Financial Cooperation in East Asia:

A comparative regional perspective

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1. Introduction

In the aftermath of the 1997 Asian crisis, a region-wide consensus has emerged that the East Asian (EA, henceforth) countries need to collectively oversee regional economic issues in a coordinated way or to move a step further up for concrete regional financial arrangements to help prevent the outbreak of financial crises in future. Before then, general concerns for the EA countries were to succeed in overseas markets outside the region. Such an export-oriented drive had been one of the main reasons for the region's spectacular economic growth.

The first initiative to develop an intra-regional measures for dealing with any possible financial crisis was taken by Japan with its proposal to create an Asian Monetary Fund(AMF) amidst the 1997 crisis. The Japanese proposal included such a significant sum of facility that crisis-hit countries welcomed it and even envisioned a long-term regional goal of creating an Asian Monetary Union (AMU, henceforth), which would be modeled after the European Monetary Union (EU).

Confronted with the strong oppositions from the existing international institutions as well as from the United States, the EA countries had to turn their efforts to build an internationally acceptable integration framework, which resulted in the Chiang Mai Initiative (CMI, henceforth) proposed at the annual meeting of the Asian Development Bank (ADB) in 2000. The CMI envisioned the institutionalization of foreign exchange reserve swap arrangement between the countries in the EA region. The initiative is the first interwoven financial network in the region which is coercive in emergency. The CMI is the first-ever arrangements that include the EA region's economic powerhouses of China, Japan, and Korea. Before the initiative, Southeast Asian (SEA) countries (now 10 countries) formed regional for a with a secretariat called ASEAN since 1997. They already set up bilateral swap arrangements which currently serve as the model of the CMI. However, SEA countries' small economic sizes and dependence on outside-ASEAN region limited the extent and significance of their cooperation. The inclusion of the three countries which are strongly influential on the ASEAN countries both in trade and direct investment added momentum to the regional cooperation and brightened the forward path. The CMI is now seen as a founding step toward a broader and deeper coordination at the regional level.

The CMI includes other notable agendas that would not only contribute to the stability of the regional economy but also build up to a higher degree of integration. In this regard, it is important to understand the implications for future developments from its details. Above all, in order to fully and successfully utilize the CMI as a corner stone for more constructive integration in the region, it is necessary to learn from the experiences of the existing regional institutions and the conditions for the success at each step. In this respect, the EA countries are in a position to take advantage of the lessons from the more successful euro experience as well as from the less successful Latin American case. In contrast to Europe, the Latin American countries have not yet established any notable regional institutions which could have a significant role to play in financial cooperation in spite of a long history of their efforts for regional integration. By drawing on other regional experiences, constructive footsteps can be suggested toward a possible financial cooperation and integration for the EA region.

In the following section, we will start with reviewing the region's initial efforts for financial cooperation, In this paper we will mainly be concerned with the countries of ASEAN group plus 3 (Japan, China, South Korea). Among the ASEAN countries, our analysis focuses on such countries as the Philippines, Indonesia, Thailand and Malaysia, and Singapore. This selection of countries is mainly based on the interest of research and the availability of information. Section 3 discusses Chiang Mai swap arrangements as the subsequent initiative for regional cooperation. Section 4 surveys and evaluates the experiences in financial integration outside East Asia, focusing on institutional aspects in Europe and Latin America. This is followed in Section 5 by an overview from a comparative perspective of the EA regional economy's structural features to assess whether the EA region meet the necessary preconditions for financial integration and to explore possibilities of further development for the region. Policy suggestions beyond Chiang Mai and prospects for EA regional integration are examined in Section 6. The findings are highlighted in the concluding Section 7.

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Possibilities and Prospect for Financial Integration:

A Comparative Perspective from the Latin American and European Experiences.

1. Introduction

In the aftermath of the 1997 Asian crisis, a region-wide consensus in East Asia (10 AEAN nations plus China, Japan and S. Korea) has emerged for a need to collectively oversee regional economic issues in a coordinated way or to move a step further up for regional financial arrangements to help prevent financial crises in future.

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The first initiative to develop an intra-regional measures for dealing with any possible financial crisis was taken by Japan with its proposal to create an Asian Monetary Fund(AMF) amidst the 1997 crisis. The Japanese proposal included such a significant sum of facility that crisis-hit countries welcomed it and even envisioned a long-term regional goal of creating an Asian Monetary Union (AMU, henceforth), which would be modeled after the European Monetary Union (EU).

Confronted with the strong oppositions from the existing international institutions as well as from the United States, the EA countries had to turn their efforts to build an internationally acceptable integration framework, which resulted in the Chiang Mai Initiative (CMI, henceforth) proposed at the annual meeting of the Asian Development Bank (ADB) in 2000. The CMI envisioned the institutionalization of foreign exchange reserve swap arrangement between the countries in the EA region. The initiative is the first interwoven financial network in the region which is coercive in emergency. The CMI is the first-ever arrangements that include the EA region's economic powerhouses of China, Japan, and Korea. Before the initiative, Southeast Asian (SEA) countries (now 10 countries) formed regional for a with a secretariat called ASEAN since 1997. They already set up bilateral swap arrangements which currently serve as the model of the CMI. However, SEA countries' small economic sizes and dependence on outside-ASEAN region limited the extent and significance of their cooperation. The inclusion of the three countries which are strongly influential on the ASEAN countries both in trade and direct investment added momentum to the regional cooperation and brightened the forward path. The CMI is now seen as a founding step toward a broader and deeper coordination at the regional level.

The CMI includes other notable agendas that would not only contribute to the stability of the regional economy but also build up to a higher degree of integration. In this regard, it is important to understand the implications for future developments from its details. Above all, in order to fully and successfully utilize the CMI as a corner stone for more constructive integration in the region, it is necessary to learn from the experiences of the existing regional institutions and the conditions for the success at each step. In this respect, the EA countries are in a position to take advantage of the lessons from the more successful euro experience as well as from the less successful Latin American case. In contrast to Europe, the Latin American countries have not yet established any notable regional institutions which could have a significant role to play in financial cooperation in spite of a long history of their efforts for regional integration. By drawing on other regional experiences, constructive footsteps can be suggested toward a possible financial cooperation and integration for the EA region.

In the following section, we will start with reviewing the region's initial efforts for financial cooperation, In this paper we will mainly be concerned with the countries of ASEAN group plus 3 (Japan, China, South Korea). Among the ASEAN countries, our analysis focuses on such countries as the Philippines, Indonesia, Thailand and Malaysia, and Singapore. This selection of countries is mainly based on the interest of research and the availability of information. Section 3 discusses Chiang Mai swap arrangements as the subsequent initiative for regional cooperation. Section 4 surveys and evaluates the experiences in financial integration outside East Asia, focusing on institutional aspects in Europe and Latin America. This is followed in Section 5 by an overview from a comparative perspective of the EA regional economy's structural features to assess whether the EA region meet the necessary preconditions for financial integration and to explore possibilities of further development for the region. Policy suggestions beyond Chiang Mai and prospects for EA regional integration are examined in Section 6. The findings are highlighted in the concluding Section 7.

2. The Earlier Cooperation Models: AMF and AMU

In the wake of the eruption of the 1997 Asian crisis, there have been a surge of proposals for financial integration of East Asian (EA, hereafter) countries. Two noteworthy but related proposals for integration were the Asian Monetary Fund (AMF) and the Asian Monetary Union (AMU). Both proposals emerged in the midst of the financial crisis in 1997 to cope with the worsening situations and to reduce possibilities of a crisis in the future.

The AMF proposal gained its momentum of its support during the crisis because of the urgent need for prompt actions to contain the crisis. It took more than a month for the IMF to unveil the rescue package of US$16 billion after the Bank of Thailand decided to abandon the pegging of the baht to the dollar. The delayed rescue by the IMF contributed to the rapid spread of the currency crisis across South East Asian (SEA, hereafter) countries and prompted criticism within and out of the region. Rather than waiting for the rescue decisions by the international institution which were often too slow and untimely, the crisis-affected SEA countries came up with the idea of creating an Asian monetary fund, which would function as a region-based funding institution to complement the roles of the IMF.

Japan's initiative for the AMF was perceived as critically important since the ASEAN countries alone would not be able to financially afford to build and preserve such a fund. Even before the 1997 crisis Japan took the initiative in exchanging uncomfortable dialogues with the international financial policy makers concerning the potential financial woes for Asia. In spite of the mounting international demands for a thorough restructuring of Japanese banks and banking system, Japan had kept its characteristic approach: implicit and slow. At the time of the outbreak of the crisis, Japan had a distinct view, diverging from that of the IMF, on the approach to the resolution of the future crisis. While the IMF, represented mostly by the US and the EU, urged on the market reform of the economy as well as the restructuring of the country's financial sector, Japan focused on a much bolder rescue package to create regional funds. Having invested heavily in the region, Japan had a much bigger stake in the EA economy than the IMF's influential member countries. The needs from both sides of Japan and ASEAN resulted in Japanese Finance Minister Mitsuzuka's open announcement that Japan would offer facilities to a regional fund during the Bangkok meeting of finance ministers of 25 Asian and European countries in 1998. In addition to that, he expressed his view that amidst breaking up the pegs with the dollar, the yen could have a larger role in the region. The amount of facility was unveiled as US$ 100 billion at the IMF-World Bank meeting in Hong Kong a few days later. This proposal can be seen as the first step toward currency integration in the region.

