

Monetary and Financial Cooperation in Asia. Motives, Sequencing and Political Obstacles
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ABSTRACT

The working paper explores the dynamics of monetary cooperation and integration in East Asia. Various options for monetary regionalism in the region – including the Chiang Mai initiative and the more recent bond market initiatives - are discussed. The paper also analyses the merits and drawbacks of different exchange rate regimes to be introduced at the regional level. For East Asian countries, the priority after the Asian crises seems to be on the mitigation of vulnerability to financial market volatility, even if this comes at the cost of waiving some sovereignty. Whilst a consensus amongst East Asian governments has apparently been reached with regard to the non-participation of the United States, the further course of monetary regionalism is unclear. A deepening of the process is hampered by Japan's ambiguous approach to regionalism and its unwillingness to assume the role of a stabiliser of the Asian Monetary System (AMS) – the part which Germany played in the European Monetary System (EMS). This in turn gives China more leeway to push its own agenda. The most important obstacles to monetary and financial integration are to be found at the political level, i.e. political will and leadership matter more than the technical intricacies of the various cooperation schemes.

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1. Introduction

At the beginning of the 21st century, the international financial architecture is characterised by continuing change. A major difference to the preceding decades is that dollar hegemony can no longer be taken for granted. The successful introduction of the euro results in increasing competition for the dollar, and consequently the world is currently moving to a bipolar monetary arrangement (Bergsten 2005: 4). These changes are a challenge for East Asian and Southeast Asian countries:¹ First, they demonstrate that monetary regionalism and the creation of a single currency is possible in practice, not just in theory. Second, Asia's traditional reliance on the dollar – as an external anchor for exchange rates, a reserve currency as well as the main invoicing currency – has to be evaluated from a new perspective. Is it sensible to tie one's currency to the dollar? Is the accumulation of large dollar reserves a wise strategy? In addition, Asian policy makers have to ask themselves whether it is useful to continue emphasizing the use of the dollar, both as a transaction currency but even more so as a reserve currency. The United States are confronted with an unsustainable deficit in the current account, the result of which will probably be a severe reduction of imports within the coming decade, combined with a substantial fall of the dollar's exchange rate vis-à-vis the euro.

Regional economic co-operation has several dimensions, but monetary and financial regionalism probably receives most attention in East Asia. The reasons for the emphasis on this element of economic integration of a region are obvious: After decades of trade-driven rapid growth, the entire region experienced a traumatic shock when the Asian financial crisis hit in 1997. This event continues to be the most important factor for the advancement of regionalism in East Asia. The experience of being both put-up and let-down by Western countries – at least that is the perception of many observers in the region – drives the desire to develop regional safety nets as well as greater independence from Western money markets in particular.

So what are the characteristics of monetary and financial co-operation in a region? Within the process attention is focused on four goals, in particular the facilitation of trade in goods and services by providing stable monetary conditions, the provision of efficient, well-functioning financial markets, the prevention of financial crisis, and finally the regional management of credit and currency crises.

¹ Throughout this paper, the term Asia will refer to East and Southeast Asia, i.e. the countries that constitute ASEAN+3.

Although these four goals are primarily economic, there is nevertheless much to be said against purely economic evaluations of monetary regionalism.² The process is essentially driven by political motives, and one-dimensional economic evaluations – for instance debating whether Asia satisfies the criteria to be an optimum currency area – do not fully grasp the contexts in which it evolves. As in Europe, a combination of political and economic motives can be observed in Asia. Monetary integration always had and still has a strong political connotation – both in Asia and in Europe. However, the key point driving the search for monetary regionalism is a perceived communality of interests (Grenville 2000: 1).

Until today, steps toward monetary integration in Asia have been rather limited in scope. After the experience of the Asian crisis, governments have pursued a two-track strategy. The first and most obvious is the build-up of enormous currency reserves. Countries have significantly strengthened their first lines of defence. The second development has been a novel concerted effort to strengthen monetary co-operation in the region. There is the so-called Chiang Mai process, established in 2000 and aiming at creating a regional liquidity reserve. Although this appears to be useful – and mirrors a similar proposal by Giscard d’Estaing and Helmut Schmidt in the late 1970s – the goals of this process remain largely undefined. Is it aiming at providing liquidity in the event of an unexpected credit crunch, i.e. the simultaneous retreat of the majority of international lenders? Or is the stabilisation of exchange rates the goal? The latter remains the more ambitious project and the paper will need to explore which preconditions will have to be satisfied for the process to be a success. Again, political issues are at least as important as economic considerations, and leadership issues have to be resolved *before* further substantial steps can be taken.

However, even in the absence of a consensus on the further evolution of economic integration in general and monetary regionalism in particular, a surprising number of activities have emerged in the region in recent years. Similar to the co-operation of central bankers under the gold standard, which flourished despite reoccurring political tensions, today central bankers in Asia do work together. Again, there was very little if any co-operation of that kind prior to the Asian crisis. If central bankers exchanged views, it was in multilateral organisations, such as the Bank for International Settlements (BIS), not in regional ones. The shift to regional dialogue on monetary affairs – resulting in some rather concrete steps – can be observed at four levels: The networking of

² Monetary regionalism aims to contribute to the stability of currencies and financial markets in a region without the need for **formalising** trade links. The terms regional financial cooperation and monetary regionalism can virtually be used synonymously – although there is a difference: Monetary regionalism is a broader approach with a more ambitious agenda.

currency swaps under the Chiang Mai agreement, the monitoring of short-term capital flows and other surveillance measures. Furthermore, initiatives to strengthen the regional bond markets and cooperation on exchange rates.

This paper will evaluate the debate on monetary regionalism since 2000. Of course, the debate by now is so comprehensive that a selection has to be made with regard to the issues addressed. The topics have been selected in order to cover those dimensions of monetary regionalism that are of relevance to policy makers in Asia or differ from the European experience. In the next section, emphasis will be on the rationale for monetary and financial co-operation. Why do Asian policy makers consider enhanced co-operation? What are the potential benefits? In addition, the sequencing of integration processes will be discussed. There is considerable debate on the merits of a swift shift to monetary stability. The following section will analyse the Chiang Mai process, one of the more tangible results of Asian monetary cooperation today. Subsequently, monitoring and surveillance as well as the evolution of regional bond markets shall be discussed. The next section centres around the choice of exchange rate regimes available for a region, followed by an analysis of the regional scope of monetary regionalism: if it can evidently be shown that there is no progress in economic co-operation in Asia, open possibilities for sub-regional initiatives will arise. One of them is a Greater Chinese Currency Union, comprising China, Hong Kong, Taiwan and perhaps Singapore. Finally, the institutional dimension will be addressed and proposals for the anchoring of integration by way of establishing regional monetary organizations will be made.

2. *The Rationale for Monetary Regionalism and Sequencing*

There is virtual unanimity amongst academic and political observers that the Asian crisis of 1997 is the single most influential reason for pursuing more intensified monetary and financial cooperation in Asia.³ As countries in Southeast and East Asia were receiving identical treatment by international financial markets – regardless of their individual merits or problems – this experience has laid the foundation for intensive monetary and financial co-operation.

Nevertheless, the Asian crisis alone would not have generated sufficient momentum for the current drive towards monetary regionalism. The frustration of Asian policy makers with the slow reform of the international financial architecture is probably equally important (Wang 2004: 940). It is becoming increasingly obvious that Asian elites resent the dominance of Washington in regional

³ See for example Milner 2003, Stevenson 2004, Kohsaka 2004, Wang 2004, Dieter 2000b, de Brouwer 2002, Ryou/Wang 2003.

and global affairs. Eisuke Sakakibara, an important Japanese government official and former Deputy Finance Minister, sees a parallel between the decline of Britain after 1918 and America's decline today. Whereas World War I symbolised the end of the British Empire, today's so-called War on Terror indicates the end of Pax Americana. The watershed was the Asian crisis, a position that Sakakibara spells out clearly:

After the Asian crisis of 1997-98, Asian countries strongly perceived the vulnerability of their region, which does not have any viable regional cooperative scheme. They recognised that there is no global lender of last resort, that international organisations like the IMF and the World Bank were not of much use in preventing or addressing the crisis, and that the United States did not infuse much in the way of resources into Asian countries when the crisis broke (Sakakibara 2003: 232f).

The Asian crisis was therefore not simply an unexpected and badly managed financial affair. It rather altered the relationship between Asia and the USA. Governments and elites were reminded that America had a domestic agenda to deal with, and the interests of the American financial sector prevailed over the interests of America's allies in Asia.

However, there is more to monetary regionalism than resentment about past developments. Open capital markets, i.e. the absence of capital controls, have resulted in the need to improve governance structures, either on a national, regional or global level. The lack of effective Global Governance, including the development of a lender of last resort and the regulation of capital flows, will not disappear quickly. National regulation can no longer provide sufficient regulation, but the region – from a theoretical perspective – is much more apt in providing these structures (Sakakibara 2003: 234). Although regional financial governance could be inferior to global financial governance, provided by the IMF in particular, this is not inherently the case. It all depends on how the instruments of co-operation and the institutions created are structured in practice (de Brouwer 2002: 19). Considering the experience of the last decade, there is little evidence for the assumption that regions are less prepared for financial governance than the IMF.

Eric Girardin stresses the potentially positive contribution of monetary regionalism, when considered as public good:

The gains from regional financial cooperation essentially stem from reducing regional systemic risk. Regional financial stability has the nature of a public good, in that no country would have an incentive to work toward it if others do not do it, while all benefit from it. Disruptions caused by financial crises, at a regional level, are a major incentive for cooperation. The public good nature of regional financial coordination is due to the fact that financial instability is a potential public bad that spreads across countries (Girardin 2004: 334).

There are, however, also strong divisions within Asia. The motives in non-Japan Asia for enhanced monetary cooperation are partly driven by the inability of Japan to speak-up for the region as loudly as it could have, in particular in the IMF. Whereas the United States and Europe have long been robust supporters of their respective regions in the Fund, Japan has failed to do so for Asia. Gordon de Brouwer argues that this has damaged Japan's position in the region:

Whatever the reasons – the legacy of colonialism and war, Japan's dependence on US security, a preference for consensus, the division of policymakers' focus on domestic economic problems – the result is that East Asia's champion has let itself be squeezed out (de Brouwer 2002: 8).

