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Regional Financial Integration in East Asia: Challenges and Prospects*

Yung Chul Park**
Korea University

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** yungcp@korea.ac.kr

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1. Introduction

The large currency crises of the last decade have been regional in nature (Glick and Rose 1999). Clearly, neighboring countries have a strong incentive to engage in mutual surveillance and to extend one another financial assistance in the face of potentially contagious threats to stability. Regardless of whether the sudden shifts in market expectations and confidence were the primary source of the Asian financial crisis, foreign lenders were so alarmed by the Thai crisis that they abruptly pulled their investments out of the other countries in the region, making the crisis contagious. The geographical proximity and economic similarities (or similar structural problems) of these Asian countries prompted the withdrawal of foreign lending and portfolio investment, whereas differences in economic fundamentals were often overlooked. If the channels of contagion cannot be blocked off through multilateral cooperation at the early stage of a crisis, countries without their own deep pockets of foreign reserves could not survive independently. Hence, neighbors have an interest in helping put out a fire (a financial crisis) before it spreads to them (Ito, Ogawa and Sasaki 1999). As long as a crisis remains country-specific or regional, there is no urgent political need for unaffected countries to pay the significant costs associated with playing the role of a fire fighter.

The formation of a regional financial arrangement in East Asia also reflects frustration with the slow reform of the international financial system (Park and Wang 2002). The urgency of architectural reform in the G7 countries has receded considerably. The slow progress has been further complicated by the perception that the current international architecture is defective. The lack of global governance, including a global lender of last resort and international financial regulation, is not likely to be remedied anytime soon (Sakakibara 2003). As long as the structural problems on the supply side of international capital such as volatile capital movements and G3 exchange rate gyrations persist, the East Asian countries will remain as vulnerable to future crises as they were before. It would be in the interest of East Asians to work together to create their own self-help arrangements. The Chiang Mai Initiative(CMI) of ASEAN+3 is one such available option. However, it is equally important that East Asian countries continue to undertake financial sector restructuring and development. Without sound financial institutions and adequate regulatory regimes, Asian financial markets will remain vulnerable to external shocks. Regional policy dialogue should also contribute to strengthening the efforts to restructure and advance the financial markets in East Asia. The CMI has been developed into a regional forum for policy dialogue and also for concerted regional efforts at financial reform in the region.

The three pillars of liquidity assistance, monitoring and surveillance, and exchange rate coordination are essential elements for regional financial and monetary cooperation. However, the development of regional financial cooperation and its related institutions will be evolutionary as shown in the case of European monetary integration. A shallow form of financial cooperation may comprise no more than a common foreign reserve pooling or mutual credit arrangement such as bilateral swaps. In other words, some kinds of shallow financial cooperation are conceivable without any commitment to exchange rate coordination under which exchange rates of the participating countries are pegged to each other or vanish through the adoption of a common currency. East Asian countries presently appear to pursue this form of financial cooperation (Henning 2002). Although a full-fledged form of monetary integration is not viable at this stage, East Asia may begin to examine the feasibility and desirability of cooperation and coordination in exchange rate policies.[1]

Before the Asian financial crisis broke out in 1997, few would have seriously argued for the creation of a system of regional financial cooperation in East Asia. Only a market-led integration process was taking place in East Asia. However, the financial crisis that erupted in 1997 was a major financial breakdown that gave East Asians a strong impetus to search for a regional mechanism that could forestall future crises. This search is now gathering momentum and opening the door to possibly significant policy-led integration in East Asia (Bergsten 2000; Henning 2002). Bergsten noted that East Asia might be on the brink of a historic evolution, as Europe was half a century ago.

[1] East Asian currency union remains a very remote possibility, but this conclusion is not necessarily a case against a currency union as a long-term objective.

Evidently, there is a rising sense of East Asian identity today. After the proposal to create an Asian Monetary Fund (AMF) was shot down, the leaders of ASEAN responded by inviting China, Korea and Japan to join in an effort to seek economic cooperation in the region. The ASEAN+3 summit in November 1999 released a "Joint Statement on East Asian Cooperation" that covers a wide range of possible areas for regional cooperation. Recognizing the need to establish regional financial arrangements to supplement the existing international facilities, the finance ministers of ASEAN+3 at their meeting in Chiang Mai, Thailand, in May 2000 agreed to strengthen the existing cooperative frameworks in the region through the "Chiang Mai Initiative (CMI)."

The purpose of this paper is to provide a view on the current process and future prospects for regional financial and monetary cooperation. More specifically, the study attempts to draw an institutional design of the two important pillars of a regional financial architecture (liquidity assistance arrangement and policy dialogue process). Through an evolutionary process of enlargement and consolidation of the CMI, this study envisions creation of an Asian Monetary Fund that is fully equipped with liquidity support facilities and a monitoring and surveillance mechanism. In this paper, we do not consider any manifest collective exchange rate coordination under the ASEAN+3 framework.

The paper is organized as follows. Section 2 and 3 examine conditions for a common currency area with reference to regional financial cooperation in East Asia. Section 4 analyzes economic rationale for a regional financial arrangement in East Asia, which is followed by arguments against such an arrangement in Section 5. In Section 6, recent developments in the Chiang Mai Initiative are discussed. Section 7 addresses major barriers to financial cooperation and integration in East Asia. Finally, section 8 concludes with a discussion of the future prospects for financial and monetary cooperation in the region.

2. East Asia as a Common Currency Area

2-1. Overview

In designing the structure of the CMI, the architects of the initiative did not have in their mind laying the groundwork for a common currency area in East Asia. Nevertheless, formation of regional financial arrangements such as the EMS is motivated by the need to stabilize regional financial and foreign exchange markets. If indeed the policymakers of the ASEAN+3 contemplate possibilities of adopting a single currency in the future as part of their cooperative efforts, then questions would arise as to whether East Asia qualifies as a common currency area[2].

Since the early 1990s, there has been a clear trend toward shrinking of independent currencies relative to independent countries. With the advent of the Euro, this trend has become more visible; more and more countries are either joining the existing common currency areas such as the EMU or creating new currency unions. Barro (2001) estimates that 60 countries out of nearly 200 independent countries are members of currency unions or use other currencies such as the U.S. dollar or the Euro.

What are then the developments in the global economies that have induced a large number of countries in particular, smaller ones, to give up their national monies in favor of adopting foreign currencies as their monetary standards? One development has been growing trade and financial integration. With sustained liberalization of trade and opening of domestic financial markets, a growing number of emerging market economies have been integrated or integrating regional as well as global markets for goods and services and for financial assets. The global and regional economic integration has increased pecuniary incentives to reduce transaction costs of trade in goods and services and in financial assets.

The second development is that the benefits of independent monetary policies have declined in many countries. There has been a growing awareness that monetary

[2] See Yam (1999), Murase (2002) and Sakakibera (2002) for the advocacy of monetary integration in East Asia.

policy cannot be used to take advantage of the trade-off between inflation and unemployment. Since monetary policy cannot easily mitigate real disturbances, there is widespread consensus that monetary authorities should concentrate on stabilizing prices rather than influencing employment or output movements. Reflecting this reevaluation of the role of monetary policy, central banks in many countries including emerging market and developing economies have become much more independent than before. As a result, many smaller countries find it easier to give up their monetary independence than otherwise.

The third development is the original sin or the incompleteness in financial markets argument. According to Eichengreen and Hausmann (1999), practically all of emerging market economies, not to mention other developing countries, cannot use their own currencies to borrow abroad or to obtain long-term finance even from domestic financial markets. This inability causes financial fragility because financial institutions and firms are exposed to currency and maturity mismatch problems. As a result, when the currency depreciates, the currency mismatch causes deterioration in the balance sheet that could easily threaten insolvency of financial institutions and firms. If policy authorities defend the fixed exchange rate and as a result a speculative attack ensues, then borrower are likely to default, on their short-term borrowings. Eichengreen and Hausmann (1999), therefore, argue that countries that are not able to secure foreign loans denominated in local currencies will be better off by joining a currency union or using the currency of a large country.

Since the early 1990s, many of the East Asian countries have made great strides in deregulating and opening domestic markets including financial markets to foreign competition. As a result of trade liberalization and market orientation, East Asia has seen a large increase in intra-regional trade and investment. In terms of the importing country data, intra-regional trade in East Asia (ASEAN+3 and Taipei, China) was more than 50 percent of the region's total trade in 1998 when the entire region was in a deep crisis. There is every indication that this trend will continue. The growing integration of intra-regional trade in goods and services has increased the demand by the business community in the region for stabilizing the bilateral exchange rates of East Asian currencies.

Most of the East Asian countries have been reluctant floaters. Policymakers of these countries intervene extensively in the foreign exchange market to stabilize nominal exchange rates. They also realize that stabilizing intra East Asian exchange rates will help increase intra regional trade and capital movements. This interest in regional growth and integration has naturally led to the search for regional collective exchange rate arrangements that could stabilize intra-East Asian bilateral exchange rates.

The Asian crisis in 1997 has also brought home to the region the need of establishing a region-wide mechanism of defence against future financial crises. One such an arrangement is, of course, an East Asian Monetary Union. Since creating an EMU equivalent in East Asia is at best a long-term objective, East Asian countries may have to consider other arrangements such as pegging to a common basket (Williamson, 1998), which could stabilize bilateral exchange rates (effective) in East Asia or an exchange rate mechanism similar to the EMS as a transitional regime.

Before considering the possibilities of introducing an Asian Monetary System (AMS) or common basket pegging, however, it may be in order to examine whether the ASEAN+3 as a group satisfy some of the criteria for a CCA or have the potential of doing so in the future.

2-2. Traditional Criteria for an East Asian Currency Union

Does East Asia satisfy all or some of the conditions for an optimum currency area? What would be the benefits and costs of monetary integration in East Asia? The theory of optimum currency area (Mundell, 1961) suggest that the relative share of intra-regional trade, the nature of shocks, flexibility of factor markets, and economic sizes of participating countries are important factors for determining the benefits and costs of monetary integration.

In order to test empirically whether eight East Asian countries (Hong Kong, Indonesia, South Korea, Malaysia, Philippines, Singapore, Thailand, and Taipei, China) qualify as an optimum currency area, Eichengreen and Bayoumi (1999) estimate an equation of exchange rate variability between a pair of countries which is a function of symmetric output disturbances, the dissimilarity of the export product composition, the ratio of bilateral exports to GDP, and economic size over the 1976-95 period for Japan and its 19 trading partners. Using the predicted level of exchange rate variability between a pair of countries (the standard deviation of the change in the log of the bilateral exchange rate between two countries), they devise an OCA index of which smaller values suggest that countries are good candidates for an OCA. According to Eichengreen and Bayoumi, the estimated equation shows that "the theory of OCA does a credible job of explaining the exchange rate policies of Japan's principal trading partners and that small open economies like Hong Kong and Singapore could benefit more than other East Asian countries by pegging to other East Asian currencies (p.353)."

Using a structural VAR model, Eichengreen and Bayoumi (1999) also analyse time series for prices and output to determine whether disturbances are aggregate demand or supply shocks. They find that compared to Europe, the magnitude of aggregate demand shocks is less than a half in East Asia whereas there is not much difference in aggregate supply shocks over the 1972-89 period. These pieces of empirical evidence suggest that demand and supply shocks in East Asia are smaller and more symmetric than in Europe. In addition, the large increase in intra-regional trade and investment and the relative flexibility of wages and prices in East Asia suggest the conclusion that judging from the traditional criteria, East Asia qualifies as an OCA as much as Europe does. In a recent paper, Bayoumi, Eichengeen and Mauro (2000) apply the E-B's empirical model to the ASEAN data. Not surprisingly, they find that in terms of the OCA criteria, ASEAN is as well positioned for forming a currency union as Europe was a few years before its signing the Maastricht Treaty.

In a recent empirical study, Baek and Song (2001) extend the time period and coverage of countries in testing the Eichengreen and Bayoumi's model for East Asia. They find that the 15 East Asian countries do not share the degree of similarity in the economic structure comparable to that of the EU members; in contrast, however, the share of intra-regional trade, share of manufactures in exports, and openness (the ratio of trade to GDP) of the 15 East Asian economies are close to those of the EMU. A relative measure of intra-regional trade rose to 45 percent in 1999 from about 40 percent in 1990 (Kawai and Urata 2002). Another measure of intra-regional trade development, which is known as trade intensity index, however, shows that trade interdependence among the East Asian countries has not increased very much since the early 1980's (Goto, 2002).

Baek and Song (2001) also show in terms of the output and price data of the 15 East Asian countries that supply shocks are similar across Hong Kong, Korea, Indonesia, Thailand, and Malaysia, whereas demand shocks are correlated at the five percent level among Korea, Indonesia, Thailand, Malaysia, and Taipei, China. The average size of supply disturbances is twice as large as that of the EMU. For demand disturbances, the East Asian average is eight times the European average. Compared to the EMU members, however, the sample East Asian countries show a faster speed adjustment to supply and demand disturbances.

