Focus

II. Economic and monetary integration in East Asia: Are there lessons to be learned from Europe's experience?

The European experience of economic and monetary integration has been followed closely in East Asia, especially since the Asian financial crisis in the late 1990s. Academics, but also policy-makers, have started to consider whether, mutatis mutandis, exchange rate coordination and monetary cooperation might not be a viable way for East Asia to achieve greater monetary and financial stability in the region and help to prevent any repetition of the crisis the late 1990s. From a strictly economic viewpoint, given the growing intra-regional integration of East Asian economies, greater monetary and exchange rate cooperation would have its advantages and could be beneficial to the region. Even if the processes of economic and monetary integration in East Asia and Europe will inevitably be different, this focus shows that some aspects of the European experience are relevant for the current efforts under way in East Asia to enhance exchange rate coordination and monetary cooperation. From a long-term perspective, a case can be made for an Asian Monetary Union. Some of the obstacles are of an economic nature, since East Asia is not an optimal currency area and, in most of the countries, major structural changes will have to take place before a process of monetary unification can be started. Some other obstacles relate to governance issues and require a political commitment to regional integration. Even in a market-driven and institution-light process of economic and monetary unification, effective surveillance, based on some form of institutional cooperation, is a precondition to achieving successful exchange rate and monetary coordination. This is certainly the main and most important lesson that East Asian countries can draw from the European experience.

1. Introduction

The Asian financial crisis in the second half of the 1990s provided new momentum to the process of East Asia economic and monetary integration. However, since then, the progress made has been uneven. On the one hand, the rapid growth of intra-regional trade has made the region increasingly integrated. On the other, despite a flurry of (often uncoordinated) initiatives (trade agreements, bilateral currency swap arrangements, initiatives aimed at creating a regional bond market, etc.), from an institutional perspective, East Asia economic integration is still in its very early stages.

This focus section argues that the European experience provides some guidance for the subsequent stages in this process. Although East Asia and Europe are very different and the international environment has changed dramatically from the time when Europe started its unification process, the integration process in East Asia can still be informed from Europe's experience. After reviewing the progress made in economic and monetary integration in East Asia in the last decade, this focus section discusses whether East Asia can be considered an optimal currency area. It also reviews different approaches to achieving exchange rate stability in the Asian region and their trade-offs. The analysis then turns to the issue of why and how the European experience in terms of exchange rate and monetary cooperation can be relevant for this region. The final part of the focus is devoted to the main obstacles hampering the process of Asian economic and monetary integration and looks at what useful lessons can be learned from the European experience.

2. East Asia economic, financial and monetary integration

Through various groupings, …

The process of East Asia integration mainly takes place within three regional frameworks: ASEAN,[21] ASEAN+3 (i.e. ASEAN plus Japan, China and Korea) and the East Asia Summit (EAS).[22]

[21] Established in 1967, ASEAN now encompasses 10 South-East Asian countries (Brunei, Burma/Myanmar, Cambodia, Indonesia, Laos, Malaysia, the Philippines, Singapore, Thailand and Vietnam).

[22] There are also a number of intra-regional groupings, such as APEC (a Pacific-wide forum) and ASEM (a forum for dialogue between Asia and Europe), and a number of economic forums, such as EMEAP (the Executives' Meeting of East Asia-Pacific Central banks), which also help to foster regional integration. EMEAP aims at enhancing financial and monetary cooperation. It comprises the central banks of eleven economies: Australia, China, the Philippines, Hong Kong, Indonesia, Japan, Korea, Malaysia, New Zealand, Singapore and Thailand.

ASEAN is the most advanced framework for integration in Asia and the only one that has a coordinating structure at regional level (the ASEAN Secretariat). The past years have seen its integration process accelerate. In 2003, an ASEAN Summit agreed to achieve an Economic, Security and Social-cultural Community by 2020. An ASEAN Free Trade Agreement (AFTA) is now in place, with reduced tariffs applying to some 95% of intra-ASEAN trade. In 2007, the 12th ASEAN Summit decided that an ASEAN Single Market should be created by 2015, five years ahead of schedule, so as to cope more effectively with the competitive pressure from China and India.

Since its creation in 1997, the main aim of ASEAN+3 has been to provide a framework for closer cooperation in East Asia. A Summit meeting takes place each year back-to-back with the ASEAN Summit. Results have been limited so far to noteworthy cooperation, mainly in the exchange rate and financial areas.

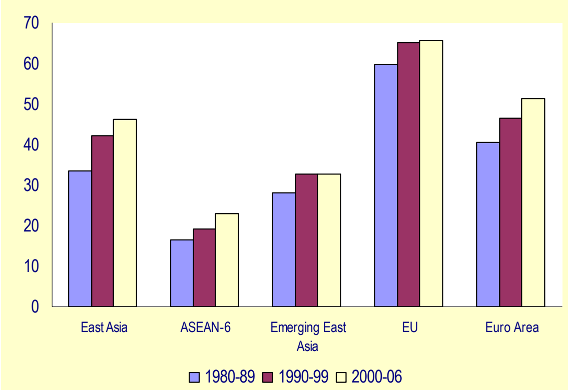
Created in 2005, the East Asia Summit is the most recent initiative to promote closer integration in East Asia. EAS membership is wider than ASEAN+3 (it includes ASEAN+3 plus India**,** Australia and New Zealand) and it is a much looser forum for cooperation than ASEAN or ASEAN+3. It is not yet clear how EAS will evolve in the future.

The variable geometry of these frameworks and groupings provides some flexibility in the early stages of cooperation arrangements, but it often unduly complicates the picture and produces a plethora of weak agreements that make further regional integration difficult to achieve.

… regional integration in East Asia takes place mainly in trade …

For the past four decades, trade has been the engine of economic growth in most of East Asia. While unilateral liberalisation of trade has helped to initiate export-led development in the region, increasing economic integration has been a significant factor in supporting the region's growth. Graph 13 illustrates the rise in intra-regional trade in East Asia in the past decades. It also shows that regional trade integration has reached levels comparable to that of the euro area when the EMU project was launched.