The reaction from the IMF, the US, and the EU was far from being enthusiastic, eventually contributing to the short-life of the Japanese plan. Many issues led to a sharp confrontation. The IMF placed priority on avoiding moral hazard; the Japanese initiative was perceived to make a bailout too easy. While the IMF pressured the SEA countries to accept more stringent conditions including macroeconomic restructure, the SEA countries complained about those conditions. The IMF was also concerned with the huge size of proposed funds that might dwarf any IMF package for the region, allowing the SEA countries for an easy bailout without having to negotiate with the IMF. The IMF could not simply allow another institutions to weaken its role of leadership amidst a financial turmoil.

The moral hazard issue aside, the political economy on the exchange rate regime was also another factor forcing the chasm. Japan envisioned its own initiative and its substantial contribution to the IMF as providing an opportunity to seek a new exchange regime for the region that would take the yen as an additional key currency. This would imply the retreat from the dollar in the region and the reshaping of the global exchange regime toward the dollar-euro-yen tripod. The EU, whose major concern was a successful launching of the Euro due in 1999, did not wish to see the ongoing currency regime disturbed by an unexpected advent of a huge currency block. Since the EA currency block based on the yen would imply the eventual replacement of the US dollar as an anchor currency, neither could the US welcome the idea of the AMF, which could be seen as Asia's first step toward the formation of a currency block.

Although the AMF plan was seemingly dead with the acknowledgement from Japanese officials, Japan and the ASEAN countries continued to whisper their wishes for the AMF or for other form of regional cooperation. The Manila-based Asian Development Bank (ADB) and Japanese institutes began to come up with compromised plans. For example, Japan-based Institute for International Monetary Affairs produced a research in March 1999, according to which funds can be organized, not as an independent pool of capital but commitment arrangements of borrowing both from the central banks and the markets.

As critiques began to question the IMF policy of untimely and excessive intervention, the IMF and the US have softened their opposition to Asian initiatives for regional financial arrangements and would more or less be ready to accept a modest version of the plan so far as it does not detract from the IMF authority. The Chiang Mai Initiative (CMI) in May 2002 was such a compromised plan. The Finance ministers of 10 ASEAN countries plus China, Japan, and Korea agreed to institute a facility for bilateral currency swaps in case of the crisis affected country's need for short-term liquidity assistance. The assisted countries are required to accept the IMF conditionality. The CMI clearly falls short of the original plan of the AMF. But the importance of the CMI must not be underestimated; it can be viewed as the initial step leading toward financial integration in the region.

To some policy makers in the region, the ultimate goal of creating a regional monetary union has been perceived as reasonable. One such an example is the idea to build an Asian Monetary Union (AMU) with a common currency following the line of the European Monetary Union model. Since this ambitious goal is seen as a long-term aspiration, the proposal for an AMU has been presented as an addendum to a more realistic short-term plan. Nonetheless, there have been strong voices for the AMU by . Japanese officials who continued to revive the idea of a common currency in the region. Their idea is to mobilize regional currencies into transactions, to make the yen as an anchor currency, and eventually to transform it into a single regional currency. Although such neighboring nations as China and South Korea have reservations about the yen as the anchor currency, the idea of a single regional currency as an ultimate goal has easily been agreed upon. As the euro and the currency union demonstrate, regional financial integration is believed to infuse vitality and momentum into the regional economy.

In passing, it is worth noting that there is another view on the currency union. Nobel laureate Robert Mundell (2002) considers the creation of a common currency as a contemporaneous issue rather than a futuristic one. He questions the effectiveness of the yen as an anchor currency in Asia. Given the current financial sector problems and inadequate macroeconomic policy decisions in Japan, the necessary preconditions for the yen to become the anchor currency are not met. Besides, the US dollar has long been served as an anchor currency in the region and there is no substantial need to replace it with the yen. Moreover, deciding on the anchor currency is not purely based on economic rationale but also on geopolitics. This makes it very hard for the former Asian colonies of Japan to accept Japan's leadership in a monetary union. A hasty enforcement of a currency union could lead to a devastation rather than a blessing. Unrealistic exchange rate arrangements could make some currencies vulnerable to the speculative attacks or macroeconomic fallout as seen in the speculative attacks for some currencies belonging to the European Monetary System in 1992. The problematic issue of a regional common currency and the failed proposal for the AMF or the AMU demonstrate the importance of a careful and patient approach to regional cooperation. Regional financial integration per se is an admirable motive. But to harvest fruits from regional cooperation, it is crucial to prepare for the details on what aspects of cooperation would be achievable and agreeable in and out of the region.

3. Chiang Mai Initiative (CMI) as a Cornerstone

One of reasons that the CMI did not meet a strong opposition from the outside the region is the realization of the IMF’s shortcomings in dealing with the contagious effects of financial crises on other countries.. The resources that the IMF can offer in a short period were not large enough. A substantial portion of the lending to the Asian countries came from elsewhere. The IMF had to arrange for alternative, multiple sources of credit resources, which would delay a rescue operation.

In the light of serious doubts concerning the IMF’s ability to safeguard financial stability in emerging markets, the CMI to create currency swap arrangements was agreed by the thirteen countries of ASEAN plus Three. And as of June, 2002, the total amount of BSAs is estimated at US$ 20 billion. (Park, 2002b) As already referred to, the American rejection of Japan-initiated AMF proposal called for a more modest approach toward a regional financial cooperation. The CMI was given a birth from the efforts to meet the arguments of both sides.

Contrary to the critiques of the CMI, the terms of bilateral Swap Arrangements (BSA) are not at all indulgent. This reflects the alerted responsibilities on the part of the engaging parties. As the resources for the swaps should be supplied by the countries in the region, the involved countries as creditors carefully safeguard risks in a lending position. The position as a potential creditor for many East Asian countries likely contrasts with that of a potential borrower in the IMF system. Their quotas in the IMF windows tend to be relatively small. Thus being a creditor implies that those individual countries would be forced to become more stringent in lending. The conditionalities set up under the BSA tend to reflect their cautious approach. The criticism of the CMI as encouraging to play the role of a proliferate lender can be questioned for its plausibility. On the other hand, a harsher criticism can be made at the current IMF practice in which small countries do not have to be responsible in deciding the terms and restrictions in lending because of their minor positions in policy- making.

The CMI is structured to play the role supplementary and complementary to that of the IMF. It provides additional resources to the IMF work and accomodates the basic conditionality stipulated by the Fund. (Henning, 2000, p. 50) In this regard, the US has endorsed the CMI and is ready to accommodate the CMI within the framework of the IMF. At the same time, the US continues to monitor the development of the CMI and will intervene in case that CMI structuring is judged as contradicting the interest of the IMF.

While proposing the BSA as a core achievement of the CMI, the ministers convened at Chiang Mai also agreed to pursue three additional goals of monitoring capital flows, regional surveillance, and training personnel. (Henning, p. 12) There are already a number of regional institutions, such as ASEAN and Asian Development Bank (ADB), and Asia-Pacific Economic Cooperation Forum (APEC). But none of them is responsible for a consistent and systematic surveillance of individual countries' macroeconomic and financial matters related to regional financial stability. Since the successful operation of the BSA would be contingent on the correct financial information, the EA countries need to have a centralized institution that collects, directs, and mandates financial information from each country. Individual states would inform each other on major policy changes that can have impacts, in particular on exchange rates and interest rates. Although it is too early for the EA countries to follow codified and mandated policies, the presence of discussion channels and regional fora can reduce the risk of disorder caused by an unexpected policy change of a country.

Even if there is no assurance that the BSA will be much effective in preventing a financial crisis, they are bound to enhance the spirit and environment for a close cooperation among involved states for regional financial stability. It is to be noted that setting up institutions and organizing international fora are not the sufficient conditions for a broad and deep regional integration although they serve as the necessary preconditions for further integration. This point becomes evident when we consider the case of Latin America. The continent have had many regional institutions and financial arrangements. There is no evidence suggesting that a regional cooperation has made a substantial contribution to regional financial stability. In many cases of the crisis in LA, specific bilateral deals between the involved country and the international financial institutions had to be drawn to resolve the issues. The less than successful cases of regional cooperation in LA provide a contrast to the more successful cases of Europe, which finally led to the single currency Euro.

The successes and failures in other regions' experiences should provide invaluable lessons to Asia. The next section provides an overview of European and Latin American experiences in regional cooperation and integration.

4. The European and Latin American Experiences in Financial integration

The European Union (EU) has set itself as a textbook model for regional integration. While other regions may take it as a role model to learn from, its long history of ups and downs in the path toward integration and its superior economic fundamentals compared with other regions are often overlooked. A hasty glance at the EU is likely to lead to a mistaken belief that an organized set of policy codes could bring a regional integration into reality. Even though the EU members have in recent past been in a situation conducive to seek a regional financial integration, the path to the integration to date was not predetermined, nor was foreseen in an optimistic mood. The simple fact to note is that the path to the current integration has taken a half century from the formation of the European Economic Community with six member countries to the current integration structure - the EMU with 12 member countries. (Tsoukalis 1993, Chapter 2)

In case of Europe, while the recent history of integration is marked by the financial aspects, economic integration in the early period had been motivated by interests in regional free trade. The major goal of the EEC, founded in 1958, was to create a common market to assure free movements of goods and factors of production across national borders. By 1961, the intra-region exports among the major Western European countries already accounted for more than fifty percent of their total exports, and creation of a custom union with uniform external tariffs was easily agreed on..