Goto (2002) uses the principal component analysis to measure the degree of synchronization of real disturbances (no distinction between demand and supply) among Asian countries in terms of an investment equation that has the real interest rate, the level of income, and a time trend as explanatory variables. A principal component analysis of the error terms of the sample countries, which are assumed to be proxy variables for real disturbances, show that real disturbances of Indonesia, Korea, Malaysia, Philippines, Singapore, and Thailand are very much synchronized.

Goto (2002) also present a number of recent statistics that suggest that there has been a substantial increase in labor mobility in East Asia. According to the International Labor Organization (ILO), for example, intra-Asian migration increased to 6.5 million in 1997 from about one million in the early 1980s. The migration took place mostly from Indonesia and Philippines to Japan, Hong Kong, Singapore, and Taipei, China.

Baek and Song (2001) also use the model developed by Bayoumi and Prasad

(1997) designed to measure the degree of labour mobility[3]. Their results show that labor mobility is low in East Asia. By combining these pieces of evidence presented by Baek and Song (2001) and Goto (2002), one may conclude that the nine countries of East Asia that include Japan, Korea, Hong Kong, Indonesia, Malaysia, Thailand, Singapore, Taipei, China, and PRC are as plausible candidates as the EMU members are for an OCA.

Lee, Park, and Shin (2002) extend the analysis of Eichengreen and Bayoumi by improving their methodology. In their study, changes in aggregate output in each country are decomposed into three components: a world common, a region-specific, and a country-specific factor. A dynamic factor model then explains fluctuations in output.[4]

As the Maastricht Treaty of 1991 may have influenced the nature of regional co-movements of output, the entire sample period is divided into two sub-sample periods: 1978-1990 and 1990-1999. Lee, Park, and Shin (2002) then estimate the shares of the variances accounted for by the world, the region and the country-specific factors; volatility of growth rates of output for each country; and volatility of output decomposed into shares of variances.

In terms of volatility, the size is much larger for the East Asian than European region. In the former period the average volatility of the East Asian countries (3.113) is about 1.75 times higher than that of the European countries (1.770). In the latter period, it increases in both regions, the difference widening in the latter period, so that the average volatility in the East Asian region (3.888) is almost twice as large as that of the European region (1.983). This shows that the East Asian region consists of more volatile countries and, if this is due to non-policy related shocks, more active implementation of monetary policies may be called for.

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[3] In this model, an average growth rate of labour productivity in a given industry of a country is explained by industry and country dummy variables respectively. If productivity differences among countries are caused by demand and supply shocks with high labor mobility, they tend to be eliminated by migration of labor from countries with higher to lower productivity. Given a high degree of labour mobility, industry-specific factors will dominate country-specific factors in explaining productivity changes.

[4] The dynamic factor model has been used by many studies, as it was popularized by Stock and Watson (1991). Other studies based on the dynamic factor model include Geweke (1977), Geweke and Singleton (1980), Sargent and Sims (1977) and Gregory, Head and Raynauld (1997).

In the East Asian region, the share of the variance in output accounted for by the country-specific factor significantly decreases in the latter period. This decrease is compensated mostly for by the increase in the importance of both the region and the world common factors. The same phenomenon is observed in the European region: However, the decrease in the share of the variance explained by the country-specific factor is relatively more absorbed by the growing significance of the world common factor.

The relative increase in the importance of the world common factor in the latter period reflects globalization of the world economy[5]. The increase in the share of the variance accounted for by the region common factor may explain deepening integration in both Europe and East Asia in the latter period. The surge of the region common factor in the East Asian region in the latter period relative to Europe, however, may be related to the following two developments.

One development is the 1997-98 East Asian crisis, which started in Thailand and then spread to other countries in the region. This crisis contagion obviously has amplified the significance of the region common factor. Another is that East Asia has managed a greater degree of trade and capital account liberalization in the post crisis period than the European region that by then had reached a mature stage of integration.

Focusing on the latter period, although it is somewhat exaggerated by the crisis, the East Asian region seems to be better prepared for a currency union than Europe: the share of the region common factor is over .5 on average, indicating that the regional co-movement explains more than a half of the fluctuation in the individual country's output. In Indonesia (.888), Malaysia (.845), Korea (.792), Hong Kong (.738), Thailand (.604), Philippines (.585), which were heavily affected by the crisis, their movements of output are closely linked to the region common factor.

Lee, Park, Shin (2002) also examine the extent to which business cycles are synchronized across countries in East Asia. They estimate an equation where the fraction of an economy's output change related to regional common shocks is explained

[5] Gregory, A.W., A.C. Head and J. Raynauld (1997) and Kose, Otrok and Whiteman (2001) both find that the world common factor is an importance source of volatility in output.

by the level of intra-regional trade, similarities of both trade and industry structures, the level as well difference in per capita GDP. In the East Asian group, changes in the shares of intra-regional trade, and similarities of trade and industry structures have no significant effects on output comovements, but the period dummy for the 1990s is positive and statically significant, suggesting that shocks that were specific to the 1990's explain most of the variations in output co-movements in East Asia.

3. Financial Market Integration and Common Currency Are a

3-1. Benefits of Financial Liberalization

Trade liberalization is likely to result in more closely correlated business cycles across countries, more so if the liberalization promotes trade within similar industries. Therefore, countries that establish close economic ties through trade liberalization are likely to be members of a CCA in the sense that the similar business cycles make it easier for them to accommodate a common monetary policy regime.

There is general consensus that economic liberalization in emerging market economies should begin with trade liberalization to be followed by deregulation of domestic financial markets before lifting restrictions on capital account transactions and on entry of foreign financial institutions. This sequencing strategy suggests that countries would go through the process of financial market integration before adopting a common currency: that is, creation of a CCA would take place at the last stage of full economic integration in any region or a group of countries.

However, there is no theory predicting that liberalization of the trade regime would subsequently produce market pressure for liberalization of financial markets and capital account transactions to follow. Indeed East Asian countries started lowering tariffs and non-tariff barriers long before taking steps to liberalize and open their financial markets. Furthermore, the sequencing strategy does not explain whether financial deregulation and opening among a group of countries such as the ASEAN+3 will also pave the way for financial and monetary integration within the group. As will be shown below countries that establish close financial linkages through financial market liberalization would benefit from joining for a common currency area. However, these financially integrated countries do not necessarily satisfy the traditional criteria for potential candidates for a CCA.

Financial market deregulation and opening facilitate migration of real capital in the long-run and cross-border financing of current account imbalances in the short-run, thereby reducing the costs of adjustment to shocks to demand and supply. Financial liberalization also allows extensive sharing of the risks associated with macroeconomic shocks across countries as it broadens the range of portfolio diversification by including foreign bonds and equities in individual portfolios. It follows then that the countries with close financial ties would benefit more from financial liberalization by forming a CCA among them as monetary integration lowers costs of and eliminates exchange rate risks associated with financial transactions. However, the financially integrated countries are likely to be heterogeneous in terms of their economic structures and exposed to asymmetrical shocks. This means that financial liberalization and integration generate incentives for monetary integration among a group of heterogeneous countries whereas trade expansion and integration among relatively homogeneous countries

? Capital Mobility and External Financing

An increase in capital mobility (factor migration in general) between countries could relieve a country's external deficit as well as unemployment that reflects its internal imbalance. An adverse demand or supply shock to a given industry of a country may require shifts in labor and capital to other industries. After all adjustments have been made within the country including a fall in factor prices, some factors of production are likely to remain unemployed. In this case, capital account liberalization facilitates migration of capital to other countries, thereby mitigating the burden of adjustment through changes in factor prices and employment. That is, real capital mobility can be a partial substitute for price-wage flexibility[6].

However, in the short-run, real capital mobility is low and as a result only in the long-run could ease difficulties of adjustment to demand and supply shocks. In the absence of price and wage flexibility, an adverse supply shock such as an oil price increase may result in a deficit on the current account in addition to both an increase in unemployment and decrease in factor prices. Countries with an open financial regime have a better access to both regional and global capital markets so that it would be easier and less costly for them to borrow to finance their current account deficits. External borrowing could make the real adjustment smaller or unnecessary if the deficit is transitory and hence reversible.[7]

? Risk Sharing through International Portfolio Diversification

With financial market opening, domestic residents can diversify their portfolios in terms of assets issued by firms and financial institutions of other countries in addition to domestic ones. This possibility of enhancing portfolio diversification across a large array of assets means that a country suffering an adverse terms of trade shock could share some of the loss with other countries to the extent that it holds claims on their output. The amount of the loss that could be shared would increase, if this country holds diversified portfolios of bonds and equities of those countries with different structural characteristics that is, with lower business cycle correlations of macroeconomic variables.

The presence of currency risk under free floating, however, increases the cost

[6] Financial market liberalization and opening facilitate real capital mobility as it increases the availability of external financing for trade in both used and new capital goods. Some of the firms in a country that sustains a demand or supply shock may move their production facilities such as machines and equipment to other countries. Alternatively, some of the investment planned by these firms may be relocated in other countries in the form of foreign direct investment as a result of the adverse shock, a possibility that is rather limited in a controlled capital account regime.

[7] If the deficit reflects changes in economic fundamentals instead, external borrowing would simply mask the imbalances that require real sector adjustments.

of international portfolio diversification in terms of foreign securities: free floating would inhibit countries from cross-holding of securities, thereby bottling up the cost of the shock more in the country it is originated.

3-2. Does Homogeneity Really Matter for CCA?

The increased mobility of real capital between countries and greater access to international financial markets for deficit financing and portfolio diversification then help ease the difficulties of subjecting to a common monetary policy regime of a CCA. Both trade and financial liberalization remove some of the obstacles to establishing a CCA, but through different channels.

Financial liberalization and integration may call in question some of the criteria for a successful CCA focusing on similarity of business cycles. In contrast to the earlier literature on the CCA, financial considerations imply that countries with asymmetric shocks and dissimilar structural characteristics will find it easier to integrate financially with one another and can be potential candidates for a CCA.

Mundell (1973) showed, contradicting his earlier argument, that reserve pooling and international portfolio diversification could mitigate asymmetric shocks because a country suffering an adverse shock could minize its loss by drawing down on its claims on or borrowing from other countries in the CCA. This possibility of diversification means that asset holding for the risk sharing could be better served by establishing a CCA that includes a large number of structurally heterogeneous countries.[8]

Consider a group of economies in which business cycles are synchronized across countries. The traditional argument is that the member countries in such a group may readily yield their monetary independence to a supra national authority, because they are likely to pursue a similar monetary policy. However, once financial

[8] A recent analysis on risk sharing through international portfolio diversification, see Mckinnon (2001).

integration is taken into consideration, synchronization of business cycles may no longer be a critical criterion for identifying potential CCA candidates.

To elaborate further on this argument, suppose the group of countries with symmetric shocks is hit by an adverse shock such as an oil price increase. Because of the similarity of their economic structures, all of the countries in the group will suffer from the shock with the consequence of a group-wide slowdown. This group-wide slump then leads to a decrease in intra-group trade, which in turn aggravates further the downturn in each country. That is, the slump in one country amplifies output contraction in other countries through the trade channel. Since all of the member countries suffer, from the same shock, they cannot supplement their output and income losses by liquidating their claims on the other countries. Under these circumstances, there is also little room for capital to move between countries.

Most of the countries in the group may also experience deterioration in their current accounts. As a result, the deficit countries may find it difficult to borrow from the other countries in the group. For the group as a whole, the deficit financing to be secured from outside of the group would be larger and hence the cost of financing higher. This means that the impact of the shock would, other things being equal, be much less severe and hence more manageable, if the members of the group have different structural characteristics. That is, heterogeneity of the members of a CCA could reduce the burden of adjustment to external shocks because it induces factors of production to move to and also eases financing of current account deficits from the countries unaffected by the shock.

The risk sharing through asset diversification also implies that countries with similar economic structures would not gain from joining a CCA. It is because an adverse supply shock in one country could be much more contagious to other countries when they are more homogeneous (Park and Song 2001) and also because the benefits of risk sharing through international portfolio diversification would be smaller than otherwise. Financial liberalization would encounter less resistance to financial market integration among a group of heterogeneous rather than homogeneous countries. From the point of view of portfolio diversification in a liberalized and open financial environment, larger currency unions with more heterogeneous countries are likely to be more successful than smaller ones with homogeneous members: as far as financial integration in concerned, countries with asynchronous macroeconomic shocks would make better candidates for a CCA.

