

Financial Cooperation in East Asia⁺

Yunjong Wang^{*}

1. Introduction

The growing interdependence in the world through trade and financial integration has heightened the need to engage in international and regional economic cooperation. This was never demonstrated more clearly than during the Asian financial crisis of 1997. The reality is that financial instability is unlikely to remain within the national borders of the country of origin. Cooperative efforts at both regional and global levels are therefore needed to counter the negative spillovers. The IMF's surveillance activity is just such an example of the provision of a global public good. By the commonsense logic of "two heads are better than one," regional initiatives could complement the IMF surveillance process (Wang and Woo, 2002).

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

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^{*} Director of Center for Regional Economic Studies and Senior Research Fellow, Korea Institute for International Economic Policy (KIEP), yjwang@kiep.go.kr.

The formation of a regional financial arrangement in East Asia also reflects frustration with the slow reform of the international financial system (Park and Wang, 2002). The urgency of architectural reform in the G7 countries has receded considerably. The slow progress has been further complicated by the perception that the current international architecture is defective. As long as the structural problems on the supply side of international capital such as volatile capital movements and G3 exchange rate gyrations persist, the East Asian countries will remain as vulnerable to future crises as they were before. It would be in the interest of East Asians to work together to create their own self-help arrangements. The CMI of ASEAN+3 is one such available option. However, it is equally important that East Asian countries continue to undertake financial sector restructuring and development. Without sound financial institutions and adequate regulatory regimes, Asian financial markets will remain vulnerable to external shocks. Regional policy dialogue should also contribute to strengthening the efforts to restructure the financial markets in East Asia.

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

Before the Asian financial crisis broke out in 1997, few would have seriously argued for the creation of a system of regional financial cooperation in East Asia. Only a market-led integration process was taking place in East Asia. However, the financial crisis that erupted in 1997 was a major financial breakdown that gave East Asians a strong impetus to search for a regional mechanism that could forestall future crises. This search is now gathering momentum and opening the door to possibly significant policy-led integration in East Asia (Henning, 2002).

Evidently, there is a rising sense of East Asian identity today. After the proposal to create an Asian Monetary Fund (AMF) was shot down, the leaders of ASEAN

responded by inviting China, Korea and Japan to join in an effort to seek economic cooperation in the region. The ASEAN+3 summit in November 1999 released a “Joint Statement on East Asian Cooperation” that covers a wide range of possible areas for regional cooperation. Recognizing the need to establish regional financial arrangements to supplement the existing international facilities, the finance ministers of ASEAN+3 at their meeting in Chiang Mai, Thailand, in May 2000 agreed to strengthen the existing cooperative frameworks in the region through the “Chiang Mai Initiative (CMI).”

Significant progress has been made in implementing the CMI. The ASEAN Swap Arrangement (ASA), one of the main components of the CMI, has increased to US\$1 billion, effective as of November 17, 2000, and encompasses all ASEAN member countries. Regarding the network of bilateral swap agreements (BSAs) under the CMI, substantial bilateral agreements have been reached and are currently under negotiation. Japan has been playing a leading role in terms of both number and amount: Japan concluded six agreements with Korea, China, Indonesia, Malaysia, the Philippines, and Thailand, and is currently negotiating one more agreements with Singapore. Korea also concluded four agreements with China, Malaysia, the Philippines and Thailand in addition to the Japan-Korea BSA. Korea is also expected to conclude BSA negotiations with Indonesia [See Table 1].

Insert Table 1

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

2. Rationale for Regional Financial Cooperation

The Asian financial crisis provided a strong impetus for East Asia to reform and strengthen its domestic financial systems (markets and institutions). At the same time, a strong need has emerged for developing a framework that can support regional financial cooperation to prevent and manage such crises in the future. However, the terminology – regional financial cooperation – seems ambiguous and thus needs to be more clearly

specified. No one can deny the need for regional financial cooperation in the genuine sense, but when it comes to discussing the details and specifics of concrete proposals, there is disagreement all around among insiders and outsiders alike. One clear example is the proposal for the Asian Monetary Fund (AMF), which was shot down in 1997 (Wang, 2001).