Graph 13: **Intra-regional trade**
(Share of total trade in %) (1)



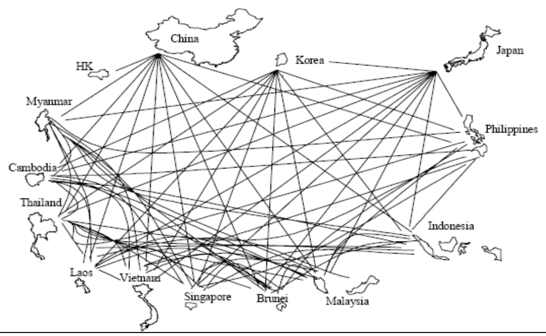
(1) East Asia is defined as Japan, China, Hong Kong, Korea, Thailand, Singapore, Indonesia, Malaysia, Vietnam and the Philippines; ASEAN-6 includes Thailand, Singapore, Indonesia, Malaysia, Vietnam and the Philippines; and Emerging Asia includes China, Hong Kong, Thailand, Singapore, Indonesia, Malaysia and the Philippines.
Source: IMF Direction of Trade Statistics.

One of the key features of Asian trade patterns is the prominent role taken by vertical trade integration through the rapid expansion of supply-chain networks. Vertical intra-industry trade, involving trade in goods at different stages of production, has come to the fore in East Asia, with comparative advantage driving countries to specialise in those segments of production in which they are most efficient. By lowering transport and communication costs, technological progress has played a key role. Another factor behind the expansion of supply-chain networks has been the strategic reallocation by multinational companies of parts of their production process to low-cost countries. Falling tariff barriers have also supported the trend, while the trade policies of East Asian countries have also played a role. For instance, trade policies that lowered tariff rates on imported inputs have raised the effective protection in processing industries reliant on such inputs, reducing their costs of production and assisting their development. An additional key factor has been the emergence of China as a major low-wage producer. There is now a triangular trade pattern in Asia, with firms located in more advanced economies using China as a platform for final exports to third countries.[23]

Another illustration of the intra-regional business activity of multinational companies in East Asia can be found in the rapid increase in FDI flows to and from the region over the past decades – at a faster pace than the region's growth in trade – and in the fact that many of these flows have become intra-regional.

In this intra-regional trade network, it is often argued that East Asian countries are currently both 'comrades and competitors'. The similarities between the various economies in the region have also resulted in increasing rivalry between Asian countries for market shares abroad. This implies that exchange rate movements between the Renminbi and other East Asian currencies have become increasingly relevant to trade and FDI.

Graph 14: **The noodle bowl syndrome** (1)



(1) The map shows FTAs signed or under negotiation in 2006. East Asia is defined here as the 10 ASEANs, China, Japan and Korea
Source: Baldwin, R. (2006), 'Managing the noodle bowl: The fragility of East Asian regionalism', CEPR Discussion Papers No 5561.

This intra-regional competitive dynamics has led to a proliferation of bilateral and regional trade agreements in Asia in recent years, referred to by Richard Baldwin as the Asian Noodle Bowl (see Graph 14). While fewer than 20 agreements notified to the WTO involved East Asian countries in 2005, the Asian Development Bank (ADB) estimated that almost 110 were signed in 2006 and over 80 were under negotiation.[24] While about one-third of Asian FTAs involved extra-regional partners, the remaining two-thirds were between East Asian partners.

As stressed by the ADB, the proliferation of bilateral regional trade agreements in Asia reflects both countries' strategic and political interests and their commercial interest in institutionalising market-driven integration processes. However, the pursuit of overlapping bilateral, regional and plurilateral FTAs by Asian countries has resulted in multiple agendas for integration. Harmonising these agendas to tap the potential of non-discriminatory approaches to liberalisation, and to expand the reach of integration, is a major challenge and may become an obstacle to further integration.

… as well as in financial and monetary areas.

Regional financial cooperation in Asia is relatively new. Asian interest in exploring forms of financial cooperation increased greatly following the 1997-98 Asian financial crisis, alongside growing intra-regional trade and investment. The main objective has been to diversify sources of financing, improve mutual surveillance and dialogue and consolidate the stability of financial systems. In this regard, the main steps taken by East Asian policy-makers are the following:

(1) The Chiang Mai Initiative (CMI). This was launched in 2000 and consists of swap arrangements aimed at providing short-term liquidity support to participating ASEAN+3 countries facing balance of payments problems.

(2) The monitoring of Short-Term Capital Flows. In 2001, ASEAN+3 Finance ministers agreed on bilateral exchange of information on cross-border short-term capital flows, in a bid to promote policy coordination.

(3) The ASEAN+3 Economic Review and Policy Dialogue (ERPD). This was created in 2002 to exchange information on economic situations and policy issues in the region. It meets once a year at Finance minister level and twice a year at finance and central bank deputy level.

(4) The Asian Bond Markets Initiative (ABMI). Discussions began in 2002, with the aim of developing regional bond markets in East Asia. In 2003, ASEAN finance ministers agreed on the

[23] See, for example, Zebregs, H. (2004), "Intraregional trade in emerging Asia", IMF Policy Discussion Paper PDP/04/1

[24] Asian Development Bank (2006), 'The Asian development outlook'.

establishment of working groups, to be engaged primarily in constructing a regional infrastructure and in devising plans for harmonising various financial standards, regulatory systems and tax treatment throughout the region.

(5) The Asian Bund Funds Initiative. EMEAP launched this initiative with the aim of (i) providing a catalyst, as a lead investor, for private investors to consider investment in Asian bond issues, particularly domestic currency bonds, and (ii) diversifying investment of foreign currency-denominated assets held by central banks into Asian bonds. This initiative is implemented via two different funds: the Asian Bond Fund – established in 2003 - which invested USD 1bn in a basket of US dollar-denominated bonds issued by Asian governments – and the Asian Bond Fund 2 – launched in 2005 - which invested around USD 2bn in local currency bonds.

