

# The Euro as an International Currency

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With the start of European Monetary Union (EMU) on 1. January, the euro has now become the world's second currency, after the dollar and before the yen. EMU countries account for 14 per cent of world GDP and 17 per cent of world trade. They are comparable with the United States, which represents 19 per cent of world GDP and 14 per cent of world trade. If the UK and the three other EU countries outside EMU were to join, the euro-15 share in GDP would rise by a quarter to 18 per cent of the world total, almost the same as the US. However, the pace of development of the use of the euro remains somewhat unpredictable, and will vary between different uses.

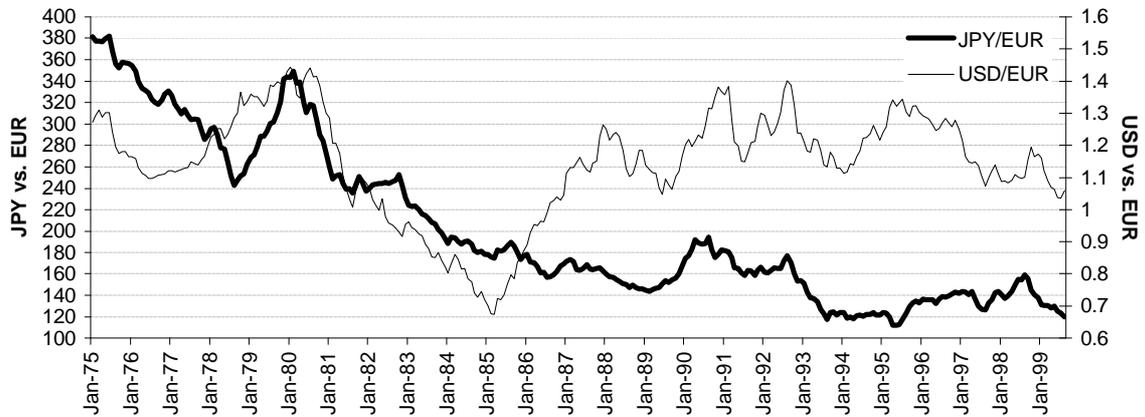
Since its launch the euro has fallen against the dollar by 10% before appreciating again recently. However, this is not in itself a sign of instability, even though it was unanticipated. Judged against the background of other currencies, it is as much a rise in the dollar as a fall in the euro. The trade-weighted exchange rate of the euro has fallen by only 4%. Today's euro exchange rate against the dollar corresponds to that of its constituent currencies a year ago (see figure 1 and 2). However, lasting instability in exchange rates would have far-reaching consequences for third countries, especially Asia.

There is widespread disagreement on two major issues. How quickly will the euro take over some of the dollar's share as an international currency? How volatile will the dollar-euro exchange rate be? Both issues matter, and they are linked. This depends on how central banks and the private sector will adjust their currency portfolios and how these portfolio adjustments effect the euro exchange rate.

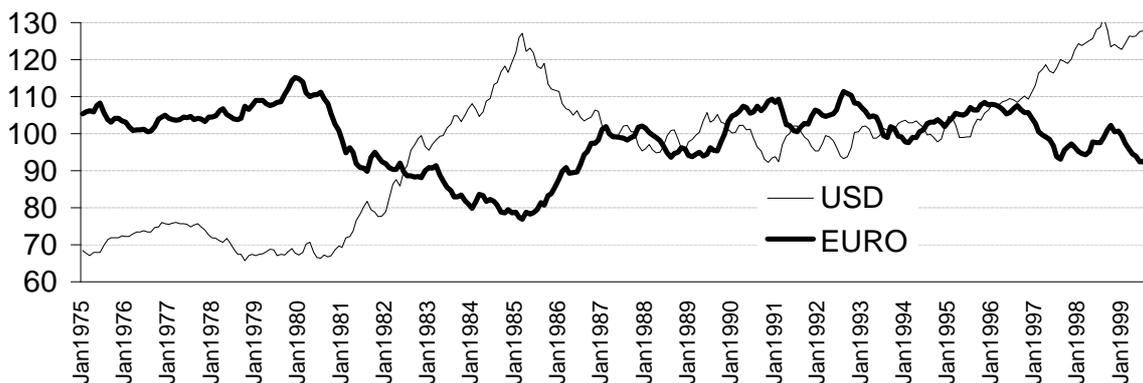
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**Figure 1: Monthly Nominal Exchange Rate JPY and USD vs. EURO**



