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Use of National Currencies for Trade Settlement in East Asia: A Proposal

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Abstract

Despite a few landmark achievements such as the Chiang Mai Initiative, financial deepening and monetary integration in East Asia has been slow. Meanwhile, proliferation of FTAs and China's successful accession to the WTO have enabled faster progress on trade integration among the East Asian economies. Building on the expanding intra- regional trade, we suggest creation of a multilateral currency arrangement where some of the national currencies could be used for trade settlement within the cooperative framework of ASEAN+3. This would facilitate closer financial integration and greater flexibility of the Asian currencies against the US dollar without being kept captive by the slow progress in capital account liberalization in some countries.

JEL Classification: F15, F33, F36

Keywords: regional financial arrangement; regional financial integration; currency internationalization; international monetary system

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1. Introduction

Achieving deeper financial and monetary integration in East Asia has been an elusive goal. In the aftermath of the 1997-8 Asian financial crisis, ASEAN+3 (the members of the Association of Southeast Asian Nations plus China, Japan and Korea) realized the urgency of constructing regional cooperative arrangements for regional economic integration and expanding the scope of policy coordination to prevent future crises and help safeguard the region from financial spillovers from outside the region. In 2000 they decided to create a regional liquidity support system known as the Chiang Mai Initiative, which was later restructured and renamed the Chiang Mai Initiative Multilateralization (CMIM).

Since then, other regional initiatives followed to expand and complement the role of the CMIM.[1] As memories of the 1997-8 financial crisis faded and financial stability returned, ASEAN+3 momentum for regional cooperation grew until the region experienced the contagion from the 2008 global financial crisis. After years of negotiating to reorganize and increase the size of CMIM finances, CMIM was expected to act. Markets were watching closely to see what role CMIM could play in insulating the region from the onslaught of vagaries of global financial market.

Some of the member countries suffered severe shortages of US dollar liquidity, which drove them to the edge of another financial meltdown. Yet, despite their acute need, none of the countries would consider drawing down liquidity from the CMIM. Accordingly, both global and regional financial markets have ignored the existence of this system.[2] This ineffectiveness of the CMIM, together with travails of the Euro-zone as a monetary union in recent years, has dampened further interest of the member states of ASEAN+3 in consolidating regional monetary and financial cooperation.

While regional efforts at financial cooperation and integration have languished, ASEAN+3 members have been actively pursuing trade liberalization by initiating and concluding negotiations for a number of bilateral and plurilateral free trade agreements (FTAs), both within and outside the region. The proliferation of FTAs has been a new driver for regional economic integration.

In this new milieu of free trade fervor, by virtue of its large size and a commanding share in intra-regional trade, China has been at the center of trade integration in East Asia. While negotiating FTAs with regional partners, China has also been active in elevating the status of its currency — the renminbi — to a global as well as regional unit of account and medium of exchange. Over a relatively short period since it initiated the pilot program for renminbi internationalization in 2009, China has made great strides in expanding the use of its currency for trade settlements throughout East Asia.

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[1] The Economic Review and Policy Dialogue is a non-binding surveillance process structured as a peer review, which is supported by the ASEAN+3 Macroeconomic Research Office located in Singapore and established in 2011. The Asian Bond Market Development Initiative set the stage for creating regional bond markets and integrating the ASEAN+3 financial market.

[2] Because of the limitations of the CMIM as a regional liquidity support system and their aversion to approaching the IMF for its short-run lending facilities, many ASEAN+3 members have chosen to accumulate more foreign exchange reserves than before and sought to secure liquidity through bilateral currency swap arrangements with countries within and outside the region.

Theory and historical experiences of other countries suggest that countries wishing to internationalize their currencies need to satisfy first a set of preconditions including financial reform that liberalize financial markets, deregulate capital account transactions, and make their currencies convertible. China was far from meeting these conditions. Realizing that it was not prepared to embark on a sweeping financial reform, China chose first to promote the use of the renminbi for settling trade with its neighboring economies.

Soon after the start of the pilot program, however, China broadened the scope of the initial program by removing some of the restrictions on capital account transactions and foreign investments in domestic financial assets to support renminbi's international use.[3]

If the Chinese strategy is viable and promising, then some other members of ASEAN+3, that are not ready to open their financial markets and relinquish control over the capital account, may find the path that China has taken a more tenable approach than to go for full convertibility.

The purpose of this paper is to develop such a currency scheme among the ASEAN-5 member states and China, Japan and Korea. Any country with a relatively open trade and financial regime is a potential participant, but these countries are the most appropriate candidates. Each has established an institutional base that is broad enough to accommodate such a regional cooperative arrangement.

This paper proposes a multilateral currency system for trade settlement within the cooperative framework of ASEAN+3. The first section examines regional patterns and structure of trade to gauge the scope of cooperation and the potential benefits from the use of national currencies in trade settlements.[4] Are the trade and financial environment conducive to the construction and operations of such a system?

The second section turns to China's experience with permitting greater use of the renminbi both regionally and globally. Since China is the largest trading partner to all other members of ASEAN+3 as the center country in East Asia's network trade, and has been at the forefront of currency internationalization, China's approach could be emulated by others in the region.

The third section discusses the objectives and the potential size of the currency scheme while the proposed structure of scheme is outlined in the fourth section. Since some of the potential members are likely to run deficits with other members and outflows of currencies of deficit would occur at the initial phase of development, it would be helpful to contain the volatility of capital flows to get the currency scheme off the drawing board. The fifth section examines benefits and risks of the currency scheme, followed by concluding remarks.

[3] Internationalization of currency is defined as a currency's use outside the issuer's borders, including for purchases of goods, services, and financial assets in transactions by nonresidents. It is essentially an organic, evolutionary, and market-driven process. See Kenen (2011).

[4] In this paper the geographical coverage of East Asia includes the 13 countries of ASEAN+3.

2. Trade Patterns and Financial Openness: Preconditions of ASEAN-5, China, Japan and Korea

China, Japan, and Korea and some of the ASEAN-5 will consider participating in the new currency scheme only if they could see the possibility of reaping the benefits of a wider use of their currencies for current account settlement. The benefit will largely arise from lower exchange rate risks and conversion costs, and at the macroeconomic level, from the need to hold a smaller amount of international reserves. Later as these currencies become convertible, the benefit will include reduced cost of financing and investment within the region. Thus, the viability of the new system would, among other things, depend on:

- the degree of openness of trade and the future prospects for trade liberalization
- the share of intra-regional trade and the structure of intra-industry trade
- the degree of financial openness and the future prospect for financial market opening and capital account liberalization.

2.1. Trade Openness

The amount of the benefits would, other things being equal, be positively related to the degree of openness of the trade regime. Historically, the degree has been high in East Asia. From the early 1990s to 2007, all of the ASEAN+3 countries except Indonesia saw a sharp increase in their total trade relative to GDP. The economic slowdown in the aftermath of the 2008 global financial crisis and the subsequent Euro-zone debt crisis has caused a large contraction of trade in both China and ASEAN-5.

As shown in Table 1, during 2008-12, the ratio of total trade to GDP plummeted by more than 11 and 21 percentage points in China and ASEAN-5, respectively. Notwithstanding the setback, except Japan, all other countries in the group still heavily depend on exports relative to emerging economies in other regions.

Table 1. Openness of the Trade Regime: Ratio of Total Trade to GDP

(Unit: %)

	2003-07	2008-12
China	60.2	49.1
Japan	24.2	26.6
Korea	64.9	90.6
ASEAN-10	125.2	104.3

Source: UN COMTRADE Database.

2.2. Proliferation of Free Trade Agreements

There has been a large increase in the number of FTAs in East Asia. At the end of 2012, there were 71 FTAs and more under negotiation in Asia, ASEAN+3, India, Hong Kong SPC, and Taiwan POC. The member states of ASEAN+3 have concluded a number of FTAs with partners within and

outside the regional grouping. Among larger plurilateral ones are the ASEAN FTA and the three ASEAN+1 FTAs with China, Japan, and Korea. They have also initiated negotiations for other bilateral and multilateral FTAs. China and Korea are expected to conclude a bilateral FTA before the end of 2014. ASEAN+3 are participating in the negotiation for a 16-country FTA that includes Australia, India, and New Zealand through the mechanism of the Regional Comprehensive Economic Partnership, which is expected to be concluded by the end of 2015.