The focus on the real- sector regional integration economy continued until the collapse of the Bretton Woods system in 1973. Under the Bretton Woods system, the Western world enjoyed the period of economic and financial stability as reflected by stable exchange rates and sustained economic growth. The breakdown of the fixed exchange rate system subsequently turn the attention of European countries to the problems of stabilizing exchange rates. The first attempt for exchange rate arrangements was to organize bilateral exchange- rate coordinations between the six EEC countries. In this so called ‘snake’ plan (Tsoukalis, p. 39), they intended to maintain the exchange rates relative to each with each within the certain margins for deviation. This diversified approach gave way to the German mark as a de facto anchor currency. After a short period of a flexible and/or a managed float system in the global financial world throughout the 1970s, the European nations agreed on the need to set up a systematic exchange rate arrangement, which resulted in creation of the European Monetary System (EMS) in 1979. A trend of economic recovery started after the late 80s and brought a confidence to the European countries, encouraging to take a much bolder move toward the Maastricht Treaty in 1992, by which a single currency union was to be effected as of January 1999.

The EMU has a single currency called Euro and a central bank called European Central Bank (ECB) with a full monetary authority. Although it is still premature to foretell the success of the EMU, its successful launch was already impressive enough to inspire other regions to share the EU experience.

As for the efforts toward regional integration, the Latin American countries were as enthusiastic as the European countries were. However, the motivation and background for regional cooperation were quite different. Unlike the case of Europe, many Latin American countries suffer from the small size of their domestic markets. In the 1950s, the small size of the economy was perceived as a stumbling block to the success of import substitution industrialization. To overcome the country’s limited market size, a number of the Latin American countries initiated a move toward creation of sub-regional free trade areas. The Latin American Free Trade Association (LAFTA, later to become the Latin American Integration Agreement, LAIA), Andean Group, Central American Common Market (CACM), and Caribbean Community (CARICOM) are four major free trade frameworks (listed in the descending order of size), which have been grouped more or less by geographical location.

Though those countries showed some expansion in intra-regional trade during the 60s and the 70s, the ratio of intra-regional trade has continued to remain very small compared to that of the European counterpart. For LA as a whole, the intra-trade ratio rose from 7 or 8 percent in the early 60s to 16 or 17 percent in the late 70s. (Figure A-4)

For the same period, the largest export market was the US whose share always exceeded 30 percent of the total trade volume. (IMF, Direction of Trade Statistics, annual) A number of reasons can be advanced to explain the LA setback in their intra-regional trade. First, their ambitious plans were not followed by consistent implementations given the unstable economic and political situations. Second, the low-value added commodity composition in exports where primary commodities account for the bulk of exports has worked against the terms of trade and as a result against the region's balance of payments. Third, the weakened LA currencies due to unstable financial conditions have made the LA countries to focus their exports more on extra-regional markets. And fourth, the ISP approach has resulted in the resource drains for LA's export-oriented sector. Both the inner and external imbalances of the LA countries led to a chronic financial crunches or crises and consequently to structural adjustments as prescribed by the IMF.

With the conventional ISI policy completely debunked, under the new neoliberal economic order supported by the US, various attempts have been made to create free trade areasthe LA regions. MERCOSER with Brazil and Argentina as the major members and the NAFTA consisting of the US, Canda and Mexico were given birth to in 1991 and 1994 respectively. Currently, under the initiative of the US creation of the Free Trade Area of the Americas (FTAA) that covers the whole American continent is being envisaged (Bethel, 1998).

While their efforts to expand free trade in the region have been active, the move toward financial integration has not been successful notwithstanding several attempts made at the subr-regional level. Among them have been the Latin American Reserve fund (FLAR) and the Mutual Payments and Credit Agreement (CPCR) of the Latin American Integration Association (ALADI).

The FLAR was set up as a regional fund for the Andean Community in 1978 and reflects a small scaled IMF in the region. This regional fund is now open to other Latin American countries. It has assets amounting to about US$ 1 billion as of 1998 whose sources are made up from the member country quotas. Although limited in size, the regional fund has been more effectively used by member countries. They have drawn more liquidity from the FLAR than from the IMF given the regional fund's more favorable terms in borrowing. The CPCR, which was instituted in 1969, comprises two arrangements: the clearing house (monitored by the Central reserve bank of Peru) and the mutual lines of credit. Unlike the FLAR, the CPCR does not own its own fund but only oversees the allocation of available credits from the member countries' central banks to the countries in need. During the LA crisis in the 1980's, the CPCR played a useful role in helping member banks to some extent, but the amount of available credit to offer is too small to be effective in preventing the contagious effects of a financial crisis (Agosin, 2001).

As seen from the above cases, LA efforts for regional financial cooperation can be doubted for their effectiveness, and as such have failed to attract serious attention for further development. This can be explained by the importance of US participation in a regional arrangement. Given the dominance of the US in LA capital and financial markets, any attempt for financial integration without the active participation of the US can be questioned for its feasibility as well as for its sustainability.

5.Lessons and Possibilities for East Asia.

Other regions' experiences in financial cooperation should shed some light on the possibilities for East Asia. In this section, we draw lessons from their experiences to reflect on the East Asian circumstances, exploring at the same time possible avenues for financial cooperation in East Asia. The integration experiences in Europe and Latin America show contrasting patterns in the importance of a country's economic fundamentals in determining the outcome of financial integration. From a theoretical perspective, the preconditions for a successful financial integration can be summarized simply as larger benefits and smaller costs. (Bayoumi et al., 2000) Larger benefits may draw on the mutual dependence of the economies. The greater the amount of transactions of products and factors, the greater will be the benefits from stability and predictability of such regional economic variables as the exchange rates. On the other hand, the integration costs are negatively linked to the degree of symmetry of the regional economies. If the macroeconomic conditions and institutional structures are alike, the burden from negative economic shocks would spread more evenly across the countries. If the costs are small, a financial integration is more sustainable and is ready to reap its benefits. One caveat about the similarity of the economies is that the sum of bad economies does not make a good economy.

A well-known theory on the preconditions necessary for regional financial integration is Optimal Currency Area (OCA). One aspect of OCA theory is to analyze the relationship between bilateral exchange-rates and other major variables such as growth rates and regional trades. According to Bayoumi et al (2000) the exchange rate movements turn out to be less stable in the AEAN countries compared to the EU countries but the differences are too small to discourage regional integration for Asia.

Bayoumi et al (2000) and Yuen and Ling (2001) additionally developed a pattern analysis in which the impacts of shocks on such variables as output and price level are investigated using VAR forecasting methods. According to Bayoumi et al. (2000), the ASEAN countries are not very different in shock response although the differences are more prominent compared with the EU countries. Yuen and Ling (2001) broaden the coverage of countries including Japan, Korea, Taiwan, and China and look into the sub-regional characteristics using the impulse analysis. Their results show that geographical neighbors tend to response in a similar way, for example, in the case of Japan and Korea. Accordingly, their analysis supports in favor of sub-regional level integration than of regional-level one.

While their studies shed light on possible theoretical criteria for regional integration, it must be noted that their use of the variables are limited in numbers and the research is based on a simulation model. Thus it will be useful to analyze economic problems in a broader context, focusing in particular on institutional aspects. We will begin with two key transaction data including trade and direct investment are introduced.

Intra-regional exports and foreign direct investment (FDI) for East Asia are then compared as an indirect indicator of minimum feasibility of achieving regional financial integration. Data for exports show notable differences across the regions. The EU shows increases in intra-regional exports and has reached between 60 and 70 percents of the total exports while its dependence on the US market continues to stay below 10 percent.

(Figure A-1) In contrast, LA countries' intra-regional exports are still less than 20 percent except for a few years although the intra-regional trade has slightly increased over time. (Figure A-2) Nonetheless, their dependence on the US market has risen remarkably over the past decade, reaching almost 60 percent of the region's total exports. On the other hand, EA countries show a rapid rise in their intra-regional exports up to 50 percent while their dependence on the US market has been less than 30 percent over the decade. [1] (Figure A-3)

Latin American countries' interest in regional cooperation has been linked to the US initiative for regional trade liberalization while EA has achieved an increasing autonomy from the US market, shifting more toward regional interdependency. This is noticeably the case with Japan. Japanese exports to Asia have reached more than 40 percent of their total exports while those to the US have decreased throughout the past decade.

The examination of FDI data show similar patterns for each region. As the EU, US, and Japan occupy a dominant portion of FDI in the world, how each player sets its position in each region decides the regional pattern in FDI. In the EU, the EU itself is the largest investor.(Figure A-4) In LA, the US has been the largest investor. (Figure A-5) In Asia, Japan has played the largest role in investment. (Figure A-6) As FDIs are long-term projects in the recipient country, the investing countries have deep interest in the host country and are sensitive to the economic conditions. In this regard, FDI is a "readiness indicator" for integration, even better than the intra-regional trade measure. In particular, the performance of FDI would be affected by the degree of financial liberalization in the recipient countries. Ipso facto, a large FDI inflow in the recipient country would imply the evidence that its domestic economy is already integrated into the global economy.

Japan and the US's dominance in foreign investment in East Asia and Latin America, respectively, has important implications for regional integration. As evident from the currently limited efforts for sub-regional integration in Latin America, a financial integration without the participation of the US cannot exercise a significant influence on the region and as a result, does not draw much attention or participation from the countries in the region. For the EA region, in contrast, Japan has been an enthusiastic partner in initiating regional financial integration. Given its influential linkage to the EA region in trade and direct investment, Japan is indeed in a position to create a regional financial institute. In this regard, compared with Latin America, the EA countries may be in a better position to pursue financial integration in the region.

