Financial Cooperation in East Asia[+]

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1. Introduction

The growing interdependence in the world through trade and financial integration has heightened the need to engage in international and regional economic cooperation. This was never demonstrated more clearly than during the Asian financial crisis of 1997. In reality, financial instability is unlikely to remain within the national borders of the country of origin. Cooperative efforts at both regional and global levels are therefore needed to counter the negative spillovers. The IMF's surveillance activity is just such an example of the provision of a global public good. By the commonsense logic of "two heads are better than one," regional initiatives could complement the IMF surveillance process (Wang and Woo 2004).

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

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playing the role of a fire fighter.

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

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

Before the Asian financial crisis broke out in 1997, few would have seriously argued for the creation of a system of regional financial cooperation in East Asia. Only a market-led integration process was taking place in East Asia. However, the financial crisis that erupted in 1997 was a major financial breakdown that gave East Asians a strong impetus to search for a regional mechanism that could forestall future crises. This search is now gathering momentum and opening the door to possibly significant policy-

led integration in East Asia (Bergsten 2000; Henning 2002). Bergsten noted that East Asia might be on the brink of a historic evolution, as Europe was half a century ago.

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

The purpose of this paper is to provide a view on the current process and future prospects for regional financial and monetary cooperation. The paper is organized as follows. Section 2 discusses the rationale for regional financial cooperation. Section 3 reviews the current status of regional financial cooperation in East Asia. Section 4 examines the current level of financial integration at the regional level. Section 5 addresses major barriers to financial cooperation and integration. Finally, section 6 concludes with a discussion of the future prospects for financial and monetary cooperation in the region.

2. Rationale for Regional Financial Cooperation

The Asian financial crisis provided a strong impetus for East Asia to reform and strengthen its domestic financial systems (markets and institutions). At the same time, a strong need has emerged for developing a framework that can support regional financial cooperation to prevent and manage such crises in the future. However, the terminology – regional financial cooperation – seems ambiguous and thus needs to be more clearly specified. No one can deny the need for regional financial cooperation in the genuine sense, but when it comes to discussing the details and specifics of concrete proposals, there is disagreement all around among insiders and outsiders alike. One clear example is the proposal for the Asian Monetary Fund (AMF), which was shot down in 1997 (Wang 2004).

The adoption and implementation of the CMI could be counted as a major step toward strengthening the financial cooperation among the thirteen East Asian countries. However, ASEAN+3 countries will face much tougher challenges and tasks in exploring developments beyond the CMI. East Asian countries need to clarify to the international

community what their motivations are, how they will develop an action plan, and how they believe it fits in with the existing global financial system (Park and Wang 2000).

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

The issue of moral hazard is one strong argument against the regional monetary fund. At this stage of development, East Asians may not be prepared to negotiate an international treaty that includes provisions for sanctions and fines for countries that do not adjust their domestic policies accordingly (Eichengreen 2000).[1] This unwillingness would make it difficult for the regional monetary fund to impose politically unpopular policies on the member countries and, hence, may pose a serious problem in policy discipline. However, the IMF itself is also not immune to the moral hazard problem.[2] It has not yet been made clear why an East Asian monetary fund would suffer more from the moral hazard problem than the IMF. As Sakakibara (2000) puts it, if those countries unaffected by the East Asian crisis do not have any political incentive to contribute their own money, they should say so instead of using the moral hazard argument as an excuse for opposing regional arrangements in East Asia.

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

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[1] Eichengreen (2000) argued that East Asia, in contrast to Europe, lacks the tradition of *integrationist* thinking and the web of interlocking agreements that encourage monetary and financial cooperation in Europe. For over a half-century, European countries have worked very hard to develop a wider web of political and diplomatic agreements that encourage their cooperation on monetary and financial matters. If the European experience is any guide, East Asia may take many years to develop an effective cooperative arrangement for money and finance.

[2] The task force report of the Council on Foreign Relations (1999) advises the IMF to adhere consistently to normal lending limits to redress the moral hazard problem.

Once established, an East Asian monetary fund could provide additional resources to the IMF while joining forces to work on matters related to the prevention and management of financial crises. At the same time, it could also support the work of the IMF by monitoring economic development in the region and taking part in the IMF's global surveillance activities.

