Regional monetary cooperation: the European experience and possible lessons for Asia

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Summary

Never in the more recent history did Europe have a floating exchange rate regime. Ever since the Bretton-Woods system started in 1944, Europe has slowly progressed to ever closer monetary integration, and has now reached full monetary integration at least in a good part of the continent. This process has not been seamless; it has seen setbacks and conflict. Any monetary cooperation or even integration ultimately requires the will to surrender national autonomy to some extent. On the other hand, a common currency also has undeniable advantages, most importantly the elimination of risk premia associated to exchange rate fluctuations. This trade-off is captured by the concept of an optimal currency area (OCA). Whether the European Union satisfies the conditions of an OCA, and so the process of monetary integration has indeed been economically beneficial for Europe, is even today still open to debate.

If the OCA status of the EU is questionable, then certainly Asia, or even just ASEAN, cannot be an OCA, since Asia or ASEAN is much more heterogeneous than the EU. An Asian monetary union does not seem to be the right goal. On the other hand, some monetary cooperation may be useful. Certainly, an exclusive orientation toward the US dollar is not the wisest strategy. This strategy implies a very large economic risk should the dollar suddenly appreciate or — more likely — devalue. It also implies a huge financial risk for the dollar pegging central banks, due to the large dollar reserves they have to hold. A diversification of the currency basket that is being targeted could be a better strategy.

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Short historical review: the road to the Euro

European nations have cooperated on monetary affairs for a very long time before they finally agreed on a common currency. In fact, never in the more recent history did Europe have a purely floating exchange rate regime. There was progressive cooperation, which has now culminated in full monetary integration with the adoption of a common currency. This is so at least for a significant part of the continent.

This process that ultimately lead to monetary integration has not been seamless; it has seen setbacks and conflict. Let me quickly go though the phases of monetary cooperation that Europe has experienced in the last century, in order to give you the historical background:

Until the early 1970ies, fixed exchange rates were the rule globally. Until 1931, there was the gold standard. The UK broke away from this system in 1931, and it collapsed. Then, after World War II, the Bretton-Woods regime was put in place. This was a peculiar system: all member countries were obliged to hold their respective exchange rates fixed vis-à-vis the U.S. Dollar. The American Federal Reserve Board, however, was free to pursue a monetary policy as it saw fit. Effectively, what this meant was that the American central bankers decided about the monetary policy of the whole world, since, say, a monetary expansion in the US had to be matched by parallel expansions in the rest of the world. Otherwise, the exchange rates would have gone astray. Yet, despite this fact, only US interests were reflected in Fed decisions, since the Board consisted only of representatives of the US reserve banks.

This system collapsed 1971, after the US initiated a very expansionary monetary policy. This policy was pursued probably at least in part to finance the Vietnam War effort. It lead to unacceptably high inflation rates, and the UK, Germany, and Switzerland were no longer prepared to follow this policy. The monetary goal of the US simply became too much different from the goal of the European Bretton-Woods members, so that the basis for the cooperation vanished.

But even post Bretton-Woods, Europe has not allowed exchange rates to float in an unmanaged fashion within Europe. It started the currency snake in 1972, right after the breakdown of Bretton-Woods. The snake was not a very imaginative system because it was still tied to the US dollar. A few years later, however, the snake evolved into the European exchange rate mechanism ERM. ERM officially started 1979 and was, essentially, a mini Bretton-Woods agreement just for Europe. The Deutsche Mark was certainly a leading currency, but unlike in the Bretton-Woods, all currencies that participated in the ERM had to

observe bilateral bands with respect to all other member currencies. These bands were ±2.25% for most members, and ±6.0% for some exceptions.

[SLIDE]

Yet, the ERM was also not stable. It collapsed 1992 after a huge idiosyncratic shock hit Germany and lead to widely dispersed monetary conditions within the ERM block. This huge shock was of course the German unification. The sudden addition of former Eastern Germany to the West induced a huge demand for capital and accordingly a surge of the real interest rate. The Bundesbank was not prepared to ease monetary conditions, and other member currencies were less and less prepared to further raise interest rates in order to hold the peg vis-à-vis the German Mark, until finally the UK announced on 16 September 1992 ("Black Wednesday") that it would leave the ERM.

The similarity of the breakdown of ERM and the Bretton-Woods agreement is instructive. In both cases it was a dispersion of monetary conditions that induced members to ignore the agreement and break away from it; and in both cases it was an economic shock to the leading country in the system that initiated the crisis. In the Bretton-Woods it was the financial needs that were induced by the Vietnam War, in the case of ERM it was the financial needs that emerged with reunification.

