EUROPEAN ECONOMY

Economic Papers 329 | September 2008

Monetary and Financial Integration in East Asia: The Relevance of European Experience

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Economic and Financial Affairs
DIRECTORATE-GENERAL

EUROPEAN COMMISSION

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ISBN 978-92-79-08254-2
doi 10.2765/80564

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Monetary and Financial Integration in East Asia:
The Relevance of European Experience

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September 2008

Report to the European Commission under Contract ECFIN/D/2007/003 – OJEU 2007/S51 – 062495. We are grateful to Simone Meier for research assistance and to Lucas Papademos, Antonio de Lecea, Moreno Bertoldi and Caroline Gaye for very useful comments and suggestions. We alone are responsible for the views expressed in this report.

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Executive Summary

This report examines the process of economic and financial integration in East Asia in the light of Europe's experience. Its aim is to evaluate the evolution of the last decade and to offer policy suggestions.

Although, prior to the 1997-8 crisis, the East Asian countries had been enormously successful in achieving fast increases in standards of living, they exhibited a number of distortions. To a varying degree, and with important differences from one country to the other, these distortions played a role during the crisis and threatened to prevent the resumption of sustainable rapid growth afterwards. Europe too exhibited numerous, and often strikingly similar, distortions before the oil shocks of the late 1970s, and never recovered its postwar growth performance.

Most East Asian countries undertook structural and institutional reforms to deal with these distortions in the aftermath of the crisis, with varied successes.

- Banking sector reform has been limited. For similar, largely protectionist, reasons Europe too found it difficult to make fast progress in this area in the 1980s until the adoption of the Single Act in 1986 gave the European Commission the means to speed up the process.
- East Asian capital markets have grown rapidly after the crisis. As a result, in most countries, the financial systems are no longer dominated by the banking sector. Yet, with the exception of Hong Kong and Singapore, institutional reform still has a considerable distance to go. Limitations typically concern shareholder protection, creditor rights, capital account liberalization, regulatory capacity, legal infrastructure and the lack of credit rating agencies.
- Governance at various levels – government, financial institutions, and corporations – has improved but, relative to the rest of world, they remain far behind.

One reason for the slow progress in financial sector reform is that the institutional process is not subject to pressure from external competition. Europe also kept for a long time underperforming banking sector and asset markets. The trigger was London's Big Bang in 1986, which forced other countries to speed up their hitherto languishing reform processes.

Capital account liberalization is not universally complete in the East Asian region. Prudence in this area is partly driven by the perception that exchange rates cannot be allowed to float freely when exports are seen as the driver of growth.

Since the crisis, most East Asian countries have accumulated large amounts of foreign exchange reserves. Given the fast growth of cross-border financial liabilities, it is not clear that these reserves are excessive, with a few exceptions. These reserves are seen by policymakers as a guarantee against speculative attacks. The value of this guarantee may be exaggerated.

Much of the post-crisis effort has been devoted to developing regional monetary and financial cooperation. This effort has largely been driven by a defensive logic, that of preventing the occurrence of a new crisis. In contrast, monetary cooperation in Europe has been driven by the wider aim of economic integration and financial reforms have been guided by the goal of integration with the global markets.

The Chiang Mai Initiative (CMI) was designed in the aftermath of the crisis to pool foreign exchange reserves at a time of scarcity. It first led to a web of Bilateral Swap Arrangements (BSAs) before being multilateralized as the Self-managed Reserve Pooling Arrangement (SRPA). While, over the years, the amounts available through the BSAs have been raised, the accumulation of foreign exchange reserves has reduced the usefulness of the BSAs. The CMI is also facing the need to develop adequate surveillance, where progress has been slow. Europe had a similar aarrangement in the 1970s within the European Monetary Cooperation Fund (EMCF). The arrangement did not succeed in underpinning the loose exchange rate "snake" arrangement. Still, this experience prompted European policymakers to adopt the tighter and more ambitious

ERM arrangement, which in turn made the monetary union possible. Without any exchange rate arrangement, the CMI is unlikely to be more successful than the EMCF. It is now expected to evolve toward a cooperation process through the institutionalization of the Economic Review and Policy Dialogue (ERPD). This is a desirable evolution but casting cooperation within the reserve pooling arrangement may not be the most effective approach. We suggest redirecting ERPD without a flexible exchange rate arrangement, which is detailed below.

The Asian Bond Market Initiative (ABMI) was also a direct response to the currency mismatches that lie at the root of the 1997-8 crisis. It aims at creating regional markets where assets denominated in regional currencies can be floated. The ABMI has been slow to produce its effects, because of several roadblocks such as limits to capital mobility, heterogeneous regulatory and supervision frameworks, and slow progress in building regional settlement and guarantees. When these roadblocks are removed, it is likely that the East Asian markets will spontaneously be integrated into the global financial system. This is what happened in Europe, which relied on a market-driven approach that allowed all countries to issue debt instruments in their own currencies. The implication is that the ABMI could evolve from an institutions-based to a market-driven approach based on the liberalization of capital flows and on the adoption of world-class regulation and supervision practices.

Being very open to trade, East Asian and European countries share an aversion to exchange rate volatility. Indeed, many – but not all – European countries have actively sought to stabilize their bilateral exchange rates. This has led them to adopt the Exchange Rate Mechanism (ERM), an elaborate arrangement of monetary and exchange rate cooperation. The ERM eventually led to the adoption of a common currency. Europe's experience shows that exchange rate stabilization is not an all-or-nothing objective. Limited arrangements are helpful, if only because they boost confidence and pave the way for further integrative steps.

East Asian countries face two possible paths. One of them is to complete the liberalization of their capital accounts – establishing full convertibility in the case of

China – which would require allowing their exchange rates to float fairly freely. The other path is to focus on exchange rate stabilization. An attractive solution is for each country to limit flexibility relative to its own basket. Both objectives can jointly be pursued if the range of allowed fluctuation is wide, possibly with fuzzy limits.

Introduction

Over the years, there has been a continuing stream of research on "lessons for East Asia from Europe". This topic is of obvious interest to academic researchers. Indeed, both regions share a number of characteristics. Europe in the 1950s and East Asia in the 1980s both embarked on a successful catching-up process. Because of geographic and, to some extent cultural, proximity, trade integration has been a natural component of the growth process, while financial integration lagged. Made up of number of countries of different sizes, both regions inherited a legacy of bitter infighting. At the same time, important differences exist. East Asia is more diverse and its political regimes have long been less democratic and less stable than in Europe. Reconciliation was deep and deemed essential in Europe. Europe caught up in a word considerably less globalized than the one faced by East Asia at the same stage of development. East Asian countries are also more diverse than Europe in a number of economic and political dimensions. This combination of similarities and differences are fascinating for researchers.

The similarities have not escaped East Asian policymakers. They too have been asking what, if anything, could be learned from Europe's experience. Their interest for policy solutions has been heightened by the 1997-8 crisis. Not only did the crisis expose faults in the region's amazingly rapid catch-up process, it also established the vulnerabilities of their exchange rate systems. These systems had been largely uncoordinated but the simultaneity and similarity of speculative attacks suggested that a common approach could be helpful to reduce the odds of future crises. It was natural, at this stage, to look at Europe, which had developed over several decades an increasingly cohesive arrangement.

The present report, written at the invitation of the European Commission, draws lessons from past research and debates among policymakers and between policymakers and researchers. While full agreement on such a complex set of questions is impossible, a number of conclusions have emerged over the years. Disagreements too have been clearly identified and are useful to consider as East Asian countries seek to deepen their economic and financial cooperation. A specificity of this report is to examine the large number of issues raised over the integration process by systematically comparing the East Asian and European experiences. This dual track should be of interest to both researchers and policymakers.

Chapter 1 provides an overview of the postcrisis integration process in East Asia. It focuses on the many policy responses to the crisis. The next chapter offers a critical review of the relevant literature. Its main objective is to collect and assess the results achieved through a vigorous research effort which has attracted a large number of researchers from all over the world. It lays the ground for the two subsequent policy-oriented chapters. Chapter 3 describes and assesses the main initiatives taken in East Asia since 1998. This ten-year effort has led to a number of initiatives that bear much resemblance with Europe's own integration process. The underlying question is why East Asia and Europe have adopted different processes. The answer is that important differences have played a key role but also that priorities have changed. Chapter 4 brings together the conclusions from the previous chapters to provide pointed evaluations of the more recent developments and, whenever possible, to provide practical proposals. The last chapter briefly sums up the main results of this report.

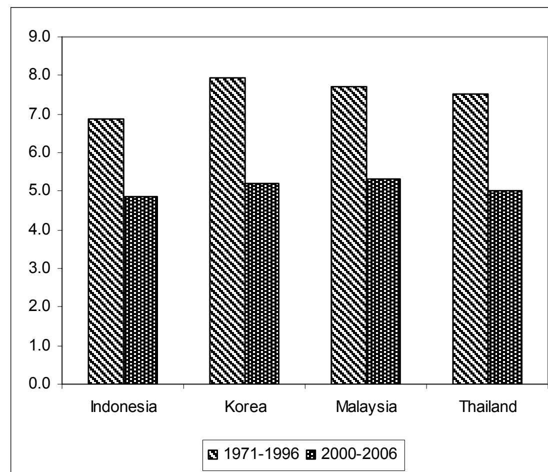
Chapter 1
East Asia's Response to the Crisis: Economic Reforms, Growth, and Integration in East Asia

1. Introduction

For most of East Asia there is a before and there is an after. The crisis has not just been profound, it has left a long-lasting imprint, both in terms of economic performance and in the way the countries of the region relate to the rest of the world. As Figure 1 shows, the four crisis-affected countries of the region have not recovered their growth performance of the three previous decades. There is much debate whether this disappointing outcome is still a delayed effect of the crisis. It has been widely noted that that the relative underperformance of the 2000s is associated with lower investment rates. Kramer (2006), among others, argue that lower investment after the crisis reflects the overinvestment that characterized the pre-crisis period, and partly caused the crisis. Others, including Park and Lee (2004), note that several East Asian countries were nearing the technology frontier so that the catch-up growth performance could not have been sustained anyway. This view, which implies that lower investment is a consequence, not a cause of the growth slowdown is shared by the Asian Development Bank (2007).

None of these arguments is fully convincing. Pre-crisis overinvestment could have been a problem for quite a while, but much of the excess capital must have depreciated ten years later. As for the end of the catch-up phase, it is undeniable that slower growth had to occur but the precise conjunction with the crisis is surprising, especially since the four countries displayed in Figure 1 are not at the same distance from the technology frontier.

Figure 1 Real GDP Growth Rates



Source: International Financial Statistics, IMF

This apparent break in trend growth is remindful of what happened in Europe after the oil shock of the early 1970s. Then too, most European countries were nearing the end of the post-war catch-up phase when the first oil shock occurred. Growth declined and never recovered. Considerable research has been devoted to this coincidence. The consensus, as presented e.g. in Blanchard (2005), indicates that relatively minor pre-existing distortions, which mattered little at a time of rapid growth and low unemployment, started to take their toll when the situation worsened. In retrospect, Europe should have taken the road to financial and labor market reform and removing industry regulations. Instead policy attempts to limit unemployment became the source of additional distortions that transformed temporary shocks into a permanent decline in growth. Is this what is also happening in East Asia?

A definitive answer is not available, and is unlikely to be available any time soon. According to Ghosh (2006) most of the emerging East Asian countries, including the four crisis affected economies, have made great strides in pursuing Washington consensus based reforms – restructuring the financial and public sectors, reforming governance institutions, and deregulating and opening markets, including financial ones. But, then, the disappointing growth performance of the early 2000s would suggest that these reforms have not had any visible effects on improving growth performance. It

could be that some of the pre-existing distortions still remain; in that case wider overall reforms would still be required. The challenge would be not just to reduce these distortions, but to avoid new ones. On the other hand, even a decade after the crisis, it may still be too early to conclude that growth has permanently declined. Over the last two years, East Asia has still been the fastest growing region in the world, enjoying a resurgence of growth. Despite an impending recession in the US, ADB (2008), IMF (2008), and World Bank (2008) all show that growth in East Asia will be robust with the regional GDP expanding almost 8 percent in 2008 and faster thereafter on the back of strong consumption spending.

It is too early to tell whether this growth resurgence will be long lasting, whether it is the delayed effect of past reforms or whether it is driven by the Chinese locomotive. In this chapter, therefore, we do not attempt to directly answer the question of whether reforms have been effective. Instead, we review the situation before the crisis and the measures taken after the crisis in comparison to the reform process in Europe since the Single Market movement began in the 1960s.

2. Pre-Crisis Distortions

Most of the analyses of economic distortions in East Asia have focused on potential explanations of the crisis but much less is known about non-financial distortions that matter for growth and employment. East Asian financial systems suffered from government control of market interest rates, asset management at financial institutions, and under-developed market supporting infrastructure. The lack of professional expertise in securities business, the inadequacy of the financial and legal infrastructure (including the regulatory system), low standards of auditing and accounting, and the weakness of corporate governance may have all slowed the development of domestic capital markets in the region.

2.1. Financial Distortions

A short summary of the situation of East Asian financial markets before the crisis inevitably ignores important differences from country to country. Yet, some features were common.

The first feature is the dominant role of banks in providing corporate finance[1].This feature makes East Asia more similar to continental Europe than to the US or the UK where market finance has taken over the main role. This situation does not have to be a distortion if banks adequately perform their financing role. But banks were often state-owned or under close government control, with the result that lending operations were dictated and ended up allocating a large share of loanable funds to state-sponsored, export-oriented or other firms identified as 'strategic'. This meant that there was no guarantee that savings were channeled via banks to their most productive use.

This (again) bears some resemblance with the industrial policies adopted in post-war Europe, which in many countries also relied on state-owned banks directed to lend in priority to firms or sectors identified as 'strategic'. A central objective of the Single Act, which came into effect in 1992, was precisely to bring preferential lending to an end. Even today, the European Commission closely monitors the situation and is sometimes led to prevent explicit or implicit subsidies – not necessarily through preferential loans – to corporations deemed special or strategic. It should be noted, however, that the argument put forward in the Single Act emphasizes fair competition in the Single Market rather than the more theoretical – and sometimes controversial – view that growth is enhanced when savings are channeled to their most productive use. Lacking any agreement such as the Single Act, East Asian countries cannot therefore monitor each other. This leaves the task to be conducted at the national level, without serious collective pressure, and on the basis of the argument that savings ought to be channeled

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[1] There is no commonly accepted measure of bank or market dominance of a financial system. When measured in terms of the share of bank assets in the financial system, banks play a dominant role in East Asia (see Table 1.1 in Ghosh (2006). Demirguc-Kunt and Levine (2001), however, argue that this characterization may not be valid. Their assessment shows that except for Indonesia and Japan all other emerging economies in East Asia had developed a market-based system prior to the 1997 crisis.

to their most productive use, which may be as controversial in East Asian as it was, and sometimes remains, in Europe.[2]

2.2. Domestic Industrial Policies and Resource Allocation

While the *dirigiste* strategy may have been successful in both East Asia and Europe at the beginning of the catch-up phase when rapid capital accumulation delivers quick results, it becomes increasingly less efficient when firms climb the quality ladder. Moreover, as they become large and close to political power, the risk of poor choices, not well associated with market developments, grows. A number of authors have documented excessive capital accumulation in many Asian countries, at the expense of total factor productivity (TFP) growth (Young, 1992, 1995; Lau and Kim, 2003), but Yoshitomi (2003) shows that, before the crisis, East Asian TFP growth in manufacturing was comparable to that of advanced economies. Studies of Europe's fast growth in the postwar period have not suggested excessive capital accumulation but typically identify capital accumulation as a key success factor, although industrial policy is sometimes identified as having had a negative effect.[3]

The towering position of East Asian banks under government control created moral hazard and worked as an encouragement to undue risk taking at these institutions. One symptom was serious term and currency mismatches in their balance sheets as they were engaged in long-term financing and also served as the main conduit for foreign currency financing. Another implication was poor banking regulation and supervision, which resulted in an inefficient regulatory system and poorly trained regulators and supervisors. Yet, another implication was the relative shallowness of bond and stock markets, along with poor regulation. Here again, there were similarities with Europe in the 1960s and even the 1970s. The difference is that Europe opened up slowly, both in trade and finance while many Asian countries were strongly encouraged – forced, some would say – to speed up the process as part of the reform program imposed on the IMF and also influenced by the general acceptance of the Washington consensus after the

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[2] Important examples of state-owned banks whose mission is to support 'important' industries or firms, is the French Caisse des Dépôts et Consignations and the German Landesbanken.

[3] See the collection of studies in Crafts and Toniolo (1996).

crisis. This involuntary nature of the reform, unlike in the case of Europe, may explain the backslidings and regression of reform in recent years in East Asia.

In the end, East Asians industrial policies have led to widespread interferences and resource misallocation. Beyond the usual disincentive effects on protected industries and firms, they have been accompanied by financial market repression, the use of the exchange rate as an active instrument of export promotion and to explicit or implicit price/wage controls. Many European countries also resorted to industrial policies with similar support through financial repression. But price controls remained rare and exchange rate policies were restricted by the Bretton Woods agreements first, by Common Market rules next.

2.3. Exchange Rate Distortions

Much as many European countries, the East Asian countries considered exchange rate stability as necessary for export promotion. The consequence was either fixed or heavily managed exchange rate regimes before the crisis. The similarity between the European and Asian experiences does not go very far, however. As is further discussed in Section 3, the European Monetary System's Exchange Rate Mechanism (ERM) aimed at stabilizing intra-European exchange rates, leaving European currencies to freely float vis-à-vis third currencies. East Asian currencies, in contrast, were tied to the dollar, with limited attention paid to intra-Asian exchange rate stability.

This difference reflects deeper choices: Europe emphasized trade opening through the Common Market, whereas East Asian countries followed an export promotion strategy. This distinction has a profound effect on exchange rate policies and resource allocation. In the European case, decisions on exchange parities were subject to mutual approval. Parity changes had to be approved by all members of the Exchange Rate Mechanism of the EMS. This implies that the exchange rate could not be used as a strategic instrument for export promotion within the Common Market. Since these currencies were jointly freely floating vis-à-vis the other currencies, the exchange rate was not an export-

promotion policy instrument.[4] In Asia, instead, each country carefully insisted on keeping the exchange rate under control and used it to support the export promotion strategy. This approach had several important implications for resource allocation.

To start with, as part of a low cost export-led development strategy, exporting firms were relying on a favorable exchange rate to maintain a competitive edge. This led exporting firms to be remiss about technological innovation. It also led to a price distortion favoring traded goods when the Balassa-Samuelson effect already directed more resources to the non-traded services sector. In addition, the low cost strategy implied the need to contain labor costs, suppressing wages and paying less attention to social protection to fully benefit from fast growth. The result was that export-oriented large corporations had access to ample financial resources at financial institutions that could be re-invested in their own operations with limited ability to determine whether returns were competitive. Moreover, a fixed exchange rate strategy required restrictions on capital mobility. Although it is not clear whether emerging economies of East Asia had developed institutional capacity to open their capital account, the restrictions were in part responsible for financial distortions reported in the previous section.

2.4. Political Failures

In assessing the causes of the crisis, a number of observers, including the IMF, pointed to serious governance issues in a number of affected countries. Some of these aspects are related to the export promotion strategy that brought together governments, large corporations and the dominating banking sector.

One way to gauge this interpretation is to look at the Corruption Perception Index produced annually by Transparency International.[5] This index, compiled on the basis of polls, attempts to measure corruption among public officials and politicians. It ranges from to 0 (highly corrupt) to 10 (highly clean). Other similar indices exist, measuring

[4] Quite to the contrary, in fact, the exchange rate evolved into a constraint that anchored monetary policy. This was eventually made clear when France adopted the “Franc fort policy” (Strong Franc policy), better dubbed the disinflation competitive strategy.

[5] Below, we examine the World Bank indices.

different aspects of governance, and they tell similar stories. Table 1 presents the results for some East Asian countries. It makes one point: not all countries are similarly affected by corruption, which can hardly be seen as a key causal factor for the crisis. Indeed, while the two best-ranked countries were not seriously shaken in 1997-8, the distance among the others are considerable. Obviously, corruption is an important source of resource misallocation.

Table 1 Corruption Perception Index

	1998			2007		
	Rank	Percentile rank	Score (0-10)	Rank	Percentile rank	Score (0-10)
Singapore	7	8.2	9.1	4	2.2	9.3
Hong Kong	16	18.8	7.8	14	7.8	8.3
Malaysia	29	34.1	5.3	43	24.0	5.1
Taiwan	29	34.1	5.3	34	19.0	5.7
Korea	43	50.6	4.2	43	24.0	5.1
China	52	61.2	3.5	72	40.2	3.5
Philippines	55	64.7	3.3	131	73.2	2.5
Thailand	61	71.8	3.0	84	46.9	3.3
Indonesia	80	94.1	2.0	143	79.9	2.3
No. of countries	85			179		

Source: Transparency International

Corruption did not only affect domestic actors. Foreign firms and banks too were led to play by the same rules of the game. This did not prevent them from large-scale investments during the fast growth period. Nor did it prevent them from blaming corruption when they hurriedly left the scene during the 1997-8 crisis.

3. Policy Responses to the Crisis

3.1. Reforms of the Financial System

In the banking area, reforms have been relatively modest. In most countries, banks were small, often family-owned and therefore not subject to shareholder scrutiny (Turner, 2007). This called for consolidation through mergers and acquisitions. Governments can encourage the process through capital requirements and tighter regulation and supervision, and many did. Some indirect evidence is presented in Table 2. In most countries, as the result of consolidation, the average size of banks has increased and foreign ownership has taken hold. Controls over asset and liability management of the banking sector have been removed so that banks are now freer to conduct business in securities and insurance. This should enhance efficiency. Noting that evidence to that effect is lacking, Ghosh (2006) suggests it might be too early to reap the gains from consolidation. At this stage, the main result of the consolidation is a domination of banking by a small number of large banks, which may have undermined competition.

Table 2 Concentration in the Banking Industry

	Indonesia	South Korea	Malaysia	Philippines	Thailand
End of 1998	29.0	27.0	53.4	41.6	51.5
End of 2004	59.1	48.6	70.7	51.5	69.0

*Five largest banks' assets as percentage of total assets. For South Korea, the share of the top three banks.

Source: Turner (2007)

State-ownership in the banking sector remains sizeable in a number countries, as Table 3 indicates. In some countries, the size of the state-owned sector initially grew as the result of nationalizations following failures during the crisis. Privatization has since taken place but still has some distance to travel before establishing a privately owned banking system.

Table 3 Market Shares of State-Owned Banks (%)

	1996	2002	1998-2000	2005
Cambodia	n.a.	0	16.0	n.a.
China	100.0	99.8	n.a.	68.8
Indonesia	63.0	36.1	44.0	38.5
Japan	3.8	1.2	1.2	n.a.
Korea	24.0	25.8	n.a.	18.8
Malaysia	0.1	0.5	0.0	0.0
Philippines	22.8	12.0	12.1	12.1
Singapore	0.0	0.0	0.0	0.0
Thailand	17.9	22.3	30.7	14.5
Vietnam	82.5	85.7	n.a.	n.a.

Sources: 1996 and 2002: Micco et al. (2004); 1998-2000: online update of Barth et al. (2001).

Note: The market share is defined as the share of assets of state-owned banks in total bank assets.

East Asian banks have also been slow to universalize, largely because many East Asian countries systems still adhere to a principle that separates banking from insurance and securities business. As a result, in commercial banking, where home bias is a significant advantage, East Asian countries have seen their domestic market shares chipped away by foreign financial institutions, albeit slowly, reflecting the failure of East Asian banks to move out of traditional deposit-taking and lending businesses into capital market services, insurance, and other new lines of business. Except for Japanese banks, most East Asian banks have limited access to international capital markets. This is due to relatively small size, low credit ratings and inexperience in international corporate banking. They also have small regional branch networks in East Asia itself because of entry restrictions in many countries. By and large their customer base is confined to domestic borrowers and lenders.

Bond and equity markets too remain small in size and limited in terms of depth and liquidity. Except for those of Hong Kong and Singapore, other domestic capital markets of East Asia's emerging economies do not fare well and belong to the bottom quartile of efficiency ranking (Ghosh 2006). This is a clear indication that much of the necessary underpinnings – regulation, supervision, settlement systems – are not yet up to world

standards. These aspects are very important if East Asia is to develop markets where major institutions can borrow and lend in domestic currencies.

Markets for financial derivatives have only recently begun to emerge. Under these circumstances, western financial institutions have captured a large share of the East Asian financial services industry in a relatively short period of time. Yet there is little evidence that this foreign penetration has contributed to improving either efficiency or stability of the banking sector.

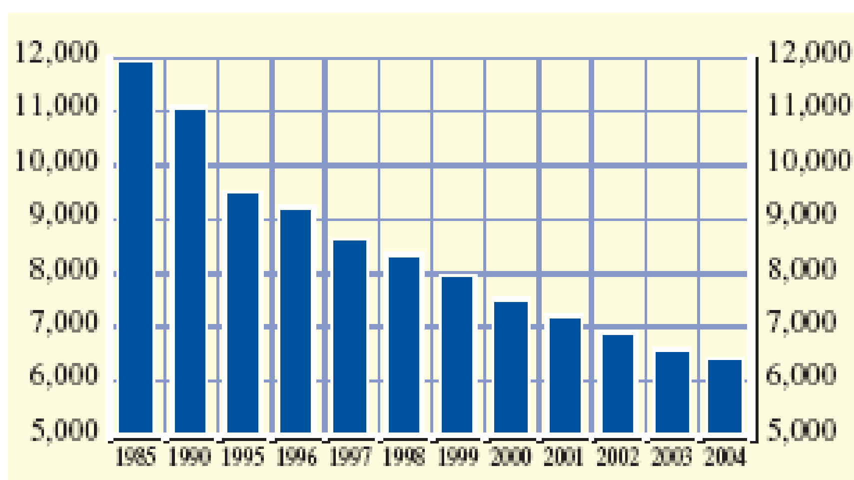
What can be learnt from the European experience? We already noted that the strategic use of bank financing in support of industrial policy has been gradually reduced in Europe. A similar process has been taking place, albeit a slow pace in East Asia. Restructuring the banking sector is a difficult exercise, especially when it consists of a few large institutions, some of which are closely connected to government and large corporations. In East Asia, the impetus came first from the IMF in the wake of the crisis, but with limited effect; the impetus must now be provided at the national level, which calls for domestic consensus, an uneasy prerequisite. In Europe, a large part of the impetus has come from the European Commission, because trade has long been seen first and foremost as intra-European. Privileged relationships between governments, banks and national champions have been identified as anticompetitive, in fact incompatible with the operation of what is now called the Single Market.

As a result, under pressure from the Commission, under its role as the Guardian of the Treaty, a large number of measures have been taken to bolster competition in the banking sector and to dismantle favored relationships. This has led to bank privatization in those countries where state-ownership remained, leaving few exceptions (chiefly the German Landesbanken). Thus, a first lesson from Europe is that an external agent can play an important role when long-established practices need to be shaken in the face of insiders' resistance.

A second lesson is that, due to the existence of scale and scope economies, bank concentration is probably unavoidable. The lack of competition in the sector allows

small "niche" banks to survive, often at the local level. This is illustrated in Figure 2, which shows that the number of banks has declined quite dramatically as several banking directives have been adopted starting in the 1980s. The process has continued, but not accelerated, after the adoption of the single currency. This suggests that, contrary to some expectations, the common currency has not led to increased competition in the banking sector. Another indication is that most bank mergers occur within borders. There have been some cross-border mergers, but they have often involved banks based from countries that do not belong to the Euro area.

Figure 2 Number of Banks in the Euro Area



Source: ECB

A third lesson is that the removal of restrictions to capital movements has not led to widespread internationalization of the European banking market. In the largest countries, foreign banks, including from other European countries, remain relatively small players. Undoubtedly, this reflects protectionist policies. As is well known, the liberalization of services, including financial services, is far from complete in Europe. At the same time, many European banks have successfully penetrated the markets outside Europe. In *Euromoney*'s 2006 ranking of the world's largest banks by capitalization, three banks from the Euro area appear in the Top Ten list (Crédit Agricole is 6th, BNP-Paribas 8th and Santander Central Hispano 9th), which includes two

British banks (HSBC 4th and RBS 7th). In contrast, in East Asia (excluding Japan), foreign banks have become a significant presence but no domestic bank has yet joined the world league. A likely explanation is that East Asia, which started from a low capital and expertise base, must first acquire some know-how, which is accelerated by the presence of foreign banks.

3.2. Reforms of Domestic Financial Markets

Between 1997 and 2005, according to Ghosh (2006), except in the Philippines, the size of the financial sector, measured by the sum of bank assets, equities and bonds as a proportion of the GDP on average more than doubled in most countries (Table 1.1 P.27). The growth of the banking sector has been impressive, but it has been outstripped by the phenomenal expansion of assets in both equity and bond markets. The size of the equity market in the two most financially sophisticated economies – Hong Kong and Singapore – and in Indonesia has more than doubled. The increase has been more than tenfold in Korea and almost fivefold in Thailand. Only the Philippines has seen a modest expansion of its equity market. The growth of assets in the bond market, albeit starting from a low base, has been faster than that of the equity market in all East Asian economies. Nevertheless, except for China, the size of the bond market is still much smaller than that of the equity market.[6] Except for China and Indonesia, by 2005, the size of the combined assets of both equity and bond markets became larger than that of the banking sector. East Asia's financial system no longer appears to be dominated by the banking sector.

The East Asian financial markets have been widely blamed for the crisis: it has been argued that they had built up large short positions in foreign currencies, that they had lent without adequate caution and that they had disregarded standard prudential norms.

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[6] These figures are also from Table 1.1 on P.2 from Ghosh (2006). Ghosh also shows that in terms of the size of the bond market relative to the per capita income, East Asia lags behind other emerging economies elsewhere such as Latin America. Furthermore, much of the growth has come from the increase in government bond financing for the acquisition of non-performing loans at insolvent financial institutions as part of the crisis resolution. Partly for this reason, the corporate bond market is much smaller than the government bond market. One of the major constraints on the growth of the bond market has been the limited liquidity in the secondary markets and the small size of the corporate bond market contributes to the lack of liquidity.

Since the 1997-98 crisis, measures have been taken to strengthen and improve the efficiency of financial systems. To some extent they have been effective, but the reform process has also been difficult and protracted. Size has been a factor, raising the cost of constructing the necessary financial, regulatory and legal infrastructure. Because of the cost, the inertia, and the receding fear of financial crises, institutional reform in many East Asian countries has been slow and incompletely successful and has a considerable distance to go before establishing financial systems comparable to those of advanced economies in terms of efficiency and stability.

