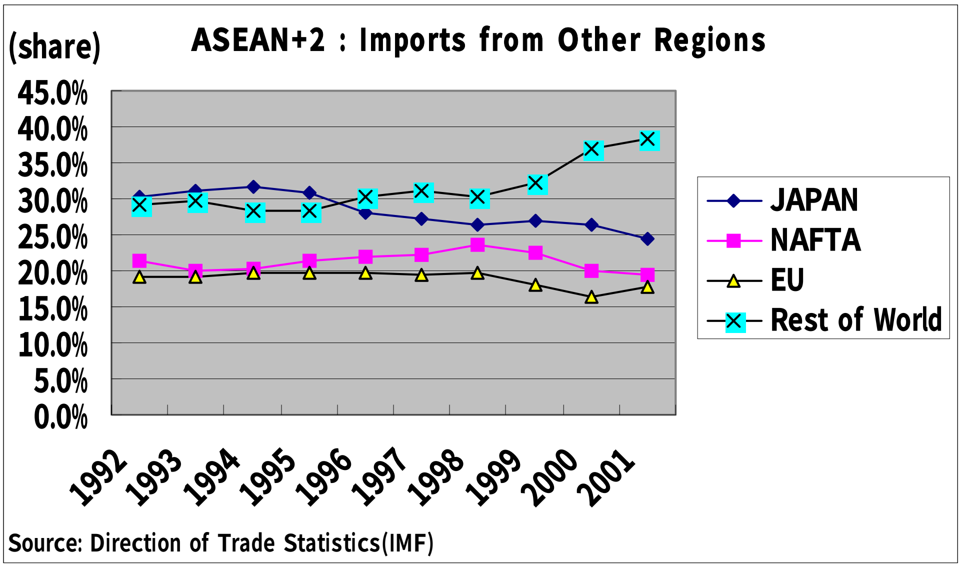


Figure 7 and 8 show the ratio of Japan, NAFTA and EU in the exports and the imports of ASEAN+2 (China and Korea). This observation will be useful when we consider the introduction of a currency basket in this region.

Figure 7 shows that NAFTA's share reached the highest level in the year 2001. A considerable part of this higher share of NAFTA is explained by the rapid growth of China's exports to the US in the year 2001 and stagnant world trade in the same year. The shares of the rest of the world and the EU remained rather constant at the level of 25% and 22% respectively during the period. Japan's share decreased during the Asian crisis and recovered to 18% recently.

Figure 8 shows imports of the ASEAN+2 from "the rest of the world" jumped up in the year 1999, and this is partly due to increasing oil imports of China from the Arab countries and Russia.

What can we conclude from the observations made above? We summarize our conclusions into four points.

(1) ASEAN+3 has increased its regional ties in trade during the period. The share of intra-regional trade in ASEAN+3 has increased, and will remain at almost the same level as in the EU and NAFTA. Regional financial cooperation will be more meaningful when the regional tie is stronger.

(2) More attention will be paid to the following points in considering future regional financial cooperation as well as the way in which to incorporate China.

   a. China has increased its importance for the ASEAN countries as an export destination, while Japan keeps its weight as an export destination in spite of its stagnant economy. And China increased its share and Japan decreased its weight as the source of imports for the ASEAN economies. Both China and ASEAN increased their importance as a source of imports for Japan. China increased its importance for Japan's exports and surpassed ASEAN as an import source.

   b. In this context, it makes sense for Japan to work with China to strengthen regional financial cooperation.

(3) NAFTA remains the most important destination of ASEAN+2 exports while the EU maintains its share. On the imports side of ASEAN+2, NAFTA and the EU keep almost a constant share, while the share of other regions increased significantly, because of the import of the oil in accordance with the economic recovery.

(4) Regional financial cooperation should reflect NAFTA's large weight for the ASEAN+2 and Japan, and the increasing importance of China in the region.

