ECONOMIC REGIONAL INTEGRATION IN EUROPE AND ASIA

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Looking at the process of economic and financial integration in Asia, it is natural to ask oneself to what extent the European experience of monetary unification, however unique, is relevant to Asia.

I will try to shed some light on it by looking at the similarities and differences of the two models when comparing first the current Asian arrangements and those put in place in the initial stages of the European integration. Then I will compare the current European arrangements with the existing strands of research and initiatives regarding the outlook of future Asian integration.

But before that it is important to recall the **objectives** of the two integration processes, described by previous speakers:

- in Europe, the objective was the completion of the internal market in a framework of a much broader gradual and pragmatic integration process of small steps leading to an “ever closer Union”.
- In Asia, the objective was to prevent the repetition of the 1997 financial crisis and, more recently, to replace the current exchange rate systems in the region, most of them anchored in the US dollar. This system is subject to tensions in view of the export led economic policies of countries in the region and the important global imbalances.

These starting differences must lead to caution when comparing the two processses and hence assessing the relevance of the European model for Asia.

Similarities and differences. The first stage.

Previous speakers also described the **current** exchange rate cooperation arrangements, based primarily on the Chiang Mai initiative.

One can signal here one similarity and one big difference.

- Both are ***similar*** in the sense that they are a pragmatic way of signalling the will to **create the conditions for confidence building, closer dialogue and surveillance through the set up of mechanisms requiring the involvement of national economic authorities at regional level**. As in Europe, the approach had to be slow and gradual.

- The ***difference*** is that in its process of monetary and exchange rate coordination, early European exchange rate coordination attempts, such as the Short Term Monetary Facility and the European Monetary Cooperation Fund **were not bilateral, but multilateral arrangements**.

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[1] Based on M. Bertoldi and C. Gaye, EMU and economic and monetary integration in East Asia: Are there lessons to be learned?

As a matter of fact, in spite of the official statements and its expansion in 2005 with the doubling of the swap amounts, **the more than 3 trillion dollars of accumulated currency reserves seem to indicate that Asian governments did not consider**, the current BSAs a sufficiently credible and effective mechanism should a crisis arise. Luckily **the bilateral swap arrangements of the Chiang Mai Initiative** in its current format were never **really tested**. A system based on bilateral swap arrangements is more vulnerable than the multilateral one.

The next stages:
While comparing the two models in their past or current stages is relatively easy, assessing the relevance of the European model for Asia into the future is clearly much more complex and requires some much braver assumptions or estimations on future developments.

I will look at two main developments: the refinement of exchange rate arrangements, and the intiatives to set up an Asian exchange rate mechanism possibly leading to an Asian single currency.

Multilateralising exchange rate arrangements
Asia's decision of studying the possibility of a multilateral swap arrangement (MSA) is certainly aimed at giving new momentum to the integration process and at putting in place a effective mechanism in case of currency turmoil.

The MSA does present some similarities with the Short Term Monetary Facilities (STMF) set up in the 1970s , where the six members of the European Community pledged to lend to each other, on demand, pre-declared amounts.

The facilities, introduced in 1970 became in **1972 the European Monetary Cooperation Fund, which collected the reserves pledged under the Short Term Monetary Facilities**. It was managed by the central bank Governors, and its board was supposed to exert some form of surveillance, which however proved to be very limited.

As Park and Wyplosz (2008) find, there are **some similarities between the proposal of Self-Managed Reserve Pooling in East Asia under the CMI and the European Monetary Cooperation Fund (EMCF)'s** experience in Europe.

As they argue, this European experience is relevant because it showed that **reserve pooling can certainly evolve into a virtuous circle**. **But it can equally turn into a vicious** one because of **moral hazard.**

- Thus, **participating countries need guarantees that moral hazard will be contained to agree to pool sizeable amounts of reserves**.

The size of the pooled reserves might not be an issue among ASEAN+3 members given the large accumulated reserves in the region. The difficulties rather lie in overcoming several political and institutional obstacles to be efficiently implemented.

- Here another European reference may be worth considering. In Europe a structure, with a clear political mandate, was set up to carry the political weight to implement **enhanced peer review** and **“due diligence”** processes. This is **the ECOFIN Finance Ministers Meeting and the Economic and Financial Committee (EFC) of senior officials of the Ministry of Finance and the central banks.**

  One wonders whether a similar surveillance structure could be created in Asia by merging the two existing surveillance mechanisms, the “Economic Review and Policy Dialogue” (EPRD) at the level of ASEAN+3 Ministers of finance and the EMEAP at the level of central bank governors

  This merger would be far from easy, not least because:
    - **the countries participating in EPRD and EMEAP are not the same**,
    - the **level of central bank independence varies**,
    - the member states should forego some of their sovereign prerogatives, etc...
    - In addition, it **would require a political agreement on which countries should be in the initial Asian Community**[2].

  Nevertheless an "East Asian ECOFIN and EFC", supported - as suggested by Kawai (2008) - by an “independent secretariat”
    - would represent a milestone in the process of exchange rate and monetary coordination and
    - would create strong momentum to move the integration process forward.

The choice of a new exchange rate mechanism

- In the choice of an exchange rate system there seem, at first glance, to be more differences than similarities between the Asian and European models. These differences broadly respond to the different objectives.
    - As is well known, **European** countries, when they decided to create a basket, chose a **basket among their own currencies** that would float freely vis-à-vis the dollar. The European choice was dictated by the **objective of developing further the single market and avoiding currency tensions (in particular, competitive devaluations) among the Member States**.