Rapid innovations in the financial industry furthermore have required developing the necessary skills to analyze the complexity and potential risks associated with new financial services and in strengthening regulation of securities markets. The lack of shareholder protection and of creditor rights implies that external reporting continues to receive low priority, which has in turn been responsible for relatively low standards of accounting and public disclosure.

Nor have East Asian countries succeeded in developing credible credit rating agencies and investment banking essential for efficient capital markets. The absence of reliable credit rating agencies has meant that a majority of East Asian borrowers have not been able to obtain reliable credit ratings for their bond financing. In the absence of efficient investment banking, few financial institutions are capable of assuming full responsibility for selling entire issues of new stocks and bonds of firms. As a result, financial institutions wishing to raise funds through capital markets bear all the risks of potential price fluctuations. Markets in derivative financial instruments such as forwards, swaps, options and bond future, which are important for facilitating risk management and enhancing market liquidity, are still in their early stages of development.

Although they are now much more market-oriented, the financial systems are not yet fully liberalized. Liberalization has been plagued by the lack of agreement on the scope and speed of reform among domestic constituents and marked by relapses and backslidings in many countries in the region. Capital account liberalization, arguably

the last stage of financial reform, has moved at a snail's pace. Although there is no generally accepted measure of the openness of financial markets, Chinn and Ito (2006) show that most of the East Asian emerging economies have made little progress in financial market opening in recent years and have a long way to go before reaching the level of Singapore and Hong Kong. In contrast, Gosh (2006) argues that East Asian countries have made a considerable progress in liberalization of capital account transactions.[7]
Aside from the domestic politics, the official conventional wisdom on financial opening has shifted in response to ambiguous evidence about its effects on growth and financial stability.

The Washington consensus on rapid integration into world markets has now given way to a more prudent set of principles. For example, Kose et al. (2006) recognize that emerging economies need to cross several thresholds before they open up their financial markets; they mention the need to establish sufficiently deep domestic financial markets, for companies to be adequately well managed and for macroeconomic policy to be disciplined. On these criteria, few of East Asia's emerging economies are ready to fully open their financial markets. In addition, the huge build-up of foreign exchange reserves has given East Asia's policymakers a sense of protection and may make them complacent about addressing their financial fragilities.

Official data indicate that the percentage of non-performing loans has declined substantially since the crisis and that various prudential ratios are above BIS norms, even though they vary a great deal from country to country, with the exception of the Philippines where there has been a decline recently. Currency mismatch among financial institutions – the villain of the crisis – has declined throughout Asia, with the exception of the Philippines. Goldstein and Turner (2005) note that "increases in

[7] Ghosh (2006), using the IMF data, provides a totally different picture that "Regulation prohibiting or restricting capital inflows and outflows have been progressively reduced, and, except in China, they are now fairly minimal" (P.37).

reserves not only serve to reduce [currency mismatch], but also offer an opportunity to deeper domestic debt market" (p. 117).[8]

The opaqueness of corporate governance and looseness and unreliability of financial disclosure in East Asian banks were the other factors claimed to have triggered and deepened the Asian crisis. The crisis-hit countries have since then sought to introduce and enforce international standards on the legal and regulatory requirements on information disclosure, shareholder and creditor rights, and accounting and auditing standards. Despite these reform efforts, although the available evidence is rather sketchy, it appears that they have not made much progress in governance reform. Asian Development Bank (2007) shows that there has been little improvement in the transparency of financial institutions: transparency deteriorated in China, Taiwan, and the Philippines whereas other countries managed a modicum of improvement between 1999 and 2005. The combination of inadequate disclosure rules – more widely limited transparency of the corporate sector – and of large foreign holdings of equities suggests that the equity markets could be quite sensitive to internal and external shocks, possibly the epicenter where financial market turbulences emanate.

Ghosh (2006) finds that the scope of disclosure by the top five banks in East Asia's Emerging Markets (EMs) is relatively broad, except for the Philippines. Singapore has by far the best disclosure system in East Asia. Among the crisis-affected countries, Korea and Malaysia, followed by Thailand, have made the most progress in reforming their laws, regulations and practices, but these and other EMs in the region still trail far behind Singapore in protecting minority shareholder rights, in improving the quality of financial reporting and disclosure, and in enforcing the rules and regulations. China has only recently begun to strengthen its corporate governance.

The IMF's *Global Financial Stability Report* (GFSR 2006) notes weaknesses in some countries' regulatory capacity and legal infrastructure. Since the crisis, revamping and

[8] Goldstein and Turner (2005) also point out that better macroeconomic and exchange rate policies, developing domestic bond markets, and improving efficiency of financial oversight are critical to limiting the degree of currency mismatch. Not many East Asia's EMs, it seems, have taken these precautionary measures seriously

consolidating the system of prudential control of financial markets and institutions has been one of the focal points of the reform agenda throughout East Asia. Unfortunately there are few studies that can shed light on qualitative improvement of the regulatory control system.[9] According to Kaufmann, Kraay, and Mastruzzi (2006), the quality of the overall regulatory control has deteriorated in China, Indonesia, and the Philippines, and remained roughly at the same level in Malaysia, Singapore, and Thailand between 1998 and 2005. Only Korea registered a substantial improvement during the same period.

Until the late 1980s capital inflows in the forms of equity and bond finance did not exist in East Asia. Since then, financing from international capital markets has been on the rise. Meanwhile, bank finance, after a surge over the 1994-96 period, has continued to decline relative to capital market finance. With this increase in the access to global capital markets, it is not surprising that large corporations with investment grade ratings, though a minority, have migrated to international financial hubs where they can tap into a wider investor base and obtain funds at lower cost and on better terms. Services offered by stock markets in New York and London are easily accessible, of course, from anywhere in the world. Various measures of the internationalization of stock market activities – the relative market capitalization of firms listed abroad, the value of shares traded abroad relative to GDP, and the ratio of value traded abroad to value traded domestically – all show the migration of issuance and trading of equities (Claessens et al. 2002).

Yet, only a small fraction of East Asian corporations have had access to international capital markets. While regional capital markets could have accommodated the financing needs of less creditworthy East Asian corporate borrowers, the region has yet to see the mergence of region-wide stock exchanges and bond markets to serve as a source of financing for major corporations.

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[9] According to the *Global Financial Stability Report* (2006) emerging market economies' policymakers need to develop a comprehensive legal and regulatory framework and infrastructure for better assessment of systemic risk and their mitigation

Growth of capital market financing requires the development of services such as underwriting, securities trading, financial consulting, asset management and mergers and acquisitions. Trade and financial liberalization have also stimulated the demand for new financial services and products such as instruments for hedging exposure to currency and commercial risks and derivative products – options, swaps, and futures – for portfolio diversification and risk management purposes.

However, a legacy of long periods of financial repression and bank-oriented finance, which did not leave much room for capital market development, was that East Asian economies did not have a comparative advantage in supplying any of these services. As a result, nascent capital market institutions have been overwhelmed by their counterparts from the West despite the fact that, in principle, they enjoy information advantages locally.

Foreign financial institutions now receive national treatment when they enter the markets of East Asian countries. Many western banks have established branch networks and subsidiaries throughout the region, as have western securities firms, investment banks, insurance companies, and other non-bank financial institutions. There are numerous emerging market funds operating out of New Work to invest in East Asian securities. There is little doubt that the hold of western financial institutions in East Asian has increased since the early 1990s. So long as the gap in financial technology and expertise between East Asian and Western financial institutions remains, borrowers and lenders form East Asia will have an incentive to go to the New Work and London markets.

Evolution in Europe has been slow but steady, starting at the national level and then, recently, moving to a coordinated approach. Prompted both by domestic forces and by integration into international markets, European countries have gradually tooled up, for along time without much effort at cooperation. An important motivation for the national adoption of better laws and norms has been intra-European competition in financial services. London's Big Bang in 1986 is a one of the few clearly identified turning points. The ensuing emergence of the City as Europe's largest market has provided to

the other countries to adopt state-of-the art practices and regulations. Yet, each country has followed its own path, leading to very different structures (e.g. the relative roles of banks and markets) and legal and regulatory arrangements.

This diversity has been recognized to act as a stumbling block to intra-European financial integration. This is why the main collective effort has come much later. It started with the adoption of two Financial Directives in the mid-1990s. The first one established minimum capital requirements, the second introduced the concept of mutual recognition in security markets. The next major step, again originating from the Single Act of 1986, has been the adoption in 1999 of the Financial Services Action Plan (FSAP). This comprehensive plan called for the harmonization of prudential rules, the establishment of a single market in wholesale financial services (through a common legal norms and enhanced transparency and financial comparability) and efforts to unify the retail market. Yet, national traditions and vested interests have limited the results from the FSAP, prompting the adoption in 2001 of the Lamfalussy process.[10] The process is a complex slow-moving but precisely described program that relies on four steps: 1) the adoption of common core legal values; 2) the adoption of detailed proposals at the national level: 3) the consolidation of these measures at the European level, including the creation of a Committee of European Securities Regulators (CESR), which brings together a newly created regulator, the European Securities Committee (ESC), and the national regulators; 4) enforcement of the agreements by the European Commission. The difficulties met in Europe are likely to also exist in East Asia, for the same reasons. Powerful interests seek various forms of protection and are eager to maintain national practices that limit competition from abroad.

Diversity of national institutions and regulations also characterize East Asia. In that respect, the FSAP is a relevant example. The *raison d'être* of the FSAP is that, despite the Single Act a common currency, financial services remained fragmented in Europe as they are in East Asia. National interests prevail and ensure the *status quo*, even though it would be greatly beneficial for both financial institutions and their customers to achieve

[10] Called after Alexander Lamfalussy, former Chairman of the European Monetary Institute (the predecessor of the European Central Bank), in his capacity as Chairman of a Committee of Wise Men.

the scale and scope economies that deeper integration would offer. The low speed of the process in Europe suggests that East Asia should not expect rapid progress either. The prudence of the Lamfalussy process testifies to the sensitivities involved in Europe, and there is every reason to believe that they are just as important in East Asia. An added reason to doubt fast progress in East Asia, possibly no progress at all, is that the FSAP relies of existing arrangements – the Single Act –, that it intends create a new institution – the Committee of European Securities Regulators – and that it will ultimately rely for enforcement on a well-established institution – the European Commission.

3.3. Exchange Rate Regimes and Capital Mobility

Before the crisis, all East Asian countries officially declared that their currencies were either pegged to a basket of currencies, sometimes not disclosed, or freely floating. According to Rogoff and Reinhart (2005), in fact, they were pegged to the US dollar (see Table 4). As is well known, the IMF has strongly urged them to allow for more flexibility, in effect encouraging the freely floating end of the spectrum. Some of them (Indonesia, Korea) have followed this advice but others (Philippines, Malaysia, Thailand) continue to heavily manage their currencies, as does China.

Table 4 Official and *de facto* regimes prior to the crisis

	Official	De facto
Indonesia	Basket peg	Crawling dollar peg
Korea	Basket band	Crawling dollar peg
Malaysia	Basket peg	Moving dollar band
Philippines	Float	Dollar peg
Thailand	Basket peg	Dollar peg

Source: Reinhart and Rogoff (2005)

The prime reason for the Fund's advice for free floating is that exchange rate flexibility removes a currency from harm's way. While large fluctuations can be painful, it is asserted, currency crises are far more dangerous. China, the region's emerging power, however, allows for very limited capital mobility and keeps its exchange closely tied to an undisclosed basket. For all practical purposes, it is pegged to the US dollar. As a

result, most East-Asian countries are quite reluctant to let their currencies appreciate vis-à-vis the RMB and the US dollar. This is especially so as China is following the region's favored growth strategy based on exports to developed markets.

IMF's insistence on adopting freely floating exchange rates is predicated upon a high degree of capital mobility, which it regards a natural objective. Many East Asian countries have taken steps to open domestic bond markets to foreign borrowers and investors and create offshore markets. As competition among these countries rises, it is expected that borrowers and investors to migrate to markets with the most efficient payment and settlement systems, which will then become regional financial centers. Tokyo, Hong Kong or Singapore are the key contenders but, to attract borrowers and investors, they must offer low-cost lending. This requires a variety of market-supporting institutions, in particular insurance and financial-derivative markets.

Although the benefits of capital mobility could be substantial, capital market liberalization has brought with it the danger of making financial crisis more likely as well as 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.

Under these conditions, it does not follow that free floating and full capital mobility is the obviously most desirable solution. Even the floaters have retained some restrictions to capital mobility as do the others. In fact, as is well known, there is no generally optimal solution. While most countries would be ready to float vis-à-vis the major currencies (dollar, euro and yen), they are concerned of their relative competitiveness and, therefore, with the regional bilateral exchange rates.

3.4. Reserves Accumulation

In theory, floating rates and capital account liberalization are supposed to reduce the need for holding a large amount of reserves. In contrast to the theory, however, the East Asian countries have not reduced their reserve holdings. Quite to the contrary, since the crisis, they have accumulated massive amounts of foreign exchange reserves. Part of the

reason, of course, is that they have not let their currencies float freely and have resisted a significant appreciation vis-à-vis the depreciating US dollar.

Another part of the reason is the widely held belief that large reserve stocks provide an insurance against currency crises. Except for Malaysia, all other crisis countries have deregulated their capital account transactions to a considerable degree since 1998. This liberalization has increased, not reduced, Asian demand for reserves. The emerging market countries have not witnessed any marked improvement in their access to international capital markets. Crucially, capital flows are perceived to remain unstable and unpredictable.

Recent studies have asked which of these motives, external competitiveness or self-insurance, has driven the process of reserves accumulation in emerging countries. Formal testing by Aizenman and Lee (2006) and by Ruiz-Arranz and Zavadjil (2008) generally support the self-insurance motive, with the possible exception of China. Wyplosz (2007) argues that reserves should be compared to gross liabilities and reaches a similar conclusion.

Another consideration is that large reserves are costly in many ways. Financial returns are usually below the marginal productivity of capital. They complicate monetary policy by exerting downward pressure on interest rates. Sterilization is financially costly. Thus sefl-insurance comes at a sizeable cost.

Finally, Dooley et al. (2003) argue that East Asia is using the financial services of the US to channel its savings, and will continue to do so for many years, much as Europe did in the 1950s and 1960s, as then argued by Kindleberger (1965). The transformation of some of these reserves into Sovereign Wealth Funds lends support to this view. Of course, the next question is why savings are channeled through official reserves rather through private financial institutions. The answer has to be that it is a sign of an underdeveloped and uncompetitive domestic financial market. This answer may have applied to Europe at the time and applies to some East Asian countries.

Whether reserve accumulation has been excessive in some countries remains highly controversial. On the other hand, the widely held belief that large amounts of reserves provide a solid guarantee against speculative attacks may one day be revealed misleading. These issues are deeply related.

Before the onset of capital account liberalization in the 1990s, as far as the adequacy of reserves was concerned, developing economies were generally preoccupied with the management of their current accounts. A popular rule of thumb was to hold an amount of reserves equivalent to imports of three to four months. With considerably increased capital mobility, this rule has become inadequate. For instance, Korea has accumulated a large volume of foreign reserves (US$ 260 billion as of the end of 2007) equivalent to 25.5 percent of its GDP. At the same time, its capital account transactions have increased tenfold in gross terms.

This has led to another rule of thumb, sometimes referred to as the Greenspan-Guidotti-Fischer (GGF) rule, which prescribes the holding of an amount of reserves equal to the country's short term foreign currency liabilities. The intuition is simple: in an emergency situation, the rule would allow a central bank to buy back all the liabilities that investors liquidate. This intuition can be deceptive, as we argue below.

Yet the GGF rule has the merit of helping to think about the scale of foreign exchange reserves. When the older rule that used trade as a yardstick became obsolete, a number of authors have started to use GDP and reported impressive increases in reserve to GDP ratios. But there is no particular reason to use the GDP as a scaling factor, even if it is commonly – and adequately – used for other macroeconomic variables. The reasoning behind the GGF rule suggests scaling the reserves stock by the stock of foreign liabilities.[11]

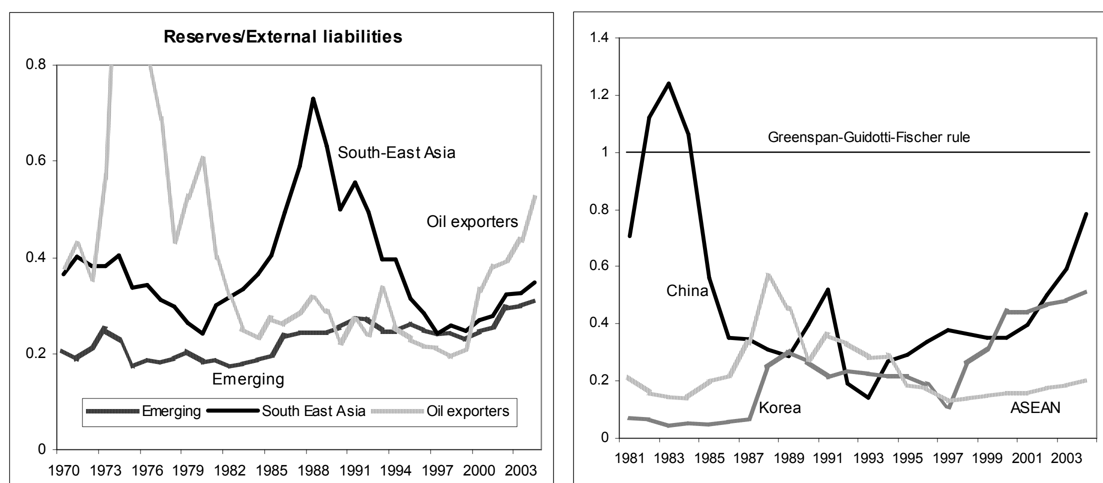
Figure 3 displays the ratio of foreign exchange reserves to all foreign liabilities, not just short-term ones. One reason is data availability but another reason is that, in case of an impending crisis, many, if not all, liabilities can be promptly disposed of or hedged

[11] For a detailed analysis, see Wyplosz (2007).

against. This undercuts the distinction between short and long term. The figure shows that, for most countries except China, Korea and Taiwan, the amount of reserves has simply grown proportionately to gross external liabilities.[12]

The "Greenspan-Guidotti-Fischer line" Figure 3 is a misnomer since, as previously noted, the available data scale down reserves with all foreign liabilities, not just those short term ones as in the GGF rule. Working in the opposite direction, the rule focuses on foreign currency liabilities while the data used here do not distinguish between domestic and foreign currencies. This may not matter much to the extent that East Asian countries mostly borrow in foreign currencies. Keeping these two caveats in mind, Figure 3 and Table 5 suggest that the reserves in most countries – including China – still fall short of the GGF rule.[13] Since this is just a rule of thumb, we do not wish to draw any conclusion from this observation, except to note that, inasmuch as reserves are seen as an insurance against the risk of a crisis, the figure implies that insurance has simply kept up with the exposure in most countries. In that view, the massive increase in foreign exchange reserves has not actually provided additional insurance; it has merely kept the insurance in line with the exposure.

Figure 3 Ratio of Foreign Exchange Reserves to Gross External Liabilities



Source: Lane and Milesi-Ferretti (2006)

[12] Unfortunately, the data base has not been updated.

[13] The data stop in 2004. Since then reserves have continued to grow, often faster than external liabilities. It may be that the gap from the Greenspan-Guidotti-Fischer rule has been erased by China.

Note: South-East Asia includes the ten ASEAN countries, China, Japan, Korea and Taiwan.

Yet, in absolute numbers – or as ratios to GDP – the reserve stockpiles have grown enormously. Since most emerging economies are not in a position to move to free floating, they may have to accumulate reserves in line with the growth of their capital account for both insurance and transaction purposes. While some argue that the foreign exchange reserves stockpiles have become vastly excessive and possibly wasteful, they have given policy makers a sense of comfort as they contemplate the risk of crisis. The risk, then, is that large reserves may foster some complacency concerning the risk of a renewed currency crisis. In particular it seems to encourage most countries to manage their exchange rates rather than let them float freely.

Table 5 Ratio of Foreign Exchange Reserves to Gross External Liabilities - 2004[14]

Brunei Darussalam	Cambodia	China	Indonesia	Japan	Korea	Laos
6.7%	17.5%	78.6%	20.3%	35.0%	51.6%	6.1%
Malaysia	Myanmar	Philippines	Singapore	Taiwan	Thailand	Vietnam
49.9%	5.9%	15.5%	24.8%	115.0%	40.1%	18.8%

Source: *IFS* and Lane and Milesi-Ferretti (2006)

There is no doubt that very large reserves stocks discourage speculative activity. On the other side, determined markets can virtually overwhelm any stock. Speculators chiefly operate by taking short positions on currency that they perceive as weak. If they are unsure about their expectations, they will not act when facing a central bank which holds sufficient reserves to sustain a speculative attack, because the outcome can be costly for them. If, however, the market sentiment builds up and expectations are firmly held, speculators can hold short positions of any size. In effect, a speculative attack is a

[14] The Lane and Milesi-Ferretti data have not been updated beyond 2004. Not strictly comparable 2007 data are available for some countries: Indonesia 21%, Japan 40%, Korea 47%, Malaysia 54%, Singapore 28%, Philippines 26%, Hong Kong 13% and Thailand 50%. (Source: Foreign reserves and portfolio investment liabilities from *IFS*; FDI Stock liabilities from UNCTAD's *FDI Statistics*; debt liabilities from Joint BIS-IMF-OECD-World Bank Statistics on External Debt.)

run on the reserves of the central bank; the larger the reserves, the bigger the run.[15] The main advantage of very large reserve stocks is that they are likely to raise the level of conviction required for markets to dare trigger a speculative attack. Yet, once an attack is under way, this protection is lost.

In addition, the mere observation that reserves are being quickly accumulated may be interpreted as a sign that the exchange will have to appreciate. This may encourage more capital inflows and yet even faster reserve accumulation, as happened in China in early 2008. It is conceivable that the process is ultimately unstable, leading to overvaluation followed by a downward correction.

We argue in Chapter 3 that the evolution of East Asia contrasts with the European path. Continental Europe has chosen to maintain its bilateral exchange rate fixed (and adjustable), all the way to a monetary union, while maintaining capital account restrictions until the late 1980s or early 1990s. Whether the European experience is relevant is not clear however. Indeed, we will observe that the current world situation is very different from the one that prevailed in the 1960s, 1970s and 1980s when these issues were alive in Europe.

3.5. Regional Cooperation

The crisis has created a deep sense of solidarity throughout East Asia. Because they were all victims of international financial market malaise-panic, herding, excessive speculation, and bank-run among others- and because they all feel that international support has been inadequate in many ways, the countries have spontaneously sought to develop a common defense system. This may be where the lessons from the crisis have been taken more faithfully on board. We briefly mention these steps here and fully discuss them in Chapter 3.

The perceived lack of adequate reserves promptly led to the Chiang Mai Initiative. Given the massive accumulation of reserves, this initiative has lost some, but not all of

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[15] The argument if formalized in Jeanne and Wyplosz (2003).

its relevance. Immediately after the crisis, the call for creating regional bond markets led to the launching of the Asian Bond Market Initiative (ABMI). The proponents of the initiative argue that regional markets could help reduce the degree of currency mismatch to which many emerging economies in the region were exposed to and which lay at the root of the crisis. The aim of the ABMI is therefore to increase regional borrowing and lending in regional currencies. Since the region is a net saver, in theory, all borrowing could be done in regional currencies, and there would still be fund left. Ideally, these excess savings should also be lent out in regional currencies. For that to happen, the regional financial markets must compete with the main world markets, chiefly New York and London. Crisis prevention was certainly one of the main reasons behind the Asian Bond Market Initiative, but with the perception of a diminishing risk of a new crisis, the initiative has been losing public support.

The most ambitious project was the Asian Currency Unit idea championed by Japan. It has been dropped from the research agenda of ASEAN+3 at the objection of some of its members. Nevertheless an analysis of the background of the proposal and structure of the regional accounting unit would be worthwhile as it helps understand the thinking of ASEAN+3 policymakers on exchange rate policy cooperation. Since the early 1990s, East Asia has seen a large increase in intra-regional trade and investment. In terms of the importing country, intra-regional trade in East Asia (ASEAN+3 and Taipei, China) was more than 60 percent of the region's total trade in 2006 and there is every indication that this trend will continue. The growing integration of intra-regional trade in goods and services has increased the incentives for governments in the region to stabilize their bilateral exchange rates. Combined with the need of establishing a region-wide mechanism of defense against future financial crises, economic and financial integration provides the incentive to build 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. Pegging to a common basket (Williamson, 1998) is seen as one way of stabilizing bilateral exchange rates; another possible transitional regime could be an exchange rate mechanism similar to the EMS.

Box: Country Groupings in East Asia

The most elaborate organization is ASEAN (Association of South-East Asian Nations), which brings together ten countries: Brunei-Darussalam, Cambodia, Indonesia, Laos, Malaysia, Myanmar, the Philippines, Singapore, Thailand and Vietnam. ASEAN has a permanent secretariat and a Secretary General based in Jakarta, Indonesia. Its Heads of States meet (at least) once a year. The initial five members are Indonesia, Malaysia, the Philippines, Singapore and Thailand (ASEAN 5).

ASEAN + 3 adds the three largest economies: China, Japan and Korea. Created in 1997 at the time of the crisis, it is an informal forum, which promoted agreements or "mechanisms". A special unit has been established at ASEAN headquarters.

We examine in Chapter 2 these developments, some of which are partly inspired by the European experience. A general observation is that East Asia is not making much progress in regional monetary cooperation. The initiatives taken so far are more symbolic than effective because, in the end, no country is willing to surrender monetary policy autonomy for the sake of cooperation (Wyplosz, 2006a). This reluctance is often interpreted as the consequence of deep political resistance, including the absence of an acceptable leader country. Another interpretation emphasizes the logic of economic opening as discussed above in Section 2.2.

3.6. Governance

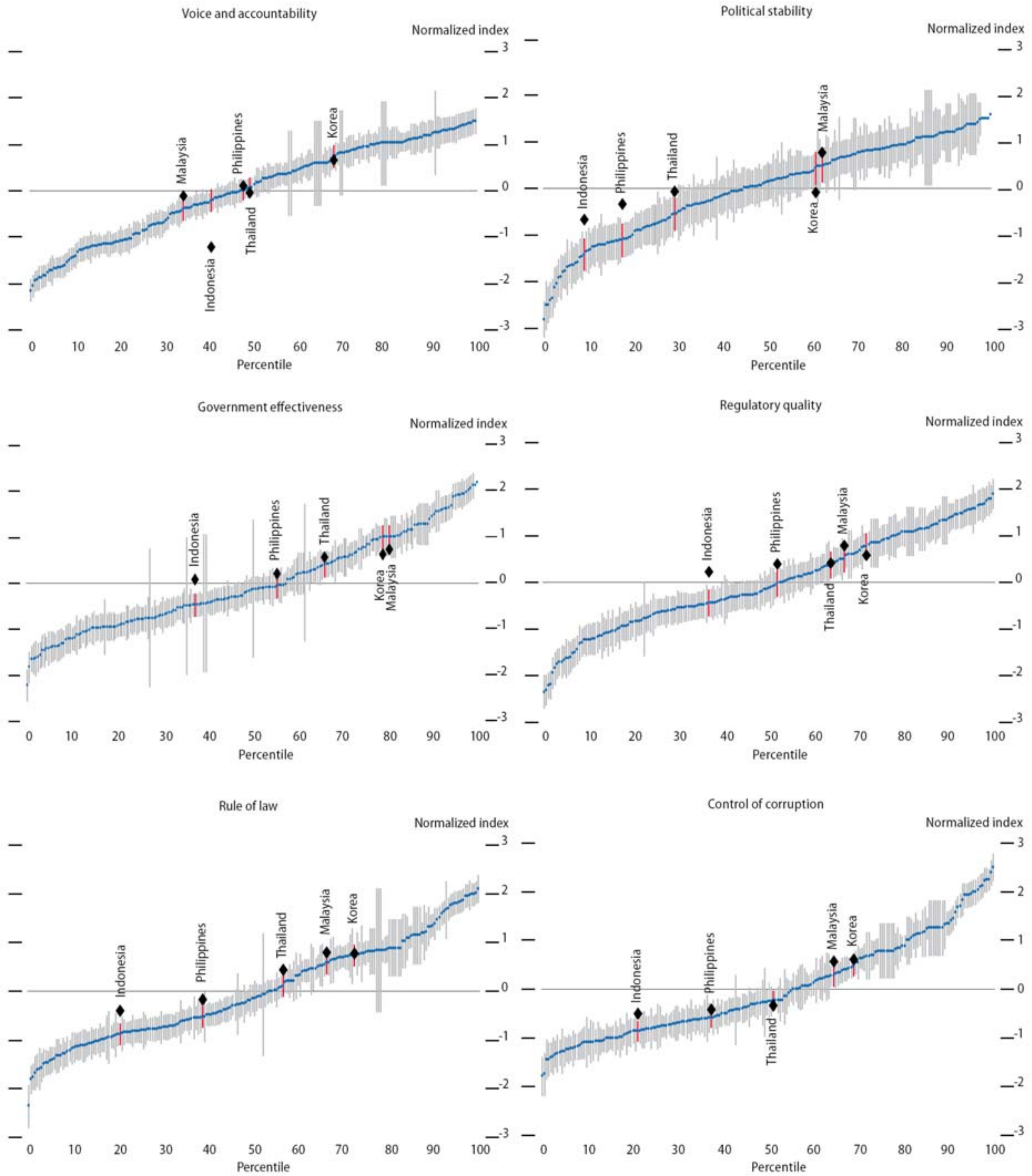
In the aftermath of the crisis, many observers have pointed out limitations in the area of governance at various levels – government, financial institutions, and/or corporations. The IMF included in the list of its conditionality numerous reforms aimed at improving governance. The general perception is that these reforms were not really undertaken in the wake of the crisis, but some countries have since made some progress.

In *Asian Development Outlook* (2007), the ADB uses data recently compiled by the World Bank to provide a graphical description of the situation and its evolution in some East Asian countries, including those hit by the crisis in 1997, for each of the six available criteria. The ratings are computed to be distributed normally, so that zero

represents the world average and positive (resp. negative) ratings represent above (resp. below) average governance performance. It also means that the ratings are relative, not absolute. Figure 4 reproduces the Fig. 1.4.18 of the ADB report. The central line ranks all the countries in the sample for 2005, with an indication in each case of the 90% confidence interval (the ratings are complied from a variety of sources). The five Asian countries are identified vertically by a diamond; in each case, the position of the diamond establishes the rating achieved in 1996 so that a diamond above the line indicates that the corresponding country's rating was higher in 1996 than if 2006. This is a valid comparison since the ratings compare every country to all the other countries.