Although it is beyond the scope of this paper to analyze the causal relation between the increase in the number of FTAs and use of national currencies for trade settlement, recent studies by Kawai and Wignaraja (2013) and Wignaraja (2013) suggest that the proliferation could have positive effects on construction of the currency scheme. In their examination of the results of a number of independent country surveys as well as the Asian Development Bank and Asian Development Bank Institute firm-level survey in 2007-08, they show that the increase in the number of FTAs in Asia contributed to expanding trade among firms, and prevented collapse of intra- and inter-regional trade during the 2008 global financial crisis.

More important to our study is the finding of these surveys that FTA use by enterprises in East Asia has been higher than expected, and it is increasing as more firms plan to utilize them. If this is the response at the firm level, one may then surmise that the widespread use of FTAs therefore points to the possibility that firms in East Asia — large and small — may also actively participate in the regional currency scheme for trade settlement to the extent that they are fully informed of its benefits.

The increase in the number of FTAs will strengthen the case for use of national currencies for trade settlement, and more so if the existing bilateral and plurilateral FTAs are integrated into a large region-wide FTA. The increase in the number of countries joining the currency scheme could facilitate negotiations for forming such a region wide FTA, and resuscitate construction of the FTA among China, Japan and Korea — a parallel negotiation that has been making slow progress for more than a decade since 2003 when the three countries agreed to a feasibility study.

2.3. Intra-regional Trade

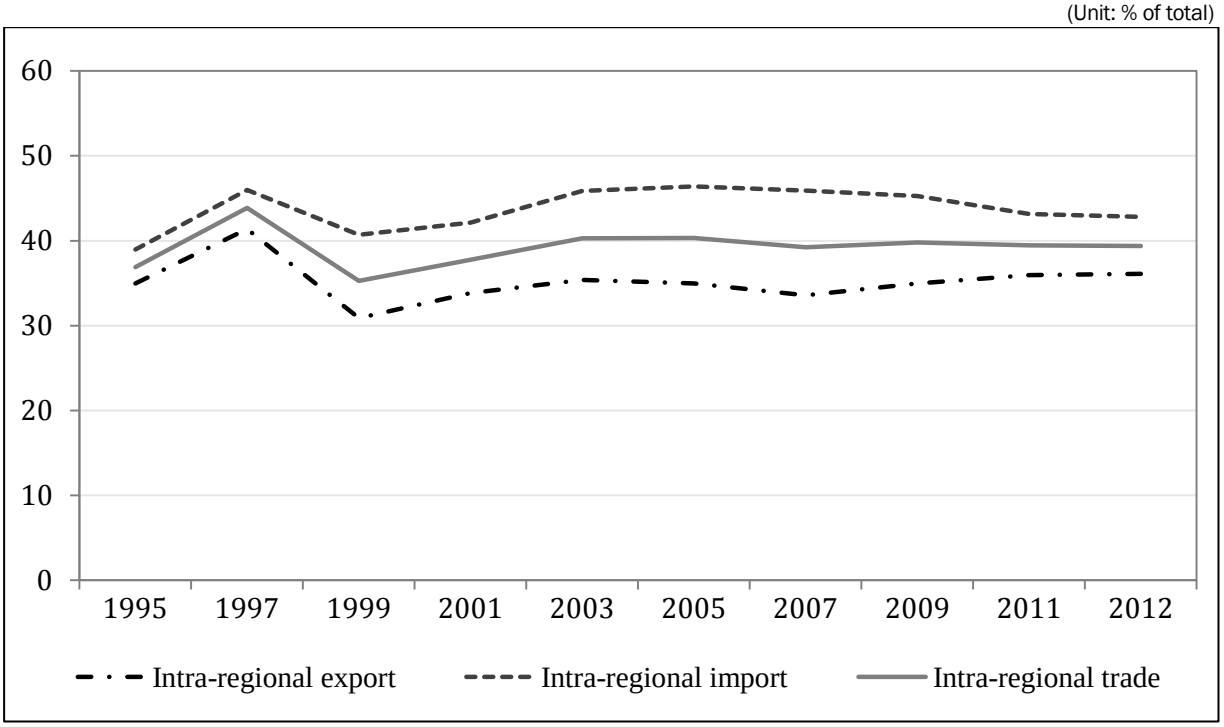
a. ASEAN+3

The greater the potential gains from developing the currency scheme, the larger the intra-regional share in ASEAN+3's total trade. As shown in Figure 1, intra-regional trade in East Asia suffered a severe setback during the 1997-8 Asian financial crisis. The share returned to the pre-crisis level around 2003 and since then has remained at around 40 percent. Among the individual countries, China trades relatively more with the countries outside than those within East Asia. China's regional trade share was smaller at about 30 percent compared to ASEAN (52 percent), Korea (42 percent), and Japan (40 percent) during the 2008-12 period (see Figure 3). However, it provides the largest market for exports and the second largest for imports to all other economies in East Asia. Compared to the Economic and Monetary Union in 1989 — ten years before the creation of the Euro — the proportion of intra-regional trade is much lower in East Asia, but its growth has been impressive,

given the rapid increase in total trade during the relatively short history of economic integration in the region.[5]

Figure 1. Intra-regional Trade Share in ASEAN+3

(Unit: % of total)



Source: UN COMTRADE Database.

b. Trade with China

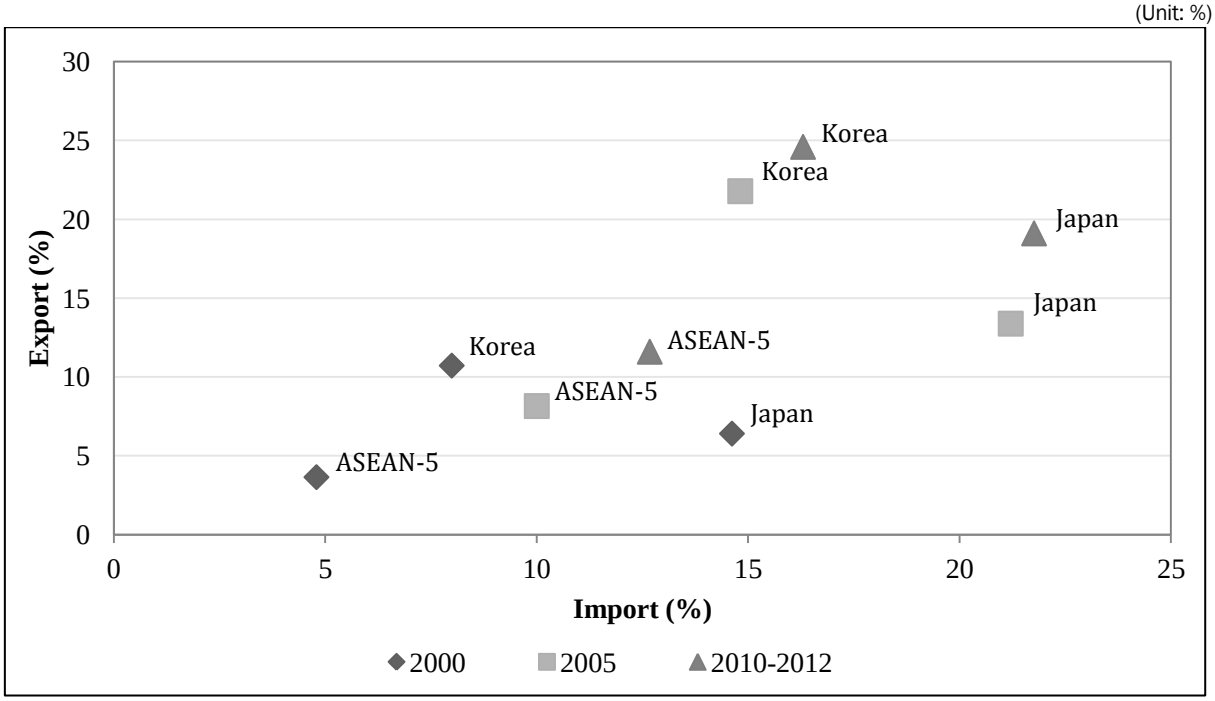
With the rise of China as a global trader and the major assembler of parts, components, and other intermediate inputs, two-way trade of other East Asian countries with China has been growing and is expected to rise. Among the members of ASEAN+3, the increase in the dependence of ASEAN-5 on China for their exports has been remarkable (see Figure 2). In 2000, they shipped less than 4 percent of their exports to China; 12 years later this has grown to more than 12 percent largely at the expense of their exports to the United States. Japan and Korea also depend heavily on China's market as they send on average more than 22 percent of their exports to the country.

