The Parallel Currency Approach to Asian Monetary Integration[1]
Barry Eichengreen

Since the crisis of 1997-8, there has been a proliferation of proposals for fostering Asian monetary integration. Asian countries, it is suggested, should collectively peg their currencies to the dollar, the yen, or a dollar-yen-euro basket or establish a multilateral currency grid like the European Monetary System. The resulting exchange rate stability would promote intra-regional trade, simplify investment planning, and encourage cross-border participation in local bond markets. Experience with establishing and maintaining a system of stable exchange rates would help to ready the region for the introduction of a single currency. Asia, in this view, should emulate Europe's approach to regional monetary integration.

But, along with the attractions of the European example, there are also dangers. Defending a system of currency pegs in the presence of high capital mobility requires the close convergence of policies and the maintenance of confidence.[2] If either precondition is disturbed, a country will require extensive financial support in order to defend its peg or to undertake an orderly realignment. In practice, Asian countries possess neither the willingness to subordinate other policies to these imperatives nor the solidarity needed to offer extensive financial supports.[3] Absent an appetite for political integration, there is little readiness to create a regional central bank like the European Central Bank, since there is no counterpart to the European Parliament to hold it accountable for its actions. Hence there is little prospect of early monetary union to tie down expectations. A system of Asian currency pegs would consequently be fragile and crisis prone. As a road to monetary unification it would be a dead end.

Better would be for governments to create an Asian Currency Unit, or ACU, constituted as a weighted average of Asian currencies, and allow it to circulate alongside their national currencies.[4] This would have three advantages. First, it would not be necessary to stabilize exchange rates between the currencies comprising the basket; hence, fragility would be less. Second, the parallel currency would be more stable than any one national currency in terms of aggregate Asian production and exports; it would thus be a vehicle for encouraging intra-regional trade and investment. Third, the decision to move to a single currency could be driven by economics rather than politics. Only when a critical mass of producers, exporters and investors had adopted the parallel currency would it be clear that Asian economies were ready for monetary unification.

1. Lessons from Europe

This approach resembles another European precedent: efforts starting in the 1970s to use the European Currency Unit, or ECU, as a steppingstone to monetary unification.[5] The ECU was defined in 1974 as a basket of currencies of the members of the European Community (EC) for purposes of EC accounting. It was adopted in 1975 as the unit of account for the European Development Fund and then for the European Investment Bank and the EC budget. With the establishment of the European Monetary System (EMS) in 1979, participating countries were supposed to stabilize their exchange rates against the ECU basket. Currency positions acquired as the result of interventions were similarly to be settled in ECU.

But in practice the ECU never acquired a significant role in the business of the European Community and the EMS in particular. Although credits within the EMS were

denominated in ECU, they were extended in national currencies. Rather than actually basing EMS parities on an ECU central rate, that central rate was only used to compute bilateral rates, which became the focus for central banks and the markets.

If the ECU was to gain popularity, this would have to be because importers, exporters and financial market participants took it up. There was some movement in this direction. European banks began dealing in ECUs in order to handle the deposits of EC institutions and governments. In turn this facilitated the growth of interbank and other private ECU deposits. Banks seeing this as a promising line of business invested in a multilateral clearing system for ECU deposits. With the spread of ECU deposits, it became more attractive to issue ECU bonds.[6] Medium-term ECU notes appeared at the beginning of 1988. There also developed a market in ECU commercial paper.

But, notwithstanding these positive signs, the vast majority of Europe's transactions continued to be conducted in national currencies. The ECU's unit of account role was limited to the financial accounts of EC institutions and a few European corporations engaging in extensive cross-border business. In the 1990s only about one per cent of trade within the Community was invoiced in ECUs. At their height, ECU-denominated claims still amounted to less than 10 percent of the non-dollar foreign currency claims of banks reporting to the Bank for International Settlements. ECU bonds never accounted for much more than 20 percent of all non-dollar Eurobonds. Medium-term ECU notes accounted for barely 15 percent of the non-U.S. dollar market in such notes, ECU commercial paper for only about 10 percent of all euro-commercial paper. As the European Community grew more integrated, it was at least conceivable that Europe's

residents would have conducted more of their transactions in ECUs. The question is why this was not the case.

One answer is that it was unattractive for any one resident to move in this direction in the absence of evidence that others were prepared to do likewise. It was unattractive for individual European producers to set prices in ECU unless other European producers did so, limiting transactions costs. It was unattractive for individual financial institutions to float bonds denominated in ECU unless other financial institutions did likewise, creating the critical mass needed for the creation of a deep and liquid secondary market. It was unattractive to quote product prices in ECU so long as wages and other domestically-sourced inputs were priced in the national currency. Money is characterized by network externalities; it pays to use the same medium of exchange and unit of account as other market participants (Kevin Dowd and David Greenaway 1993). As with any network, there is a tendency for the status quo to be locked in. Governments can attempt to make the parallel currency more attractive by giving it legal tender status alongside the national currency. But the incentive to continue relying on the national currency will remain strong. Efforts to promote use of the parallel currency may have to overcome considerable historical inertia.