The failure of Japan to provide leadership to the region became obvious in 1997. Japan was the only country that could have beaten the panic, but it failed and missed the 'golden opportunity' (Walden Bello). The failure of Japan could be witnessed on two levels. First, Japan reduced its imports from the region rather than expanding them. Imports from the countries in crisis dropped significantly after 1997, in some cases by over a third (Dieter 2005a: 129). Rather than being a regional consumer of last resort, Japan left that role to America. Second, and probably more important, Japan failed to implement its own proposal of an Asian Monetary Fund.

Japan had suggested an Asian Monetary Fund (AMF) in September 1997. The AMF was a brainchild of Eisuke Sakakibara, then Deputy Minister of Finance, and was put forward to G-7 Ministers of Finance. The AMF should have been equipped with a capital of \$100 billion and should have applied fewer conditions than the IMF. In practice, the countries of the region would have strongly preferred the AMF to the IMF, first and foremost because of the preferable conditionality. Nevertheless, Japan's proposal was not well prepared, and within weeks, the idea of creating an AMF was abandoned. In October 1997, during the annual meeting of the IMF and the World Bank in Hong Kong, Japan withdrew its plan.

A number of reasons caused that failure. First, the Clinton Administration, particularly Finance Minister Robert Rubin and his deputy Larry Summers, strictly opposed the Japanese initiative. They correctly assumed that there would be no need for the IMF if the AMF was successful (Stiglitz 2002: 134). For the US government, which in the past had successfully used the IMF to further its own agenda, this was no longed-for prospect. A regional competitor for the Fund would have undermined its monopoly for the management of financial crises, bringing along a weakening of American influence.

Second, accepting the creation of an AMF would have diminished the opportunity for the liberalisation of the Asian economies affected by the crisis. Opening those countries was an aim of the Clinton administration, and the Asian crisis provided an opportunity to pursue that goal.

Third, and probably most important, the Japanese government was quickly intimidated by the resistance it faced. Although Tokyo clearly saw the opportunity to position itself as the leading power in Asia, it was ill-prepared to implement its own initiative. Waldon Bello identifies an 'occupation psychology' as the reason for that timidity (Bello 1998b: 19). However, the inability of Japan to lead Asia in the event of a severe crisis might reflect a serious dilemma. Japanese policy makers see their country as part of the West, and not necessarily as a part of an Asian community. The willingness to fight with Washington over an issue that did not directly affect Japan was limited, even though the failure to utilize the opportunity the Asian crisis provided has done crucial harm to Japan's leadership aspirations (Dieter and Higgott 1998).

Sequencing - Monetary Regionalism before Trade Integration?

When analysing the rationale for monetary regionalism the issue of sequencing has to enjoy a prominent position. The conventional sequence for regional economic integration starts with trade, to be followed by monetary integration at a much later stage. This is the path Europe successfully took, but today the reverse strategy might be sensible. Since barriers to trade are much lower than they used to be in the 1960s and 1970s, the benefits from regional free trade are more limited. Furthermore, financial instability can cause severe damage to economies, and this potentially is an incentive for a different sequencing: Finance first, followed by integration of markets for goods and services at a later stage (Dieter 2000b; Shin/Wang 2002; Pomfret 2005).

In Europe, trade integration preceded monetary integration. The customs union was accomplished in 1968, years before monetary integration saw a fresh impetus. In the late 1970s, monetary integration was pushed forward. It was proposed that monetary integration should be accompanied by pooling of reserves. The concept that was suggested by Valéry Giscard d'Estaing and Helmut Schmidt in 1978 envisaged three elements of monetary integration:

- Firstly, the creation of a parallel currency, the European Currency Unit (ECU). The ECU was a new unit of account based on an internal currency basket.
- Secondly, the European Monetary Cooperation Fund (EMCF), a liquidity pool that was supposed to multilateralise the national foreign reserves.

- Thirdly, the Exchange Rate Mechanism (ERM), whose purpose was to stabilise exchange rates (Ing 2003: 384).

The joint liquidity fund, which is today the most tangible achievement of monetary regionalism in Asia, was never implemented in Europe. The German Bundesbank vigorously opposed the concept that would have reduced its own influence and that would have given the other participating central banks the option of drawing on the joint pool without the Bundesbank's consent (Dieter 2005a: 367). If Asia intends to follow the European model, sequencing would have to be different from today's CMI.

So what would the advantages of monetary integration ahead of trade integration be? Shin and Wang suggest that a monetary union may speed-up intra-regional trade without requiring a free trade agreement or other measures (Shin/Wang 2002: 11). Reducing the costs of hedging against currency volatility – zero in a monetary union but high in the event of substantial exchange rate movements – is an advantage that can be quantified for individual companies as well as for countries. The cost of insuring against volatility can reach five percent of the value of an export item, which is substantial by any standard. Furthermore, today's most frequent type of preferential trade agreement, a free trade area, is also not without substantial costs: In order to qualify for duty-free treatment, goods have to have certificates of origin, and the administrative cost for the issuance of these certificates is estimated to be around five percent of turnover (Dieter 2004a: 281). Considering that a monetary union immediately reduces cost whilst free trade areas increase them, inverting sequencing appears to be a concept worth exploring.

An empirical study by Andrew Rose supports the expectation that a common currency has a dramatic positive effect on bilateral trade. Rose analysed bilateral trade over a twenty-year time period in 186 countries. The results are surprisingly positive: Other things being equal a common currency more than triples bilateral trade. However, the samples that support his argument are somewhat atypical: They involved a very small economy that formed a currency union with a much larger neighbour, and that choice of sample distorts the findings (Pomfret 2005: 117). There is, however, no need to argue about the quantitative results. The main finding is that the absence of monetary instability in space, i.e. a monetary union or a single currency between countries, is facilitating trade.

However, the lack of connection between trade and monetary integration in the literature makes this endeavour complicated. There are very distinct theoretical approaches: In trade the basic concepts go back to Jacob Viner's seminal book on customs unions, whilst the theory of monetary integration was first developed by Robert Mundell in the early 1960s (see Viner 1950; Mundell 1961). Nevertheless, this artificial separation does not seem sensible: Trade flows are influenced by the prevailing monetary conditions, and capital flows are, up to a certain degree, a function of trade. A sequencing pattern that differed from the traditional trade-based model of integration has been suggested by Dieter (2000b). Rather than starting with a free-trade area, followed by a customs union, a common market, an economic and monetary union and finally a political union, Dieter has proposed to start with the pooling of foreign reserves, followed by the creation of a regional exchange-rate regime, an economic and monetary union and a political union. Instead of postponing the benefits of monetary integration, this four-stage approach would begin with a monetary measure. A formal trade agreement would not be necessary in that scheme, although a differentiation has to be made: regional trade would be facilitated, but there would not be a formal agreement, which would have severe negative side-effects in any case.⁴

Yunjong Wang has suggested that regional monetary co-operation does not have to evolve into a regime that could be characterised as deep integration. The three pillars Wang identified – liquidity assistance, monitoring and surveillance and exchange rate stabilisation – might not be fully implemented in a region. Some type of shallow financial co-operation, e.g. the pooling of foreign reserves without any exchange rate coordination, might be the maximum level of co-operation that a given group of countries is willing to engage in (Wang 2004: 940). Needless to say that such an approach to monetary regionalism is a low-risk and low-profit strategy: not much sovereignty is lost, not much is gained.

3. *The Chiang Mai Initiative and the Pooling of Reserves*

As already mentioned, during the Asian crisis the Japanese proposal for an Asian Monetary Fund was confronted with opposition by the US, the IMF as well as China and was not implemented. Only two years after that experience, the leaders of ASEAN responded and invited China, Japan and South Korea to join in efforts to deepen economic and monetary co-operation. The ASEAN+3 Summit in November 1999 released a joint statement that covered a wide range of potential areas

⁴ The negative effects of bilateral trade agreements are by now well documented. See, inter alia, Dieter 2004a and the report by the Consultative Board on the Future of the WTO (2004).

for co-operation (Wang 2004: 941). The first major result was presented by the ASEAN+3 finance ministers less than one year later.

In May 2000, the ASEAN swap agreement of August 1977 was reconsidered and strengthened. It was widened to cover all ASEAN members and the amount available was raised from \$200 million to \$1 billion in May 2001. The second development, also under the umbrella of the Chiang Mai Initiative (CMI), was the development of a full series of bilateral swap and repurchase agreements between the ASEAN+3 countries. Countries can swap their local currency for major international currencies for up to six months and for up to twice their committed amount (Pomfret 2005: 114). By mid-2002, the sum of bilateral deals agreed had already reached \$ 30 billion (de Brouwer 2002: 25). Since then, the CMI has been further expanded.

Table 1: Progress on the Chiang Mai Initiative (as of 31 August 2004)

Bilateral Swap Arrangement	Currencies	Conclusion dates	Amount (in US-dollar billion)
Japan-Korea	USD/Won	4 July 2001	7.0 ^a
Japan-Thailand	USD/Baht	30 July 2001	3.0
Japan-Philippines	USD/Peso	27 August 2001	3.0
Japan-Malaysia	USD/Ringgit	5 October 2001	3.5 ^a
China-Thailand	USD/Baht	6 December 2001	2.0
Japan-China	Yen/Rmb	28 March 2002	3.0 equivalent
China-Korea	Won/Rmb	24 June 2002	2.0 equivalent
Korea/Thailand	USD/Baht	25 June 2002	1.0
Korea/Malaysia	USD/Ringgit	26 July 2002	1.0
Korea-Philippines	USD/Peso	9 August 2002	1.0
China-Malaysia	USD/Ringgit	9 October 2002	2.0
Japan-Indonesia	USD/Rupiah	17 February 2003	3.0
China- Philippines	Rmb/Peso	29 August 2003	1.0
Japan-Singapore	USD/S \$	10 November 2003	1.0
China-Indonesia	USD/Rupiah	30 December 2003	1.0
			Sum: 34.5

a) Amounts include credits agreed under the New Miyazawa initiative.

Source: Park/Wang 2005: 95.

The Chiang Mai Initiative was started as a very cautious endeavour. The amounts agreed on are modest compared to the enormous national reserves that central banks in Asia have accumulated.⁵ Furthermore, the decision to limit the amounts available under the swap at the discretion of the two

countries involved to 10 percent of the total and to require IMF consent for the remaining 90 percent has been surprising observers (e.g. Dieter 2001). The explanation for this decision has to be found not in economic rationality, but in diplomatic considerations. The ASEAN+3 countries had no desire to give the US government and the IMF an opportunity for renewed criticism. Functionally, the need for IMF consent does not make sense. It is not plausible to expect the IMF to be any faster or generous with the Chiang Mai funds than with its own loans. Thus, taking the experience of 1997 into account, there is much to be said for the exclusion of the IMF. Therefore, the requirement of the IMF could have been considered as a temporary measure (from the beginning), primarily for diplomatic reasons.