As shown in Figure 3, China trades relatively more with non-ASEAN+3 countries. Nevertheless, its share in intra-regional trade among China, Japan, and Korea surged 50 percent in 2012 from about 30 percent in 1995 mostly at the expense of Japan (see Figure 4).

[5] In 1989, the average ratio of intra-regional trade in the Euro Area was 69 percent for imports and 66 percent for exports.

Figure 2. Share of Trade with China by Country or Group

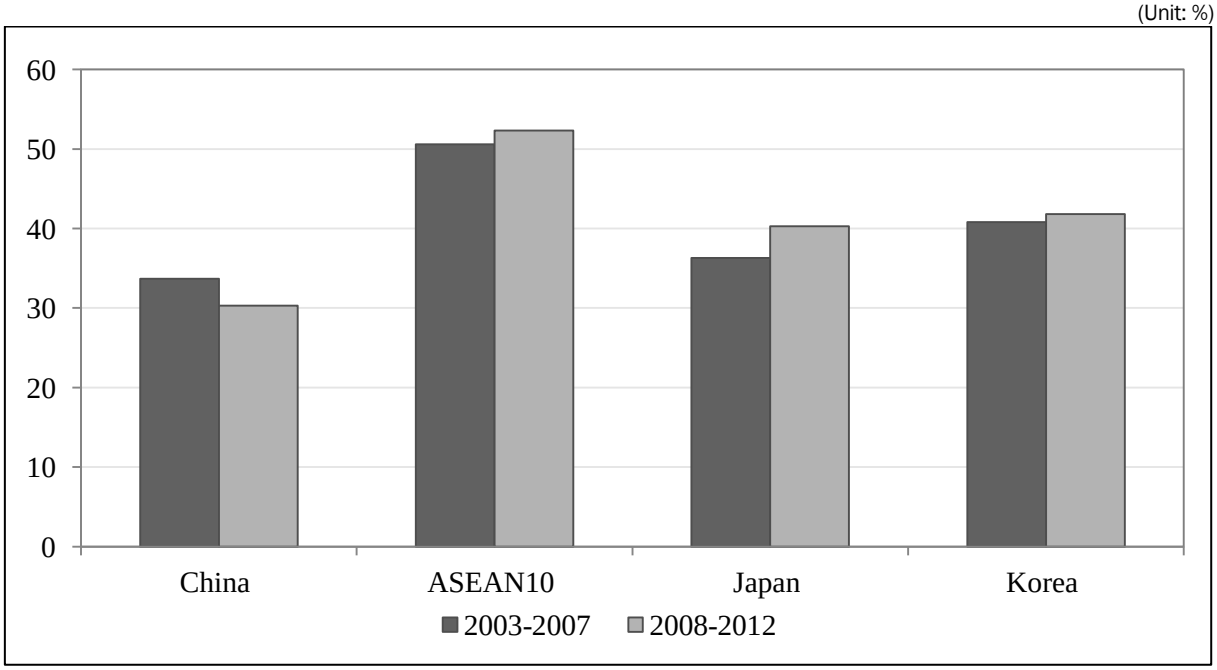
(Unit: %)



Source: UN COMTRADE Database.

Figure 3. Share of Trade with ASEAN+3 by Country or Group

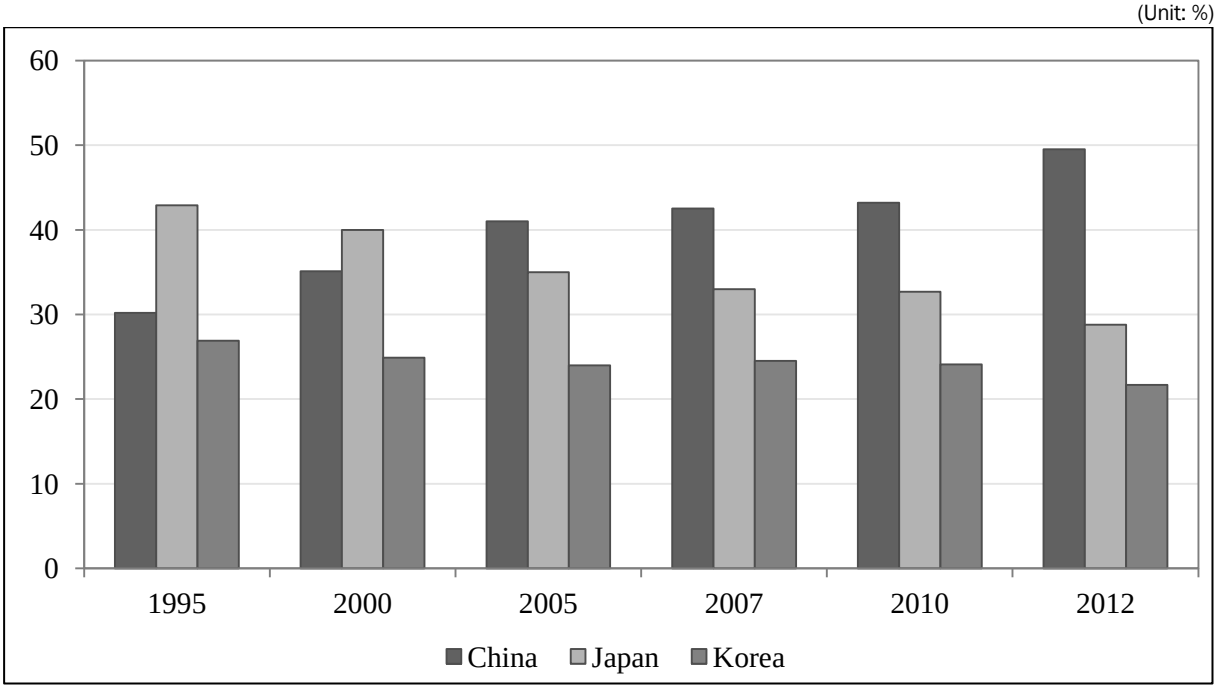
(Unit: %)



Source: UN COMTRADE Database.

Figure 4. Share in Intra-regional Trade among China, Japan and Korea

(Unit: %)



Source: UN COMTRADE Database.

2.4. Intra–industry Trade

a. ASEAN

The network trade centering on China has long been a defining feature of East Asia's intra-industry trade structure. The available data confirm that there has been little change in this structure.[6] Table 2 presents five-year averages of the Grubel and Lloyd (1975) index of the three categories of intra-industry trade — parts and components, capital goods and consumer goods — of ASEAN-5 vis-à-vis China as the center country for the two sub-periods from 2000 to 2009 and a similar average for the 2010-12 periods.

As expected, except Indonesia, parts and components display the highest indices, which did not change to any noticeable degree throughout the 2000s, followed by capital goods. The indices for consumer goods are very low, though rising in recent years.

[6] This is also true for ASEAN+3. See Table 7 in appendix.

Table 2. Intra-industry Trade of ASEAN-5 with China: Grubel and Lloyd Index

	Category	2000-04 average	2005-09 average	2010-12 average
Thailand	Parts and components	0.91	0.75	0.61
	Capital goods	0.47	0.91	0.71
	Consumer goods	0.80	0.74	0.80
Indonesia	Parts and components	0.58	0.27	0.13
	Capital goods	0.31	0.27	0.07
	Consumer goods	0.38	0.40	0.46
Philippines	Parts and components	0.64	0.67	0.90
	Capital goods	0.63	0.68	0.65
	Consumer goods	0.46	0.24	0.23
Malaysia	Parts and components	0.88	0.76	0.86
	Capital goods	0.58	0.62	0.70
	Consumer goods	0.27	0.36	0.33
Singapore	Parts and components	0.95	0.83	0.78
	Capital goods	0.71	0.51	0.45
	Consumer goods	0.42	0.71	0.81

Source: UN COMTRADE Database.

b. China, Japan and Korea

The indices for parts and components and capital goods are also very high in both Japan-China and Korea-China bilateral trade (See table 3). They have remained relatively stable throughout the 2000s. The index for consumer goods between Japan and China is low, though rising in recent years. In contrast, the index for consumer goods between Korea and Japan is higher than the index for parts and components. However, one should hasten to note that at the level of integration in Tables 2 and 3 the data do not necessarily measure the degree of horizontal integration in parts and components and capital goods. In a recent study, Lanz and Miroudot (2011) show that much of the trade in parts and components and capital goods takes the form of intra-firm trade between parent firms and their affiliates and between these affiliates.