**Figure 2: Monthly Nominal Effective Exchange Rate EURO and USD vs. Ind. Countries (1987 = 100)**



## 1 EURO AS AN INTERNATIONAL CURRENCY

As an international currency, the euro would have to fulfil the three classical functions of store of value, unit of account and means of payment. They take slightly different forms in the private and public sector. The attractiveness of the euro depends largely on the size of its domestic markets, its substitutability (liquidity) and its general acceptability with potential non-resident holders.

**Table 1 : Dimensions of an International Currency**

Function	Private Sector	Public Sector
means of payment	vehicle	intervention
unit of account	denomination	anchor currency
store of value	portfolio	official reserves

Source: Krugman (1991)

Probably the most important is the financial role of the euro as a store of value and its use to denominate financial liabilities. The euro is already quite important in this regard. In the first two quarters of 1999 net issues of pure international debt securities in euro exceeded those in US dollars (although the total amount including domestic issuers in dollars is still slightly more important than the euro).

For the private sector, the store of money function will further expand rather rapidly as domestic financial markets develop further. In large financial market, where euro-denominated assets are actively traded and domestic and foreign borrowers could raise sizeable volumes of funds at low costs, the euro's attractiveness as an international currency would be greatly enhanced.

**Table 2 : Financial Market Indicators**

	EU11/euro	EU15/euro	US/\$	Japan/Y
GDP 1997	4800	6050	6300	2350
<i>% of world total</i>	<i>14</i>	<i>18</i>	<i>19</i>	<i>7</i>
World trade share % 1997	17	22	14	4
Forex reserves by currency 1997 ( <i>% of total</i> )	19.6%		57.1%	4.9%
Debt securities, in euro bn:				
Amount outstanding Jun. 1999	563	766	1379	418
<i>% of total amount outstanding</i>	<i>20%</i>	<i>27%</i>	<i>66%</i>	<i>15%</i>
International Issues (incl. Domestic), <i>first two quarters 1999</i>	263	318	314	-7
<i>% of total</i>	<i>41%</i>	<i>50%</i>	<i>49%</i>	<i>-2,8%</i>
International Issues (excl. Domestic), <i>first two quarters 1999</i>	100	121	87	-13
<i>% of total</i>	<i>48%</i>	<i>58%</i>	<i>42%</i>	<i>-6%</i>
Foreign exchange market daily turnover Apr. 1998 euro bn	710	890	1470	350
<i>% of total world forex market turnover</i>	<i>25</i>	<i>30</i>	<i>47</i>	<i>11</i>

Source: BIS, ECB Monthly Bulletin, August 1999

Private and public functions of a currency can experience different developments. A currency might be chosen as a vehicle currency without being used as an intervention instrument. Trade might be denominated in euro although monetary authorities have not pegged their currency to it. Finally, official reserves will be denominated in euro only if the monetary authorities want to stabilise the exchange rate against the euro whatever the composition of private portfolios might be.

## 1.1 THE OFFICIAL USE OF THE EURO

According to the IMF, the share of the dollar in official reserves has been falling over the last twenty years from 76.1% in 1973 to 58.9 % at the end of 1996. Over the same period the share of the main European currencies grew from less than 15% to 25%. At the end of 1997, the former euro area national currencies accounted for 19.6 %, the dollar for 57.1% and the Japanese yen for 4.9 %. Such figures, however, are likely to underestimate the effective share of these reserve currencies since the currency breakdown of individual countries' official reserves is in most cases confidential.

