Speech by
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Economic and Monetary Union in Europe: 10 Years On

"The Importance of the Euro in a Rapidly Changing Environment: An Asian Perspective"

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I. Introduction

Mr. Strauss-Kahn, Mr. Regling, fellow panellists, distinguished guests, ladies, and gentlemen:

In less than 10 years, the euro has evolved into an international currency that can stand shoulder to shoulder with the US dollar. Asia has been particularly interested to see how the euro has helped promote prosperity and financial stability in Europe. The long process of regional initiatives that led to its establishment can serve as a benchmark for the growing regionalism and economic integration we are now experiencing in Asia.

Ten years ago several Asian countries were struggling to extricate their economies from the currency and banking crises that shook the foundations of Asia's much-heralded economic expansion. Despite the so-called Asian "miracle", the region's financial systems were largely underdeveloped and relied heavily on bank financing. This source of financing was in turn too closely associated with vested interests and government policies. At the same time, reliance on short-term foreign debt led to currency and maturity mismatches. Speculators preyed on Asia's structural weaknesses, and the crises ensued. Some hard lessons were learned in the process.

But recovery from the crisis was fast and market-based. With structural reforms in place and competition intensifying, our region's international economic influence has surged. Today, Asia faces new challenges arising from globalization and the rapidly changing global financial environment. The euro has played an essential role in fostering harmony among diverse economies, which had conflicting monetary and fiscal policies, tariffs, and other restrictions on trade and investment. This experience is extremely useful for Asia as the region moves ever-more resolutely toward its own style of regionalism.

Today I will speak of the importance of the euro to Asia and our own experience with regional cooperation and integration. Then, I will briefly touch upon the challenges facing Europe and Asia as the current global financial turmoil continues to unfold.

II. The euro and Asia

There is little question that the international role of the euro has grown rapidly. When it replaced 12 European currencies—particularly as successor to the mark and the franc—many questioned if the euro could challenge the pre-eminence of the dollar. Asia in particular relied on the dollar for trade and financial transactions and the dollar covered a sizeable share of the US market for Asian goods. Since the introduction of the euro, however, Europe has gained proportionally as a destination for Asian products, while the dominance of the US market has waned. In 2000, East

Asia's trade with the eurozone was 14% of its global total, compared to 24% with the US. Today, exports to eurozone countries and the US are almost equal, each comprising about 16% of the global total.

In its early days, the dollar was the preferred mode of payment in trade finance with Asia. Also, during that time the euro was depreciating apace against the US dollar. But as US spending requirements increased against the backdrop of rapid globalization and Asia's surging economic growth, the huge global payments imbalances that ensued left international businessmen and traders looking for alternative currencies. The euro as a currency for invoicing trade has been steadily on the rise.

With the rapid depreciation of the dollar in recent years, preference for the euro in financing trade between Europe and Asia appears to have risen. Many exporters from China, for example, are now quoting and demanding payment in euros for products shipped to the EU. Private businessmen have been seeking alternatives to protect their export revenues from the rapid depreciation of the US dollar. And the euro has provided just that alternative.

This is not to say that use of the USD as an international currency in Asia has fallen precipitously. But its influence is relatively declining. And use of the euro as a component of international reserves is increasing. Reserves held in euros worldwide increased from 14% of the world total in 2000 to 17% in 2007. Use of the US dollar for reserves fell 15 percentage points, from 56% in 2000 to 41% last year. And the decline of US dollar assets in reserves was far more evident in surplus emerging markets, particularly those in emerging Asia.

While still limited in terms of international transactions and reserve holdings in emerging Asia, use of the euro is expected to increase further as the economic relationship between Europe and Asia continues to strengthen.

So what can Asia learn from the euro experience? Let me now turn to how our region is managing the process of economic cooperation and integration.

III. Progress and prospects for Asian monetary and financial integration

One of the foremost lessons derived from the 1997/98 Asian financial crisis was the importance of regional cooperation in fostering financial stability. Today, varied intergovernmental forums in Asia support cooperation among finance ministers, central bank governors, and capital market regulators. The momentum for financial and eventual monetary integration has been growing within the Association of Southeast Asian Nations, or ASEAN; and in particularly within ASEAN+3, the expanded group that includes China, Japan and Republic of Korea.

In fact, the ASEAN+3 finance ministers recently reiterated their commitment to mutilateralize the Chiang Mai Initiative to create a self-managed reserve pooling arrangement governed by a single contractual agreement. The Chiang Mai Initiative was created to address short-term liquidity problems in the region and to supplement existing international financial arrangements. Among the rigorous principles governing the Initiative are economic surveillance through a stronger Economic Review and Policy Dialogue, an activation mechanism, decision making rules and lending covenants, and timely disbursement. The initial size of the new Chiang Mai Initiative will be at least $80 billion.

Through cooperation, Asian financial markets have become stronger and safer. Countries have introduced greater competition, encouraged private sector ownership and foreign entry, and tightened governance, disclosure, and prudential regulation. Financial institutions' capacity to assess and manage risks has improved. Financial deepening has been faster in emerging East Asia than either in the EU or US—though of course this comes from a substantially lower base. Interestingly, as a percent of GDP, Asia now has larger capital markets than the EU. Capital markets have grown rapidly in absolute terms, as a share of total financial assets, and relative to GDP.