Large shares of trade in different parts and components are also distinguished by technological and skill contents and used at various stages of the value chain between countries at different stages of development. These features suggest that more disaggregated data on the Grubel and Lloyd index would show an increase in vertical rather than horizontal integration in intra-industry trade among China, Japan and Korea.

Table 3. Intra-industry Trade among China, Japan and Korea: Grubel and Lloyd Index

	Category	2000-04 average	2005-09 average	2010-12 average
Japan-China	Parts and components	0.75	0.76	0.73
	Capital goods	0.98	0.88	0.90
	Consumer goods	0.10	0.19	0.28
Korea-China	Parts and components	0.64	0.60	0.64
	Capital goods	0.85	0.85	0.72
	Consumer goods	0.47	0.45	0.57
Korea-Japan	Parts and components	0.62	0.65	0.65
	Capital goods	0.46	0.60	0.58
	Consumer goods	0.62	0.92	0.86

Source: UN COMTRADE Database.

Although reliable data are not available, anecdotal evidence suggests that with the growth of foreign direct investment by Japan and Korea in China intra-firm trade, between parent firms of the two countries and their affiliates in China, is likely to account for an increasing share of intra-industry trade between China on the one hand and Japan and Korea on the other.[7] More than any other enterprises, those heavily engaged in intra-firm trade will gain more from settling trade with their national currencies. Therefore, the growing share of intra-firm trade will help garner public support for construction of the currency scheme in the region as a whole and among China, Japan and Korea in particular.

2.5. Financial Openness

Government control of financial markets and the capital account together with currency inconvertibility has been and will continue to stand in the way of currency internationalization in China, Korea and ASEAN-5. As shown in the subsequent sections, following the Chinese strategy, the new currency system proposed in this paper explores the possibility of internationalization in a heavily regulated financial system before transiting to a more liberalized regime over time.

Since the early 2000, Korea has made a great deal of progress in developing a deregulated and open financial regime. As shown in the next section, China has come a long way from a relatively tightly controlled financial regime of the pre-2008 crisis period. Departing from its long standing policy of gradual reform in the past, the statement from the Third Plenary Session of the 18th Communist Party of China Central Committee has affirmed its plans to accelerate interest rate liberalization and capital account convertibility.

ASEAN has launched a long-term plan to liberalize and integrate financial markets and deregulate capital account transactions of the member countries, to be completed by around 2020. Some of the members may be ready to join the currency scheme before the target year.

Changes in East Asia's trade pattern and structure suggest that there is considerable room for deeper

[7] However, the share of intra-firm trade in total manufactured exports was relatively small — only 10 percent in 2007 in Japan. See Lanz and Miroudot (2011).

trade integration through an expansion of intra-regional trade in East Asia. Proliferation of FTAs and vertical structure of intra-industry trade are expected to help promote wider use of national currencies for trade invoicing and settlement, which could in turn speed up trade integration. At the same time if the scheme creates and builds up market pressure for domestic financial reform among the participating countries, it will also serve as a catalyst for harnessing regional cooperation for financial market integration.

3. Progress in Internationalization of the Renminbi

China's financial markets are largely closed to foreign lenders and borrowers and its currency is not convertible. Yet, given the sheer size of its economy and its growing share in global trade, there is little doubt that the renminbi will emerge as East Asia's dominant currency and eventually attain global reserve currency status. Although as the second largest economy in the world, it may have a greater stake in global rather than regional integration at the level of ASEAN+3, and it also has interest in forging deeper economic relations with ASEAN, Japan, and Korea.[8]

Renminbi internationalization — understandably a long-term process — could reduce East Asia's reliance on the US dollar and make Asian currencies more flexible vis-a-vis the dollar. Further progress in renminbi internationalization, however, requires China to open access of its renminbi assets to non-residents, which implies capital account liberalization. Given the elevated global financial uncertainties since the 2008 crisis and excess liquidity swirling around in the global economy, the Chinese monetary authorities apparently came to the conclusion that rapid progress in capital account liberalization was undesirable and could even be destabilizing since China's domestic financial institutions have yet to be efficient and stable enough to compete in the global environment.

China's response was to shift the focus to trade settlement in renminbi, instead of renminbi internationalization. It then opened windows to non-residents to access renminbi assets as necessary to keep the demand for renminbi alive. At the same time, it made steady progress to deregulate capital account transactions to facilitate the second stage of renminbi internationalization.

3.1. Renminbi as a Currency of Settlement

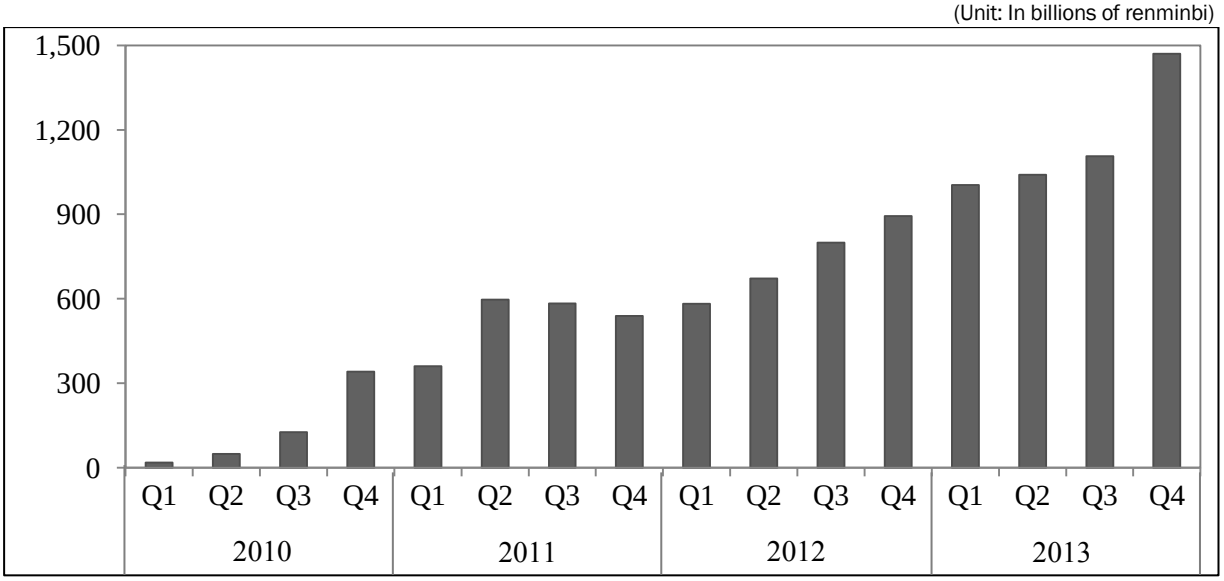
On April 2009, China launched a pilot program for cross-border trade settlement in renminbi in a limited number of cities and regions with the intent of promoting economic and trade ties with its neighboring countries. By August 2011 the geographical coverage was expanded to the entire nation. The eligible transactions have also been enlarged to include not only trade in goods but also in services and other items of current account transactions. Over a span of four years since the inception of the pilot program, all restrictions on trade settlement in renminbi have been lifted. The

[8] Covering the period before the 2008 global financial crisis, Park (2010) and Park and Song (2011) show that there was a reasonable prospect for the renminbi to become a regional medium of exchange and even an anchor currency for a group of East Asian economies — ASEAN-10, Korea, Taiwan POC, and Hong Kong SAR. Since 2008, changes in trade relations and financial markets in the region appear to have further improved its position to become an international currency.

accumulated volume of China's cross-border trade settlement in renminbi under current accounts reached RMB10.2 trillion (US$1.7 trillion) by the end of 2013 (see Figure 5). The share of renminbi trade settlement in China's total international trade saw a six-fold increase from 3.2 percent in 2010 to 18 percent in 2013.[9]

Figure 5. Renminbi Settlement for Cross-border Trade

(Unit: In billions of renminbi)



Source: CEIC.