The analysis of the costs of integration is based on major macroeconomic indicators of the countries. The Maastricht stipulation of the key macroeconomic variables can serve as a reference (Zahler, 2001). The agreements required five convergence criteria for inflation rates, interest rates, exchange rates, government debts, and budget deficits (Pentecost, 2001). These criteria are made as minimum condition to prevent financial instability of a country, contamination to other countries and a possible breakdown of the integration. In the case of the EA region with a number of less

[1] The data for Asia includes South Asia. However, this does not result in significant bias since South Asia is not prominent in Asia's total exports.

developed economies, it is desirable to use other indicatotrs in addition to the Masstricht variables. The crucial difference of the EU from other regions is that the EU has already achieved a high level of economic development and sophisticated markets. Thus the key concern is convergence in standard macroeconomic variables. In contrast, the EA regional economy is faced with other problems related to economic development, besides regional harmonization of economic policies. Typical problems are low standards of living and vulnerability to the external shocks. In this context, we start with the examinations of per capita GDP and external variables such as trade balance, external debt and foreign reserves.

The data about the average of per capita GDPs in each region show that both EA countries and LA countries have not yet caught up with that of EU.(Figure A-7) Indeed, EA countries' living standard rose until 1997 crisis but deteriorated onward. LA countries continued to lag behind from the EU and the gap has been widened. As a result any region could not reach 35% of the EU's average GDP since 1960s when European countries initiated to create a common market in Europe. The data about the standard deviation of countries' per capita GDPs normalized by the average show that EA countries are far more diverse in standard of living than LA countries which in turn are more diverse than European countries.(Figure A-8) This means that European countries are not only rich but also homogeneous and that East Asian countries show a huge deviation in standard of living among countries. This result is not at all unexpected considering that European countries occupy to rank in standard of living and that East Asia covers from world-class rich countries like Japan to subsistent-level countries like Vietnam. Not only the absolute level of standard of living but also the relative differences in East Asia and Latin America cast a pessimistic foresight about a high degree of regional integration.

The country variables that are widely employed in measuring the robustness to external shocks are trade deficit, external debt, and size of reserves. And finally, since effective policy coordination for regional cooperation is predicated upon mutual trust among involved countries, the reliability and transparency of governments and the financial sectors can be called into the question. In this context, some relevant indicators are also presented for comparisons.

Starting with the external shock indicators, we first note that as trade deficit continues without any foreseeable change for a reverse, such price variables as exchange rates become unstable and vulnerable to domestic and external shocks. Continued trade deficits cannot be fully financed by foreign investment and lead to a rise in the national debt, undermining financial markets by pressuring on interest rates and exchange rates. In particular, for many developing countries that are not competitiveness in exports markets, cumulative trade deficits often lead to financial crisis. For this reason, trade balance data will be compared first. Since the mid-1980s,the European countries as a whole had trade surpluses, which facilitated implementation of the ambitious Maastricht Treaty. Latin America has experienced a far longer period of trade deficits than that of trade surpluses

Figure A-9). During the 1980s, Latin American countries as a whole (in particular six largest countries[2]) recorded a deterioration in trade balance. If we include most of countries in Latin America except for several small island countries, the past decade saw a very bad situation in trade. This contrasted with the East Asian region as the ASEAN plus three countries had surpluses except several years in the early 90s. After the crisis, trade surplus skyrocketed although this should be carefully interpreted in terms of cyclical effect as the aftermath of the crisis. The patterns were not that different between the ASEAN only group and the ASEAN plus three group.

Nonetheless, for both regions, there is no assurance that they are on a solid track toward a long-term external equilibrium as the share of high-value added or high-tech commodities in exports are extremely low in most of the countries in these regions. As cumulative trade deficits lead to the rise in external debts, it signals an warning to the investors and makes them hesitate or withdraw from investment activities. As the external debt grows, rising interest rates and debt services suppress the economy, possibly igniting a vicious cycle.

The EU countries are mostly credit suppliers to the developing countries, including Asian nations. This feature implies that the EU's external debt size by itself cannot be used for comparing with other developing countries. As an alternative benchmark for comparison, we use South Korean debt data for East Asia; South Korea never had a debt delinquency problem even though its trade balance had been in deficits for many years and the country's development was financed by foreign debts.

Up to the early 1980s, the average debt-GDP ratios were similar, albeit with generally increasing trends, across the groups of LA and EA.(Figure A-10) Since then, both groups of countries reached a peak around 100 percent, hovering over 60 percent. In Latin America, the group average of the six largest countries recovered to about 40 percent recently. On the other hand, South Korea showed less than 20 percent for about ten years since the mid-80s. Though it rose around 1997 but still stayed at about 30 percent level. Since what level of debt should be regarded as a warning status would depend on each specific country case, it is not easy to interpret the data in terms of economic security. However, both the EA and LA groups seem to be at high levels of debt, considering that Argentina's debt ratio had been 40 percent since 1996 and had to deal with debt repayment problems with the outbreak of the financial crisis in 2001-2002.

As for exchange reserves, the EA countries have done better. For the past four decades, the EA countries had the highest levels of reserves, even higher after the 1997 crisis than before. (Figure A-11) In contrast, the LA countries remained roughly at half the level of the EA countries. The EU countries had peaks and similar levels as the EA countries in the early 80s (about 15 percent in average) and had kept reducing their level since then and now are lower than the LA countries. However, the EU countries are mainly creditors in international finance and the creation of the EMU made them in need of less foreign reserves. Without such a regional finance institute that can systematically protect member countries in case of external shocks, a lower reserve is an important

[2] Brazil, Mexico, Columbia, Argentina, Peru, Chile in descending order of population. Venezuela is the sixth in population but was uncounted because its major source of revenue is oil exports

factor that could make the country vulnerable to potential threats from exchange rate adjustments or speculations.

That the EA countries have kept high levels of reserves should make regional financial cooperation easier. Higher reserves could prevent or minimize the risk of being subjected to financial shocks. Nonetheless, the current EA reserves are excessively high with the resulting economic losses. More will be said about the losses later in the paper.

Among the domestic indicators measuring the stability of the economy, inflation is an important one since it gives a referendum to judge whether the economy is on a sustainable path. LA countries were in bad shapes with respect to inflation. For the last three decades, the averages of inflation rates were mostly higher than 10 percents and recorded hyperinflation for many years. (Figure A-12) After the structural adjustment in the 1990s, inflation has been subdued to the lowest level in history. The EU countries has successfully controlled inflation since the mid-1980s; the average has been lower than 5 percent recently. The ASEAN+3 countries also recorded lower inflation rates except in the smaller states of Brunei, Myanmar and Laos. Though a little higher than that of the EU countries, the average was close to five percent for the past 15 years except during the financial crisis period in the late 1990s. Low inflation rates would help the task of coordinating macroeconomic policy at the regional level much easier.

The country's ability to manage financial health is generally reflected by government budget status. Persistent deficits over years drain the resources for the private sector, also affecting interest rates and causing inflation.. Not only for successful domestic policy but also for policy coordination, deficits should be constrained to a certain level. For instance, the Maastricht agreements require that the budget deficits should be smaller than 3 percent of GDP.

The EA countries's budget deficit has on average been much lower than the other two regions since the early 1980s. (Figure A-13) During the last decade, their budgets operated on a surplus trend. Many EU countries were in deficits during the 1980s but since the early 1990s their deficits have been reduced significantly, reaching close to a balance recently. Most of the LA countries registered budget deficits,which were lower than two percent of GDP. However, it must be noted that domestic bond markets in developing countries are very thin and budget deficits must be covered by growth in money supply or external debt. Thus a persistent pattern of deficits could undermine the financial stability in the economy.

As for institutional measures of the suitability of a group of countries for financial integration, the transparency in government and business sector activities needs to be taken into consideration. In spite of some differences, the leading indicators currently used for evaluating such institutional aspect seem to indicate largely consistent results. The effectiveness in uses made of funds and credits lines, and transparency in the intermediary role of the government are the critical components in these measures. The more transparent the public sector agents are, the larger amount of credits can be supplied and the easier the access to international funds will be. As seen from the table, while the EU countries are ranked high, many of the EA and LA countries are at the lower end of the list with a few exceptions of such countries as Singapore and Chile. The low profiles in transparency in both regions will be a hurdle to developing a broader and deeper regional integration.

There are other institutional arrangements as necessary preconditions for regional integration, which are more serious huddle in East Asia according to Bayoumi (2000). For instance, the region-wide accessibility and sharing of vital economic and financial information should be made available and compiled for a systematic analysis. As for this, the EU and LA countries have accumulated much experience because they have longer experiences in regional cooperation.[3] In East Asia, the ASEAN (since 1967 at Bangkok) and the Asian Development Bank (since 1966 at Manila) have functioned as a regional body. However, nether has played as a regional body that oversees the regional economic matters in a broad scope. The ASEAN has covered only 10 member countries in South East Asia and the ADB's major concern has been with anti-poverty and related development programs. In order for the regional bodies to successfully coordinate policy issues, mutual sharing of accurate economic information needs to be institutionalized as a precondition for financial integration. Such an institutional arrangement has not yet been established in East Asia.

Other institutional arrangements may include the legal provisions allowing for free factor mobility (labor and capital) across the national borders. Without free factor movements, complete regional integration would be difficult to expect. Free mobility not only helps to achieve a more efficient use of resources but also enhances the effects of the results from policy coordination at the regional level. It is to be noted that largely inhibited by the international differences in ethnic culture and languages, labor mobility even within the European Union is still limited.