Another obstacle was the international role of the dollar. A substantial fraction of European countries' commercial and financial transactions with one other and with the rest of the world were invoiced and settled in dollars. As a currency in which to denominate financial instruments, the dollar continued to dominate the Eurobond market. The dollar thus provided many of the same advantages as a parallel European currency and in addition had the advantage of incumbency. In Asia, where it is also widely used in

international transactions, one can similarly question whether an ACU could out-compete the dollar.

2. Mechanics

Building on experience with the ECU, the ACU would be defined as a fixed number of units of each constituent currency – including, for example, the 10 ASEAN currencies plus the Japanese yen, Chinese yuan, and South Korean won. While the quantity of each component currency would remain fixed, its contribution to the value of the ACU thus would vary with its exchange rate; as currencies depreciated, their weight in the ACU would decline. The composition of the basket might be revised periodically to reflect the changing weights of the participating countries. Weights could be determined by the share of the country in regional GDP or exports.

Official ACUs would be created in exchange for swaps of a fraction of the international reserves of participating central banks. The amount of these swaps could change periodically to reflect changes in the quantity and value of those gold and dollar reserves. Participating central banks would agree to accept ACUs in transactions among themselves. Governments would agree to experiment with the issuance of ACU-denominated bonds.

The existence of these benchmarks would make it more attractive for financial and nonfinancial firms to issue and accept ACU-denominated liabilities and assets, subject to standard prudential regulations. Bond or deposit documentation would specify that when the composition of the official ACU basket changed, the value of private ACU assets and liabilities would change accordingly. The value of the private ACU would be

guaranteed by the commitment of the issuer (such as a bank accepting a deposit) to convert the instrument into its underlying components. Arbitrage would in any case prevent significant divergences from opening up between the value of the private ACU and the constituent currencies.

3. Dangers

By design, this parallel-currency scheme is intended to encourage banks, firms and households to take on ACU-denominated claims. But if some end up with more ACU liabilities than assets, they will then be subject to currency-mismatch problems and heightened financial fragility. If banks match their ACU liabilities and loans, the currency risk will simply be transferred to their corporate customers, saddling the banking system with heightened credit risk. Liquidity risk can also result if depositors are aware of these vulnerabilities and run on the banking system.

These risks can be contained by tightening prudential supervision and regulation to ensure that banks hold sufficient liquid ACU assets and constituent foreign currency assets to avert a run. The central bank should hold additional foreign reserves in ACU or constituent foreign currencies in order to be able to replenish the ACU reserves of the banking system. The authorities should consider a managed float to encourage banks and firms to hedge their ACU exposures.

But forcing banks and governments to hold additional foreign currency reserves would have a significant opportunity cost. Limiting their ability to incur liabilities in ACU would prevent them from issuing additional ACU-denominated bonds and thereby enhancing the liquidity of secondary markets. Forcing banks to hold additional foreign

currency reserves would limit the growth of intermediation. And, given the gap between the promulgation and enforcement of prudential regulations, it is not clear that tighter supervision would ultimately succeed in containing the risk to stability. The conclusion of much of the literature is that partially dollarized economies should urgently move forward to full dollarization or back toward a predominantly domestic currency basis.[7] This suggests than an extended period when the parallel currency circulates alongside national currencies could be one of heightened financial fragility.

Moreover, limiting the freedom of banks to accept ACU deposits in excess of their ability to make ACU loans and otherwise restraining the growth of transactions in ACU claims would slow the spread of the parallel currency. Inevitably, then, the parallel-currency route to monetary integration could be a lengthy one.

In Europe, there was also discussion of whether establishing a parallel currency would threaten price stability. The worry was that as commercial banks created claims in ECU, there would be more money and credit chasing the same goods and services. Here subsequent experience with foreign-currency-denominated assets and liabilities has refined discussion of these issues. Banks in Asian countries can already access foreign funding subject to the standard prudential regulations. They can make foreign currency denominated loans subject to those same regulatory provisions. ACU transactions would be no different from the other foreign currency transactions of the banking system in this regard. There is no intrinsic difference between a Thai bank accepting dollar deposits and making dollar loans and it accepting ACU deposits and making ACU loans. The literature on partially dollarized banking systems does not suggest that these jeopardize price stability. (See Carmen Reinhart, Kenneth Rogoff and Miguel Savastano 2003.) If the

central bank uses its standard instruments to limit the growth of aggregate bank assets and liabilities, there is no reason why development of the parallel currency should threaten price stability.

4. Pegs and Dollars

There exist at least two motivations for monetary cooperation in Asia. One is to limit exchange rate variability within the region in order to promote intra-regional trade and investment. The other, manifest in calls for a common basket peg against the dollar and the euro, is to buttress exchange rate stability vis-à-vis the rest of the world. But, as John Williamson (2005) notes, there is no incompatibility between the two objectives. Nothing prevents a group of countries adopting a basket of outside currencies as their peg from also basing a parallel regional currency on a basket of their own currencies.