In spite of these initiatives, most observers agree that East Asian financial and monetary integration is still at the conceptual stage and continues to lag when compared with progress made in trade integration. Not surprisingly then, standard measures of financial integration show that global financial integration dominates intra-regional integration in Asia.[25]

3. *Is East Asia an optimal currency area?*

While East Asia could satisfy some of the conditions required to be an OCA …

In its traditional definition, an optimum currency area (OCA) is an economic area composed of economies with strong intra-regional trade links, high correlation of demand and supply shocks, and in which labour, capital and other factors of production move freely. In such an area, a single currency would maximise economic efficiency. Although such a definition of an OCA is difficult to achieve, the theory of the optimum currency area provides a useful benchmark to assess real and nominal convergence within a given area. As seen above, East Asia's intra-regional trade accounts for a high share of total trade and supply chains are particularly well-developed and sophisticated. The level of intra-regional integration of East Asia is now comparable to intra-regional trade within the European Union when it decided to create EMU and the single currency. In addition, nominal and real wages in East Asian countries are relatively flexible, possibly more flexible than wages in Europe pre- and post-EMU. There is also evidence that business cycle synchronisation between members of ASEAN+3 – as measured by the bilateral correlation of GDP growth rates – has increased, especially since the financial crisis.[26] A few studies have also reported that, with the exception of Japan and China, cross-country correlations of supply and demand shocks in Asia are not much different from those across Europe in the early 1990s and are becoming stronger over time, although shocks seem to be mostly symmetric within two specific groups, i.e. ASEAN and North-East Asia.[27]

… others still need to be met.

However, there are other prerequisites for an OCA that are not easily met by East Asian countries. Intra-regional labour mobility is limited. Although there are no reliable statistics available, the foreign population share in Asian countries is likely to be many times smaller than in the European Union, and most East Asian countries apply very tight immigration rules, which impede intra-regional labour mobility. It is argued, however, that domestic labour markets in East Asia are more flexible than in the euro area, allowing thus for faster adjustment to shocks. As a result, the importance of labour mobility as an OCA criterion is less relevant for East Asia than it was for Europe.[28]

[25] See, for example, Cowen, D., R. Salgado, H. Shah, L. Teo and A. Zanello, (2006), 'Financial integration in Asia: Recent developments and next steps', IMF Working Paper No 06/196.

[26] See Rana, P. B. (2007), 'Economic integration in East Asia: Trends, prospects, and a possible roadmap." Economic Growth Centre Working Paper Series No 2007/01, Nanyang Technological University.

[27] Kwack, S. Y. (2004), 'An optimum currency area in East Asia: Feasibility, coordination and leadership', *Journal of Asian Economics*, Vol. 15 No 1, and Zhang, Z., K. Sato and M. McAleer (2004), 'Is a monetary union feasible for East Asia?', *Applied Economics* Vol. 36 No 10.

[28] See, for instance, Watanabe, S. and M. Ogura (2006), 'How far apart are two ACUs from each other? Asian Currency Unit and Asian Currency Union', Bank of Japan Working Paper Series No 06-E-20 and Kawai, M. (2008), 'An East Asian currency for an integrated Asia', Asian Development Bank (forthcoming).

Leaving OCA theory aside, real convergence is also lagging. The standard deviation of GDP per capita in Asia (in PPP terms) is about two to three times that of Europe.[29] In addition, the correlations of demand and supply disturbances show that the effects of external shocks are not quite symmetric across East Asian economies and this asymmetry is significantly higher than in the euro area. This implies that national economic structures in East Asia are still significantly different and a unified monetary policy would have problems in providing an appropriate response to external shocks. And although East Asian countries are also faster to adjust to supply and demand shocks, the large size of these disturbances indicates that monetary unification would be more costly for East Asia than for Europe. [30]

Financial market integration remains insufficient despite some decline in cross-market differentials in interest rates and bond yields. As mentioned above, East Asian financial markets are increasingly integrated globally, much more than at regional level. In addition, although cross-border portfolio investment flows in East Asia have gradually increased over the past decade (in particular for equities), the share of intra-regional portfolio investment flows remains limited (6% in 2005) compared to the EU-15 (62%).[31]

Another prerequisite not met by a number of Asian countries is production and consumption diversification. High diversification in production and consumption weakens the incidence of specific sector shocks. Therefore, diversification reduces the need for changes in the terms of trade via the nominal exchange rate. Highly diversified economies are more likely to incur reduced costs as a result of forsaking nominal exchange rate changes between them. However, the patterns of production and consumption of a number of ASEAN countries are still not diversified enough and make them more vulnerable to asymmetric shocks if they cannot use any longer the exchange rate instrument.

Overall, as discussed further in Section 6, East Asia departs from an optimal currency area in several respects, as was also the case of the euro area when EMU was launched. Furthermore, history shows that OCA criteria can partly be endogenous in the sense that monetary integration affects economic structures and may bring the region concerned closer to an OCA.

4. *Toward an East Asia exchange rate regime?*

In order to stabilise intraregional exchange rates…

Current exchange rate regimes in East Asia differ widely. Most ASEAN countries and Korea have managed floats; China and Malaysia have a managed peg to the dollar; Hong Kong has a hard peg to the dollar; and the Japanese yen floats freely. Although *de facto* the US dollar remains the reference currency for all East Asian currency regimes (including the free-floating Japanese yen), their diversity presents major drawbacks, which makes the current exchange rate configuration in East Asia far from optimal.

It is no surprise, therefore, that there is a strong interest in the region in proposals aimed at enhancing exchange rate cooperation and, in the long term, at setting up a process of monetary and financial integration. Part of this interest is related to the lessons drawn from the Asian financial crisis of 1997-98, in particular on the issue of contagion. The potential for 'real contagion' was thought to be small, given the relatively low levels of trade integration at the time,[32] and the fact that portfolio investment among the countries in the region was almost non-existent. The crisis showed that this was not the case. The crisis was also aggravated by dollar-peg exchange rate regimes, which were inherently unstable and vulnerable to speculative attacks. The absence of exchange rate cooperation in the region only made things worse.

In response to the crisis, a number of proposals designed to lay the foundations for exchange rate cooperation, to introduce a common managed floating regime and, in some cases, to create a

[29] See Watanabe, S. and M. Ogura (2006), op. cit..

[30] See Kwack (2004), op. cit.

[31] See, for instance, Cowen et al. (2006), op. cit.

[32] See Plummer, M. and G. Wignaraja (2007), 'The post-crisis sequencing of economic integration in Asia: Trade as a complement to a monetary future', Asian Development Bank, Working Paper Series on Regional Economic Integration No 9.

currency union as the ultimate goal emerged. Both the reorganisation of supply chains in East Asia and the successful launch or the euro gave new momentum, not only among academics, but also among policy-makers and business people, to the idea that the region needs enhanced currency and monetary coordination to ensure greater financial stability and reduce risks related to currency crises.