One of the implications of the figure is that the situation of the East Asian countries varies relatively little from one criterion to the other. In general, Korea ranks among the top 30% countries while Indonesia often belongs to the lowest third of the distribution. The second implication is that, with few exceptions, the five countries under scrutiny have not improved their ratings. This does not necessarily mean that governance has become less satisfactory, but that progress has been slower on average than in the rest of the world. It also shows that Korea has surpassed Malaysia while it was trailing behind

Figure 4 Evolution of the World Bank Governance Ratings



Note: The blue dotted line presents estimates for the 2005 governance ratings for each of the more than 200 countries in the worldwide sample, arranged by the percentile rank of countries from the lowest (worst) to the highest (best) rating. The thin black vertical lines represent the 90% confidence interval around the estimated 2005 ratings for each country. Black diamonds identify the corresponding ratings in 1996 for the five countries most directly affected by the crisis. These observations are (vertically) aligned with the 2005 percentile rankings for ease of comparison. A black diamond above (below) the blue dotted line indicates deterioration (improvement) in the governance rating for that country from 1996 to 2005. The 2005 confidence intervals for each of the five countries is identified by the red vertical lines.

Source: Asian Development Outlook (2007)

on all but one criterion – "voice and accountability" which measures political freedom and democracy.

Keeping in mind that such indices must be taken with a grain of salt, a couple of observations can be made. First, the East Asian countries of 2005 are far below the European countries of 2005. This does not necessarily mean that the Asian countries of 2005 have a worse governance performance than that of the European countries of, say, the 1960s when economic integration started in Europe. Yet, one can argue that it is indeed the relative, not the absolute performance that matters. Financial capital moves on the basis of comparative returns and risks. The perception of substandard performance is bound to harm local financial markets, especially in periods of heightened instability. In that view, the East Asian financial institutions ought to aim to reach world standards. The concern is that this objective will not be reached through the kind of regional arrangements undertaken since 1998. Deeper reforms are needed at the national level. The second observation is that international pressure exercised at the time of the crisis has not worked. One reason is that the recommended measures have been imposed while their direct relevance to the crisis was not established. This has left an impression of interference in domestic affairs, which still lingers and serves as a deterrent. Another reason is that most East Asian countries did not have the institutional capacity to carry out the proposed reforms. Yet another reason is that the reforms were perceived as inappropriate.

4. Conclusions

Taken together, these observations raise an interesting question: could regional peer pressure succeed where international peer pressure has failed to trigger governance reform. There is much talk of peer review and regional surveillance in East Asian policymakers' conferences, but there is an implicit agreement that the ASEAN+3 members do not interfere with domestic policies of others. In some way, this is a form of soft coordination reminiscent of Europe's Lisbon strategy, which is also designed to encourage domestic-level reforms through peer pressure. Launched in 2000 with objectives set to be reached in 2010, the Lisbon strategy got an official "New Start" in 2005. In spite of fairly elaborate peer review of national reform programs, the strategy

has yet to clearly establish its usefulness. Limited attempts by the European Commission to clearly rank countries – including once a "hall of fame" and a "hall of shame" – were quickly vetoed by policymakers who, like their East Asian counterparts, have displayed little taste for peer pressure. Without a Commission to prod them, it is even less likely that Asian policymakers will feel enough pressure to carry out reforms that face serious political constraints.

On the other hand, peer pressure is quite intense in Europe in the area of budget deficits, which remain a national prerogative. The reason is that all euro area member countries have formally agreed to the Stability and Growth Pact, which sets precise limits to national budget deficits along with a detailed procedure to deal with countries that fail to abide by their commitments. Even though the pact was put in abeyance in 2003 when the pressure became too strong, its effects are clearly felt. Collective pressure is obviously more effective in areas where member countries have given up sovereignty – such as external trade and the internal market – because the European Commission is legally entitled to require compliance with formal commitments. Even so, it is not always sufficient.

Almost by definition, governance reforms are politically sensitive. External pressure from international organizations or "friendly" governments is unlikely to be effective, if only because external pressure is easily perceived as foreign interference into domestic affairs. More generally, domestic concerns (voters, pressure groups) are bound to weigh more than peer pressure. External pressure by regional policymakers also tends to be ineffective unless based on formal commitments that are both precise and under direct government control. As an example, we can compare the Stability and Growth Pact and the Lisbon strategy in Europe. The pact aims at eliminating budget deficits. In spite of many implementation difficulties, it has arguably acted as a brake on national deficits (Debrun and Kumar, 2007). The pact relies on precise commitments and concerns the budget under direct government control. The Lisbon strategy, on the other hand, has a vague objective, "to become the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion", and involves objectives many of which that are not

under direct control of governments (for instance, one objective is to increase employment in services).[16]

In contrast to soft coordination, having built a quasi-government in the form of the European Commission, policy coordination in Europe has been quite effective – in spite of some failures, such as trade in services – in areas which have been explicitly designated as a shared competence. Explicit sovereignty transfers are the key for successful cooperation. Cooperation and peer pressure is far more difficult where competence is not shared and the Commission has to rely on national governments to support its proposals. Occasionally, some member governments can carve out agreements in areas of national competence (e.g. the creation of the Eurocorps military force) but, traditionally, this has been the case only when France and Germany were in the driving seat.

Even though soft coordination has allowed some achievements in East Asia, further progress will be difficult. Combined with the absence of the equivalent of to the French-German leadership, the lack of adequate institution and, more generally, strong objections to sovereignty transfers explain why East Asian countries have so far been unwilling to even consider setting up a common surveillance process.

[16] For an early assessment of the Lisbon Strategy, see Tabellini and Wyplosz (2004).

Chapter 2
Critical Survey of the Literature on Financial and Monetary Integration in East Asia

1. Introduction and Overview

East Asia displays a continuing interest in regional monetary cooperation, but it is unlikely that the ASEAN+3 members will be able to accept in the not too distant future a regional numeraire or even an internal common basket. One reason for this pessimistic outlook is the perception that the thirteen members, and for that matter the eight countries participating in the Chiang Mai initiative (CMI), weakly meet the optimum currency area (OCA) criteria.[1] As mentioned below, the OCA criteria are not set once and for all; indeed they may become better fulfilled as the result of monetary integration – they are said to be endogenous – and in the presence of adequate institutions.

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 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 the global developments 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. The emergence of global markets for goods and services and for financial assets has increased the incentives to reduce transaction costs.

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[1] On the criteria for OCA in East Asia, see Eichengreen and Bayoumi (1999), Bayoumi and Mauro (1999) and Baek and Song (2002). Yam (1999), Murase (2002) and Sakakibara (2002) are authors who advocate monetary integration in East Asia.

The second development is the decline in benefits from independent monetary policies. There has been a growing awareness of the limited effectiveness of monetary policy in taking advantage of the trade-off between inflation and unemployment. This awareness has led to a widespread consensus that monetary authorities should concentrate on stabilizing prices rather than influencing employment or output movements. Reflecting this re-assessment 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.

The third development is the original sin or the incompleteness in financial markets argument. According to Eichengreen and Hausmann (1999), 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. The result, which is currency mismatches, causes financial fragility. When the domestic currency depreciates, balance sheets of households, firms and banks deteriorate, which can lead to insolvency. This has led Eichengreen and Hausmann (1999) to 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.

Most of the East Asian countries have long been reluctant floaters vis-à-vis the main world currencies. Now that they have become interested in regional growth and integration, policymakers in these countries consider that they also need to stabilize intra East Asian exchange rates, possibly going all the way to adopting a common currency. This raises immediately the question whether East Asia satisfies all or some of the conditions for an optimum currency area. What would be the benefits and costs of monetary integration in East Asia? In contemplating the possibility of forming a monetary union, East Asian countries will naturally weigh benefits against costs of adopting a single currency.

2. East Asia as an Optimal Currency Area

2.1. Traditional Criteria

The theory of optimum currency area (OCA) developed by Mundell (1961) suggests that the relative share of intra-regional trade, the nature of shocks, flexibility of factor markets, and economic size of participating countries are important factors for

determining the benefits and costs of monetary integration.

The benefits are low transaction costs and the elimination of the exchange rate risk in trade in goods and services as well as financial assets. The gains from joining a currency union are likely to increase with the degree of openness of an economy. Open economies with a large trade sector will reap the benefits of lower transaction costs and elimination of currency risks more than closed ones (McKinnon 1963). The composition of trade may also have an effect on the gains from having a common currency. In general fluctuations in the exchange rate tend to have a greater impact on intra-industry trade in differentiated products than on trade in homogenous products with a well integrated world market (Kenen, 1969). This means that countries that have a large share of intra-industry trade will have more incentives for forming a common currency area than those which do not (Bayoumi and Mauro, 1999).

The costs are related to the loss of independence in monetary and exchange rate policy. If external shocks are asymmetric across potential members of a currency union and the speed of adjustments is low, the costs are likely to be higher. Put differently, the economic costs of adopting a common currency will be smaller, the smaller the size of disturbances and the faster the speed of adjustments. Countries with a similar economic structure are likely to be subject to similar aggregate disturbances so that they display similar patterns of business cycle and as such will find it easier to adopt a common currency. In particular, if factor prices are rigid and factor mobility is limited, asymmetric shocks can create persistent disequilibria for the affected economies.

As Frankel and Rose (1999) point out, however, it is not clear whether deeper trade relations or trade integration could lead to tighter correlations of business cycles. When countries are specialized in inter-industry trade, business cycles may become more idiosyncratic, but if they are competing in international markets for differentiated but substitutable products or exposed to demand shocks more than supply disturbances, business cycles may become more similar across countries. On the other hand, Frankel and Rose predicts that trade integration will deepen as a result of financial integration. However, depending on the nature of trade, this may or may not increase business cycle correlations. If trade is mainly of the inter-industry variety and industry-level shocks are prevalent, deeper trade may lead to less cyclical synchronization if. With inter-industry trade, industry-level shocks increase cyclical comovements.

2.2. Empirical Studies on Monetary Integration East Asia

Most of the empirical studies on the prospects of monetary integration in East Asia analyze the underlying shocks across, the degree of openness, labor mobility, and financial market integration among the countries in the region. The focus is usually on ASEAN plus the larger countries (China, Korea and/or Japan) because the economic size and diversity of its membership makes ASEAN alone an unlikely candidate, as indicated below.

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 pairs of countries for Japan and nineteen trading partners over 1976-95. Exchange rate variability is a function of symmetric output disturbances, the dissimilarity of the export product composition, the ratio of bilateral exports to GDP, and economic size. 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 obtain an OCA index by interpreting low realized volatility as an indication of readiness to share the same currency. They conclude 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 the structural VAR methodology, Eichengreen and Bayoumi (1999) also analyze the time series properties of prices and output to identify demand (temporary impact on output) and supply (permanent impact on output) shocks. Adopting as a benchmark similar estimates for the EU, they are able to compare the size of the underlying shocks and the speed of adjustment in both regions. They find that the magnitude of aggregate demand shocks is less than a half in East Asia, with no significant difference in aggregate supply shocks over the 1972-89 period. They also argue, on the basis of international circumstantial evidence, that financial weakness is "the strongest economic case against schemes for a common currency peg" (p. 359). In addition, they note that a large increase in intra-regional trade and investment and the relative flexibility of wages and prices would favor monetary integration in East Asia. Overall they conclude that East Asia does not satisfy all the standard OCA criteria, but nether does Europe.

Three other studies use the same VAR methodology. Bayoumi and Mauro (1999) examine the potentiality of ASEAN as an OCA. They conclude that this group is less

suited for an OCA than Europe was before the Maastricht Treaty. Zhang et al. (2001 report that their results do not display strong support for forming a currency area in East Asia but that some small sub-regions are potential candidates because their disturbances are correlated. They also note that the small economies of the region adjust rapidly to shocks.

Baek and Song (2002) extend the time period and coverage of countries covered by Eichengreen and Bayoumi. They find that similarity of the economic structure of 15 East Asian countries (ASEAN 10 plus China, Japan, Korea, Hong Kong, and Taiwan) is not comparable to that of the EU members. They note, however, that the share of intra-regional trade, the share of manufactures in exports, and openness (the ratio of trade to GDP) of these economies are close to those of the EMU member countries.[2]

A key result of their study is that, in contrast with Eichengreen and Bayoumi (1999), disturbances are larger in East Asia than in Europe: by a factor of two in the case of supply disturbances and eight for demand disturbances. This result, however, is not compelling. What matters for OCA principles is the asymmetry of disturbances, not their size. In fact, they report that supply shocks are similar among Hong Kong, Korea, Indonesia, Thailand, and Malaysia, whereas demand shocks are correlated at the 5 percent level among Korea, Indonesia, Thailand, Malaysia, and Taipei, China. Finally, Baek and Song (2002) confirm earlier findings that, compared to EMU members, East Asian countries show a faster speed adjustment to supply and demand disturbances. Using the model developed by Bayoumi and Prasad (1997), Baek and Song (2002) further find that labor mobility is lower in EA9 than the in the EMU countries, while capital controls were still relatively tight, contradicting the findings of Eichengreen and Bayoumi (1999).

In the end, combining these pieces of evidence and comparing them to what is known of the EMU countries before the Maastricht Treaty, Baek and Song (2002) conclude that a subgroup of nine East Asian countries (EA9: China, Hong Kong, Indonesia, Japan, Korea, Malaysia, Singapore, Taiwan and Thailand) are viable candidates for adopting a single currency. This conclusion is reached while recognizing that these countries are more heterogeneous in economic structure and are subject to larger disturbances than

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[2] A relative measure of intra-regional trade rose to 45 percent in 1999 from about 40 percent in 1990 (Kawai and Urata 2002).

their European counterparts.

Lee, Park, and Shin (2002) extend the analysis of Eichengreen and Bayoumi (1999) by improving upon their methodology[3]. Using a dynamic factor model, they decompose changes in aggregate output into three components: world-wide, region-specific, and country-specific.[4] Since the Maastricht Treaty of 1991 may have influenced the nature of regional co-movements of output, the sample period is divided into two sub-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. As in previous studies, they find that output volatility is much larger over 1978-1990 in East Asia (3.113) than in Europe (1.770). Over 1990-1999, volatility increases in both regions and the difference widens (3.89 in East Asia and 1.98 in Europe).

Importantly, however, the share of the country-specific factor significantly decreases in both East Asia and Europe. The main difference is that, in Europe, it is the world factor that increases proportionately more, most likely a consequence of globalization.[5] The relative surge of the regional common factor in East Asia may be related to contagion during the 1997-98 crisis and to trade and capital account liberalization in the post crisis period. This is why the very high share of the common factor over the most recent sample must be interpreted with caution. Excluding China from their sample, Moneta and Ruffer (2005) also find that real activity is driven by a joint business cycle and that there has been a weakening of synchronization of the business cycle between Japan and other East Asian countries including China. Both Japan and China display a considerable degree of co-movements with the rest of East Asia with respect to their exports, but in the case of Japan, neither private consumption nor investment co-move

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[3] The study includes 16 European countries: Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, and UK, 10 East Asian economies: ASEAN 5, China, Japan, Korea, Hong Kong, and Taiwan, and two North American countries.

[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).

[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.

with these demand components of the other East Asian economies, suggesting a relative independence of the overall Japanese business cycle.

On the basis of OCA criteria (symmetry of output and price shocks, commitment to price stability, trade and financial integration) Lee and Barro (2006) conclude that East Asia (ASEAN+3 plus Hong Kong and Taiwan) is less suited to a currency union than Europe. They note that "low political proximity between Japan and other East Asian economies restricts Japan's leadership in the creation of an East Asian currency union". Notwithstanding its leadership role, any grouping that includes Japan will not constitute a viable currency union. Indeed, unlike the other members of ASEAN+3, Japan does not have strong economic incentives to participate in any regional currency arrangement, if only because its economy is less export-oriented,[6] so that a high degree of nominal exchange rate volatility poses much less serious burden than in other countries. In addition, as noted above, its cycles are less synchronized with the rest of the region, and so is the trend growth of output as shown by Baek and Song (2005) who find that the degree of correlation of permanent outputs depends on the structure of exports, the level of financial development and the degree of capital account liberalization.

At any rate, Japan will not, and perhaps cannot, forgo its free-floating regime. According to Williamson (2005), Japan may not be prepared to "face the opprobrium that would result from breaking ranks" with its peers in the G7 by abandoning free-floating. If Japan cannot eschew free floating, it will not join any collective exchange rate arrangement among the ASEAN+3 countries.

All in all, the literature suggests that ASEAN+3 at best weakly fulfills the traditional OCA criteria. But this does not mean that ASEAN+3 should eschew the idea of working for monetary integration in the region. As Frankel and Rose (1998) have argued, the traditional criteria for membership of an OCA are not as binding as they are often made out to be because the forming of a monetary union is an endogenous process. Indeed, a common currency is expected to deepen trade links, as has been the case in Europe, see Baldwin and Di Nino (2006). Trade integration, in turn, is likely to result in more closely correlated business cycles across countries, hence less frequent asymmetric shocks and a greater ability to accommodate a common monetary policy regime. In

[6] In 2007, total trade as a proportion of GDP was about 33.5 percent in Japan, to be compared to over 70 percent in China.

addition, trade integration facilitates real capital mobility: 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 domestic investment planned by these firms may be shifted to other countries.

The endogenous nature of the OCA criteria reduces – but certainly does not eliminate – the relative importance of purely economic considerations, raising the relative importance of political aspects. The region needs a country or a group of countries that can lead the ASEAN+3 members in working together for monetary cooperation. [7] As will be discussed in the following section, China and Japan are naturally expected to provide such leadership, but they have not been able to set aside territorial disputes and war time legacies or to overcome their rivalry to cooperate closely on building the requisite regional institutions for monetary cooperation.

3. Monetary and Financial Integration

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. This sequencing strategy suggests that countries would go through the process of financial market integration before adopting a common currency. The creation of a common currency area should 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, which in turn creates incentives for monetary integration.

Indeed, East Asian countries started lowering tariffs and non-tariff barriers long before

[7] The prospects of monetary integration also hinge on the effectiveness and future viability of a macroeconomic policy regime built on the three pillars of free floating, inflation targeting and free capital mobility, as advocated by the IMF. The advocacy for such a policy regime for emerging economies has waned a great deal in recent year, but realizing uncertain prospects for monetary cooperation among the ASEAN+3 countries, some members such as Korea, Singapore, and Thailand may choose to move toward greater exchange rate flexibility with inflation targeting, while other members continue to link their currencies to baskets of the currencies of their major trading partners.

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 pave the way for monetary integration within the group.

Both theory and empirical examination suggest that intra-regional exchange rate stability can be instrumental to deeper integration of regional financial markets as it mitigates currency risks involved in cross border investment. Danthine et al. (2000) and Fratzscher (2001) provide evidence that the introduction of the euro has increased the degree of financial integration in euro area member states. But financial integration may or may not be conducive to monetary integration for a number of reasons. It is not possible to determine *a priori* the consequences of financial integration on monetary integration in any regional cooperative arrangements; this is an empirical issue for which there is no reliable evidence yet.[8] This indeterminacy, which challenges some of the OCA criteria, goes as follows.

Some of the benefits of financial liberalization imply that countries with asymmetric shocks and dissimilar structural characteristics may find it more desirable to integrate financially with one another and can be potential candidates for a common currency area. When the benefits from financial integration are taken into account, joining a common currency area is even more attractive when asymmetric shocks are prevalent. A number of reasons support the view that heterogeneous countries may turn out to benefit more from the adoption of a common currency area than homogeneous countries.

First, financial market integration may lead to co-movement of business cycles of the countries in the same region to the extent that they are subject to simultaneous capital inflows and outflows as was the case during the Asian and Latin American crises (Cashin et al. 1995, Calvo and Reinhart 1995, and Claessen et al. 2001). Imbs (2004) also shows that if capital flows are correlated internationally, financial integration may help synchronize output co-movement.

Second, in financially open economies, economic agents have more and better opportunities for portfolio risk management, thereby reducing income volatility. The increase in the scope of portfolio diversification across a large array of assets can

[8] See Shin and Shon (2006) for the empirical literature.

mitigate asymmetric shocks, because a country suffering from an adverse shock could minimize its loss by drawing down on its claims on the output of or borrowing from other countries.[9] The presence of currency risk under free floating, however, may increase the cost of international portfolio diversification. Portfolio diversification for risk sharing could then be enhanced by establishing a common currency area that includes a large number of structurally heterogeneous countries.

Kalemli-Ozcam et al. (2001), however, observe that greater financial market integration may provide better income insurance but also induce countries to assume more risk, for instance by opting for higher specialization of production. This could result in larger asymmetric shocks across countries and a disincentive to join a currency union. On the other hand, deeper financial integration raises consumption co-movements across countries through increased risk sharing. While in theory the correlation of output co-movement should be lower than that of consumption co-movement, Shin and Shon (2006) do not find any evidence that financial liberalization contribute to consumption co-movement in East Asia.[10] A likely explanation is that most citizens do not – and often cannot – hold internationally diversified portfolios. It can even be argued that the insurance benefits from financial integration bypass the citizens most exposed to, and less equipped to deal with exchange rate fluctuations.

It follows that risk sharing through international portfolio diversification could encourage emerging market economies to link 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,

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[9] 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. Gourinchas and Jeanne (2006) claim that the effects are small. 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.

[10] They argue that their measure of financial integration may not adequately measure financial integration. At this stage financial integration is not deep enough to provide risk sharing across countries in East Asia. It is a well-known puzzle that, despite no evident impediment to the international capital flows, there is little evidence of international risk sharing (Backus et al. 1992).

dollarization, or Euroization, may make more sense for small emerging market economies than forming a currency union among themselves.

Third, the lack of labor mobility and the existence of price and wage rigidity is a tradition argument against joining monetary union because it becomes costly to loose the monetary policy instrument. But financial market integration may reduce the need for asymmetric policy responses to asymmetric shocks. When the financing of current account imbalances is easy, high capital mobility can substitute low labor mobility. This enhances the case of a currency union.

Indeed, easy cross-border financing of current account imbalances reduces the costs of adjustment to shocks. 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, some factors of production are likely to remain unemployed. In this case, financial integration facilitates migration of capital to other countries, thereby mitigating the burden of adjustment through changes in factor prices and employment. Put differently, a high degree of capital mobility through financial liberalization can be a partial substitute for price-wage flexibility. External borrowing could make the real adjustment smaller or unnecessary if the deficit is transitory and hence reversible.

The European experience is largely silent on these issues. With few exceptions, financial liberalization has proceeded in parallel with monetary integration. Most countries removed capital account restrictions after the adoption of the EMS.[11] In fact, it is the removal of these restrictions (which made the EMS unsustainable, leaving either free floating or a common currency as the only viable options) combined with a desire to maintain exchange rate stability within Europe, which became the main incentive to adopt a common currency.

Why, then, did Europe choose not to follow the free floating path? As previously noted, the conventional wisdom among policymakers was that trade integration requires exchange rate stability. This level-playing field argument has long been viewed with suspicion. It has been argued, for instance, that exchange rate hedging is widely

[11] Eichengreen and Wyplosz (1993) argue that the 1992-3 EMS crisis was a direct consequence of the removal of the last capital controls.

available and reasonably cheap. In theory, the question arises regarding the correlation of exchange risk with other macroeconomic risks. Indeed, for a long time, empirical research failed to provide any solid backing to European policymakers' assumption. More recently, however, new research has started to identify a negative effect of exchange rate volatility on trade. The effect, however, is found to be small and doubts remain as to its robustness.[12] Policymakers, however, were mostly worried about the strategic use of exchange rate to boost competitiveness. As noted in Wyplosz (2003), the competitive devaluations of the 1930s have left a deep imprint on policymakers, many of whom fear that strategic considerations might indeed lead to competitive devaluations that would eventually tear the Single Market apart. This is a risk that they were simply not willing to take.

Reducing exchange rate volatility through exchange rate agreements is one solution to this real or perceived threat. Adopting a common currency is a more radical approach, which of course entails greater losses of sovereignty. Does the cost outweigh the benefits? The seminal work of Rose (2000) seemed to establish that a common currency is very significantly more powerful in encouraging trade than fixed exchange rate arrangements. While the magnitude of the results found in this study has since been seriously scaled down (Rose, 2004), more recent studies such as (Baldwin, 2006; Baldwin and Di Nino, 2006), based on Europe's experience with the euro, leave little doubt that the trade-enhancing effects of a common currency are significant. Naturally large benefits must be weighed against large costs, but there is no uncontroversial way of measuring the costs of the loss of sovereignty in monetary policy.

In the end, therefore, the desirability of a fixed exchange rate arrangement or of a common currency cannot be settled on pure economic grounds, if only because they are inconclusive. In fact, economic arguments weighed relatively little in the decisions to either establish the European Monetary System or the Monetary Union. Political considerations were dominant, and not just regarding the decision itself, but in shaping the agreements. For instance, as recalled in Wyplosz (2006b), Optimum Currency Area principles were conspicuously absent in the design of the Maastricht convergence criteria. It is very likely that political considerations will dominate again should the monetary union entail serious costs.

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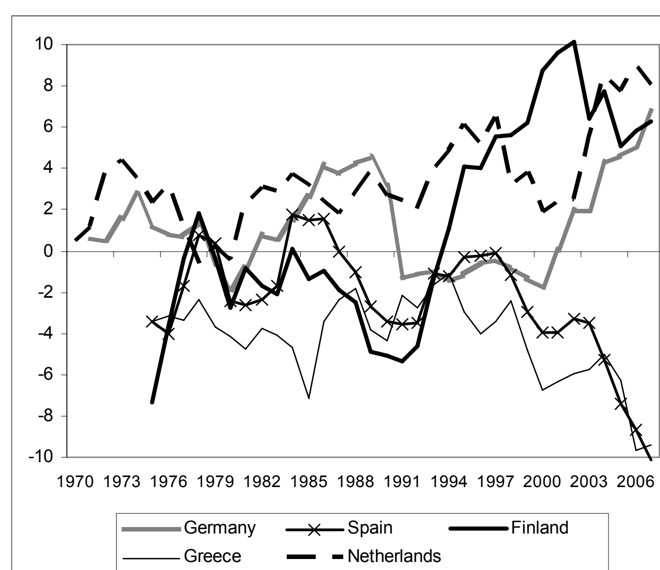
[12] The tide started to turn with Rose (2000). For an exhaustive review of the recent literature, see Clark et al. (2004).

Another interesting aspect is the dynamics of monetary integration. Up until 1973, the European countries relied on the Bretton Woods agreements to achieve internal exchange rate stability. When the dollar external anchor was lost, it seemed natural to seek another mechanism. This gave rise to the European Snake arrangement – a commitment to peg exchange rates but without any formal surveillance and support systems – and, when it failed, to the European Monetary System. Then, the success of the system emboldened policymakers to adopt a common currency. It is not clear that the euro would have been adopted had European currencies been left to float freely after the end of the Bretton Wood system. For instance, except for a brief episode, the UK always allowed Sterling to float and has decided not to join the euro area.

Figure 1 Current Accounts of Euro Area Member Countries (% of GDP)



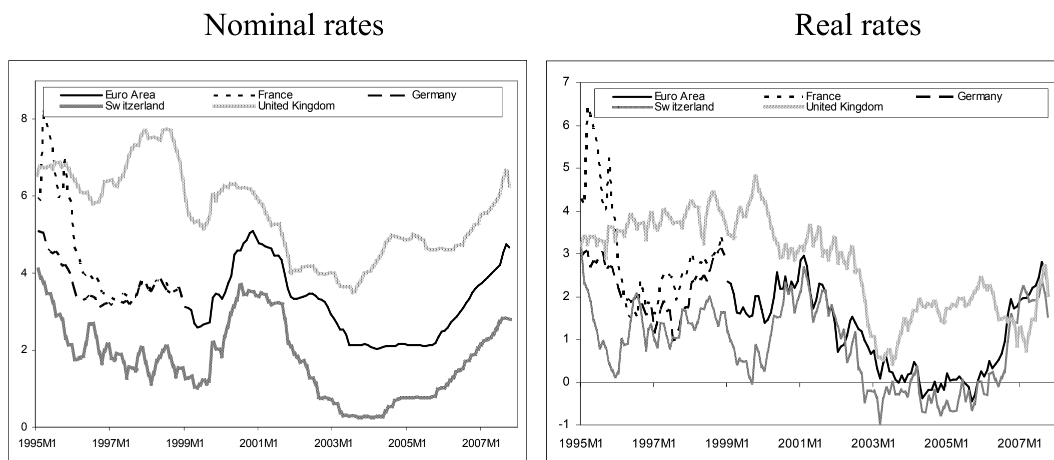
Source: Economic Outlook, OECD

Finally, it is sometimes believed that financial liberalization reduces incentives to join a currency union. This is a view that prevails in Sweden and the UK, for example. Of particular interest to East Asian countries is the fact that both countries find no difficulty to borrow and lend externally in their own currencies. In fact, as a result of easy international borrowing, several European countries have seen their current account imbalances increase – in both directions – in recent years, as can be seen in Figure 1: it seems easier to run external imbalances. Formal evidence by Blanchard and Giavazzi (2002) confirms the visual impression and suggests that this is an effect of financial

integration.

A related issue is whether euro area membership lowers borrowing costs. Some informal evidence can be gathered from Figure 2, which presents three month nominal and real interest rates. The nominal rates on the left hand-side chart shows higher borrowing costs for the UK than for the euro area, but the costs are lower for Switzerland, another non-euro area member. It also indicates that French rates declined to the German level in anticipation of the launch of the euro. Since what matters are real rates, the right hand-side chart may more relevant. In broad terms, the pattern of real rates confirms the pattern of nominal rates, but with some differences. First, the differences are much smaller, which confirms that inflation explains much of the nominal differences. Second, the “Swiss advantage”, a popular argument against euro area membership, has gradually vanished and turned into a disadvantage. Finally, most of the time, British real rates are significantly above euro rates.

Figure 2 Nominal and real Interest Rates (LIBOR – 3 months)



Source: IFS

4. Financial Integration: Regional or Global?

One of the most striking aspects of Europe’s recent development has been the growth and integration of financial markets. Bond markets have grown explosively since the advent of the euro. Cross border transactions in government bonds have risen sharply with the emergence of the German bund as a benchmark asset, while the volume of

corporate bond issues has grown even more dramatically.[13] Securities markets are consolidating around London and Frankfurt, which are competing for the mantle of Europe's dominant financial center. This rapid market integration has raised questions about the viability of Europe's traditional model of bank-based financial intermediation, causing commercial and investment banks to respond with a wave of mergers and acquisitions.[14]

In East Asia, in contrast, there has been less progress in financial integration (Cowen et al., 2006). Cross border bank credit flows remain at low levels. There is no sign of the development of an integrated market in government and corporate bonds. Equity markets have not yet begun to consolidate. If anything, the countries of East Asia have developed stronger financial ties with Western Europe and the United States than with one another.[15] As shown in Table 1, private holdings of external securities by EA10 investors are much smaller than private holdings of EA10 securities by external investors. This is much more pronounced for EA7, which excludes Japan, Hong Kong and Singapore where regional financial centers are located. Why, then, are intra-regional holdings of East Asian securities so limited? It can be that the underdevelopment of regional capital markets limits the menu of financial products, in particular derivative instruments for hedging. Poor disclosure and the lack of information on East Asia's corporations and financial institutions may act as a disincentive, along with the illiquidity of financial markets and the instability of the exchange rate regime. Probably the most important explanation is the process of financial market liberalization: it often

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[13] In addition, the volume of outstanding commercial paper rose by nearly a third in the nine month ending in October 1999 alone (the first three post-euro quarters), while international banks have been able to book very large money-market deals on a cross-border basis at very fine bid-ask spreads (Eichengreen 2000).