However, the CMI has additional shortcomings. Despite the fact that the CMI has now been operational for five years, the project remains vague and ambiguous. It does not yet have an operational structure, in particular a monitoring and surveillance mechanism. But more important is that it is still unclear what its ultimate purpose is (Wang 2004: 948). Is the CMI the nucleus of an emerging process of monetary regionalism in Asia? Alternatively, is the goal much more limited, i.e. do the participating countries envisage a joint liquidity program? Cynics could argue that the ASEAN+3 countries have followed the European model: In 2005, almost 50 years after the signing of the Treaty of Rome, Europeans are not sure what the ultimate goal of their integration process is. Nor do they know where the borders of the European Union should eventually be.

However, there is considerable conflict between Japan and China that hampers the further deepening of the CMI. Japanese authorities expect some sort of assurance that their loans will be repaid, and unless they receive such guarantees, there will be continuing reluctance to expand the credit volume substantially. Consequently, for a meaningful expansion of the lending volumes Japan expects the development of monitoring mechanisms that are both efficient and provide Japan with the opportunity to exercise influence on other countries. At the same time, China almost certainly feels no desire to play second fiddle to Japan in any regional organisation in Asia, and these concerns probably constitute the most important roadblock to further development of regional integration in Asia in general and the CMI in particular (Wang 2004: 949).

However, there has been some progress in recent years. During the annual meeting of the ADB in May 2005, the Finance ministers decided to transform the bilateral swap arrangements to a multilateral fund. In the event of a crisis, individual decision processes to activate bilateral swaps

⁵ It should be noted that accumulating high reserves has the drawback of high fiscal costs because the country

were replaced by joint decisions patterns (E&Z, Vol. 46, No. 6: 227). This is a significant step forward and adds a new spirit of community to the process. In addition, the part of the entire fund that does not require IMF consent was doubled to 20 percent of the total amount. During the meeting, the doubling of the sums available was considered as well (Frankfurter Allgemeine Zeitung, 9 May 2005: 145). This suggestion has been implemented in 2006, when the region's finance ministers decided to double the size of the Chiang Mai fund to \$ 71.5 billion (New Straits Times, 26 May 2006).

However, the sums that are available under the CMI – even if doubled – are still insignificant compared to the combined national reserves of Asian countries, which in 2007 will exceed \$ 3,000 billion. Green and Torgerson have argued that reserve holdings of that magnitude far exceed precautionary levels and that the costs of foreign reserves are substantial (Green/Torgerson 2007). Countries holding such high reserves have to bear both significant sterilisation and opportunity costs. The former arise when central banks neutralise the inflationary impact of reserve accumulation, typically by issuing domestic debt instruments (Green/Torgerson 2007: 7). Whilst these costs only arise if the build-up of reserves is sterilised, opportunity costs always occur. The resources used to purchase foreign reserves could be used in a number of other ways. For example, governments could invest in infrastructure or education. Although it is difficult to estimate what the real costs of holding these high reserves are, both the opportunity costs and the sterilisation costs are substantial for all the large reserve holders (Green/Torgerson 2007: 9). In 2007, Asian countries have been starting to reconsider the level of their reserve holdings as well as the way in which they hold the reserves. China, for example, has announced that it will invest a substantial part of its foreign reserves to provide capital to a government investment fund. This fund, with an initial capital of between \$ 200 and 500 billion, will invest primarily abroad (Frankfurter Allgemeine Zeitung, 3 April 2007: 20). The consequences of this policy shift will be dramatic: In many countries, China will quickly become one of the largest foreign investors. The discussion of this development, however, goes beyond the scope of this paper.

Rajan and Siregar have emphasised that the pooling of reserves – accompanied by the reduction of national reserves – would result in a substantial reduction of fiscal costs (Rajan/Siregar 2004: 320). They have suggested a three-tier system of liquidity provision in the event of a financial crisis: First, the country will draw on its own national reserves, which can be used quickly and without consideration of conditionality. The second tier would be the regional liquidity arrangement, which

effectively swaps high-yielding domestic assets for lower yielding foreign ones (Rajan/Siregar 2004: 293).

would be subdivided into the country's resources placed with the pool and the other members' reserves. The third tier would be conventional IMF lending (Rajan/Siregar 2004: 320f).⁶

Today, many countries in Asia apparently have not fully embraced the concept of monetary regionalism, despite showing a keen interest in exploring its possibilities. If the countries participating in the CMI would decide to go ahead and deepen integration, then the CMI could serve as a starting point and could be expanded into a regional liquidity pool, perhaps the first step of monetary regionalism (see Dieter 2000b; Dieter/Higgott 2003).

4. *Monitoring and Surveillance*

The rationale for regional surveillance – as opposed to national or global approaches – is not only based on the desire to integrate further, but also on the assumption that there is a risk of contagion. If there is a risk that a financial crisis in neighbouring countries will probably spread beyond the borders without the fundamentals providing an explanation, then regional surveillance makes sense. The Asian crisis was a powerful catalyst for increasing the understanding for the need of regional monitoring.

The spread of a financial crisis to many countries can be due to externalities such as the transmission of domestic shocks to foreign countries through trade and financial flows; exposure to common shocks, such as a common external lender withdrawing liquidity, or informational imperfections on regional and international markets (pure contagion) (Girardin 2004: 345).

Monitoring and surveillance is part of the regional policy dialogue, without which policy formation in a region cannot function properly. Whilst it is true that regional surveillance is no substitute for efficient national banking supervision, the exchange of information nevertheless is essential for the development of regional responses to challenges that affect a number of countries.

It was nowhere more obvious than in Asia. Prior to the crisis of 1997, there was very little – if any – dialogue between finance ministers, central bankers and regulators. Paul Blustein has provided anecdotal evidence that shows the level of co-operation in the middle of the crisis: On 17 October 1997 Lee Kyung Shik, governor of the Korean central bank, was playing golf with his Taiwanese counterpart, Hsu Yuan Dong. Both central bankers kept talking to each other during the game, which was frequently interrupted by incoming phone calls for Hsu. On that very day Taiwan

⁶ Jean Tirole has expressed doubts whether the concepts on which the regional liquidity pool is based make sense. The implicit assumption is that there are phases of illiquidity which can be distinguished from insolvency, the latter category not being a temporary shortage of liquidity, but a permanent one. Tirole argues that there is never illiquidity without the suspicion that insolvency may follow (Tirole 2002: 111). Although this is true, Tirole ignores the possibility that herd-behaviour and the pro-cyclical tendencies of financial markets may turn illiquidity into insolvency without any fundamental economic problem.

devalued its currency, and the fact that this issue was not debated between the two central bankers sheds a light on the lack of trust that prevailed in regional economic co-operation (Blustein 2002: 123).

There is an emerging consensus in Asia that an independent monitoring and surveillance process is an important element of any deepening of monetary and financial co-operation in the region (Wang 2004: 944). A distinction has to be made: There can be monitoring with agreed sanctions or there can be monitoring without any ex-ante agreed rules. In Asia, the former type is difficult to implement in the short-term. In Europe, by contrast, there is a well developed set of institutions for supranational governance. The European Commission, the European Parliament, the European Court of Justice and not to forget the European Central Bank provide the institutional environment for governance above the level of the nation state. Although the European institutions are in continuing competition with the nation states, they nevertheless guarantee that the supranational perspective is not overlooked in any decision. There is no equivalent in Asia, and the lack of powerful supranational institutions has negative consequences for surveillance.

Monitoring and surveillance is of great importance in Asia because financial markets are not yet as developed as they ought to be for successful monetary integration. After the crisis of 1997, Eichengreen and Bayoumi pointed out that underdeveloped financial markets are major obstacles for the further integration of the region.

The strongest argument against even a limited sacrifice of monetary autonomy is that domestic financial systems are less well developed than in Western Europe. The legacy of financial repression and capital controls continues to limit financial depth ... Currency pegs, whether unilateral or collective, are risky where governments are required to intervene in support of their banking systems (Eichengreen/Bayoumi 1999: 364).

This assessment is less convincing in 2005 than it was immediately after the Asian crisis. There has been considerable effort to make national financial markets – and for the time being the regulation of these markets is a matter of national policy – more efficient. Nevertheless, the regional monitoring and surveillance processes that have emerged since the Asian crisis are useful stepping stones for monetary integration because they may create the functional basis for further integration. Surveillance, however, should not be overestimated. Some institutions, e.g. the IMF, have expressed the expectation that surveillance can be a powerful tool in the prevention of future financial crises. At closer inspection, it cannot. In financial history, there are few examples of successful crisis prevention by efficient surveillance (Dieter 2005a: 396). To take two prominent examples: There was no lack of data both in the Asian boom prior to 1997 or in the dotcom bubble

before 2000. There simply is no formula that is not predicting too many crises but does not miss the main ones. Until today, there is no forecasting model that could have predicted the Asian crisis (Frenkel/Menkoff 2000: 29).

5. *Initiatives for the Deepening of Regional Bond Markets*

Before the Asian crisis, many companies in the region borrowed funds from Western financial institutions, usually denominated in foreign currency. The absence of an Asian bond market left enterprises in Asia with little choice. After 1997, the concept of an Asian bond market to keep the region's savings in Asia and to enable financing without currency risk enjoys renewed attention (Tourk 2004: 859). Financial systems, which rely entirely on bank financing or foreign financial markets, unduly concentrate risk (Stevens 2004: 68).

The development of regional bond markets has important advantages. Sophisticated bond markets contribute to the deepening of regional financial markets, which gives borrowers more choice, and simultaneously stabilises the markets. Rather than having to borrow in London or New York, being able to use the region's savings without either facing exchange rate risk or having to hedge against that risk would represent a major improvement of the region's financial architecture. It should be remembered that the combination of declining exchange rates and the unwillingness of international lenders to roll-over existing debt were the two most-important factors in the financial meltdown of 1997.

The initiatives to create regional bond markets as well as strengthen national markets have taken various forms: The Asian Bond Market Initiative (ABMI), proposed by the Japanese Ministry of Finance in 2002, the Asian Bond Fund (ABF) and the initiatives of the Executives' Meeting of East Asia and Pacific Central Banks (EMEAP), which will be discussed in turn.