2. Reviewing the Exchange Rate System

(1) Moving on from the Dollar-Pegged System

Before the Asian currency crisis ASEAN+2 adopted various currency systems, such as a dollar-pegged currency board and a managed float. But even the managed float system was engineered so as to be most closely associated with the US dollar which means that except for Hong Kong's currency board, which was formally pegged to the dollar, the currency systems of ASEAN+2 had all been, in effect, dollar-pegged. The close association with the US dollar weakened momentarily with the 1997 Asian currency crisis but as the dust settled, the ties are said to have begun strengthening again.

There are various reasons why the ASEAN+2 countries, in effect, adopted the dollar-pegged system.

First of all, as we have seen in the previous chapter, intra-regional trade plays a weighty role for ASEAN+2, just as for NAFTA and the EU, and has been the locomotive of the region's economic growth. In order to increase trade between two countries, the exchange rate must be stable and there should not be uncertainties such as fluctuations in the collection of sales proceeds. ASEAN+2 can stabilize the exchange rates within the region and increase trade, which is indispensable for economic development, with all the economies in and out of the region effectively adopting a dollar-pegged system.

Second, most of the ASEAN+2 members have not developed deep and mature financial markets that can absorb exchange rate fluctuations. When hedging means are not in place, the effective way to enhance trade and investment is to peg the home currency to the dollar, which is the major international currency, in order to mitigate the uncertainties related to exchange rate fluctuations.

Third, since market confidence in the financial policies of these countries is not high, when the domestic situation is not stable such as when the inflation rate does not tend to decline, the dollar can serve as a nominal anchor if the currency is pegged to the dollar. This will damp down the expectation for inflation and hold down the price level.

Another reason why the currencies of ASEAN+2 have, in effect, been pegged to the dollar is because the US dollar has been used extensively for some time as the only international currency, and trade transactions have traditionally been dollar denominated.

But one of the factors that led to the Asian crisis is said to have been this de facto dollar-pegged system. Although a large proportion of exports from ASEAN + 2 are directed to NAFTA countries, the amount directed to Japan and the EU are just as substantial. During the higher-yen, lower-dollar phase between the Plaza Accord of 1985 and 1995, being dollar-pegged allowed the effective exchange rate of the ASEAN+2 currencies to depreciate which enhanced the development of those economies. But once the yen depreciated after 1995, their effective rates appreciated again and the international competitiveness of these economies decreased. In some of these economies this led to difficulties in acquiring foreign currencies and to a decrease in the credibility of their home currencies, and these trends are said in turn to have led to the Asian financial crisis.

(2) Regression Analysis of Asian Currencies on Three Major Currencies

Although there have been many reports that the Asian currencies started to be pegged again to the US dollars after the Asian crisis, Kawai [2002] recently reported to the contrary. We also made an analysis using the following formula.

$$\Delta \log AC = a_0 + a_1 \Delta \log USD + a_2 \Delta \log JPY + a_3 \Delta \log EUR + a_4 \Delta \log BP + \varepsilon$$

where, AC is the exchange rate of respective Asian currency to Swiss Franc, USD is the exchange rate of US dollar to Swiss Franc, JPY is the exchange rate of Japanese yen to Swiss Franc, EUR is the exchange rate of Euro to Swiss Franc, BP is the exchange rate of British Pound to Swiss Franc. Data used is daily basis, and ε is a residual term.

Subjects of our analysis are currencies of Indonesia, Korea, the Philippines, Singapore, Thailand, and Taiwan.

This is similar to the method that Ogawa [2001] and Kawai [2002] applied in their studies. We extended the calculation to the end of June of this year.

The result is summarized in appendix 1.

As reported in other studies, Asian currencies ceased to be de facto pegged to the dollar in 1998 after the Asian crisis. In the case of the Thai baht the correlation coefficient decreased during 1998, but it increased to around 80% after the crisis and remains at that level. This level is still lower than that of the pre-crisis level of 95%. The Singapore dollar seems to be pegged to a currency basket, which in the year 2001 consisted of 80% US dollars, 13% Japanese yen and 6% euro. However, the dollar portion seems to have declined in the first half of the year 2002.