... and reduce East Asia exposure to global imbalances …

Another argument in favour of exchange rate cooperation in Asia is linked to the persistence of global current account imbalances and the rapid accumulation of foreign exchange reserves in East Asia, which have played an important role in financing the US current account deficit.[33] Reserve accumulation prevents East Asian currencies from appreciating against the dollar, but it may also have unintended consequences (for instance, on money supply and inflation). To limit these effects, East Asian central banks have engaged in extensive sterilisation and, in fact, so far have been successful in preventing money supply growth from accelerating excessively. However, sterilisation also produces undesired effects. As a result, commercial banks end up holding central bank bills yielding low interest rates. This erodes banks' profitability and affects credit allocation. In addition, the huge accumulation of dollar-denominated assets exposes East Asian monetary authorities to large losses if the dollar goes through rapid depreciation.

The risk of an abrupt fall in the US dollar and parallel appreciation of East Asian currencies has become even more prominent amidst the current financial turmoil. While some currency appreciation would be desirable in most East Asian countries (in particular those facing strong domestic inflationary pressures), such an appreciation, if the currencies move in an uncoordinated way, would also damage some countries' international price competitiveness, and all countries would face significant capital losses.

To address the pitfalls of the *de facto* peg to the dollar, a number of proposals have been put forward to enhance exchange rate coordination and monetary policy cooperation in East Asia, and ultimately to abandon the *de facto* dollar peg for a basket of currencies.

… several proposals have been made.

Most of the proposals/initiatives aimed at achieving exchange rate stability in East Asia can be divided into four types of possible currency arrangements (some of which can be a variant of a multi-stage process towards monetary union):

(1) The creation of <u>bilateral swap agreements</u> (BSAs) between East Asian countries. The goal of BSAs' is to provide liquidity assistance at bilateral level. The main aim is to build a defensive system against future crises and discourage speculative attacks against the currencies of countries that have subscribed to BSAs. They can also be a first step in the process of monetary and financial integration, as they can constitute a test to the readiness of countries to cooperate in tense and difficult conditions.

BSAs between ASEAN countries pre-dated the crisis, but their small size was no match for the turmoil of the late 1990s. To make them effective after the financial crisis, Japan, China and Korea were called in. In 2000, ASEAN+3 Finance ministers agreed in Chiang Mai to set up a network of BSAs of a much bigger size than past arrangements, now known as the Chiang Mai Initiative (CMI). In 2007, the 17 bilateral swaps among ASEAN+3 countries had grown to the sizeable level of almost 83 billion US$.

The CMI, however, is unsatisfactory for several reasons. There are in particular concerns about the way and the speed with which BSAs would be activated. While delays in BSA activation may undermine an effective defence of the currency, a partial BSA activation, with some countries declining to lend their support, may even be

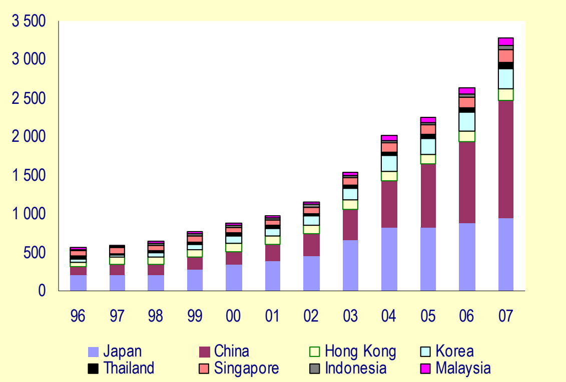
[33] See Yoshitomi, M., (2007), 'Global imbalances and East Asian monetary cooperation', in Chung D.K. and B. Eichengreen (eds.), <u>Toward an East Asian Exchange Rate Regime</u>, Brookings Institution Press.

worse, feeding speculative attacks against the currency under pressure.[34]

Therefore, it is hardly surprising that, despite signing a panoply of BSAs, almost all East Asian countries have dramatically increased the amount of their reserves, *de facto* signalling that they did not consider BSAs to be either credible or effective. As shown in Graph 15, the Chiang Mai Initiative has not had a mitigating impact on reserve accumulation in East Asia, which is now more than 30 times bigger than the BSAs in total.

Acknowledging these drawbacks, most of the ASEAN+3 participating countries agree that the CMI network needs to be supported by an independent monitoring and a surveillance system and that the CMI should be multilateralised. This "multilateralisation of the CMI" includes the creation of a secretariat or committee that could allow joint activation of all BSAs of a requesting country to facilitate a concerted and timely reaction in the event of a crisis. This kind of collective decision-making mechanism has been agreed in principle, but the details of it still need to be worked out.

Graph 15: **Foreign exchange reserve accumulation in East Asia** (USD bn)



Source: IMF IFS, Ecowin.

(2) The creation of a <u>multilateral swap arrangement</u> (MSA) would allow rising the effectiveness and credibility of the defensive system in place and increasing the commitment to monetary cooperation in East Asia.[35]

Compared to BSAs, MSAs have the advantage of really pulling together the financial resources of the participating countries. Furthermore, it would send out a signal that all East Asian countries stand behind the economy under attack. Once in place, contrary to BSAs, an MSA cannot function without a system of monitoring and surveillance, in order to allow collective solution to payment defaults.[36]

Although not in place yet, in 2007, the ASEAN+3 Finance ministers' agreed in principle that a self-managed reserve pooling (SMRP) arrangement governed by a single contractual agreement would be an appropriate form of multilateralisation' of the existing system.

The SMRP project would replace the current CMI network. It would be set up as an independent fund managed by the Central bank Governors, who would also be supposed to harmonise their monetary policies; this implies a system of collective surveillance. Being a legally binding and enforceable agreement, it would provide effective protection for the participating countries. This, in turn, would guarantee the required credibility of the system. Under certain conditions (see next section), the SMRP could prove to be effective in fending off speculative attacks without raising major moral hazard problems.

(3) While the function of bilateral and multilateral swap arrangements is mainly defensive and aims at countering speculative attacks against one or more currencies, the adoption of a <u>managed float based on a basket numeraire of the currencies of the major trading powers</u> would bring monetary and currency cooperation to a much more advanced stage. This proposal suggests that each country should peg its own currency to a basket composed of the currencies of the dollar, the euro and the yen, the so-called YES basket.[37] Each country would tolerate a pre-determined range of deviations from a central rate and review this rate when needed.