The ASEAN+3 finance ministers endorsed the creation of an Asian Bond Market Initiative (ABMI) in Manila in August 2003. The ABMI aims at the creation of a suitable environment for the emission of bonds in regional financial markets (Tourk 2004: 862). The ministers agreed not only on principles, but established six working groups, e.g. on standardised debt instruments, the creation of credit rating agencies and the setting-up of guarantee mechanisms (de Brouwer 2005: 7). For the development of improved bond markets, other problematic factors are weak financial institutions, a lack of financial intermediaries such as insurance companies and pension funds as

well as the unwillingness of international ratings agencies to provide credit ratings for Asian companies, many of which are family-owned and unable to provide the data required for financial analysis by independent evaluators. Without an improvement of the conditions for bond emissions, companies in Asia will continue to be reluctant to use these instruments because unsecured corporation bonds will simply be significantly more expensive than bank loans.⁷ The Asian Development Bank supports ABMI by issuing bonds denominated in Thai baht and Philippine pesos (Financial Times, 15.4.2005: 9).

The Japanese initiative, however, has not been limited to improving the infrastructure. Takatoshi Ito has proposed an Asian Basket Currency (ABC) Bond Corporation, whereby Asian governments issue bonds denominated in local currency and contribute them to the ABC entity. These bonds would back the emissions of the ABC Bond Corporation, which itself would issue bonds to match the value of the original assets, but denominated in the Asian Basket Currency. In the second phase, the private sector would be enabled to establish a corporate bond market, again using the Asian Basket Currency for the denomination of the bonds (Tourk 2004: 863).

Taken together, these two initiatives could represent important steps forward, both for the deepening of regional financial markets *and* for the emergence of an Asian currency. However, it remains to be seen whether this Japanese initiative will gain momentum in the coming years.

The Asian Bond Fund was established in 2003. Nine Asian governments agreed to contribute to this fund, which will invest in Asian debt securities. Each country will contribute one percent of its foreign reserves to the fund. The participating countries are China, Japan, Hong Kong, Malaysia, Indonesia, the Philippines, Singapore, South Korea and Thailand (Tourk 2004: 865). Since foreign reserves are very high in the participating countries, the ABF will probably be a very liquid instrument attracting national and international investors. The ABF initiative underlines the willingness of Asian governments to promote actively the deepening of their financial markets. Rather than waiting for the private sectors alone to develop these structures, governments in the region seek to speed-up that process by creating the necessary market environment.

In contrast to the other projects, EMEAP is not a purely Asian venture. Membership is similar to the ABF, with the significant addition of Australia and New Zealand. There can be little doubt that these two economies have well-developed financial markets and that their central banks possess expertise which is very useful in the development of deeper financial markets. In fact, Bowman has

⁷ Tourk suggests that unsecured bonds would require interest coupons of more than 18 percent p.a. (Tourk 2004: 862).

argued that the Australian dollar today is as important in Asia as the yen, a development that could be observed after the Asian crisis (Bowman 2005: 84). In the post-crisis period, linkages between the Asian currencies and the Australian dollar have been significantly intensified. Whilst the yen was much more important for Asia prior to 1997, the Australian currency has caught up in all categories that were analysed by Bowman (2005: 96). The inclusion of Australia in the co-operation scheme of central bankers in the region is therefore not only justified by the expertise in financial markets the Australians possess, but also by the importance of the Australian dollar in the region.

EMEAP is one of the older dialogue institutions in the region, having been set up in 1991 at the behest of the Bank of Japan (Castellano 2000: 1f). During its first years of existence few concrete steps were taken, but since the turn of the century it has become an important – even if underrated – venue for central bank cooperation in the region. The importance of EMEAP has not escaped the attention of Washington, but the USA are excluded from this scheme today.⁸

The first EMEAP Asian bond fund was launched in June 2003 with a capital of \$1 billion, to be invested in a basket of *dollar denominated* bonds, which were issued by governments in all EMEAP countries except Japan, Australia and New Zealand, since these three had already well-developed bond markets. The fund was managed by the BIS in Basle (Battellino 2004: 13; Tourk 2004: 860; de Brouwer 2005: 8).

The next phase is the Asian bond fund 2, which comprises a Pan-Asia Bond Index Fund (PAIF) and a Fund of Bond Funds (FoBF), which consists of investments in eight separate country sub-funds (Battellino 2004: 13). The implementation phase has been announced on 12 May 2005. PAIF is a single bond fund investing in sovereign and quasi-sovereign *local-currency denominated* bonds issued in the eight EMEAP markets, excluding again Australia, Japan and New Zealand. The single-market funds are also investing in local-currency denominated bonds. The EMEAP group has allocated 2 billion dollars for the entire phase 2. PAIF will be managed by State Street Global Advisors, domiciled in Singapore and initially listed in Hong Kong. The single-market funds will each be managed by a financial institution from the respective country and all nine funds will have the Hong Kong and Shanghai Banking cooperation as their master custodian (EMEAP Press Statement, 12 May 2005).

⁸ According to well-informed circles in Canberra, in recent years the Federal Reserve Bank knocked at the door and wanted to participate in EMEAP, but that request was turned down by the Asian central bankers.

The importance of the EMEAP initiatives is significant.⁹ Central bankers from the larger economies of the region have taken active steps to broaden and deepen financial markets in the region. The aim of the initiatives is to reduce dependence on non-Asian financial markets and enable borrowing in domestic currency – both dimensions reducing the vulnerability of the region. If successful, in the long run these efforts will result in reduced risk and better management in Asian financial markets. At the same time, the willingness to exclude the American Federal Reserve underlines the willingness of central bankers to emancipate themselves from the mighty authority of the USA, and this dimension of the EMEAP process is as important as the bond market initiative itself.

However, despite the enthusiasm that has characterised the above named processes, a note of caution is appropriate. Regional bond markets are not a substitute for the reform of national financial markets. Furthermore, even if the initiatives for the creation of regional bond markets will be successful, the deepening of those will take time and further investment in the infrastructure of financial markets (Wang 2004: 947). Although the will to achieve can be observed today, there is no guarantee that this wave of enthusiasm will persist.

The scenarios for the CMI mirror those for the entire process of regional integration in Asia. Consider three scenarios: The first is a Chinese/Japanese alliance in which Japan dominates the CMI process and China the process of trade integration. There would be distinct spheres of influence, and the entente would serve both countries' leadership aspirations. The second scenario assumes a continuing rise of China, which over time could try to pursue its own liquidity scheme and attempt to bypass Japan. Considering that successful trade integration is facilitated by monetary stability and taking into account the leadership aspirations of China, this might indeed be a realistic proposition (Wang 2004: 953). Thirdly, the CMI could muddle through, searching for direction, but not achieving substantial progress.

6. Exchange Rate Co-operation and an Asian Currency

We have to ask whether the Asian region would benefit from the introduction of new exchange rate regimes at the regional level.

⁹ EMEAP itself claims that the launch of the Asian bond fund 2 represents a milestone in central banking cooperation in the region, which is a rather unusual expression of excitement for central bankers (EMEAP press statement, 16 December 2004).

Barry Eichengreen and Tamin Bayoumi have analysed the suitability of Asia for a currency area (Eichengreen/Bayoumi 1999).¹⁰ They argue that Asia is as suitable for monetary union or a single currency as Europe.

We find that the region satisfies the standard optimum currency area criteria for the adoption of a common monetary policy as well as Western Europe. Its small, open economies would benefit from the reduction in uncertainty that would result from the creation of a durable common peg. Intra-Asian trade and investment have reached relatively high levels. Adjustment to shocks is fast, and supply and demand disturbances are small and symmetric by European standards (Eichengreen/Bayoumi 1999: 364).¹¹

Although the political will for improved monetary arrangements in Asia can be identified, there is uncertainty about the potential shape of such a cooperation scheme. Any political agreement in a region on the need for joint exchange rate arrangements is only a starting point. It is necessary to identify the precise nature of such a regime. Tommaso Padoa-Schioppa from the European Central Bank has identified four categories: floating for all economies, a regime with exchange rates tied to a basket of currencies, an intra-regional exchange rate mechanism, and a single currency (Padoa-Schioppa 2004: 321). It is important to note that these four concepts do not address the same issues: There is no attempt to stabilise exchange rates in the free float, whilst tying the individual exchange rates to a basket is aiming at the stabilisation of exchange rates with the rest of the world. By contrast, the main aim of an intra-regional exchange rate mechanism is to stabilise exchange rates within a region, and the same applies for a monetary union as well as for a single currency.

6.1. What Kind of Regime: Floating and Anchors, Baskets and Numeraires

Immediately after the Asian crisis, the so-called bipolar view enjoyed widespread support. The idea was that intermediate exchange rate regimes, e.g. crawling pegs or managed floats, were unsustainable over time. Only the two corner solutions, a free float or a hard-peg, i.e. a currency board, were supposed to be manageable. Needless to say that a free float is indeed controllable, since the affected central bank takes a very passive position and does not try to intervene in foreign exchange markets. The trouble with free floats is that they do not produce convincing results. Although appealing in theory, in practice a free float – whether for an individual economy or for an entire region – can cause lasting imbalances. Serious misalignments even occur for today's two major currencies. Free floats is even less desirable for small and medium-sized economies (Padoa-Schioppa 2004: 321).

¹⁰ For a discussion on optimum currency areas see Mundell 1961; Pomfret 2005; Ryou/Wang 2003 and Kenen 2002c.

But there are alternatives. An individual country as well as a group of countries can tie their own currency to a basket of other currencies. There is a prominent example for such an approach: China has been changing its peg from a single-currency peg to a basket of currencies in July 2005. However, pegging to a basket is not as beneficial as it may sound. Although in theory a basket will avoid the disadvantages of a single-currency peg, new problems arise. Baskets require a liquid foreign exchange market for all currencies, which is a condition that does not always exist (Padoa-Schioppa 2004: 321).

Furthermore, a region would have to agree on a basket of currencies and their relative weight, which might be complicated: some countries will suggest a greater weight for, e.g., the euro, because a high percentage of trade is done with the eurozone. Moreover, pegging to a basket has additional disadvantages, as Ronald McKinnon pointed out after China changed its peg from a single-currency to a basket of currencies. Instead of a clear regime with a well-defined monetary anchor, China has entered a nebulous no-man's land, with the consequence of reduced predictability of monetary policy (McKinnon 2005). Part of the specific problem with the Chinese basket is that it is composed of relatively many currencies, the result of which is reduced transparency and clarity.¹² John Williamson does not share McKinnon's position. He argues that shifting from a single-currency peg to a basket (which he calls a basket numeraire) is beneficial and can be constructed in a manner that is neither complicated nor results in a lack of transparency. Williamson emphasises that switching to a basket numeraire does not imply that any intervention in foreign exchange markets would have to be conducted in the currencies represented in the basket. Even the composition of reserves could differ from the composition of the basket without causing problems (Williamson 2005: 2). Williamson emphasises that a basket numeraire differs from a basket peg: The former is the more general concept and permits both the fixing of exchange rates and a managed float (Williamson 2005: 3).