With the introduction of the euro, the share of euro area currencies in the foreign exchange reserve assets of central banks declined as a result of two technical adjustments: First, on 31 December 1998 the Eurosystem unwound into gold and US dollars the official ECUs that were issued to EU central banks through revolving swaps against the contribution of 20 % of their gross gold holdings and US dollar reserves, for a total amount of ECU 60.9 billion. Second, with effect from 1 January 1999 the Eurosystem's reserves previously denominated in former euro area national currencies became domestic assets, which brought about a decrease in the Eurosystem's foreign exchange reserves.

These developments, which are related to technical implications of the changeover to the euro, resulted in a contraction of the share of the euro in official reserves. However, although no updated information is currently available, the euro is likely to remain the second international reserve currency as a legacy of the former euro area national currencies.

Where, then is the euro as a reserve currency going to develop from here ? This largely depends on the synergies with other key currency functions :

- Countries who decide to peg to the euro will necessarily need to hold official reserves and to intervene in the euro in order to defend the peg.
- As transaction costs are low, monetary authorities are likely hold assets denominated in that currency, provided they are expected to be a stable store of value. Therefore price stability and exchange rate volatility (stability of internal and external purchasing power) are crucial elements for the future development of the euro as an international currency.

The use of the euro as an intervention currency is mainly related to its function as a pegging currency. In addition, countries with currencies which are not directly pegged to the euro can also use it for intervention purposes to pursue more informal exchange rate objectives. No quantitative data are available on this function since, with a few exceptions, most central banks do not release figures on their intervention operations. However, it has been known that the European Central Bank has been intervening on behalf of the Bank of Japan this summer, in order to dampen the rapid appreciation of the Japanese yen.

With regard to the use of the euro as a pegging currency, there are a number of arrangements ranging from the introduction of the euro as their own currency by a few countries to the adoption of exchange rate regimes involving the use of the euro.

**Table 3 : Exchange rate regimes involving the Euro**

Country	Exchange rate regime	Peg against
Bosnia-Herzegovina	Currency board	EUR/DEM
Bulgaria	Currency board	EUR/DEM
Croatia	Managed floating (EUR/DEM used informally as reference currency)	
Czech Republic	Managed floating (EUR/DEM used informally as reference currency)	
Cyprus	Peg	EUR
Denmark	Peg within co-operative arrangement	EUR
Estonia	Currency board	EUR/DEM
Greece	Peg within co-operative arrangement	EUR
Hungary	Crawling fluctuation band	Basket: EUR (70 %) USD (30 %)
Iceland	Peg	Trade-weighted basket incl. the euro
Latvia	Peg	SDR
Macedonia	De facto peg	EUR/DEM
Malta	Peg	Currency basket: EUR (56.8 %) USD (21.6 %) GBP (21.6 %)
Poland	Crawling Fluctuation band	Currency basket: USD (45 %) EUR (55 %)
Slovak Republic	Managed floating	euro used informally as reference cur.
Slovenia	Managed floating	euro used informally as reference cur.
Turkey	Managed floating with de facto crawling peg	Currency basket Including USD and EUR/DEM
14 African countries of which the CFA franc is the legal tender	Peg	EUR
Bahrain	Peg	SDR
Bangladesh	Peg	Basket of trading partners' currencies, including the euro
Botswana	Peg	SDR and basket of trading partners' currencies, including the euro
Burundi	Peg	Basket of currencies of its major trading partners, including the euro
Cape Verde	Peg	EUR
Chile	Crawling fluctuation band	Basket USD, EUR/DEM, JPY
Comoros	Peg	EUR
Israel	Crawling Fluctuation band	Basket (in terms of units of each currency in the basket): USD (0.6741) EUR (0.2282) GBP (0.0589) JPY (6.5437)
Jordan	Peg	De jure peg to the SDR
Libyan Arab Jamahiriya	Peg	SDR
Morocco	Peg	Undisclosed basket
Myanmar	Peg	SDR
Qatar	Peg	SDR
Saudi Arabia	Peg	SDR
United Arab Emirates	Peg	SDR
Vanuatu	Peg	Undisclosed transactions-weighted currency basket