The ERM did effectively collapse, but it was too important for the European Union's political agenda to let it go, so it was formally saved by extending the original bands of ±2.25% to effectively meaningless ±15%. Interestingly, even though these bands were way too wide to ever be binding, bilateral exchange rate movements declined rapidly after the initial disruption.

Remarkably, despite the fragility of the system that had become obvious with the crisis of 1992, the EU continued on its path towards further monetary integration. It started ERM-2 in 1999. This was a preparation toward complete monetary union. It replaced the bilateral currency bands with ranges vis-à-vis to the European currency unit ECU. This new unit served as an accounting or reference unit within the ERM system, and was designed as a predecessor of the Euro. Only three years later, in 2002, the European monetary union (EMU) started and Euro banknotes and coins were issued.

Today we have in Europe a mixture of currency union members, pegging countries (i.e. members of the still existing ERM-2), and countries whose

currencies formally float against the Euro, but who take the Euro exchange rate into strong consideration in their monetary policy actions.

[SLIDE] **Blue:** monetary union members. **Orange:** remaining members of ERM-2 (they do not use the Euro, but have a formal peg to the Euro). **Dark red:** other EU member states. Of these, Bulgaria has a unilateral Euro peg (outside of ERM-2), and the Czech Republic, Hungary, Poland, and Romania are bound to become members of the monetary union eventually. The same is formally true for Sweden. However, the Swedish government has postponed membership indefinitely after a negative public referendum that was held in the matter. Of the EU members, only the UK and Denmark have formally opted out of the monetary union.

The monetary union appears today as the latest step in a somewhat long road towards monetary integration. The development is continuing in this direction with the planned admission of new members.

Political obstacles

It is quite instructive to observe that there would have been a simpler way to create a monetary union in Europe. The move from the ERM through ERM-2, which introduced the European currency unit ECU as the reference unit, was a preparatory step with no economic rationale. The only reason for this step was political.

Consider this: in the ERM, officially there was no leading currency, all were equally important. But effectively, the Deutsche Mark was the leader. Germany enjoyed the lowest interest rates of all members and its central bank, the Bundesbank, was globally renowned for its resolve in keeping inflation at bay.

A straightforward way of exporting this reputation to all countries interested in creating a monetary union would have been for all these countries simply to adopt the Deutsche Mark as their currency. For a technocrat, that seems feasible. It's probably better to do it this way, as one can avoid the uncertainties that are unavoidable when one has to create a whole new central bank with no reputation of its own to begin with. In fact, one could even have foreign members in the Bundesbank council to assure that it is not only German interests that would be heard in monetary policy decisions. In fact, the European Central Bank (ECB) today is very independent and committed to price stability in a way that is comparable that the commitment the Bundesbank had before, so the Euro really is much like the former Deutsche Mark in new clothing.

Hence, from an economist's point of view, the result would have been effectively the same as what we have today.[1]

But for real people, this shortcut is unthinkable. French people would use German Marks in France to buy their croissants in the morning? This is simply politically not viable. The detour through the new currency unit ECU, the new currency Euro, and the new central bank ECB was therefore necessary on political grounds.

The economic pros and cons of a common currency

Any monetary cooperation that aims at reducing foreign exchange rate fluctuations or even, as in the case of the European monetary union, requires complete monetary integration, entails a loss of local monetary autonomy, and robs central banks of the ability to design monetary policy in a way that is adapted to local conditions. In other words, monetary cooperation or even integration necessarily requires the will to surrender national autonomy to some extent.

The impossible trinity — a well-established result of economic theory — states, that it is impossible to achieve all three of the following aims simultaneously [SLIDE]:

- free movement of capital
- control of foreign exchange rate
- monetary autonomy (that is to say, control over domestic inflation)

Only two of these can be achieved; one has to be given up.

Western European countries had free movement of capital since after World War II. Since it is also true that the exchange rates have never been completely floating, this implies that the countries must have had some monetary cooperation, to the extent that their inflation rates had to have some interdependence. That means that, to the extent that Western European countries did manage their respective exchange rates, they have also jointly controlled inflation. They have not done so individually.

Why would anyone give up national autonomy? Well, to get something at least a valuable back in exchange. Personally, I believe that the main aim of many proponents of European monetary integration was simply political integration *per se*. I do not see political integration as a value of its own, but that is just my own personal view.

[1] The ECB and the Bundesbank are even located in the same city, Frankfurt.

On the other hand, the common currency also has undeniable economic advantages. An obvious (small) advantage is of course the enhanced convenience for travelers within Europe because they do not need to carry different currencies around. More important however, is the elimination of risk premia associated to exchange rate fluctuations.

The advantages of monetary integration are essentially microeconomic in nature: reduction of risk premia and of transaction costs. The economic cost of monetary integration, in turn, is macroeconomic in nature. The have directly to do with the loss of monetary autonomy. Let me explain.