6. Beyond Chang Mai: Further Steps

The deepened mutual dependence among the EA countries as reflected by high levels of intra-regional trade and investment, along with the generally sound macroeconomic situation in the regional economy favors a move toward regional financial integration. On the other hand, glaring asymmetries in macroeconomic conditions and institutional development among the countries in the region are a stumbling block in the path toward ultimate financial integration. Moreover, the EA countries lack in political experiences for regional cooperation. Given the past history of Japanese colonial rule in Asia as well as the complex geopolitics involving Japan and China, the formation of social capital at the regional level in forging mutual trust and confidence among the member countries is still incipient. Sufficient level of social capital would be instrumental in facilitating regional financial integration, as demonstrated by the post- World War 11 cooperation between Germany and France in forging European integration. Given this reality, policy coordination at the regional level, which should serve as the basis for further financial cooperation, is expected to remain in the realm of each country's volunteerism. In other words, East Asia does not appear yet to allow a supra-national governance. Thus, the

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[3] In Europe, the OECD (Organization for Economic Cooperation and Development, since 1961) and European Community (since 1958) have managed policy coordination. In Latin America, the Economic Commission for Latin America (ECLA, the Spanish acronym is CEPAL) has helped forming regional policy and monitoring information since 1948.

prevailing geopolitical environment justifies to take a cautious, piecemeal approach to financial integration. Instead of a grandiose framework for integration, many small patches need to be tried and utilized for further pragmatic steps.

In this context, the CMI is a good start. Although its ability to prevent or minimize the risk of financial crisis is yet limited, it paves way to the prospect for further cooperation. The CMI initiated a series of bilateral negotiations and multilateral discussions between the EA countries and contributed to forming a general consensus that East Asia should build a more solid framework for cooperation. For this, we elaborate further on the following points.

First, as suggested by the initial plan of the CMI, a more concerted and concentrated institutional framework should be arranged to gather economic data and to monitor the regional economic and financial situation. Such a function could easily be handled by the existing regional economic institutions such as the Asian Development Bank or a new institution can created. The current objective of the ADB is largely concerned with reductions in poverty in the region. The ADB has recently contributed to the study of financial integration in cooperation with Japan, and can be expanded to equip with the technical staffs and resources to manage and disseminate information flows. Alternatively, at the current juncture of Asian financial market development, a new regional institution needs to be modeled on the likes of the OECD or the CEPAL rather than on the more proactive IMF.

Second, the EA countries and the new regional institutions could cooperate to delineate the goals and strategies of regional integration and specifically define the roles of the institutions and their relations with member countries. This may include a new negotiation about expanding to the multilateral swap arrangement from the current bilateral system along with the terms and sizes of multilateral swaps. After pooling some amount of reserves into a single fund, the member countries can make a contract to borrow and reimburse it. Considering the huge volume of East Asia’s total reserves - estimated at $800 billion, multilateral swap arrangements could be very effective in preserving financial stability. (Park, 2000b).

Third, in addition to the preparation for an emergency rescue, regional coordination about exchange rate policies should be promoted. As the EA countries compete in extra-regional markets, there is a tendency in competitive devaluations by member states. Prior to the outbreak of the Asian Crisis, China’s decision to depreciate their exchange rate to stimulate their exports contributed to the spiral fall in other countries’ trade balance. Consultation at the regional level concerning the exchange rate adjustments could have reduced the risk of contagious effects of the crisis.

Lastly, another important multilateral effort should be to promote the expansion of regional free trade. In effect, in parallel with arrangements for financial cooperation, Asian ministers have begun with the agreements to expedite liberalization of bilateral trade. For example, the ASEAN countries agreed to have a free trade zone and Japan and Singapore also agreed on bilateral free trade. China and Korea also have shown interest in bilateral free trade and proceeded for negotiations. (Park, 2002a)

The diversity in the EA countries makes it important to pay attention to specific country problems. Although the EA countries show generally sound economic indicators, many of them are still in the stage of economic development and have to deal with many underdevelopment issues such as low standards of living, poor social welfare, underdeveloped financial infrastructure, lack of transparency in both government and business sector. Financial integration would need a political commitment from members for a common policy goal. Thus, the costs should be shared more equitably by specific institutional arrangements. Adequate provisions for social welfare benefits by both the country and regional institutions could reduce the economic repercussion from the country's policy commitment. For the least developed countries in the region such as Cambodia, Laos, Vietnam, special consideration must be given for the possibility of prioritizing development aid rather than the option for financial integration.

Other advanced developing countries, however, may have many institutional weaknesses in financial areas. Typically their financial sector is not yet well diversified and is composed mainly of banking activities.[4] As a result, the real and financial sectors likely end up with a high dependence on foreign debt and are vulnerable to external shocks. Since their surveillance mechanism is weak and unreliable, their economy is still exposed to capital flight. Given this reality, a full-fledged capital mobility, which is the key to the success in financial integration, must be questioned. Still in the EA region, capital control remains as an option. The exception was the case of Malaysia. During the Asian crisis, the country was forced to resort to restrictions in international capital movements to overcome financial instability. For the EA region, careful management is called for a cautious weighting between financial liberalization and control on capital flows.

6. Summary and Conclusion.

As the policy goal for the EA regional economy which possibly could include a wider range of neighbor non-EA countries, the governments of the EA countries should aim to deepen financial integration in parallel to the region's deepening trade integration. It must be noted that regional financial arrangements complement the region's move toward trade liberalization and should he1p reduce the risk of financial crises for the region, thereby contributing to regional and global financial stability.

In spite of the common aspiration for financial integration in East Asia, this paper takes a cautious position in approach to the integration. It has been argued that the current situation in EA does not satisfy the real and financial criteria required for a financial integration, in particular under a common currency. More specifically, the main points of the paper are as follows.

A key issue in forging a sustainable regional financial arrangement is the selection of countries suitable to be a member of the regional group. For the EA regional economy, the enormous economic gap between the more advanced member states consisting of a few ASEAN nations plus the Three and the rest consisting of such less developed partners as Laos, Vietnam, Cambodia, and Indonesia raises doubts about the

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[4] *Economist.* February 28, 2003.

benefits of regional integration. Thus, if the ultimate goal for EA is a monetary union - something similar to the current EU framework, the challenging task remains in that a reasonable degree of real-sector convergence must take place before any plan for the regional financial stability is to be implemented. It is conceivable that the less developed partners' aspiration to meet financial convergence criteria - for instance, low inflation rates and low public debt levels in joining a currency/monetary union- could result in slower economic growth, harming the prospects of their real sector convergence. Clearly more time would be needed to close the gap, and for this, the less developed partners might be allowed wider discretion in exercising monetary and exchange rate policies during a transition period. Thus for East Asia, the question of a region-wide common currency framework seems premature at this stage of the evolution in integration.

As a workable framework for financial integration, the sub-region based categorization of appropriate groups may be conceived. For instance, while the framework ensuring the stability of exchange rates among the more developed, trade interdependent members would be highly desirable and more feasible, the less developed countries with asymmetric industrial structures could be allowed more discretion in exercising monetary and exchange rate policy. Moreover, depending on the severity of a crisis, the less developed members could even be allowed some privilege of applying restrictions on capital flows for a transient period until financial stability is restored.

Except for the allowance of a certain degree of monetary and exchange rate policy autonomy for the weaker set of countries, there must, however, be at the entire regional level a systematic exchange and compilation of information, carefully orchestrated surveillance, and harmonization of national policies on such macroeconomic issues as exchange rates, interest rates, inflation rates, fiscal deficits and public indebtedness. Most of the EA countries do not yet meet the macroeconomic preconditions necessary for financial integration. The region has not yet agreed on standardized accounting and statistics systems, let alone to have the supervisory or monitoring institutions in the region. The huge non-performing loans continue to saddle many EA countries. Limited and dysfunctional equity and bond markets will continue to slow the progress toward an effective regional financial cooperation. Thus, concerted regional efforts to collectively eliminate these stumbling blocks should help prevent and reduce the risk of a financial crisis and its contagious effects, and at the same time is a step in the right direction toward regional financial integration.

In this context, the Chang Mai initiative for swap arrangements is a good starting framework for promoting financial cooperation and policy coordination in the region. There is, nonetheless, a caveat in the excessive reliance on the Chang Mai reserves. While in the short run, an expansion in the amount of reserves for purposes of swap uses would be helpful in reducing the risk of a liquidity crisis, there is a need to make the working of excess reserves - which are already excessively high in East Asia - more efficient over the longer term. The amount of reserves can be reduced by developing new institutional infrastructure that promotes the process of financial deepening and/or by expanding the areas of financial policy coordination among member states. Excess reserves could be released for economic development of the less developed partners or for other regional infrastructure development.