Source: ECB Monthly Bulletin, August 1999

The implications of the use of the euro as a pegging currency are twofold :

- First, if the euro is used as a nominal anchor, the incentive to use it for trade invoicing and debt denomination will increase for those countries, thereby reinforcing the international role of the euro. Private sector traders might increasingly denominate transactions in euro, a practice that would lead them to hold working balances in euros, and ultimately reinforce the tendency for investments to shift to the euro.
- Second, the use of the euro as an anchor currency could push the international monetary system towards a bipolar framework, which in turn also has consequences for the variability of the dollar-euro exchange rate. In a world with two major currency blocs, the exchange rate between the two anchor currencies could be more volatile, as this is the only exchange rate to adjust for fundamental disequilibria between the currency blocs. Such a development could be of utmost importance to the future growth of Asian economies.

In the following chapter we will explain the concept of bloc floating and the consequences for exchange rate variability and world wide growth and investment.

## **THE EMERGENCE OF CURRENCY BLOCS**

After the breakdown of Bretton Woods, world economic development was characterised by the emergence of two large currency blocs around key currencies - the dollar and the D-Mark. Most small regional currencies linked their currencies to an anchor in order to achieve monetary stability at home and to improve investment and competitiveness in the international arena. As a consequence, regional currency blocs have emerged which float against each other while at the same time maintaining significant exchange rate stability within the currency blocs.

Thus, it is only logical that the arrival of the euro should have a profound impact on world relations. Central and Eastern Europe and Northern Africa seem to peg to the euro (see Table 3). NAFTA and Latin America primarily use the dollar. Asian countries will have to decide whether to integrate around a regional anchor or what strategy to choose with respect to the two main international key currencies.

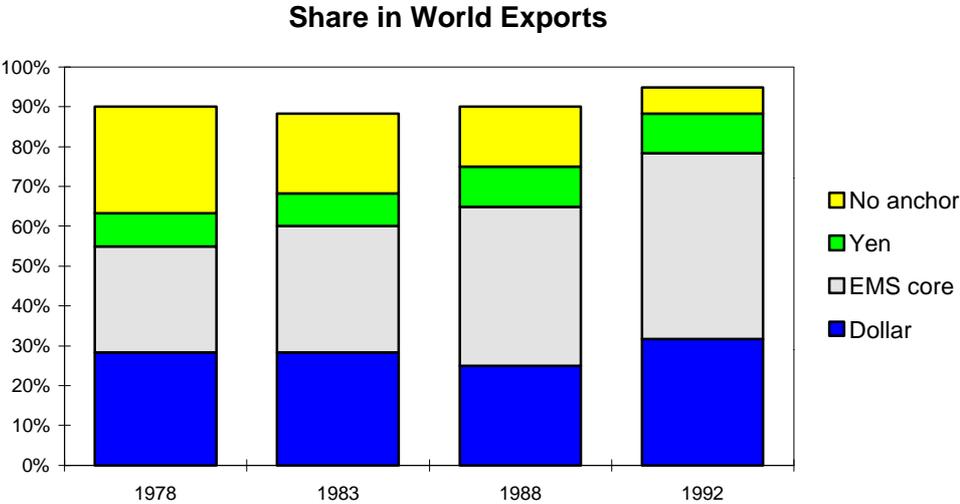
### **1.2 CURRENCY BLOCS : INTERNAL VERSUS EXTERNAL STABILITY**

Bloc-floating has become the dominant feature in the world economy during the 1980s. In theory, flexible exchange rates imply that foreign exchange reserves become more stable because exchange rates adjust to supply and demand in the foreign market. However no clear structural break was apparent in the reserve volatility of the USA or Germany. As a rule, periods of exchange rate instability seem to be correlated to periods of foreign reserve volatility. This contradicts the theory. But it is easily understandable in light of bloc-floating: if authorities attempt to reduce the volatility of exchange rates, they have to intervene in the market and that creates reserve volatility. After abandoning their link to the US dollar in the 70s, an increasing number of countries have pegged their exchange rates to regional anchor currencies. In 1992, only 26 currencies out of 178 followed a fixed exchange rate to the dollar. However, more important than the number of currencies is a currency zone for international trade.