The adoption and implementation of the CMI could be counted as a major step toward strengthening the financial cooperation among the thirteen East Asian countries. However, ASEAN+3 countries will face much tougher challenges and tasks in exploring developments beyond the CMI. East Asian countries need to clarify to the international community what their motivations are, how they will develop an action plan, and how they believe it fits in with the existing global financial system (Park and Wang, 2000).

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

Let me further consider the issue of moral hazard, one strong argument against the regional monetary fund. At this stage of development, East Asians may not be prepared to negotiate an international treaty that includes provisions for sanctions and fines for countries that do not adjust their domestic policies accordingly (Eichengreen, 2000). This unwillingness would make it difficult for the regional monetary fund to impose politically unpopular policies on the member countries and, hence, may pose a serious problem in policy discipline. However, it has not yet been made clear why an East Asian monetary fund would suffer more from the moral hazard problem than the IMF. The IMF itself is also not immune to the moral hazard problem. An East Asian monetary fund could provide additional resources to the IMF while joining forces to work on matters related to the prevention and management of financial crises. At the same time, it could also support the work of the IMF by monitoring economic development in the region and taking part in the IMF's global surveillance activities.

Eichengreen (2000) finds it useful to distinguish between technical assistance and financial assistance. True enough, there is no reason to discourage competition in the market for technical assistance. Governments should be free to choose the source of technical assistance with the best track record. However, his concern is that if multiple monetary funds were available, East Asian governments would have an incentive to

shop around for the most generous assistance and the least onerous terms. He seems to believe that AMF conditionalities would be much softer than IMF conditionalities. At the end of the day, his concern should be well taken when we consider further development beyond the CMI that assumes IMF conditionality as a given.

When the Asian crisis broke out in 1997, advocates of the AMF avowed the need for a regional monetary fund, referring to the fact that the IMF allocation of funds for East Asia was not sufficient to meet the need of sizeable emerging market economies. The international community at that time widely recognized that the IMF's financial resources were not sufficient to provide necessary emergency assistance to other mid-size emerging market economies such as Russia and Brazil. As a response, the IMF decided in its September 1997 annual meeting in Hong Kong after the Asian financial crisis to increase the quota of 182 member countries by 45 percent.¹ The IMF's resources were further replenished through the establishment of the New Arrangements to Borrow (NAB), effective as of November 1998.

Although the IMF's financial position has improved since the Asian financial crisis, it is also a reality that the IMF alone cannot provide all necessary liquidity to the crisis country. As was seen in the case of the 1994-95 Mexican peso crisis, a group of countries including the United States had to provide liquidity support in tandem with the IMF to fill in the financing gap. A more formalized regional financial arrangement could play a role as a parallel lender instead of ad hoc (mostly determined on a geopolitical basis) group of parallel lender countries.

More seriously, most East Asian countries are underrepresented in the quota formula. East Asian countries are willing and prepared to contribute to more resources for the operation of the IMF. Commensurate with their enlarged contribution, the East Asians should be accorded greater representation both on the board of directors and in management. At the same time, they could receive an enlarged package of liquidity based on their increased quota. However, quota reform is not simple politics. Increased voting rights for currently underrepresented members would be allowed only when currently overrepresented members agreed to reduce their proportionally greater voting rights. Since any reallocation of quotas and voting rights is seen as a zero-sum game, even a perfectly designed quota formula would not satisfy the political interests of all members involved.