In searching for potential partners for a CCA, risk sharing through international portfolio diversification implies that emerging market economies would prefer tying themselves up with advanced countries whose bonds and equities are relatively more secure and carry high rates of return adjusted for default and liquidity risks, such as U.S. Treasury bonds. Focusing on finance alone, therefore, globalization may be a better strategy than regionalization including forming a CCA for a large number of small countries: dollarization, or Eurorization, may make more sense to many emerging market economies than forming a currency union among themselves. Consideration of international portfolio diversification alters the traditional criteria for ideal countries for a successful CCA: structural similarity is not a condition as important as it was claimed in the earlier literature for ideal candidates for a CCA.

In a recent paper, Heathcote and Perri (2002) argue that the decline in the correlations of output, investment, employment, and consumption between the United States and the rest of the world comprising Europe, Japan, and Canada between the two post Bretton Wood periods -1972-86 and 1986-2000- they observe could in part be explained by a decrease in the correlation of exogenous shocks, but also by financial globalization. Emergence of global financial markets increases opportunities for intertemporal specialization in production that in turn contributes to lowering the correlation of factor supplies as the globalization increases the scope of international portfolio diversification.

In terms of an infinite horizon model, Heathcote and Perri (2002) demonstrate that a decline in the correlation of shocks leads to greater international portfolio diversification, which then further reduces international correlations of macroeconomic variables. Calibrating the model, the authors also show that a combination of the decline in the shock correlation and the resulting endogenous growth in international trade in financial assets jointly account for most of the observed decline in the correlation of international business cycles during the post Bretton Wood period between the United States and the rest of the industrial countries.

One of the implications of the analysis of Heathcote and Perri (2002) is that capital account liberalization – an exogenous development- could reduce the business cycle correlation of output investment, and employment in East Asia, if it has not already. Another implication is that growing similarity of business cycles among the East Asian countries through trade expansion may encourage global diversification of portfolios including assets issued by corporations and financial institutions of advanced countries and hence integration of East Asian financial markets into global financial markets.

How significant are then the benefits associated with financial market opening such as the international risk sharing quantitatively? There are few empirical studies that shed light on this question. The well-known home bias in asset holding suggests that the benefit would not be as large as the theory would predict. Despite the ongoing financial liberalization stretching over more than two decades, the increase in international diversification in assets, in particular bonds, across countries has been relatively small. McKinnon (2002) points to the principal-agent problem as the main cause of limited global portfolio diversification.

In a recent study, however, Park and Bae(2002) present empirical evidence that since the early 1990s the most East Asian Countries embarked on deregulation of capital account transactions and entry of foreign financial institutions. East Asian Capital markets have been integrating into global financial markets rather than forging clear linkages with one another. This development has become more pronounced after the 1997-98 financial crisis.

4. Economic Rationale for a Regional Financial Arrangement in East

Asia

Empirical studies on the common currency area are not conclusive as to whether East Asia satisfies the criteria for a CCA. It is not also clear whether further trade and financial liberalization in the region would develop conditions necessary for adopting a single currency in East Asia. If the discussion of the CCA does not necessarily justify the construction of a regional financial arrangement, are there other rationales for doing so? There are several.

Since the early 1990s, many of the East Asian countries have made sustained efforts to deregulate and open domestic markets including financial markets to foreign competition. As a result of trade liberalization and market orientation, East Asia has seen a large increase in intra-regional trade and investment. In terms of imports, intra-regional trade in East Asia (ASEAN+3 and Taipei, China) accounted for 46 percent of the region's total trade (see Table 1A and Table 1B) in 2001 when the entire region was still recovering from the crisis. There is every indication that this trend will continue.

Table 1A. Trade Share in East Asian Countries (export)

Unit: percentage

Export from / To	East Asia			China			Japan			Korea			Other NIEs			ASEAN4		
	'80	'90	'01	'80	'90	'01	'80	'90	'01	'80	'90	'01	'80	'90	'01	'80	'90	'01
East Asia	**32.0**	**36.2**	**42.2**	**52.9**	**66.9**	**44.9**	**21.8**	**24.2**	**32.6**	**28.5**	**33.0**	**38.9**	**31.3**	**39.9**	**49.5**	**54.2**	**50.6**	**47.4**
China	2.8	4.6	9.8	0.0	0.0	0.0	3.9	2.1	7.7	0.0	0.0	12.1	4.0	15.7	24.2	0.8	2.1	4.4
Japan	10.2	8.2	8.9	22.3	14.8	16.9	0.0	0.0	0.0	17.4	19.4	11.0	6.3	6.9	6.6	34.6	24.4	16.1
Korea	2.7	3.8	4.0	0.0	0.7	4.7	4.1	6.1	6.3	0.0	0.0	0.01	1.3	2.3	2.6	1.7	3.9	3.7
Other NIEs	9.3	12.3	11.5	26.4	47.0	19.6	6.7	8.3	9.4	6.2	8.6	9.0	6.0	4.5	4.7	13.8	16.0	15.9
ASEAN 4	7.0	7.1	8.1	4.3	2.9	3.8	7.0	7.7	9.3	5.0	5.0	6.8	13.7	10.6	11.5	3.2	4.2	7.2
South Asia	1.7	1.4	1.5	1.1	1.5	1.5	1.6	1.2	0.8	2.0	1.7	1.8	2.8	1.9	2.1	1.1	1.3	1.8
Central Asia	0.0	0.0	0.1	0.0	0.0	0.4	0.0	0.0	0.0	0.0	0.0	0.3	0.0	0.0	0.0	0.0	0.0	0.0
CER	2.8	2.2	2.0	1.4	0.8	1.5	3.1	2.8	2.2	1.5	1.7	1.6	4.3	2.2	2.0	1.8	1.8	2.5
USA	21.4	25.7	21.0	5.4	8.6	20.4	24.5	31.7	30.4	26.4	29.9	20.8	19.4	23.0	10.3	18.8	19.4	20.0
EU	14.6	17.7	14.9	13.1	10.1	15.4	14.0	20.4	16.0	15.5	15.4	13.1	17.9	17.2	14.0	13.6	16.7	15.0
Others	27.5	16.8	18.2	26.1	13.6	15.9	35.1	19.6	18.0	26.0	18.3	23.4	24.3	15.9	22.1	10.4	10.2	13.2
World	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100

Table 1B. Trade Share in East Asian Countries (import)

Unit: percentage

Export from / To	East Asia			China			Japan			Korea			Other NIEs			ASEAN4		
	‘80	‘90	‘01	‘80	‘90	‘01	‘80	‘90	‘01	‘80	‘90	‘01	‘80	‘90	‘01	‘80	‘90	‘01
East Asia	**30.4**	**38.7**	**45.8**	**33.3**	**49.0**	**32.3**	**20.7**	**23.4**	**36.2**	**33.4**	**34.4**	**39.9**	**47.9**	**57.1**	**62.8**	**41.1**	**46.2**	**50.8**
China	3.9	7.8	15.0	0.0	0.0	0.0	3.1	5.1	16.6	0.1	0.0	9.4	10.8	22.6	29.9	2.8	2.6	5.6
Japan	11.2	12.8	9.0	27.0	14.7	0.3	0.0	0.0	0.0	26.3	26.6	18.9	20.4	17.8	12.2	24.3	25.6	19.8
Korea	1.8	3.4	5.4	0.0	0.5	13.7	2.2	5.0	4.9	0.0	0.0	0.0	2.3	3.8	4.1	2.0	3.4	5.1
Other NIEs	3.1	6.4	5.1	4.0	29.6	8.5	1.5	2.4	2.0	1.2	2.2	3.0	4.3	3.6	3.8	8.3	10.6	10.9
ASEAN 4	10.4	8.2	11.2	2.4	4.2	9.8	14.0	10.9	12.7	5.9	5.6	8.6	10.2	9.2	12.8	3.8	4.1	9.4
South Asia	0.9	1.1	1.4	1.0	1.7	2.4	0.9	1.0	0.8	0.3	0.7	1.1	1.2	1.0	1.5	0.7	1.5	1.6
Central Asia	0.0	0.0	0.1	0.0	0.0	0.6	0.0	0.0	0.0	0.0	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.0
CER	4.7	4.1	3.4	6.4	2.9	3.6	5.6	6.0	4.7	3.4	4.4	4.4	2.3	1.6	1.4	4.3	3.8	3.1
USA	17.0	17.8	14.5	20.0	12.7	15.4	17.4	22.5	18.3	21.9	24.3	15.9	13.0	11.5	10.3	16.1	13.9	12.9
EU	8.8	14.9	12.9	14.7	17.6	20.9	5.9	16.1	12.8	7.2	13.0	10.6	11.7	11.8	10.5	13.5	16.4	11.7
Others	38.3	23.4	22.0	24.6	16.2	24.8	49.5	31.0	27.3	33.6	23.4	28.0	23.9	17.1	13.5	24.2	18.3	19.9
World	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100

Note: Other NIEs(Singapore, Hong Kong), ASEAN4(Indonesia, Malaysia, Philippines, Thailand), South Asia(India, Sri Lanka, Bangladesh, Pakistan), Central Asia(Kazakhstan, Uzbekistan), CER(Australia, New Zealand)

Source: International Monetary Fund, *Direction of Trade Statistics Yearbook*, Various Years.

Financial liberalization and market opening has also contributed to the integration of financial markets in the region and the establishment of closer linkages between East Asian and international financial markets. The growing integration of intra-regional trade in goods, services and financial assets has increased the demand by the business community in the region for stabilizing the exchange rates of East Asian currencies. More than anything else, the Asian crisis in 1997 has brought home to the region the need of establishing a region-wide mechanism of defence that can support regional financial cooperation to prevent and manage such crises in the future. However, the terminology – regional financial cooperation – seems ambiguous and thus needs to be more clearly specified. No one can deny the need for regional financial cooperation in the genuine sense, but when it comes to discussing the details and specifics of concrete proposals, there is disagreement all around among insiders and outsiders alike.

One clear example is the proposal for the Asian Monetary Fund (AMF), which was shot down in 1997.

The adoption and implementation of the CMI could be counted as a major step toward strengthening the financial cooperation among the thirteen East Asian countries. However, ASEAN+3 countries will face much tougher challenges and tasks in exploring developments beyond the CMI. East Asian countries need to clarify to the international community what their motivations are, how they will develop an action plan, and how they believe it fits in with the existing global financial system (Park and Wang 2000).

The creation of a regional monetary fund in East Asia was strongly opposed by the United States, European countries and, of course, the IMF for a number of reasons. Opponents dismiss the contention that an East Asian regional fund may have a comparative advantage in diagnosing regional economic problems and prescribing appropriate solutions. In this regard, the CMI and its follow-up implementation seem acceptable to many detractors of the regional monetary fund. The CMI does not require a new institution like the AMF, and it is also tightly linked to IMF conditionalities.

While the Asian financial crisis provided a strong impetus for regional financial integration in East Asia, there have been several other developments that have encouraged the formation of a regional financial arrangement in East Asia. This section discusses some of these developments as a background for the examination of whether they can maintain the momentum for enhanced regional cooperation and lead to the formation of monetary unification in the long run.

As noted earlier, diversity among the CMI group members is not necessarily an obstacle to forming a CCA. Indeed, if business cycles are divergent across a group countries, this could be an incentive for financial integration and possibly a monetary union for the group. In general, it is difficult to identify a set of criteria for ideal candidates for a CCA; indeed, it appears any group of countries could form a successful CCA.

When the East Asian crisis broke out in 1997, many East Asian countries were perceived to have similar economic structures by foreign investors and lenders.

Because of this perception, contagion of the crisis was much more severe than otherwise: depreciations and downturns in the crisis countries were transmitted more rapidly and widely to other countries in the region, thereby precipitating the region wide slump.

As is well documented, the recovery from the crisis has been faster than anticipated, and this development also renewed the interest in forming a regional financial arrangement in East Asia for reasons other than those pertaining to the optimal currency area. One is the limitation of the ability of the IMF in managing a capital account crisis. Another is the slow progress in reforming the international financial system that makes it difficult to expect the emergence of a global mechanism of defence against future crises. A third is the lack of confidence in the free floating system.

4-1. IMF and Capital Account Crisis Management

A recent IMF report (2003) makes it clear that East Asia suffered a capital account crisis in 1997 and 1998, which required a management and resolution strategy different from the traditional IMF recipe for crises originating from current account deficits.[9] A large increase in capital inflows into some of the East Asian countries set off an asset market boom and a precipitous increase in the current account deficit, thereby making these countries vulnerable to speculative attacks. The perception of vulnerability of these countries triggered a sharp and large capital outflow, which was further aggravated by the panic and herding behavior of foreign investors. Once the dollar peg became indefensible, the value of the currencies plummeted. Many banks and corporations with balance sheet mismatches could not service their foreign currency denominated debts and eventually became insolvent. A sharp contraction in the level of output then followed.