Empirical evidence for the emergence of monetary blocs has been provided by Frankel and Wei (1992) and Bénassy-Quéré (1995, 1997, 1999). A country is defined as belonging to a currency bloc when the relative exchange rate variability is significantly lower within a group of countries than

across groups.<sup>2</sup> This definition permits some flexibility in the pegging rule but emphasises the reduction in exchange rate volatility. The size of the currency bloc can be measured by the share of foreign trade between countries belonging to the bloc compared to total world trade. It appears that the dominant characteristic of the last 20 years was the emergence of the DM-bloc, while Asia, with the exception of Japan, belonged to the dollar zone.

**Figure 3: Importance of Currency Blocs**



Source: Bénassy-Quéré in CEPII n° 63

Yet the size of a currency bloc is not to be explained solely in terms of the stabilisation of the major trade relationships. While the D-mark served as anchor currency only for those economies in which trade with the European Union (EU) accounted for over 50 % of their exports, the U.S.A. did not necessarily have to be the major trading partner to induce a country to link its currency to the dollar. The reason for this was the international role fulfilled exclusively by the dollar since the second World War.

What trends are displayed by exchange rates in a world of bloc floating? There are numerous treatises in the literature explaining exchange rate volatility. The *overshooting effect* of the nominal

<sup>2</sup> For Bénassy-Quéré (1999) the criterion is a quarter of the volatility compared to the other two world currencies.

exchange rate as a deviation from long-term equilibrium as cited by Dornbusch (1976) results from the differing price elasticities of capital and product markets. The *magnification effect* (Bilson, 1979) of a nominal exchange rate overreaction is based on differing monetary policy expectations by market participants. But bloc floating gives rise to an additional enlargement effect differing from the two previously mentioned in that the equilibrium rate of exchange is in itself instable and volatile. Thus, in the absence of any orientation for financial market operators, exchange rate movements are left to chance (*random walk*).<sup>2</sup>

How is the "enlargement effect" of bloc floating explained? Countries peg their currency to an anchor to create stability in the region and promote investment. Hence, given the existence of a currency bloc, the external exchange rate between the blocs is the only instrument to adjust fundamental imbalances between the blocs. The larger the currency zone, the greater is the need for adjustment of the flexible exchange rate between the anchor currencies for a given imbalance.

Consequently, there is a trade-off between intra-bloc stabilisation and inter-bloc volatility through exchange rate pegging. As a result the equilibrium exchange rate between the anchor currencies becomes volatile and can no longer serve financial market operators an orientation for exchange rate expectations. For when a large proportion of trade is conducted within one currency bloc, the adjustment of fundamental imbalances can take effect only in relation to the remaining flexible exchange rates. In 1992, for instance, 45 % of U.S. imports came from the dollar zone. The impact of dollar devaluation as a result of the U.S. deficit on foreign trade affected only about one half of American trade. Hence the necessary devaluation of the dollar against the yen and the D-mark had to be greater than with a truly flexible exchange rate in order to achieve an objective for the American balance-of-trade deficit. The more currencies are pegged to the dollar, the greater the devaluation in relation to the flexible exchange rates must be in order to achieve the desired current account response. In other words, the larger the currency zone, the less efficient is the exchange rate as an adjustment tool and the greater is the required adjustment of the inter-bloc equilibrium rate.