[34] Another drawback of CMI is that, under the current arrangement, the duty of surveillance falls to the lending country, which may have only limited information on the real situation that the borrowing country may be facing.

[35] See Kwack (2004) op. cit.

[36] Park, Y. C. and C. Wyplosz (2008), 'Monetary and financial integration in East Asia: The relevance of the European experience', Preliminary draft report to the European Commission, January.

[37] There are various versions of the YES basket, some of which, the so-called G3-plus currency baskets, also include emerging East Asian currencies.

The key feature of this system is that it would reduce nominal effective exchange rate fluctuations both between Asian countries and between Asian countries and the rest of the world. Hence, the regime 'would guarantee that no change in third-country exchange rates would disturb the trading relationships among the East Asian countries themselves'.[38]

(4) The adoption of a managed or free float based on the creation of a parallel currency, the Asian Currency Unit (ACU), whose value would be defined as a basket of East Asian currencies.[39] The creation of an ACU would advance the process of East Asian monetary integration a step further. It would be used as a calculation unit for intra-regional trade and foreign exchange reserves. According to its proponents, it could also serve as a measure of divergences of Asian currencies from a regional average. Some economists even envisage the issuance of ACU-denominated bonds.

Eichengreen (2007) suggests that the ACU should be allowed to circulate alongside existing East Asian currencies. A "virtuous" circle could materialise, where the advantages of using the ACU would increase while integration would deepen, which would, in turn, reduce (both financial and logistical) transaction costs of the use of a parallel currency and would further stimulate intra-regional trade and investment.

The major risk related to the ACU as a parallel currency is the possibility of financial turmoil. It will indeed allow the emergence of currency mismatches (i.e. differences in currency composition between assets and liabilities), which could become a source of vulnerability if the system were to lose its credibility.[40] Eichengreen (2007) argues that one of the advantages of the ACU is therefore that it would highlight the urgency of reforms to strengthen supervision and regulation and to promote investor discipline.

5. Why and how the European experience can be useful for East Asia

East Asia is not Europe …

Europe opened the way for regional economic integration. As a pragmatic first mover, through a process of trial and error, it has progressed for over 50 years. Although its integration sequencing cannot be reproduced, the effectiveness and desirability of the choices made can be assessed. Therefore, they can provide some guidance for other countries that want to follow the path of regional integration, even if this path will necessarily be different.

A word of caution is however needed when regional economic integration in East Asia and Europe is compared. Both regions are very different. From an economic viewpoint, Europe is much more homogeneous than East Asia, which includes some of the richest and some of the poorest countries in the world. East Asia is also much more polarised by size than the European Union or the euro area. While the two biggest economies in the euro area make up less than 50% of its GDP, in East Asia, the share of China and Japan in total GDP is around 75% (see Graph 16). In addition, while Germany and France are close allies and have developed very strong political and cooperation ties, China and Japan are not only economic partners, but also strategic rivals, with different political regimes and belonging, among other things, to different systems of alliances.

The integration path followed by Europe, i.e. to proceed from a free trade area to a single market and from there to monetary and financial integration, cannot be reproduced by East Asia, since, because of globalisation, trade and financial integration are taking place in parallel.[41]

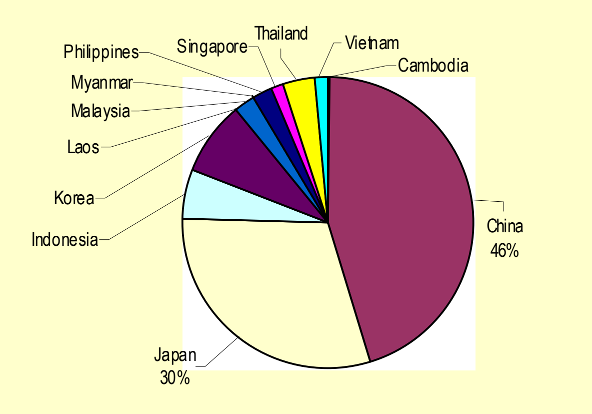
[38] See Williamson, J. (2005), 'A currency basket for East Asia, not just China', Policy Briefs in International Economics, PB05-1, Institute for International Economics. As additional advantages of a common YES basket, Williamson mentions that it would facilitate further regional monetary integration and a possible 'Plaza-type agreement, under which all the countries of developing East Asia adjusted their currency values simultaneously'.

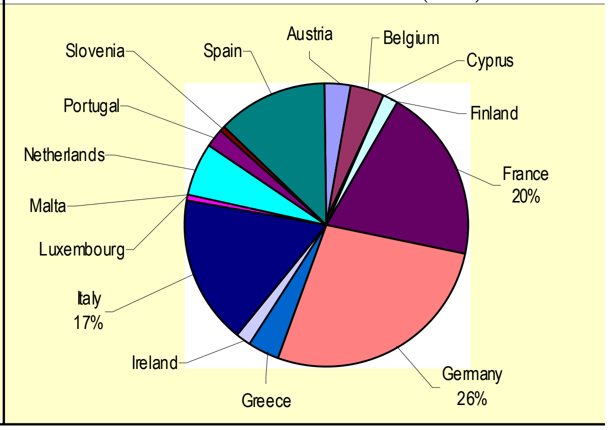
[39] See Chung D.K. and B. Eichengreen (2007), op. cit.

[40] This is paradoxical in certain aspects: the efforts to improve the coordination of exchange rate policies, started in response to the Asian financial crisis, would end up reproducing some of the conditions that made that crisis possible.

[41] For instance, the capital controls with which the European Community was able to delay the move to financial integration are not present in Asia.

Graph 16: **Comparison between euro-area and Asia GDP shares**





Sources: IMF WEO

However, this does not mean that it is impossible to draw inferences from the European experience, in particular in the area of monetary and exchange rate cooperation and integration. On many key issues this experience transcends the concrete historical experience of Europe and has a more general dimension.[42]

… but the European experience in terms of exchange rate coordination and monetary cooperation is valuable to East Asia.