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[9] IMF (2003), *"The IMF and Recent Capital Account Crises- Indonesia, Korea Brazil", Evaluation Report*

The crisis resolution strategy of the IMF was twofold. First, it imposed tight monetary and fiscal policy with the aim of stabilizing the exchange rate and generating current account surpluses by contracting domestic demand. High interest rates together with weak currencies were expected to contribute to luring back foreign investors. Second, the IMF required these crisis countries to undertake a wide range of reform covering the corporate, financial, and public sectors to strengthen the structural foundation of the economy. The reform was to help these countries return to the pre-crisis path of robust growth; it was also viewed critical in restoring the confidence of international lenders to these economies.

Seven years have elapsed since the outbreak of the crisis. Among the five crisis countries, Korea stands out as the most successful case of recovering from the crisis, although the aftereffects of the crisis still linger on. Indonesia has been mired in a deep economic and political crisis; recoveries in other crisis countries have been rather uneven. Most of all, the assessment of the structural reforms remains mixed. A recent World Bank report (2002) still argues that "progress on structural and institutional reforms remain key to retaining confidence and resilience to shocks" in East Asia.

What went wrong with the IMF strategy? Once the crisis broke out, output contraction and the turbulence of the foreign exchange and other financial markets in one country were rapidly transmitted to other economies in the region through trade and financial market linkages. The pronouncements by international financial institutions including the IMF and policymakers of the G-7 countries that the crisis countries had serious structural problems in their financial, corporate, and public sectors did not help inspire confidence in these economies. In some sense, the IMF crisis management program was fueling contagion of the crisis.

The IMF rescue programs mandated structural reforms along the lines of the Washington consensus without a careful scrutiny of their appropriateness and in disregard of the reform capacity of these countries. Many of the reforms included in the IMF programs have been ignored, put on the backburner, or at best resulted in cosmetic changes. In retrospect, the IMF's view that structural problems were the root causes of the crisis was not borne out by subsequent events. In the midst of the crisis, the timing of initiating structural reform was questionable. At the time of the crisis, many western observers argued that only a major shock like the one savaging East Asia could force the crisis countries to accept reforms that were badly needed and overdue. Whatever the merit of this argument was the IMF right in seizing the crisis as an opportunity of applying pressure on these countries to undertake the reform it recommends?

The experience with the East Asian crisis management suggest that when a crisis in a country originates in the capital account, policy coordination or at least policy dialogues and reviews among neighboring countries is essential in preventing contagion of the crisis. The importance of policy cooperation would increase with integration of financial markets at the regional level. Without a constant exchange of information and policy dialogues among close economic partners, individual countries often find it difficult to understand the causes of large changes in capital flows and exchange rates. To ward off speculative attacks, policymakers will have to be on constant alert to monitor and respond to changes in expectations of market participants. With deepening of trade and financial integration, monitoring will not be effective unless an efficient mechanism of policy coordination is constructed at the regional level. Even smoothing-out of high frequency movements of the nominal exchange rate in individual countries may have to be coordinated at a regional level in order not to send wrong sequels to other countries.

When a country in the region experiences severe financial instability, it is critical to diagnose whether the turbulence reflects domestic macroeconomic imbalances or speculative activities of market participants in order to devise a proper crisis management strategy. If the country suffers from currency speculation, the neighboring countries would have incentive to organize liquidity support to contain contagion. Unless the countries in the region maintain close working relationships in coordinating policies and exchanging information they will not be able to make a prompt assessment of the nature of and response to the crisis.

The IMF could monitor capital flows within and between regions and also the behavior of market participants. Given its narrow mandate and its small staff, it is difficult to imagine that the IMF could establish close working relationships with individual member countries and coordinate policies. Furthermore, as an institution entrusted with monitoring economic developments in the member countries, the IMF may have to maintain an arm's length relationship with them. The IMF cannot constantly monitor the developments in financial markets through the channel of day-to-day communication with the authorities of individual countries. Without understanding the background of policy changes in each country, the IMF will not be in a position to deal effectively with capital account crises. Most of all, to the extent that the IMF cannot serve as a lender of last resort, it cannot serve notice to the international financial markets that it is ready to supply whatever amount of liquidity it takes to thwart an impending speculative attack.

4-2. Contagion of Financial Crises

At the time of the crisis, the CMI countries as a whole held about US$700 billion in foreign reserves. The total amount of financing required restoring financial stability in Indonesia, Korea, and Thailand by the IMF, other international financial institutions, and a number of donor countries amounted to US$111.7 billion. If the thirteen countries had established a cooperative mechanism in which they could pool their reserves to fend off speculative attacks, they could have managed the Thai crisis and minimized its contagion by supplying a small fraction of their total reserves. In view of the large loss of output and fall in employment in the region, such a cooperative response was indeed desirable.

Insofar as East Asia suffered a liquidity crisis compounded by the panic and the herding behavior of foreign investors, a more effective IMF crisis management strategy would have focused on squelching the speculation by supplying a large amount of short-term financing to replenish foreign exchange reserves at the first sign of a speculative attack, instead of tightening monetary and fiscal policy. Such a strategy could have stopped the spread of the crisis and slump throughout the region. At the time of the crisis, there were neither regional nor global lenders of last resort to deal with bank run problems East Asian countries were facing. Perhaps because of the lack of experience and understanding of the nature of liquidity crises, the IMF may have resorted to standard remedies it had relied on managing current account crises. It was also true that with limited financial resource, the IMF could not manage the East Asian crisis by itself; it had to enlist the financial support of the G-7 and other countries. The G-7 support is then a testimony that as a global institution, the IMF would be more effective in resolving crises if it establishes cooperative relations with its regional counterparts and hence encourage development of regional financial mechanisms.

Contagion is geographically concentrated, so that a regional grouping for support is logical. In addition to providing financial assistance in tandem with international support, a regional financial cooperation mechanism may conduct policy reviews and initiate a dialogue process. Policy dialogue, including monitoring and surveillance, is the bedrock on which coherent policy formation under the regional financial arrangements rests. A monitoring and surveillance process would provide prompt and relevant information for assessing the situation of countries in trouble and the potential contagious effects of a crisis to neighboring countries. Furthermore, a joint exercise based on a region-wide early warning system would facilitate closer examination of financial vulnerabilities in the region. In addition, the regional policy dialogue process would contribute to ensuring effective implementation of high-quality banking and financial standards, and promoting financial market development in East Asia.

Although regional financial cooperation is desirable in a broad sense, the devil is in the details (Pereira da Silva and Yoshitomi 2001). If a scheme for regional financial cooperation is effective in preventing and managing future financial crises as well as promoting financial market development in the region, no one can deny the desirability of the regional arrangement. However, various regional institutions have different memberships and different goals for regional financial cooperation. If some institutions cannot achieve the collectively set goals, they should be closed and new institutions created. In this regard, an important task is to identify those regional institutions that perform effectively to achieve their stated goals.

4-3. Limited and Slow Progress in International Financial Reform

One of the recent developments that have encouraged regional cooperation in East Asia has been the slow progress in the reform of the international financial system. The urgency of reform in the G-7 countries has receded considerably despite the collapse of Argentina, instability of Brazil, and economic slump in East Asia. The slow progress has been further complicated by the perception that none of the many proposals for a new architecture may be effective in sustaining global financial stability. In particular, as long as the structural problems on the supply side of international capital markets are not addressed, the East Asian countries fear that they will remain as vulnerable to future crises as they are now (Park and Wang, 2002).

Griffith Jones and Ocampo (2002) show that there has been no international reform agenda accepted by both developing and developed countries. The recent Monterrey consensus has produced a new international agenda, but it is not altogether clear whether the new agenda will be put into action. Some of the progress that has been made is asymmetrical in the sense that the reform has focused on strengthening financial and corporate sectors of emerging market and developing economies instead of rectifying imperfections of international capital markets. Some of the advances in the new architecture have also met the risk of reversal such as the growing opposition of developing countries to support large IMF financing. Finally, it should be noted that developing countries have been excluded in the key institutions and fora involved in international financial reform.

Faced with the uneven and slow process of the reform, many emerging market economies have begun to develop their own mechanisms of defence against future financial crisis. One such defensive measure was the construction of regional financial arrangements such as the CMI in East Asia. Instead of waiting until the G-7 creates a new architecture, whose effectiveness is at best questionable, it would be in the interest of East Asia to work together to create its own system of defence. For this reason alone, there has been increasing support in East Asia for developing a regional defence mechanism in the form of financial cooperation. This support has culminated in the Chiang Mai Initiative of ASEAN+3 (CMI) to create currency swap arrangements among the thirteen countries.

A regional financial cooperative scheme such as the CMI could be structured and managed to be complementary to the IMF. For example, an East Asian regional fund could serve as a source of supplementary financing to the IMF facilities. It could support the IMF's global surveillance activities by specializing in regional surveillance. Like the CMI, a regional financial arrangement could rely on the IMF for designing and enforcing policy conditionality to be imposed on borrowing countries.

4-4. Building a War Chest

Many EMEs and DCs, in particular those which have experienced financial crises, have taken recourse to amassing their foreign reserves above the level that may be adequate in terms of their import requirements as a means of defence against future crises. Before the onset of capital account liberalization in the 1990s developing economies were preoccupied with the management of the current account, and as far as the adequacy of reserves was concerned, the rule of thumb was holding an amount of reserves equivalent to imports of three to four months. This implicit rule appears to be no longer acceptable. For instance, Korea has accumulated a large volume of foreign reserves (US$ 121.3 billion as of the end of 2002) equivalent to 25.5 percent of its GDP, in part because of the increased volume of its capital account transactions, but largely because of the need for building a war chest that may be needed to stave off speculative attacks. At the end of 2000, the volume of reserves as a percentage of GDP in Korea was more than four times the level of 1996.

A similar development has taken place in other crisis-hit countries in East Asia (Table 2). In Indonesia, the ratio of reserves to GDP almost doubled between 1996 and 2001. The ratio climbed to 27 percent at the end of 2000 from less than 9 percent three years earlier in the Philippines. However, reserve accumulation has been relatively modest in both Thailand and Malaysia. Yet these countries have also added more than 10 percentage points to the ratios they had at the end of 1997. By any measure, this level is excessive, costly, and represents a clear case of misallocation of resources.

Table 2. Foreign Exchange Reserves and Current Account Balance (incomplete)

Korea

	Foreign Exchange Reserves (million U.S. dollars)		Current Account Balance (million U.S. dollars)	
		In Percent of GDP		In Percent of GDP
1996	34,037	6.5	-23,005	-4.4
1997	20,368	4.2	-8,167	-1.7
1998	51,975	16.2	40,365	12.6
1999	73,987	17.8	24,477	5.9
2000	96,131	21.0	11,040	2.4
2001	102,753	24.05	8,239	1.93
2002	121,345	25.45	6,092	1.28

PRC

	Foreign Exchange Reserves (million U.S. dollars)		Current Account Balance (million U.S. dollars)	
		In Percent of GDP		In Percent of GDP
1996	107,039	13.1	7,243	0.9
1997	142,762	15.8	36,963	4.1
1998	149,188	15.8	31,472	3.3
1999	157,728	15.9	15,667	1.6
2000	168,278	15.5	20,518	1.9
2001	215,605	18.3	17,401	1.5

2002	291,128	22.9	35,442	2.8

[1] estimates by the International Institute of Finance

Hong Kong

	Foreign Exchange Reserves (million U.S. dollars)		Current Account Balance (million U.S. dollars)	
		In Percent of GDP		In Percent of GDP
1996	63,840	41.4	-3,509	-2.3
1997	92,823	54.3	-6,159	-3.6
1998	89,625	55.0	3,891	2.4
1999	96,255	60.5	10,545	6.6
2000	107,560	65.8	8,806	5.4
2001	111,160	68.3	9941	6.1
2002	111,900	69.3	14390	8.9

Taipei, China

	Foreign Exchange reserve (million U.S. dollars)		Current account balance (million U.S. dollars)	
		In Percent of GDP		In Percent of GDP
1996	88,038	31.5	10,923	3.9
1997	83,502	32.7	7,051	2.8
1998	90,341	32.6	3,437	1.2
1999	106,200	35.9	8,384	2.8
2000	106,742	36.4	9,316	3.2
2001	122,211		17,891	
2002	161,656		25,629	

Thailand

	Foreign Exchange reserve (million U.S. dollars)		Current account balance (million U.S. dollars)	
		In Percent of GDP		In Percent of GDP
1996	37,731	20.7	-14,691	-8.1
1997	26,179	17.3	-3,021	-2.0
1998	28,825	25.7	14,243	12.7
1999	34,063	27.5	12,428	10.0
2000	31,947	26.0	9,200	7.5
2001	32,355	28.0	6,221	5.4
2002	38,046	29.9	7,650	6.0