¹¹ Ryou and Wang as well as Ing have supported the assessment East Asia is not inferior to Europe in satisfying OCA conditions (Ryou/Wang 2003: 22; Ing 2003: 399).

¹² Taking these difficulties into consideration, the negative consequences of a basket could be mitigated by limiting the number of currencies in the basket to two or three. If China would have changed its dollar-peg to a basket in which both dollar and euro would have had a 50 percent weighing, this regime would have been both an improvement over the dollar peg and would have maintained clarity and transparency.

Table 2: Direction of trade of East Asian economies in 2004 (in percent)

Country	United States	Japan	European Union	Non-US Western Hemisphere	Rest of non-Japan East Asia	Rest of world
China						
Exports	22.8	12.4	18.1	4.6	30.1	12.1
Imports	7.7	16.1	12.4	4.8	39.4	19.5
Total	15.2	14.3	15.3	4.7	34.8	15.8
Hong Kong						
Exports	17.0	5.3	14.0	2.7	55.3	5.8
Imports	5.3	12.1	8.0	2.0	67.6	4.9
Total	11.1	8.7	11.0	2.3	61.5	5.3
Indonesia						
Exports	13.5	21.8	14.3	2.1	35.6	12.7
Imports	5.7	19.3	12.1	2.5	43.3	17.1
Total	9.6	20.5	13.2	2.3	39.4	14.9
South Korea						
Exports	17.8	8.3	13.8	6.3	41.4	12.5
Imports	12.7	21.6	10.8	3.4	28.8	22.7
Total	15.3	14.9	12.3	4.8	35.1	17.6
Malaysia						
Exports	18.8	10.1	12.6	1.8	44.6	12.2
Imports	14.6	16.1	12.1	1.6	47.4	8.1
Total	16.7	13.1	12.3	1.7	46.0	10.2
Philippines						
Exports	17.5	15.8	15.5	1.9	46.6	2.8
Imports	16.0	20.6	8.8	1.8	42.1	10.8
Total	16.7	18.2	12.1	1.8	44.3	6.8
Singapore						
Exports	13.0	6.4	14.5	2.1	51.9	12.1
Imports	12.7	11.7	13.5	1.4	45.2	15.5
Total	12.9	9.1	14.0	1.7	48.5	13.8
Taiwan						
Exports	18.0	8.3	11.3	n.a.	48.2	n.a.
Imports	13.2	25.6	9.9	n.a.	30.1	n.a.
Total	15.6	17.0	10.6	n.a.	39.2	n.a.
Thailand						
Exports	15.9	13.9	14.7	2.6	38.8	14.1
Imports	7.6	23.6	9.9	2.3	34.4	22.2
Total	11.8	18.7	12.3	2.5	36.6	18.2
Weighted average						
Exports	18.3	11.3	14.9	4.1	40.3	11.1
Imports	9.5	15.9	10.6	3.5	43.5	16.9
Total	13.9	13.6	12.7	3.8	41.9	14.0
Japan						

Exports	22.7	n.a.	15.8	5.4	47.6	8.5
Imports	14.0	n.a.	12.7	4.6	44.6	24.1
Total	18.4	n.a.	14.3	5.0	46.1	16.3
India						
Exports	18.4	3.5	22.6	3.4	22.9	29.3
Imports	7.0	3.5	23.1	5.2	24.2	37.0
Total	12.7	3.5	22.9	4.3	23.5	33.1

Source: Policy Briefs in International Economics, Number PB05-1, Institute for International Economics, August 2005, p. 4.

For many years Williamson has been advocating the use of a currency basket to stabilise exchange rates (Williamson 1999: 327), a concept which he has somewhat refined in a paper in August 2005. He suggests a basket numeraire for the entire East Asia region.¹³ Williamson explicitly mentions Indonesia, Malaysia, the Philippines, Singapore, Thailand as well as China, Japan and South Korea with a participation of Hong Kong and Taiwan being possible. The existing intra-regional trade is an indicator of the level of interdependence that has been achieved by a particular region, and Asia shows quite a high level of intra-regional trade. In 2004, the share of intra-regional trade (exports and imports combined for Japan was 46.1 percent of total trade, and for the other countries in the sample the average was even higher (55.5 %, see table 2).

There is little gain from a very complex basket composition. Large baskets add complexity without providing much additional benefit (Williamson 2005: 6). Taking the rationale for switching to a basket into consideration, this is obvious: The main purpose of a basket numeraire is to reduce the volatility of one exchange rate vis-à-vis the rest of the world. However, the most prominent as well as most important swings of exchange rates are admittedly between the major currencies, i.e. the dollar, euro and yen.

This leads to the question whether – if a region has made the decision to switch their exchange rates regimes to basket numeraires – individually designed basket numeraires are superior to joint baskets. Williamson supports a joint basket, because only this approach, as he argues, guarantees that changes in external exchange rates do not disturb the intra-regional rates (Williamson 2005: 8). Apart from this economic point, a more political aspect has to be added: Individual baskets would not contribute to the perception of monetary regionalism as a joint project, and perception matters in regional integration. The basket composition proposed by Williamson is quite straight-forward: The dollar should have a weighing of 40.2 percent, the euro of 31.6 percent, and the yen of 28.2 percent.

¹³ Sung Kwack has proposed a similar pegging to a basket (Kwack 2005: 66). He suggested a composition that would include the dollar, the yen and the euro with weights of 40 percent (dollar) and 30 percent for the other two currencies.

Although one could debate whether the precise figures should not be somewhat adjusted, the bottom line is clear: Roughly the same weight for dollar, euro and yen.

There is one aspect that makes this particular basket problematic: Japan would virtually be excluded as on the one hand, it is impossible to tie one's own currency to a basket in which that very currency is featured. On the other hand, the exclusion of the yen from a joint basket would decrease usefulness for the non-Japanese Asian countries, because the fluctuations of the yen would result in substantial variations of their effective exchange rate.

Robert Mundell suggests that East Asia should use an anchor – whether internal or external – in order to move quickly towards a monetary union. Although he admits that the European approach was different – the EMS was a basket of currencies without an explicit internal or external anchor – Mundell argues that is not applicable for Asia. Europe, he asserts, could have reached monetary union three decades earlier by using the dollar as an external anchor in the 1960s (Mundell 2003: 5). Furthermore, Mundell argues that even with an internal anchor, i.e. the German mark, the creation of a monetary union would have been faster. After the end of fixed exchange rates vis-à-vis the dollar, the European countries could have floated together if they had been able to choose one currency as the anchor for the joint float. In the 1970s, however, European countries were unable to agree on the German mark as an anchor for a joint float against the dollar. Although the mark was the key currency in Europe, neither France nor the UK wanted to give that prestigious position to the German currency. The consequence was that a joint float was not implemented, but individual floats instead. It took another decade before the mark became the internal anchor of the European Monetary System (Mundell 2003: 5).

Ronald McKinnon and Gunther Schnabl have been supporting a dollar-peg for East Asia for some time (McKinnon/Schnabl 2003; McKinnon 2004). They argue that it is entirely rational for Asian countries to peg their currencies to the dollar. This enables traders and banks to hedge against volatile exchange rates, while at the same time central banks can anchor their domestic price levels to an external anchor. They identify two motives:

The *microeconomic* rationale for stabilizing dollar exchange rates in East Asia stems from the need to limit foreign exchange risk in intra-regional trade and capital flows that are mainly invoiced in dollars. ... The *macroeconomic* rationale stems from the monetary need for a nominal anchor for domestic price levels – more against the threat of inflation before 1997, and now against threatened deflation in the new millennium (McKinnon/Schnabl 2003: 4; see McKinnon 2004: 204f).

McKinnon and Schnabl point out that many East Asian economies are no longer facing the problem of being unable to borrow in their own currency, a situation that has been termed by Barry Eichengreen as ‘original sin’. In fact, they have the opposite problem: They cannot lend in their own currency and accumulate large dollar holdings, which results in a currency mismatch (McKinnon/Schnabl 2003: 6). It is, however, an advantageous situation, since there is only a risk of reduced returns on the claims of those countries, but there is no risk that an unmanageable situation emerges.

The criticism of the McKinnon proposal has an economic as well as a political dimension. First, the US economy is of decreasing importance for Asian economies, since growth rates in Asia continue to be higher than in the US. With the American economy set for a period of adjustment and significantly lower imports than in the past, America will no longer be the consumer-of-last-resort for Asian-made manufactures (Dieter 2005b). Second, using the dollar as an anchor implies that the region will not explore the possibility of setting up its own, regional currency area (Ryou/Wang 2003: 25). Third, using the dollar as an anchor currency for the whole of Asia is becoming increasingly difficult because the Americans themselves are not in favour of this policy. The campaign against the fixed exchange rate of the yuan in 2004 and 2005 clearly demonstrates that there is a tendency in Washington to interpret fixed exchanges rates as an unfair exploitation of the US. Even though this explanation does not seem justifiable, it has to be considered.

6.2. Intra-regional Exchange Rate Mechanism à la EMS:

In literature on monetary regionalism, the terms monetary union and single currency are sometimes used referring to the same arrangement. This is not the case. Monetary union differs from a single currency, as adopted in Europe. A monetary union requires the permanent fixing of exchange rates between participating countries, but there is no single currency (Castellano 2000: 5). The plan proposed by Pierre Werner in 1970 envisaged this type of monetary integration for the then European Community. The result would have been 1980 permanently fixed parities and persistence of all national currencies (James 1996: 202f; Wyplosz 2002a: 26).¹⁴

The Werner Plan was never implemented, nevertheless an intra-EC exchange rate mechanism dubbed “Snake in the Tunnel” was implemented from 1972-1979. Its purpose was to provide stable exchange rates between the participating economies (Ing 2003: 383).

¹⁴ The Werner Plan was endorsed by the Council of Ministers in 1971, just before the Bretton Woods System collapsed (Ryou/Wang 2003: 8).

Whilst the economic consequences of a monetary union and a single currency do not differ sharply, variances remain. Only a single currency symbolises the integration both to the citizens of the integration project and to financial markets. The individual currencies of a monetary union will have difficulties to become accepted as reserve currencies, which is easier for a single currency. However, for Asia a monetary union – for the time being – might be sufficient. A monetary union would provide stable exchange rates without requiring the abandonment of national currencies.