[14] These mergers and acquisitions so far remain mainly within national borders but increasingly occur across them (as with the acquisition by Spanish banks of the leading Portuguese banking groups and by Swedish intermediaries of some Danish institutions).

[15] This conclusion holds whether one analyzes the distribution of lead manager by nationality, the source of cross-border bank credit flows, or any of a number of other indicators of financial integration. Kim, Lee, and Shin (2008) find evidence that EA10 are relatively more linked with the global financial markets than integrated with one another. Park and Bae (2002), Eichengreen and Park (2006), and Shin and Shon (2006) present similar evidence.

begins with opening domestic capital markets to foreign investors, while retaining restrictions on domestic residents' portfolio investment abroad.[16]

Financial integration with Western Europe and the United States is asymmetric, in effect one-way. East-Asian private sector holdings of external assets are very small while governments of EA10 hold more than $ 3.5 trillion in foreign exchange reserves. The bulk of these reserves are held in relatively risk free and short-term dollar or euro denominated assets such as US Treasuries with relatively low yields. At the same time, financial institutions and other investors from outside the region invest in equities and extend short term loans to relatively riskier East Asian banks and corporations. As we discuss late in this chapter, this means that overall EA10 is exporting risky assets while importing safe assets.

This may not be surprising, simply reflecting differences in the broader process of integration in the two regions. 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 toward 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. Where Europe has built institutions of transnational governance (the European Commission, the European Parliament, the European Council, the European Court of Justice, and now the European Central Bank), East Asian integration is "weakly institutionalized." It operates on the basis of intergovernmental agreements that defer to the sovereignty of the participating states, not on transnational institutions. Nor is integration in 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.

[16] See also, Kim, Lee, and Shin (2008) for these factors.

Table 1 Portfolio Invetment of EA10 (US $ billion)

Year	Country	Destination (Assets)					Origin (Liabilities)				
		EA10	Japan	US	EU	Total	EA10	Japan	US	EU	Total
2001	EA10	89.50	20.01	553.82	486.38	1614.59	73.86	19.38	299.99	298.16	819.34
		(5.54)	(1.24)	(34.30)	(30.12)		(9.01)	(2.37)	(36.61)	(36.39)	
	EA7	3.04	0.21	6.36	2.24	13.99	36.60	11.13	47.29	35.67	129.65
		(21.74)	(1.48)	(45.44)	(16.01)		(28.23)	(8.58)	(36.47)	(27.51)	
	Japan	21.52	n.a.	490.20	398.94	1289.75	20.00	n.a.	197.84	201.03	542.31
		(1.67)		(38.01)	(30.93)		(3.69)		(36.48)	(37.07)	
	Hong Kong	32.35	9.25	39.25	51.49	205.60	11.60	6.12	32.05	44.09	96.69
		(15.73)	(4.50)	(19.09)	(25.04)		(12.00)	(6.33)	(33.14)	(45.59)	
	Singapore	32.58	10.55	18.01	33.71	105.24	5.65	2.13	22.82	17.38	50.70
		(30.96)	(10.02)	(17.11)	(32.03)		(11.14)	(4.21)	(45.01)	(34.28)	
2006	EA10	303.84	28.24	934.36	1098.44	3285.06	167.87	33.60	903.20	880.13	2241.56
		(9.25)	(0.86)	(28.44)	(33.44)		(7.49)	(1.50)	(40.29)	(39.26)	
	EA7	17.91	2.89	34.80	34.27	104.52	79.05	14.38	177.39	157.58	446.87
		(17.14)	(2.76)	(33.29)	(32.79)		(17.69)	(3.23)	(39.70)	(35.26)	
	Japan	46.52	n.a.	797.61	850.70	2343.48	28.24	n.a.	585.57	598.63	1434.92
		(1.99)		(34.04)	(36.30)		(1.97)		(40.81)	(41.72)	
	Hong Kong	158.64	18.84	64.87	146.31	592.48	40.63	11.72	87.52	82.95	233.68
		(26.78)	(3.18)	(10.95)	(24.69)		(17.39)	(5.02)	(37.45)	(35.50)	
	Singapore	80.77	6.50	37.09	67.16	244.58	19.98	7.50	52.73	40.96	126.09
		(33.02)	(2.66)	(15.16)	(27.46)		(15.84)	(5.95)	(41.82)	(32.49)	

Source: Coordinated Portfolio Investment Survey (CPIS), International Monetary Fund.

Notes: EA10 includes five ASEAN states (Indonesia, Malaysia, Philippines, Thailand, and Singapore) as well as China, Japan, Korea, Hong Kong and Taiwan. EA7 is EA10 less Japan, Hong Kong and Singapore In brackets: percentage of total.

4.1. Regional financial integration

In their gravity model analysis for the year of 2000, Eichengreen and Park (2006) show that cross-border bank claims in Asia are smaller than in Europe: they are 33.9 per cent of regional GDP in Europe but only 3.5 per cent in East Asia. They find that part of this difference can be explained by the very different levels of economic development in East Asia and Europe, along with other non-economic characteristics such as distances between countries, the absence of a common language or the sharing of a land border. The rest of the gap is explained by policy variables.[17]

As ASEAN elaborates its free trade area and links itself to the other economies of the region, additional cross-border finance needed to grease the wheels of trade will presumably be forthcoming. Eichengreen and Park (2006) also report that controls on capital account transactions have a lingering effect on the volume of cross-border claims, and that their shadow is longest where those controls were maintained for the greatest number of years. The underdevelopment of financial markets and institutions in some potential lending countries also appears to be an impediment to financial integration in the region; this too can be addressed by policy, in particular by initiatives designed to promote the growth of Asian financial markets.

On the other hand, Eichengreen and Park (2006) find little effects of other factors sometimes believed to hinder financial integration in East Asia. For instance, we could expect that the problems faced in the 1990s by Japanese banks, the largest in the region, could have had a negative impact. Similarly, the disparity of domestic interest-rate regulation across countries is widely believed to slow down integration. Nor do lower levels of financial regulation appear to reflect Asia's failure to follow Europe down the road to monetary unification or any obstacles to financial integration associated with Asian countries' move in the direction of greater exchange rate flexibility.

The message, in terms of future prospects, is mixed. Per capita incomes in large parts of Asia, notably China, will remain significantly lower than in Europe for some years. Until they do, the region will almost inevitably continue to lag Europe in terms of

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[17] Eichengreen and Park (2006) also note that finance follows trade. Since the completion of their study, however, the emergence of China as a major global trader has been accompanied by a massive increase in intra-regional trade as a share of total trade in East Asia. In 2006, the share of intra-regional trade was 50.2 percent, which is almost the same as in Europe (50.1 percent).

financial integration. Of course, policies to promote intra-regional trade and to remove remaining restrictions on international financial transactions could force the pace of financial integration. But, as recent experience has demonstrated, quick liberalization also has a downside in the form of increased financial vulnerability. Better developed and integrated regional financial markets (in East Asia, and elsewhere) can be part of the solution to this problem, but as the 1997 crisis reminds us, capital account opening can also be a source of problems along the way.

This view is reinforced by the results from Gaytan and Ranciere (2006) who find that it may be optimal for middle-income countries to choose risky domestic banking systems that encourage development, even if the result is more exposure to crises. In line with strong evidence that the capital liberalization process usually creates financial instability as the process unfolds (Kaminsky and Schmukler 2002), Gaytan and Ranciere (2006) argue that middle-income countries have an incentive to pursue risky financial strategies as they rapidly build up their productive capital stock.

4.2. Competition or cooperation?

In theory, both global and regional integration should proceed at the same time. As noted earlier, several pieces of evidence suggest that most of the emerging economies of East Asia are likely to establish tighter and more extensive linkages with financial markets of advanced countries before they merge with other regional markets. For example, developments in East Asia's equity markets in recent years suggest that, once they start opening their financial markets, East Asia's emerging economies find it easier to integrate with the wide open markets of advanced economies than with restrictive regional markets.

They have gradually opened their stock markets ahead of their domestic bond markets. Most of foreign investors in these newly opened markets have come from the US and Europe rather than from other Asian countries, largely because of the restrictions on cross border investments in the region (see Table 1). These restrictions have been further compounded by information asymmetry and perceived weaknesses in legal and regulatory frameworks. In 2006, portfolio investment of 10 East Asian economies stood at an average of only 7. 5 percent of the 10 economies' total cross border investment. In 2003, financial instruments of emerging economies of Asia accounted for only 5 percent of Asian total cross-border portfolio investment. Similar figures for Europe and NAFTA

were 63 and 16 percent respectively (Kuroda 2005).[18]

In addition, business cycles in non-Japan East Asia are increasingly synchronized. These economies share in common a number of structural characteristics, including reliance on exports for growth and an increasingly large share of their exports to China. A closer correlation of business cycles implies that the rates of return on East Asian assets adjusted for risks are likely to be highly correlated to one another. A prudent investment strategy for regional savers therefore includes non-regional assets.

This is quite logical. Diversification, a key role of financial markets, and this is a powerful reason for global integration. Regional integration initiatives, such as the Asian Bond Market Initiative extensively discussed in latter chapters, aim at increasing market liquidity. This is generally a welcome step, but more liquid markets will still have a natural tendency to link up with other markets outside the region.

In the end, if financial globalization is an inevitable trend, could East Asian economies not be better off by integrating their domestic capital markets with global markets from the beginning, rather than going through an intermediate stage of regional integration? The smaller countries may find that global integration is neither practical nor feasible, but then there is no assurance that they will find it any easier to integrate with regional bond markets. Depending on how they are structured, the Asian bond markets can be specialized in Asian bonds with sub-investment grades. They will then be complementary and subsidiary to global bond markets.

4.3. Global integration and risk sharing

Financial opening provides investors with increased opportunities to diversify their portfolio internationally. The amount of risk sharing will be greater to the extent that investors hold diversified portfolios of bonds and equities of countries with very different structural characteristics, including countries whose business cycles have a relatively low correlation with one another. The question is whether this opportunity for risk sharing does more to encourage intra- or extra-regional financial integration.

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[18] 10 East Asian economies include five ASEAN member states (Indonesia, Malaysia, Philippines, Singapore, and Thailand) plus China, Japan, Korea, Taiwan, and Hon Kong. For the geographical boundaries of emerging Asia and Asia, see any issue of ADB's annual economic Outlook.

The 1997-98 crisis does not necessarily support this argument. Suppose that there existed a well-developed Asian yen bond market before the crisis. Would such a market have prevented or made the consequences of the crisis less painful? It would not have, because investors in both regional and global markets are likely to have the same pattern of behavior as far as their credit risk management is concerned. In fact, there is little difference in terms of the demand for bonds between the Asian yen and other global bond markets in that investors in these markets buy only high quality investment grade bonds. A large amount of bond financing relative to bank financing could have made East Asian economies less vulnerable to speculative attacks, but it is not clear whether the size of the Asian yen bond market would have made any difference.

One could argue that institutional and private investors from Japan and other East Asian countries have preferences for regional bonds as they are more familiar with the issuers of these bonds. But then East Asian investors should have been much more restrained than investors from outside of the region in withdrawing their investments during the 1997-98 financial crisis; in particular it was widely known that the crisis-hit countries suffered a liquidity, not an insolvency, crisis. This was not the case. The lending behavior of Japanese banks was hardly different from that of western banks.

Regional bias in portfolio investment, if it is pronounced, may provide a justification for creating Asian bond markets. Although there is dearth of information, it is reasonable to assume that East Asian governments, corporations and individual savers have taken advantage of capital market liberalization to place in part their funds in bonds and equities issued by East Asian borrowers they are familiar with. McCauley, Fung and Gadanecz (2002), for instance, claim that East Asian capital markets are already highly integrated. Crockett (2002) makes a similar argument. They show that East Asian investors bought up 46 percent of these primary issues of the $41.2 billion worth of bonds issued by East Asian borrowers from April 1999 to August 2002. East Asian governments and government agencies issued more than 40 percent of these bonds. Yet, the authors admit that they "solely rely on second hand reports from underwriters that are at best approximation" (p.84). In addition, they cannot identify the final buyers of these East Asian bonds. It is quite possible that East Asian financial institutions as well as subsidiaries of foreign investment banks purchased the bonds and brokerage houses located in Hong Kong, Singapore and Tokyo purchased the bonds on behalf of investors from America and Europe. It is in general difficult to ascertain whether residents in one country buy bonds issued by the entities in their own country or whether they buy bonds issued by borrowers in other countries.

However, there is a piece of evidence that casts doubt on the view developed by McCauley et al (2002). Japan, the world's largest exporter of capital, has acquired more Latin American bonds than Asian ones in recent years. In 1996, the share of Asian bonds in the total overseas portfolio investment of Japan was 3.2 percent as opposed to 8.3 percent for Latin America. By 2001, the Asian proportion had fallen to 1.3 percent (14.1 percent for Latin American bonds) before dipping further to 0.7 percent in 2006.[19] Between 2001and 2006, Japanese holdings of Asian bonds fell in an absolute amount by $136.6 billion. Questions then arise as to the identity of East Asian investors who invested in East Asian paper. It is difficult to believe that residents of Hong Kong, Singapore and Korea bought more East Asian bonds than Japanese investors.

Crockett (2002) argues that East Asia has been importing safe assets while exporting risky ones. Foreign direct investment, portfolio equity, bad loans and bonds are risky East Asian assets acquired by American and European investors. East Asian investors, on the other hand, have been importing low risk securities such as U.S. Treasury bonds, U.S. agency paper and inter-bank deposits. If East Asia has been importing safe assets and there has been a limited variety and quantity of safe bonds issued by East Asian borrowers, it is difficult to accept the data provided by McCauley et al. or Crockett's argument that among the buyers of East Asian bonds, East Asian accounts take almost half of the issues which are relatively more risky assets than U.S. bonds.

In fact, much of the increase in East Asia's holdings of safe foreign assets corresponds to the massive increase in its foreign reserves. East Asian institutional investors have been relatively more risk averse than their U.S. and European counterparts largely because they have not developed or acquired sophisticated risk management technologies and have a limited access to information about global as well as regional borrowers. Many of the financial institutions of East Asian emerging market economies became highly vulnerable to financial crisis, and some of them went bankrupt, as a consequence of the poor risk management of their asset portfolios, that led to large investments in risky bonds issued by other emerging market economies' borrowers. The lessons of the 1997 crisis and the subsequent tightening of regulations on assets management have made East Asian investors more conservative and careful in managing risk of their asset portfolios than before, but they may have a long way to go

[19] The share of Asia in Japan's total portfolio was 2 percent in 2006.

before reaching the global standard of risk management.

This risk averseness can be gleaned from the large increase in East Asia's demand for U.S. government and government agency bonds in recent years and reduced share of Asian securities in the Japanese aggregate investment portfolio. While the percentage of East Asian equities and bonds in the Japanese aggregate portfolio declined substantially, the share of capital market instruments issued by U.S. and European entities rose to 90 percent of total foreign assets held by Japan in 2000 and 2006.

Chapter 3
Assessment of the Initiatives for Financial Cooperation and Macroeconomic Surveillance

The 1997 Asian financial crisis marked a watershed in East Asia's recent economic history. It signaled the end of the East Asian economic miracle and opened up a long and painful period of economic reform and restructuring. As part of their efforts to build resilience to external shocks, most of the East Asian countries including the crisis-hit ones have voluntarily or under external pressure increased the pace and scope of domestic financial reform to liberalize and open their financial markets and also to improve soundness, corporate governance, and risk management at financial institutions. The 1997 financial turmoil has also served as a catalyst for a movement for building a region wide defense system against future crises as well as financial market and monetary integration. This movement has culminated in the institutionalization of two regional initiatives: the Chiang Mai Initiative (CMI) and Asian Bond Market Development Initiative (ABMI).

Before the Asian financial crisis broke out in 1997, few had seriously thought about the need for establishing regional arrangements for financial cooperation and market integration in East Asia. To many a market-led integration process was in fact taking root in the region. The financial crisis that erupted in 1997 shattered the region's confidence in such a process, giving a strong impetus to searching for a regional cooperative mechanism that could help safeguard the region against future crises. This search gathered momentum and opened the door to significant policy-led integration in East Asia (Bergsten 2000 and Henning 2002).

1. Economic Rationale for a Regional Financial Arrangement in East Asia

While the Asian financial crisis provided a strong impetus for regional financial integration in East Asia, other developments have encouraged the formation of regional arrangements for financial cooperation and financial market integration. 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 defense against future crises. A third is the lack of confidence in the free floating system.

1.1. IMF and Capital Account Crisis Management

A review of the Asian crisis management by the Independent Evaluation Office of the IMF (2003) makes it clear that the 1997-8 capital account crisis required a management and resolution strategy different from the traditional IMF recipe for crises originating from current account deficits. 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 had become 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.

The crisis resolution strategy of the IMF was twofold. First, it imposed tight monetary and fiscal policies 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 institutional reforms of the corporate, financial, and public sectors, with the aim to strengthen the structural foundation of the economy and, therefore, to restore the confidence of international lenders.

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 and policymakers 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.

Even before the crisis, cynics would often express their doubt by saying that nothing short of a major shock could force East Asian economies to accept reforms that were

badly needed and overdue. It was not surprising therefore that the IMF rescue programs for the crisis countries mandated structural reforms along the lines of the Washington consensus without a careful scrutiny of their appropriateness and of reform capacity. Implementing deep reforms in the midst of a crisis is a questionable objective. As a result, many of these reforms have been ignored, put on the backburner, or at best resulted in cosmetic changes. The view that structural problems were the root causes of the crisis has not been borne out by subsequent events.

It has also became known 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. 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. The crisis brought home the lessons that the IMF did not have the institutional capacity to prevent or manage properly capital account crises and that monitoring of developments in regional financial markets crucial for fending off crisis contagion would 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 signals to other countries.

This is one of the functions fulfilled by the EMS in Europe. Exchange rate realignments must be agreed upon by all members of the Exchange Rate Mechanism (ERM), i.e. those countries that are party to the fixed exchange rate arrangement.[1] This implies that a country that wants to change its exchange rate must convince its partners and negotiate the size of the adjustment. This feature does not just imply a significant loss of sovereignty, it also means that each country must present to the other members detailed information on its economic situation. Mutual surveillance, therefore, is part of the mechanism. It can be noted that the IMF is not involved in this process.

The IMF can monitor capital flows within and between regions and also the behavior of market participants but it is difficult to imagine that it could establish close working relationships with individual member countries and coordinate their policies.

[1] All European Union members are de facto members of the EMS. The ERM applies only to those countries that agree to peg their currencies.

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. Moreover, to the extent that it cannot serve as a lender of last resort, the IMF 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.

1.2. Contagion of Financial Crises

At the time of the crisis, the ASEAN + 3 countries jointly held about US$700 billion in foreign reserves. The total amount of financing required to restore 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 and immediately supply liquidity to stave off speculative attacks when they see one, they could have nipped the Thai crisis in the bud and minimized contagion by making available a small fraction of their total reserves and more so the total amount of financing needed to resolve the Asian crisis. In view of the large loss of output and employment that followed, such a cooperative response was indeed desirable.

In managing a liquidity crisis, an effective management strategy would have focused on squelching the speculation by supplying a large amount of short-term financing to replenish foreign exchange reserves, instead of tightening monetary and fiscal policy. But there were neither regional nor global lenders of last resort. The IMF resorted to standard remedies it had relied on managing current account crises. Then, with limited financial resources, 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 lesson is that regional support is logical when contagion is geographically concentrated. 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 regional financial arrangements rests. Monitoring and surveillance processes are needed to provide prompt and relevant information and to assess the situation of countries in trouble and potential contagious effects.

In doing so, the East Asian countries regard Europe as a model. As already noted in the previous chapter, most of their objectives have so far remained timid in comparison

with the degree of cooperation that has been gradually deepened in Europe since the end of the Bretton Woods system. Reserves pooling, automatic support under EMS, mutual surveillance, were all part of the process that eventually led to the adoption of the euro, as we explain further below. Why, they ask, have these efforts been hailed then when similar projects now in Asia are regarded with suspicion? It may well be that the East Asian countries are not prepared to go that far, at least for the foreseeable future, and that financial markets have changed deeply since then, making the slow European process ill-adapted. Alternatively, the rapid pace of development is deeply affecting the balance of costs and benefits of deeper monetary and financial integration; as a result, Europe's experience may be becoming more relevant.

1.3. Limited and Slow Progress in International Financial Reform

For years following the collapse of Argentina, acute instability in Brazil, and economic slump in East Asia, the G-7 countries have not shown much interest in reforming the international financial system. As a result, the East Asian countries feared that they will remain as vulnerable to future crises as they are now (Park and Wang, 2002). Interest in reform has only grown as the result of global current account imbalances, because these imbalances affect the US and, via the dollar decline, Europe. To make matter worse, token gestures – minimal increases in IMF quotas – are accompanied by strong demands that directly affect policymaking in China and therefore throughout Asia.

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. Developing countries remain excluded from the key institutions and fora involved in international financial reform.

It is not surprising, therefore, that many emerging market economies have begun to develop their own mechanisms of defense against future financial crisis. Instead of waiting until the G-7 creates a new architecture, whose effectiveness is at best questionable, the East Asian countries have concluded that they need to work together to create their own defense system.

2. The Chiang Mai Initiative

2.1. Origins

At the IMF and World Bank annual meetings in Hong Kong right before the outbreak of

the crisis in 1997 Japan proposed a plan to create a regional monetary fund known as the Asian Monetary Fund (AMF) modeled after the IMF. The proposal was withdrawn because of the strong objections from the US and the IMF. This did not stop the leaders of ASEAN from seeking other forms of regional economic cooperation. They invited China, Japan and the Republic of Korea to join in an effort to build a regional mechanism for economic cooperation in East Asia, which resulted in creating the grouping known as ASEAN+3. The Joint Statement on East Asian Cooperation released by the ASEAN+3 summit in November 1999 covered a wide range of possible areas for regional cooperation. One area was in creating regional financial arrangements to supplement the existing international liquidity support facilities at the IMF.

Following up on the summit, the finance ministers of ASEAN+3 agreed at their meeting in Chiang Mai, Thailand, in May 2000 to set up a system of bilateral currency swap arrangements (BSAs) among the eight members of ASEAN+3 under what has come to be known as the Chiang Mai Initiative (CMI). The eight countries participating in the CMI have also institutionalized, in addition to the annual ASEAN+3 summit, regular meetings of finance ministers (the ASEAN+3 Finance Ministers' Meeting, AFMM+3) and deputy ministers (the ASEAN+3 Finance and Central Bank Deputies' Meeting, AFDM+3) for policy dialogue and coordination and concerted regional efforts at financial reform in the region.[2]

CMI rests on three pillars: liquidity assistance, monitoring and surveillance, and exchange rate and other policy cooperation. It is anticipated that cooperation will evolve over time, much as has been the case in Europe. It has started with a mutual credit arrangement in the form of bilateral swaps, which is being restructured into foreign reserve pooling without any commitment to exchange rate coordination.

2.2. Objectives and Structure

The CMI consists of two regional financial arrangements: a network of bilateral swaps and repurchase agreements among the eight members of ASEAN+3 and an expanded ASEAN swap arrangement (ASA) created by the original five ASEAN countries in 1977. In May 2000, the ASA was expanded to include the other five new ASEAN members and the total amount of the facility was raised to US$ 1 billion from the initial

[2] The eight members include the five original members of ASEAN (Indonesia, Malaysia, the Philippines, Singapore and Thailand) plus China, Japan, and Korea.

amount of US$ 200 million.[3]

- Structure

The bilateral swap arrangements (BSA) provide for liquidity assistance in the form of swaps of US dollars for the domestic currencies of the participating countries[4]. In the initial agreement, for each BSA, the contracting parties determine the maximum amount of swap. A member country can draw automatically up to 10 percent of the contractual amount (now 20 percent) When exceeding the limit, the member is placed under the IMF surveillance including a macroeconomic and structural adjustment program. The BSA network is thus complementary to the IMF lending facilities. Participating countries are able to draw from their respective BSAs for a period of 90 days. The first drawing may be renewed seven times. The interest rate applicable to the drawing is the LIBOR (London interbank offered rate) plus a premium of 150 basis points for the first drawing and the first renewal. Thereafter, the premium rises by an additional 50 basis points for every two renewals, but it is not to exceed 300 basis points.

The BSAs include one-way and two-way swaps. China's and Japan's initial contracts with the five Southeast countries were one-way BSAs from which only the ASEAN five can draw. The first round of CMI contractual agreements was completed in May 2004 with sixteen BSAs totaling US$ 36.5 billion having been concluded (see Table 1). Japan contracted seven agreements and China and Korea six respectively. Korea, which is the largest beneficiary of the CMI, could draw a maximum of $13 billion from the system, including the resources made available under the Miyazawa initiative. However, the amount of liquidity available from the CMI was seen as insufficient to support members suffering from short run balance of payment problems and hence to prevent contagion of future crises in the region. This realization led to doubling the total size of the CMI in 2005. Since then further contributions have been made to increase the total amount to US$84 billion by April 2008.

- Surveillance

Most participating countries agree that, in principle, the BSA network needs to be supported by an independent monitoring and surveillance system. At this stage, however,

[3] The five new members of ASEAN do not participate in the Chiang Mai Initiative.

[4] China chose swaps between local currencies with Japan, Korea, and Indonesia. With Indonesia, it has also a dollar-local currency swap (see Table 1).

they do not seem prepared to establish such a system, although collective efforts are being made in this regard.[5] In the initial agreement, surveillance is not required because up to 10 percent of each BSA swap can be disbursed without the consent of swap-providing countries and any additional drawing is subject to the IMF surveillance. Hence, there is no collective mechanism for the resolution of repayment default problems. This deficiency effectively puts the onus of surveillance on the lending countries and the IMF. With the increase in the size of the BSAs and the automatic drawing limit, however, there has emerged widespread agreement that the CMI would need in the future its own surveillance mechanism to deal with operational matters such as the activation, execution, and default resolution.

In fact, a number of participating countries have proposed to sever the CMI from its linkage with the IMF conditionality and to replace it with an independent regional monitoring and surveillance system that also serves as an institutional framework for policy dialogue and coordination among the members. At the 2005 annual AFMM+3 ASEAN+3 finance ministers reaffirmed the necessity of enhancing the ASEAN+3's economic surveillance capacity and integrate it into the CMI, but was not able to make any decision on the structure, role and the location of the proposed surveillance institution. The joint statement of the AFMM+3 at the 2006 ADB annual meeting once again reiterated their commitment to improving the regional surveillance capacity, but all they could do was to establish a group of experts and an technical working group composed of finance ministry officials to study further the feasibility of constructing a regional economic and financial monitoring and surveillance system.

5 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).

Table 1 Progress on the Chiang Mai Initiative

Bilateral Swap Arrangements (BSA)[a]	Currencies	Conclusion dates	Amount as of[b]	
			May 30, 2004	Apr 1. 2008
Japan-Korea[c]	US$/Won (one-way)	Jul 04 2001	US$2 bn.[d]	
Japan-Korea	US$/local (two-way)	Feb. 23 2009		US$15 bn.
Japan- Korea	Yen/Won (two-way)	Jul 3 2010		US$6 bn.
Japan-Thailand[c]	US$/Baht (one-way)	Jul 30 2001	US$3 bn.	
Japan-Thailand	US$/local (two-way)	Nov 8 2010		US$9 bn.
Japan-Philippines[c]	US$/Peso	Aug 27 2001	US$3 bn.	
Japan-Philippines	US$/local (two-way)	May 3 2009		US$6.5 bn.
Japan-Malaysia	US$/Ringgit (one-way)	Oct 04 2007	US$1 bn.[d]	US$1 bn.[d]
Japan-China	Yen/ RMB (two-way)	Sep 20 2010	US$6 bn.	US$6 bn.
Japan-Indonesia[c]	US$/Rupiah (one-way)	Feb 17 2003	US$3 bn.	
Japan-Indonesia	US$/Rupiah (one-way)	Aug 30 2008		US$6 bn.
Japan-Singapore[c]	US$/Sing.$ (one-way)	Nov 10 2003	US$1 bn.	
Japan-Singapore	US$/local (two-way)	Nov 07 2008		US$4 bn.
Korea - China[c]	Won/ RMB (two-way)	Jun 24 2002	US$4 bn.	
Korea - China	Won/RMB (two-way)	Jun 23 2010		US$8 bn.
Korea-Thailand	US$/local (two-way)	Dec 11 2007	US$2 bn.	US$2 bn.
Korea-Malaysia[c]	US$/local (two-way)	Jul 26 2002	US$2 bn.	
Korea-Malaysia	US$/local (two-way)	Oct 13 2008		US$3 bn.
Korea-Philippines[c]	US$/local (two-way)	Aug 09 2002	US$2 bn.	
Korea-Philippines	US$/local (two-way)	Oct 16 2010		US$4 bn.
Korea-Indonesia	US$/local (two-way)	Dec 26 2009	US$2 bn.	US$4 bn.
China-Thailand	US$/Baht (one-way)	Dec 05 2004	US$2 bn.	US$2 bn.
China-Malaysia[c]	US$/Ringgit (one-way)	Oct 08 2005	US$1.5 bn.	US$1.5 bn.
China-Philippine	RMB/Peso (one-way)	Apr 9 2010	US$1 bn.	US$2 bn.
China-Indonesia	Rupiah/RMB (one-way)	Dec 03 2003	US$1 bn.	
China-Indonesia	US$/Rupiah (one-way)	Oct 16 2009		US$4 bn.

Source: Asian Development Bank, "Progress Report on the Chiang Mai Initiative: Current Status of the Bilateral Swap Arrangement Network as of 10 November 2004"; Japan Ministry of Finance, "Network of Bilateral Swap Arrangements under the Chiang Mai Initiative (as of February 24, 20006)"; Japanese Ministry of Finance, "Japan's Bilateral Swap Arrangements under the Chiang Mai Initiative (as of February 24, 2006)"; and various press releases from central banks of ASEAN+3 countries.