3.2. Renminbi Settlement Services

From the beginning of the renminbi internationalization, Hong Kong SAR has served as the premier offshore renminbi business center, offering renminbi clearing and settlement services through the Bank of China (Hong Kong). By the end of 2013, the volume of renminbi trade settlement in Hong Kong rose to RMB 470 billion, accounting for 81.2 percent of total renminbi trade settlement. In addition to Hong Kong, Macao and Taiwan branches of the Bank of China and the Singapore branch of the Industrial and Commercial Bank of China have been authorized to offer renminbi clearing services.[10]

China began renminbi settlement of overseas direct investment in January 2011, and in October of the same year, it allowed domestic banks to operate overseas renminbi loan services.[11]

3.3. Interbank Market for the Renminbi

China has also expanded direct trading of renminbi with non-major-reserve currencies. On August

[9] In value basis.

[10] Hong Kong SAR hosts the largest pool of renminbi liquidity outside Mainland China. Banks and other financial institutions in Hong Kong SAR now offer a full range of renminbi financial products, including certificate of deposits, renminbi stocks, renminbi insurance policies, renminbi futures, and 'dual currencies, dual stocks' that were denominated in both renminbi and Hong Kong dollar.

[11] See the People's Bank of China (2011b)

2010, China Foreign Exchange Trade System created an interbank market for the Malaysian Ringgit, which was the first emerging market currency traded in China's interbank market. It was followed in November 2010 by the Russian Ruble and a month later, creation of an offshore market in Moscow. Since then, the renminbi is being traded against the Thai Baht in the interbank market in Yunnan Province (December 2011), the Japanese Yen (June 2012) and the Australian dollar (April 2013) in their interbank markets. Currently, nine currencies are traded for renminbi in their respective interbank foreign exchange market.[12]

3.4. Renminbi as an Investment Currency

China's Ministry of Finance issued sovereign bonds denominated in renminbi for the first time in September 2009 in Hong Kong SAR as part of its effort to construct a yield curve for the offshore renminbi bond market. The offshore renminbi bond market has grown rapidly since July 2010 when the 'Clearing Agreement for RMB Business' was amended to facilitate development of renminbi asset management and insurance business. In April 2012, renminbi-denominated bond amounting to RMB2 billion was also issued in London by the HSBC.

China has steadily opened onshore financial markets to foreign investors. It allowed foreigners to invest and trade in the domestic securities market for the first time in 2002 by launching the qualified foreign institutional investor (QFII) program. Only licensed foreign investors have been allowed to buy and sell equities and bonds in China's stock exchanges in Shanghai and Shenzhen. Since then, China has increased the amount of quota and as of January 2014, a total of 235 foreign institutional investors and US$ 51.4 billion quota have been approved under the QFII program.[13]

The renminbi qualified foreign institutional investors (RQFII) scheme launched on December 2011 permits renminbi fund investments in China's domestic financial assets, whereas the QFII scheme is reserved for US dollar-denominated investments. The investment quota for RQFII rose to RMB 167.8 billion for 57 institutions on January 2014. Also, foreign central banks and renminbi clearing banks outside China have been allowed to invest their renminbi funds in China's interbank bond market since August 2010.

Another key scheme, which links the offshore market in Hong Kong and onshore market in Mainland China, is the pilot program for three types of eligible institutions to invest in China's interbank bond market, launched in 2010 (People's Bank of China 2010). Under the scheme, foreign central banks and monetary authorities, the renminbi clearing banks in Hong Kong and Macau, and banks outside mainland China participating in cross-border trade settlement transactions can invest their renminbi fund[14] in the interbank bond market[15] in mainland China. By the end of July 2013,

[12] The US dollar, euro, Japanese yen, Hong Kong dollar, British pound sterling, Malaysian ringgit, Russian ruble, Australian dollar and Canadian dollar can be traded. The Thai baht can also be traded, but only in the province of Yunnan.

[13] On October 2011, China allowed renminbi-denominated direct investment in China for overseas investors in order to facilitate the direct investment and the People's Bank of China (2011a) issued the rules on settlement of renminbi-denominated foreign direct investment, stipulating that banks start to provide settlement services.

[14] The sources of their renminbi funds are from currency cooperation between central banks, cross-border trades and investment in RMB business.

[15] The interbank mark is the largest bond market in China accounting for more than 95% of total trading volume. In March 2013, the People's Bank of China (2013) issued a notice, allowing QFIIs to apply to invest in the interbank bond market. Prior to that, QFII could only access the exchange bond market.

holdings of foreign banks amounted to only 1.7 percent of total renminbi-denominated government bond outstanding in the interbank bond market.

3.5. Renminbi as a Reserve Currency

To provide an adequate amount of short-term renminbi liquidity and to promote bilateral trade, by the end of 2013, China signed bilateral renminbi-local currency swap agreements with central banks or monetary authorities of 23 countries and regions, amounting to RMB 2.6 trillion (see Table 4).

Table 4. Bilateral Currency Swap Agreements Negotiated by China

Number	Country	Amount (RMB billion)	Date
1	Belarus	20	11 March 2009
2	Argentina	70	2 April 2009
3	New Zealand	25	18 April 2011
4	Uzbekistan	0.7	19 April 2011
5	Kazakhstan	7	13 June 2011
6	South Korea	360 (180)	26 October 2011 (12 December 2008)
7	Hong Kong	400 (200)	22 November 2011 (20 January 2009)
8	Thailand	70	22 December 2011
9	Pakistan	10	23 December 2011
10	United Arab Emirates	35	17 January 2012
11	Malaysia	180 (80)	8 February 2012 (8 February 2009)
12	Turkey	10	21 February 2012
13	Mongolia	10 (5)	20 March 2012 (6 May 2011)
14	Australia	200	22 March 2012
15	Ukraine	15	26 June 2012
16	Singapore	300 (150)	7 March 2013 (23 July 2010)
17	Brazil	190	26 March 2013
18	United Kingdom	200	22 June 2013
19	Hungary	10	9 September 2013
20	Iceland	3.5	11 September 2013 (9 June 2010)
21	Albania	2	12 September 2013
22	Indonesia	100	1 October 2013 (23 March 2009)
23	European Central Bank	350	9 October 2013

Note: The numbers in the parenthesis refer to initial swaps and the date.
Source: People's Bank of China.

Since the relaxation of investments in China's interbank bond market in 2010, a growing number of foreign central banks have begun to invest in China's government bonds to hold as part of their foreign reserves. In December 2011, the People's Bank of China announced that the Bank of Japan would invest in China's government bonds. In April 2013, Reserve Bank of Australia announced its decision to invest up to 5 percent of their foreign reserves in renminbi through the Australian Chamber of Commerce in Shanghai. It was reported that Chile, Malaysia and Nigeria also hold renminbi bonds as part of their foreign reserves.[16]

3.6. The Shanghai Pilot Free Trade Zone

China established the Shanghai Pilot Free Trade Zone on September 2013. In its effort to support the development of the free trade zone, the People's Bank of China (2014) announced the general principles to apply to its operations and development. One of them is continuing reform and innovation, and leading the way in experimentation to promote cross-border use of the renminbi and moves toward capital account convertibility, market-based interest rate reform, and foreign exchange administration reform.

The central bank allowed the banking institutions located in Shanghai to process directly cross-border renminbi settlement for current account transactions and foreign direct investment. Also, financial institutions and non-financial companies located in Shanghai can borrow renminbi fund from overseas.[17] Further measures are expected to be adopted in the free trade zone to speed up internationalization of the renminbi.

4. Objectives and the Potential Size of the Currency Scheme in East Asia

4.1. Objectives

The combined GDP of the economies of East Asia including ASEAN, China, Japan, and Korea — ASEAN+3 — is already as large as that of the United States. East Asia is home to a number of international financial centers. It has a large number of growing domestic financial markets linked with one another more closely than before. In 2010, ASEAN+3 accounted for more than 25 percent of global trade, yet the shares of the two major currencies — the yen and the renminbi in the region — in total global trade payments were about 2.5 and 0.24 percent, respectively, whereas their shares in total global trade were 5 and 11.4 percent (Auboin 2012).