Indonesia

	Foreign Exchange reserve (million U.S. dollars)		Current account balance (million U.S. dollars)	
		In Percent of GDP		In Percent of GDP
1996	24,024	10.6	-8,532	-3.8
1997	20,609	9.6	-5,790	-2.7
1998	22,713	23.0	4,102	4.2
1999	23,540	16.2	5,783	4.1
2000	28,502	18.9	7,985	5.3
2001	27,246	19.2	6,899	4.8
2002	30,969	17.9	7,450	4.3

Malaysia

	Foreign Exchange reserve (million U.S. dollars)		Current account balance (million U.S. dollars)	
		In Percent of GDP		In Percent of GDP
1996	27,009	26.7	-4,462	-4.4
1997	20,788	20.8	-5,936	-5.6
1998	25,559	35.0	9,529	13.1
1999	30,588	37.7	12,606	15.9
2000	29,075	32.6	8,850	9.9
2001	30,474	34.6	7,287	8.3
2002	34,222	36.0	7,190	7.6

Philippines

	Foreign Exchange reserve (million U.S. dollars)		Current account balance (million U.S. dollars)	
		In Percent of GDP		In Percent of GDP
1996	10,030	12.1	-3,949	-4.8
1997	7,266	8.8	-4,353	-5.3
1998	9,226	14.9	1,546	2.4
1999	13,242	17.3	7,911	10.3
2000	13,048	27.4	9,349	19.7
2001	13,442	18.6	1,323	1.8
2002	13,144	16.8	4,197	5.3

Singapore

	Foreign Exchange reserve (million U.S. dollars)		Current account balance (million U.S. dollars)	
		In Percent of GDP		In Percent of GDP
1996	76,976	83.7	13,898	15.1
1997	71,392	85.2	16,912	20.2
1998	75,028	99.9	21,025	23.3
1999	77,176	89.3	21,254	24.0
2000	80,362	82.2	21,715	22.2
2001	75,375	88.8	16,137	19.0.01
2002	82,021	94.3	18,704	21.5

In a recent speech at a Tokyo conference, Stiglitz (2002) argued that the existing dollar based reserve system benefits the U.S. whereas developing countries bear a disproportionate burden of holding large amounts of reserves to counter volatility in the currency market. He went on to say that an Asian Monetary Fund, which would have given a quicker remedy to the Asian financial crisis, could be an alternative model, providing a good basis for a new global regime.

In theory, floating rates and capital account liberalization are supposed to reduce the need for holding a large amount of reserves. Except for Malaysia, all other crisis countries have been on a flexible exchange rate system and deregulated their capital account transactions to a considerable degree after the 1997 crisis. In contrast to the theory, however, the shift to floating rates and participation in international financial markets in these countries for the past five years, have not reduced their reserve holdings relative to their output. In fact, liberalization of capital account transactions has increased the demand for reserves largely because capital flows have been unstable and unpredictable in these countries. Furthermore, there is little evidence that capital account liberalization has improved the access of emerging market economies to international capital markets.

For these reasons, the adequacy of reserve holdings is often gauged by the amount of short-term foreign borrowings, and a good benchmark is that the ratio of reserves to short-term foreign debts should be equal to or higher than one. Even when this benchmark is applied, reserve holdings of the crisis-hit countries in East Asia are excessive. In both Korea and Thailand, the ratios have been higher than 2, and even in Indonesia, it has fluctuated between 1.3 and 1.45 (see Table 3). The excessive holdings of reserves in emerging market economies in East Asia and elsewhere raise a number of questions as to whether these countries should borrow at all from the short end of international capital markets and whether it would be advisable to ask these countries to open their financial markets.

Table 3 Foreign Reserves/Short-term Debt

	Indonesia	Korea	Thailand	Taipei, China	PRC	Chile
1998. IV	0.89	1.31	1.15	5.24	4.37	1.68
1999. II	1.45	1.43	1.53	6.46	5.75	1.52
1999. IV	1.33	1.69	2.23	6.24	7.75	2.06
2000. I	1.38	2.19	2.21	6.53	7.45	1.67
2000. II	1.32	2.06	2.32	7.43	7.28	1.63
2000. III	1.35	2.14	2.72	7.33	7.63	1.41
2001	1.24	2.92	2.44			

If the emerging market economies have to maintain an amount of reserves equal to their short-term foreign indebtedness, it is unclear as to why they should secure short-term currency financing which they cannot use. The short-term foreign debt benchmark therefore suggests that reserve holdings for other uses must be secured by long-term foreign borrowing or accumulating current account surpluses.

Commercial banks hold a small fraction of their deposit liabilities that are mostly short-term, and they could do so because, among other things, they have access to the domestic lender of last resort. In the absence of a global and regional lender of last resort, financial institutions in the EME cannot engage in term transformation involving foreign currency loans. Could the EMEs then make arrangements with international banking institutions to establish private contingent lines of credits they could draw from in case they come under a speculative attack? The Mexican experience is instructive in this regard: the availability of contingent credit lines does not increase liquidity once a financial crisis breaks out, because the banks which provide contingent credit lines to the central bank withdraw other credits extended to firms and financial institutions to reduce their country exposure (Carstens, 2001).

Given the limited availability of private contingent lines of credit, together with the absence of a global or regional lender of last resort, EMEs may therefore have to hold a larger amount of reserves than otherwise, and to do so they may have to run a sizeable amount of surplus on the current account as the East Asian crisis countries have done since the crisis broke out in 1997. The reserve accumulation in EMEs thus has undesirable implications for the future trade relations between developing and developed countries and for growth of the world economy.

As an increasing number of EMEs increase their holdings of reserves by running current account surpluses trade relations between developing and developed countries are likely to suffer from tension and unnecessary conflicts. The large accumulation of reserves in EMEs could also sap global growth as it reduces global aggregate demand. Therefore, both developing and developed countries will find it in their interests to search for other schemes that could reduce EMEs' holdings of foreign exchange reserves. For example, a group of countries, not necessarily from the same region, may decide to pool a certain percentage of their reserves to create new credit facilities for short-term liquidity support. Individual countries belonging to the arrangement could then reduce their holdings as they can borrow from these new credit facilities.

The group of thirteen East Asian countries (ASEAN+3) has command over a large amount of foreign currency reserves estimated to be more than one trillion U.S. dollars. Depending on how these reserves are pooled together and managed, a mere ten percent of the total amount will be sufficient to provide a formidable line of defence against any speculative attacks.

4-5. Stabilizing Bilateral Exchange Rates for Intra-regional Trade Expansion

Recent studies by Rose and Engel (2001) show empirically that the formation of a currency union leads to a substantial increase in trade and lowers the volatility of real exchange rates of the countries joining the union. A regional financial arrangement such as the CMI in East Asia could help stabilize bilateral exchange rates in the region by creating a financing mechanism that could provide a cushion for adjustment to external shocks. As Rose (1999) points out, trade is mostly regional and "the fast track to trade liberalization of late has tended to be regional." The regional nature of trade is likely to grow in importance in East Asia also. With this growing trend in regional trade integration, it is clear East Asia is bound to lose disproportionately more from trade disruptions caused by currency crises than otherwise. This means that the East Asian countries have a collective interest in preventing crises in individual countries and more so in stopping contagion. In this regard, the CMI could help facilitate negotiations of several free trade proposals in East Asia as it reduces some of the impediments to intra-regional trade.

Together with the deepening of trade integration, Easy Asia has also witnessed growing mobility of capital with the liberalization of capital account transactions in many countries. Although the benefits of capital mobility could be substantial, capital market liberalization has brought with it the danger of making financial crisis much more disruptive than otherwise. There is a general consensus that short-term speculative capital flows should be controlled to minimize disruptions in domestic financial markets, although the same cannot be said about the modality of control. The means of controlling short-term capital flows would be greatly enhanced if countries with close ties in trade and finance could coordinate their policies. A regional financial arrangement such as the CMI could provide a forum for such a cooperative effort.

For a while after the eruption of the East Asian crisis, the flexible exchange system was the accepted norm in the new international financial architecture. The new consensus, however, did not last very long. Williamson (2000) and Frankel (1999) argue that intermediate regimes such as the BBC system are more likely to be appropriate than the corner solutions for many EMEs. In particular, Williamson advocates several intermediate regimes with soft margins. Fischer (2001) suggests that developing countries which are not exposed to capital flows could choose from a wide range of intermediate regimes and that flexible exchange rate systems suitable for EMEs could include crawling bands with wide ranges.

If indeed East Asian countries find it desirable to follow some type of intermediate regime, then one can make a strong case for creating regional financial cooperative arrangements to help stabilize intra-regional nominal and real effective exchange rates. Although the authorities of the ASEAN+3 have not indicated any interest in promoting monetary union as on objective of the CMI, the East Asian countries could work together to develop an East Asian common currency area in the long-run after a transition period during which a mechanism of the coordination of exchange rate policies is established. An East Asian financial arrangement could therefore serve as a forum for managing a region-wide collective exchange rate system with the ultimate objective of introducing a common currency in the region.

5. Is East Asia Ready for a Regional Financial Arrangement?

Any argument supporting regional arrangements must begin by answering the most fundamental question of whether regional groupings, whatever forms they may take, are conducive to multilateral free trade and an orderly globalisation of financial markets. Despite many misgivings about the role of regional economic arrangements that have grown in number in recent years, the experiences of the past decade – in particular, that of the EU – suggest that they have been complementary to multilateral trade and financial liberalization. That is, they have been building blocks rather than stumbling blocks for a more integrated world economy. There is no evidence suggesting that an East Asian financial arrangement will be oriented toward a withdrawal from the global economy and, hence, erect barriers to global financial integration.

Several years ago Lawrence (1996) pointed out that the forces that were driving the wave of regionalism at that time might differ fundamentally from those driving earlier moves toward regionalization in this century and that the regional initiatives represented efforts to facilitate their members' participation in the world economy rather than their withdrawal from it. Trade and financial developments since then have not been at odds with this observation. Many developing countries are motivated to join regional groupings as their participation could facilitate implementation of a strategy to liberalize and open their economies. Since most of the East Asian EMEs are pursuing export cum foreign investment-led policies, they will gain very little by forming a regional arrangement that is designed to thwart globalisation.

Ever since the proposal for creating an Asian Monetary Fund was made, the idea has been opposed by the U.S., EU, and the IMF for a variety of reasons. Although both the U.S. and IMF have softened up their opposition to regional financial arrangements recently, they still maintain that the arrangements should be both complementary and supplementary to the IMF financing facilities (Köhler, 2001). The opponents of a regional financial arrangement in East Asia raise two issues. First, they argue that the ASEAN+3 countries have yet to develop economic, social, and political preconditions that could support a regional financial arrangement. Second, there is no need for regional financial arrangements because finance is increasingly globalized.

Many of the countries participating in the CMI have been embroiled in numerous territorial and economic disputes with one another, and animosity toward Japan's atrocities during World Ward Two lingers on. For many years, the three Northeast Asian countries have been embroiled in the controversy over historical interpretations of Japan's role in East Asia in the 19th and the early 20th centuries. As Eichengreen (1999) put it, East Asia lacks the tradition of integrationist thinking and the web of interlocking diplomatic and agreements that could encourage monetary and financial cooperation in Europe. The opponents therefore claim that since East Asian countries are not ready for, and not capable of, creating and managing an efficient regional financial arrangement, their efforts at financial cooperation in an institutionalized setting could produce undesirable consequences to the countries in other parts of the world. Specially, the regional funds, many argue, could aggravate moral hazard problems associated with excessive borrowing and loose macroeconomic policies of participating economies.

What is so unsettling about this argument is that East Asian policymakers are so inept and undisciplined that they are likely to commit the sins of moral hazard; whereas, European counterparts have been able to avoid this problem. At this stage of development, it may be true that East Asians may not be prepared to negotiate an international treaty that includes provisions for sanctions and fines for countries that do not adjust their domestic policies accordingly. This unwillingness would make it difficult for the regional fund to impose politically unpopular policies on the member countries and, hence, may pose a serious problem concerning policy discipline.

However, moral hazard is not a problem that will beset only regional arrangements. The IMF is not immune to this problem. The moral hazard concern is so serious that some people even question whether the IMF should continue to play the role of a quasi lender of last resort, and to them creation of regional monetary funds must be an anathema. (The Meltzer Commission, 2000) The task force report of the Council on Foreign Relations (1999) advises the Fund to adhere consistently to normal lending limits to redress the moral hazard problem. The reasons why East Asian financial arrangements would suffer more from the moral hazard problem than the IMF or any other regional institution have not been made clear. As Sakakibara (2000) puts it, if those countries unaffected by the East Asian crisis do not have any political incentive to contribute their own money, they should say so instead of using the moral hazard argument as an excuse for opposing regional arrangements in East Asia.