Notes: a. The total size of a two-way BSA is double the face value of the BSA.

b. The total size of all BSAs amounted to US $36.5 bn. as of May 2004 and to $71.5 bn. as of February 2006

c. This contract has been replaced

d. The US dollar amounts shown do not include the amounts committed under the New Miyazawa Initiative: US$5 bn. for the Republic of Korea, which expired on February 24, 2006, US$2.5 bn. for Malaysia, and the ASEAN Swap Arrangement (US$2 bn.)

e. US$/local (two-way) is US$/yen and US$/won in this case and analogous for other countries

- The CMI as a Policy Coordination Mechanism

As is currently structured, the CMI is a small regional source of financial assistance. And there is no guarantee that bilateral swaps will be activated in times of crisis. These deficiencies do not mean that the CMI is irrelevant. To the contrary, in addition to providing liquidity, it has been evolving into an important forum for policy dialogue and even coordination for regional financial stability that has been wanting in East Asia for a long time. Most CMI members are not likely to draw from the BSAs in the foreseeable future as they have managed to reduce some structural weaknesses of their financial systems through reform and more importantly they have amassed large amounts of foreign exchange reserves. At the end of 2007, the seven CMI members excluding Japan held more than $2.5 trillion in reserves. Table 2 provides the ratios of foreign exchange reserves to GDP. Some of these ratios are very large, possibly even excessive. We return to this issue below.

Table 2 Foreign Exchange Reserves in 2007 (% of GDP)

China	Indonesia	Japan	Korea	Malaysia	Philippines	Singapore	Thailand
47.2	12.7	20.1	26.9	54.1	21.0	103.1	34.7

Source: International Financial Statistics, IMF

Notes: Japan, Korea and Singapore: figures for 2006.

Now that they feel more secure and hence less in need for regional liquidity assistance, the ASEAN+3 members have turned to policy dialogue and coordination. They have institutionalized a peer review mechanism known as “Economic Review and Policy Dialogue (ERPD)” which assesses regularly the overall economic outlook of the region. They have also established an early warning system for crisis management and formal and informal channels of communication within the framework of the CMI for the exchange of information on significant market changes such as a large appreciation or depreciation of any regional currency caused by speculative capital inflows or outflows.

Regional cooperation may open other formal and informal channels of liquidity support in addition to the BSAs among the ASEAN+3 countries. For example, when Indonesia and the Philippines showed signs of financial strain in 2005, which was deemed contagious, ASEAN+3 policymakers considered short term public sector loans to serve as a first line of defense before activating the BSAs, although in the end these loans were not needed.

2.3. Enlargement and Multilateralization

Since its inception, the eight participating members of ASEAN+3 have gone through several rounds of discussion for enlarging the size and improving operational procedures of the CMI. The discussions have mainly dealt with the expansion of the swap amounts, increasing the limit of automatic drawing, and severing the linkage with the IMF. As pointed out in the previous section, the total size of the BSAs has been raised to $84 billion. Several members of the CMI had previously proposed that the 10% limit available without IMF conditionality be raised to 20 or 30 percent. The limit was lifted to 20 percent in 2005. The enlargement of the CMI membership to non-member countries, including Australia, New Zealand, and India, which have expressed interest in joining the CMI, has also been considered. Japan favors the inclusion of these countries, but at present, there is broad consensus that enlargement should be differed until some of the operational issues of the CMI are settled.

In redesigning the CMI the member countries have been mostly preoccupied with the creation of a multilateral surveillance system for the BSAs. Multilateralization has been of particular concern, because there is no guarantee that, under the existing system, the BSAs will be activated promptly, in time to support a member in need of short term liquidity. Some of the swap-providing countries could exercise their right to opt-out. Any country wishing to obtain short-term liquidity must negotiate the activation with all swap-providing countries individually. If a large number of the members refuse to provide swaps and different swap providers demand different terms and conditions, then the CMI may cease to be an efficient liquidity support system. Swap activation with multiple parties may take time and hence may deprive the swap requesting country of the ability to mount an effective and prompt defense against a speculative attack. In order to avoid this inherent bias in the system, it has been proposed to create a secretariat or committee that would determine joint activation of all swap contracts of the swap requesting countries, so that swap disbursements could be made in a concerted and timely manner (ASEAN+3 2005b). In 2006, at their 9th annual meeting (ASEAN+3 2006), the finance ministers of ASEAN+3 agreed to establish a collective decision-making mechanism or multilateralization for simultaneous bilateral swap activation.

However, the CMI members realize that neither the multilateralization of the CMI nor an increase in the drawing limit will be possible unless an effective surveillance system is established. This has been a controversial issue. As noted before, the working group assigned to produce recommendations for surveillance has not been able to produce a

system acceptable to all members. Indeed, the member countries are divided on its role and structure. The bilateral swap arrangements, when activated collectively and supported by a surveillance system, can function as a de facto regional monetary fund and could lay the foundation for monetary cooperation and integration in the long run that follows in the footsteps of European monetary integration At this stage of development, it appears that at least some members of the ASEAN+3 are not prepared to restructure the CMI into an Asian Monetary Fund, an idea that was proposed by Japan in 1997 and quickly abandoned.

2.4. CMI and the European Experience

The CMI sharply differs from support arrangements in Europe before the creation of the monetary union in 1999. These arrangements evolved over time, mainly starting after parity changes in France, Germany and the UK in 1967-9. The first step was the setting up in 1970 of Short Term Monetary Facilities (STMF). The six members of the European Community pledged to lend each other, on demand, pre-declared amounts. Medium and very short-term facilities were added in 1972. These arrangements resemble the CMI with the important difference that the facilities were not bilateral; each country's pledged amounts were available to all other countries, up to some quotas. Real reserve pooling took the form of the European Monetary Cooperation Fund (EMCF), which in effect collected the funds pledged under the Very Short Term Facility agreement. The Fund was set up as an independent body managed by the central bank Governors. In addition to administering the funds, the Governors were meant to harmonize their policies, an arrangement that supposed some surveillance. In the end, the EMCF never really functioned. The amounts were small and the Governors displayed no willingness to exercise surveillance over each other.

The EMCF was meant to underpin the "European Snake", in existence between 1973 and 1978. The Snake called for exchange rate stability but it relied on individual governments to enforce self-declared parities vis-à-vis the US dollar. The inability of the EMCF to function led several countries to withdraw from the Snake, which convince European policymakers that a tighter arrangement was required. This explains the key feature of the ERM:

- Parities were set bilaterally, not vis-à-vis the US dollar.
- Parities had to be agreed upon by all members, and included an explicit margin of fluctuation of +/-2.5% (which extended to +/-15% in the wake of the 1992-3 crisis).
- Any time a bilateral exchange rate reached its limit of fluctuation, both countries were bound to intervene, and to do so in unlimited amounts.

- If one country felt that the bilateral parity under stress could not be upheld, it had to secure an agreement with all other countries to adjust the parity.

Thus, the CMI bears some resemblance with the STMF and the EMCF, which never played much of a role, but not to the ERM intervention mechanism, which has been effective.[6] To start with, the motivation is different. The ERM aimed at limiting bilateral exchange rate fluctuations, initially under capital account restrictions, while 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. In the absence of exchange rate coordination, incentives for mutual surveillance are limited since a member country facing a speculative currency attack is free to float its exchange rate (Wang and Woo 2004). In addition, the principle of unlimited mutual support under ERM contrasts with the East Asian view that the size of the swap does not have to be large enough to meet the potential liquidity need because they are supplementary to IMF resources. Yet, the European evolution from arrangements in the spirit of the CMI to the much tighter ERM may suggest that ASEAN +3 will eventually follow a similar path.

The ASEAN+3 countries are following a path not entirely different from Europe. They explicitly link a multilateralization of reserve pooling to surveillance, as did Europe when moving from its financing facilities to the EMCF and to the ERM. What is currently missing in Asian plans, though, is an anchor for surveillance. In Europe, the anchor was the fixed and adjustable exchange rate system. The requirement that every country's exchange rate be accepted by the other countries implied an in-depth discussion of many parameters such as inflation, monetary policy, production costs, the current account, etc. The debate was not whether national policies were "right" or "wrong", but whether they were compatible with the exchange rate regime and which parity was justifiable. In the absence of a criterion, such as the exchange rate anchor, surveillance inevitably involves value judgments. Interestingly, cooperation within the ERM was natural because the currency parities were fixed internally, not vis-à-vis the dollar.

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[6] During the 1992-3 crisis, the Bundesbank refused to be dragged into unlimited support. This was the first and only failure of the mutual support agreement. The new ERM, put in place after the launch of the euro, does not include an unlimited support system.

2.5. CMI Multilateralization: Self-Managed Reserve Pooling Arrangement (SRPA)

In recognition of the structural deficiencies of the BSAs, ASEAN+3 began a review of the system to develop a more effective multilateral framework of regional liquidity support in 2005. The proposal for multilateralization that was approved at the 9th meeting of finance ministers in 2006 has culminated in the conversion of BSA bilateral contracts into a single contract informally known as a common fund or a self-managed reserve poling arrangement (SRPA). At their 10th meeting held in Kyoto, Japan, the ASEAN+3 finance ministers "agreed in principle that a self-managed reserve pooling arrangement governed by a single contractual agreement is an appropriate form of multilateralization" of the existing swap system (ASEAN+3, 2007a). They also agreed to carry out further in-depth studies on the key elements of the multilateralization including surveillance, reserve eligibility, size of commitment, borrowing quota, and activation of a new system. For these studies a task force was established in November 2006.

The SRPA, which is meant to replace the BSAs, essentially replicates the model of reserve pooling of the European Monetary Cooperation Fund (EMCF) previously described. From the Asian perspective, the innovation of the SRPA is that it is meant to be legally binding and enforceable contract, which would give effective protection to participating members. Even when finance ministries or the central banks manage the system, unlike the BSAs, the new reserve pooling system would require a single contractual agreement to be governed by a third country's law so as to make it a multilateral arrangement.

Constructing an efficient system of surveillance would be crucial to garnering public credibility of the SRPA. For them to contribute sizable amounts to the fund, the ASEAN+3 countries need reassurances that moral hazard will be contained. Unless an effective system of surveillance is established, there is the danger that the SRPA may not serve as an efficient liquidity support system. In Europe, surveillance was, in principle, to be exercised by the central banks' Governors. The pooled reserve amounts were probably too small to overcome the Governors' distaste for surveillance. This suggests that the circle can be virtuous or vicious. In a virtuous circle, large amounts of reserves are pooled together, which provides an incentive for effective surveillance and eventually makes the system effective. This is why the ERM worked in Europe. The EMCF failed because it was caught in a vicious circle of small reserve commitments, no surveillance and, therefore, a strong reluctance to make the system operational for moral

hazard reasons.

At the 11th meeting of finance ministers in Madrid in May 2008, some of the features of the SRPA, such as the size, the respective shares of the members, the modality of decision making, and terms and conditions of borrowing were formalized (ASEAN+3 2008). On other issues, such as the borrowing accessibility, the activation mechanism, custody and surveillance, the ministers could not reach consensus and decided to wait for recommendations to be made by a task force. The size of the pooled reserves was agreed to be at least $ 80 billion with the 20 and 80 proportion of the amount of contribution between ASEAN and Plus Three. The shares of individual countries will be determined through negotiations among the members belonging to the two respective groups.

The ASEAN members agreed in principle that the maximum amount of borrowing in US dollars against collateral in local currency could be equal to a multiple of the member's contribution to the pool. However, the exact figures remain undecided, except that multiples are likely to be higher for the ASEAN members than the Plus Three. On the pooling structure of reserves, four options have been proposed: 1) pooling of investment assets; 2) cash contributions to the SRPA in return for a claim on the arrangement; 3) pooling of promissory notes to be issued to the ADB or ASEAN secretariat which acts as an administrator; 4) pooling in a single global custodian. As for the conditions and covenants of borrowing from the pool, ASEAN+3 has decided to adopt those of the BSAs. They will also retain the 20 percent IMF rule. On the decision making process, the members appear to be divided between a majority and unanimity rule when making management decisions. They are likely to adopt a consensus base rule on important matters such as lending, but other routine management issues could be decided by majority rule. There are two critical issues on which the members have not been able to obtain consensus: the pooling structure and surveillance. On the poling structure, they are debating the feasibility and relative merits of two options: pooling of promissory notes and pooling in a single global custodian.

As previously emphasized, surveillance has been a major concern ever since the establishment of the CMI. It has become critical with the introduction of the reserve pooling arrangement. Despite much discussion, the members have not been able to agree on a modality of surveillance. At present ASEAN+3 relies on informal surveillance conducted through ERPD when finance ministers and their deputies meet (once a year for the ministers and twice a year for their deputies). The ERPD will serve

as the normal mechanism for monitoring and for exchange of information, but when a request for borrowing is made by a member, it will be decided by other members either by a majority or unanimity rule. There will be more ERPD meetings and more standardized information and data will be shared among the members. Obviously, this type of peer review and informal exchanges on policy coordination will not be sufficient. The member countries have no intention of setting up an independent surveillance, but could not agree on the extent to which they are going to rely on the IMF and other IFIs for surveillance.

The SRPA has a tiered sharing arrangement. Given their large economic size and reserve stocks, China and Japan will be the two largest contributors to the arrangement. Since these two countries are not likely to borrow from the reserve pool, there will be a clear line of demarcation between potential lenders and borrowers. China and Japan will be lenders and four ASEAN members – Indonesia, Malaysia, the Philippines, and Thailand – are potential borrowers, while South Korea and Singapore can be either lender or borrower. As the two major contributors, therefore, cooperation between China and Japan, which has been wanting in recent years, will be crucial to a successful launching of the SRPA.

Would the $80 billion reserve pool will be enough to make it a credible liquidity support system? Would it not be dismissed outright by the market as its size is so small compared with the total amounts of foreign exchange reserves held by the ASEAN+3 members? More generally, when markets can take huge position, is the pool likely to deter speculative attacks? Answers will not be known until the SRPA is subject to market tests in the future. However, as noted earlier, the ASEAN+3 members are going to increase their contributions as they have done with the BSAs and at present may not need a large regional liquidity support system.

Because of their small size and complicated activation procedure, the BSAs have been very much ignored. The new system could well meet the same fate. As long as the reserves remain under respective members' custody and management instead of being centrally managed by an independent third party, the activation mechanism becomes crucial. The mechanism under discussion does not appear to be a major improvement on that of the BSAs. This raises concern that liquidity will be no more readily available than it was the case with the BSAs. Furthermore, to be helpful, the new facility needs to raise the maximum amount a member can draw well above the level of the BSAs. It may be necessary to include an opt-out clause but this clause should only be available

under exceptional circumstances. If the IMF link were to be maintained, precise and transparent agreements between the IMF and ASEAN+3 would need to be spelled out.

The new system signals a desire to deepen financial and monetary integration through an advanced institutional structure. Few details are known about and how long it will take to construct an operational framework. The shortcomings of the BSAs have long been well known, but what is not known is how effective they can be because the system has never been activated. ASEAN+3 are introducing a new system without having had the opportunity of learning the advantages and drawbacks of the bilateral swap system.

Europe's multilateral EMCF was too limited to be effective. Even though it represents an undeniable progress, the SRPA is even more limited. In today's world, to be credible to the markets, available reserves must be considerably larger than in the 1970s when most European countries imposed tight capital account restrictions. The reserves, which were deposited with the BIS, were not managed nationally but by the EMCF Board, composed of the central bank governors. Even if some surveillance is accepted within the SRPA framework, much like it was the case with EMCF, the lack of an anchor around which surveillance can be conducted is likely to undermine the whole construction.

In the end, it seems that the SRPA is not designed so much as a regional liquidity assistant mechanism as it is a regional forum for policy cooperation. Now that the original CMI has been restructured into a multilateral system, it will become a more effective forum for regional cooperation and policy coordination in the future.

3. Asian Bond Markets Initiative

3.1. Origins

Since the 1997-98 East Asian crisis, many countries in the region have given priority of financial reform to developing domestic capital markets as part of the strategy to diversify their bank-based financial systems. Underdevelopment of both domestic and regional bond markets are often argued to have exacerbated capital outflows, thereby deepening the crisis and multiplying the loss of output and employment during the 1997-98 financial crisis. For instance, one year after the crisis, Donald Tsang, then the financial secretary of the Hong Kong Special Administrative Region (SAR) of China,

cited the failure to establish a strong and robust Asian bond market as a key reason for the turmoil. His question, "How is it that we in Asia have never been able to replicate the success of the Eurobond market in this part of the world?" hit a raw nerve.[7] Since then, the development of local bond markets has been one of the major objectives of financial reforms proposed by the IMF, World Bank, and the Asian Development Bank (ADBI 2002).

While there is a clear need to develop domestic bond markets in the region, smaller economies may not have developed the capacity to support efficient domestic capital markets that are broad and deep in terms of the variety of financial instruments, issuers and investors. Even to more advanced economies, the inertia and large costs of constructing market-supporting infrastructure may prevail on staying with the bank oriented system rather than investing in the capital market. To overcome these efficiency and cost problems of fostering domestic capital markets, repeated calls have been made for East Asian countries to join forces to develop larger and more efficient regional capital markets[8]. The question is how to proceed.

The ASEAN+3 took up the challenge of constructing regional bond markets by launching the Asian Bond Markets Initiative (ABMI) in 2003. For the promotion of a new initiative, ASEAN+3 organized six working groups on a voluntary basis to conduct detailed studies on the construction of market infrastructure: a clearing and settlement mechanism, credit guarantee institutions, and credit rating agencies- and creating new debt instruments including bonds denominated in local currencies issued by foreign government agencies, multilateral development banks and multinational corporations.

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7 See Tsang (1998). It has also been asserted that the absence of broad local bond markets has in part been responsible for the massive increase in the region's overseas portfolio investment(ASEAN+3). For example, Kuroda (2005) also claims that developing efficient domestic bond markets in Asia will reduce the global imbalances by ensuring that more of Asia's savings are invested in the region.

[8]There has been some confusion concerning the definition of Asian bond markets or Asian regional bond markets. As the term is used in the ABMI and other documents of ASEAN+3 it does not necessarily refer to new off-shore regional bond markets to be created in Asia, although one of the objectives of the ABMI is claimed to create regional bond markets(ASEAN +3 2004) or an international bond market in the region (ASEAN+3 2006). In general, it is a collective term for domestic bond markets of East Asian economies, some of which may already serve or have developed into regional financial centers for bond trading and listing.

The first progress report of the six ABMI working groups presented to the 8th meeting of the ASEAN+3 finance ministers in Istanbul in May 2005 (ASEAN+3 2005) suggests that most of the groups did not make any headway in their studies and were in need of new directions. In order to sustain the momentum for the ABMI, the ASEAN+3 finance ministers introduced a roadmap. As part of the roadmap, two new studies were launched: one was on Asian Bond Standards, which was to identify necessary market infrastructure and introduce market procedures comparable to those of global bond markets, and the other on the possible issuance of Asian currency basket bonds. They also endorsed a new research area which would "collectively look at capital flow liberalization and institutional arrangements" (ASEAN+3 2005).

By the time of the 9th meeting in Hyderabad in May 2006 the six working groups had been reorganized into four engaged in the development of the market infrastructure-credit guarantee and investment mechanism, settlement system, credit ratings, and the Asian Bond Standards. In the following 10th meeting in Kyoto in 2007, several new studies were endorsed, which included exploring new debt Instruments for infrastructure financing, promotion of securitization of loan credits and receivables, and promotion of Asian medium term note (MTN) program. By then, however, there was growing recognition that after four years of studies, proposals, and numerous official meetings for the development of regional bond markets the overall progress in the ABMI did not meet the initial expectations and the initiative was in need of new directions and renewed commitment on the part of the of ASEAN+3 leadership. This recognition led to the promulgation of a new ABMI roadmap at the 11th meeting in Madrid in May 2008, which created four task forces on "(1) promoting issuance of local currency-denominated bonds, (2) facilitating the demand of local currency-denominated bonds, (3) improving regulatory framework, and (4) improving related infrastructure for the bond markets" (ASEAN+3, 2008).

As far as the ABMI is concerned, market liberalization and opening is a necessary condition to fulfill Donald Tsang's vision, but it is not enough. Also needed is a system of clearing and settlement, credit guarantee institutions, harmonization of legal and regulatory systems, hedging facilities, and regional credit rating agencies. If individual Asian countries compete to attract a regional financial center, bond markets in East Asia will remain separated from global financial markets. Unless their linkages with global financial markets are diversified and strengthened, Asian bond markets will not become efficient enough to compete on a global scale.

3.2. What Are Asian Bond Fund I and II?

The eleven central banks of East Asia and Pacific belonging to EMEAP (Executive Meetings of East Asia and Pacific Central Banks) have launched Asian Bond Fund (ABF) I and II.[9]

While ASEAN+3 has been primarily engaged in constructing market infrastructure for Asian bond markets and harmonizing various financial standards, regulatory systems, and tax treatments throughout the region, EMEAP has taken the initiative of creating funds that invest in bonds issued by Asian governments and corporations. ABFI and ABFII were intended to serve as low-cost catalyst for domestic financial reforms in Asia.

Announced in June 2003, ABF I is mandated to invest in dollar-denominated Asian sovereign bonds whereas ABF II invests in Asian bonds denominated in local currencies. The EMEAP central banks invested in ABF I at its launch, which had a capitalization of US $1 billion. The initial subscription has been fully invested in bonds issued by sovereign and quasi-sovereign issuers in eight EMEAP economies (China, Hong Kong, Indonesia, Korea, the Philippines, Malaysia, Singapore and Thailand). Introduced on December 16 2004, ABF II consists of two components: a Pan-Asian Bond Index Fund (PAIF) and eight country sub-funds (see Figure 1). The PAIF is a single bond index fund that invests in the eight EMEAP economies previously mentioned. It also serves as a parent fund for sub-funds.

ABF I has had relatively little effect on the market for East Asian sovereign dollar bonds, since non-EMEAP investors are precluded from investing in it. With $2 billion in capital, ABF II could have more impact. The ABF II funds are passively managed against a set of transparent and pre-determined benchmark indexes. In 2005, the PAIF and the single-market funds of Hong Kong, Malaysia, and Singapore were listed. The remaining five single-market funds were offered to the public in the first half of 2006.

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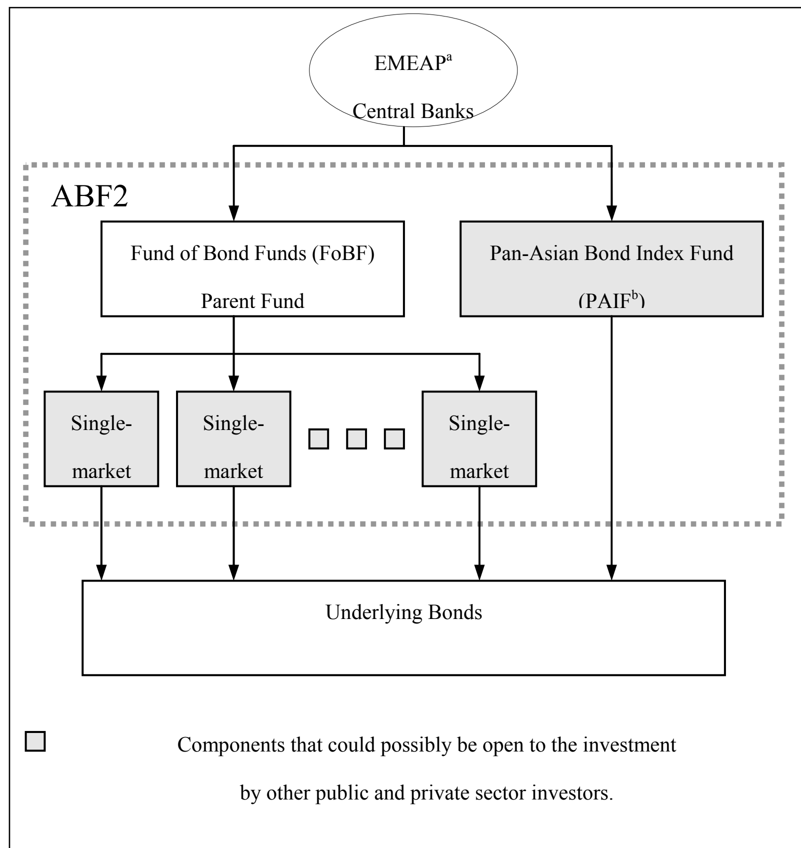
9 The central banks of Korea, China, Japan, Hong Kong, Singapore, Thailand, Malaysia, the Philippines, Indonesia, Australia and New Zealand.

Figure 1 Asian Bond Fund II



Notes: (a) Executives' Meeting of East Asia-pacific Central bank; (b) Pan-Asian Bond Index Fund

3.3. Rationale for the ABMI

The under-development of bond markets and the resulting excessive dependence on bank-intermediated and foreign short-term financing were seen as major causes of the 1997-98 crisis. Several bond markets already existed in East Asia. In theory, East Asian corporations could raise resources in other countries of the region, including Samurai bonds denominated in yen or Shogun bonds denominated in a foreign currency and issued in Japan, but these markets never really took off. Furthermore Singapore had actively sought to develop a corporate bond market to allow foreign entities to issue Singapore-dollar-dominated bonds. Hong Kong had taken the lead in organizing an Asian clearing and settlement networks by linking its system with those of other countries in the region, which strengthened its status as a regional financial center.

In spite of considerable progress since the crisis, by 2003 Asian bond markets still lagged in both breadth and depth. The huge current account surpluses that followed

spurred demand for financial instruments, especially bonds. In the absence of deep bond markets in the region, a substantial portion of savings have been invested in bonds denominated in major foreign currencies. This pattern was inherently unstable. Fund flows out of Asia were often recycled back into regional institutions managed by foreign financial intermediaries, mostly as equities and derivatives, which are more volatile instruments than bank lending or debt financing. These foreign financial intermediaries are usually large international financial institutions with considerable market power and influence because of the volumes they can mobilize relative to the size of emerging economies' financial markets. When the market is under duress, they can "push" prices in a particular direction. The implications for the emerging markets are market volatility, a strong tendency to overshoot, and consequently, daunting challenges to maintaining monetary and financial stability. There is no reason, however, to believe that the Asian bond market will be immune to these problems.

An additional motivation has been the need to develop the capacity to support efficient domestic capital markets that are broad and deep in terms of the variety of financial instruments, issuers and investors. Constructing market-supporting infrastructure is often hampered by inertia and large costs. Joining forces to develop larger and more efficient regional capital markets has been seen as the way to overcome these obstacles.

As we will see in Section 3.6, this strategy faces serious limitations. A natural question is why there has never been such an endeavor in Europe. One reason is the maintenance of capital controls until very late in the integration process. With few exceptions, most countries in effect bottled in national savings. This allowed the development of local financial markets with instruments denominated in the local currencies. Capital controls were often accompanied by – explicit or implicit – domestic financial repression, which reduced the role of financial markets and led to a large intermediation role for domestic banks, in the absence of competition in that sector. As a result, there was little financial instability and no currency mismatch. Obviously, there must have been a cost in term of allocation efficiency, but it was invisible. It is only in the late 1980s that these restrictions were very gradually lifted. This came as a result of a coordinated effort – the Single Act of 1992. In sharp contrast with the ABMI, the effort concentrated entirely on lifting national restrictions, with no common market-building ambition, at least until the Single Act was signed.

3.4. Institutional Aspects

It was always expected that the ABMI would have to overcome many institutional

hurdles so that laying the foundation for an integrated regional bond market in East Asia would be painstakingly slow. After five years of efforts, the momentum for market building is slowing down. Except for the agreement to create a Credit Guarantee and Investment Mechanism (CGIM) as an in-house organization of the ADB and the plan for establishing a settlement mechanism known as Regional Settlement Intermediary (RSI), other proposals such as Asian Financial Forum for regional monitoring of financial supervision, Asian Bond Standards and long term development strategies for the ABMI are slated for further study and discussion. One reason for the slow progress is the failure of the ABMI architects to articulate the structural characteristics and ultimate objectives of the markets that they propose to create, along with a lack of leadership. Many small member countries have been indifferent to the ABMI as benefits from constructing regional bond market are rather abstract to them. It is not clear either which country, or group of countries, has the moral authority, influence, and money to lead the region-wide financial reform and the construction of a regional financial infrastructure.

Few of East Asian economies are able or prepared to issue bonds denominated in their own currencies on global or even regional bond markets. Many still do not allow non-residents to hold large amounts of their currencies for fear that it could erode their control over monetary policy and make them susceptible to currency speculation. This illustrates the difficult relationship between financial integration, the exchange rate regime and mutual support. The European approach has been easier because each country gradually developed its own financial market, which attracted foreign investors while, in parallel, monetary cooperation was being developed. Monetary cooperation is only meaningful if it affects the outcome, which means that decisions are different from what they would have been absent cooperation. In other words, meaningful cooperation means that some independence is lost. Once the EMS was in place, national central banks were already constrained, with only margins of flexibility: the ability to devalue/revalue within the ERM – subject to collective approval – and some capital controls. Most Asian countries fiercely resist any restriction to monetary policy autonomy, implicitly refusing meaningful cooperation.

As also shown by the European experience, even with a common currency, financial integration can be derailed unless market distortions are removed and practices in different countries are harmonized. For this reason, the emergence of a regionally integrated market in East Asia is a long-term prospect that is at best uncertain.

Another development is the emergence of regional trading centers for Asian bonds as a number of countries open their bond markets to foreign borrowers and investors. Japan, Hong Kong, China, Singapore, and Korea all have plans to develop regional markets in their own currencies. We may well observe the development of several bond markets with regional ambitions but differentiated by the currency denomination (yen, Singapore dollar and Hong Kong dollar).

Along with the growth of onshore bond markets, a number of offshore regional bond markets may also become new sources of bond financing in East Asia. These off-shore markets are likely to resemble the old Euro bond market. New or already existing off-shore regional bond markets may become deeper and wider as financial market deregulation and opening permeate through East Asia. Bonds issued in these markets are likely to be denominated in major international currencies and some of the currencies of the East Asian countries with open domestic bond markets. Issuance of Asian bonds in these off-shore bond markets are likely to be private placements offered by underwriters via dealers to institutional and private investors. These offshore bond markets will be subject to little regulation from host regulators and withholding income taxes. Disclosure, likely to depend on the prominence of the issuers, is likely to remain less stringent than on the onshore markets.

It is not clear which markets will survive the ongoing competition to become major trading centers for Asian bonds. In view of the European experience, it appears that countries with deregulated and open financial markets and with an efficient system of payment and settlement will win over. At present, the requisite infrastructures for regional bond market hardly exist and it may take years to build them. Cooperative efforts to integrate different local clearing and settlement systems are needed, but may not be easily organized and may not succeed even if they are organized.