This point has been emphasised by Robert Mundell in 2003. He has supported the plea for a common currency, but not for a single currency, referring to the lack of political accord between China and Japan (Mundell 2003: 4). Mundell argues that the Delors report of 1989 – which favoured a single currency over a common currency for international transactions – was a big gamble for Europe, but the proposal was made based on the greater irrevocability of the single currency. When national currencies are abolished, the cost of abandoning the single currency is significantly greater.¹⁵

Barry Eichengreen has been advocating an approach for East Asia that uses a parallel currency, similar to the early phase of monetary integration in Europe. The value of the parallel currency would be defined as a basket of East Asian currencies, and it would be used in the region (Eichengreen 2004a). John Williamson has proposed that East Asian countries use a basket of currencies as an anchor for their exchange rates (Williamson 1999 and 2005). It is necessary to make the differences between the various types of baskets very clear: Eichengreen suggests a fixing of exchange rates within the region and a float vis-à-vis the rest of the world, whereas Williamson proposes a stabilisation of the individual exchange rates vis-à-vis the rest of the world. These are two distinct concepts.

Ryou and Wang suggest the use of an internal basket. They propose the introduction of a parallel currency, the Asian Currency Unit (ACU). This currency would be a basket comprised of all regional currencies, weighted according to economic size. The exchange rate of each national currency vis-à-vis the ACU would be limited – like in the European Monetary System. The main advantages would be a limited volatility between the regional currencies – including the yen – and the harmonisation of monetary policies in the region (Ryou/Wang 2003: 28). The replication of the EMS indeed has a number of attractive features. Volatility between the yen and other currencies would be reduced and intra-regional trade further facilitated. Traders and financial intermediaries

¹⁵ In 2005, there has been some debate on this issue in Italy. The introduction of the euro has deprived Italy of the ability to regularly devalue its currency and thereby regain international competitiveness. The much harder process of improving productivity is causing great strains in the Italian economy.

would have reduced expenses – if any – for hedging intra-regional flows. It has to be pointed out that such a scheme would not be aimed at stabilising exchange rates vis-à-vis the rest of the world. However, both approaches could be combined: A group of countries could both stabilise their regional exchange rates as Eichengreen has suggested and stabilise the exchange rate of that basket vis-à-vis a basket of non-regional currencies (Williamson 2005: 1). It is evident that the two approaches serve different purposes: Eichengreen's proposal would enhance regional exchange of goods, investment and services, while Williamson's primary goal is to facilitate economic exchange with the rest of the world. In Williamson's words:

One possibility is that they (East Asian currencies, H.D.) would in due course be candidates for a monetary union, on the European model. In that event, they might wish to create a parallel currency at an early date, as suggested by Eichengreen (2005), and the value of that parallel currency probably ought to be defined as a basket exclusively of East Asian currencies. There is absolutely no contradiction between creating such a basket to determine the value of a parallel currency and using currency baskets that contain – perhaps exclusively – extraregional currencies in order to peg or otherwise manage the exchange rate of regional currencies. These are two quite independent decisions, and either could be taken with or without the other (Williamson 2005: 11).

Williamson's proposal is complex, but manageable. He himself defends it by arguing that the calculations might be sophisticated, but there is no need for the entire population to understand these details. It is more important to understand that using a basket numeraire provides enhanced monetary stability, a goal many people would support (Williamson 2005: 12).¹⁶

Robert Mundell has argued along similar lines. He maintains that a monetary union would be best for East Asia and he suggests that this requires the choice of an anchor currency. But which currency would be a suitable anchor? The first-best solution would be an internal anchor. This is not just a question of data, but also of Asian pride. At the same time, it can be the source of distrust between countries competing for leadership in East Asia. For economic and political reasons the choice is limited in Asia: Either the yen or the yuan could in principle be used as anchors (Mundell 2003: 6). The currencies of smaller economies are far too vulnerable to externally induced fluctuations to be viable.

But would any of these two currencies be a good choice? The answer is easier in the case of the yuan: As China continues to use restrictions on capital flows and since the Chinese financial system

¹⁶ A point that is of secondary importance for the purpose of this paper was considered by Stefan Collignon. He has argued that the goal of reduced exchange rate volatility of some countries that tie their exchange rates to an anchor currency has had the unintended side-effect of increasing volatility between the floating key currencies. In other words: there is a trade-off between intra-bloc stability and inter-bloc volatility (Collignon 1999: 317).

is in a rather fragile constitution, the yuan could not serve as an internal anchor for a monetary union.

However, the yen is also not as convincing as it could be. Evidently, Japan continues to be the economic heavyweight in the region and produces a GDP that is several times larger than the Chinese GDP. Japan is the world's largest creditor nation and inflation rates have been very low through decades. Although the Japanese currency possesses some qualities an anchor currency should have, much remains to be desired. The Japanese economy is by and large still crippled by the 15-year-long recession that started in 1990. The macro economy is still in a mess. Gross government liabilities will reach about 170 percent of GDP in 2005 – far above any other OECD-country. The financial sector – despite some signs of improvement – still suffers from the aftermath of the simultaneous bubbles in the stock and real estate markets in the 1980s. In addition, perhaps most significant problem is the volatility the yen has shown vis-à-vis the dollar. No country would choose an anchor that would provide increased external volatility, instead of stability. Needless to underline that the period of Japan's most rapid growth – 12 percent per annum between 1955 and 1970 – correlates with fixed exchange rates. The same is true for Germany. If Japan wants to achieve the position as the financial hub of Asia, it has to stabilise its exchange rate as well as sort out its macroeconomic problems. There are very few indications for such a policy change.

From today's point of view, the only option for an internal anchor is the yuan – if current trends continue. By 2010, China might have solved the problems of its financial system *and* have demonstrated its ability to provide a relatively stable exchange rate vis-à-vis the rest of the world (Mundell 2003: 8).

Barry Eichengreen has argued that Asia possesses none of the institutions that characterise integration in Europe. There is no administration implementing integration, no parliament and no regional court of justice. Consequently, Eichengreen takes a sceptical position with regard to the ability and plausibility of creating a monetary union in Asia (Eichengreen 2004a: 2). Whilst he certainly has a valid point, Eichengreen's assessment is both underestimating the (potentially) dynamic process of integration and is simplistic in his analysis of the paths available. As monetary regionalism is not a recipe cast in stone, it can be adopted to region-specific conditions. In Asia, it is true that there is limited willingness to initiate an integration process that imposes substantial limitations on national sovereignty. However, this does not imply that Asian governments are unable to agree on substantial monetary cooperation and a monetary union with fixed exchange

rates. Consequently, Eichengreen's list of preconditions for monetary union in Asia is questionable.

He states:

The essence of monetary unification is therefore agreement to establish an international institution to which the participating national governments are prepared to delegate the relevant policy prerogatives (Eichengreen 2004a: 5).

Whilst the creation of a regional central bank is a precondition for the establishment of a common currency, it is not necessary for a monetary union. One can envisage an integration process that seeks to establish stable exchange rates as the final goal of the process, without aiming for a common currency. Of course, a monetary union, e.g. the establishment of a new global reserve currency, is second-best in a number of areas but that second-best evaluation stems from economic, not political analysis. Asia, which includes a number of countries that were colonies of England, the Netherlands or Japan, might be better advised not to aim for goals that are too demanding. Recent European experience is underlining such caution. Whereas European policy elites have advocated further deepening and widening of integration, the negative referenda on the proposed European constitution in France and the Netherlands have shown that it is risky to assume everlasting support for a good purpose.

It is, however, also true that fixing exchange rates without a common institution requires additional harmonisation of economic and fiscal policy. In the Werner-Plan of 1970, exchange rates should have remained stable, but economic and fiscal policy should have been guided by a regional body. Rather than fixing certain targets for fiscal policy, the Werner-Plan envisaged supranational control of national finance ministers. Furthermore, markets for capital and labour should have been integrated quickly (Eichengreen 2000: 204). The plan eventually implemented set a different emphasis: The treaty of Maastricht required the participating economies to observe set targets for fiscal policy.

6.3. Exchange Rates and the Trinity of International Finance

Whatever the eventual path chosen, the options available to policy makers are determined by a fundamental policy choice. The underlying dilemma is described in the impossible trinity of international finance, analysed by Robert Mundell and Marcus Flemming in the early 1960s (see Mundell 1962; Flemming 1962). Mundell and Flemming have pointed out that monetary policy tries to reach three goals at the same time: independence of monetary policy, unrestricted flows of capital and stable exchange rates. However, it is impossible to reach more than two goals at the

same time (see Frenkel/Menkhoff 2000: 11ff; Fischer 2001: 8). Monetary policy can only choose between the following three options:

- Firstly, either a stable exchange rate and an independent monetary policy. This option requires the use of capital controls. This option describes the system of Bretton Woods. Capital controls were a central element of that monetary regime. These controls are necessary to enable the implementation of an independent monetary policy. For instance, in the absence of capital controls the lowering of domestic interest rates would lead to an outflow of capital with subsequent pressure on the exchange rate. Bretton Woods was a stable financial system for more than 20 years. Moreover, Bretton Woods was a period of rapid economic growth of the global economy. Another example is China, which also generated exceptional growth over a long period of time. During the Asian crisis, China could maintain its fixed exchange rate vis-à-vis the dollar primarily because of the tight capital controls it implemented.
- Secondly, unrestricted capital flows and an independent monetary policy. In this case, the exchange rate will have to be flexible. The second case describes the current system in the OECD outside the Eurozone. Exchange rates fluctuate while capital flows are more or less unrestricted. National monetary policy enjoys a certain, but limited autonomy, at least in the larger OECD-countries.
- Thirdly, unrestricted capital flows and a stable exchange rate. The central bank gives up an independent monetary policy and concentrates its activities on the stabilisation of exchange rates. The third case is plausible from an economic point of view, but not politically. The reason is that in such a scenario, monetary policy has to give absolute priority to the stabilisation of the exchange rate. Thus, the central bank may have to raise interest rates even if that is counterproductive for the domestic economy. In democratic societies, very few interest groups support such a monetary policy. Both trade unions and employers' associations are not willing to accept a stable exchange rate as the primary target of monetary policy. In addition, many sectors of an economy are not affected by changes in the exchange rate and would therefore not support a policy that ignores the consequences for the

domestic economy.¹⁷ The bottom line is that stable exchange rates and an independent monetary policy are only achievable with capital controls.¹⁸

Hence, there is a trade-off between autonomy and stability. If capital controls are excluded, there is a choice between independent monetary policy and flexible exchange rates. With the goal being stable exchange rates, there is no alternative to the partial surrender of monetary autonomy. This applies to a global currency as much as it does to a regional currency, and this issue should not be taken lightly. In particular for countries that had been governed by colonial forces for longer periods, surrendering monetary autonomy is not easy. Indonesia, Malaysia and South Korea are the most prominent examples that can be identified in Asia.