The Korean won also became de facto dollar-pegged in 1999. However, in the year 2000 it began to be pegged more closely to a currency basket of the US dollar, the yen and the euro. The US dollar coefficient declined from 1 in 1999 to 0.72 in 2002.

The Indonesian rupiah has been closely pegged to the US dollar. However, its US dollar coefficient declined very recently.

Other currencies in the region, including the Malaysian ringgit and the Chinese renminbi, are pegged to the US dollar and are not in this table. US dollar coefficients of the two currencies are 1.

There seems to be a tendency for several currencies to show a lower US dollar coefficient recently, as Kawai described.

One possible explanation is that the US dollar weakened and showed more volatility against other major currencies in the first half of this year. In case of Korea, there seems to be more flexibility in its exchange rate policy and that more consideration has been paid to the Japanese yen[4].

Our observations show that the Asian economies seem to have become more flexible in their exchange rate policies in 2000 and 2001. During these two years NAFTA's share in ASEAN+2 exports increased and these countries became more dependent upon the US dollar area. We cannot tell why these countries seem to have adopted more flexible exchange rate system at such a time.

It will also be interesting to observe how these economies behave in the rest of the year 2002 and 2003. Very recently US stock prices came down to the level of the year 1998 and the recovery of the US economy seems to be more fragile. Will the Asian economies continue to be flexible in their exchange rate policy during such a period or will they return to de facto dollar-peg again? We anticipate that the Asian economies will be more flexible and that there will be a tendency to peg their currencies to a basket of major currencies. If NAFTA, especially the US, cannot absorb Asian exports so extensively as in the past, there will not be a strong reason to peg their currencies to the US dollar.

(3) Comparison of the Exchange Rate Systems

In the course of the debates on the exchange rate system that should be adopted by the East Asian economies, many economists in the US and at the IMF seem to have supported the idea of the two-corner solution. This is the idea that the only exchange rate system that can be sustained in an environment where there is free movement of capital is either a free-floating one or a hard-pegged one, such as a currency board or dollarization. A currency basket is perceived as a system somewhere in between.

The two-corner solution derives from the tri-lemma that a fixed exchange rate system, a completely free movement of capital and management of an independent financial policy can hardly be achieved simultaneously. According to this diagnosis, only a free-floating system or a hard-pegged system could be applied when capital can move completely freely.

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4 For example, when the yen depreciated against the dollar in January 2002, the deputy finance minister of Korea said that it was undesirable for Japan to intentionally let the yen weaken as it could cause uneasiness in the neighbouring markets and that it would be desirable for the won to reflect the yen's trend if the yen fell further. Oh Suk-tae, an economist at Citibank, Seoul, commented that the bigger concern would be inflation rather than maintaining the competitiveness, if the won devalues further. (Reuters News Service 2002.1.9)

If the free-floating system is adopted, then the independence of monetary policies can be maintained and there would be a good chance of the exchange rate adjusting the external imbalance. But on the other hand, because the exchange rate would be unstable, proceeds from trade transactions and direct investments would be unpredictable, and this could inhibit trade and investment growth. Foreign exchange rate fluctuation could also cause over-shooting or misalignment in the medium term, and they could be distracting factors for economic growth.

If the hard-pegged system is adopted, exchange rates would be stable and the credibility of the currency would be enhanced. But monetary policies would lose independence and the only major macroeconomic method of achieving domestic balance would be fiscal policy. For ASEAN+2 countries whose major trading partners include the United States, Japan and the EU, fluctuation of any of the major currencies against US dollar would bring a fluctuation of the effective rate under a pegged system. As we have seen in the case of the dollar-pegged system, this could result in an unstable trade balance.