The Supplemental Reserve Facility (SRF), created on December 17, 1997, could be

¹ The quota increase was not immediately put into force mainly due to the delay in approval by the U.S. Congress. During the 11th General Review of Quotas (January 22, 1999), the quota was finally increased from SDR 145.6 billion to SDR 212 billion.

an answer to enlarged liquidity assistance exceeding the normal stand-by quota disbursement. In principle, any country may use the SRF. However, it is intended for situations where the effects of difficulty in one country may potentially destabilize the international financial system. The disbursement takes place when there is a chance of improvement in the balance of payments during a short period, based on bold restructuring and monetary policies. Korea, Russia, and Brazil have received assistance from the SRF. However, it is still not clear whether those countries were recipients simply because of the systemic consequences that would arise in the event of their financial collapse.

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

Although regional financial cooperation is desirable in a broad sense, the devil is in the details. If a scheme for regional financial cooperation is effective in preventing and managing future financial crises as well as promoting financial market development in the region, no one can deny the desirability of the regional arrangement. However, various regional institutions have different memberships and different goals for regional financial cooperation. If some institutions cannot achieve the collectively set goals, they should be closed and new institutions created. As in the case of the EU enlargement process, forming a critical mass should precede any enlargement. In this regard, a more important task is to identify those regional institutions that perform effectively to achieve their stated goals.

3. Status of Regional Financial Cooperation

The form of regional financial cooperation and institutions depends on the stage of

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

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

In East Asia, except for the CMI under the ASEAN+3 framework, other regional institutions or forums do not have any mutual liquidity support arrangement. Even the CMI has nothing to do with exchange rate coordination. In comparison with Europe, the CMI has a different motivation from the beginning. The European facilities were created with the purpose of limiting bilateral exchange rate fluctuations among regional currencies. The CMI started with high capital mobility and flexible exchange rates, although some members of ASEAN+3 have maintained a relatively fixed exchange rate regime. So far, the ASEAN+3 countries have not presumed any manifest exchange rate coordination. In the absence of exchange rate coordination, incentives for mutual surveillance will be limited because a member country facing a speculative currency attack may be free to float its exchange rate vis-à-vis those of other neighboring countries. Under the current ASEAN+3 policy dialogue framework, the purpose of the CMI and mutual surveillance system is to prevent the occurrence of financial crises and contagion in the region.

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

Although the CMI does not need to design its own conditionality at this point, it

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

Most participating countries agree in principle that the CMI needs to be supported by an independent monitoring and surveillance system that 1) monitors economic developments in the region, 2) serves as an institutional framework for policy dialogue and coordination among the members, and 3) imposes structural and policy reform on the countries drawing from the BSAs. To do so, the ASEAN+3 finance ministers agreed to organize a study group to produce a blueprint for an effective mechanism of policy dialogues and economic reviews for the CMI operations at the ADB annual meeting in Honolulu on May 9, 2001. Japan and Malaysia were chosen to co-chair the group. The study group met in Kuala Lumpur November 22, 2001 to discuss the report on possible modalities of surveillance prepared by Bank Negara Malaysia and Japan's Ministry of Finance. However, the member countries could not reach an agreement on the surveillance issues, agreeing only to institutionalizing the ASEAN+3 meetings of deputies for informal policy reviews and dialogues. At this stage of development of the CMI, many countries feel uncomfortable about creating an independent regional monitoring and surveillance unit as part of the CMI.

In the long run, however, the participating countries are likely to wean themselves from their reliance on the IMF. If the CMI develops into more or less an independent financial arrangement from the IMF, then the regional financial arrangement should be designed to discipline the borrowers to adhere to sound macroeconomic and financial policies by imposing conditionalities. However, the ASEAN+3 countries at the current stage do not seem well prepared for establishing a policy coordination mechanism in the surveillance process.²

² For instance, the ASEAN surveillance process is built on the basis of consensus and informality in keeping with the tradition of non-interference (Manzano, 2001). East Asian in contrast to Europe lacks the tradition of integrationist thinking and the web of interlocking agreements that encourage monetary and financial cooperation (Eichengreen and Bayoumi, 1999). Eichengreen and Bayoumi (1999) stress that East Asia does not meet the necessary intellectual preconditions for regional integration. For this reason, they conclude that it is unrealistic to speak of pooling national sovereignties. While there is no doubt considerable work to be done in promoting policy coordination in the region, it is wrong to say that it cannot be done in East Asia.