Exchange rate uncertainty, in turn, is not without effect on investment activity and growth prospects. The emergence of currency blocs can be attributed to countries' striving to maximise the profitability of domestic investment for risk-averse investors and hence to maximise investment,

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<sup>2</sup> Formal derivation see Collignon (1997, 1999).

because lessening the exchange rate risk within the bloc eliminates risk premiums and makes investment more profitable. Hence, the prime motive of pegging is economic stability and growth. But this is accompanied by increased exchange uncertainty between the currency blocs: if the equilibrium rate of exchange between currency blocs is volatile, international investors will make allowance for short-term policy measures and will demand risk premiums to offset volatile equilibrium rates. Hence investment will shift to the less-risky short-term sector. The larger the currency bloc, the greater the risk premium that may be expected. Thus bloc floating triggers a negative feedback effect on reserve currencies. This in turn exerts a negative, unintended effect on investment and growth.

In the steady state, the logic of bloc floating implies benefits for the country of the anchor currency by reducing the exchange rate risk within the bloc without constraining domestic policy objectives. But for the pegging countries the situation is more ambivalent. While diminished exchange rate volatility within the bloc will stimulate trade and investment, the pursuit of a restrictive monetary policy in the anchor economy would generate deflationary pressures. This exerts a counterproductive effect on economic growth in peripheral countries, since higher growth would require interest and exchange rates to be lower than is possible in a bloc floating regime.<sup>3</sup> This leads to irregular adjustment crises in currency blocs, as witnessed in Europe in 1992/3 and in Asia in 1997.

### 1.3 CURRENCY BLOCS - THE ASIAN EXPERIENCE

Although nobody could foresee the dramatic consequences of the Asian crisis which broke out in 1997, it had already become apparent for some time that the successful development of South East Asian economies had come to an impasse. Their rapid integration into the world market had been dependent on the monetary stability of their dollar peg. This provided a stable environment for investment and trade and kept the cost of capital comparatively low. However, once the penetration of the dollar area by cheap Asian exports had reached a significant degree, the dollar-oriented strategy yielded diminishing returns and further advances were difficult. Japan and Europe became attractive alternative markets to the US in the early 1990 when both regions' exchange rates were overvalued in relation to the US dollar.

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<sup>3</sup> See Collignon, 1999, Chapter 4.

**Table 4: Exchange Rate Management and Trade Orientation of Asian countries 1991**

Country	Nominal anchor	Main trading partners: (20 to 50% of total trade)	
		Import	Export
India	None	EU	EU
Indonesia	Dollar	Japan	Japan
Pakistan	Dollar	EU	EU
China	Dollar	Japan	USA
Malaysia, Philippines, Thailand	Dollar	Japan	EU/Japan/USA
Korea, Singapore	Dollar	Japan	USA

Source: Comptes Harmonisés sur les Echanges et L'Economie Mondiale (CHELEM) and Agnes Bénassy-Quéré (1997)

After the EMS crisis of September 1992 economic growth in Continental Europe slowed down and the bursting of the speculative bubble in Japan reduced the demand for imports from the East Asian countries significantly. As a result, East Asian exports were constrained (except to the US), while booming domestic demand stimulated imports primarily from EU and Japan. Their current account deficits worsened markedly after 1993/94. These deficits were funded mainly with unhedged short term dollar credits from Japanese and European banks.

When the dollar began to appreciate from early 1995 onwards, export earnings from Europe and Japan were insufficient for the needed liquidity to service dollar-denominated foreign debt. By mid 1997, the dollar exchange rate had risen from 1.40 D-Mark to 1.80 D-Mark and from 85 Yen to 115 Yen.

Although Asian debtor countries were poorly regulated, their deposits were more or less insured by their national governments. Asian banks were therefore tempted to overborrow by accepting foreign exchange liabilities without covering the exchange rate risk. Short term bank loans into the five affected economies – Indonesia, Korea, Malaysia, Philippines and Thailand – peaked in 1996 at \$40.6 billion and then reverted to \$32.3 billion in 1997.