Heavy reliance on the US dollar as the dominant reserve currency no longer serves the interests of either the United States or East Asia as this reliance has left currencies in the region less flexible vis-à-vis the US dollar. If East Asian countries are serious about addressing the mismatch between trade and payment, constructing a regional scheme for using some of the regional currencies including non-convertible ones for trade settlement could prove to be an effective strategy for reducing their

[16] *Financial Times* (25 April, 2013).
[17] However, the borrowed money must not be used for investment in securities or derivatives.

dependence on the US dollar, enhancing flexibility of their currencies against the US dollar, and dampening any financial spillovers emanating from advanced economies,

In addition, such a regional currency arrangement will also help internationalize some of the non-convertible currencies, thereby speeding up trade and financial integration in the region at the same time. The scheme is also expected to provide fresh impetus to supporting various regional free trade negotiations underway and reviving cooperation for financial integration within the framework of ASEAN+3 that has been stalled by global financial instability and stagnation.

Among the currencies of East Asian countries, the yen is a full-fledged reserve currency. As shown in the preceding section, China has put into effect a number of measures for deregulating capital account transactions and limited opening of domestic financial markets for foreign investments. Although they are hardly adequate for what are required for full-fledged currency internationalization, it has now advanced too much to retreat from the pilot program: it is expected to continue to move forward with financial reform. Korea has made several attempts to internationalize its currency, but Korea failed each time because it did not have the will or political support for the requisite institutional and policy reform.[18]

At the 12th ASEAN Summit in January 2007, the member countries affirmed their commitment to create the ASEAN Economic Community by 2015 and 'to transform ASEAN into a region with free movement of goods, services, investment, [and] skilled labor, and freer flow of capital' (ASEAN 2008).

To achieve this ambitious goal in the financial sector, ASEAN has drawn up "plans for capital account liberalization (CAL) and financial services liberalization (FSL) in the ASEAN banking sector, together with institutional and policy reforms and an ASEAN framework for policy coordination and mutual assistance over 2011–2020" (ADB 2013, p. 1).

The probability of success of the proposed multilateral currency settlement scheme would be higher, if it begins with the currencies of China, Japan, and Korea largely because they are major trade partners to each other. We assume that some of the ASEAN-5 member states could join the system from the beginning on a voluntary basis.

Over time, the currency arrangement could increase the number of participating countries as well as the scope of coverage of settlement to include, eventually, capital account transactions. However, use of national currencies would need to be a gradual process, with stability concerns fully addressed at each stage.

In constructing the scheme, this study envisions a multilateral arrangement in which the participating countries agree to use not only their own currencies but also those of others as vehicle currencies in bilateral trade settlements with other partners. For instance, Chinese traders could make payments for their imports from Korea with any one of the participating currencies.

As shown in Table 5, more than 40 percent of bilateral trade between Korea and Japan and between China and Japan were settled by the yen in recent years. In comparison, similar shares for the

[18] See Kim and Suh (2011) on Korea's internationalization of the won.

renminbi were paltry at 1.4 percent with Korea and 0.4 percent with Japan. None of the yen, renminbi, and won was used in trade with third countries as a vehicle currency.

Table 5. Use of National Currencies in Trade Settlement[1)]

(Unit: %)

	Korea-China[2)]	Korea-Japan[2)]	China-Japan[3)]
US dollar	97.3	58.9	52.4
Renminbi	1.4	0.0	0.4
Euro	0.8	0.3	0.4
Yen	0.5	40.2	43.9
Won	0.1	0.6	-
Hong Kong dollar	0.002	0.0001	1.6

Notes: 1) Trade settlement refers to the sum of exports and imports.
2) Average, January – May 2013.
3) May 2012.
Source: Bank of Korea.

However, since the opening of the renminbi-yen interbank market in both Shanghai and Tokyo in June 2012, the volume of renminbi-yen transactions soared to US$20 billion per month in Shanghai and about US$3 billion in Tokyo on average during the March-April 2013 period, up from a previously negligible amount.

At the country level, the new currency system bring several benefits to the participating countries similar to those enjoyed by countries with an internationalized currency, which include lower transaction costs and reduced exchange rate risk, and the ability to issue international debt in their own currencies. However, the participating countries will have to bear substantial costs too, as they are exposed to a number of risks in addition to those difficulties that countries with an internationalized currency often encounter — such as complication of monetary management and straining the domestic financial system's ability to handle increased volatility and large shifts in portfolio flows.[19]

A few challenges will need to be addressed. Since traders are free to choose the currency they prefer, they may discriminate against non-convertible currencies in favor a currency like the yen in their trade settlement. The onus will therefore be on the non-convertible currency members to make their currencies more attractive to traders as a vehicle for financial investments as well as for trade settlement.

Another is the problem of clearing imbalances of currency outflows and inflows stemming from trade deficits or surpluses of the participating countries. If one member runs a persistent deficit on its trade account, then the system may come under strain in the absence of an adjustment mechanism that could control the flows. This problem could be of manageable proportions, if capping on the use of national currencies for settling import bills could be imposed during the initial phase (years) of this arrangement.

[19] For a comprehensive discussion on benefits and cost, see Maziad *et al*. (2011).

A third is the downside risk associated with changes in the imbalances in currency flows, which could create opportunities for currency speculation, increasing the volatility of capital flows and hence the bilateral exchange rates of the member countries. These problems, as discussed in the following section, could be mitigated if the scheme institutes a currency swaps arrangement through which short-term liquidity could be made available to the members suffering from temporary liquidity shortage of a particular currency. In any event, at the initial stage, such position taking will be limited as currencies will be tied to real transactions.

4.2. Potential Size

Based on the 2012 data, and assuming that all trade settlements take place in respective national currencies — export receipts are received in importing country's currencies — a multilateral agreement that covers only trade settlement in national currencies results in a net outflow of national currencies equivalent to US$234 billion for the nine economies as a whole, as shown in Table 6.

About half of this amount will be in Hong Kong dollars amounting to US$124 billion, followed by renminbi equivalent to US$98 billion. Japan, Korea, and Singapore, each of which would have a current account surplus against the countries listed in Table 6, accumulate other Asian currencies equivalent to US$40 billion, US$63 billion, and US$86 billion, respectively. In reality, the actual amounts of the net outflows are likely to be much smaller than the maximum figures shown in Table 6, suggesting that the total amount of the imbalances between the three countries would be of a volume manageable for clearance.

Table 6. National Currency Outflows from the Multilateral Trade Settlement Scheme in National Currencies in 2012

(Unit: In millions of US dollars)

	Export to									
	HK	China	Japan	Korea	Indonesia	Malaysia	Philippines	Thailand	Singapore	**Net**
Hong Kong		123,811	18,576	7,606	2,674	3,712	2,901	5,384	7,222	171,885
China	177,630		126,788	73,313	34,291	28,756	12,888	24,820	36,937	515,422
Japan	24,662	160,591		61,515	20,273	17,701	11,855	43,696	23,290	363,583
Korea	28,265	138,664	38,796		13,955	7,723	8,211	8,221	22,888	266,723
Indonesia	291	24,002	30,135	15,050		11,280	3,708	2,634	17,135	104,235
Malaysia	6,957	31,551	26,879	8,202	8,954		3,398	12,231	30,944	129,116
Philippines	4,776	6,159	9,881	2,862	840	1,018		2,446	4,861	32,843
Thailand	13,041	26,702	23,320	4,752	11,142	12,351	4,830		10,763	106,901
Singapore	40,454	48,391	18,826	16,580	43,332	50,432	6,337	15,622		239,973
Net	296,076	559,872	293,201	189,880	135,461	132,973	54,127	115,053	154,039	1,930,681

Table 6. Continued

(Unit: In millions of US dollars)

	Net based on exports									
	HK	China	Japan	Korea	Indonesia	Malaysia	Philippines	Thailand	Singapore	**Net**
Hong Kong		-53,819	-6,086	-20,659	2,383	-3,245	-1,875	-7,657	-33,233	-124,191
China			-33,803	-65,351	10,289	-2,795	6,729	-1,883	-11,454	-98,269
Japan				22,719	-9,862	-9,177	1,973	20,376	4,464	30,493
Korea					-1,095	-479	5,349	3,470	6,308	13,553
Indonesia						2,326	2,868	-8,508	-26,197	-29,511
Malaysia							2,379	-120	-19,487	-17,228
Philippines								-2,384	-1,477	-3,861
Thailand									-4,859	-4,859
Singapore										0
Net	0	-53,819	-39,890	-63,291	1,715	-13,370	17,424	3,293	-85,934	-233,873

Notes: 1) Negative amounts represent inflows into the export recipient country.
2) Adjusted for re-exports through Hong Kong.