3.5. The Role of Central Banks

At present there is no shortage of demand for high quality Asian sovereign bonds denominated in Asian currencies. This means that both the PAIF and its country sub-funds are competing against private and institutional investors for a relatively limited supply of these instruments. Because of its small size, ABF II is not a major market player, and hence does not pose any serious crowding out problem. However, if the EMEAP builds up the size of the investment portfolios of both the PAIF and the country sub-funds as it plans to do, the probability of squeezing out private investors will increase in the future.

EMEAP (2006) reports that both the PAIF and the country-sub-funds have invested in local currency sovereign bonds of Indonesia and the Philippines with a rating below the minimum investment grade that private and institutional investors might not normally include in their portfolios. This investment strategy raises the question of prudence in central bank reserve management. Although the EMEAP central banks are not directly involved in managing ABF II, they may be viewed as taking undue market risk even if investment in Indonesian and the Philippines bonds is currently seen as safe. The planned increase in size of ABF II may raise concern that the participating central banks hold risky assets in their reserve portfolios. If indeed it is acceptable for EMEAP to invest, albeit indirectly, in non-investment grade bonds, then the EMEAP needs to answer the questions of whether it is equally acceptable for its member to do the same individually and if so, what the prudent share of these speculative bonds in their total reserves is. In addition, if demand is substantial, EMEAP will compete with private investors. Then if the risky bonds are not marketable to private and institutional investors, then the EMEAP central banks may end up subsidizing non-investment grade issuers.

Insofar as ABF II invests in East Asian sovereign bonds denominated in local currencies, it may serve as a vehicle of mutual financing of fiscal deficits among the EMEAP members. If ABF II grows to be of considerable size, ABF II investment operations will be carefully monitored by the markets, which is bound to affect the foreign exchange and interest rate policies of the eight EMEAP member countries where ABF II operates. Even if the amount of a sale or purchase is relatively small, the operations of the PAIF and its country funds may send wrong signals to the financial markets against the wishes of the EMEAP central banks. A solution would be for a private institution to manage the funds, but this would not fully eliminate the signaling problem as long as the central banks retain a controlling stake.

Finally, central banks' investments in the bond funds ought to be considered as foreign reserves. Since these instruments are illiquid, central banks cannot invest too large amounts in ABF II. The future growth of ABF II would then depend on its attractiveness as an investment vehicle to institutional and other private investors.

Despite these concerns, the EMEAP member central banks could contribute to the development of Asian bond markets, if they used the ABF II leverage to strengthen the regional financial infrastructure and to remove institutional constraints on the supply of

high-grade Asian corporate and sovereign bonds as well as existing restrictions on cross border investments. In evaluating the performance of ABF II, the EMEAP emphasizes that one of the objectives of the bond fund is indeed to promote financial integration in the region. It further claims that, despite its relatively short history, ABF II has been a catalyst for the deregulation and opening of local bond markets in several member countries (Ma and Remolona 2005 and EMEAP 2006). Many pieces of evidence, most of which appear to be rather anecdotal, have been presented to substantiate the claim, but, given the small amount of ABF II investment in designated countries, it is unclear whether and to what extent the ABF II initiative has had a serious influence.

The amount of ABF II investment for a given local market is determined by such factors as the market size, turnover rates, and credit ratings, which carry a 20 percent weight each, and the market openness, which receives 40 percent. This weighting scheme suggests that the investment strategy of ABF II favors financially open economies. This may encourage bond market opening in EMEAP's emerging member economies, but it may also be criticized for being biased against financially underdeveloped members, which may not have the ability to manage and speed up the needed reform. While few would object to the EMEAP efforts, they could be more effective if coordinated with similar programs of other regional institutions such as the ASEAN+3 and its member governments, and tailored to take into account the structural constraints of the targeted countries. This is important because normally central banks are not directly involved in formulating or implementing financial reform.

There has been no similar central bank involvement by central banks in Europe. The only similar institution is the European Investment Bank (EIB). Initially, the EIB was designed along the lines of the World Bank: it borrows on most favorable terms on international banks because it benefits from government guarantees, which allows it to lend at attractive rates. Over time, it has shifted its lending to non-European countries, becoming an aid instrument. It was never in its mission to foster the development of financial markets. As for central banks, they have always invested their reserves in safe US dollar-denominated short-term instruments. On the other hands, European central banks have long been involved in the regulation and supervision of their domestic markets. It was always felt that this function ruled out the kind of involvement assumed under the ABMI, precisely to avoid the difficulties raised in this section.

3.6. Objectives and Misconceptions

From the beginning, the ABMI has suffered from a lack of clarity of its objectives.

Although the bond suppliers are meant to be mostly borrowers from East Asia, the buyers include global as well as regional investors. Because of this global investor base, Asian bond markets will not be geographically segmented markets: they will inevitably be linked up with global bond markets. This observation underscores confusion between Asian bond markets and international bond markets. ABMI and other documents of ASEAN+3 indicate that the aim is to create both regional bond markets (ASEAN +3, 2004) and an international bond market in the region (ASEAN+3 2006). Some domestic bond markets already serve or have developed into regional financial centers for bond trading and listing. The continuing globalization of financial markets and advances in financial technology, which allow financial firms in international financial centers to reach investors and borrowers in remote corners of the world, raise questions as to the need and rationale for creating regional capital markets.

It is also true, however, that given the dynamism of the East Asian economy and its enormous pool of savings, the region could accommodate large and efficient markets. As noted earlier, ASEAN+3 has been involved primarily in building institutions such as regional credit agencies, cross-border securities borrowing and lending mechanisms, credit enhancement and guarantee agencies, clearing and settlement systems, a centralized depository system, and exchanges and over-the-counter bond markets. In addition, the six working groups are devising plans to harmonize various financial standards, regulatory systems, and tax regime throughout the region.

However, cooperative efforts must not be undermined by institutional weaknesses and regulatory controls at the national level. A lack of professional expertise in the securities industry, inadequate financial and legal infrastructure, low accounting and auditing standards and opaque corporate governance are pervasive. Unfortunately, these issues are not addressed because they are considered as internal affairs.

One hoped-for effect of the ABMI is peer pressure to speed up financial reforms. Withholding tax must be harmonized. A bewildering array of controls over domestic capital markets and market practices that stand in the way of cross border investment remain to be removed. Some indirect evidence to that effect is provided in Table 3 below. The Chinn-Ito index includes several dimensions of restrictions to capital mobility; it shows a wide gap between Singapore, which is free from restrictions, and Korea and Malaysia, not to mention China.

Table 3 Chinn-Ito Index of Restrictions to Capital Account Openness

China	-0.44
Indonesia	0.47
Japan	0.79
Korea	-0.04
Malaysia	-0.04
Philippines	0.06
Singapore	1.00
Thailand	-0.04

Source: Chinn-Ito (2007) and authors' calculation.

Note: The index, which averages 0 for the whole world, has been rescaled to be 1.0 for the most open countries (e.g. the US, France, the UK, etc.).

Unfortunately, the rhythm of financial reforms, which began after the 1997 crisis, is slowing down. In fact, several countries are relapsing into old practices and outmoded financial policies. Another objective, which has been seldom mentioned, is that the ABMI and CMI can reinforce each other. If the CMI can be developed into a mechanism for stabilizing bilateral exchange rates, it will facilitate financial market integration by reducing exchange rate risks.
ASEAN+3 has so far skirted around these critical reform issues, engaging instead in rather peripheral matters such as the creation of regional credit rating and credit guarantee institutions and diversification of bond instruments. Despite many studies on impediments to cross-border bond issuance and investment, results and reform recommendations have not been taken up.

On these issues, Europe has followed a radically different path. As noted before, the Single Act was designed to enhance the openness of all domestic markets, including the financial markets. In the area of openness and competition, in principle, there are no internal affairs in Europe.[10] A first consequence is that national bond markets have been brought into direct competition with each other and with world markets. The presence of large returns to scale has led to several rounds of consolidation. The Amsterdam, Brussels and Paris markets have formed Euronext, which has recently been merged with

[10] "In principle", since services have remained largely outside the Single Market purview. This includes banking services, despite numerous efforts by the European Commission.

the New York Stock Exchange. Unsuccessfully so far, Frankfurt has tried to merge with London, and such an evolution may be unavoidable. A second consequence is that national authorities have had every incentive to implement the best possible regulations and that tax regimes must be efficient. For instance, to compete with the German Treasury papers (Bunds), which have become the euro area benchmark, the French Treasury has become very innovative in recent years, floating indexed and very long term notes that are becoming benchmarks as well. Thus, by agreeing to open their markets, the European countries have relied on market forces to drive the reforms on national markets, solving the problems that are likely to undermine the ABMI.

3.7. Assessment

In retrospect, it appears that the objectives have not been defined clearly enough, which has led to a number of misconceptions. It remains, in particular, to articulate precisely what is a regional or an international bond market. Is the intention to create an offshore bond markets like the old Eurobond market or to transform some existing on-shore domestic bond markets into regional financial centers where Asian bonds are issued, listed, and traded? Will these regional bond markets be distinct from the existing ones or from the planned global bond markets? In an increasingly globalized financial system, domestic and regional bond markets will eventually have to be integrated into the global bond markets in Europe and the US. It can be argued that a first step should be to integrate existing domestic bond markets into the global markets instead of going through the round-about way of creating regional bond markets. If this is not feasible, ABMI advocates need to explain why. They also fail to specify whether regional bond markets are meant to be integrated into the global financial system.

Second, it is often felt that the global bond markets cannot meet the financing needs of Asian governments and corporations. Indeed, these markets have not done much to identify credit-worthy East Asian borrowers and to help them issue local and foreign-currency denominated global bonds. A possible explanation is the existence of a large number of restrictions on bond issuance and trading that have seriously limited the access of many East Asian borrowers to the global bond markets and of global investors to East Asian domestic and regional bond markets. These restrictions are also largely responsible for the narrowness, shallowness, and illiquidity of East Asia's domestic and regional bond markets. ABMI advocates still have to explain why East Asian borrowers whose low credit ratings preclude them from issuing investment-grade bonds denominated in their own currencies in the global bond markets would be able to do so in regional bond markets, unless they are proposing the construction of high-yield

(junk) Asian bond markets.

In addition, ABMI advocates argue that Asian savers and investors rely much more on regional markets than on global financial markets. Indeed, a substantial portion of Asian savings is invested in short-term foreign government bonds, only to be recycled back by selling risky assets to finance Asian investment. Importing safe assets and exporting risky short-term assets could make the region vulnerable to speculative attacks, thereby increasing the likelihood of the recurrence of financial crisis because of the resulting currency mismatch (Rhee 2000 and Tsang, 1998). Currency mismatches are an undeniable source of vulnerability. Yet, many other countries are also subjects to currency mismatch and do not face crises. In the end, there is no substitute to sound macroeconomic policies.

It is also argued that the channeling of practically all official reserves from Asia to developed markets is both a consequence and, albeit to a lesser degree, a cause of the underdevelopment of the Asian bond market. But it should be also pointed out that much of the reserve accumulation has been for self-insurance. The ASEAN+3 countries collectively hold more than USD 3.5 trillion in reserves, the bulk of which is invested in US short-term Treasury and agency securities. Some of these reserves, it is claimed, could be used to finance Asian investment, with better returns, at a time when East Asian borrowers pay high interest rates. If they are used for domestic investment financing then the ASEAN+3 members will be risking appreciation of their currencies and hence losing export competitiveness

The Asian and European approaches differ in many ways. The Asian approach can be described as regional-defensive. It aims at strengthening bond markets in the region, but without interfering with national sovereignty. It is, partly at least, motivated by the currency mismatches that triggered the 1997-8 crisis. This legacy means that the building up of regional markets is seen as a defense against currency instability, which explains the involvement of central banks. This involvement, in turn, is the source of many ambiguities regarding foreign exchange reserve management, exchange rate policy and the usual arm-length relationship between central banks and financial markets.

In contrast, the European approach has gone through three phases. First, financial repression, both domestic and internal, has led to the development of (often distorted) local markets in local currencies, which eliminated the currency mismatch problem.

Then, market opening in the late 1980s, mandated by the Single Act, has brought national markets into direct competition, including regulatory competition. Harmonization efforts now follow in an effort at establishing a European level-playing field. Thus, European bond markets have become spontaneously part of the global market once the restrictions were lifted. This has not prevented some national attempts at promoting local markets, but these efforts could only take the form of the search for the most efficient regulatory environment since the referee was the global market itself. In Asia, on the other hand, the combination of a process driven by the authorities and of an unwillingness to agree on binding harmonization measures, competition does not automatically lead to the elimination of politically-motivated inefficiencies.

A question of interest to East Asia is what triggered the market opening in Europe and what form did it take. One reason for opening, which is even more powerful today, is the world evolution towards large and effective financial markets. Many European countries did not want to be left out, even though domestic lobbies were clearly opposed to the move. Another reason is that financial opening was cast within the overarching framework of the Single Market. The European Commission could argue that financial markets ought to be treated as other markets. While being part of the expanding world financial markets is a clear motivation behind the ABMI, there is no Single Market and no Commission in East Asia.

The main conclusion, therefore, is that Asian efforts at developing regional markets through government-led institutional efforts are likely to be disappointing. Assuming that they manage to adopt a common set of regulatory practices designed to increase capital flows within the region, either these practices are compatible with global markets and the local markets will become parts of the global markets, or these practices end up being restrictive and they will develop secondary local markets, losing market shares to the global markets. Europe, instead, has relied on a market-driven process to develop its markets, which are now fully integrated in the global markets.

The remaining issue concerns harmonization. European financial markets were opened to world competition, without fully harmonizing at the regional level. Implicitly, the hope of several countries was that they could build up their own financial center to become the regional center. This was a natural approach because market structures and regulations differed significantly from one country to another. In particular, the financial markets on the continent were smaller and in many ways different from London. As it turned out, even though the UK did not adopt the euro, financial integration and the

monetary union benefited London. As a consequence, while it was initially seen as a strategic instrument to promote domestic markets, non-harmonization came to be seen as an impediment to build a center able to take on London and the other major centers around the world. East Asian countries are following a similar track; there is no reason to doubt that they will eventually reach the same conclusion.

4. Asian Currency Unit[11]

4.1. Origins

One way or another, the Chiang Mai and Asian Bond Market initiatives are designed to foster currency stability. The CMI is meant to provide a collective line of defense against currency turbulence; the ABMI aims at reducing currency mismatches and at building deep and resilient markets, which should reduce both the frequency and impact of financial disturbances. Yet, neither initiative directly promotes monetary cooperation in contrast to the ERM, and *a fortiori* EMU. In many ways, the Asian countries have focused on treating the symptoms, not the cause of currency instability.

Aware of this limitation, the ASEAN+3 countries agreed in 2006 to explore steps to create regional currency units (RCU), whose contents remain to be specified. This agreement was preceded by a proposal for the creation of an Asian Currency Unit (ACU). The proposal was developed by the Asian Development Bank and a number of Japanese economists, among them Mori, Kinukawa, Nukaya and Hashimoto (2002), Ogawa (2006), and Ogawa and Shimizu (2006).

4.2. ACU Arithmetic

Both the ADB and Ogawa (2006) define the ACU or Asian Monetary Unit (AMU) as a basket of the thirteen currencies of the ASEAN+3 member countries weighted by their relative importance in terms of GDP, trade volume, population, and the degree of capital account liberalization.[12] These definitions are directly borrowed from the European

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[11] As noted in chapter 1, facing objections from some members, ASEAN+3 has discontinued the study of feasibility of introducing an ACU. However, an in-depth examination of the ACU remains worthwhile as it helps gauge the scope of exchange rate policy cooperation and the prospect of monetary unification in the region. It also points to lessons that ASEAN+3 can learn from the European experience.

[12] The unit of account is variously referred to as ACU or AMU. We use these denominations interchangeably.

Currency Unit (ECU).

In Ogawa (2006), the 13 ASEAN+3 currencies are weighted by their relative GDPs valued at purchasing power parity (PPP) and by total trade volumes (the sum of exports and imports). In order to reflect the most recent trade relationships and economic trends, Ogawa uses the averages of these variables for the most recent three years for which data are available. The value of the AMU is then quoted in terms of a weighted average of the two major international currencies – the US dollar and the euro. The weights are the shares of the US and the Euro area in total trade of the ASEAN+3 countries, 65% and 35%, respectively. The benchmark period of the ACU exchange rate of the dollar-euro , for which the ACU exchange rate is set at unity, is chosen for a period (2000-2001) when the total trade balance of the thirteen countries with the rest of the world and the total trade balance of ASEAN+2 (excluding Japan) with Japan was close to zero. Formally, the "euro and dollar value" of AMU is:

$$E^{(\$,€)/AMU} = a\,E^{\$/AMU} + b\,E^{\$/AMU},$$

where $a = 0.65$ and $b = 0.35$, and the dollar and euro exchange rates are:

$$E_t^{\$/AMU} = \sum_{i=1}^{n} w_i E_t^{\$/i} \text{ and } E_t^{€/AMU} = \sum_{i=1}^{n} w_i E_t^{€/i},$$

where w_i is the weight of Asian currency i and $E_t^{\$/i}$ and $E_t^{€/i}$ are the dollar and euro exchange rates of currency i at time t, respectively. This, in turn, defines the dollar-euro exchange rate or currency i as $E_t^{(\$,€)/i} = a\,E_t^{\$/i} + b\,E_t^{€/i}$. The ACU exchange rate of the currency i is then:

$$E_t^{i/AMU} = \frac{E_t^{(\$,€)/AMU}}{E_t^{(\$,€)/i}} = \sum_{j=1}^{n} w_i \frac{E_t^{(\$,€)/j}}{E_t^{(\$,€)/i}}.$$

Still following the ERM divergence indicator, Ogawa defines the AMU Nominal Deviation Indicator (NDI) for currency i at time t as:

$$NDI = \frac{E_t^{(\$,€)/i} - E_0^{(\$,€)/i}}{E_0^{(\$,€)/i}} \times 100,$$

which measures the percent discrepancy from the benchmark rate $E_o^{(\$,€)/i}$ observed in 2000-1.

4.3. What role for the ACU? : The ECU Experience

The ACU is initially presented as a unit of account. Much as was the case for the ECU. However, (Kuroda, 2006a, 2006b) also suggests that it could assist ASEAN+3 policy authorities in the conduct of their exchange rate policies by serving as a surveillance

indicator for regional exchange rate policy coordination in East Asia. Several proposals go further. Ogawa and Shimizu (2006) note that the ACU may serve as a common currency basket to which the ASEAN + 3 members, except Japan, could link their currencies. Kuroda (2006) considers that it could facilitate the creation of a regional market for basket bonds denominated in the ACU. It has also been suggested that the ACU could be the first step to making the yen as the anchor currency for the member states of ASEAN + 3.

These various ambitions are remindful of the many views expressed in Europe when the European Currency Unit (ECU) was established. Formally, the ECU was used as an internal accounting unit for all official transactions and accounts of the EU. The central banks did not use it in their transactions. For some advocates, the ECU was a political gesture towards monetary union. In that sense, the ECU was symbolic, just as the SDR is a symbol for a future world currency. In practice, however, there was no such official commitment.

The ECU was introduced as one of the four elements of the ERM in addition to the grid, mutual support, and a commitment to joint decision of realignments. In practice, the ECU played no particular role in stabilizing the ERM currency exchange rates, which were defined on a strictly bilateral basis (the parity grid). Although, initially, the ECU divergence indicator was expected to impose a symmetric intervention burden on weak and strong currencies to intervene, it was never really used. Market interventions were mostly carried out by the weak currency countries well before the limits of the system were reached, so that the burden was largely asymmetric. The only real lasting effect of the ECU is that when the euro became the European Monetary Union's new unit of account, its conversion rate was €1 = ECU 1, as stipulated in the Maastricht Treaty.[13]

Paradoxically, the ECU assumed a larger private role. As bilateral exchange rates became increasingly stable within the ERM in the late 1980s, private borrowers started to issue ECU-denominated bonds. Some governments followed suite and the ECU occupied a modest but nontrivial place among the main currencies used for international bond issues. Technically, it never was a currency on its own, but a basket. It is this

[13] The reason is that many private and public contractual arrangements were denominated in ECUs. The stipulation was meant to allow for a smooth continuation of these contracts, which were all redenominated from ECUs to euros.

feature that was deemed attractive: as an average of several exchange rates, the value of the ECU was generally more stable than that most of its constituent currencies, as was its rate of return.[14] The Deutsche Mark, one of the world's strongest currencies, could have offered even more stability but, as argued by Dammers and McCauley (2006), ECU instruments benefited from active restrictions on its internationalization by the Bundesbank, which (mistakenly) feared inflationary consequences. The EU did little to encourage or otherwise supported the development of the ECU bond market, which shrunk after the 1992-3 ERM crisis.[15]

4.4. ACU-Denominated Asian Basket Bonds

The view that ACU could become the "currency" of choice for Asian bonds seemingly challenges the lessons drawn from the European experience. An important difference, though, is that the advocates of Asian basket bonds, including ACU bonds, envision an active role of the public sector. Indeed, governments could issue ACU-denominated debt as could the ABF. The question is whether there exists sufficient demand for such a product. *A priori*, we would expect that if such a demand existed, private institutions would have exploited the market opportunity. Indeed, it is not difficult for investment banks or other securities firms to create and market ACU-denominated bonds, or for that matter in any currency basket. The fact it has not happened so far casts doubt on the viability of this proposal.

It may seem strange that investors do not seem to demand such instruments, which provide some desirable stability properties. In fact, they do, but they do not need synthetic currencies. They can easily hold a portfolio consisting of bonds in different currencies. Self-made diversified portfolios allow each investor greater flexibility than a basket-denominated bond. For the ACU to capture a significant market share, it should provide some advantages. The most obvious one is transaction cost saving. The weakness of basket-denominated bonds, which affected ECU bonds, is that it requires numerous currency conversion costs. To overcome this disadvantage, the ACU should become a quasi-currency, which would require a commitment by the monetary

[14] The launch in 2004 of the Bloomberg-JPMorgan Asia Currency Index is remindful of the ECU. Like the ECU it is a basket of Asian currencies, not a currency on its own. Much like the ECU assumed a life of its own as a privately created basket of European currencies, this index may develop a niche market.

[15] It can be noted that the European Investment Bank and several governments have issued ECU-denominated bonds.

authorities. This would come close to the adoption of a common currency in Asia, a step that is currently ruled out.

Another hurdle is the weakness of regulatory controls and of market infrastructure in many Asian countries. The proponents of ACU bonds must identify these restrictions and spell out how they could be mitigated before proposing a public sector involvement in the development of such a market.

4.5. The ACU as a Surveillance Indicator for Exchange rate Policy Coordination

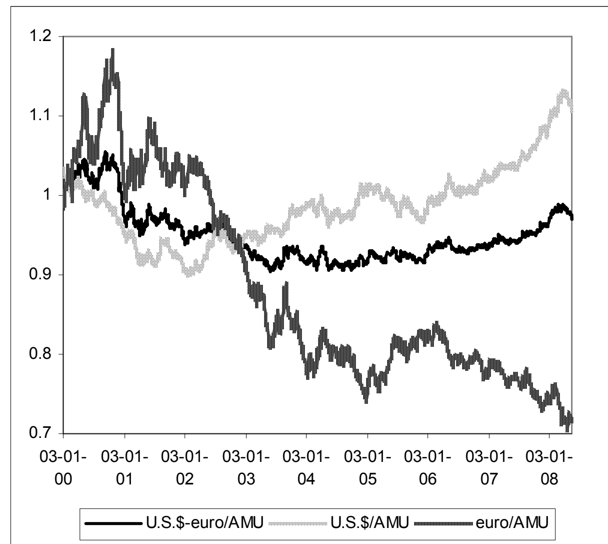
The view that, in and by itself, the ACU could strengthen exchange rate policy coordination runs counter to the European experience. In Europe, policy coordination was based on the Exchange Rate Mechanism (ERM) of the EMS, in which the ECU played no role. As noted above, even the anticipated divergence indicator turned out to be largely ignored. Policy coordination in Europe was based on explicit commitments (bilateral parity pegs, automatic and theoretically unlimited mutual support, consensus on realignments) that significantly reduced the margin for maneuver of national central banks.

The role of the ECU in monetary unification of the EU makes it clear that the creation of the ACU in and by itself will not strengthen exchange policy coordination in East Asia. What is needed for the coordination in East Asia is a collective regional exchange rate regime such as the ERM or a common basket pegging. Recent movements of some of the key East Asian currencies vis-à-vis the US dollar, the Euro (and, therefore, the ACU) illustrate this argument.

The question, then, is whether the Asian countries are willing to move to a tighter form of policy coordination. Even ignoring the deep issue of national sovereignty, the case must be made that it is desirable and possible. The recent evolution of the AMU, depicted in Figure 2, offers an interesting case study. Since early 2005, it has appreciated against the dollar while losing in value vis-à-vis the euro, with an overall appreciation vis–à-vis the dollar-euro basket defined in Section 4.2. The depreciation vis–à-vis the euro is largely explained by a weakening of the yen and by the inflexibility of the dollar-renminbi exchange rate at a time when the dollar has sharply depreciated. With sizeable surpluses, the group of ASEAN+3 countries have no reason to let their currencies follow the dollar in depreciating vis–à-vis the euro. What could they do?

Figure 2 AMU Exchange Rates

Jan.3, 2000-May 16, 2008 - Index January 2000 = 1



Source: RIETI (http://www.rieti.go.jp)

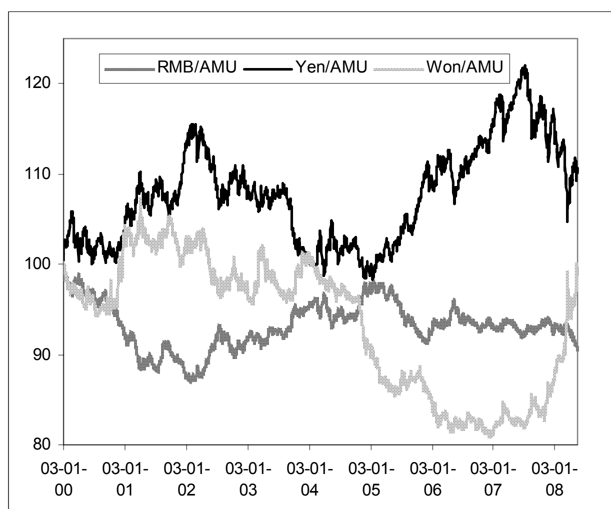
The two currencies with the heaviest weights in the AMU are the yen and the renminbi. Since the yen is freely floating, there is little chance that the Japanese authorities will explicitly try to reverse its depreciation. The renminbi it closely linked to the dollar. Strengthening the AMU then requires the other countries to strongly revalue their currencies against the dollar, but also vis–à-vis the yen and the renminbi. This would mean a serious loss of competitiveness. Regional cooperation without the two regional giants is impossible.

Indeed, so far, the reactions to the dollar depreciation have been individual. Figure 3 shows that the Korean won has strongly appreciated relative to the AMU, that the yen has strongly depreciated and that the renminbi has returned to parity after a period of depreciation. The major cause of these movements is the depreciation of the yen vis-à-vis the dollar, the renminbi and the Korean won. If China and Korea were to stabilize their AMU exchange rates for the sake of coordinating their exchange rate polices, they would have to appreciate their currencies against the dollar. If China does not let its dollar-renminbi exchange rate appreciate, Korea will have to assume an even greater burden of adjustment. More generally, countries like Korea and Thailand face an impossible challenge.

This example illustrates that the AMU cannot be used for regional and the promotion of exchange policy coordination as long as the yen remains a free-floating currency and China is reluctant to revalue its currency. Nor can AMU provide any useful guidelines to individual members of ASEAN+3 in formulating their exchange rate policies. The similarity with Europe is simply missing. By itself, the ECU did not play any coordinating role even though, excluding Sterling, all major country currencies were subject to the tight ERM agreements. Quite to the contrary, the European experience indicates that, even in the unlikely case where the three largest countries – China, Japan and Korea – were to agree to stabilize the AMU exchange rates in term of the US dollar or euro, they would have to agree beforehand to a set of rules governing intra-group exchange rate adjustments. In Europe, the ECU did not matter, ERM rules did. Similarly, for the sake of regional currency cooperation, Asia does not need an AMU or any other common nominal anchor but a collective exchange regime.

Figure 3 Exchange Rates vis a vis AMU: Yen, Renminbi and Won

Jan.3, 2000-May 16, 2008 - Index January 2000 = 100



Source: RIETI (http://www.rieti.go.jp)

4.6. The ACU as a Common Basket of Internal Currencies for ASEAN+3

The regime shift in both China and Malaysia to a basket arrangement in 2005 has underscored the need for closer coordination of exchange rate policy in East Asia. As Kawai (2002) notes, South Korea and Thailand have shifted to a de facto currency basket arrangement similar to Singapore's managed floating since the 1997-98 crisis.

The movements of both the nominal and real effective exchange rates of Indonesia and the Philippines also indicate that their currencies are linked to a basket of the currencies of their major trading partners. Practically all seven emerging market economies in East Asia – the original ASEAN 5, China, and South Korea – are now explicitly or implicitly on some form of basket arrangement.

With similar currency management arrangements and aims, it becomes easy for these countries to monitor the evolution of their respective nominal and real effective exchange rates to make sure there is no erosion in their relative export competitiveness. If any one of them lets is currency weaken vis-à-vis the dollar, competitive devaluations throughout the region could follow. Undoubtedly, these seven countries have a common interest in adopting some coordination.[16]

Williamson (2005) has argued that coordination would be easier, and beneficial, if the East Asian countries were to adopt a common basket of external currencies including the dollar, the euro and the yen, rather than carrying on with different baskets.[17] However Park and Wyplosz (2004) have shown that the difference between a common basket and own-basket pegs is very limited. More convincing, perhaps, is the further argument that a common basket would help adjust exchange rates simultaneously and improve the chance for cooperation on monetary integration in the long run.

This view is shared by Ogawa and Shimizu (2006) as they propose the AMU. In their mind, however, Japan would not peg to the common basket and the yen would remain a free floating currency. Obviously, the yen would still play a dominant role in the evolution of the ACU (especially if the weights are calculated in terms of the nominal GDP instead of PPP-adjusted GDP, as the ADB currently does). With the yen in the basket, a great deal of variations of the ACU vis-à-vis the dollar and euro would result from changes in the dollar-yen or the euro-yen exchange rates. Most of the changes in the ACU exchange rates of the twelve countries of ASEAN+3 will also be caused by

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16 With a new regime in place and its growing economic influence in the region as leverage, China may be in a position to initiate the discussion on the coordination of exchange rate policies among the seven countries.