[2] Although ASEAN+3 seems the most likely grouping, so far, no official statement exists on who is in and who is out. In this respect, the recent creation of the EAS (*de facto* an ASEAN+6 grouping) complicates the picture further. Furthermore, it seems to indicate that there is not much clarity (and probably conflicting interests) on the type of regional integration that Asian policymakers intend to set up. As a result, the widening of regional groupings proceeds much faster than their deepening.

- The aim of a **basket** in Asia seems somewhat different: as pointed out by Williamson (2005), is to find a **better solution than the *de facto* dollar peg to the fear of losing competitiveness vis-à-vis their regional peers. Hence the idea of creting** a common basket numeraire based on the dollar, the euro and the yen.

In addition, a YES basket would certainly contribute in the medium-term to ensure that the valuation of East Asian currencies evolves more in line with economic fundamentals than in the current *de facto* peg to the dollar.

- Should East Asian nations decide **to peg their currencies to a basket composed by the euro, the dollar and the yen, the European experience appears to be less enlightening than in other scenarios**.

However, further scrutiny shows that it does, since a YES basket, as any other based on trade-weighted foreign currencies, **may in the end result detrimental to Asian regional integration**.

The reason is that it would **keep the East Asian countries in an export-led growth framework, where exchanges with the rest of the world matter more than intra-regional trade.**

In the absence of further steps toward enhanced exchange rate coordination, this choice may not be very forward looking since East Asia's export-led growth models **are not sustainable in the long-run and exacerbate global imbalances.** Setting the peg of their currencies to a YES basket of currencies can serve East Asia well while it continues to pursue export-led policies, but **export-led policies may not be appropriate for global economic stability** and growth and **in the end may thus result detrimental to Asian regional integration**.

The European experience, especially that related to the **EMS**, would become particularly relevant if **a YES basket were an intermediate step towards** closer monetary and exchange rate cooperation and eventually the creation of **an Asian Currency Unit and** of **a formal exchange rate mechanism**.

As pointed out by Park and Wyplosz (2008), an exchange rate mechanism would help integration in Asia by becoming an **anchor for surveillance**.

In addition, in a system with formal exchange rate policy coordination, such as the EMS, two key lessons can be drawn from the **European experience:**

- **The first one is that pre-determined ranges for intra-regional exchange rate variations can be viable** and withstand financial market turbulence and/or speculative attacks **only if there is a commitment to establish a currency union in a not too distant future**.[3]

[3] The difficulties for Asia risk being bigger than those faced by Europe in the past in particular because capital flows in Asia can move today much more freely, making much more difficult for East Asian countries stabilise their exchange rates around a central parity.

In the absence of such a commitment, it is unlikely that, in a world of globalised finance, a pegged exchange rate regime involving multiple countries can be defended indefinitely, even in presence of strong policy commitments by all participants.

- The second is that such a mechanism **has worked because European countries were ready to share with their partners detailed information** and engage in **multilateral surveillance** of the economic situation and the difficulties encountered and, more importantly, they were **ready to accept a significant loss of sovereignty.**

Here the task seems to be harder in Asia than in Europe for both economic and political reasons.

- Differences of **economic** development and structure in Asia are much higher than they were in Europe. **The levels of development of East Asian countries are still very different** and, even with the rapid growth rates, **real convergence is Asia's Achille's heel'**.
- **Political** divergences seem also more accute. History, different political regimes, regional rivalries, unresolved border disputes, different systems of military alliances make regional political and economic cooperation **much more difficult in East Asia than in Europe**.

Take China, for instance.

- With almost half of total employment still in agriculture, China needs fast GDP growth to absorb surplus labour from agriculture and is aware that the current pattern of growth creates the conditions for a dual economy, with important personal and regional disparities, which is not politically sustainable[4].
- China's domestic financial system, though strengthened, is probably not yet ready for financial and exchange rate liberalisation.
- Redressing these domestic imbalances will take time. It is doubtful that the authorities will be willing to **surrender any degree of monetary and financial autonomy in the early stages of the process**; and so far, they have been rather successful in preserving it [5]

Taking into account these political and economic realities, some economists look to the European experience of the **open method of coordination**, in which countries share information and best practices and exert forms of peer support and peer pressure to encourage the implementation of agreed policies.

But they admit that the final outcome would be a much more 'loosely configured grouping than the European Union', [6] in which **surveillance and peer pressure would be much more problematic and difficult to implement**.

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[4] See KUIJS and WANG, 2006.

[5] See MA and McCAULEY (2005).

[6] See EICHENGREEN (2007b), op. cit., p.18.

Conclusion
Is the process of European monetary unification relevant for East Asia? Despite the huge differences between East Asia and Europe processes of regional integration, I think we must reply positively to the question.

What the European experience shows in this respect is clear all over, from the first uncertain steps toward exchange rate cooperation to EMU:

- **mutual surveillance** is key, and
- it works and is effective where it is backed by
  - **clear procedures**
  - carried out by **independent regional institutions**
    (e.g. **an enhanced EPRD, an independent secretariat)**

    able to make sure that
    - **real surveillance and**
    - **peer pressure**

    are effectively implemented..