Source: Author's estimation.

5. Structure of the System

The proposed system is built on a set of multilateral agreements among the participating countries on an institutional and operational framework that includes:

(i) convertibility of national currencies of the participating countries received as export payments;
(ii) a clearing and settlement mechanism, involving the designation of clearing banks;
(iii) the creation of interbank foreign exchange markets for direct trading in some of the members;
(iv) investment vehicles for exporters with non-national currencies received from their trading partners; and
(v) an adjustment mechanism for imbalances in currency flows between trade surplus and deficit countries.

Agreement on these five agreements is critical to the success of the system as they are designed to alleviate some of the constraints on use of non-convertible currencies.

5.1. Convertibility

In this currency arrangement, exporters and importers decide on the choice of currency for their transactions. National governments should not intervene to dictate the choice in favor of particular currencies to ensure competition among the participating currencies. Importers will favor use of their national currencies, but it is a different matter to exporters. In choosing a settlement currency, they would consider, among other things, changes in the expected exchange rates of the currencies of their trading partners, transactions and hedging costs, and most of all convertibility into their own or other reserve currencies such as the US dollar.

Exporters are likely to prefer payments of their receipts in yen rather than other non-convertible currencies including the renminbi unless their full convertibility is guaranteed. Their preference for reserve currencies will be even stronger if they import inputs for their exports from non-member countries, which may demand payments in reserve currencies. Exporters may have still fewer incentives to accept non-convertible currencies if they are not allowed to invest their export proceeds in domestic financial assets denominated in their trading partners' currencies.

Two of the keys to successful launching and expansion of the currency scheme will therefore be sustaining stability of the exchange rates and ensuring access of traders to domestic financial markets of the non-convertible currencies. We turn to these issues below.

5.2. Clearing and Settlement

A well-organized multicurrency clearing and settlement system offering services in all participating currencies would be crucial for the efficiency of the operation of the currency scheme. The initial construction of such a system will be the most difficult hurdle the architects of the currency system will have to deal with as they are faced with unevenly developed national clearing and settlement arrangements and different business practices across the member countries. These differences could also be a major source of systemic risk and inefficiency.[20]

The clearing and settlement system is built on a network of clearing banks established throughout the participating countries. These clearing banks provide local banks with diversified clearing services, including settlement accounts, deposit and withdrawal of banknotes, remittance, foreign exchange and bonds settlement in all participating currencies. In the process, they would manage counterparty risk and guarantee contractual performance by playing the role of central counterparty and serve as settlement agents for and intermediaries between local clearing banks and their respective central banks.

5.3. Interbank Foreign Exchange Markets

The convertibility guarantee and an efficient clearing and settlement system would be critical to the scheme in establishing its credibility at the early stage of its development. However, equally important would be the need to complement the scheme by creating the interbank foreign exchange markets for the participating currencies to facilitate their direct trading.

At the initial stage, state-owned banks or other designated non-bank financial institutions could serve as market makers to provide liquidity and to set and control transactions costs to facilitate creation of the markets onshore and offshore.[21] Interbank markets for the renminbi and the yen are

[20] Even in the early 2000s when the European Union had already developed into a highly integrated region, a 2001 study on cross-border clearing and settlement arrangements in the European Union by the Giovannini group for the European Commission found that cross-border transactions within Europe are far more complex, are hindered by a number of significant barriers and are much more costly than domestic transactions. Inefficiencies in clearing and settlement represent the most primitive and thus most important barrier to integrated financial markets in Europe.

[21] In 1996 Korea opened a won/yen market, but closed it less than a year later because of the lack of liquidity and high costs of transactions compared with the won/US dollar and yen/US dollar markets.

already in operation in both Shanghai and Tokyo. Other members will need to make preparations for creating the onshore and offshore markets for their currencies.

5.4. Investment Vehicles

Each member country may create an investment vehicle reserved exclusively for exporters of other member countries to invest their holdings of the country's currency. The demand for the instruments issued by the vehicles could be controlled by adjusting the return on these assets. The most basic instrument would be deposits offered by the clearing banks.

5.5. Adjustments of Imbalances of Holdings of National Currencies

Trade account developments would differ from country to county and the participating countries may run deficit or surplus in their bilateral trade with other members. The new scheme faces the problem of managing imbalances in national currency outflows. As shown in Table 6, for example, China has been running deficits in its bilateral trade with both Japan and Korea. China will then experience a continuing outflow of renminbi, which will be absorbed by the surplus countries. Unless these imbalances are managed in a way that can prevent an excessive accumulation of a particular currency outside of its issuer to sustain stability of the foreign exchange markets, the scheme will come under strain.

It is difficult to conjecture the effects of the national currency scheme on trade account balances of the participating countries. The scheme may, other things being equal, stimulate imports to the extent that importers can use their national currencies, but the actual increase will also depend on exporters' choice of currency for settlement. This feature of the system could interfere or help with adjustments of trade imbalances among the members by increasing the volatility of exchange rates, exacerbating speculation in the foreign exchange markets, and complicating the conduct of monetary policy. Therefore, a protracted one-sided trade deficit or surplus will need to be addressed through an adjustment mechanism that is agreeable to the members.

Although importers are not — and should not be — subject to any restrictions in using national currency, a limit could be set initially on the use of each currency for trade settlement at the country level to prevent excessive accumulation of the deficit country's currency. For example, if Korea runs a larger bilateral deficit in its trade with Japan, Japanese banks (whose customers are the Japanese exporters) may end up holding more Korean won than they desire. The monetary authorities of Japan and Korea will then agree to a bilateral adjustment mechanism to clear the excessive accumulation of Korean won in Japan. If the volume of the actual settlement exceeds the limit, then the excess could be settled by the yen or other reserve currencies such as the US dollar or the euro.

Suppose that, to be more specific, Japan and Korea agree to settle 50 percent of Korea's imports from Japan in Korean won. If the actual amount of the won settlement exceeded the limit, the difference would be adjusted *ex post* in terms of the yen or the US dollar as a 'rebalancing' currency, through a clearing mechanism set up by the two countries' central banks.

The participating countries could also entertain a more gradual approach for adjustment. Suppose Japan accumulates 100 million units of Korean won at the end of the year due to an increase in trade

imbalance. A limit could first be set at 100 million units, and then increase to two times 100 million units. During the second year, Japan would be expected to exchange any amount, including zero, in excess of 100 million units of the Korean won with the US dollar. For any amount in excess of three times 100 million units, Japan would be required to exchange with the US dollar with Korea such that the total amount does not exceed three times the base year's trade imbalance.[22]

6. Benefits and Risk

6.1. Benefits

Although it is fully convertible, the yen has not been as widely used as a full-fledged reserve currency. Most of its exports are still invoiced in US dollar. As the share of ASEAN+3 in its total trade continues to grow as shown in Figure 3, Japan will benefit more than other countries from joining the currency scheme. This is because the yen has a competitive edge — exporters are likely to favor it — over the other currencies for trade settlement. More importantly, if most ASEAN-5 countries sign on, Japan will find it in their interest to go along with them.

Taking advantage of its vast market for regional exporters and importers as leverage, China could take the lead in promoting the new currency scheme. The benefits to China would be sizeable, as the scheme will help broaden its regional base as a launching pad for renminbi globalization. The new currency scheme will also provide some impetus for China to speed up the pace of renminbi internationalization by breaking the impasse on capital account liberalization.

Korea has taken a few steps towards internationalizing its currency. It has established bilateral currency swap arrangements with China, Japan, Malaysia, Indonesia and the United Arab Emirates in recent years and plans to negotiate similar arrangements with other countries. As a highly open economy that is extensively integrated with the global economy, Korea realizes that it has no choice but to open its financial industries and make the won convertible. Participation in the currency scheme may help Korea's policy makers garner domestic support to — and speed up — capital account liberalization and currency convertibility.

For other countries, the benefit would be equally substantial. It would boost confidence in their currencies and allow them to hold relatively fewer reserves in convertible currencies than before. The total amount of foreign exchange reserves held by these countries could be smaller as the use of other currencies for current account settlement will require a smaller buffer, and the inter-changeability of these currencies implies *de facto* a pooling of foreign exchange reserves in convertible currencies.