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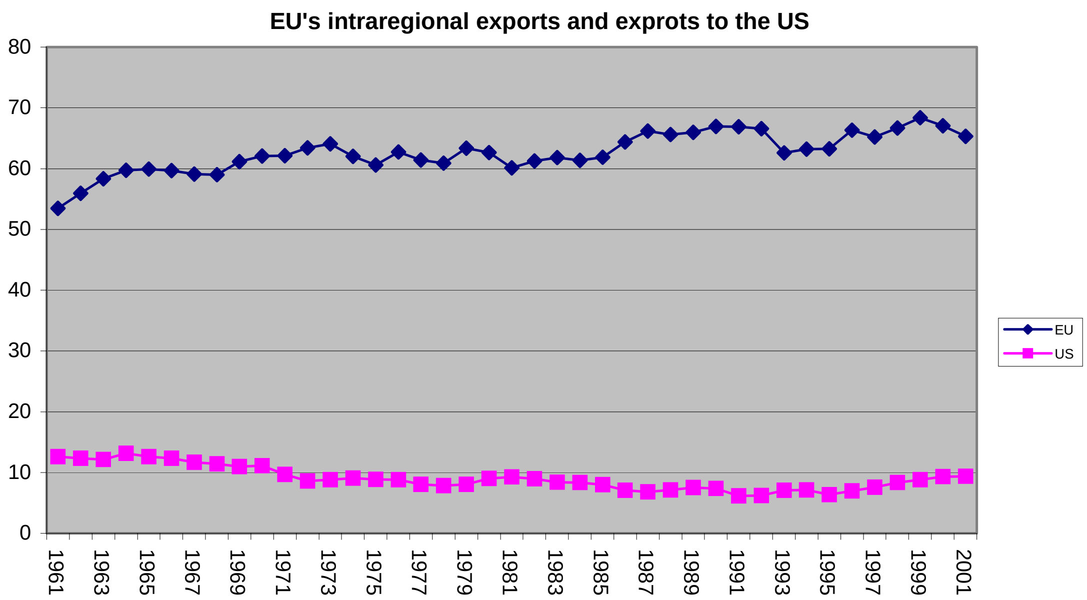
Appendix

Table A.1 Government favoritism*

	ranking		ranking		ranking
Austria	23	Argentina	28	China	51
Belgium	30	Bolivia	18	Indonesia	59
Denmark	2	Brazil	38	Japan	32
Finland	1	Chile	12	Korea	35
France	10	Colombia	37	Malaysia	54
Germany	15	Ecuador	24	Philippines	55
Greece	45	El Salvador	26	Singapore	4
Ireland	16	Mexico	44	Thailand	50
Italy	27	Peru	36	Vietnam	42
Luxembourg	19	Venezuela	33		
Netherlands	3				
Norway	11				
Portugal	31				
Spain	22				
Sweden	7				
UK	9				
Average	16.9	Average	29.6	Average	42.4

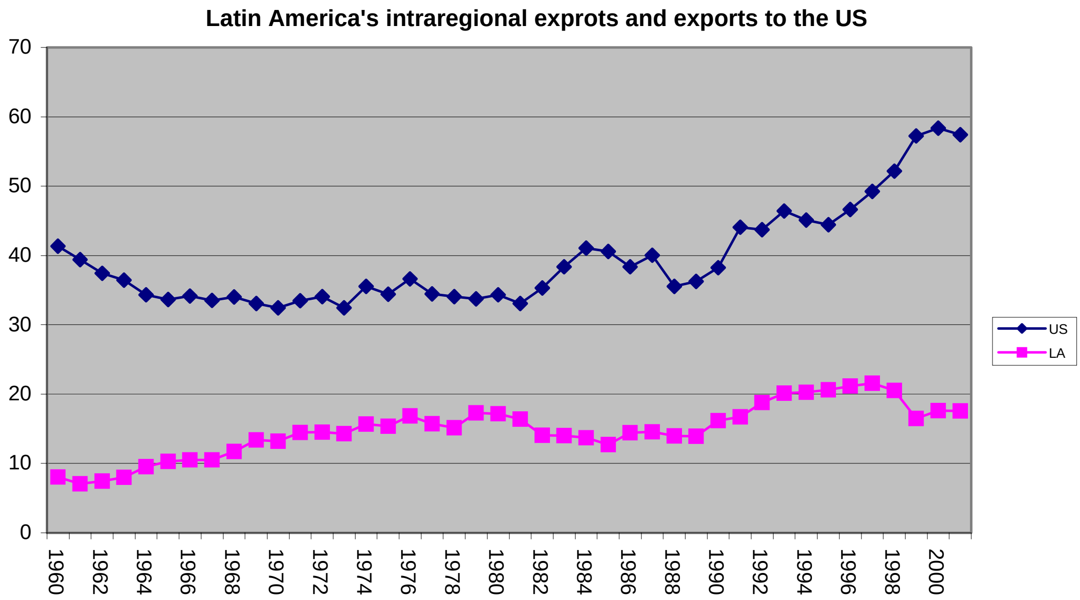
Source: *Global Competitiveness Report 1999*,
Note * Sweetheart deals between well-connected private firms and the government are not common. Ranking is based on 56 countries in the survey.

Figure A-1



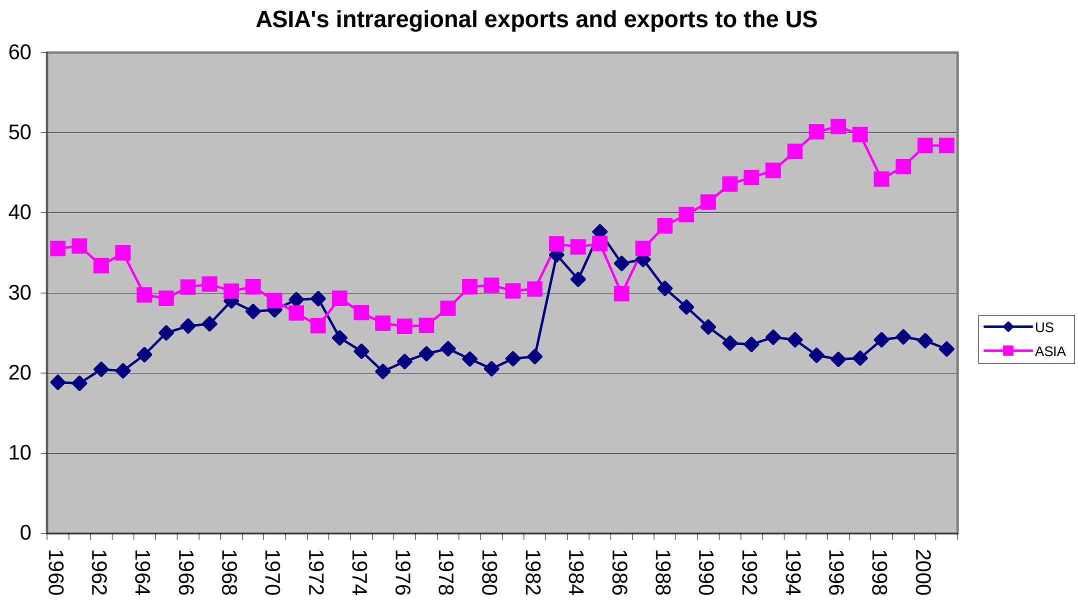
Source: OECD (1997).
Note: Figures represent the shares of exports to designated markets in EU's total exports

Figure A-2



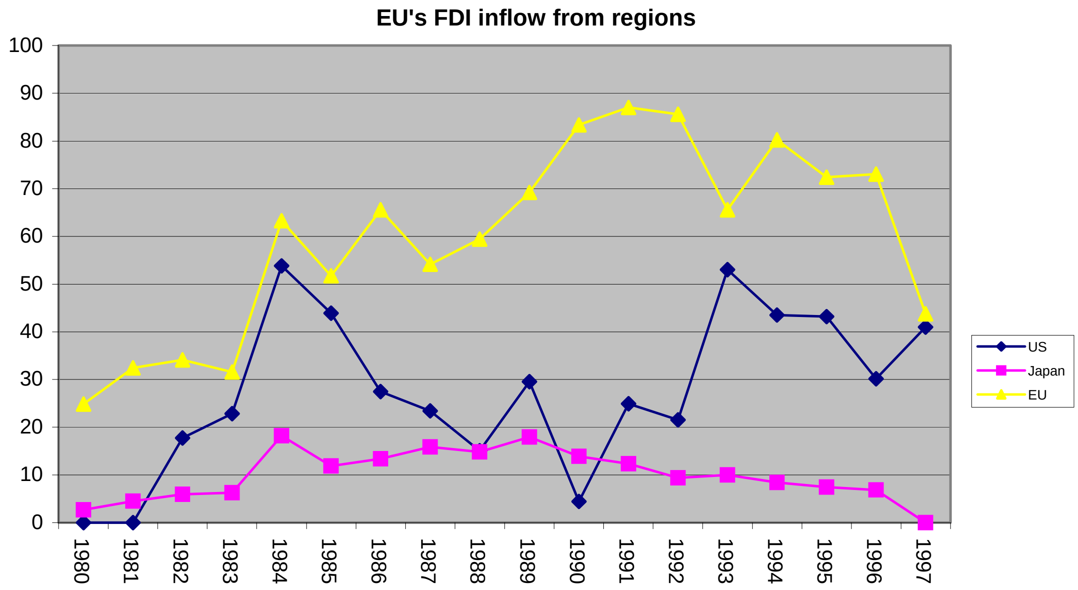
Source: IMF's *Direction of Trade Statistics* (annual).
Note: Figures represent the shares of exports to designated markets in LA's total exports. Latin America is the Western Hemisphere in the IMF's definition

Figure A-3



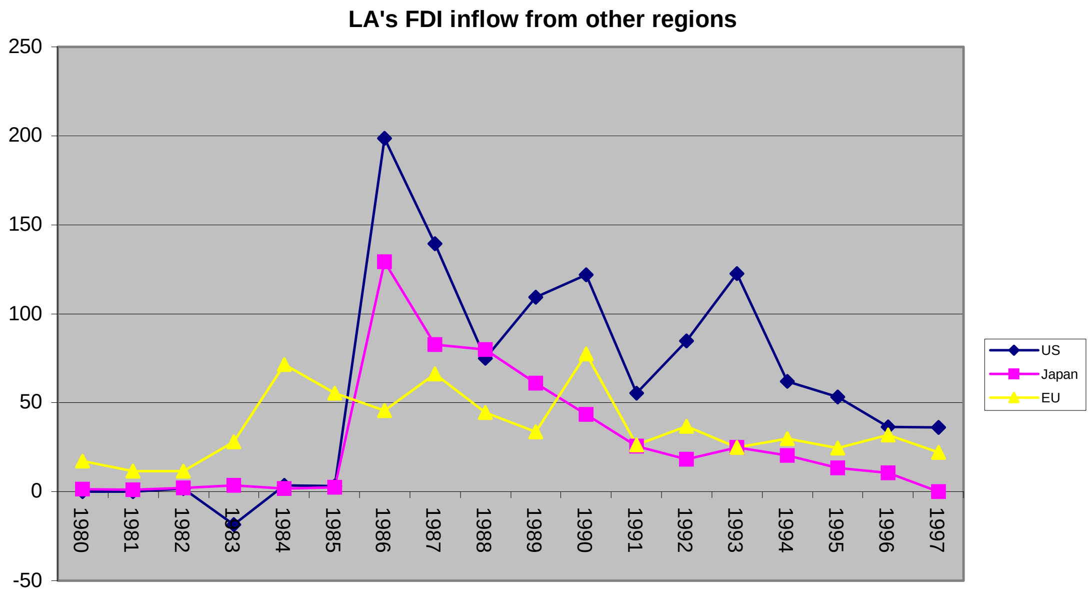
Source: IMF (annual).
Note: Figures represent the shares of exports to designated markets in Asia's total exports. Asia covers both South and East Asia including Japan.