The loss of monetary autonomy means that there is no local monetary authority that could take steps to dampen particular macroeconomic shocks that hit the economy. Let us go back to the near-collapse of ERM in 1993. Germany had experienced an increase in its inflation after money supply had been increased in the aftermath of German unification. As a result, the Bundesbank was not prepared to lower interest rates for fear of fuelling inflation even more. Simultaneously, the UK was in a recession and needed monetary stimulus, which they could unfortunately not deliver, for otherwise the British Pound would have violated the ERM bandwidth vis-à-vis the German Mark. Ultimately, the British chose to leave the ERM and pursue the monetary policy that was right for their country. Germany did the same thing: it kept interest rates high because it was the right thing for themselves, even at the risk of breaking ERM.

In other words, the ERM crisis of 1993 was not economically dangerous in and of itself. Rather, it was a symptom of an underlying fact, namely that the business cycles of ERM members were out of synch, mainly due to the large idiosyncratic shock that German unification represented. The natural thing to do in such a situation is of course to realign the exchange rates. In a floating regime, this will happen automatically. Exchange rate movements, whether formally realigned or done automatically by the markets, allows both involved economies to pursue their own monetary policy, in this case, Germany to be tight and the UK to be loose. This would have distributed the shock more evenly and allowed the UK business cycle to gain strength, at the expense of the German economy, which had to cool down. With the creation of EMU, the EU has effectively shut down the exchange rate as a channel that could dampen idiosyncratic shocks. Today, such shocks would have to be absorbed directly by the real economy, and would involve a much bigger relocation of resources from one region to another. This is much more painful and more wasteful. So these are potentially very significant macroeconomic costs of monetary union.

As I said, the ERM crisis did not *per see* constitute an economic risk. It was only a symptom of a misalignment of macroeconomic needs. It was, however, dangerous for EU's political plan of creating EMU, and that is the reason why it was formally, on paper, saved by moving to meaningless bandwidths.

So, we see that there is a clear trade-off involved in monetary cooperation. There are microeconomic gains on the pro side and macroeconomic risks on the contra side. This trade-off is captured by the concept of an optimal currency area (OCA). An area is an OCA if its regions are economically sufficiently similar and production factors can easily move between them. Is the USA an OCA? That is not so clear: the Mid-West or the South-Eastern US economy are quite different from California. At least both production factors, labor and capital, move freely within the country. What about the EU? Again, the economic structures are quite diverse. Some economies are strong in financial or other services; others are strong in heavy industry or have oil. Capital flows freely among regions, but labor is more reluctant to move. There are only little legal barriers left nowadays with the creation of the common market, but the language barriers remain.

Whether the European Union satisfies the conditions of an OCA, and so the process of monetary integration has indeed been economically beneficial for Europe, is even today still open to debate. At the time of the creation of the Monetary Union, the EU was very probably not an OCA. And yet, the microeconomic structure of Europe is endogenous, and as European economies become more intertwined with each other (also as a result of monetary integration), the microeconomic reasons for a common currency become stronger, and the macroeconomic reasons against it may become weaker, for instance, because labor mobility across boarders has increased.

Monetary cooperation in Asia?

You know much more about Asia than I do, so I will be brief. As an outsider, though, it seems to me that Asia is much more heterogeneous economically than Europe. This is a reason to think that Asia, or even only East Asia, or just the ASEAN counties, do not constitute an optimal currency area. For this reason, I think that monetary integration should not be the goal in the region. Also, bear in mind that the surrender of some national sovereignty and the creation of super-national institutions would be required. I am not sure if the people of Asia want this.

At the same time, some monetary cooperation among similar East Asian countries seems to make sense. In particular, the huge US dollar reserves that have been accumulated by local central banks constitute a very real financial risk, should the dollar suddenly drop. A more balanced portfolio — and I believe this has happened to some extent — is just a matter of due diligence. Moreover, Asia's economies are booming and are becoming more and more important globally. It would therefore make sense for everyone, Asian central banks but also central banks of Europe or the US, and incidentally for any portfolio manager, to hold a larger exposure in Asian currencies. Since Asia is booming, and Asian economies actually do trade with each other quite intensely (and probably even more so in the future), maybe for some Asian countries it would make sense to pursue a managed floating system that does not focus on just one currency (e.g. the US dollar), but on a basket consisting of, say, USD, Yen, Euro, the Renminbi, the Rupee, or whatever combination seems suitable for the country at hand. If two countries in a region peg a similarly defined currency basket, this automatically also leads to small variance of the bilateral exchange rate, so you would get locally relatively smooth exchange rates as a bonus. A floating system is of course possible too, but it requires stable institutions for financial markets and a solid banking system. It also requires a central bank that has a reputation of competence and independence.