With the progressive abolition of capital controls, managing national monetary policy with the aim to sustain the exchange peg meant that short term interest rates had to be flexible and increasing. This in turn required that the term structure of finance within each Asian country be lengthened. If business finance were short term, changes in short term rates imposed undue strain on commercial

banks and enterprises and were therefore also harmful for growth. The difficulties in servicing the short-term debt then shattered the confidence of the lending banks and induced them to withdraw their capital abruptly. It forced the borrowing countries to make much higher reductions in imports and production than would have been necessary had the financial debts been restructured in a coordinated way. As a consequence, the dollar peg of many Asian countries became unsustainable. After the crisis, Asian countries had to choose a new exchange regime: a new peg – and which currency? – or free floating?

#### 1.4 FUTURE OPTIONS FOR EXCHANGE RATE POLICY IN ASIA

The pre-crisis exchange rate regimes of the Asian countries had three features in common:

1. The dominance of the dollar for the majority of countries in the region despite the comparatively minor role of trade relations with the U.S.A.
2. The comparative rigidity of the exchange rate regime despite increasing liberalisation of capital movements.
3. Underdeveloped monetary policy co-operation within the region despite the proliferation of trade and direct investment links.

Hence pegging to the dollar was not an optimal solution for the Asian region in the long term, although it allowed the increasing integration of the emerging economies into the world market. In many ways the 1997 shock and its consequences in Asia resembles the European experience after the end of the Bretton Woods System and the first oil shock in 1973 with volatile exchange rates, rising inflation and low growth. It remains to be asked, therefore, what an optimum exchange rate policy for the Asian region could look like in future.

Against a background of increasing intraregional trade links (Table 5), volatile exchange rate trends are detrimental for the entire Asian region. More than 40 % of South East Asia's imports and nearly half its exports are with Asia, while trade weights with the US and Europe are similar although America dominates as a supplier and the EU as a market. In a bloc-floating world with a highly volatile dollar/euro exchange rate, trade and external debt strategies will be constantly disrupted given the importance of these two reserve currencies. Flexible exchange rates are counterproductive

in the medium to longer term if the region aims to pursue a sustainable growth path. Accordingly, there are two available options: greater monetary integration within the region or stabilisation with respect to one of the key currencies of the major trading zones.<sup>4</sup>

However, an unstable or highly volatile transatlantic exchange rate would be a permanent source of instability for Asia. Therefore, the region must have a prime interest in the exchange rate management by EU and US authorities. Secondly, given the increasing regional trade, intra-Asian exchange rate arrangements seem recommendable. Yet, mainly for political and cultural reasons, Asia has not been able to achieve close regional co-operation comparable to Europe after the war, although intra-regional trade in South-East Asia has become substantial. Willingness to co-operate may improve as a result of the crisis. Ideas of regional monetary funds and mutual credit lines have been explored. In the medium to long term, the essential question will be whether Asian countries should integrate around the Japanese yen, which could quickly become an international key currency or around a regional anchor such as the Chinese yuan.

The trade structure of Asian countries is diverse and their main trading partners are the USA, Europe, Japan and intra-regional countries. None of these countries could claim a dominant position in Asia. This mismatch raises the question of the optimal pegging strategy given that the reduction of exchange rate instability improves investment: A new regime could therefore be based on a trade-weighted basket of currencies. Such a basket could link a regional currency system, perhaps centred around the yen, with a global currency system based on the dollar and the euro.

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<sup>4</sup> Dornbusch and Park (1999) and Williamson (1999), for example, have proposed a "BBC" exchange rate regime (band-basket crawling).