Figure A-4



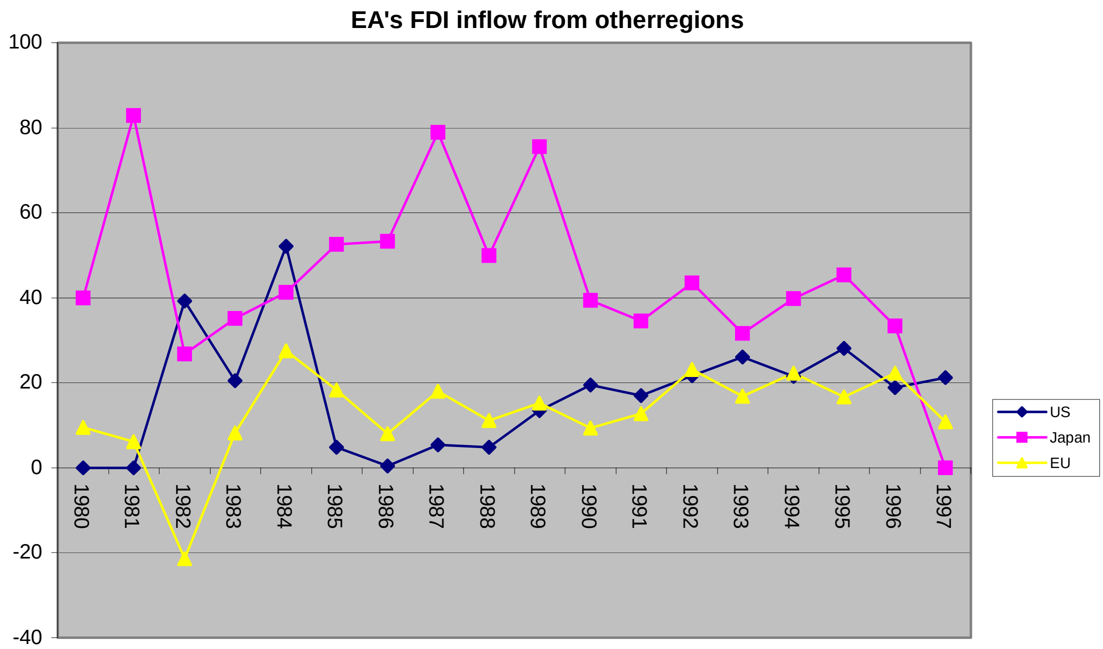
Source: OECD (1997) and World Bank(2002).
Note: Figures represent the shares (in percentage) of regions in FDI inflows to EU. The sum of shares can be larger than 100 because of different data sources.

Figure A-5



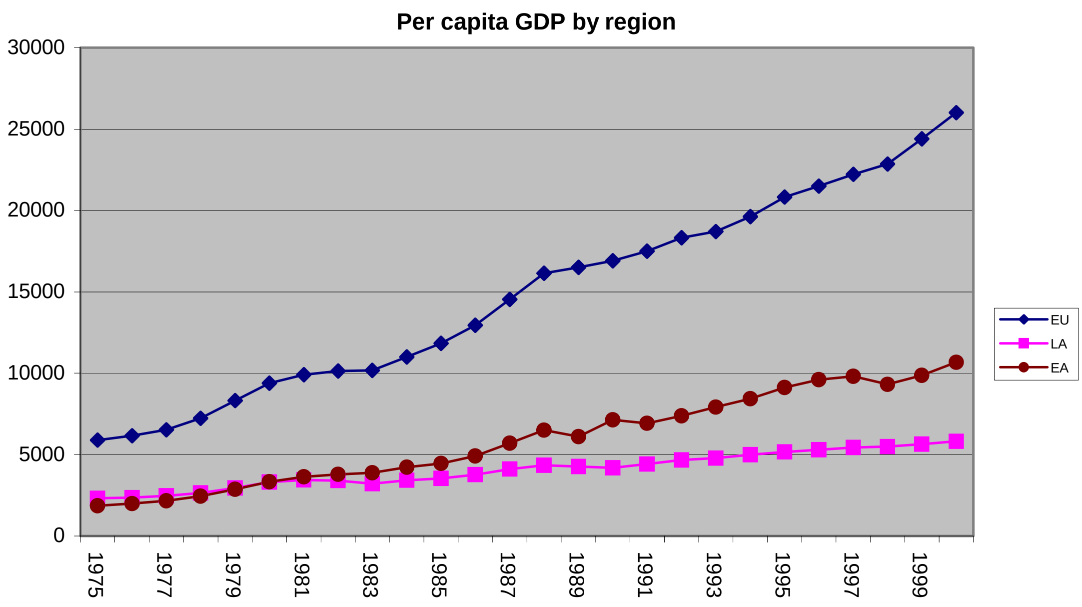
Source: OECD (1997) and World Bank(2002).
Note: The sum of shares may exceed 100 because of different data sources.

Figure A-6



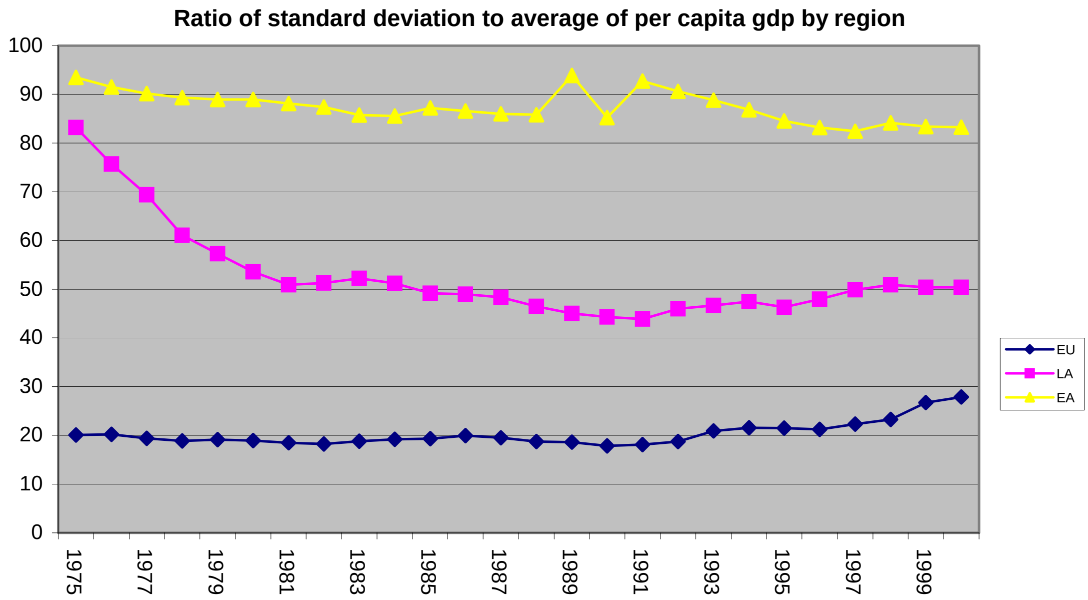
Source: OECD (1997) and World Bank(2002). Note: Figures represent the shares (in percentage) of other regions in total FDI inflows in EA.. EA is ASEAN plus China and Korea. The sum of shares may exceed 100% because of different data sources.