Eichengreen (2000) finds it useful to distinguish between technical assistance and financial assistance. True enough, there is no reason to discourage competition in the market for technical assistance. Governments should be free to choose the source of technical assistance with the best track record. However, his concern is that if multiple monetary funds were available, East Asian governments would have an incentive to shop around for the most generous assistance and the least onerous terms. He seems to believe that AMF conditionalities would be much softer than IMF conditionalities. At the end of the day, his concern should be well taken when Asians consider further development beyond the CMI that assumes IMF conditionality as a given.

Once established, an East Asian monetary fund could provide additional resources to the IMF while joining forces to work on matters related to the prevention and management of financial crises. At the same time, it could also support the work of the IMF by monitoring economic development in the region and taking part in the IMF's global surveillance activities. As Henning (2002) noted clearly, the validity of the additionality is difficult to assess ex ante. The problem arises in principle whenever there are multiple sources of finance and conditionality, yet it appears to have been managed successfully in numerous historical cases. Potential conflicts can be avoided through coordination and consultation, which may be provided in part by the United States and East Asian governments.

For over a half century, European countries have worked to develop a wider web of political and diplomatic agreements that has served as a foundation for cooperation on monetary and financial matters. Certainly, such a web does not exist in East Asia, and as far as East Asia's limited capacity for cooperation is concerned, Eichengreen, and Bayoumi (1999) have a point. Indeed, if the European experience is any guide, East Asia may take many years to develop an effective cooperative arrangement for finance, not to mention monetary union.

While the importance of political preconditions for establishing an effective regional financial mechanism cannot be denied, it should also be noted that the ASEAN+3 countries have participated in various regional groupings and in the process have accumulated a great deal of experience in managing cooperative arrangements with other countries. The ASEAN states have more than thirty years' of experience with regional cooperation. Since its inception in 1967, ASEAN has contributed to consolidating unity, promoting free trade, and providing mutual financial assistance among the member states. The ASEAN+3 also have been active members of the APEC.

Some of these countries also participate in the Manila framework; and there are other regional cooperative arrangements such as EMEAP, SEACEN, and SEANZA that have served as informal fora for policy dialogues.

Recent economic developments in East Asia may suggest that political integration has become less critical than before largely because many of the East Asia's central banks now enjoy greater independence than before and, more importantly, democratic principles are taking root in the governance of these countries. East Asia is changing and may be on the brink of an historical evolution, as Europe was half a century ago (Bergsten, 2000). Despite the many political and economic issues that have alienated many countries from others the ASEAN+3 were able to agree to the CMI. In that respect, the launching of the CMI has been a historic event. It may be possible to delegate regional financial affairs to the CMI or similar institutions. The East Asian countries could bypass political issues and disputes to build trust for regional cooperation. Having suffered such a painful and costly financial crisis, the East Asian countries appear to have enough incentives to set aside their differences to develop a region-wide mechanism of defence against future crises.

The opponents of the CMI also argue that there may be no need for regional funds and other regional financial arrangements in a world economy where finance has been increasingly globalized. The ongoing revolution in information and communication technology will accelerate financial globalisation. An orderly globalization requires global governance. However, the world economy is far from developing a new system of global governance, which may include a global central bank and global regulatory authorities. In order to exploit the scale economies in finance related to the development of the IT technology, the scope of financial governance could encompass the entire the world. In theory, public goods, such as the services of lender of last resort and regulatory institutions could be better provided at a global level.

While in theory the creation of such a system of global governance may appear reasonable, in reality it is politically unacceptable and must be dismissed as quixotic

(Eichengreen, 1999). As a second best alternative to the global governance system, global standards and codes of conduct on banking, corporate governance, management of monetary and fiscal policies, and many others have been proposed by emerging market economies and developing countries. However, doubts have been raised as to whether one-size-fit-all codes and standards should be imposed on EMEs and DCs, and if it they should, whether they could be enforced. If regional differences matter in devising standards and codes and harmonizing institutions, one could argue that some of the public goods for finance could be more efficiently produced at the regional level.

As noted earlier, the architects of the CMI may have a more ambitious long-term goal of promoting monetary integration in East Asia. If indeed they do, their ambition is likely to be met by a great deal of skepticism. Eichengreen (1999), and Eichengreen and Bayoumi (1999), and Bayoumi, Eichengreen and Mauro (2000) argue that while a group of East Asian countries may satisfy requirements for an optimum currency area as much as the EU does, it has not developed political preconditions necessary for a durable regional arrangement, which is not certainly as much as Europe has accomplished in this regard. These authors argue that "any monetary arrangement that seeks to stabilize exchange rates in the absence of the necessary political preconditions will be fragile and crisis prone".

Drawing on the European experience, these sceptics emphasize the need for an efficient management of a relatively long period of transition to a common currency peg and eventually a common currency in the long run. They argue that East Asian countries would therefore have a better chance of defending itself against crisis by focusing attention on crucial areas of structural reform and trade policy rather than wasting time and energy on a premature idea such as an East Asian EMS. In this regard, Bayoumi *et al* are more constructive in that they suggest a number of objectives that must be achieved during the transition period emphasized by the Maastricht Treaty.

Few East Asian policymakers would be naive enough to believe that they will be able to work out an agreement on creating an East Asian monetary fund or a common currency area in the near future. At best monetary unification is a long-term objective, and the ASEAN+3 have just taken the first step toward regional integration in financial markets. However, East Asia enjoys the latecomer's advantage in promoting financial and monetary integration as it can learn from the European experience. In the end, the western countries will have to decide whether the regional financial arrangements in East Asia will contribute to global stability and welfare. And the European experience suggests that they are likely to do so. That is, it would be in the U.S. and European interest to support the expansion and consolidation of the CMI insofar as financial deepening in East Asia supports an orderly globalization of the world economy.

6. Recent Developments in the Chiang Mai Initiative (CMI)

6-1. Structure of the CMI

The CMI has two components:

(i) an expanded ASEAN swap arrangement; and

(ii) a network of bilateral swap and repurchase arrangements among the thirteen countries.

In 1977, five ASEAN countries -- Indonesia, Malaysia, Philippines, Singapore, and Thailand -- agreed to establish an ASEAN swap arrangement (ASA) – a short-term liquidity support facility for the participating countries suffering balance of payment difficulties. In May 2000, the ASA was expanded to include the five new member countries under the CMI and the total amount of the facility was raised to US$ 1 billion from the initial amount of US$ 200 million.

The currencies available under the ASA are the U.S. dollar, yen, and euro. The euro, yen and Euro LIBOR interest rates are used as the base rate for swap transactions. Each member is allowed to draw from the facility a maximum of twice its committed amount for a period not exceeding six months, subject to an extension for another period not exceeding six months.

The system of bilateral swap arrangement (BSA) the ASEAN+3 agreed to is a short-term facility for liquidity assistance in the form of swaps of U.S. dollars with the domestic currencies of the thirteen participating countries. The maximum amount of drawing under each of the BSAs is to be determined by bilateral negotiations. However, it is expected that disbursements to a member in need of liquidity assistance will be made in a concerted manner through consultation among the swap providing countries. One of these swap-providing countries will then serve as the coordinator for the consulting process. The BSA agreement allows an automatic disbursement up to 10 percent of the maximum amount of drawing. However, countries drawing from the facility more than the 10 percent are required to accept an IMF program for macroeconomic and structural adjustments. In this sense, the BSA is complementary to the IMF's financial assistance.

A number of the participating countries have expressed their reservation on the linkage of the BSA with the IMF conditionality and have proposed to increase gradually the 10 percent automatic draw and to abolish the IMF linkage after a period of transition. For instance, Malaysia advocates complete independence of the CMI from the IMF. Severance of the IMF linkage requires creation of a regional surveillance mechanism for the CMI. At the fifth ASEAN finance ministers' meeting in April 2001 in Kuala Lumpur, however, there was consensus that the BSA should remain complementary and supplementary to IMF facilities until a regional surveillance system is brought into existence. The ASEAN ministers also agreed that "the terms and modalities of the BSA should take into account the different economic fundamentals, specific circumstances, and financing needs of individual countries". This agreement implies that the contracting parties of the BSA could deviate from the basic framework on setting terms and conditions of the swap agreements.

Participating countries are able to draw from the BSA for a period of 90 days. The first drawing may be renewed seven times. The interest rate applicable to the drawing is the LIBOR plus a premium of 150 basis points for the first and first renewal drawings. Thereafter, the premium is increased by an additional 50 basis point for every two renewals, but not exceeding 300 basis points.

The Repo agreement is also established to provide short-term liquidity to a participating member through the sale and buyback of appropriate securities. Basic features of Repo agreements are to be finalized through bilateral negotiations between the contracting parties. Securities of the Repo agreement are U.S. Treasury notes or bills with the remaining life of not more than 5 years and government securities of the counterpart country of the Repo.

The period of the Repo agreement is one week, but could be extended on the termination value date by agreement between the contracting parties. The minimum amount for each Repo transaction requested is five percent of the total amount of the Repo agreement. In each Repo transaction, the buyer will be given a margin of 102 percent for U.S. Treasury notes or bills and 105 percent for government securities of the counterpart country.

6-2. Negotiations for the BSAs and Surveillance System

Bilateral Negotiations

The CMI has been a key initiative for Asian financial cooperation. Significant progress has been made in implementing the CMI. The ASEAN Swap Arrangement (ASA), one of the main components of the CMI, has increased to US$1 billion, effective as of November 17, 2000, and encompasses all ASEAN member countries. Regarding the network of bilateral swap agreements (BSAs) under the CMI, substantial bilateral agreements have been reached. At the end of December 2003, the first round of CMI implementation has been completed by concluding the sixteen BSAs that amount to US$35.5 billion in total. Japan has been playing a leading role in terms of both number and amount: Japan concluded seven agreements with Korea, China, Indonesia, Malaysia, the Philippines, and Thailand, and Singapore. China also concluded five agreements with Korea, Indonesia, Malaysia, the Philippines and Thailand in addition to the China-Japan BSA. Similarly, Korea concluded five agreements with China, Indonesia, Malaysia, the Philippines and Thailand in addition to the Japan-Korea BSA (Table 4).

Table 4. Progress on the Chiang Mai Initiative

(As of December 31, 2003)

BSA	Currencies	Conclusion Dates	Amount
Japan-Korea	USD/Won	July 4, 2001	US$ 7 billion (a)
Japan-Thailand	USD/Baht	July 30, 2001	US$ 3 billion
Japan-Philippines	USD/Peso	August 27, 2001	US$ 3 billion
Japan-Malaysia	USD/Ringgit	October 5, 2001	US$ 3.5 billion (a)
PRC-Thailand	USD/Baht	December 6, 2001	US$ 2 billion
Japan-PRC	Yen/RMB	March 28, 2002	US$ 3 billion equivalent
PRC-Korea	Won/MB	June 24, 2002	US$ 2 billion
Korea-Thailand	USD/Baht	June 25, 2002	US$ 1 billion
Korea-Malaysia	USD/Ringgit	July 26, 2002	US$ 1 billion
Korea-Philippines	USD/Peso	August 9, 2002	US$ 1 billion
PRC-Malaysia	USD/Ringgit	October 9, 2002	US$ 2 billion
Japan-Indonesia	USD/Rupiah	February 17, 2003	US$ 3 billion
PRC-Philippines	RMB/Peso	August 29, 2003	US$ 1 billion
Japan-Singapore	USD/S$	November 10, 2003	US$ 1 billion
Korea-Indonesia	USD/Rupiah	December 24, 2003	US$ 1 billion
PRC-Indonesia	USD/Rupiah	December 30, 2003	US$ 1 billion

Note: (a) The US dollar amounts include the amounts committed under the New Miyazawa Initiative, US$5 billion for Korea and US$2.5 billion for Malaysia.

In East Asia, except for the CMI under the ASEAN+3 framework, other regional institutions or forums do not have any mutual liquidity support arrangement. Even the CMI has nothing to do with exchange rate coordination. In comparison with Europe, the CMI has a different motivation from the beginning. The European facilities were created with the purpose of limiting bilateral exchange rate fluctuations among regional currencies. The CMI started with high capital mobility and flexible exchange rates, although some members of ASEAN+3 have maintained a relatively fixed exchange rate regime. So far, the ASEAN+3 countries have not presumed any manifest exchange rate coordination. In the absence of exchange rate coordination, incentives for mutual surveillance will be limited because a member country facing a speculative currency attack may be free to float its exchange rate vis-à-vis those of other neighboring countries (Wang and Woo 2004). Under the current ASEAN+3 policy dialogue framework, the purpose of the CMI and mutual surveillance system is to prevent the occurrence of financial crises and contagion in the region.