On the other hand, under the currency basket system, the home currency would be pegged to a basket consisting of the major currencies and has the merit of being able to stabilize the effective rate as well as the nominal rate to some extent. This could help enhance both trade and direct investment, which would be a large benefit for ASEAN+2, where intra-trade and external trade as well as direct investment serve as the locomotive of economic growth. Later we will propose a basket consisting of three major currencies.

Many of the East Asian currencies still maintain a strong correlation with the US dollar in order to stabilize the exchange rate. If one of those countries leaves the dollar-pegged system and opts for the basket system, and the yen happens to gain against the dollar at the same time, the effective rate of that currency would rise relative to other currencies, which still keep the dollar-pegged system. This could weaken the international competitiveness of that economy, which is why countries are reluctant to move to the basket-pegged system even though it is preferable from the structural economic point of view. This dilemma shows the necessity for the East Asian economies to coordinate their action when selecting a exchange rate system and when shifting from a de-facto dollar peg to the basket system.

In Europe the euro was adopted in January 1999. If it develops further as an international currency comparable to the dollar, then there is a possibility of bipolarization between the US dollar and the euro in the international financial system. This means that the currencies in East Asia could be at the mercy of the European Central Bank and the Federal Reserve Board, if one of them puts priority on domestic matters or pursues benign neglect policy. The paper by Goto and Hamada (1995) points out the possibility that the creation of the EMU and the expansion of the dollar region could be damaging to the East Asian economy. There is also a possibility that reforms debated within international organizations would not benefit East Asia (Rhee [2002]).

In order to balance the possible US and EU led international financial order, it is critical to enhance regional macro-economic and financial cooperation as a step towards a single currency in East Asia in the future.

3. Adoption of the Currency Basket System and a Step by Step Approach

(1) Recommendation

We would like to recommend a two-step approach towards an Asian single currency. The first step is the adoption of an individual currency basket system by each country. The second step is to move on to a common basket.

The components of the currency baskets in the first step differ from economy to economy. Although they would all consist of the dollar, the yen and the euro, the weight of currencies would be determined by individual economies. As has been mentioned previously, Japan and the EU are important trading partners for ASEAN+2 along with the US (NAFTA). The currency baskets adopted by all ASEAN+2 members should not only reflect this fact but should be weighted according to the proportion of trade that each member conducts with these regions. Critics of currency baskets often mention the complications and difficulties in understanding the system, but adopting only three currencies would counter those criticisms. The countries could also avoid some political difficulties by not publicly announcing the shift to a currency basket.

The ACU and the Asia Clear could be established in the latter part of the first stage, about one year after the adoption of the individual basket system in each country.

The second stage is as follows. When the timing is ripe, the East Asian economies would introduce a common currency basket and peg their currencies to that basket or keep a band around that basket.

The common currency basket would reflect the ratio of regional trade. The ratio, which we calculated based on trade data, is shown in figure 9. Williamson [2000] calculated the components of a currency basket based on the weighted share of trade between the East Asian economies and the US, EU and Japan. We calculated it on the basis of the weighted shares of NAFTA, EU and Japan. Williamson then added the share of the rest of the world calculating from the weight of the GDP of the US, EU and Japan. At this calculation, we consider the rest of the world should be included in US dollar portion. The most important point of this calculation is the simpleness so that it could be easily understandable and manageable. Under present circumstance the composition of the common currency basket should be US dollar:6, euro:2, yen:2. Similar calculation would be made at a later stage when we specify the components of a common basket currency for East Asia (see Figure 9), and it should be done[5]

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[5] The calculation may include detailed analysis of the trade of “the rest of the world”. Can we include Mercosul as a dollar region or Euro region? How about oil producing countries, and so on?

very carefully.