Figure A-7



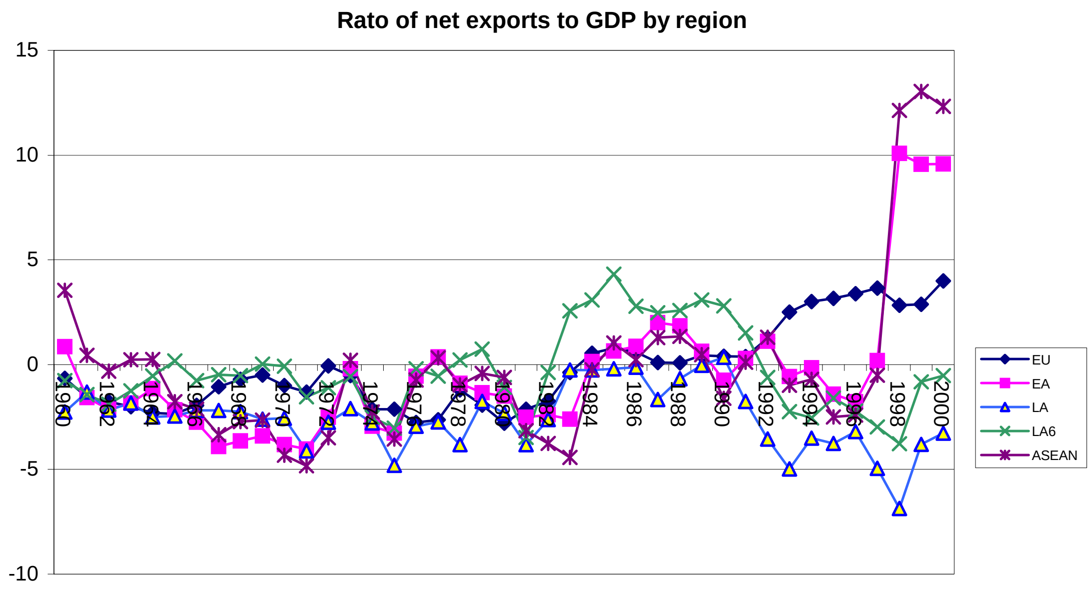
Source: World Bank (2002).
Note: East Asia consists of large ASEAN countries plus Japan, China and S. Korea

Figure A-8



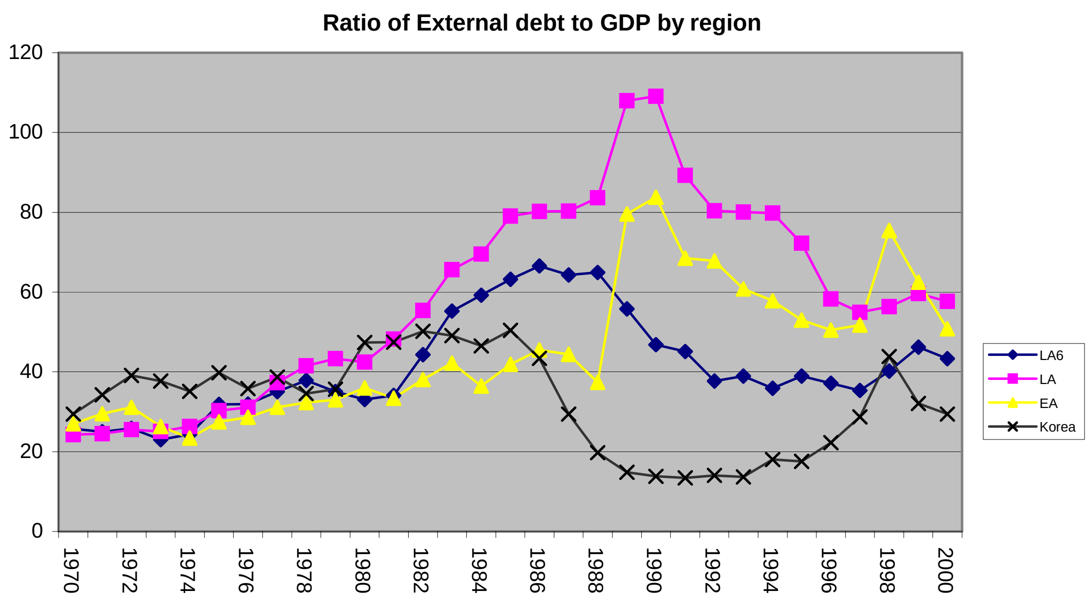
Source: World Bank (2002).

Figure A-9



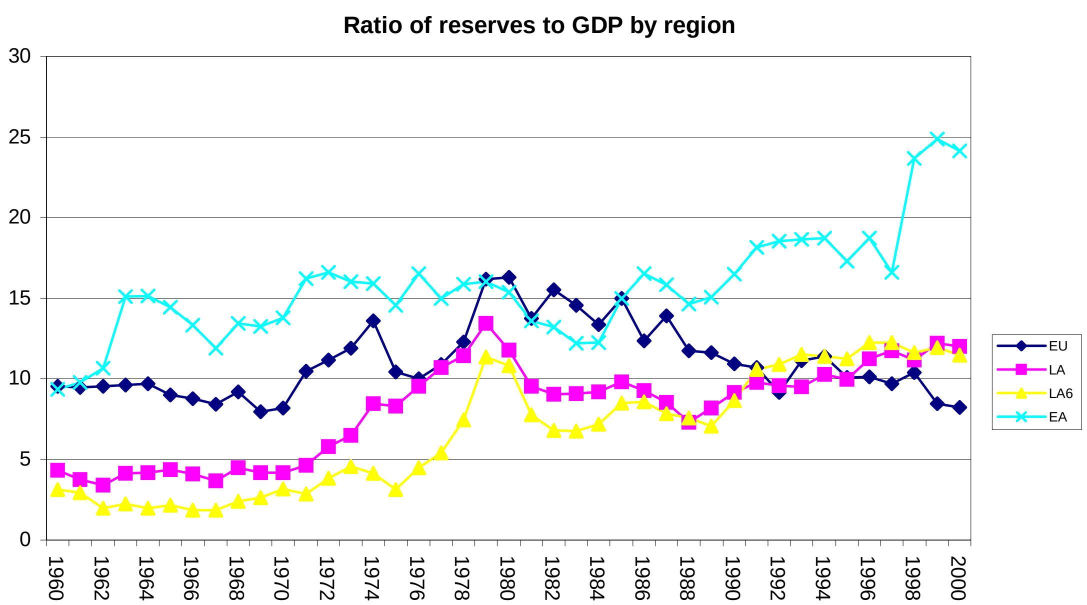
Source: World Bank (2002).
Note. LA6: six largest nations in Latin America.

Figure A-10



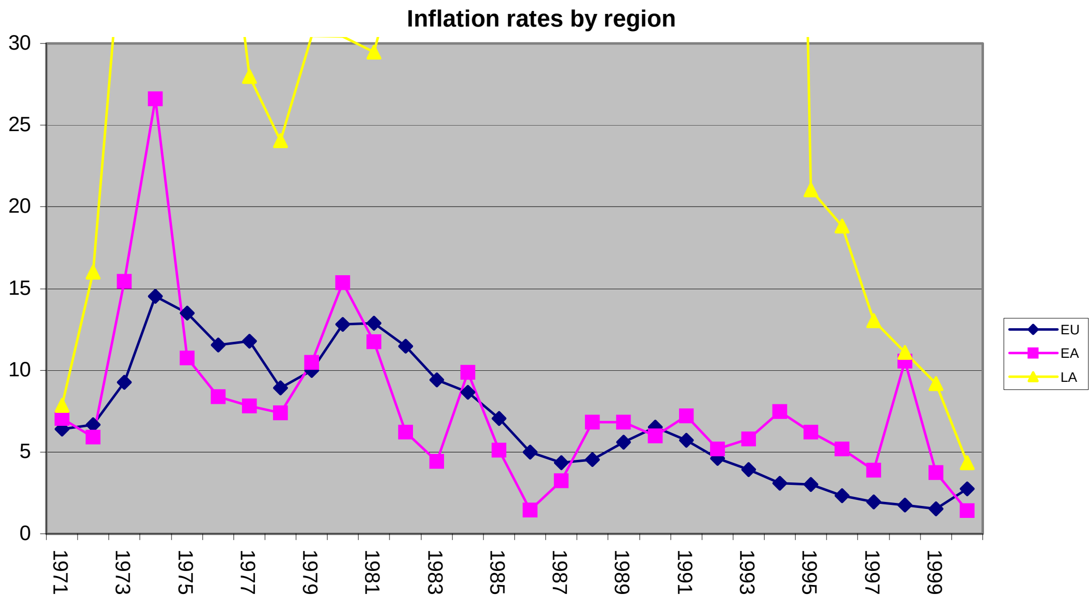
Source: World Bank (2002).

Figure A-11



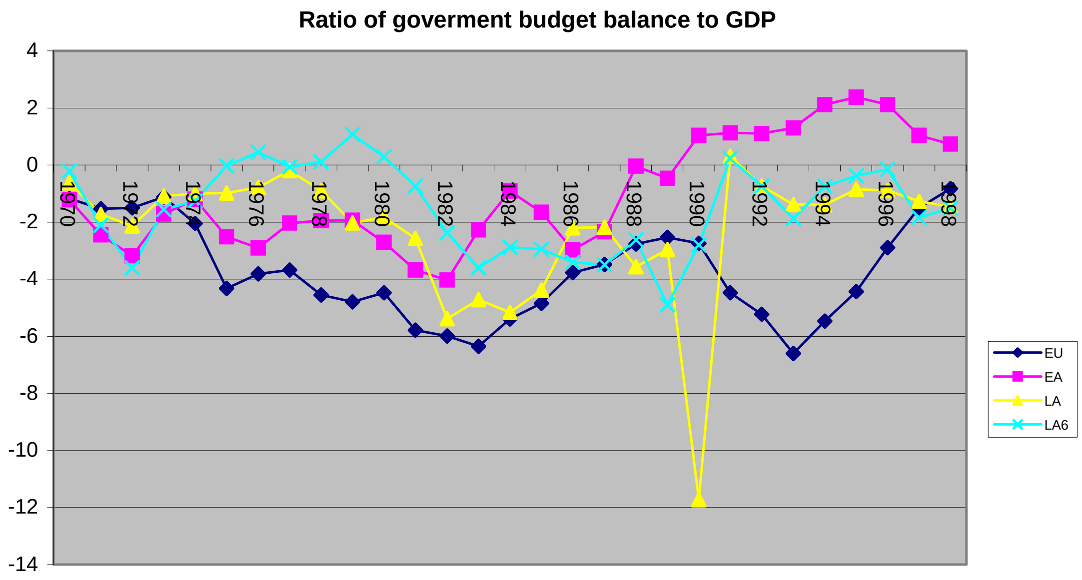
Source: World Bank (2002).

Figure A-12



Source: World Bank (2002).

Figure A-13



Source: IMF (2002). Note: The figures are the averages of ratios of government budget balance to GDP.