However, whilst the support for a monetary policy that puts priority on stable exchange rates is not plausible for European and North American countries, conditions might be different in Asia, one reason being the Asian crisis. The traumatic experience of 1997 has probably left the region with lasting legacies, and the willingness to accept limits for the options available to national monetary policy might be one of them.

At this stage, it is necessary to introduce a further distinction: fiscal and interest rate policy are both frequently considered to be in need of harmonisation in a monetary union (and for a common currency). While there is little doubt that interest rate policy has to be harmonised in both a monetary union and a common currency, because failure to do so would create strong capital flows endangering the exchange-rate stability, there is probably less need for harmonisation of fiscal policy. Eichengreen doubts that excessive fiscal deficits in one part of a monetary union will drive up interest rates union-wide. Further, he suggests that the costs of debt servicing will continue to be borne by the national governments and their taxpayers, with no monetary free riding involved (Eichengreen 2004a: 17).

The choice of exchange rate regime is evidently the most complex part of monetary regionalism. From a theoretical point of view, the most convincing proposals at this stage are the introduction of

¹⁷ Before the First World War, such policies were implemented under the Gold standard. The participating countries made the stability of the exchange rate an absolute priority of their economic policy. In the three core countries of the Gold standard, i.e. France, Germany and the United Kingdom, the gold reserves and the convertibility at a given exchange rate were defended regardless of the short-term cost for the domestic economy (see Eichengreen 2000: 51). The political opposition against these policies was limited, mainly because trade unions were too weak to argue their case: Full employment was not yet on the political agenda.

an internal parallel currency, the ACU, combined with an external basket numeraire as proposed by John Williamson. These two regimes combined would provide external and internal stability, and thus make a significant contribution to the creation of growth-enhancing conditions in the region. In March 2006, the Asian Development Bank has been publicly advocating the concept of creating an ACU as an instrument for denominating bond issues in the region (International Herald Tribune, 28 March 2006). Although the selection of participating currencies is controversial – Taiwan, Hong Kong, Australia and New Zealand are contested – there appears to be substantial political support for this process (Financial Times, 26 March 2006).

There is, however, one important caveat. In Europe, the EMS was sustainable because the larger countries in Europe provided ample financial support, whilst the weaker players continued to use capital controls to protect their currencies. The country that would have to stabilise the Asian Monetary System (AMS) is Japan, and Japan appears to be less willing to play the role Germany played in the EMS. In that vacuum, China might try to push its own project.

7. Greater Chinese Currency Union and other Alternative Projects

The rivalry between China and Japan also overshadows monetary co-operation in the region. Although one could argue that both countries have had a constructive relationship in recent years – and the various initiatives outlined above prove just that the unresolved nature of the two countries' relationship is the decisive issue for all types of integration in Asia. In addition, some of today's issues go way back indeed. The Chinese-Japanese war in 1894/95 resulted in a humiliating defeat for China and – more important today – the loss of Taiwan, which was a Japanese colony until 1945. In the second decade of the 20th century, Japan presented the '21 requests' and sought to integrate China in a Pan-Asian union under Japanese leadership (Hilpert/Wacker 2004: 7). Therefore, the occupation of Manchuria in 1931 and further invasions of Chinese territory in 1937 by Japanese forces are only the most prominent issues overshadowing Asian co-operation.¹⁹

At the beginning of the 1990s, China's position in Asia was much worse than today. At that time, it did not enjoy full diplomatic relations with Indonesia, South Korea and even Singapore whilst the

¹⁸ Stanley Fischer, for many years the most important figure in the IMF, accepts this conclusion and asserts that the implementation of capital controls permit a stable exchange rate. In Fischer's opinion, the problem is the declining efficiency of capital controls. Over time, the evasion of capital controls rises (see Fischer 2001: 10).

¹⁹ Polls both in China and in Japan demonstrate that the citizens of both countries have limited sympathy for their respective neighbour. In 2002, 49.1 % of surveyed Japanese considered China to be hostile to Japan. In the same year, only 7 % of Chinese citizens asked agreed to the proposal that China should have friendly relations with Japan (Hilpert/Wacker 2004: 9).

relations with Russia, India and Vietnam were hostile (Shambaugh 2004: 66). In the first decade of the 21st century, this has changed dramatically. David Shambaugh has emphasised that China is the fundamental cause of change in Asia, altering the traditional underpinnings of international relations in the region. In contrast to the past, China is seen today as an opportunity and no longer predominantly as a threat.

...most nations in the region now see China as a good neighbour, a constructive partner, a careful listener, and a nonthreatening regional power. This regional perspective is striking, given that just a few years ago, many of China's neighbours voiced growing concerns about the possibility of China becoming a domineering regional hegemon and powerful regional threat (Shambaugh 2004: 64).

In the last two decades, China has become an economic hub in Asia. Both in trade and production, the countries in the region and elsewhere are increasingly benefiting from intense links with China. Today, nearly 50 percent of China's trade is intra-regional, and there is no large trade surplus or deficit with any country in the region (Shambaugh 2004: 83). By opening itself to foreign investment and trade, China has not only become an indispensable trading partner, but also of strategic interest to many foreign companies (Zakaria 2005).

Chinese diplomacy has escorted this company-level development by portraying the country as the benign emerging giant in East Asia.²⁰ Today, as David Shambaugh has put it, China is an exporter of goodwill and consumer durables instead of revolution and weapons (Shambaugh 2004: 65). China is investing in soft power: The efforts to popularize Chinese culture in the region and the attempts to lure future elites into Chinese universities are just two examples of that process. The rise of China's influence has been most significant where America's influence simultaneously declined: in South Korea and in Southeast Asia (Shambaugh 2004: 90). This is no coincidence. America's position has deteriorated in those countries that were affected by the Asian crisis and had to deal with IMF programmes, and in those countries, China appears to be a more benign partner.

As a consequence of its decreasing influence, American diplomacy has been changing its opposition to Asian monetary co-operation. Whilst the USA opposed earlier attempts of Asian monetary co-operation, both the willingness expressed by Asian countries to exclude the Americans – as demonstrated in EMEAP – and the gradual but steady progress in monetary regionalism have resulted in a new policy of the USA in 2006. Tim Adams, Under-Secretary for International Affairs at the US Treasury, has signalled that the United States would no longer fight efforts to create an

²⁰ For example, China has offered an asymmetrical opening of its markets five years ahead of the opening required from its ASEAN trading partners (Cai 2003: 396).

Asian currency unit (Financial Times, 16 June 2006).²¹ A few weeks earlier, in May 2006, the United States still opposed any move towards an ACU (International Herald Tribune, 5 May 2006, p. 12). However, this policy shift is rather a belated acceptance of America's inability to bloc the emergence of monetary regionalism in Asia than an expression of a new willingness to constructively engage America in a new form of financial governance in the region.

Leading by example is surely an appealing characteristic of the Chinese model, but the rigorous defence of the concept of national sovereignty is probably as important for the governments of smaller countries in the region. However, there is one area where China has not yet attempted to advance its position in the region and that is finance and monetary co-operation.

This, of course, is no coincidence. The financial sector in China requires comprehensive reform. At the end of 2001, the four largest state-owned banks were struggling with non-performing loans worth about \$200 billion (Schröder 2003: 8). The presence of capital controls enables the Chinese authorities to postpone reform because Chinese savers cannot export their savings, i.e. capital stays in China. However, if the Chinese government will successfully reform the financial sector, there will also be room for a greater role for China in financial affairs. Considering the large foreign reserves of Beijing, which can partly be used for consolidating the state-owned banks, China could attempt to establish itself as the monetary and financial heart of the region within a decade.

In 2005, there has been a somewhat unexpected development in the Chinese financial sector. Foreign investors have started to make major investments in Chinese banks. The two largest ones, Bank of China and Industrial & Commercial Bank of China, have secured foreign investment of about €5,000 million in August 2005. The Industrial & Commercial Bank has sold a 10 percent stake to a consortium of Goldman Sachs, American Express and Allianz, whilst the Bank of China has received a similar investment from Singapore's state-owned investment company Temasek (The Wall Street Journal, 31 August 2005, p. 1 and 8). Together with these two latest deals, foreign banks and other financial intermediaries have already invested around € 12,000 million in the Chinese financial sector. The other foreign investors are equally well-known: Bank of America, Royal Bank of Scotland, Merrill Lynch as well as HSBC (The Wall Street Journal, 31 August 2005, p. 1). These are fundamental changes. Foreign banks are betting that the profit potential in China outweighs the legacy of bad loans and a state-controlled financial sector. By making substantial investments in China, foreign investors can be expected to intervene in the management of these

²¹ Adams added that the US does not consider an Asian Currency Unit as a competitor to the dollar.

banks – at least over time. With foreign capital and foreign management skills, the Chinese financial sector might be commercially run and be competitive much faster than many observers are expecting today. If this were to happen – and there cannot be any doubt that the risks for this process are formidable – the prospect of China becoming the financial hub in Asia suddenly looks much less futuristic and becomes by far more plausible.

With hindsight, the Asian crisis has been a good opportunity for China, and it has exploited it. The decision not to devalue its currency in 1998 was wise and probably stopped the further spread of panic (Dieter/Higgott 1998). China offered aid packages to several Southeast Asian states, whilst the USA initially refused to participate in the bail-out of Thailand. The Chinese approach was appreciated in the region, and it stood in stark contrast to the authoritarian way the IMF and other international creditors imposed their programs (Shambaugh 2004: 68).

The opportunity for taking a leading role has opened up largely because of the unwillingness of the obvious candidate for that role, Japan, to provide stability and leadership in financial affairs. During the entire post-war period, monetary policy in Japan was geared toward national economic goals (Hilpert 1992: 185). With the long-lasting recession of the 1990s, this path has not been altered. The Japanese central bank tried to reduce the negative consequences of the economic slump, a policy that was counterproductive for developing a leading role in international monetary affairs (Herr 1997: 135f). In recent years, the interventions of the Japanese central bank aimed at stopping an appreciation of the yen vis-à-vis the dollar have further strengthened the perception that the yen is not a suitable anchor currency for Asia (Hilpert/Wacker 2004: 40).