Figure 9

ASEAN+2 : Exports to Other Regions(1999～2001)

	Japan	NAFTA	EU	Rest of World
1999	17.6%	34.3%	23.4%	24.8%
2000	18.7%	34.0%	22.3%	24.9%
2001	18.8%	34.7%	22.1%	24.5%
average	18%	34%	23%	25%
sdjusted value[1]	18%	59%	23%	−

ASEAN+2 : Imports from Other Regions(1999～2001)

	Japan	NAFTA	EU	Rest of World
1999	27.0%	22.6%	18.2%	32.2%
2000	26.5%	20.1%	16.5%	36.9%
2001	24.5%	19.4%	17.8%	38.2%
average	26%	21%	17%	36%
adjusted value[1]	26%	57%	17%	−

1 : Share of Rest of World is Added to NAFTA in calculation.

	Japan	NAFTA	EU
average of exports and imports	**22%**	**58%**	**20%**

	Yen	US dollar	Euro
share in ACU	**2**	**6**	**2**

The components of the basket may change depending on economic developments in the future. In the phase-one of the second stage, component currencies of the common basket would not include most currencies in East Asia, as their autonomy in foreign exchange rate policy and domestic monetary management policy could be eroded if these currencies are included. Let’s assume that the common basket includes not only the US dollar, the euro and the yen, but also Korean won and a situation occurs, where offshore participants want to sell the basket currency. When they cannot sell as much as they want due to the limited size of the basket currency market, then they may turn to the won market and then sell the won. It could make an impact on the foreign exchange and monetary policy of Korea to some extent[6]. Major currencies in East Asia could be included, however, at a later stage when such limitations are solved. For example, if the renminbi should be convertible in the future, then we may change part of the US dollar component to the renminbi. Or we may add the Korean won at the initial phase if the Korean authorities do not object to the idea.

(2) Adoption of the Individual Currency Basket

The individual currency basket to be adopted by an individual economy as the first step should be realistic and reflect the diverse economic and trade situations of each economy.

In designing a currency basket for each economy, it is useful to note the trading partners. Reflecting the exact weight of trade with various partners on a currency basket will contribute to

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6 During the Asian currency crisis, Singapore dollar was sometimes utilized as an alternative currency for other ASEAN currencies such as Indonesian rupiah and Malaysia ringgit as the liquidity of the foreign exchange market of those currencies were so limited especially in offshore market.

stabilizing the effective rate, which will result in trade balance stabilization. The appendix 2 and appendix 3 show that the trading partners of the economies in the region vary a great deal. And they also differ year-by-year reflecting the changing environment.

The graphs in appendix 2 show that the export destinations of ASEAN+2 vary very much from country to country. For example, the share of NAFTA in mainland China's exports increased substantially after 2000 while the share of NAFTA in Singapore's exports declined. The share of Brunei's exports to Japan is very large. Most of it is oil and priced in the US dollar.

The graphs in the appendix 3 show that the variety is also apparent in the imports side of the economies. It is interesting to see that the imports from the rest of the world jumped up in the years 2000 and 2001. The reason is the higher oil imports of the East Asian economies, especially mainland China.

With such a variety of patterns, it would be rather difficult to introduce a common currency basket in East Asia. Some currencies in East Asia still keep capital control and it might not be feasible for the common currency basket to include those currencies with such controls. Even Korea limits the availability of won to non-residents outside Korea and one billion won is the maximum that non-residents can raise presumably by borrowing from financial institutions. Still, the currency basket could include some currencies in the region with lesser capital control, such as the Singapore dollar and the Hong Kong dollar.

(3) Benefits of adopting an individual Currency Basket System

Then, what are the benefits for an economy to adopt an individual currency basket system?

First, it is relatively easy for economies in East Asia to take up an individual currency basket system.

An economy would not need to announce publicly that it was shifting to an individual basket regime. It could take up the individual currency basket system under the current framework of foreign exchange and monetary management policy. A managed float system, which some economies in East Asia took up, could make the individual currency basket system possible.

Also inflation targeting system is considered to be compatible with individual currency basket system.

Second, an economy could enjoy some of the merits of introducing a currency basket system without much difficulty under an individual currency basket system. It could start monitoring the movement of the effective exchange rate of the currency basket itself in addition to the exchange rate of the home currency against the component currencies. Also it is not a complex system by itself.