When looking at the process of monetary unification in Europe, it is probably correct to infer that, since the integration process in East Asia is still in its early stages, the periods that are presently most relevant for this region are the coordination attempts of the 1970s and the European Monetary System more than the euro and EMU.

As we shall see, this does not imply that there are no useful lessons to be learned from the transition to the single currency and from the first 10 years of the euro, in particular if the ultimate objective of cooperation efforts in East Asia is to create a currency union.

In its process of monetary and exchange rate coordination, the European Community did not set up any bilateral swap arrangements. Because of their many shortcomings, European countries discarded them from the beginning. The long survival of the Chiang Mai Initiative in its current format is mostly due to the fact that it has never really been tested. There was talk of activating it in 2005 when the Indonesian and Philippine currencies came under pressure, but in the end, it was not needed, and the CMI has gone untested to this day.

As in the case of early European exchange rate coordination attempts, such as the Short-Term Monetary Facility and the European Monetary Cooperation Fund (which, however, were not bilateral, but multilateral arrangements), the real value added of CMI is elsewhere, namely in its symbolism. In 2000, Asian countries used it to signal that, after the financial crisis, they were ready to gear up their exchange rate cooperation. However, in the absence of a well-defined regional institutional setting and strong political determination to move towards East Asian regional integration, the approach had to be slow and gradual. BSAs would be the first step in such a gradual process. The hope was also that, as was the case for the first attempts of monetary and currency cooperation in Europe, they would help to build confidence and trust between economic and monetary policy-makers and create the conditions for an effective surveillance process, which, as the European experience shows, is a prerequisite to moving to enhanced forms of monetary and exchange rate coordination. Although failing to create the mechanisms for effective surveillance by setting up a regional forum for policy dialogue on monetary and financial issues, the CMI can be considered to be partially successful at this early stage of Asian exchange rate cooperation.

[42] Eichengreen, B. (2007), 'Integrating Asia: Lessons from Europe', paper presented at the conference 'Integrating Asian economies: Ten years after the crisis', Bangkok, 18 July 2007.

As it now stands, with all its limits, the CMI is the most advanced institutional process so far developed by ASEAN+3 countries on their way to enhanced monetary and exchange rate cooperation. Therefore, it will be from the CMI experience that East Asian policy-makers will have to start when they decide to move forward in the project of regional economic integration.

As a result, *mutatis mutandis*, some goals of the Chiang Mai Initiative are common to those of European policy-makers in the 1970s, namely to create the conditions for closer dialogue and surveillance through the setting-up of mechanisms requiring the involvement of national economic authorities at regional level. In this respect, the European experience proved successful since it was able to create both the political momentum and the institutional framework that, despite the failure of early attempts, such as the European Monetary Cooperation Fund and the European Monetary Snake, would lead twenty-five years later to the successful introduction of the euro.

However, with 17 BSAs signed and never activated and more than 3 trillion dollars of accumulated currency reserves, it is clear that, in its current format, the Chiang Mai Initiative has probably exhausted its role. Its continuation without any change or its mere expansion (as it happened in 2005 with the doubling of the swap amounts) would have been interpreted as a stalemate in the process of regional integration. The decision to look into the possibility of a multilateral swap arrangement (MSA) is certainly designed to give new momentum to the integration process and to put in place an effective mechanism to counter any currency turmoil.

The MSA presents some similarities with the Short-Term Monetary Facilities (STMF), where the six members of the European Community pledged to lend pre-declared amounts to each other, on request. The facilities were introduced in 1970 and, in 1972, became the European Monetary Cooperation Fund, which collected the reserves pledged under STMF. It was managed by the central bank governors, and its board was supposed to exert some form of surveillance, which proved to be very limited, however. In the same way, Park and Wyplosz (2008) find some similarities between the proposal of Self-Managed Reserve Pooling in East Asia under the CMI and the experience of the European Monetary Cooperation Fund (EMCF) in Europe. They argue that one of the lessons to be drawn from this experience is that reserve pooling can evolve equally into either a virtuous or a vicious circle. For instance, participating countries need guarantees that moral hazard will be contained before they agree to pool sizeable amounts of reserves. Therefore, while the size of the pooled reserves might not be an issue among ASEAN+3 members (given the large accumulated reserves in the region), the proposal will have to overcome several political and institutional obstacles before it can be implemented.

One way of overcoming some of these obstacles is to merge the two existing surveillance mechanisms, the "Economic Review and Policy Dialogue" (EPRD) at the level of ASEAN+3 Ministers of finance and the EMEAP at the level of Central bank Governors. This would create a surveillance structure similar to that in place in the EU with the ECOFIN and the Economic and Financial Committee (EFC) that include representatives of the financial ministry and central bank of the Member states, the European Commission and the ECB.[43] This kind of structure, with a clear political mandate, would in fact have the political weight to implement enhanced peer review and "due diligence" processes. This merger would be far from easy, however, not least because the countries participating in EPRD and EMEAP are not the same, the level of central bank independence varies, and the member states would have to abandon some of their sovereign prerogatives, etc. In addition, it would require a political agreement on which countries should be in the initial Asian Community.[44] Nevertheless, an

[43] In reality, an East Asian ECOFIN and EFC would probably be the final step of a process that, as in the case of Europe, would start from looser forms of cooperation and coordination. This was the case with the Monetary Committee, the institutional framework that carried out the economic surveillance and the coordination of exchange rate policies when the European Monetary System (EMS) was set up.

[44] Although ASEAN+3 seems the most likely grouping, so far there has been no official statement as to who is in and who is out. In this respect, the recent creation of the EAS (*de facto* an ASEAN+6 grouping) complicates the picture further. Furthermore, it seems to indicate that there is not much clarity (and probably conflicting

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

Should East Asian nations decide to peg their currencies to a basket composed of the euro, the dollar and the yen (or a G3 plus currency basket) the European experience could be less enlightening than in other scenarios. When they decided to create their own basket, European countries chose a basket from among their own currencies. This basket was floating freely vis-à-vis the dollar. Europe's choice was dictated by the objective of developing the single market further and avoiding currency tensions (in particular, competitive devaluations) among the Member States. The aim of a YES basket would be somewhat different: as pointed out by Williamson (2005), a common basket numeraire based on the dollar, the euro and the yen would be a better solution than the *de facto* dollar peg for fear of losing competitiveness vis-à-vis their regional peers. In addition, a YES basket would certainly help in the medium term to ensure that the valuation of East Asian currencies evolves more in line with economic fundamentals than in the current *de facto* peg to the dollar. However, it would keep the East Asian countries in an export-led growth framework, where exchanges with the rest of the world matter more than intra-regional trade. In the absence of further steps toward enhanced exchange rate coordination, this choice may not be very forward-looking, since East Asia's export-led growth models are not sustainable in the long run and they exacerbate global imbalances.