The CMI will be reviewed in May 2004. One important remaining issue is the linkage of the CMI to the IMF. As long as the CMI is simply a source of financial resources supplementary to the IMF, the size of the swap borrowing is not necessarily sufficient to meet potential needs, because there exists another deep pocket of financial resources provided by the IMF. Although the CMI does not need to design its own conditionality at this point, it does need to establish its own surveillance mechanism. Under the current CMI framework, 10 percent of the swap arrangements can be disbursed without IMF involvement. But because this 10 percent of swap can be disbursed only with the consent of swap-providing countries, the swap-providing countries need to formulate their own assessments about the swap-requesting country. At present, the current practices under the ASEAN+3 process cannot effectively capture emerging problems.

Most participating countries agree in principle that the CMI needs to be supported by an independent monitoring and surveillance system. This system monitors economic developments in the region, serves as an institutional framework for policy dialogue and coordination among the members, and imposes structural and policy reform on the countries drawing from the BSAs. To do so, the ASEAN+3 finance ministers agreed to organize a study group to produce a blueprint for an effective mechanism of policy dialogues and economic reviews for the CMI operations at the ADB annual meeting in Honolulu on May 9, 2001. Japan and Malaysia were chosen to co-chair the group. The study group met in Kuala Lumpur November 22, 2001 to discuss the report on possible modalities of surveillance prepared by Bank Negara Malaysia and Japan's Ministry of Finance. However, the member countries could not reach an agreement on the surveillance issues, agreeing only to institutionalize the ASEAN+3 meetings of deputies for informal policy reviews and dialogues. At this stage of development of the CMI, many countries feel uncomfortable about creating an independent regional monitoring and surveillance unit as part of the CMI.

In the long run, however, the participating countries are likely to wean themselves from their reliance on the IMF. If the CMI develops into more or less an independent financial arrangement from the IMF, then the regional financial arrangement should be designed to discipline the borrowers to adhere to sound macroeconomic and financial policies by imposing conditionalities. However, the ASEAN+3 countries at the current stage do not seem well prepared for establishing a policy coordination mechanism in the surveillance process.[10]

At present, the total amount of BSAs covering all 8 countries is estimated to be around US$20 billion. The maximum amount of money any individual country can draw varies a great deal. In the case of Thailand, the maximum is about US$ 6 billion, 10 percent of which can be drawn automatically. Given such a relatively small amount of liquidity available through the CMI, doubts have been raised as to whether the BSA system could serve as a credible and effective system of defence against speculative attacks in the future. Participants of international financial markets may not be impressed with the amount of liquidity available and hence ignore the CMI, unless the ASEAN+3 are prepared to increase the number of BSAs and expand the swap amount of each BSA.

However, it should be noted that the BSA system is a first line of defence against future speculative attacks. If an additional amount of liquidity is needed to restore financial stability in a member country under attack, the ASEAN+3 will be able to come to rescue the country in question by supplying additional short-term credit

[10] For instance, the ASEAN surveillance process is built on the basis of consensus and informality in keeping with the tradition of non-interference (Manzano 2001). East Asian in contrast to Europe lacks the tradition of integrationist thinking and the web of interlocking agreements that encourage monetary and financial cooperation (Eichengreen and Bayoumi 1999). Eichengreen and Bayoumi (1999) stress that East Asia does not meet the necessary intellectual preconditions for regional integration. For this reason, they conclude that it is unrealistic to speak of pooling national sovereignties. While there is no doubt considerable work to be done in promoting policy coordination in the region, it is wrong to say that it cannot be done in East Asia.

collectively. The ASEAN+3 can serve as a mechanism for such a joint intervention as it has developed into a forum for policy dialogue and coordination in the region.

Monitoring and Surveillance

From the inception of the CMI, some of the member countries have opposed the idea of linking the CMI with the IMF program. Other members, in particular Japan and PRC, have argued for the importance of forging a cooperative relation with the IMF at an early stage of the CMI development to make it more credible. They have succeeded in persuading Malaysia and other opposing members to accept the linkage of the BSAs with the IMF conditionality as a temporary arrangement until a formal surveillance mechanism is put in place. Malaysia agreed to the IMF linkage with the condition of establishing a study group to examine the types of the monitoring and surveillance system the CMI would require to function as an independent regional financial arrangement.

Most participating countries agree in principle that the CMI needs to be supported by a surveillance system that monitors economic developments in the region, serves as an institutional framework for policy dialogues and coordination among the members, and imposes structural and policy reform on the countries drawing from the BSAs. The ASEAN+3 finance ministers agreed to organize a study group to produce a blue print for an effective mechanism of policy dialogues and economic reviews for the CMI operations at the ADB annual meeting in Honolulu on May 9, 2001. Japan and Malaysia were chosen to co-chair the group.

The study group met in KL November 22, 2001 to discuss the report on possible modalities of surveillance prepared by Bank Negara Malaysia and the Japan's Ministry of Finance. However, the member countries could not reach an agreement on the surveillance issues except for institutionalising the ASEAN+3 meetings of deputies for informal policy reviews and dialogues. At the Asian Development Bank annual meetings in Jeju, Korea in May 2004, ASEAN+3 finance ministers agree to review the progress the CMI has made and to chart a future course of development of the BSA. For this purpose, they have created a working group which is expected to prepare a report for their discussion at the 2005 ADB annual meetings.

7. Barriers to Financial Cooperation and Integration

East Asian policymakers who conceived the idea of the CMI would easily concede that the BSA system as it is currently structured has a long way to go before it can be accepted as an effective mechanism of defense against financial crises. Although three years have passed since the system was established in May 2000, the leaders of the CMI group have yet to produce an operational structure for BSAs, in particular a monitoring and surveillance mechanism. And it is highly unlikely that they will do so anytime soon.

As for institutional and political constraints on further expansion of the CMI, the most serious one has been that the thirteen countries have failed to articulate the ultimate objectives of the CMI arrangement. The participating countries themselves are still unclear about whether the CMI is going to be fostered as a regional liquidity support program or as a building block for a full-fledged regional monetary system in East Asia. If bilateral swap arrangements are activated collectively and supported by a surveillance system, then they constitute a de facto regional monetary fund. The CMI could then be used as the base on which an elaborate system of financial cooperation and policy coordination is built by following in the footsteps of the European monetary integration.[11] At this stage of development, many countries in East Asia are not

[11] From the theoretical point of the neo-functionalists, initial steps toward integration trigger self-sustaining economic and political dynamics leading to further cooperation. Economic interactions create spillovers or externalities that need to be coordinated by governments involved. Such economic policy coordination at the regional level can be seen as an inevitable response to the increased economic interactions within the region. Once integration process starts, spillovers deepens and widens integration by working through interest group pressures, public opinion, elite socialization or other domestic actors and process (George 1985).

prepared to accept the idea of or may feel uneasy about restructuring the CMI into a forerunner of the AMF.

A second institutional constraint is related to the need to coordinate the activities of the CMI with other regional arrangements such as the Manila framework supported by the U.S., Australia, and New Zealand. Most of the CMI countries also participate in the Manila framework and APEC. At some point in the future, the leaders of the ASEAN+3 countries may have to decide on the mode of cooperation and division of labor in promoting regional growth and stability between these institutions and the CMI. All thirteen countries have been engaged in policy reviews and dialogues through the various APEC meetings and the Manila framework. Unless the CMI is developed into a credible financing mechanism by increasing swap amounts, it will take on a role similar to other regional economic forums. The coherence of the group will then be weakened, as questions are raised as to whether the thirteen countries constitute an appropriate grouping for a regional financing arrangement in East Asia.

A third hindering factor is that as the fear of another round of financial crisis has receded with the recovery that has been faster than predicted on the basis of previous episodes of crises. With this false perception, the ASEAN+3 countries have become less interested in enlarging and institutionalizing the CMI operations. Instead, their focus has recently shifted to creating free trade areas in East Asia [See Table 5].[12] The ASEAN free trade area (AFTA) now includes the whole of Southeast Asia. AFTA continues to expand. In November 2001, China and the ASEAN countries agreed to form a free trade area within ten years, allowing for some preferential treatment for less developed ASEAN countries. Japan has concluded a free trade agreement with Singapore and started negotiations on a similar agreement with Korea and several states of the ASEAN on the individual basis.

[12] Historically, there has been much less movement towards trade regionalism in East Asia than in Europe. East Asian countries are reliant on the US and European Union (EU) markets, so there has been less incentive for them to expand trade integration within the region. The first major attempt was made only in 1992, when six ASEAN countries agreed to launch a scheme for ASEAN free trade.

Table 5. Free Trade Agreements in East Asia

	Year	Participants and Status
FTA in force		
ASEAN Free Trade Area (AFTA)	1992	10 ASEAN members
Australia-New Zealand Closer Economic Relations Trade Agreement (CER)	1983	Australia, New Zealand
Singapore-New Zealand FTA	2001	Effective in January
Japan-Singapore Economic Partnership Agreement (JSEPA)	2002	Effective in November
Singapore-EFTA (European Free Trade Association) FTA	2002	Signed in June and effective in January 2003
Korea-Chile FTA	2003	Signed in February
Singapore-U.S. FTA	2003	Signed in May
China-Hong Kong Closer Economic Partnership Arrangement (CEPA)	2003	Signed in June and effective as of
China-Macau Closer Economic Partnership Arrangement (CEPA)	2003	Signed in June and effective as of January 2004
Thailand-India	2003	Signed in October and effective as of January 2004 for selected items
Agreements being negotiated, studied, or considered		
East Asia Free Trade Area (EAFTA)	2000	Proposed at the ASEAN+3 summit meeting
China-Japan-Korea FTA	2000	Chines Premier Zhu Rongji proposed during the ASEAN+3 summit meeting
ASEAN-China Free Trade Area (ACFTA)	2001	Realization by 2010 (Framework Agreement signed in 2002)
Japan-ASEAN Closer Economic Partnership	2002	Realization within 10 years agreed to at an ASEAN-Japan Summit meeting
ASEAN-India Regional Trade and Investment Agreement	2002	Consideration of an agreement agreed to at the ASEAN-India summit
Thailand-Australia	2003	Negotiation to be completed by end-2003
Japan-Mexico FTA	2003	Under Negotiation
Japan-Thailand FTA	2004	Under Negotiation
Japan-Malaysia FTA	2004	Under Negotiation
Japan-Korea FTA	2004	Under Negotiation
Korea-Singapore FTA	2004	Under Negotiation
ASEAN-Korea FTA	2004	Under joint Study

The free trade movement is undoubtedly a desirable development, and the CMI could facilitate further liberalization of trade by stabilizing bilateral exchange rates of regional currencies and minimizing the disruptive effects of financial market turbulence. This advantage suggests that the ASEAN+3 countries may have an incentive to broaden the scope of the CMI in parallel with negotiations on establishing free trade areas in the region. In reality, however, it appears that free trade discussions have rather distracted many East Asian countries from their CMI negotiations.

A region-wide East Asian FTA covering ASEAN+3 countries is slow to materialize because China and Japan are seeking bilateral trade agreements rather than multilateral ones. In particular, the current pattern of regional trade agreements in East Asia is bewildering (Scollay and Gilbert 2001). It essentially consists of a web of bilateral arrangement, many of which are still on the drawing board. There has apparently been no formal attempt to build a regional multilateral agreement like the Common Market agreement. Bilateral agreement is unlikely to foster a collective framework (Wyplosz 2004).

For South Korea and Japan, the agr icultural sector is the most important barrier to an FTA with other Asian countries. In fact, any trade agreement faces the possibility of severe resistance from domestic vested interest groups, because trade agreements have different effects on different sectors. South Korea and Japan have heavily protected their agricultural sectors; there are still mounting concerns that opening this sector will ruin those who rely on it for their livelihood, although it will be beneficial for the economy as a whole. Many people in South Korea and Japan have family roots in agricultural regions, and often maintain close ties with relatives in rural areas. Consequently, any policy that inflicts heavy losses on the agricultural sector may be politically unpopular. Thus, any region-wide free trade agreement in East Asia will not be accomplished anytime soon, when it comes to liberalize agricultural sector without due protection.

Fourth, financial deregulation and market opening have drawn East Asia away from regional financial integration. Over the past decade, a number of East Asian countries have liberalized their financial markets to foreign capital by reducing restrictions on inward and outward capital flows. Financial liberalization throughout East Asia has brought many countries to establish closer linkages with international financial centers (Lee et al. 2004). In East Asia, there is no sign of the development of an integrated regional financial market. This less progress in regional financial integration is not surprising. Eichengreen and Park (2003) explain the various factors by comparing the two regions – Europe and East Asia.

According to their analysis, Europe has gone further than East Asia in the integration of product and factor markets. While the EU has a true single market in goods and services, progress towards the creation of an Asian free trade area remains incomplete. While Europe has removed essentially all barriers to the free movement of capital and most barriers to the movement of labor, in East Asia limits on factor mobility remain pervasive. In Europe, regionalism is motivated in no little part by a desire for political integration that has no counterpart in East Asia. While Europe has built institutions of transnational governance (e.g., the European Commission, the European Parliament, the European Court of Justice, and now the European Central Bank), East Asian integration is "weakly institutionalized." That is, it is predicated not on transnational institutions but on intergovernmental agreements that defer to the sovereignty of the participating states. Nor is integration in East Asia driven by an alliance of key nations like France and Germany or by a single hegemonic power (the role played by the United States in the Western Hemisphere); it is a more multi-polar process.