Third, it would stimulate more discussions within each economy as to the exchange rate regime and monetary management policy. In most East Asian economies, policy mix of foreign exchange and monetary policy has been a very important issue. To have an independent monetary authority or a central bank with a certain degree of accountability to the people would be necessary as well. In the course of the discussion on regime building, there could be a debate on the policy framework.

In this regard, we have to remember that the development of the economy and the financial system, and the tendency of inflation differ in each East Asian economy. A complete consensus has not been reached on exchange rate policy coordination or the application of a common currency system. When capital account transactions are liberalized and a common basket system is adopted in one of the economies in the future, its independence of financial policy would be lost instantly. Economies could depend only on fiscal policy as a major macroeconomic method to adjust their domestic economy. Hence this system could be a very difficult one for economies in the region to accept. This is why it would be wiser for the East Asian region to be very flexible in adopting a currency basket. The best choice, and certainly the most practical, would be to adopt the individual currency basket system with a certain degree of independence in monetary policy.

(4) Benefits of adopting a common Currency Basket System

After an individual currency basket is adopted by the individual economies, exchange rate will be stabilized with the individual baskets converging. There will be the environment to move on to the second step of adopting a common basket currency.

Following benefits can be pointed out in adopting the common currency basket system.

First, when each currency of ASEAN+2 pegs to the common currency basket, the exchange rates within the region would stabilize, and increase of trade and investment flows to the region could be expected.

Second, determining the components of the basket as the dollar, the yen and the euro, and their weights by trade shares would mean that the common currency basket would be close to the effective exchange rate of the ASEAN+2 currencies. By pegging to this basket, the currencies of the region could stabilize their effective exchange rates even when the exchange rates among the three currencies fluctuate. The arrangement would lessen the impact of volatility and would limit its effect on trade balances to the minimum. This is a huge advantage over pegging solely to the dollar.

Third, moving from the dollar-pegged system to the currency basket would increase volatility against the dollar but the volatility against the yen and the euro will decrease. Since ASEAN+2 countries enjoy extensive trade not only with NAFTA but also with Japan and the EU, the adoption of the common currency basket would, as a whole, be likely to increase inter-regional trade. Along with the US, Japan and the EU are also significant sources of direct investment. Stabilizing the exchange rates against the yen and the euro would also increase the flow of direct investment from these regions which is crucial to economic development.

Fourth, although the export destinations of ASEAN+2 vary extensively, there is competition in the export markets. Foreign exchange rate movements could affect the competitiveness of each country and hence export competition. But if the regional currencies peg to a common basket, the exchange rates among those currencies would be stable even when the currencies outside the region fluctuate. This would prevent the occurrence of competitive devaluation and bring more stability to the regional currency structure.

(5) Cluster Approach

We have so far discussed one way of adopting a common currency in Asia by first shifting to a currency basket system then developing it into a single currency. There is another approach which also moves step by step, but begins by different clusters adopting a common currency, then expanding and unifying those clusters so as to have one regional currency. (Kee Jin Ngiam and Hzel Yuen〔2001〕).

The authors recommend this step by step approach because the Asian countries differ in their economic situation, and judging from Europe's EMS experience, it is necessary to be extra cautious of speculative movements towards currency unification. So a gradual approach is preferable to a big bang.

Clusters would be determined by taking various factors into account such as the macro economic shock symmetry, closeness of the region, and social and cultural adaptability. Each cluster would fix the exchange rates within the cluster and determine a common foreign exchange policy. In other words, the initial policy concentration would be on unity within the clusters. When adequate unity is achieved within a cluster it would be possible to expand it. Once the clusters began to unify it would be possible to contemplate the creation of a common currency. The advocates of this approach recommend the creation of an AMF in order to support the continuity of clusters. They envisage three clusters; an East-Asia bloc of Brunei, Singapore and Malaysia, a Far East Asia bloc of Japan and Korea and a pan-Chinese bloc of Taiwan and Hong Kong.