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

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

3. Status of Regional Financial Cooperation

The CMI has been a key initiative for Asian financial cooperation. Significant progress has been made in implementing the CMI. The ASEAN Swap Arrangement (ASA), one of the main components of the CMI, has increased to US$1 billion, effective as of November 17, 2000, and encompasses all ASEAN member countries. Regarding the network of bilateral swap agreements (BSAs) under the CMI, substantial bilateral agreements have been reached and are currently under negotiation. Japan has been playing a leading role in terms of both number and amount: Japan concluded seven

agreements with Korea, China, Indonesia, Malaysia, the Philippines, and Thailand, and Singapore. China also concluded five agreements with Korea, Indonesia, Malaysia, the Philippines and Thailand in addition to the China-Japan BSA. Similarly, Korea concluded four agreements with China, Malaysia, the Philippines and Thailand in addition to the Japan-Korea BSA. Korea is also expected to conclude BSA negotiations with Indonesia [See Table 1].

Insert Table 1

The form of regional financial cooperation and institutions depends on the stage of regional financial and monetary integration (Wang and Yoon 2002). In principle, regional institutions range along a spectrum from simple information exchange and informal consultation forums to a supranational entity like the EMU – the exact form is a function of the degree of integration.

At the most elementary stage of zero institutional integration, governments simply take the policies of other governments as a given and do not attempt to influence them. Given limited influence, the existence of policy spillovers means that it would still be useful for governments to exchange information and consult each other in a setting free of any formal pressure. When regional cooperation moves to the level of mutual liquidity provision, then moral hazard creates a strong case for monitoring and surveillance, and a clear need for specific enforcement mechanisms. An appropriate reference point for such regional activities would be the linkage of the CMI with IMF conditionalities. Finally, when the regional group agrees on deepening regional integration through exchange rate coordination, then monetary policy coordination becomes as crucial as mutual economic surveillance. The appropriate reference point in this case would be the process through which Europe progressed from the Common Market to the European Union.

In East Asia, except for the CMI under the ASEAN+3 framework, other regional institutions or forums do not have any mutual liquidity support arrangement. Even the CMI has nothing to do with exchange rate coordination. In comparison with Europe, the CMI has a different motivation from the beginning. The European facilities were created with the purpose of limiting bilateral exchange rate fluctuations among regional currencies. The CMI started with high capital mobility and flexible exchange rates, although some members of ASEAN+3 have maintained a relatively fixed exchange rate regime. So far, the ASEAN+3 countries have not presumed any manifest exchange rate coordination. In the absence of exchange rate coordination, incentives for mutual

surveillance will be limited because a member country facing a speculative currency attack may be free to float its exchange rate vis-à-vis those of other neighboring countries (Wang and Woo 2004). Under the current ASEAN+3 policy dialogue framework, the purpose of the CMI and mutual surveillance system is to prevent the occurrence of financial crises and contagion in the region.

Another important remaining issue is the linkage of the CMI to the IMF. As long as the CMI is simply a source of financial resources supplementary to the IMF, the size of the swap borrowing is not necessarily sufficient to meet potential needs, because there exists another deep pocket of financial resources provided by the IMF.

Although the CMI does not need to design its own conditionality at this point, it does need to establish its own surveillance mechanism. Under the CMI framework, 10 percent of the swap arrangements can be disbursed without IMF involvement. But because this 10 percent of swap can be disbursed only with the consent of swap-providing countries, the swap-providing countries need to formulate their own assessments about the swap-requesting country. At present, the current practices under the ASEAN+3 process cannot effectively capture emerging problems.

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

In the long run, however, the participating countries are likely to wean themselves from their reliance on the IMF. If the CMI develops into more or less an independent financial arrangement from the IMF, then the regional financial arrangement should be designed to discipline the borrowers to adhere to sound macroeconomic and financial policies by imposing conditionalities. However, the ASEAN+3 countries at the current

stage do not seem well prepared for establishing a policy coordination mechanism in the surveillance process.[3]

4. Examination of Regional Financial Integration in East Asia

As regards to financial integration, economists propose various conceptual definitions. Financial integration refers to an individual country's linkages to international capital markets. Of more relevance for the analysis is the distinction between de jure financial integration, which is associated with policies on capital account liberalization, and actual capital flows. For example, indicator measures of the extent of government restrictions on capital flows across national borders have been used extensively in the literature. On the other hand, the volume of capital actually crossing the borders of the countries could be different from the anticipated financial flows. In this sense, de jure restrictions on capital flows and actual capital flows across national borders are two ways of measuring the extent of a country's financial integration with the global economy. The differences between these two measures are important for understanding the effects of financial integration. By either measure, developing countries' financial linkages with the global economy have risen in recent years. However, a relatively small group of developing countries has garnered a lion's share of private capital flows from industrial to developing countries, which surged in the 1990s (Prasad et al. 2003).