However, as seen above, a YES basket could also be an intermediate step towards closer monetary and exchange rate cooperation. This would imply the creation of an Asian Currency Unit and a formal exchange rate mechanism, for which the European experience, especially as regards the EMS, would become particularly relevant. As pointed out by Park and Wyplosz (2008), an exchange rate mechanism would provide something that is still missing in Asia: an anchor for surveillance, which could focus the attention of policy-makers on whether the policy pursued is compatible with the exchange rate regime.

In addition, in a system with formal exchange rate policy coordination, such as the EMS, exchange rate realignments must be agreed upon by all members of the exchange rate mechanism. The European experience has shown that such a mechanism has worked because European countries were ready to think economic policy in line with the requirements of the exchange rate regime and were ready to share detailed information with their partners on the economic situation and the problems they encountered. Despite good cooperation between ERM members and some capital controls in place, inflation differentials and differences in economic policies required frequent parity realignments among the members of the European Monetary System. In 1992, a major currency crisis could not be avoided; this triggered significant currency realignments and led to the fluctuation bands being widened. To be viable and to withstand financial market turbulence and/or speculative attacks, pre-determined ranges for intra-regional exchange rate variations may require a commitment to establish a currency union in the not too distant future.[45] In the absence of such a commitment, it is unlikely that, in a world of globalised finance, a pegged exchange rate regime involving multiple countries can be defended indefinitely, even if all participants make firm policy commitments.

6. Asian economic and monetary integration in a wider context

East Asia is not an Optimum Currency Area…

Is an Asian Monetary Union possible and conceivable? As we have already seen, some economic indicators show that the level of economic integration among ASEAN+3 countries is similar to that of euro-area Member

interests) as to the type of regional integration that Asian policy-makers intend to set up. As a result, the widening of regional groupings will be much faster than the deepening of such groupings.

[45] The problems for Asia could be bigger than those faced by Europe in the past, in particular because capital flows in Asia can move much more freely today and are of much bigger size, making it much more difficult for East Asian countries to stabilise their exchange rates around a central parity.

Box 5: **Would East Asia satisfy the Maastricht Criteria?**

The Maastricht criteria provide a useful toolbox to assess a region's degree of nominal and fiscal convergence. The table below summarises the reference values for ASEAN+3 member countries.

Maastricht convergence criteria in East Asia

	Inflation rate (1)	Interest rate (2)	Fiscal balance (3)	Gross public debt (4)
Brunei	0.2	--	--	--
Cambodia	**4.7**	--	**-3.1**	41.4
China	1.5	3.9	-0.8	17.9
Indonesia	**13.1**	**9.6**	-1.0	38.6
Japan	0.3	1.7	**-3.3**	**193.1**
Korea	**2.2**	**5.3**	-1.3	32.2
Laos	**6.8**	--	**-3.7**	**69.6**
Malaysia	**3.6**	3.7	**-3.8**	**62.5**
Myanmar	**25.7**	--	--	--
Philippines	**6.2**	**7.2**	-1.9	**77.4**
Singapore	1	2.9	6	**102.7**
Thailand	**4.6**	4.1	0.1	42.3
Vietnam	**7.5**	**10.4**	**-3.8**	45.3

Note: numbers in bold exceed the reference values set out in the Maastricht Treaty.
(1) The reference value for the inflation criterion is calculated as the average of the three lowest inflation rates + 1.5 pp.
(2) The reference value for the interest rate criterion is calculated as the average of the interest rates of the three countries with the lowest inflation rates + 2 pp.
(3) The reference value for fiscal balance is -3% of GDP.
(4) The reference value for gross public debt is 60% of GDP (or the country should be approaching this level at a satisfactory rate).

The table shows that, in 2006, no group of countries would have met the Maastricht reference values and that most countries do not satisfy at least two of the criteria. It is however worth noting that, with the exception of Japan, Singapore, and, to a lesser extent, the Philippines, the public finances criteria are met by almost all countries.

States ahead of the launch of EMU; business cycles have become more correlated, and the correlation of demand and supply shocks has increased. And, like the EU, the potential gains from having an economic and monetary union are far from negligible. However, on a number of issues, East Asia is not at the same level as “Europe in the late ’80s” (labour mobility, regulatory harmonisation, obstacles to intra-regional trade, consumption patterns, etc.).

Nominal and fiscal convergence is still far from being achieved, as the simple exercise in Box 6 shows.[46] Indicators regarding real convergence show even greater divergence. Clearly, East Asian countries exhibit much more variability than the current European Union or even Central and Eastern European countries.[47] As pointed out by Wyplosz (2001), 'this variability reflects deep differences in terms of economic structure. The absence of real convergence is Asia’s Achilles heel'. Although real convergence has increased since 2001, the levels of development of East Asian countries are still very different. Moving, with some chance of success, toward economic and monetary unification in East Asia will require huge structural changes in the region and difficult and painful structural reforms.

East Asia is not an optimal currency area, although some sub-groups of countries may not be so far from being one and other countries are converging, albeit slowly. Therefore, if well prepared and not introduced too hastily, most East Asian countries could benefit from the creation of a monetary union. From an economic viewpoint, effective East Asia monetary integration could bring greater intra-regional trade and investment, eliminate exchange rate risks, reduce the impact of international financial turmoil when it occurs, avoid intra-regional tensions related to possible “competitive devaluations”, counter speculative attacks, eliminate the transaction costs related to the presence of different currencies in the region, reduce the dependence on the dollar of the exchange rate regime and favour a better allocation of resources in the region. It is also important to stress that, before deciding to move

[46] In the late 1980s/early 1990s, several euro-area Member States did not fulfil the criteria either.