We agree with this recommendation as far as taking a step by step approach and contemplating the creation of an AMF in the process of unifying the currencies. Using clusters to realize a common currency is a possibility, but we believe a step by step approach using the currency baskets is more appropriate.

Compared to Europe, East Asia, as a region, has not developed its thinking towards a common currency. There are doubts as to whether the countries in the region would accept clusters. But leaving that on one side, we believe that adopting clusters would have the counter effect of dividing the region instead of unifying it. At the current stage, most countries place a high value on exchange rate stabilization but do not regard a single currency as realistic. It is better to place the emphasis on controlling intra- and inter-regional exchange rate fluctuations by adopting the currency basket system and policy coordination, than to seek to nurture the necessary environment for a common currency in the future.

If the cluster approach succeeds, the clusters could form the core of the developments towards a common currency. But we believe that instead of dividing into various clusters at the outset, it is better to contemplate creating, so to speak, an advance party at the second stage after the currency basket system had been adopted and for that group to lead the way towards a common currency.

4. ACU＆Asia Clear

Finally we propose the idea of the Asian Currency Unit and the Asia Clear[7]. Although there have been various discussions about a common currency basket and financial cooperation among the academics in the region, there has not been a strong echo from the policy makers and the practitioners in the private sectors of the region. How can we create an environment where the private sectors will participate in this discussion and also contribute to the development?

We think that it would be extremely useful for the region to establish an ACU as a common basket currency artificially created and an Asia Clear as a place to settle such a basket currency.

In the EU the ECU served as a kind of prototype for the euro. In the late 1970s the ECU started to be traded as a currency in markets, and its money and bond markets were gradually established. The private sector "bundled" a market ECU based on the basket component and used it for deposit placements, fund raisings and settlements of businesses. The East Asian economies could try a similar course from the early stage of the cooperation.

If the East Asian economies could offer the ACU with such a structure to their private sectors for their investment or fund raising, a common basket would become a more attractive possibility for the private sectors in the region.

The ECU served four purposes in Europe. The first function was the numeraire of the Exchange Rate Mechanism. The second was a divergence indicator in the ERM. The third was the unit of foreign exchange intervention and credit mechanism. The fourth was the unit of settlement among the monetary authorities of the EC countries.

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[7] In early 1990s, Asian Development Bank advocated the idea of Dragon Bond Market and first promulgated the idea of Asiaclear. It seems that Hong Kong developed the idea by establishing the bilateral linkages of Central Security Depositories between Hong Kong and the counter party in the region. Here we call our idea as Asia Clear instead of Asiaclear, in order to differentiate between the two concepts.

The ECU was, however, used separately from the official purposes mentioned above. The private ECU was actually made synthetically in the market by market makers. This process was called “bundling”. And it was used for various purposes, especially for financial transactions. One important development for this process was that the member economies of the EC started to recognize the ECU as a legitimate foreign currency. Italy recognized the ECU as a foreign currency in 1979 and Germany in 1987. The private market makers, in the meantime, developed the money and bond markets denominated in ECU.

When we establish the ACU in Asia, it may offer a viable business chances for the corporates and financial institutions in the region.

One possibility is for the ACU to become a hedging instrument for trade. As the ACU would be a currency basket of the US dollar, the euro and the yen, it would fluctuate in the middle of these three currencies. As we have seen in this paper, the East Asian economies tend to adjust their currencies by following a mixture of these three currencies. Private exporters or importers in the region might hedge their exposures by using foreign exchange forward transactions of the ACU. Because the ACU would be a composite of the three major currencies, market makers could produce long-term forward exchange rates against each home currency rather easily and economically. This might offer better chances for the private sectors in countries where long-term forward rates of the home currency are difficult to obtain.

