

# DIW Berlin

Deutsches Institut  
für Wirtschaftsforschung

[www.diw.de](http://www.diw.de)

Monetary and Exchange Rate Policies in Cambodia, Laos and  
Vietnam: The Scope for Regional Cooperation

## **The Euro and its Relevance for East Asia: Lessons for Monetary Policy**

Regional Workshop, Siem Reap, 26-27 Sept. 2006

---

Dr. Stefan Kooths  
DIW Berlin – Macro Analysis and Forecasting

## **Outline**

- **Overview of European Monetary Integration**
- **The ECU and the European Monetary System**
- **The Euro and the European Monetary Union**
- **Lessons for Monetary Policy (in East Asia)**

## Outline

- **Overview of European Monetary Integration**
- The ECU and the European Monetary System
- The Euro and the European Monetary Union
- Lessons for Monetary Policy (in East Asia)

# European Monetary Integration: Overview 1

- 1950s: Treaties of Paris (1951) and Rome (1957)
- 1958: European Monetary Agreement ( $\pm 1,5\%$ )
- 1969: Den Haag agreement on Economic and Monetary Union as long-term objective
- 1971: Werner Plan (Economists vs. Monetarists)
- 1972: European Currency Snake in the Tunnel
  - currency band:  $\pm 2,5\%$  (intra-European)
  - dollar and member currency interventions
- 1973: European Currency Snake
  - group floating vis-à-vis the dollar
  - European Monetary Cooperation Funds
  - system crumbles more and more (5 members left in 1978)

## European Monetary Integration: Overview 2

### EMS

- 1979 Start of the European Monetary System (EMS)
- 1986-92 Completion of the Single European Market (free movement of goods, services, capital and labor)
- 1989 Delor-report
- 1990 – 1993 EMU Phase 1: Set up
- 1992 EMS crashes
- 1994 – 1998 EMU Phase 2: Preparation
- 1999 – 2002 EMU Phase 3: Start and completion

### EMU

## Outline

- Overview of European Monetary Integration
- **The ECU and the European Monetary System**
- The Euro and the European Monetary Union
- Lessons for Monetary Policy (in East Asia)

## Building Blocks of the EMS

- European Currency Unit (ECU)
- Currency and intervention system
- Deviation indicator
- Borrowing facilities (credit mechanism)

# The European Currency Unit

- Currency basket
- Weights according to
  - intra-European trade
  - GDP
  - Standby quotas (short term support facility)
- Composition checks (ECU revisions)
  - every 5 years
  - weight changes of single currency of more than 25 %
- Functions of money
  - unit of account (European institutions), formerly EUA (1974)
  - unit of payment for interventions
  - store of value



## EMS Currency and Intervention System

- Fixed but revisable exchange rates
- ECU as reference currency
- Fluctuation margins:  $\pm 2,25$  % from bilateral central rates (some countries:  $\pm 6,0$  %)
- Unlimited intervention obligations at fluctuation margins
- Inframarginal cooperative interventions are allowed

## EMS Deviation Indicator

- Maximum deviation of currency  $i$  from central ECU rate:

$$d_{\max,i} = (1 - \text{Weight}_i) \cdot 2,25 \%$$

- Deviation threshold:

$$d_{\text{thres},i} = 0,75 \cdot d_{\max,i}$$

- Passing of the threshold indicates need for monetary action
- BUT:
  - DI does not necessarily indicate bad monetary policy by deviating country
  - tensions between groups of currencies are hardly detected

## EMS Performance

- Exchange rate stabilization?
  - 15 realignments
  - substantial interventions, capital controls
- Reduction and narrowing of inflation rates?
  - rather an international phenomenon
  - insufficient narrowing of inflations rates caused EMS tensions
- German dominance
  - Germany as n-th country
  - Bundesbank as stability anchor
- Crisis and collapse 1992/1993
  - speculative attacks
  - intervention bands widened to  $\pm 15\%$

## Outline

- Overview of European Monetary Integration
- The ECU and the European Monetary System
- **The Euro and the European Monetary Union**
- Lessons for Monetary Policy (in East Asia)

## The Path to the Euro (EMU Phases)

- **1990 – 1993 Phase 1: Set up**
  - Creation of the European Union (EU),
  - Maastricht Treaty (1992), Convergence Criteria
- **1994 – 1998 Phase 2: Preparation**
  - Creation of EMI (1994) and ECB (1998), Frankfurt
  - Independence of central banks
  - Monetisation of public debt is forbidden
  - Stability and Growth Pact (1997)
  - Irrevocably fixed parities (31.12.1998)
- **1999 – 2002 Phase 3: Start and completion**
  - Birth of the Euro (1999)
  - Euro notes and coins (2002)