Over the past decade, a number of East Asian countries have liberalized their financial markets to foreign capital by reducing restrictions on inward and outward capital flows. Net private capital inflows to East Asia in the mid-1990s were conspicuous in the postwar period in terms of the size of the flow to emerging markets. The inflows to East Asia were driven by a mixture of push and pull factors, including the pursuit of perceived large profit opportunities, the diversification of Japanese overseas direct investment, the expansion of institutional investors and country funds, the development of regional ratings, and the easing of capital account restrictions (de Brouwer 1999). However, the Asian financial crisis in 1997-98 has brought significant

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

changes to the patterns of capital flows to East Asia. Most East Asian countries became net providers of international capital due to their current account surpluses. While receiving inflows of FDI and portfolio investments on a net basis, these countries have repaid large amounts of bank loans for the past several years.

Despite the changes in the patterns of international capital flows in East Asia, the countries of East Asia has developed stronger financial ties with Western Europe and the United States than with one another (Lee et al. 2004). There is no sign of the development of an integrated regional financial market. This less progress in regional financial integration is not surprising. Eichengreen and Park (2003) explain the various factors by comparing the two regions – Europe and East Asia. According to their analysis, Europe has gone further than East Asia in the integration of product and factor markets. While the EU has a true single market in goods and services, progress towards the creation of an Asian free trade area remains incomplete. While Europe has removed essentially all barriers to the free movement of capital and most barriers to the movement of labor, in East Asia limits on factor mobility remain pervasive. In Europe, regionalism is motivated in no little part by a desire for political integration that has no counterpart in East Asia. While Europe has built institutions of transnational governance (e.g., the European Commission, the European Parliament, the European Court of Justice, and now the European Central Bank), East Asian integration is "weakly institutionalized." That is, it is predicated not on transnational institutions but on intergovernmental agreements that defer to the sovereignty of the participating states. Nor is integration in East Asia driven by an alliance of key nations like France and Germany or by a single hegemonic power (the role played by the United States in the Western Hemisphere); it is a more multi-polar process.

Evidently, East Asia is less financially integrated than Europe. But, it does not mean that further financial integration in the region is naturally desirable. Degree of financial integration endogenously and positively responds to the correlation of shocks. Countries with integrated international financial markets can ensure against country-specific shocks through portfolio diversification. Thus, countries in East Asia are likely to have much larger welfare gains from global financial integration rather than regional financial integration, assuming that global financial integration ensures a better risk sharing arrangement than regional financial integration. Furthermore, as output shocks become less correlated, potential welfare gains from portfolio diversification increase, as does the degree of financial market integration (Heathcote and Perri 2002; Imbs 2003). In this regard, East Asian countries may find more opportunities to smooth consumption through global financial integration with Western Europe or the United

States, when they find their output shocks are less correlated with countries outside the region than within the region. We need a more rigorous empirical analysis on this issue.

Kim, Kim and Wang (2004) have recently estimated the degree of risk sharing of East Asian countries within the region and with OECD countries, using cross-country consumption and output correlation. According to their estimation results, first, the degree of risk sharing of East Asian countries is far from complete and quite low for both within East Asia and with OECD countries. Second, among individual countries, Taiwan and Singapore achieve the highest degree of risk sharing, especially with OECD countries, while Indonesia and Malaysia are the countries with the lowest degree of risk sharing. They explain why the degree of risk sharing in East Asia, especially within the region, is too low. First, there are too much uninsurable country specific risks such as shocks in the nontraded sector, wage and labor markets. These risks cannot be easily diversified across countries. Second, most East Asian countries have less developed financial markets with high transaction costs and information asymmetry. Lack of financial securities that can be used for diversifying country-specific risks prevents countries from engaging in risk sharing activities.