This assessment contrasts sharply with that of the German Bundesbank, which for many years enjoyed a remarkable reputation in Western Europe. Although the Bundesbank more than once temporarily hurt European integration by stubbornly implementing its stability-oriented monetary policy – the prime example being the tight policy implemented after German unification in the early 1990s, which resulted in the EMS crisis of 1992 – this very orientation enabled it to acquire respect and leadership in its region.

Castellano has emphasised that the yen's limited role in the global (and regional) economy can partly be explained by the relatively underdeveloped status of Japan's financial sector (Castellano 2000: 8). Although the Japanese government has addressed this problem with the Big Bang initiative of April 1998, there has not been much improvement until today. For store of value and

means of transaction, the dollar continues to dominate, with the euro slowly catching up, in particular as store of value.

Cheung and Yuen have analysed the potential for a Greater Chinese Currency Union, comprising China, Hong Kong and Taiwan. They argue that these three economies have considerable complementary assets. China has low-cost resources and developed production facilities, Taiwan has advanced technological know-how and capital, and Hong Kong offers sophisticated financial services, modern management skills, and a well-developed legal system (Cheung/Yuen 2004: 1). The two authors argue that Greater China is suitable for a currency union – from an *economic* point of view. The three economies already have extensive trade and investment linkages. Furthermore, business-cycles are relatively synchronised, which would greatly reduce the negative impact of a common monetary policy (Cheung/Yuen 2004: 27).

Of course, suggesting a Chinese push for a prominent role in financial affairs is a highly speculative endeavour and can attract criticism for being unrealistic both with regard to economic *and* political conditions. Nevertheless, excluding such a possibility appears to be premature for a number of reasons. Greater China has all the features necessary: Hong Kong (and possibly Singapore) has the expertise in financial markets, Taiwan has the investment links to mainland China and China proper has the political will to establish the country as the main regional power. An additional factor to be considered when evaluating the prospects of a Greater Chinese monetary union is that overseas Chinese represent the majority of dynamic entrepreneurs in Southeast Asia (Tourk 2004: 856).

As political friction continues to dominate relationship between China and Taiwan, for the time being there is only a limited likelihood that such a project would be started in the near future. Nevertheless, in the recent past, a softening of policies towards mainland China could be observed in parts of the Taiwanese political elites, and if such rapprochement continues, the likelihood of a Greater China Currency Union would change quickly. If that were to happen, it would represent a worst-case scenario for Japan, because Asia's largest economy would become dispensable for monetary integration in Asia – a worrying prospect.

8. Conclusion: The Institutional Dimension and Political Obstacles

The previous discussion on monetary and financial integration in Asia has shown a number of merits as well as the substantial technical problems that would have to be overcome. However, the most problematic obstacles continue to exist at the political level. As discussed in the preceding

section, China's policies are one dimension to be considered. The other is doubtlessly the Japanese approach to regionalism.

Observers from the region continue to express doubts with regard to the motives of the Japanese government. First, there is the problem of ambiguity. Japan has been promoting integration among the ASEAN+5, but who are the two additional members? Australia and New Zealand or Taiwan and Hong Kong (Wang 2004: 951). Even more serious are the suspicions raised in the region concerning the motives of Japan, as Wang has expressed them.

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. 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. ... 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 (Wang 2004: 951f).

Wang raises a number of serious points, but fails to consider other issues. As much as Japan has failed to present a convincing strategy for the economic integration of the region, other players, namely China, have also not permitted such a development. The Chinese opposition to the AMF in 1997 provides an example. Furthermore, using anti-Japanese sentiment within some Asian countries is distracting attention away from their own atrocities, as well as providing legitimacy to existing regimes.

Despite these obvious flaws in Wang's analysis, his main point is convincing. If Japan is serious about its regional policies, it has to top-up its offers. There is a risk that Japan is drifting towards some kind of isolation. While closely allied with the US, it is not considering itself as an integral part of its own region, and tries to participate in regional processes without making serious, substantial commitments. Although this picture is a gross oversimplification of the Japanese position, what matters is that the regional policies of Japan might be perceived that way. In some ways, the position of Japan is similar to that of the UK in Europe. There is a strong tendency – in England in particular – to have a very critical perception of European integration.²² There are explanations for that hostility towards continental Europe, one being the relative (economic) decline

²² For instance, there is no other EU country in which the main opposition party has suggested to leave the EU and to join NAFTA, as the Tories have in the UK. Britain has declined to participate in two major integration steps, the Schengen agreement and the Eurozone.

of the UK coinciding with the deepening of European integration.²³ Whilst the centre of gravity in the European Union might over time shift further to the East, in Asia the rise of China will be the decisive factor – unless Japan is able to turn the tide in its favour.

Beyond that, there are some institutional questions to solve which might appear to be of secondary importance. However, the European experience has demonstrated that this is not the case. Institutions matter in any regional integration process. Without them, it can be difficult to sustain the necessary momentum. In the absence of powerful institutions that can provide dynamic inputs into an integration process, these processes are solely dependent on the leadership provided by individual member countries.

In Asia, one issue that has to be solved in that context is the location of an ASEAN+3 secretariat. This is an issue of national pride as much as a functional issue. An ASEAN+3 secretariat will have a prominent function in the integration process, and consequently there is considerable rivalry over this issue. De Brouwer has made some insightful proposals in this context (de Brouwer 2005: 20).

The first criterion is that the institution should not be in a large country (the Brussels solution). This excludes any city in China, Japan and Indonesia.²⁴ Secondly, the solution must protect the interests of the entire region and try to balance also the rivalry in sub-regions. The third issue is a more practical one: The institution should be located in a country with a well-developed economic infrastructure. This leaves not too many choices: Bangkok and Seoul, with some preferences for Seoul because of its greater economic dynamism and better infrastructure.

Another issue, which has to be addressed, is the name of the endeavour. ASEAN+3 is a temporary name, which does not properly reflect the regional dimension, i.e. there is too much emphasis on Southeast Asia. Considering that the region has accomplished the first East Asian Summit in 2005, it appears to be appropriate to change the name of the group to East Asian Community. Again, one might argue that this is a minor issue. Drawing lessons from the European experience, it is clearly

²³ The reservations substantial parts of the British population hold towards monetary integration in Europe can be partly explained by looking at two events in financial history. The first incident happened in 1931. British commercial banks had substantial claims on Central European banks. When the largest Austrian bank, the Vienna Creditanstalt, failed in May, a bank run started in Central Europe. In that process, British banks suffered freezes on their assets, which in turn led to the departure of Britain from the gold standard on 21 September, 1931 (James 1996: 22). The second traumatic experience was the 16 September, 1992, when a combination of high interest rates in Germany and vitriolic attacks by hedge funds pushed Britain out of the EMS.

²⁴ The European Central Bank has its seat in Germany, which appears to be a contradiction. However, the choice for the ECB's seat was made decades after the integration process in Europe started. The situation in Asia today is similar to the early days of the European integration process.

not irrelevant. The European Economic Community first dropped the “Economic” and then changed to “Union”, and both changes symbolised a new phase in integration.

In this paper, the options for monetary regionalism were analysed and, where appropriate, the European model was considered. Studying the European experience might not be useful when looking at the details. Nevertheless, there is one important lesson: technical details are far less important than political will to jump the hurdles that inevitably emerge in any integration process. Furthermore, the broad political will cannot be tied to precisely planned schedules. Too much rigidity of schedules and plans can backfire and harm the integration process.

The evaluation of monetary integration has to be done based on the analysis of the positive and negative consequences of integration. There is no win-win model in monetary integration. Inevitably, countries that participate in monetary integration will lose some options when pursuing others. Creating a single currency causes – as some countries in Europe currently experience – substantial cost. The analysis has to consider carefully gains and losses of such a process.

The financial crises of the 1990s may have been a sufficiently traumatic learning experience, especially for some of the weaker state policy making elites, to recognise a need to shed a little sovereignty, in order to preserve wider state building capacity and regional stability. Vulnerability to financial market volatility is now the major challenge to policy autonomy. It may be this sense of vulnerability that is the key to the further development of regional collective action in the monetary sphere.

However in conclusion, this analysis confirms the assumption that monetary regionalism in Asia will both be a complex endeavour and will – if at all – only be achieved in the long run. From today’s point of view, it appears to be unlikely that Asian governments are willing to give up sovereignty over macroeconomic affairs, let alone push the creation of an Asian supranational fiscal and monetary authority. At the same time, expecting Asian countries to bet solely on their own, national capabilities and the international financial institutions to support them in the event of crises is most probably a delusion. Asian countries will strengthen their ties, the main question being which shape that cooperation will take.

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Abbreviations:

ABC	Asian Basket Currency
ABF	Asian Bond Fund
ABMI	Asian Bond Market Initiative
ACU	Asian Currency Unit
ADB	Asian Development Bank
AFTA	ASEAN Free Trade Area
AMF	Asian Monetary Fund
AMS	Asian Monetary System
APEC	Asia-Pacific Economic Cooperation
APT	ASEAN Plus Three
ASEAN	Association of Southeast Asian Nations
ASEAN-4	Indonesia, Malaysia, Philippines, Thailand
ASEAN-5	Indonesia, Malaysia, Philippines, Singapore, Thailand
ASEM	Asia-Europe Meeting
ASP	ASEAN Regional Surveillance Process
BIS	Bank for International Settlements
CAFTA	Central American Free Trade Agreement
EC	European Community
ECU	European Currency Unit
EEC	European Economic Community
EFTA	European Free Trade Area
EMCF	European Monetary Cooperation Fund
EMEAP	Executives' Meeting of East Asia and Pacific Central Banks
EMS	European Monetary System
EMU	European Monetary Union
ERM	Exchange Rate Mechanism
EU	European Union
FoBF	Fund of Bond Funds
FTA	Free Trade Area
FTAA	Free Trade Area of the Americas
GATT	General Agreement on Tariffs and Trade
IAS	International Accounting Standard
IFIs	International Financial Institutions
IMF	International Monetary Fund
MERCOSUR	Mercado Comun del Sur (Common Market of the South)
NAFTA	North American Free Trade Area
OCA	Optimum Currency Area
ODA	Official Development Aid
PAIF	Pan-Asian Bond Index Fund
RTA	Regional Trade Agreement
TRIMS	Trade Related Investment Measures
TRIPS	Trade Related Intellectual Property Rights