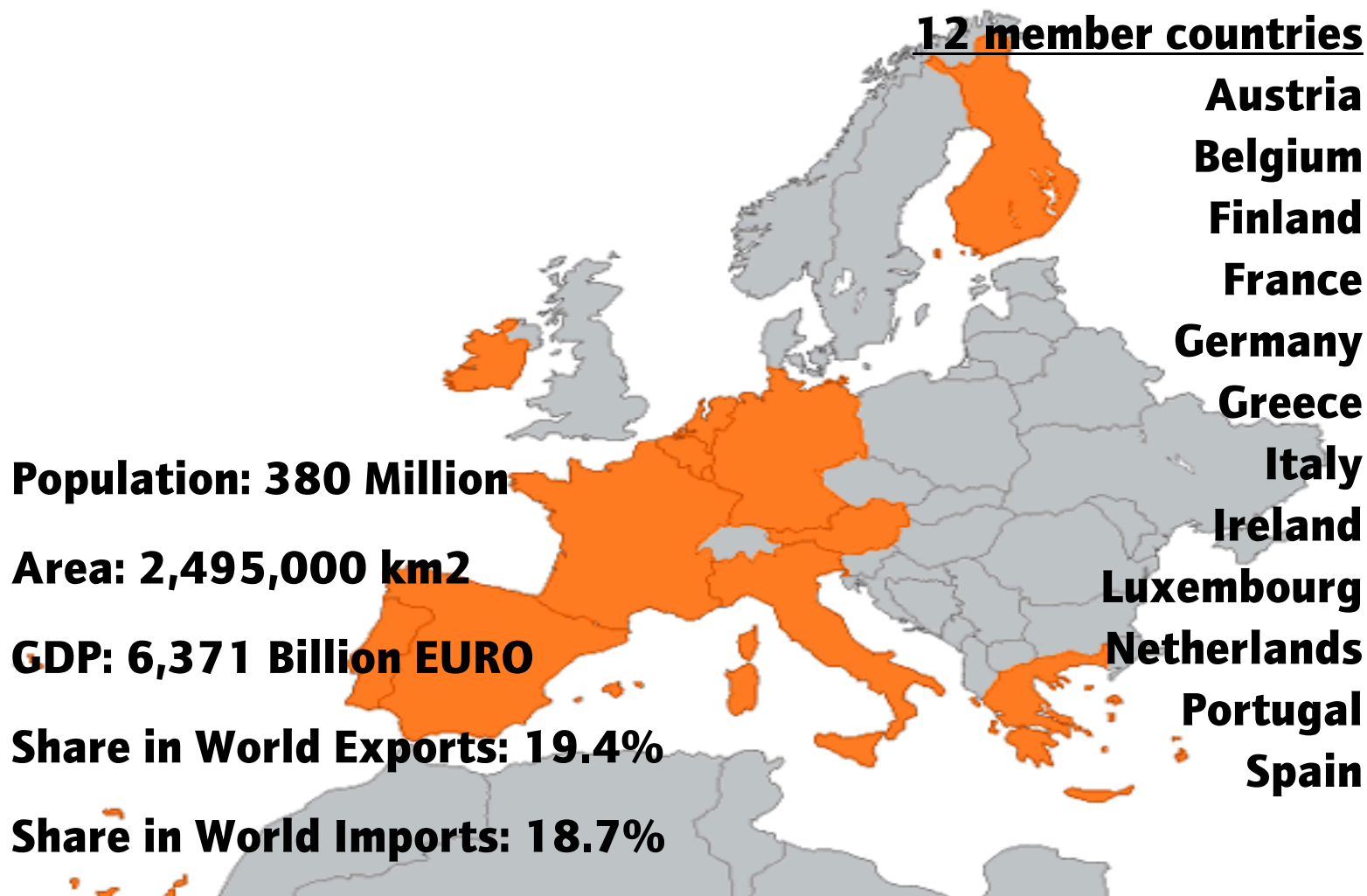
# Convergence Criteria

- Inflation  
(max. 1.5% > avg. best 3)
- Long-term interest rate  
(max. 2% > avg. best 3 for price stability)
- Public deficit  
(max. 3% GDP)
- Government debt  
(max. 60% GDP)
- Exchange rate stability  
(for 2 years)

## Kick-off for the Euro

- Euro starts from 1 January 1999
  - Inter-bank, money, capital, and foreign exchange markets in Euro
  - Wholesale payment system in Euro
  - Members' new public debt in Euro
  - ESCB conducts: Single monetary policy; Foreign exchange operations; System of payments
- 1 January 2002 - 1 March 2002
  - Completion of the changeover to EMU
  - Introduction of EURO banknotes and coins
  - Replacement of old banknotes and coins

# EURO-Area Statistics





# Benefits and Costs of the Euro

## ■ Benefits

- Elimination of exchange rate risks and significant reduction of transaction costs
- Stability-oriented macroeconomic framework
  - ECB as Bundesbank copy
  - Fiscal rules (questionable)
- Some protection against disturbances from remaining global exchange markets
- Strengthening financial market integration

## ■ Costs

- Single monetary policy despite diverging business cycles (loss of national monetary stabilization policy)

# International Role of the Euro

- Strong and stable international currency
- Deep and liquid financial markets
- Favorable conditions for the EURO to become an international currency
  - Used as currency of a large economic and trading unit
  - Well-developed and growing capital markets in the Euro area
  - Price stability within the Euro area
  - Full independence of ECB from national governments

## **Euro performance (2004/2005)**

- Inflation rate close to 2 %
- Market share (foreign exchange turnover)
  - Euro: 20 %
  - US-Dollar: 45 %
  - Yen: 10 %
- Currency denomination of international bonds
  - Euro: 45 %
  - US-Dollar: 40 %
  - Yen: 4 %
- Official holdings of foreign exchange
  - Euro: 20 %
  - US-Dollar: 63 %
  - Yen: 5 %

## Outline

- Overview of European Monetary Integration
- The ECU and the European Monetary System
- The Euro and the European Monetary Union
- **Lessons for Monetary Policy (in East Asia)**

## Lessons for Monetary Policy

- **European monetary integration**
  - followed real market liberalization
  - governed by common institutions (trust building)
  - took time (stage-by-stage approach)
  - encountered many drawbacks
  - benefited from the European landscape (no dominating power)
  - convergence (inflation, interest rates) and policy coordination
- **Successful small countries within the EMS/EMU**
  - understood and played according to the rules of the game
  - regained their right to say in currency issues via monetary integration

## Issues for Monetary Policy in East Asia

- Problem of leadership: role of China, Japan, ASEAN group of countries
- Follow a bottom-up integration process led by different countries
- Need to define convergence criteria
- Creation and strengthening of common institutions and processes for intergovernmental cooperation
- Clear definition of integration stages and Asian approach