[47] See Wyplosz, C. (2001); 'A monetary union in Asia? Some European lessons', in Gruen, D., and J. Simon (eds.), Future Directions for Monetary Policies in East Asia, Reserve Bank of Australia.

forward toward a single currency, the EU was not an optimal currency area and neither is Asia at this stage of integration. The endogeneity of an optimal currency area shows that it is not necessary for a region to be a proper OCA before moving to monetary integration, since setting up the process will create its own momentum and accelerate the process.

... but the main challenge to integration is political more than economic.

However, the political will and the institutional infrastructure that created the momentum for the endogenous development of an optimal currency area in Europe are for the time being simply not there in East Asia. This is, in fact, the biggest challenge that the region has to address if it really wants to move to enhanced levels of exchange rate coordination and monetary cooperation, and, ultimately, to a monetary union. As the European experience shows, even a gradual process will not necessarily be successful if a number of key issues are not successfully tackled. It is to these issues that the final part of this paper is devoted.

The first key issue to be addressed is mutual trust and readiness to cooperate in a regional framework. At this stage, East Asian countries do not seem ready to give up part of their sovereign prerogatives and to allow other countries to intervene/interfere in the implementation of national economic policies. However, the European experience shows that without effective multilateral surveillance even multilateral swap arrangements become problematic. This is an issue that can be solved only at political level and that will be difficult to address fully as long as East Asian countries look at their neighbours not only as partners, but also as rivals in both the economic and political sphere. History, different political regimes, regional rivalries, unresolved border disputes, and different systems of military alliances make regional political and economic cooperation much more difficult and complicated in East Asia than in Europe. Against this background, effective multilateral economic surveillance is in fact a key political decision.

The second key issue relates to the first: can countries overcome their mistrust and their entrenched rivalries mainly through an intergovernmental process? Even in Europe, where countries have made their peace with history and the fear of the emergence of a superpower is almost non-existent, mere intergovernmental cooperation proved to be a slow, cumbersome and often unsuccessful process. For this reason, even intergovernmental decision-making procedures in the European Union are facilitated if the European Commission plays an active role in them. Although the creation of an East Asian Commission is not on the agenda, it is difficult to see how a synthesis at regional level that is more than a minimum common denominator can be pushed forward without a regional institution with a high degree of independence from the various Member States.

Given the political realities in East Asia, some economists think that an institution-light intergovernmentally-driven Asian Community could be envisaged. They suggest that, rather than trying to build strong regional institutions and delegate sovereign prerogatives to them, East Asia should borrow another example of governance from the European experience: the open method of coordination, whereby countries share information and best practices and exert forms of peer support and peer pressure to encourage the implementation of agreed policies. They admit that the final outcome would be a much more 'loosely configured grouping than the European Union',[48] in which surveillance and peer pressure would be much more of a problem and difficult to implement.

It is clear that without some form of regional institutional infrastructure to provide analytical input and put forward independent proposals on how to foster regional monetary cooperation, progress might not only be extremely slow and painstaking, but also dangerously dependent on how political and economic relations evolve between the major powers in the region. As a result, short periods of enhanced cooperation can be followed by long periods of inaction, as has been the case, for instance, in recent years. Even an institution-light, market-driven Asian Community cannot operate effectively without some form of independent institutions. In this

[48] See Eichengreen (2007b), op. cit., p.18

respect, an Asian Community whose governance is based on the "open method of coordination" cannot really aspire to the creation of an economic and monetary union, even in the long term. As Eichengreen (2007) recognises, 'the open method of coordination […] is better for encouraging policies to foster the development of Asian financial markets or for helping central banks to learn how to back regimes of greater exchange rate flexibility with inflation targeting than for, say, establishing a single regional competition policy or agreeing to move to a single currency'.

Therefore, an Asian currency for an integrated Asia can only be achieved if East Asian countries already exhibit the political determination at the early stages of the process to abandon some of their own sovereign prerogatives and to cooperate openly and candidly, accepting some political interference from the other members in their policy choices. This inevitably means the creation of regional institutions (an enhanced EPRD, an independent secretariat) that can make sure that real surveillance and peer pressure are effectively implemented.

7. Conclusions

Are there lessons that East Asia can learn from the process of European monetary unification? Despite the huge differences between East Asia and Europe's processes of regional integration, this focus replies in the affirmative to the question. Three different types of lessons are identified: (1) lessons related to European reserve and exchange rate arrangements of the past, which have some similarities with East Asian arrangements currently being implemented or under consideration; (2) lessons related to the transition stages towards formal exchange rate coordination and, possibly, an Asian currency union; and (3) lessons related to decision-making and governance. This does not mean that East Asia has to follow in EMU's footsteps. The world has dramatically changed since the process of monetary unification started in Europe more than thirty years ago, and the integration sequence pursued by Europe cannot be replicated in East Asia. Furthermore, while the integration process in Europe was politically and institutionally as much as economically driven, in East Asia it has been mainly market-driven, which implies that its institutional framework will be lighter than Europe's, even once (should this ever happen) a single Asian currency is introduced and an Asian Central bank is created.

However, even an institution-light monetary unification process cannot afford lax and ineffective surveillance. The European lesson in this respect is clear from start to finish, from the first uncertain steps toward exchange rate cooperation to EMU: mutual surveillance works and is effective, especially if it is backed by clear procedures carried through by independent regional institutions. Although it can evolve in time from simple peer review to structured forms of monitoring with specific rules and possible sanctions (as in the case of the Stability and Growth Pact), it remains the most important precondition, without which it is very difficult to move forward exchange rate and monetary policy coordination, and, *a fortiori*, to an Asian monetary union.

Last but not least, is it in Europe's interest that East Asia should succeed in its efforts to gear up exchange rate and monetary cooperation? On this count, too, the answer is in the affirmative: if East Asian countries are able to achieve greater intra-regional currency stability, they will have far more scope to let their currencies appreciate without the fear of significant competitive losses to their neighbours. This could help support a more orderly unwinding of global imbalances. It could also help avoid a situation where the euro has to bear most of the weight of the exchange rate correction needed to tackle these imbalances. In addition, monetary integration in East Asia could bring more stability to the region and help to avoid disruptive crises, as it happened in 1997-98. This, in turn, would reduce uncertainty and foster economic growth. Thus, learning the right lessons from EMU is not only in the interest of East Asia, since the positive spillovers from effective and successful monetary and exchange rate coordination among East Asian countries can have beneficial effects both on the EU and on the world economy.