Another advantage of the ACU is that it might offer good possibilities for funding. Most of the Asian economies have been trying to develop their long-term bond markets especially after the Asian currency crisis. However, the market sizes are still limited. In the ACU market it would be possible for the issuers in these countries to get long-term funds with less foreign currency risks. For investors in the region, which has been growing steadily and will expand further, the ACU might offer better yield and less foreign currency fluctuations.

The ACU would at first be a common basket with major currencies like the US dollar, the euro and the yen. The composition should be US dollar: 6, euro: 2, and yen: 2. The reason for this calculation is shown in figure 9. Then later, it might be transformed into a common basket with yen, renminbi, won and other Asian currencies, depending on how extensively these currencies would be convertible and could be used internationally. The ECU changed its component several times in the 1970s and 1980s reflecting the change of the membership of the EMS. It would certainly be possible to find a smooth transformation of the ACU.

The establishment of the ACU and the Asia Clear should come at the latter part of the first stage, after the East Asian economies introduce or decide to introduce the individual currency basket system. The member economies of the ASEAN+3 would recognize the ACU as a legitimate foreign currency and accept it as a currency for these transactions. If the ACU is designed in parallel with the preparation for the second stage when the common currency basket is introduced, there might be synergies of the ACU and the common currency basket.

The central bank would not be necessary for the ACU for the time being because the size of transactions would not be large and would not cause systemic risk by themselves.

The Asia Clear, which will be a place to settle the ACU transactions, would be established and may be situated in Singapore or Hong Kong just as the ECU settlement took place in Brussels. Existing organization such as CMU (Central Money-markets Unit) in Hong Kong could be utilized. The organization may be a public institution, as the operation would not be a profitable business in the initial phase, and the financial support from the member economies of ASEAN+3 could be expected.

To create a momentum for the use of the ACU at this stage is very important. Properly designed ACU could trigger its wider use, especially when an institution with a higher credit rating such as the Asian Development Bank issues a triple-A bond denominated in the ACU, with either Singapore or Hong Kong as the settlement organization, lists it on SGX, Hong Kong Exchange and Tokyo Stock Exchange simultaneously. The ACU could attract investors in the region in this way.

5. Conclusion

We have argued the case for East Asian economies to adopt a currency basket regime and recommended a concrete process. The currency basket system should have the effect of enhancing intra and inter-regional trade and direct investment, which serve as the locomotive of economic development for the region. A step by step approach should be applied to proceed towards a common currency.

The composition of the basket should initially be the US dollar, the yen and the euro, and their weights should reflect trade shares of NAFTA, Japan and the EU.

Taking into account the different stages of development in economic and financial systems of the East Asian economies, we recommend that each economy adopt its own individual currency basket as the first step in the process. If the economies have the will to adopt their own currency basket this would not be difficult to pursue. The economies would then coordinate their policies while using the basket system to contain exchange rate volatility with currencies in and outside of the region. At the same time, the foundation for a common currency could be built gradually by enhancing the use of the ACU and the Asia Clear. They would also serve the purpose of increasing the awareness towards a common Asian currency in the private sector.

Once exchange rate stability is maintained and the individual baskets converge, there will be the environment to move on to the second step of adopting a common basket currency. At that stage, we begin to foresee the possibility of creating a common currency in Asia.

Last of all, although this has not been mentioned in this paper, foreign exchange policy coordination is not possible without liquidity support at a time of currency crisis. The Chiang Mai Initiative which is underway should be developed further and be systemized in the future so as to realize foreign reserve pooling system. There is also an urgent need for the establishment of a more efficient regional surveillance mechanism and an independent secretariat to carry out the surveillance in order to make the liquidity framework more viable. Strengthening the financial system in East Asian economies and developing the capital markets are also critical for the unification of the regional financial system[8].

[8] Comments on regional financial cooperation are compiled in the Policy Recommendation of the ASEM：KOBE RESEARCH PROJECT (February 2002). http://www.mof.go.jp/jouhou/kokkin/tyousa/kobe.htm