17 Several Japanese economists have also advocated similar arrangements for East Asia's emerging economies. See Kawai and Takagi (2000), Kawai (2002), and Ito and Ogawa (2002). These economists now argue that the ACU is a more appropriate common basket for ASEAN+3.

changes in their bilateral exchange rates against the yen, as has been the case in recent years. The other members may then ask why the yen, which will increase the variability of the ACU against the dollar and euro as well as that of their ACU exchange rates, should be included in a common basket to be chosen for exchange rate policy cooperation.

If Japan cannot or does not want to give up its free floating status, the ACU would have to be based on the currencies of the ASEAN+2. Given the size of China, such an ACU would be dominated by the renminbi. The renminbi would then become the regional anchor currency and the common currency peg would be *de facto* a renminbi bloc. Given China's relatively restricted financial markets and heavy currency management, a renminbi bloc is unlikely to meet the economic needs of the other member countries. In addition, the ASEAN plus Korea will find it politically unacceptable to join a renminbi bloc.

In theory the common pegging to the AMU may serve as a mechanism for internal exchange rate adjustments among the ASEAN+3 members if Japan forgoes its free floating status. But even in this case, it is highly uncertain whether the member countries would be able to agree to a complicated and elaborate mechanism of the kind in place in Europe's ERM. Indeed, one lesson from the European experience is that common pegging requires mutual liquidity support, especially when trade imbalances differ from country to country, as is the case within ASEAN+3. In the end, the creation of a regional currency unit as proposed by ASEAN+3 will mostly be a symbolic gesture that the ASEAN+3 member states are committed to monetary cooperation and integration in East Asia as a long run objective.

5. Conclusion

Why then, in spite often stated intentions to achieve greater monetary and financial integration, Asia has not so far progressed as far as Europe? One reason, obviously, is that it started later. Other reasons are political and institutional, as developed in Wyplosz (2003), but as important are economic considerations. Since 1945, at least on the continent, European policymakers have been driven by two unshakable convictions, born of history: 1) that deep trade relationships are the key to establish and preserve peace; 2) that monetary disorders – as those of the interwar period – represent the biggest challenge to trade. This explains both why the Common Market, now deepened

into the Single Market, is non-negotiable and why it has been the key driver of Europe's monetary integration.[18]

As previously explained, policymakers have considered that intra-European trade cannot flourish if internal exchange rates are volatile. In that sense, European monetary integration is inward-looking. In Asia, the aim has long been outward-looking. Officially, ASEAN+3 members too intend to stabilize bilateral exchange rates while collectively floating against the dollar and euro. In this sense they are trying to emulate the European model of monetary integration as reflected in their interest in introducing the ACU. Yet, at least until recently, the export promotion strategy has long focused East Asian policymakers on trade with the rest of the world chiefly the US and Europe. Thus, while they share the European view that exchange rate stability is important for trade, Asian policymakers have thought of stability vis-à-vis the dollar first, and the euro next.

As long as they mostly worry about each other's exchange rate mostly because of competition for access to markets outside the region, the inward-looking approach followed in Europe is ill-adapted to their strategic vision. Things may be changing, though. As they catch-up to the technology frontier, the Asian countries will become less dependent on export promotion; the evolution of Japan is a point in case. As their income levels grow, intra-regional trade will become more intense. In fact, they now trade nearly as intensively among themselves as the EU countries do. Crucially, China has become the largest export market for all East Asian economies and it is only a matter of time until this is the case for Japan as well. As the world's fastest growing region, the Asian market is already attracting increasing attention in the rest of the world. The proximity advantage – strongly captured by gravity trade equations – suggests that intra-East Asia trade is likely to become increasingly important. The reduced link to the dollar (or the euro) – China is the only country rigidly pegging to outside currencies – is an indication that, indeed, things are changing. The various initiatives discussed in this chapter, most of which are partly at least inspired by the European example, reinforce that impression.

Meanwhile, as the domestic financial markets further integrate into world markets,

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[18] It also explains why the UK has been a half-hearted actor of the economic and monetary integration process. For many years, Britain looked to the US as its main trade partner. After it finally joined the EU, the UK did not buy into the argument linking trade and exchange rate stability.

increasing returns to scale will encourage the development of one or more large markets in the region. These markets will not be regional, but a key segment of the worldwide network. Mergers with far away markets, similar to the Euronext-NYSE merger, are likely to happen along the way. This will be competitive process, which the monetary authorities will not be able to influence.

Does this mean that the various efforts currently under way are useless? Most definitely not. Developing financial markets in local currency is part of the development process and stabilizing exchange rates is helpful for trade reasons and to reduce the odds of a crisis. Developing a common line of defense against market turbulence also makes sense. These are more modest goals than those often stated as a justification for financial cooperation. The problem is not with currently unrealistic goals. The problem is that these goals may be seen as justifying public interventions where none is needed while delaying badly needed domestic reforms.

Chapter 4
Europe and Cooperation in East Asia

Most East Asian countries are actively pursuing economic integration within the world economy. They do so at two levels: regional and global. Is this strategy possible? Europe, for instance, has clearly first worked toward regional integration, raising sometimes fears that it would become a "fortress", but then it moved towards global integration. In fact, each step of regional integration was soon followed by similar steps toward global integration. While Europe took a sequential approach in which globalization followed regional integration, East Asia is embracing a dual approach in which both regional and global integration are pursued simultaneously. The dual approach is entirely possible, but the previous chapters have amply shown that East Asia is finding that the lack of multilateral agreements creates conflicts between regional and global integration.

Pulling together the analyses presented earlier, this chapter examines these issues in more detail. It starts by revisiting the differences between the integrative efforts of Europe and East Asia with a view to clarifying the many issues raised by the recent East Asian experience.

1. Differences and their Implications

1.1. Motivation

Efforts at integration in Europe did not start in 1945. For a long time, this idea was pursued with the sword, be it under the Roman Empire, Charlemagne, or Napoleon. Peaceful integration, in fact integration for peace, too has a long intellectual tradition. Many of the 18th century philosophers – Kant, Leibnitz, Rousseau, to name a few – openly called for both democracy and European integration. A Pan-European movement, dedicated to the creation of the United States of Europe, was created in 1923. There has been no similar intellectual movement in East Asia where regional economic integration has only become of interest in the wake of the 1997-98 crisis. It was then felt that the

crisis could have been avoided, or dealt with more easily, had a European-type of common protection system been put in place. The ongoing subprime crisis may give an added impetus to regional integration. Peace and prosperity for Europe, protection from external turmoil and unwanted IMF influence for East Asia, motivations cannot be more different.

Motivation matters a lot because integration, or even just coordination, requires some loss of national sovereignty. Under the Exchange Rate Mechanism, for instance, member countries could change their exchange rates but, to that effect, they had to request a meeting of all Finance Ministers and the new parity had to be agreed upon by every one of them. Countries only give up sovereignty when they see a serious, long-lasting benefit. In Europe, regional economic integration has been perceived as the condition for achieving peace and prosperity; the ERM was seen as one element of that ambitious strategy.

East Asian countries may be reluctant to build up an ERM-style mechanism only because they remain mainly concerned with avoiding currency and financial crises. They also face the structural problem arising from the diversity of currencies that include a free floating currency (yen) and a currency of a country pegged to the US dollar (RMB); this makes it almost impossible to build an ERM. As each country accumulates a stockpile of foreign exchange reserves, self-insurance is seen as an alternative to mutual co-insurance, as initiated via the CMI, and one that fully preserves national sovereignty. It may be interesting to note that Europe started with a reserve pooling scheme, the European Payments Union, to deal with convertible currency – in practice, the US dollar – shortages in the aftermath of the war. Although this scheme ended up being little used, it was an early exercise in monetary coordination. Another scheme, described in Chapter 3, the European Monetary Cooperation Fund did not deliver on its promises either, but this failure acted as an incentive to adopt the very tight cooperation mechanism of the EMS. Thus, while CMI may not turn out to have been used, it may serve as a forum for regional cooperation for financial integration and exchange rate and other policies and hence a confidence-building step. In the end, however, the issue is not whether reserves pooling is still needed, but whether ASEAN+3 wants to stabilize their bilateral exchange rate. The answer, so far, has not been positive.

Motivation also matters because any integration movement needs to be supported by public opinion. The lack of grass-root integrationist movements suggests that there is no

popular support in East Asia for regional integration. Nor is there political leadership for that matter. Under these conditions, governments know that they will have to demonstrate tangible advantages from any measure that limits sovereignty. In Europe, at least until fairly recently, it was enough for political leaders to mention "European construction" to justify new binding agreements.[1] Still, the very recent evolution and the perception that East Asia is becoming less dependent on the US and European economies than before may change the situation, although according to the ADB (2008) this idea of decoupling is no more than a myth. If the region is more stable and more successful than the US and Europe, some may ask, should it not reorient its integration strategy?

1.2. Diversity

Regional integration in Europe was initiated by a small number of countries that shared similar standards of living, including war devastation inflicted upon one another. Although there were differences in size, all were committed to democracy, shared a common majority religion and a long history of cultural exchanges. The situation in East Asia could hardly be more contrasted. Difference in standards of living and level of development are overwhelming, although declining. The region includes one economic giant and one population and military giant, which is also a nuclear power. The other countries are either medium sized or small on all economic dimensions. The region also includes economically-advanced city states (Singapore, Hong Kong SARG) and a country that is not recognized as an independent nation (Taiwan).

Diversity in the level of development matters because the gains from economic integration are not different from those that can be attained through global integration. It also means that financial development is highly unequal; this is reflected in the level of financial deepening, the quality of regulation and supervision, and the degree of market liberalization, a crucial element in any integrative effort. The EU is also faced with a potentially serious diversity problem as the result of recent (2004) expansions. It has already led to difficulties but these mostly relate to transfer mechanisms that were designed for a more homogeneous group of countries.

[1] Even during the 2005 referendum campaign that led to the rejection by France and theNetherlands of the Constitution Treaty, opponents never argued against "European construction". Some of them alluded instead to the existence of a Plan B.

The lesson here is that more heterogeneous East Asian countries would be well inspired to avoid any (explicit) redistribution mechanism. It might seem otherwise. Indeed, it could be argued that, since limited grassroot support at the national level prevents political leaders to make the concessions inherent in any integration process, transfers might give the project a good name. After all, for a while transfers have helped build up popular support for EU integration, especially in the new member states once they shifted from central planning to a market economy. Transfers, however, must be financed. Citizens may well consider the costs alongside the receipts. They are likely to support redistribution as long as it is seen a collective insurance mechanism. This played well in Europe when the member countries were sufficiently homogeneous to make it likely that there would not be permanent beneficiaries and net contributors.[2] As the EU expanded and heterogeneity set in, redistribution has become a major irritant. With such a heterogeneous group as ASEAN+3, collective insurance is likely quite to be more divisive than cohesive.

Diversity in size can be crippling. Europe has long been dependent on a Franco-German leadership, grudgingly tolerated by the other initial four founding members because it was, at times, efficient. This leadership has become less acceptable as the EU expanded, but solid institutions are now in place. In East Asia, the equivalent leadership would have to be exercised jointly by China and Japan. Obviously, this cannot happen as long these two countries, with different political regimes, see themselves and each other as historical competitors. Regional integration could be pursued by the other countries but the incentives to abandon some elements of sovereignty would be low since China and Japan account for about 80% of the region GDP. In Europe, the smaller countries among the initial founders created a loose union (Benelux) that was mostly symbolic but acted as a very energetic promoter of the Common Market. Their involvement also made it easier to two long-time foes to get together. ASEAN could play the mediating role a la Benelux in East Asia, but to do so it has first to achieve deeper integration among its ten members. Integration within ASEAN has been painfully slow for the very same reasons that have plagued integration efforts among the ASEAN+3 members. Korea too may have a role to play, as we further discuss below.

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[2] This is not quite true. For historical reasons, Germany undertook to be a net contributor. It is not clear whether one East Asian country is willing to play that role and, it does, whether this would be acceptable to the others.

1.3. A Different World

When Europe embarked on its regional integration path, world trade was limited, hampered by widespread protection, and financial markets were small and rudimentary outside of the US. World integration meant integration with the US, which was significantly richer and initially more a protector than a partner. The only meaningful economic integration process was within Europe. Today, East Asia faces a real choice between global and regional integration. In fact, it chose long ago global integration. As mentioned above, the only reason why regional integration is at all on the agenda is the untested perception that East Asia would have fared better during the 1997-8 crisis had its countries been able to provide mutual insurance. This perception is now gradually being has superseded by the pursuit of regional welfare and stability by way of creating a number of regional arrangements such as the CMI and the ABMI.

The motivation of mutual insurance may resurface in the wake of the crisis triggered by the subprime debacle. The perception that East Asia is decoupling provides a natural justification for regional integration where China is the hub. Intra industry regional trade integration is proceeding even without regional cooperative efforts. De facto, we may witness the emergence of a greater Chinese economic area that includes Hong Kong, Singapore, and Taiwan. Other ASEAN states will then join in whether they like it or not. This leaves Japan and Korea in limbo.

2. Scope for Economic Integration in East Asia

Clearly, the East Asian countries are not seeking to create a customs union, much less a common market, nor is a currency union likely to be achieved in the foreseeable future. By intention or not, ASEAN+3 will be pursuing global instead of regional financial integration if its members manage to open their financial systems as part of implementation of the ABMI. So, what are the ultimate goals of regional integration? How can regional integration be defined in the context of East Asia? We look at different measures.

2.1. Trade

Regional trade integration is not just an objective, it is a fact; and it is mostly driven by market forces. On many dimensions, trade integration is as intense in East Asia as it is Europe, if not more. This can be seen from Table 1, which reports bilateral trade intensity indices over 1999-2000 and 2005-2006 and Table 2, which presents trade shares. The intensity of trade with China has increased for every region except the EU.

On the other hand, each region has become less intense for China, which has therefore been able to diversify its trade links. A similar pattern is seen for East Asia's ten emerging market economies but the comparison with EA 8, which excludes China and Japan, reveals that China is the driving force behind East Asia's growing trade importance. In contrast, Japan is generally losing ground. Similar indications are given by other measures (see Eichengreen and Park 2005).

Table 1 Bilateral trade intensities

Country/Region	China		Japan		EA 8		EA10		US		EU-25	
	1999-2000	2005-2006	1999-2000	2005-2006	1999-2000	2005-2006	1999-2000	2005-2006	1999-2000	2005-2006	1999-2000	2005-2006
China	-	-	0.16	0.12	0.28	0.27	0.46	0.42	0.15	0.14	0.16	0.15
Japan	0.10	0.17	-	-	0.28	0.26	0.38	0.44	0.27	0.18	0.13	0.13
EA8	0.13	0.18	0.09	0.08	0.17	0.16	0.39	0.42	0.15	0.10	0.14	0.13
EA10	0.10	0.13	0.08	0.06	0.22	0.24	0.40	0.43	0.22	0.13	0.15	0.14
US	0.05	0.11	0.11	0.07	0.14	0.11	0.31	0.30	-	-	0.18	0.17
EU-25	0.04	0.03	0.03	0.02	0.05	0.03	0.12	0.08	0.08	0.06	-	-
World	0.04	0.09	0.05	0.06	0.10	0.13	0.20	0.28	0.14	0.14	0.34	0.43

Source: Direction of Trade, IMF

Notes: For each country or region indicated in the first column, the trade intensity index measures trade with another country or region relative to its total world trade, where trade is the sum of exports and imports.[3] EA 10 includes the original ASEAN 5 (Indonesia, Malaysia, the Philippines, Singapore and Thailand) plus China, Japan, Korea, Hong Kong and Taiwan. EA 8 is EA 10 less China and Japan.

[3] Formally, trade intensity of country or region i with country or region j is $\frac{x_{ij} + m_{ij}}{X_i + M_i}$ where x_{ij} denotes total nominal exports ($ value) from country i to region j and m_{ij} denotes total nominal imports ($ value) from region j to country i, and X_i and M_i denote country or region i's global exports and imports, respectively.

Table 2 Trade shares

Country/ Region	China		Japan		EA 8		EA10		US		EU-25		Others	
	1999-2000	2005-2006	1999-2000	2005-2006	1999-2000	2005-2006	1999-2000	2005-2006	1999-2000	2005-2006	1999-2000	2005-2006	1999-2000	2005-2006
China	-	-	16.7	10.2	30.9	29.7	47.5	39.8	21.2	21.2	16.4	18.8	14.9	20.1
Japan	6.0 [1)]	13.9 [2)]	-	-	32.4	32.7	38.4	46.6	30.5	22.8	17.5	14.5	13.6	16.0
EA8	11.2	20.7	10.6	8.6	26.4	26.4	48.1	55.7	21.7	14.5	15.5	13.4	14.6	16.4
EA10	8.1	13.2	8.3	7.2	28.8	28.7	45.2	49.1	24.2	18.2	16.2	15.2	14.4	17.4
US	2.0	5.0	8.4	5.9	14.3	12.5	24.6	23.4	-	-	22.1	20.6	53.3	56.0
EU-25	0.9	1.7	1.7	1.3	3.4	3.0	6.1	6.0	8.8	7.7	-	-	85.1	86.4
Others	1.0	2.7	3.0	3.3	4.0	4.9	8.0	11.0	19.2	16.7	72.8	72.3	-	-
World	2.6	8.4	4.2	6.4	10.0	17.5	16.8	32.3	15.0	22.2	32.3	56.0	35.9	61.7

Source: Direction of Trade Statistic, IMF, Bureau of Foreign Trade, Taiwan

Notes: (1): 1999-2000 average: (2) 2000-2006 average. See notes to Table 2.

Given the diverse stages of development in the region, as important is the pattern of trade exchanges. According to Urata (2006), much of the large increase in intra-regional trade since the early 1990s consists of trade in parts and components of the manufacturing sector. This would indicate a shift from the horizontal to the vertical form of trade in manufacturing. Thus, the pattern of trade would not just be of the intra-industry variety, it would increasingly be intra-firm. The implication is that East Asian firms use East Asian trade to raise their competitiveness on global markets. Put differently, regional trade integration is, partly at least but increasingly so, a vehicle toward global trade integration. This contrasts with the opposite view about causality, namely that intra-regional trade in Asia is a consequence of the emergence of global production chains.

Urata (2006) also shows a changing geographic pattern that reflects China's emergence as the dominant regional economy. East Asia's reliance on the Chinese market increased at the same time as the share of Japan in total trade of all other East Asian economies declined. On the other hand, China's trade with other East Asian economies declined from 60.5 percent of its total trade to 45.3 percent. In other words, China is becoming more important to East Asia while East Asia is becoming less important to China.

2.2. Foreign Investment

As shown in Tables 3 and 4 there has been a marked increase in inflows and outflows of foreign direct investment (FDI) in East Asia from and to the rest of the world since the early 1990s, even though not all countries are equally integrated on that dimension. IN some cases, FDI inflows have declined after the crisis but, generally, the 2006 figures

(for just one year, i.e. one fifth of the other subperiods) indicate a rebound. China has accounted for the lion's share of FDI inflows since the early 1980s as it has successfully sought to rely on FDI as sources of financing, technology, and marketing know-how in promoting an export-led development strategy. The emergence of China as a major and fast-growing trading country has led to a large increase in intra-firm trade; this may explain some of the increase in foreign direct investment in East Asia. In general it appears that FDI has facilitated the expansion of intra-regional trade in East Asia.[4] Much as little progress has been achieved toward free trade in the region, ASEAN+3 has avoided even the discussion of liberalizing cross-border FDI. And, as for trade, the increase in FDI flows has been driven by market forces.

Table 3 FDI Inflows in East Asia (US$ bn.)

	70-80	81-85	86-90	91-95	96-00	01-05	2006
Korea	1.1	0.7	3.4	4.3	28.6	27.9	5.0
China	0.1	5.0	14.6	114.2	213.5	286.2	69.5
Hong Kong	3.4	5.5	18.4	25.9	123.1	114.7	42.9
Taiwan	0.8	0.9	4.9	6.0	12.2	9.5	7.4
Japan	1.5	1.7	1.6	5.2	27.7	32.4	-6.5
ASEAN	15.1	15.7	34.9	91.5	139.4	139.5	51.5
Brunei	0.0	0.0	0.0	0.6	3.2	5.6	0.4
Cambodia	0.0	0.0	0.0	0.3	1.1	0.9	0.5
Indonesia	4.7	1.2	3.0	11.7	4.2	6.8	5.6
Lao PDR.	0.0	0.0	0.0	0.2	0.3	0.1	0.2
Malaysia	4.2	5.4	5.9	25.3	24.0	14.8	6.1
Myanmar	0.0	0.0	0.3	0.9	2.7	1.2	0.1
Philippines	0.9	0.9	2.7	5.6	8.0	4.8	2.3
Singapore	4.2	6.7	16.7	31.9	63.8	69.3	24.2
Thailand	1.0	1.4	6.1	9.4	23.2	28.5	9.8
Viet Nam	0.0	0.0	0.2	5.5	8.9	7.6	2.3

[4] FDI could in theory replace or increase exports to the same market because of the presence of substitution and complementary effects. Most of the empirical work in this area almost invariably shows that a complementary relationship between exports and foreign production dominates. Lipsey and Weiss (1981), Graham (1996), and Kawai and Urata (1998) find that affiliates' sales are positively correlated with exports and foreign production. In particular, using Japanese manufacturing firms, Lipsey, Ramstetter and Blomstrom (2000) find that parent companies' exports from Japan to a foreign region are positively related to production in that region by the affiliates of that parent. A vertical production relationship is another way that complementarity may occur. Investment by manufacturer may increase exports of inputs to the host market. Kawai and Urata (1998) show that there are two important factors driving complementarities: demand complementarity and complementarity from vertical relationships.

Table 4 FDI Outflows in East Asia (US$ bn.)

	70-80	81-85	86-90	91-95	96-00	01-05
Japan	18.4	25.5	160.4	103.6	127.9	176.1
China	0.0	0.9	3.6	13.3	10.0	30.0
Hong Kong	0.1	2.7	11.4	75.2	146.6	107.2
Korea	0.1	1.0	4.0	10.0	23.1	17.4
Taiwan	0.1	0.2	17.1	12.3	24.0	29.2
ASEAN	0.9	2.2	5.0	30.2	49.5	56.6
Brunei	0.0	0.0	0.0	0.3	0.1	0.1
Cambodia	0.0	0.0	0.0	0.0	0.0	0.0
Indonesia	0.0	0.0	0.0	5.8	1.0	7.0
Lao PDR.	0.0	0.0	0.0	0.0	0.0	0.0
Malaysia	0.2	1.2	1.18	6.2	10.8	8.6
Myanmar	0.0	0.0	0.0	0.0	0.0	0.0
Philippines	0.1	0.2	0.1	0.9	0.7	1.0
Singapore	0.6	0.7	3.4	15.4	34.9	38.1
Thailand	0.0	0.0	0.4	1.9	2.0	1.8
Viet Nam	0.0	0.0	0.0	0.0	0.0	0.0

Source: UNCTAD, online database.

2.3. Financial integration

East Asia has a long way to go before reaching the level of financial integration achieved in Europe, which has benefitted from the adoption of the common currency. Financial claims are all denominated in US dollars and the bulk of foreign lending and borrowing are intermediated through international financial markets in New York and London. Although five years have elapsed, the objectives of financial integration through the promotion of the ABMI have not been fully articulated. Nor has there been any discussion of linkages between the regional financial markets that ASEAN+3 members are trying to develop and global financial markets. As pointed out in the 2005 progress report on the ABMI (ASEAN+3, 2005), the goal of the ABMI is to mobilize regional efforts for the improvement of efficiency and liquidity of domestic bond markets of individual countries of East Asia for more efficient allocation of resources in and diversification of bank-based financial systems of the region.

If indeed this is the goal, domestic financial deregulation and opening should be the critical component of the most desirable roadmap for the ABMI. Market liberalization and opening would increase the supply of high quality local currency bonds and facilitate cross border investments in the region. Market liberalization and opening will

not, however, be sufficient unless it is complemented by (i) building regional financial market infrastructure that includes a regional system of clearing and settlement, regional credit guarantee institutions, hedging facilities, and regional credit rating agencies is also constructed and (ii) harmonizing legal and regulatory systems, domestic clearing and settlement systems, market practices, rating standards, accounting and auditing practices, and withholding taxes in the region. For the past five years, the ASEAN+3 countries have directed much of their cooperative effort to the former while largely setting aside the latter.

Once fully open, East Asian regional markets are bound to be integrated into international financial markets. If correct, this observation does not correspond to the ASEAN+3 countries' intention of creating self-contained regional bond markets. This is why planners of the ABMI might wish to redirect their efforts toward creating efficient regional financial centers that can compete with other global centers in Europe and the US. In the market oriented approach to financial integration, those countries that succeed in fostering liberalized and open financial systems with well-developed financial infrastructure will then emerge as regional trading centers. In fact a number of countries in the region have been competing for hosting a regional financial center, but few are willing to pay for the cost of building the requisite regional market infrastructure and to promote deregulation of cross border trade in financial instruments in the region. As the ABMI has been a response to the 1997 crisis official interest into financial integration appears to be losing steam now that the fear of new crises has receded and member countries have erected their own defense system,

ASEAN+3 policymakers realize that financial integration is mostly carried out by the private sector, provided national regulation and supervision is up to international standards (ASEAN+3 2008). Indeed, skeptics have long argued that ABMI is unlikely to be effective unless domestic markets are adequately reformed, in which case the initiative may prove to be redundant. This view is in line with the European experience. Prior to the introduction of the euro, financial integration occurred not as the result of official integrative efforts – even though many official initiatives have been taken[5] – but when restrictions to the free flow of capital were removed, which then led to an

[5] We can mention the Single European Act of 1986, which established the single market, including for financial services. Disappointing results led to adoption in 1999 of the Financial Services Action Plan, whose effects are yet to be found significant.

upgrading of regulation and supervision legislation and practices.

Much the same applies to the emergence of financial centers. London emerged as Europe's leading center and competitor to New York after its Big Bang reform in 1986 and the development of a market-friendly regulatory framework. East Asia already includes two financial centers, Hong Kong and Singapore, which are growing in size by becoming the regional outposts of major international financial institutions. Shanghai and Tokyo are vying for the position of a future autonomous regional center.

All in all, financial integration is bound to increase, mostly spontaneously once various non-trade barriers are removed. Yet, it is unclear whether the regional dimension will be privileged, and whether it should be.

2.4. Trade in financial services

In East Asia, as in Europe, trade in financial services has not taken off as much as trade in goods. It could definitely become another component of economic integration in Asia. With the Asian bond market initiative, the authorities have signaled their intention to generally favor further integrative steps in this area. As we argue in Chapter 3, the ABMI is hampered by limited progress in improving the performance and opening of national financial markets. This does come as a surprise once we look at the evolution in Europe.

Despite many efforts recounted in Chapter 1, trade in services in general, and in financial services in particular, remain limited in Europe as a result of powerful protectionist activity. This raises the question of why the services industry has been able to achieve protection while the other industries did not. One reason is that many services were not considered as tradable until the IT revolution changed the situation. The high political priority of establishing a common market in the 1960s had pushed aside protectionism in traditional industries – in fact it all started in 1952 with the Coal and Steel Community at a time of scarcity. By the 1990s, when financial services became tradable, politics had changed and powerful lobbies were in place. Still, insurance is gradually becoming an integrated market because large companies have started to acquire smaller companies in other countries.

2.5. Trade, Financial and Monetary Integration: the Causal Nexus

Trade integration may have important implications for policy cooperation and monetary

integration in the region. Intra-industry trade seems to be quite sensitive to price competition, which favors reduced transaction costs and transparency, both of which are made easier when exchange rates are stable. In addition, following Frankel and Rose (1998), one could argue that the expansion of intra-industry trade, in particular of the vertical type described above, would lead to a higher correlation of business cycles among the East Asian economies. A high correlation of economic activity, reflecting a reduction in the incidence of asymmetric shocks, is a key pre-condition to move first to a situation where monetary policies become more uniform and then, maybe, to adopt a common currency. Regional financial integration embodied in the ABMI and CMI can be reinforcing each other in integrating financial markets and forging monetary cooperation in East Asia. To the extent that the CMI can serve as a forum for stabilizing bilateral exchange rates in the region, it will facilitate financial market integration as it will reduce exchange rate risks.

For the past seven years, ASEAN+3 has concentrated its efforts on building a liquidity support system under the CMI process, although most member countries are not likely to need it in the near future. However, to many outsiders and market participants, the emphasis on consolidating regional cooperation for liquidity provision may be seen as no more than mapping out a common ground on easily agreed upon issues. Much the same applies to the development of domestic and regional bond markets through the ABMI process. But instead of addressing the core issue of market reform in the region, ASEAN+3 policymakers have diverted too much attention and resources to issues such as diversifying products and creating regional financial market infrastructure.

Yet, intentionally or not, through Free Trade Agreements (FTAs) and the CMI and ABMI, the ASEAN+3 member states may be following a strategy leading to regional monetary integration while seeking global trade and financial integration. Few East Asian policymakers would be naïve enough to believe that they will be able to work out an agreement on creating an Asian monetary fund or a common currency area in the near future. Under any plausible circumstances, monetary unification is at best a long-term objective. Now that ASEAN+3 is dropping the ACU from its research agenda, monetary integration in East Asia appears to be relegated to low priority on the integration agenda. In that respect, the analysis presented in Chapter 3 indicates that the parallel with Europe can be misleading.

2.6. Globalization: A Building Block or a Stumbling Block?

ASEAN+3 member countries are pursuing consciously or unconsciously at the same

time global and regional integration. FTAs, which have multiplied in recent years, and the initiatives of ASEAN+3 countries in matter of financial integration such as the ABMI, are not bound by membership or geographical contiguity. For instance, Korea is on the verge of concluding FTAs with both the US and the EU. It is not clear what it means for Korea's trade and financial relationship with the other countries of the group. It is not even clear whether there is a thought-through strategy behind such an evolution or whether it is driven by distinct bureaucracies within the administration. Even if the dualism of regional-global integration is not inconsistent in implementation, it may weaken regional solidarity and could lead to conflicts of interest possibly slowing down the development of regional institutions for economic integration in East Asia.

In the case of Europe, regional integration preceded and then spurred global integration. The widespread domestic public support for the common market helped to defeat protectionist resistance. Enhanced competition within Europe led to the gradual emergence of powerful firms eager to export outside of Europe. Where liberalization failed at the EU level, for example in the services sector, it also failed at the global level. East Asia proceeded in the opposite direction, starting at the global level and then modestly seeking regional integration. One could imagine that the same dynamic seen in Europe could also work in East Asia in the opposite direction. One possible reason why this is not happening easily is that East Asia's integration into the world economy relied much more on export promotion than on opening the domestic markets to foreign imports. Another possibility is that East Asian countries consider each other as competitors on third markets.