[22] One can extend this arrangement to cover all ASEAN+3 countries and allow any country to exchange bilateral excesses with any one among the selected currencies with any country that has space and is willing. In other words, extending the above example, country A can exchange 100 million unit of country B's currency with country C with country D's currency if the latter's holding of country B's currency is within three times the originally set limit. The logic behind this approach is to allow countries to adjust holding other country's currencies gradually. This will still lead to greater use of the selected currencies within ASEAN+3, and thus reduce overall reliance on the US dollar and euro.

Finally, the new currency arrangement will strengthen regional capacity to absorb external shocks. As the acceptance of these currencies grows within the bloc, one could expect less volatility among bilateral exchange rates of the East Asian currencies, and greater flexibility of the weighted average East Asian currencies against the euro and the US dollar.

6.2. Relative Advantages

If the experience with forming the CMIM is any guide, constructing a multinational arrangement involving a number of currencies would require an enormous amount of time for negotiations on the details of the scheme among the participating countries. Furthermore, the benefits could not be easily gauged while the risks could be magnified. For this reason, many detractors would not see the benefits of such a scheme.

They would argue that if any country wishes to internationalize its currency, all it has to do is to open its financial markets, remove restrictions on capital account transactions, and make its currency convertible. In particular, they would question the rationale for participation of China and more so of Japan of which yen is a full-fledged reserve currency.

While these objections deserve merit, they overlook a critical advantage that individual attempts cannot deliver. In internationalizing their currencies, emerging economies will find it more expedient, but much less risky and less costly, if they work with other countries in a multilateral framework where the participating members agree to use — and construct requisite infrastructure and a framework for policy cooperation — their national currencies for trade settlement than when they pursue it individually.

Given that the internationalization is essentially a market-driven process, it is uncertain how successful individual attempts will be, even if they are preceded by the reform satisfying most of the preconditions. In a cooperative framework it is at least assured — and market expects — that their currencies will be acceptable for settlement of trade at least among the participating countries, thereby overcoming some of the teething problems, while reaping the gains from the network externality.

In addition, by participating in a multilateral currency scheme, emerging economies could reduce severity of some of the difficulties currency internationalization entails — such as complicating monetary management and increasing the volatility of capital flows. This benefit could be realized by instituting a mutual liquidity support system and setting up a common capital control regime. Finally, participation in the currency scheme may provide justification and build up peer pressure for an extensive financial reform in emerging economies that would find it difficult to implement on their own.

Japan’s participation will be crucial to the success of the scheme. As the only reserve currency, it will enhance not only credibility and stability but also confidence of other participating members. It may also help the participating countries to avoid the strategic misjudgments Japan made in internationalizing the yen.

Although it is the world’s third largest economy, Japan has failed to expand the role of the yen in the global trading and monetary system with the share of the Japanese economy in the world. According

to Takagi (2011, p. 83), "By the end of 2003 … it was clear that any further attempt to internationalize the yen … would be futile without a fundamental change in the economic might of Japan or major cooperation efforts among Asian countries to promote the role of the yen in the region."

Japan has a large stake in a vast and growing export market of East Asia. Joining the scheme will help expand the scope of the yen as a regional settlement currency and thereby regain its export market share — which has been declining — and strengthen its role in deepening regional trade and financial market integration in East Asia. Most important of all, as a reserve currency country, Japan could enjoy the vantage point where it could dictate the terms for settling its bilateral trade with other participating countries with non-convertible currencies.

As for China, having so far managed successfully its internationalization program, one might argue that the country will not have any incentives to deviate from its independent strategy. That may be true, but over time the increase in renminbi circulation outside the country is likely to slow down unless China is prepared to overhaul its financial system to allow foreign holders of renminbi easy access to its domestic financial markets and making the renminbi fully convertible. Furthermore, if China plans to consolidate the regional base of its currency, both Japan and Korea will have to use the renminbi more extensively for their trade settlement than they have in the past. The currency scheme could be one way of achieving that objective.

Although the Chinese authorities claim that they are deeply committed to financial liberalization and openness, they are also faced with a formidable domestic opposition against the internationalization scheme, which is viewed as a cover for an extensive financial market and capital account liberalization which China may not benefit from and certainly is not ready for — at least for now (Yu 2012).

China cannot internationalize its currency and retain a repressive financial regime at the same time. If globalization of the renminbi is part of the vision of China as a global power, renminbi internationalization could serve as a banner under which parties of conflicting interests were brought together to create a deregulated financial system and its vision is realized.

6.3. Risk and Their Management

The participating countries will have to tolerate the same costs countries with an international currency have to bear. Use of one's currency outside its borders could become a source of complacency in the conduct of monetary policy. For example, a growing domestic imbalance could be financed by printing money as the usual market reaction may be absent.

In addition, they are exposed to other risks. To the extent that use of national currencies is limited to settlement of current account transactions, the incidence of speculative attack is relatively small and could be controlled. Even then, currency speculation could increase since currency traders can expect with some degree of certainty accumulation of one particular country against another from trade imbalance. As noted before, however, this pressure can be alleviated by introducing a mechanism for adjustment such as conversion into a fully convertible currency and fortifying it with currency swaps as short-term borrowing arrangements.

7. Concluding Remarks

Instability of the US dollar funding market that followed the 2008 global financial crisis has prompted China to consider ways of reducing its reliance on the US dollar through renminbi internationalization. Korea and Singapore secured access to a foreign exchange swap facility with the US Federal Reserve to ensure uninterrupted funding in the US dollar and to assure investors of their capacity to meet foreign exchange obligations. While these swap lines were critical to restoring currency stability in East Asian economies during the 2008 global financial crisis, they have further strengthened Asia's reliance on the US dollar as a reserve currency.

Over the long run, this situation is not tenable as economic activities in East Asian economies are unnecessarily disrupted by developments in the US dollar market beyond the trade and capital flow channels. Furthermore, it subjects these countries to US monetary policy that may not be optimal for their own economic situations. Each time there is uncertainty in the global financial market that leads to heightened risk aversion, East Asian economies will be at the mercy of changes in the US dollar funding market conditions, possibly forcing them to seek swap lines with the Federal Reserve. Moreover, to the extent most of the trade invoice and much of the costs are priced in US dollar, East Asian economies are reluctant to allow their currencies to instantly and fully adjust their value vis-a-vis the US dollar to any change in the external environment. This often leads to delayed clearance of imbalances.

China has already set the stage for use of national currencies in settling trade in the region. East Asia would find it more effective in reducing its reliance on the US dollar if more ASEAN+3 member states would emulate China's strategy for renminbi internationalization. This paper argues that economic conditions are rife for some of the ASEAN+3 members — in particular Korea and some of the ASEAN-5 member states — to join forces together with Japan and China to create a multinational currency arrangement where the currencies of these countries could be used for trade settlement.

The capital account regimes of these potential members still retain a large number of measures of capital control. Unless they are deregulated and the respective national currencies are made convertible, the new currency system would not be viable as a scheme for currency internationalization in the long-run. It can only be a transitional arrangement. This paper proposes that some of the market-supporting institutions could mitigate the constraints of the closed financial system on the new currency scheme. If these institutions do not work, they will at least build up pressure for capital account liberalization.

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Appendix

Table 7. Intensity of Intra-Industry Trade with ASEAN+3: Grubel and Lloyd Index

		1995	2000	2005	2007	2012
China	Parts and components	0.66	0.54	0.54	0.60	0.63
	Capital Goods	0.58	0.75	0.67	0.71	0.86
	Consumer Goods	0.26	0.21	0.37	0.47	0.51
Japan	Parts and components	0.63	0.78	0.81	0.81	0.84
	Capital Goods	0.41	0.77	0.89	0.87	0.95
	Consumer Goods	0.32	0.21	0.29	0.34	0.35
Korea	Parts and components	0.99	0.95	0.89	0.95	0.81
	Capital Goods	0.60	0.74	0.92	0.95	0.78
	Consumer Goods	0.54	0.82	0.79	0.61	0.75
ASEAN-10	Parts and components	0.85	0.96	0.98	0.99	0.99
	Capital Goods	0.75	0.85	0.88	0.84	0.76
	Consumer Goods	0.80	0.87	0.93	0.92	0.93

Source: UN COMTRADE Database.