**Table 5: Import and export shares 1995 (as % of total)**

## IMPORT SHARES

Country of origin	destination:						
	World	USA	EU15	JAPAN	SE Asia*	CHINA	Central EUR
World	100	15.18	38.70	6.37	13.86	3.48	1.93
USA	100	0.00	20.99	11.91	16.39	8.66	0.34
EU15	100	6.71	61.36	2.30	5.75	1.57	2.90
JAPAN	100	27.67	15.11	0	35.58	8.76	0.17
SE Asia*	100	20.70	15.15	13.91	27.80		0.50
CHINA	100	13.48	14.05	25.67			
Central EUR	100	4.25	52.90	3.32	7.22		11.52

## EXPORT SHARES

Country of origin	destination:						
	World	USA	EU15	JAPAN	SE Asia*	CHINA	Central EUR
World	100	11.29	41.23	9.21	12.39	2.70	3.23
USA	100	0.00	18.24	16.80	16.90	2.40	0.90
EU15	100	6.13	65.37	3.60	4.85	0.98	4.42
JAPAN	100	21.11	14.90	0	27.05	10.89	1.69
SE Asia*	100	13.36	17.12	23.66	24.85		1.68
CHINA	100	28.09	18.60	23.17			
Central EUR	100	2.01	61.96	0.81	3.21		19.32

\*\* Indonesia, India, Korea, Hong Kong, Singapore, Taiwan, Malaysia, Philippines, Thailand, Asia NDA

Source: CHELEM

Could the yen emerge as a regional anchor currency? Given the current state of the economy in Japan and its long-term prospects, this would appear to be uncertain. To date, the yen has not served as an anchor for any currency.<sup>5</sup> Since the seventies the yen has displayed a continuing trend towards overvaluation against the dollar<sup>6</sup>, resulting in permanent pressure on Japanese production costs and the shifting of investment abroad. To maintain the real rate of exchange and hence the ability to compete at international level, the constant nominal appreciation of the yen set off a deflationary spiral. Consequently there is no scope for monetary policy action in Japan, while fiscal policy lacks

<sup>5</sup> For a possible explanation of this phenomenon, see Bayoumi and Eichengreen (1998).

<sup>6</sup> Over the period from 1970 to 1994 the yen appreciated by 250 % against the dollar, twice as much as the corresponding cumulative D-mark appreciation. For an explanation of the phenomenon of the "ever rising yen", see McKinnon and Ohno (1997).

the necessary credibility of a resolute government. So it is essential for the period of the ever-rising yen that has lasted for almost thirty years to be brought to an end if Japan's domestic economy is to be strengthened. The development of the yen into a regional anchor currency, could be an important step toward containing this historic strength. The lessons from Europe are clear in this respect: by overcoming the exchange chaos of the 1970s, the creation of an DM-bloc through the European Monetary System <sup>3</sup>, Europe has returned to macroeconomic stability and the deflationary bias in Germany has been less than in Japan.

Against the background of Japan's weakness and the East Asian crisis, the People's Republic of China has played an unexpected role in the past few years, with the yuan increasingly assuming the status of a regional transaction currency in cross-border trade. The official stock of currency reserves is put at \$ 200 billion. However, China's ability to compete is undermined by regional devaluations, so that linkage to the dollar is not assured in the medium term. Given the large share of semi-finished goods in China's exports, a devaluation of the yuan could have a negative effect on China's growth and development at least in the short run, as was already the case in other Asian economies. Moreover, the reforms of the administrative system have generated tensions which the government has hitherto held in check with high growth rates. Hence extensive reforms are still needed, not least to ensure the convertibility of capital accounts. These developments would not favour the yuan as a regional anchor.

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<sup>3</sup> For a description see Collignon , 1994

## **CONCLUSIONS**

High exchange rate volatility and possible misalignments between the dollar and the euro could become a permanent source of uncertainty for emerging countries and especially for Asia. Hence, it would be natural for the yen to fulfil a greater regional role. Yet, in the long run a lack of stability and policy co-ordination between the USA, Europe and Japan could hamper economic and monetary integration in Asia as well as in Central and Eastern Europe. As Prime Minister Mahathir of Malaysia pointed out: “When elephants fight, it is the grass that gets trampled.”

However, if the relation between the three key currencies could be stabilised, this would also stabilise currency relations inside Asia and between Asia and the rest of the world. In this environment it is likely that some form of Asian monetary system could emerge where Japan would play a natural role.

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