Viewed this way, it is not surprising that there has never been any serious discussion of creating a single market among ASEAN+3.[6] Instead, some of the members have been actively searching for FTA partners from outside of the region. East Asia should change tack and start emphasizing regional trade by placing more emphasis on trade integration in view of the European experience. At present, ASEAN has established an FTA with all three Northeast Asian countries and is negotiating with the European Union. Strange as it may appear, ASEAN has become a hub, albeit a small one, and China, Japan, and Korea spokes. Such a structure is inherently unstable unless the spoke countries also agree to similar trade arrangements among themselves.

[6] ASEAN+3 countries have endorsed a plan to achieve a common market by 2025.

As we noted, trade integration is under way but driven by China's development. But, given the difference in size, structure and political systems, there is little that can be done other than spontaneous integration into a big China area. The smaller countries, outside China and Japan, could consider developing closer ties, but they are bound to increasingly depend on China. Even if they were to develop on common market, it would always be on second order of importance. On the other hand, the situation may change if Korea and Japan conclude their on and off negotiations for a FTA. At the current exchange rate the size of the Chinese economy is less than a half of Japan. If Korea succeeds in forming an FTA with both the US and EU, a Korea-Japan FTA could emerge as a regional hub that can be comparable in terms of size and influence to the China hub.

3. Politics and Geography

3.1. China and Japan: Collaborators or Rivals?

As France and Germany did in Europe, China and Japan hold the key to orderly economic integration in East Asia. If the European experience is any guide, financial cooperation and integration in East Asia needs to begin with regional institution building, which in turn calls for a regional leadership that can set forth common objectives, inspire a spirit of cooperation and mediate divergent interests between countries. The wide difference in economic, political, and military standings between the two countries suggests that, even if they come to reconcile their troubled past, they may find it difficult to work together as equal partners in managing regional affairs in East Asia.

In fact, China and Japan currently are more competitors than collaborators. Their interests differ, as do their strategies toward economic integration in East Asia. Japan has long been the largest and most successful economy in the region, often seen as a role model. Its highly disappointing performance since the early 1990s has obviously eroded its clout. Long absent, China has emerged as an active player in both the international and regional arena since the mid-1990s. It 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, stability, and creating a new international political and economic order.

Yet, while China is emerging as the new economic power in the region, its interests are

not limited to East Asia. It shares a border with Russia and many other South Asian and Central Asian countries in addition to the several ASEAN members. Therefore, it is natural for China to seek expansion and diversification of trade and financial relations with those neighboring countries. China approached ASEAN for its first free trade agreement. In November 2001, it joined the Bangkok agreement on a free trade area that includes Korea and the South Asian countries (Bangladesh, India, Laos and Sri Lanka), and also signed with Russia the Treaty of Good-Neighborliness and Friendly Cooperation in 2001. In Central Asia, China has also taken a leading role in establishing the region's first multilateral group, the Shanghai Cooperation Organization (SCO). The SCO founded in 2001 to settle long-standing territorial disputes and to demilitarize borders has shifted its focus to cooperation for counter-terrorism and regional trade among China, Russia, Kazakhstan, Kyrgyzstan, Tajikistan, and Uzbekistan.

China's ambiguity could help Japan, but it is finding it difficult to articulate its own strategic interests in East Asia. While it has been a leading member of ASEAN+3, its perspective on the geographical contiguity of East Asia has not been clear either. In particular Japan faces the suspicion that its participation in regional arrangements for free trade or financial and monetary cooperation in East Asia is, to some degree, motivated by its desire to contain China's expansion. Although Japan has now managed to break out of its long economic stagnation, prospects for sustained recovery remain uncertain. All of this undermines its ability to rally support for economic integration.

Divergences of view between China and Japan also emerge around a recent regional project, the East Asian Economic Summit, which was inaugurated in 2005. The Summit's broad objective is to promote economic cooperation and integration among a group of countries known as "ASEAN+6", i.e. ASEAN+3 plus three additional countries from outside the region: India, Australia and New Zealand. The East Asian Economic Summit will be convened annually together with the annual leadership meetings of ASEAN and ASEAN+3. At this stage, there is little agreement on the new group's geographic boundary and role. While China has a clear preference for the consolidation of ASEAN+3, Japan argues in favor of including these three additional countries.[7] It is sometimes believed that Japan's support for the East Asian Economic Summit is related to its unspoken strategy of curbing the influence of China in East Asia.

[7] "Dead on Arrival", the *Economist*, Dec 14th 2005.

Aside from the question of which countries should be included in the East Asian summit, the mandate of the group is rather unclear. The group may work together to build a giant free-trade area spanning most of Asia and Oceania. But, as the *Economist* (December 14th 2005) points out, "achieving consensus among such vastly different economies, cultures and political systems would be more arduous than anything encountered in regional community building elsewhere". The same article also notes that the rivalry between China and Japan would frustrate the realization of such a grand vision.

Japan's limited clout does not imply that China can assume the leadership role either. China is a major trader and a military super-power backed by a rapidly growing economy, but its political regime and its *dirigiste* economic system are at odd with an economic integration process that is market driven. Unless it evolves toward a more liberal political regime, China will be severely handicapped in leading a region that has worked rather successfully toward political and economic liberalization.

The situation in Europe has been very different. The existence of a Soviet Block clearly delineated the boarders of Europe in the postwar era. The main division, then, was between those who sought to develop European integration on its own and those who wanted to rely on the US leadership. Britain identified itself with the second school of thought, leaving France and Germany as the natural leaders on the continent. France and Germany were also eager to eliminate any future threat of armed conflict, which prompted them to cast their reconciliation within the broader European framework. In addition, in the immediate postwar era, acute scarcities of natural resources and currency made cooperation highly attractive, a process reinforced by the Marshall Plan. When the Soviet block collapsed, fear emerged that Germany would shift its sights toward its traditional Eastern European zone of influence. Partly to dispel these fears, Germany rededicated itself to the European project by supporting the single currency project, in effect sacrificing the dominance of the deutschemark. In return, it obtained a commitment to integrate Central and Eastern Europe into the Union, thus solving once again the question of Europe's borders.[8]

In the end, the China-Japan rivalry sharply contrasts with the strategic alliance that France and Germany forged early on in the postwar period. In spite of occasional

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[8] The Turkish issue is now reopening the issue, pitting again France against Germany.

conflicts of interest, all French and German leaders have always concluded that their alliance is too fundamental to be put under threat. It is this unflinching commitment that has made their leadership in Europe acceptable to the other countries. Furthermore, accepting this leadership has meant that France and Germany's strategic interests largely coincided with the European integration process. Such a virtuous circle is currently unthinkable in East Asia. The case that it is in both China and Japan's interest to burry their rivalry to forge a strategic alliance that would make it possible for them to exercise leadership in fostering regional integration, sketched by Sakakibara (2003), remains to be fully articulated.

3.2. Four Scenarios

We have argued that huge differences in size, level of development and political regimes prevent the emergence in East Asia of a natural leadership of the kind exercised by France and Germany in Europe. What are then the likely paths of economic integration in East Asia?

Starting with the facts, Moneta and Ruffer (2006) observe that real activity among East Asia's emerging economies excluding China is driven by a joint business cycle. They also detect a weakening of business cycle synchronization between Japan and other East Asian countries including China. Both Japan and China display a considerable degree of co-movements with the rest of East Asia with respect to their exports, but in the case of Japan, neither private consumption nor investment co-move with demand components in the other East Asian economies. Overall, this suggests a relative independence of the overall Japanese business cycle. In addition, the dependency of ASEAN, China, and South Korea on Japan as a trade partner has declined.

These developments, the fact that Japan will not give up its floating currency regime, and growing economic rivalry between China and Japan, all point to the a greater scope of monetary cooperation among ASEAN and China. But China will have a hard time to persuade the ASEAN member countries that it can contribute to closer cooperation for monetary matters in the region as long as its currency is non-convertible and its financial system is tightly controlled and closed to foreign competition. Nevertheless, now that Taiwan has elected a more pro-Mainland leadership, it may participate in the creation of a Chinese economic area. Given the vast export market it promises, the question is whether other East Asian countries could avoid joining the area.

Scenario 1: China-Japan leadership

One scenario is that China and Japan will come to terms with each other to develop a common political will to lead East Asia. Sakakibara (2003) even 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. 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 that China and Japan lead the process of economic and financial integration. The hope, therefore, is that China and Japan realize how crucial their cooperation is for the whole region. They could then soften their positions and compromise on an institutional setting. Unfortunately, they have rather moved in the opposite direction, escalating their rivalry in the region. For instance, Japan's active support of ASEAN+6, as mentioned above, is seen as an attempt to contain the rise of China. As long as this kind of perception lingers, this scenario is likely to lose the believers.[9]

Scenario 2: ASEAN+1

Another scenario is that China decides unilaterally to concentrate on deeper trade and financial integration with Southeast Asian countries to form an ASEAN+1 grouping, which could be extended to include Taiwan and Hong Kong. Once it is established, given its heavy dependence on China for its exports, Korea will have to make a difficult decision of choosing between ASEAN+1 or Japan as its FTA partner. Many believe ASEAN+1 is the most realistic course if East Asia is to develop into an integrated region. Yet, it is not clear whether the ASEAN members will be favorably inclined to join a regional organization dominated by a Chinese giant. On the other hand, they may be lured by the vast export market that China promises. Indeed, China has already established an FTA with ASEAN, and the FTA may serve as the spring board for the creation of ASEAN+1.

Scenario 3: A Three-Country Free Trade Area

[9] 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, Korea 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."

A third scenario envisages trade integration among China, Japan, and Korea through the formation of a three-country free trade area destined to become the core of economic integration in East Asia. Together, these three countries account for nearly 90% of the region's GDP. In fact, China has been active in advancing the idea of creating what is known as a China, Japan, and Korea (CJK) FTA. In principle both Japan and Korea support the idea, but in reality they believe that differences in trade structure, the degree of protection of domestic industries, and non tariff trade barriers, not to mention the political system, are too formidable to turn a CJK FTA into an alternative engine of integration. Now that Korea has moved to form trade alliances with the US and EU, this idea will be placed on the back burner for a while at least.

Scenario 4: ASEAN+3
Perhaps the most realistic scenario is that the ASEAN+3 countries will muddle through, continuously discussing modalities of policy dialogue, the types of the surveillance system appropriate for the CMI, consolidation of a reserve pooling system, and the institutional setting for the ABMI. Although they may be far from any new path breaking initiatives, they will ensure a slow but sustained integration in the region. In the meantime economic globalization will continue apace, and market forces will gradually dismantle East Asia's trade and financial market barriers. More than anything else, this market driven liberalization will then assimilate the entire region into the global economy, thereby making the CMI, the ABMI, and FTAs building blocks for global, not regional integration.

4. Exchange Rate Stability

4.1. The Challenge

Most countries in both Europe and East Asia have long considered that some degree of exchange rate stability is desirable to sustain trade. Given Europe's focus on regional trade, the quest for exchange rate stability has led to regional arrangements, all the way to the adoption of a common currency. Freeing capital movements was logically, if not fully intentionally, associated to the decision to adopt a common currency. We have previously argued that East Asia is unlikely to adopt a common currency in the foreseeable future. This implies that the quest for exchange rate stability must be pursued by other means such as the accumulation of foreign exchange reserves and some restrictions to capital mobility. Both are distortionary. Can some cooperation develop in this area?

As the European experience shows, exchange rate policy coordination requires an anchor such as the elaborate mechanism of adjustment of exchange rates of individual countries in Europe's ERM. The ACU, on the other hand, is not an anchor, it merely defines a basket of currencies, exactly as Europe's ECU, which proved to be ineffective, as explained in Chapter 3. At the same time, we already noted that ASEAN+3 will find it difficult to construct a mechanism such as the ERM. What are then the options available for exchange rate policy coordination in East Asia?

4.2. Fixed Bilateral Exchange Rates

One option is to still aim at an ERM-style arrangement, but to first deal with the obstacles identified in Chapter 3. To the extent that the diversity in the exchange regime is a serious obstacle to exchange rate policy cooperation, this means making all currencies fully convertible on both current and capital accounts. A high degree of convertibility of most European currencies had been restored toward the end of the 1950s, well before the discussion of monetary unification started. It may well be that such a move initially requires a large degree of exchange rate flexibility, seemingly moving away from the goal of cooperation. Indeed, capital mobility and exchange rate stabilization are mutually exclusive in the absence of a high degree of monetary policy coordination. This was the reason behind the exchange rate crisis of 1992-3 in Europe. When the lesson was learned, monetary policy coordination followed. Avoiding such a setback is highly desirable.[10]

This strategy has several advantages. If the ASEAN+3 members are as committed to regional financial integration through the ABMI as they say they are, they will have to deregulate capital account transactions, gradually at least. If then the currencies of the ASEAN+3 members freely float vis-à-vis major international currencies, adopting an ERM-type arrangement would lay the ground for monetary policy coordination. A period of flexibility would also help determine the equilibrium real exchange rates. A high degree of volatility of the exchange rate in a free floating regime will also build market pressure for stabilizing regional exchange rates as trade integration progresses in the region

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[10] It is likely that the ERM would not have survived in 1993 had not the Maastricht Treaty been signed and ratified by then. The common currency offered Europe an exit strategy from an unstable arrangement.

As East Asia's integration with the global trading and financial system deepens further, ASEAN+3 will also come under growing pressure to rectify any misalignment of the exchange rates of its members. The ASEAN+3 cannot ignore this pressure and hence consider gauging regional as well as global consistency of the members' exchange rates. To this end the ASEAN+3 may consider strengthening the research capacity of the ERPD and instruct it to assess the consistency of bilateral exchange rates among its members. This could be conducted first in cooperation with the IMF and independently later when the ERPD develops its own assessment capacity. Now that emerging market economies are included in the IMF's Consultative Group on Exchange Rate Issues (CGER), it would be in the interest of ASEAN+3 to establish a cooperative arrangement with the Fund for the assessment of the exchange rates of its members.

4.3. Basket Pegs

Williamson (1999, 2005) has proposed that the East Asian countries adopt a common basket peg, possibly with "fuzzy" margins. The idea is appealing and is the basis of the AMU proposal discussed in Chapter 3. A common peg would *de facto* tie bilateral exchange rates. Allowing for wide margins of fluctuation would give enough leeway to avoid the kind of advanced monetary policy coordination that ERM-type arrangements mandate, as noted above. Fuzzy margins mean that central banks lean against the wind but are not committed to defend fixed limits. This has the advantage of precluding speculative pressure once the exchange rate moves dangerously closed to the limit. It does not come for free, of course, as limits can easily be pushed away, making limited difference with a fully flexible exchange rate regime. Still, the existence of a central parity makes it possible to conduct effective surveillance as explained in the next section. Finally, adopting a basket would allow East Asian countries not to become hostages to large fluctuations in the anchor currency, be it the dollar or the euro. Figure 2 in Chapter 3 makes this point abundantly clear.

The need to agree on weights that make up the common basket idea has been an obstacle to the common basket peg proposal. Given the heterogeneity of East Asian countries, this is not an easy task. A good example is the AMU proposal which, while somewhat different from the common basket peg, has exposed the technical and political complexities of agreeing on country membership, partly because of its implication for weights.

Yet, a number of East Asian countries have adopted their own baskets, which they either peg to or just use to monitor their effective exchange rates. These baskets differ in

the number of external currencies included in the basket and in the weights attributed to each currency since these weights reflect the trade relationships of each country. Park and Wyplosz (2004) show that the details of how the baskets are constructed make little practical difference. Evidence to that effect appears in Figure 1 below, which displays for each of eight East Asian countries for which comparable data is available the effective nominal exchange rates of own baskets and of a common basket. Japan is excluded from the calculations because it seems unlikely that it would peg its currency. We also consider Taiwan since it is an important trade partner for which good data is available.

The procedure is as follows. For each country, we use data on exports and imports to construct weights for each countries (own weights) and for all ASEAN+3 countries part of our sample (common weights). We then compute for each country the value of a basket composed of dollars, euros and yens, using weights that measure the importance of each of these three 'countries' in the country's trade (own baskets). We also construct a common basket, where the weights are based on the dollar, the euros and and the yen represent total trade of these countries. Finally, for each country separately, we compute the effective value of both baskets, taking into account the evolution of its exchange rate vis a vis 41 countries. Importantly, we assume that the other ASEAN countries also adopt either the same arrangement, own baskets or common basket, respectively.

Figure 1 shows that the differences between the effective value of own and common baskets are trivial as they rarely exceed 1%. The reason is that trade patterns do not vary widely among these countries. It follows that own and common weights are not very different. I addition, since regional trade is sizeable, the effective value of the each country's basket depends on the other Asian countries's own baskets.

This observation suggests that difficult and complicated debates on common weights, as with Williamson's proposal, or on a common standard, as with the AMU project, are not worth the effort. Own baskets provide highly similar results. A possibility, therefore, would be to proceed on a decentralized and voluntary basis. Each country could decide on its own to limit the variability of its weighted average exchange rate. The decision would entail the adoption and announcement of a central parity, as in the ERM, along with possibly fuzzy margins of fluctuation of its own choice. Such an arrangement

would go a long way toward stabilizing bilateral exchange rates within the region.[11] Its voluntary nature would also sidestep the issue of membership, which has been a complicating factor affecting the AMU proposal. In addition, and importantly, it would provide a focal point for cooperation, as explained below.

Voluntary pegging to own baskets raises a number of delicate issues, however. To start with, Japan has adopted a free-floating exchange rate regime and is unlikely to return to a peg arrangement. This would create a de facto ASEAN+2 which Japan would see as potentially inimical. From an economic viewpoint, the arrangement has much to recommend to it, but it is politically delicate. This situation would be reminiscent of the European situation where the UK has opted not to join (except briefly in 1992) the ERM and to stay out of the Euro area. The European precedent shows that exchange rate cooperation can function without the full participation of all EU member countries. On the other hand, the UK is left out of all discussions carried by the Eurogroup of Finance Ministers.[12] In order to be acceptable to Japan, such an arrangement would have to include Japan in any committee that would be created to structure coordination.

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[11] Detailed calculations are presented in Park and Wyplosz (2004).

[12] The Eurogroup is presented below.

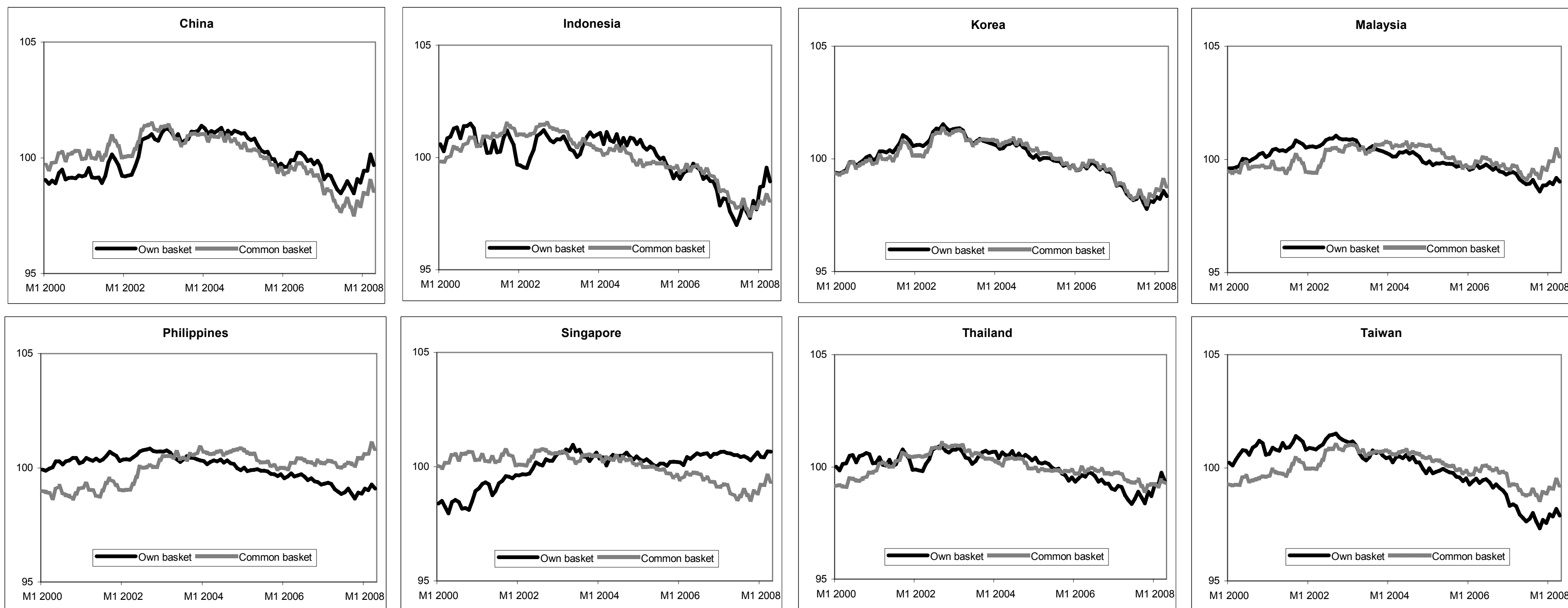

Figure 1 Own and Common Baskets Effective Exchange Rates (Jan 2000-April 2008)

Note: Index 100 = sample average.

Sources: *Direction of Trade*, IMF; *International Financial Statistics*, IMF; Central Bank of Taiwan.

Indeed, to be viable, the arrangement would have to include a process of consultation among those countries that join, possibly including those that do not. Since all ASEAN+2 countries compete for exports to world markets, each one must be assured that the central parities of the others are fair. This would not just be a one-off decision, since continuing inflation differentials and likely disturbances to competitiveness – including the Balassa-Samuelson effect of the catch-up process – will make it unavoidable that central parities are occasionally readjusted. Europe faced exactly the same issue within the ERM, even if the situation was made more complicated by the fact that all parities were defined on a bilateral basis. The European solution was to adopt the consensus rule for any realignment, which amounted to each country effectively giving up some control on its exchange rate. With wide bands and pegging to external baskets, the situation would be less demanding in East Asia, but surveillance would be unavoidable, if only to allow for smooth realignments when needed.

While this may initially be seen as a serious hurdle, the requirement of cooperation on exchange rates has a silver lining. At the present time, ASEAN+3 countries strive to develop mutual surveillance and cooperation within the CMI framework, with limited success. The adoption of a common exchange rate strategy would offer the right menu of topics for this process. The finance ministers could exchange views on the choices of the central parities, on the width of the margins of fluctuations and the actual evolution of exchange rates within the bands. Over time, cooperation could be strengthened to move toward an ERM agreement which would require consensus on the central parities and band widths. Importantly, this evolving and flexible arrangement would require that each country removes restrictions to capital movements as discussed in the previous section.

4.4. Soft Surveillance

The CMI envisions monetary cooperation and has chosen to structure it around the self-managed reserve pooling arrangement (SRPA). The pooling arrangement therefore acts an anchor to structure "soft" mutual surveillance. A drawback, as noted in Chapter 3, is that the SRPA separates countries into two groups: potential lenders and potential borrowers. Because the potential lenders have good reasons to be concerned about economic management in the potential borrower countries, the discussions are bound to be delicate.

This leaves the Economic Review and Policy Dialogue (ERPD), the only institutionalized surveillance mechanism, in a difficult position. Soft mutual

surveillance of exchange rate movements is likely to be easier and more constructive. Evaluating exchange rate movements, including agreeing of equilibrium real exchange rates, provides a powerful anchor for cooperation because exchange rates conveniently involve a very wide array of factors: policies, competitiveness, capital flows, financial market depth and liquidity, and market expectations.

The ERM served this purpose in Europe and led to fruitful discussions that culminated in extensive monetary policy cooperation. Currently, soft surveillance is conducted within the group of finance ministers of the Euro area (Eurogroup), with preparatory work by the Eurogroup Working Group, which includes high ranking officials from Finance ministries and the ECB.[13] The latter has turned out to be an efficient forum. Similar arrangements could be adopted in East Asia within the context of the ERPD.

5. Europe and Regional Integration in Asia

As Europe and East Asia develop ties, it is likely that closer links push East Asia further toward globalization than toward regional integration. Yet, Europe's own experience and the likely evolution of East Asia show that regional integration can contribute to global integration. The question arises then whether Europe can play a useful role in the East Asian regional integration process as part of the more global integration process under way.

5.1. Identifying Differences

East Asian policymakers often refer to Europe as a benchmark, if not a blueprint. Yet, Europe's way is not directly transferable to East Asia as argued in previous chapters. What is needed is to understand the differences between East Asia and Europe and draw the implications. In the present report, we have identified a number of factors that lie behind the slow progress in financial cooperation and integration in East Asia.[14] In some

[13] Non-Euro member countries join the others in similar groupings: the Council of Finance Ministers (ECOFIN), supported by the Economic and Financial Committee (EFC). The EFC brings together the Deputies from all 27 EU member countries Treasuries and central banks, from the ECB as well as from the European Commission. This large group is supported by the Economic Policy Committee (EPC) composed of the 27 Treasury Deputies.

[14] Other useful references are Eichengreen and Park (2006) and Wyplosz (2007).

cases, there are lessons to be drawn.

While the EU has a true single market in goods and services, progress towards the creation of an Asian free trade area remains far from complete. While Europe has removed essentially all barriers to 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."

The existence of transnational institutions is not enough, however. In every instance, cooperation requires that participating states accept to defer some elements of sovereignty. This can be achieved by creating institutions to which these elements of sovereignty; an alternative is the adoption of binding intergovernmental agreements.

Finally, integration in East Asia is a multi-polar process in contrast with the alliance of key nations like France and Germany or with a single hegemonic power (the role played by the United States in the Western Hemisphere).

5.2. Trade between Two Globalized Regions

There are good historical and structural reasons for East Asia not to have followed the European example of setting up a common market. Sequencing has been different, with Europe integrating first regionally and then globally while the East Asian countries sought global trade integration when they opened up. One clear reason is that world trade was very different in the 1970s and 1980s from what it was in the 1950s. Still, up to now, both East Asia and Europe have each found a way of combining global and regional trade integration. The proliferation of FTAs is challenging both.

Some East Asian countries (Korea, ASEAN as a block) are currently negotiating bilateral FTAs with the EU, as is India. An intriguing possibility would be to carefully frame Europe-East Asia trade agreements in such a way that they support regional as well global integration. The EU could propose to carry out these negotiations on a multilateral basis with ASEAN+3. Another possibility would be for Europe to follow the bilateral route currently favored by East Asian countries but to seek FTAs that are

identical or very similar. This would reduce the distortionary aspect of bilateral FTAs and lessen the spaghetti-bowl effects that discourage trade.

A difficulty of this strategy is that, to be meaningful, it would have to include China and Japan. Since the structure of the Chinese economy is very different from that of other countries, it is unclear that similar FTAs could be proposed to China and to other East Asian countries. Given its fast growing importance in world trade, China is unlikely to be willing to consider a FTA that does not meet its own interests. Similar considerations apply to Japan.

Given this situation, the EU could offer to harmonize its current FTA negotiations with the ASEAN countries and Korea. Profound differences in the level of development preclude that all East Asian countries would be interested by the exactly the same FTAs but the Lomé agreements between Europe and Sub-Saharan Africa show that this need not be a definitive stumbling block.

The same procedure can be applied to foreign direct investments between East Asia and the EU. In this area, it could be easier to include China and Japan within the same framework, be it fully multilateral or on a bilateral basis.

5.3. Europe and East Asia as World Actors

Since the 1940s, the world economic and financial scene has been dominated by the US. Europe has gradually emerged as a powerful second player. The next decade or two will most likely see East Asia become the third global player. This evolution has barely started to be recognized as can seen when looking at major institutions such as the G7 and the IMF. Transforming institutions is inherently difficult and requires much effort and patience.

In a way, both the US and Europe must now accept to make room for East Asia – and for other emerging global players – in the running of global affairs. Such a step does not occur naturally. Europe is likely to resist any diminution of its formal and informal influence unless it is accompanied by a corresponding retrenchment of the US. The US is likely to reject any significant challenge to its currently central position. Its easiest defense of the status quo is to call upon Europe to make room for East Asia. A more sensible approach would be for Europe and East Asia to jointly imagine alternative scenarios.

6. Conclusions

Different conditions, historical, geographical and political drive the economic and financial integration processes in Europe and East Asia. This largely explains the different approaches followed. This chapter has described these differences in detail. Its main objective is to explore what lessons, if any, East Asia can draw from the European experience.

A first focus is on how to deepen cooperation in East Asia. A main theme is that, at this stage, the ASEAN+3 countries have emphasized the need to protect themselves from financial disruptions. Beyond the accumulation of large amounts of foreign exchange reserves conducted at the national level, ASEAN+3 has moved into two main directions: pooling reserves within the CMI and developing regional financial markets that would reduce dependence on foreign markets. While these were natural objectives in the aftermath of the 1997-8 crisis, continuing emphasis on these objectives seems to make economic and monetary cooperation more difficult.

Indeed, as argued in Chapter 3, the pooling of reserves has become less crucial in view of the amounts already accumulated. Reserve pooling, on the other hand, raises difficult surveillance issues. The adoption of the SRPA is a noticeable achievement yet, shaping cooperation around this undertaking can be divisive.

Similarly, the objective of developing regional financial markets may end up being a circuitous route to integration into the global markets. Whether regional or global financial integration is the ultimate aim, both require the liberalization of domestic markets, the dismantling of restrictions to capital movements and the adoption of common regulatory and supervisory practices. Once this is achieved, it is hard to imagine how the East Asian markets will be regional rather than globalized, unless the harmonized regulatory and supervisory practices are sub-standard. Meanwhile, the emphasis of state-sponsored arrangements may distract attention from the need to adopt best practices in both the organization of markets and the management of financial institutions.

Yet, much as Europe beforehand, the East Asian countries display a significant degree of aversion towards wide exchange rate fluctuations. While an ERM-style system is unlikely to emerge in the near future, other arrangements are possible. We have argued that a possibility is the voluntary and decentralized adoption of basket pegs with wide margins. There is no need to force common baskets, for it makes little practical

difference. Such an arrangement could then shift the focus from the defensive foreign exchange reserve pooling undertaking to the positive aim of limiting bilateral exchange rate movements within the region. Europe's experience is that cooperation structured around exchange rate surveillance can work. After all, the monetary union is the ultimate step in a long process of coordination along these lines.

Finally, we have noted that, despite the differences previously outlined, East Asia and Europe share important common economic interests. The wave of FTAs currently underway creates as many problems as it solves. Competition pressure in this direction is intense in East Asia. As a major trade partner, Europe may contribute to structure this process in a way that it does not become intractable. Exchange rate stability is another area where East Asia and Europe may fruitfully cooperate. Both regions have a desire to limit monetary disorders. The current architecture of the international financial system is undergoing a difficult transformation. While there is no easy solution, it is clear that the US, Europe and East Asia hold the key to further progress. Deepening the exchange of views between East Asia and Europe appears to be a necessary step.

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