Recently, the ASEAN+3 group has shown great interests in developing regional bond markets in East Asia so that East Asian borrowers can issue bonds denominated in local currencies. The member countries agreed at the AFDM+3 meeting to organize six working group under the Asian Bond Initiative (ABI) to conduct detailed studies on various aspects of bond market development. Given the low degree of regional financial integration in East Asia, this initiative would be welcome if it would be a means to facilitate financial market development in East Asia. Despite strong enthusiasm of the ASEAN+3 countries for constructing bond market infrastructure and increasing the supply of as well as demand for these bonds, the creation of deep and liquid bond markets in the region will take a long time. It will require more extensive domestic financial reform, institution harmonization among and substantial investment for building the infrastructure by the ASEAN+3 (Park and Park 2003).

Many proponents of the ABI may counter this pessimistic view. Ito (2003, 2004) argues that there may be regional bias next to home bias in that investors find bonds issued in Asia attractive compared to bonds from other region.[13] However, at this stage of development, there is no guarantee that regional efforts, even if they can be organized, could succeed in fostering regional capital markets that are competitive vis-à-vis the global capital markets in North America and Europe. Furthermore, the continuing globalization of financial markets and advances in information technology that allows financial companies in the international financial centers dominate the international banking and investment businesses. In reality, there would be no home bias at the regional level, unlike at the country level. For example, a regional portfolio is not necessarily easy to hedge. Having better information at the regional level does not seem to be enormously more advantageous than having better information at the global level (Lee et al. 2004).

Evidently, East Asia is less financially integrated than Europe. Financial claims are all denominated in the U.S. dollar and the bulk of foreign lending and borrowing are intermediated through international financial markets in New York and London. As far as finance is concerned, therefore, regional financial arrangements themselves cannot effectively address the inherent structural balance sheet problem most East Asian emerging and developing countries are currently facing. The absence of regional financial integration is closely linked to the absence of regional lender of last resort. In Europe, West Germany provided unlimited supply of short-term liquidity under the European Monetary System (EMS) when weak currency countries were under severe pressure of currency devaluation. In East Asia, Japan appears to play a limited role as a

[13] Ito argues that there is natural preference among the investors that they purchase familiar products with less perceived risk. However, he also acknowledges that regional bias is still a product of theoretical deduction rather than widely observed phenomenon, such as home bias, supported by hard evidence.

regional lender of last resort.

Finally, there is the leadership issue that defies an easy solution. If the thirteen countries have a more ambitious goal of developing a collective exchange rate mechanism similar to the ERM in Europe with the long-term objective of adopting a common currency, they will have to increase the number and amounts of the BSAs. As the European experience shows, such an extension requires leadership that can foster coherence among the thirteen countries by mediating between the divergent interests of the members.

China and Japan are expected to provide leadership in forging regional consensus for expanding and consolidating the BSAs as a regional institution, but they have not been able to agree on a number of operational issues including the surveillance mechanism. Except for Japan, no other potential swap lenders including China are prepared to increase the amounts of their bilateral swaps with other contracting parties. Japan could increase its swap amounts with the ASEAN states and Korea (under the presumption that China will not borrow from Japan) to make the CMI a more credible financing scheme. However, unless Japanese authorities receive some sort of assurance that their short-term lending will be repaid, they are not likely to lead an expansion and institutionalization of the CMI. As a minimum condition for expansion of the CMI, Japan would demand the creation of an effective surveillance mechanism for the region in which it can exercise influence commensurate with its financial contribution. However, China may feel that it cannot play the second fiddle to Japan in any regional organization in East Asia. This concern appears to be the most serious roadblock to further development of the CMI.

China and Japan have different interests and hence different strategies for economic integration in East Asia. As far as China is concerned, economic integration with the ASEAN 10 members, South Asian and central Asian countries may be more important both economically and geo-politically than financial cooperation or free trade with either Japan or South Korea. While China is a super military power in the world, it is still a developing economy with a huge gap to narrow in terms of technological and industrial sophistication vis-à-vis Japan. Although China has been growing rapidly, it has a long way to go before catching up with Japan. These differences in the economic and military status of the two countries suggest that, even if they manage to reconcile their troubled memories of the past, China and Japan may find it difficult to work together as equal partners for regional integration in East Asia.

Despite slow progress in reconciliation between China and Japan, China seems to emerge as an active player in the both international and regional arena. Since the mid-1990s, China has expanded the number and depth of its bilateral relationships, joined various trade and security accords, deepened its participation in key multilateral organizations, and helped address global security issues. The pinnacle of this process was the Treaty of Good-Neighborliness and Friendly Cooperation that China signed with Russia in 2001 (Medeiros and Fravel 2003).

China borders Russia and many of the South Asian and Central Asian countries in addition to several ASEAN members. Therefore, it is natural for China to seek expansion and deepening of its trade and financial relations with those neighboring countries. In fact, for this reason, China has been courting ASEAN for a free trade agreement and joined in November 2001 the Bangkok agreement on a free trade area that includes Korea and the South Asian countries (Bangladeshi, India, Laos and Sri Lanka). In Central Asia, China has also taken a leading role in establishing the region's first multilateral group, the Shanghai Cooperation Organization. Founded to settle long-standing territorial disputes and to demilitarize borders, the organization now stress counter-terrorism cooperation and regional trade among Russia, Kazakhstan, Kyrgyzstan, Tajikistan, and Uzbekistan and China.[14]

In contrast, Japan has not been able to articulate its strategic interests in East Asia. While Japan has been at the forefront in supporting greater economic cooperation among the East Asian countries, its perspective on the geographical contiguity of East

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[14] In June 2001, the presidents of six countries signed the Declaration of the Shanghai Cooperation Organization (SCO). The SCO aims at strengthening mutual trust and friendly relations among member states, encouraging their further effective cooperation in politics, economy, science and technology, culture, education, energy, transportation, environmental protection and other fields, jointly ensuring regional peace, security and stability, and creating a new international political and economic order.

Asia has not been altogether clear. Japan has been promoting integration among the "ASEAN+5," but which are the two countries added to ASEAN+3? At times, the five countries are stated as China, Japan, Korea, Australia, and New Zealand, and at other times Taiwan and Hong Kong replace Australia and New Zealand.

There is also the suspicion that Japan is not interested in free trade and financial arrangements per se in East Asia for purely economic reasons. Instead, Japan is engaged in the discussion of those regional arrangements with other East Asian countries to maintain its leadership role as the region's largest economy by checking and balancing China's expansion. Many analysts believe that Japan's active involvement in regional economic integration is therefore motivated by its desire to maintain its traditional pole position.[15] On top of this suspicion, Japan is perceived to be a country insensitive to and unwilling to resolve wartime legacies and disputes on historical and territorial claims. Japan has also been gripped with a decade long recession and unable to restructure its economy.[16] These developments combined with its lack of a strategy for East Asian development seem to undermine Japan's ability to pull East Asian countries together for regional cooperation and integration.

8. Concluding Remarks: Future Prospects for Regional Financial and Monetary Integration in East Asia

Regionalism in East Asia is taking two forms: free trade arrangements (FTAs) and financial arrangements. The arrangements imply that geographically proximate countries hang together to foster trade on the one hand and to promote financial and exchange rate stability on the other. The two processes reinforce each other.

The euro area pursued trade integration first, but from a theoretical point of view there is no clear reason for this. Even in Europe, trade integration slowed down

[15] See David Wall, "Koizumi Trade Pitch Nests," the *Japan Times*, April 21, 2002.
[16] Uncertain economic prospects may make Japan unlikely to be the driver in the region's integration movement as it was in the past. China is emerging both as a strong competitor and as a promising market.

whenever there were concerns about exchange rate stability among member countries. In this regard, some form of monetary integration is an important condition for trade integration (Shin and Wang 2004). Furthermore, there are many good reasons for forming a monetary union before a FTA. A monetary union can quite significantly increase trade among member countries by serving as a device to avoid the bottlenecks that can be encountered during the process of negotiating and implementing a FTA. This increased trade is likely to occur mostly within similar industries, so weakening asymmetric shocks across member countries will also decrease the costs of maintaining a monetary union. A monetary union can also accelerate financial integration in the region, which might not be accomplished otherwise. Hence, a monetary union is a self-validating process.

A major hindrance to a monetary union in East Asia is the area's lack of historical experience in regionalism. Whatever economic benefits a monetary union may bring, they are unlikely to be realized in the near future if each country is unwilling to cooperate in the political arena.

What are then the likely courses of development of the regional financial architecture in East Asia? How would regional financial integration proceed in East Asia? One possible scenario is that China and Japan will come to realise that despite the differences in their strategies, China and Japan together are the key to developing a common political will in East Asia. Sakakibara (2003) argues that the role of China and Japan in East Asia's integration process is synonymous with that of France and Germany in Europe's integration process. Similarly, the Kobe Research Project report submitted to the fourth gathering of the finance ministers of the Asia-Europe Meeting (ASEM Finance Ministers' Meeting) held in Copenhagen in July 2002 states that "It is essential for the Japan-China cooperation, as a core in East Asia, to lead the process of economic and financial integration, as the France-German alliance played a central role in the integration and cooperation process in Europe.[17]

[17] France and Germany also had a wartime legacy. Although de Gaulle's nationalism was generally popular within the country, he also appreciated that membership of the common market would benefit France economically. However, de Gaulle remained implacably opposed to any increase in the powers of

This realization could soften their positions to compromise on an institutional setting and augmentation of the existing financial architecture of East Asia. For instance, China may accept Japan's demand for de facto control over monitoring and surveillance in return for Japan's pledge for a substantial increase in financial assistance in the form of one-way swaps and ODA to ASEAN members. China could agree to this scheme, if it is confident about concluding a free trade agreement with the ASEAN members in the near future. China's free trade pact with ASEAN could circumscribe Japan's influence on ASEAN affairs even if Japan is a major provider of financial resources to the region. In this process, Korea and ASEAN would serve, as a mediator in the cultivation of a common political will between China and Japan. [18]

Another scenario focuses on the possibility of China assuming a more aggressive leadership role in regional integration. In view of the uncertain prospects of the Japanese economy, China could emerge as the region's engine of growth over the longer term if it sustains its growth. Given the envisaged leadership role, China may choose to negotiate both the expansions of the BSAs and a free trade pact with ASEAN. In this case, the original CMI would become "ASEAN+1" in the sense that Japan could play the second fiddle. Realizing that financial integration is an integral part of a successful free trade area, China may indeed seriously consider this option. However, without Japan, ASEAN+1 will not be a viable arrangement for a regional financing scheme simply because China is hardly in a position to commit itself to financing the balance of payments deficits of all ASEAN member states. It is also questionable

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the European Commission, or to any other increase in supranationalism. He showed just how opposed in 1965, when he precipitated the most dramatic crisis in the history of the European Community (George, 1985). It was German Chancellor Helmut Schmidt and French President Giscard d'Estaing that accelerated stalled integration process at the end of the 1970s. The joint initiative of Chancellor Helmut Kohl and President Francois Mitterand resulted in a great leap towards EMU in the beginning of the 1990s. The Franco-German alliance formed the core for the integration process in Europe, as it was the political will of these two countries that motivated further integration.

[18] Murase (2004) emphasizes the role of Korea by saying that "as East Asian monetary and financial cooperation move ahead, Korea can be expected to fulfill a similar role to that played by the Benelux countries in Europe. In the regional monetary system formation process, therefore, it could play a constructive role as a medium-sized industrialized economy supplementing Sino-Japanese leadership while representing the interests of smaller countries in the region. When it comes to setting up regional institutions sometime in the future, Korea could well rank alongside the key members of ASEAN as a possible location for the secretariat and other organizations."

whether ASEAN will join any regional financial arrangement in which China is the dominant member.

A third scenario is the enlargement of the CMI to include Australia and New Zealand and possibly India from South Asia. This is the route favoured by Japan in the sense that Japan would find it easier to deal with China when there are more countries supporting its strategy. However, many members of ASEAN+3 believe that at this stage forming a critical mass of the CMI should precede any enlargement discussion. Since the enlargement is not likely to increase substantially the availability of short-term financing, most members of ASEAN+3 would not take the third scenario seriously.

Perhaps the most realistic scenario is that the countries participating in the CMI will muddle through, continuously discussing modalities of policy dialogue, the types of the surveillance system the CMI needs, and also augmentation of swap amounts without making any substantial progress.

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