Kim, Kim and Wang (2004) also measured potential welfare gains that each country can achieve through perfect risk sharing within East Asia and with OECD countries. The results reveal that the countries that currently have lowest level of risk sharing – Indonesia and Malaysia – have the highest potential gains around 5-6 percent of permanent consumption. More importantly, they show that for less developed countries in the region (China, Indonesia, Malaysia and Thailand), potential risk sharing gains with OECD countries are larger than those within the region. This is because output shocks of these countries are similar to other East Asian countries and different from OECD countries.

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

building the infrastructure by the ASEAN+3 (Park and Park 2003).

Many proponents of the ABI may counter this pessimistic view. Ito (2003, 2004) argues that there may be regional bias next to home bias in that investors find bonds issued in Asia attractive compared to bonds from other region.[4] However, at this stage of development, there is no guarantee that regional efforts, even if they can be organized, could succeed in fostering regional capital markets that are competitive vis-à-vis the global capital markets in North America and Europe. Furthermore, the continuing globalization of financial markets and advances in information technology that allows financial companies in the international financial centers dominate the international banking and investment businesses. In reality, there would be no home bias at the regional level, unlike at the country level. For example, a regional portfolio is not necessarily easy to hedge. Having better information at the regional level does not seem to be enormously more advantageous than having better information at the global level (Lee et al. 2004).

5. Barriers to Financial Cooperation and Integration

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

As for institutional and political constraints on further expansion of the CMI, the most serious one has been that the thirteen countries have failed to articulate the ultimate objectives of the CMI arrangement. The participating countries themselves are still unclear about whether the CMI is going to be fostered as a regional liquidity support program or as a building block for a full-fledged regional monetary system in East Asia. If bilateral swap arrangements are activated collectively and supported by a surveillance system, then they constitute a de facto regional monetary fund. The CMI could then be used as the base on which an elaborate system of financial cooperation and policy coordination is built by following in the footsteps of the European monetary

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

integration.[5] At this stage of development, many countries in East Asia are not prepared to accept the idea of or may feel uneasy about restructuring the CMI into a forerunner of the AMF.

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

A third hindering factor is that as the fear of another round of financial crisis has receded with the recovery that has been faster than predicted on the basis of previous episodes of crises. With the speedy recovery, the ASEAN+3 countries have become less interested in enlarging and institutionalizing the CMI operations. Instead, their focus has recently shifted to creating free trade areas in East Asia. [See Table 2] The ASEAN free trade area (AFTA) now includes the whole of Southeast Asia. AFTA continues to expand. In November 2001, China and the ASEAN countries agreed to form a free trade area within ten years, allowing for some preferential treatment for less developed ASEAN countries. Japan has concluded a free trade agreement with Singapore and started negotiations on a similar agreement with Korea and several states of the ASEAN on the individual basis.

Insert Table 2

The free trade movement is undoubtedly a desirable development, and the CMI could facilitate further liberalization of trade by stabilizing bilateral exchange rates of

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

regional currencies and minimizing the disruptive effects of financial market turbulence. This advantage suggests that the ASEAN+3 countries may have an incentive to broaden the scope of the CMI in parallel with negotiations on establishing free trade areas in the region. In reality, however, it appears that free trade discussions have rather distracted many East Asian countries from their CMI negotiations.[6]

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

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

China and Japan have different interests and hence different strategies for economic integration in East Asia. As far as China is concerned, economic integration with the ASEAN 10 members, South Asian and central Asian countries may be more important both economically and geo-politically than financial cooperation or free trade with

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

either Japan or South Korea. While China is a super military power in the world, it is still a developing economy with a huge gap to narrow in terms of technological and industrial sophistication vis-à-vis Japan. Although China has been growing rapidly, it has a long way to go before catching up with Japan. These differences in the economic and military status of the two countries suggest that, even if they manage to reconcile their troubled memories of the past, China and Japan may find it difficult to work together as equal partners for regional integration in East Asia.