Two important capital market initiatives are currently helping develop regional bond markets and enhance financial resilience for the region. The first is the Asian Bond Markets Initiative, launched in 2004, which has helped strengthen the market infrastructure for local-currency bond development. At their recent meeting, the ASEAN+3 finance ministers approved a new roadmap for the bond market initiative, focusing on four key areas: i) promoting issuance of local currency-denominated bonds, ii) facilitating the demand of local currency-denominated bonds; iii) improving the regulatory framework and iv) improving related infrastructure for bond markets. The second initiative- the Asian Bond Fund, which was launched by eleven central banks in 2003- supports development of regional bond funds.

ASEAN's subregional efforts provide a model for still deeper cooperation: in addition to conducting regular surveillance, ASEAN itself also has a long-term roadmap for developing capital markets and liberalizing capital accounts and financial services. Its work on capital market development, for example, covers information sharing, harmonization, trading, clearing and settlement, and even the launch of an exchange-traded fund.

In its move toward greater cooperation and integration, Asia is looking to Europe for practical experience as well. Of course, some of that experience—for example its preference for a supranational, rules-based structure—may not sit comfortably in Asia given its varied history, circumstances or stage of development. Despite ASEAN's new Charter, finalized in November last year, which places greater emphasis on a rules-based structure, Asia has yet little appetite for the kind of supranational institutions that have been established in Europe to effect deeper economic integration.

There are, however, alternative routes to integrated markets and institutional convergence. Cooperation through incentive-compatible agreements, for example on regulatory standards, is an equally valid way of creating institutions for integrated markets. This is the so called 'open method of coordination' in Europe, which allows for inter-governmental approaches to regulation, guidelines, benchmarking and peer pressure for convergence in policy development.

The sequencing of regional initiatives will also differ. In fact, monetary integration in Asia might not easily be achieved in the foreseeable future. Given the diverse socio-political background of Asia's economies, mustering political support for delegating some autonomy to regional arrangements would be much more difficult than it was in Europe.

Given these constraints, however, it is likely that a group of countries, say among ASEAN or ASEAN+3, might choose to develop a common currency basket to measure exchange rate variations or move toward greater exchange rate policy coordination. Given the rapid expansion of intra-regional trade within Asia, and particularly emerging East Asia, it might be time to start instituting a framework that can help monetary authorities coordinate their exchange rate policies. This will help reduce frictions in trade flows and ease cross-border capital mobility. An appropriate and adjustable basket of regional currencies, either trade-weighted or by using other methods, would help monetary authorities gauge whether their currency value is optimal for their policy objectives. It could be used initially as a tool for assessing where adjustments are advisable.

Greater intraregional exchange rate stability—and extra-regional exchange rate flexibility—could also help countries manage the adverse effects of a deteriorating external environment. With an enhanced and better coordinated regional strategy on exchange rate policy, regional currencies could adjust in an orderly manner against the US dollar. This would help combat imported price-driven inflation while mitigating unilateral appreciation pressures, thereby maximizing the benefits of strong intraregional trade dynamics amid slowing external demand.

With this in mind, what are the challenges facing Europe and Asia amid current financial instability and the outlook for softening global growth?

IV. Challenges amid Global Financial Turmoil

Heightened volatility in foreign exchange markets coupled with the recent financial turmoil is a major concern for policy makers. The US economic recession and the aggressive US Federal Reserve interest rate cuts have sent the dollar to historic lows particularly against the euro. Amid the recent financial turmoil, the euro's ascent against the US dollar has been nothing short of phenomenal. Widening interest rate differentials as the US Fed aggressively eased rates is one factor. But the appreciation may also reflect the declining influence of the US dollar in foreign exchange markets.

Asian currencies have also appreciated over the past few years, as pressures from large capital inflows and reserve accumulation mounted. This has helped create rather volatile exchange markets. Aside from the impact on exports, for example, the current exchange rate volatility can hurt external funding conditions for many emerging Asian economies. Volatility in the movement of foreign portfolio investments—short-term funds placed in stocks, bonds and banks' overseas borrowing—has already increased this year. Exchange rate instability in emerging markets often means hefty risk premiums for investors to cover the increased exchange rate risk. Should the cost of capital and the level of investment be severely affected—say by greater or continuing surrounding turmoil in the global credit markets—economic performance and growth in emerging Asian countries could suffer significantly.

Any sudden unwinding of global payments imbalances also poses significant risks to macroeconomic managers in Asia and Europe. A loss of confidence in US dollar assets could cause disorderly adjustments in major international currencies given the speed of transmission in the global financial marketplace. And this could have significant implications for Asian currencies. Since the financial crisis of the late-1990s, many emerging Asian economies now use flexible exchange rate regimes, with multiple anchor currencies. Increased volatility and uncertainty among foreign exchange markets requires greater and closer cooperation and policy coordination to maintain currency stability. With Europe's and Asia's growing economic influence in international forums—and their increasingly close ties together—greater policy cooperation between the two regions would contribute significantly to global financial stability.

V. Conclusion

In closing, I expect that the euro will continue along its path as an alternative international currency to the US dollar. This will benefit rapidly expanding emerging Asian economies, the region as a whole, and the world. The euro will continue to grow in prominence in Asia as a tool for trade and financial transactions.

The future of economic cooperation and integration in Asia will proceed pragmatically, and in step with emerging opportunities. The region continues to learn a great deal from Europe and the euro experience. But given its diversity, size, and varying stages of economic development, the path toward monetary integration in Asia will naturally build upon market demands for increased cross-border capital movement and the need for regional exchange rate stability amid a changing global financial environment. Ultimately, Asia can learn valuable lessons from the experience of the euro in this regional endeavor.

Thank you.

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