But not only is the rationale for the two strategies is different, the effects are different as well. Pegging Asian currencies to the dollar, the euro or a basket of which they comprise part would heighten the attractions of these outside currencies for transactions within Asia. In contrast, allowing Asian currencies to float against the euro and the dollar would make it more attractive to transact in a stable regional composite.

To gain widespread use, the ACU must out-compete not just existing Asian currencies but also the dollar, which is widely used for cross-border transactions in the region, as noted above. This observation has led authors like Robert Mundell (2002) to advocate that Asian countries should adopt the dollar as a “common parallel currency” – that is, as an officially-recognized currency for use in invoicing and settling trade. But, as intra-Asian trade continues to grow, invoicing and settling in a common Asian currency

will become more attractive relative to invoicing and settling in dollars. In any case, Asian countries are reluctant to give the currency of an outside power legal tender status for domestic transactions. As a result, the residents of an Asian country must still convert dollars into the national currency when making tax payments or engaging in other domestic transactions requiring a unit with legal tender status. Under the parallel currency approach, Asian governments would give the ACU full legal tender status for domestic use, which would make it more attractive. There are also reasons to think that the dollar will grow more volatile relative to Asian currencies as Asian countries relax and abandon their pegs to the greenback in the interest of greater flexibility and to the extent that America's twin deficits lead to a weaker dollar. This will make using ACUs rather than dollars more attractive. Finally, the hold of network externalities and therefore the advantages of incumbency may be less in our financially-sophisticated age than was the case in the past. Given the proliferation of instruments in financial markets and the decline in bid-ask spreads, it is easier for market participants to contemplate alternatives.

5. Conclusion

This paper considered the parallel currency approach to Asian monetary integration. The appeal of this approach is that the pace of progress would be dictated by economics rather than politics. This is consistent with the emphasis of Asian governments on market-led rather than politically-led growth since the crisis of 1997-8. It accommodates the fact that the context is different than in Europe, where the transition to monetary union was supported by a commitment to political integration. That this

commitment is less in Asia renders it questionable that a politically-led process could lead smoothly to monetary union.

Under this paper's approach, in contrast, the pace of regional economic integration and the market's take-up of the parallel regional currency would dictate the pace of the transition. Only when producers and consumers had adopted the parallel currency in large numbers would it be clear that market structure and behavior had adapted to the imperatives of a single currency. It would still be necessary to then take a political decision to create an Asian Central Bank. But under the scheme envisaged here, this step would have to wait on a market test.

Officials can help to prepare the way for the parallel currency. Constructing a true free trade area and promoting the further expansion of supply-chain networks in Asia can make it attractive for the private sector to transact using the parallel currency. By issuing debt denominated in the parallel currency, governments can help to create a benchmark asset and more liquid secondary markets, encouraging ACU issuance by banks and firms. They can make markets in the parallel currency more attractive by investing in the establishment of an efficient regional clearing and settlement system.

Even if regional integration heightens the attractions of the parallel currency as a unit of account, store of value, and medium of exchange, the inertia favoring national currencies is strong. History suggests that they will not be quickly out-competed by a parallel regional currency. Prudential policies to limit the risks to financial stability created by currency mismatches will also slow adoption of the parallel currency. But if this means that the process culminating in a single Asian currency will take time to

unfold, this is not necessarily a bad thing, especially since years will have to pass before the entire range of supportive conditions is in place for Asian monetary unification.

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[1] Department of Economics, University of California, Berkeley, CA 94720-3880, USA.

[2] That these are the two basic preconditions for the maintenance of currency pegs are the lessons of the so-called first and second generation of balance-of-payments crisis models.

[3] The Chiang Mai Initiative announced in 2000 is just such a system of swap lines and credits but, revealingly, Asian countries have been reluctant to actually utilize it.

[4] I am not the first to develop this idea. Junichi Mori, Maoyoshi Kinukawa, Hideki Nukaya and Masashi Hashimoto (2002) have proposed the creation of an Asian Currency Unit as a way creating an environment in which the private sector can participate in the discussion of monetary integration. Ramgopal Agarwala (2003) has proposed the creation of a parallel currency as an initial step toward a single currency for South Asia.

[5] The first mention of the parallel currency approach was in a report by the Federal Trust in 1972 (Giovanni Magnifico and John Williamson 1972). The idea was then taken up in the "All Saints' Day Manifesto" (Economist Magazine 1975). In 1990 the UK government presented a draft treaty embodying these ideas as a contribution to the debate over the Delors Report (UK Treasury 1990).

[6] The growth of the ECU bond market will be a comforting observation for Asian policy makers for whom promoting the development of regional bond markets is a priority.

[7] This is the conclusion of Gianni di Nicolo, Patrick Honohan and Alain Ize (2003).