China borders Russia and many of the South Asian and Central Asian countries in addition to several ASEAN members. Therefore, it is natural for China to seek expansion and deepening of its trade and financial relations with those neighboring countries. In fact, for this reason, China has been courting ASEAN for a free trade agreement and joined in November 2001 the Bangkok agreement on a free trade area that includes Russia and the South Asian countries. China has also taken a leading role in establishing the Shanghai Cooperation Organization, a cooperative arrangement between Russia, Kazakhstan, Kyrgyzstan, Tajikistan, and Uzbekistan and China.[7]

In contrast, Japan has not been able to articulate its strategic interests in East Asia. While Japan has been at the forefront in supporting greater economic cooperation among the East Asian countries, its perspective on the geographical contiguity of East Asia has not been altogether clear. Japan has been promoting integration among the "ASEAN+5," but which are the two countries added to ASEAN+3? At times, the five countries are stated as China, Japan, Korea, Australia, and New Zealand, and at other times Taiwan and Hong Kong replace Australia and New Zealand.

There is also the suspicion that Japan is not interested in free trade and financial arrangements per se in East Asia for purely economic reasons. Instead, Japan is engaged in the discussion of those regional arrangements with other East Asian countries to maintain its leadership role as the region's largest economy by checking and balancing China's expansion. Many analysts believe that Japan's active involvement in regional economic integration is therefore motivated by its desire to maintain its traditional pole position.[8] On top of this suspicion, Japan is perceived to be a country insensitive to and unwilling to resolve wartime legacies and disputes on historical and territorial claims. Japan has also been gripped with a decade long recession and unable to restructure its

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

[8] See David Wall, "Koizumi Trade Pitch Nests," the *Japan Times*, April 21, 2002.

economy.[9] These developments combined with its lack of a strategy for East Asian development seem to undermine Japan's ability to pull East Asian countries together for regional cooperation and integration.

6. Future Prospects

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

The euro area pursued trade integration first, but from a theoretical point of view there is no clear reason for this. Even in Europe, trade integration slowed down whenever there were concerns about exchange rate stability among member countries. In this regard, some form of monetary integration is an important condition for trade integration (Shin and Wang 2004). Furthermore, there are many good reasons for forming a monetary union before a FTA. A monetary union can quite significantly increase trade among member countries by serving as a device to avoid the bottlenecks that can be encountered during the process of negotiating and implementing a FTA. This increased trade is likely to occur mostly within similar industries, so weakening asymmetric shocks across member countries will also decrease the costs of maintaining a monetary union. A monetary union can also accelerate financial integration in the region, which might not be accomplished otherwise. Hence, a monetary union is a self-validating process.

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

What are then the likely courses of development of the regional financial architecture in East Asia? How would regional financial integration proceed in East Asia? One possible scenario is that China and Japan will come to realise that despite the differences in their strategies, China and Japan together are the key to developing a common political will in East Asia. Sakakibara (2003) argues that the role of China and Japan in East Asia's integration process is synonymous with that of France and

[9] Uncertain economic prospects may make Japan unlikely to be the driver in the region's integration movement as it was in the past. China is emerging both as a strong competitor and as a promising market.

Germany in Europe's integration process.[10] This realization could soften their positions to compromise on an institutional setting and augmentation of the existing financial architecture of East Asia. For instance, China may accept Japan's demand for de facto control over monitoring and surveillance in return for Japan's pledge for a substantial increase in financial assistance in the form of one-way swaps and ODA to ASEAN members. China could agree to this scheme, if it is confident about concluding a free trade agreement with the ASEAN members in the near future. China's free trade pact with ASEAN could circumscribe Japan's influence on ASEAN affairs even if Japan is a major provider of financial resources to the region. In this process, Korea and ASEAN would serve, as a mediator in the cultivation of a common political will between China and Japan.

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

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

[10] France and Germany also had a wartime legacy. Although de Gaulle's nationalism was generally popular within the country, he also appreciated that membership of the common market would benefit France Economically. However, de Gaulle remained implacably opposed to any increase in the powers of the European Commission, or to any other increase in supranationalism. He showed just how opposed in 1965, when he precipitated the most dramatic crisis in the history of the European Community (George, 1985). It was German Chancellor Helmut Schmidt and French President Giscard d'Estaing that accelerated stalled integration process at the end of the 1970s. The joint initiative of Chancellor Helmut Kohl and President Francois Mitterand resulted in a great leap towards EMU in the beginning of the 1990s. The Franco-German alliance formed the core for the integration process in Europe, as it was the political will of these two countries that motivated further integration.

financing, most members of ASEAN+3 would not take the third scenario seriously.

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

Table 1. Progress on the Chiang Mai Initiative

(as of December 31, 2003)

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

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

Table 2. Free Trade Agreements in East Asia

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

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