4. Evaluation of Existing Regional Institutions

There are several mechanisms developed for regional financial cooperation in East Asia. [See Table 2] Two major initiatives include the ASEAN+3 framework and the Manila Framework Group. In addition to these two, there are EMEAP and SEACEN for central banks, the APEC and ASEM for trans-regional policy dialogue, as well as small groups such as Four/Six Markets Group. As mentioned above, except for the CMI under the ASEAN+3 framework, other regional institutions or forums in East Asia do not have any mutual liquidity support arrangement. Although various regional institutions or forums may serve as mechanisms for information exchange, policy dialogue, and economic surveillance, the ASEAN+3 framework is the only mechanism to develop two of the three pillars of regional financial cooperation – liquidity assistance and mutual surveillance. The one pillar it has not developed is exchange rate coordination. In this regard, the added value of each regional institution or forum should be thoroughly evaluated.

Insert Table 2

For instance, the Manila Framework Group (MFG), established on 18-19 November 1997, has 14 member economies mainly in the Asia-Pacific region. Although the MFG has no formal status, there are now biannual meetings among 14 members plus the IMF, World Bank, and Asian Development Bank. The MFG is seen by some observers as the preeminent forum for regional surveillance and peer pressure. The IMF's Regional Office for Asia and the Pacific provides the Technical Secretariat for the Group. However, the MFG involves only a limited number of the economies in the region compared to the ASEAN+3 framework. More importantly, it is very doubtful that this group has the vision to further lead financial cooperation in the region. The MFG has not been very successful as a mechanism for regional financial cooperation. First, because the MFG has not yet clearly specified the objectives of information exchange and surveillance, no priorities, targets and rules have been set for the process of information exchange. Second, because there is no actual peer review process in the MFG, the surveillance process is simply a cursory discussion of the global and regional economic outlook, with no attempt to formulate any country-specific or region-wide recommendations for policy actions. Third, because the issues related to financial sector reform are only discussed cursorily, the MFG process has not contributed to the development of the region's financial market.

Although the current ASEAN+3 framework is incomplete, it is the appropriate grouping for regional financial cooperation. It intends to develop a clear vision for East Asia. The ASEAN+3 summit meeting also provides a basis for political support. From the beginning, the financial and monetary cooperation is a political task. As demonstrated by the European experience, what matters most in seeking economic and monetary integration is the political will to do so rather than the economic incentives to do so. Although the political preconditions for monetary unification in East Asia are not in place, the ASEAN+3 countries would be potential candidates for future monetary integration. But other regional institutions do not have that kind of vision.

The region also has inter-regional forums with the Americas and the European Union – APEC (Asia-Pacific Economic Cooperation) and ASEM (Asia-Europe Meeting). These two giant forums have complex sub-organizations to conduct various activities, one of which is the APEC and ASEM Finance Ministers Meeting. Since the objectives of APEC cover comprehensive issues including trade and investment liberalization and economic cooperation in general, financial cooperation was not a main agenda even during the Asian financial crisis. Only when calm and confidence returned to the Asian financial markets in late 1998 did APEC pursue a cooperative growth strategy. However, various collaborative initiatives were carried out through the exchange of views and non-binding policy recommendations. The issues covered by the APEC Finance Ministers Meetings was not focused on regional financial arrangements, but on financial market development such as enhancing financial supervision, developing bond markets, and strengthening corporate governance.

ASEM, a European version of APEC, was originally designed to initiate a process for strengthening partnership between East Asia and the EU. The ASEM Finance Ministers Meeting was established in September 1997, just after the Thai crisis. Three meetings have been held so far, once every two years. Starting in 2002, the Meeting will be held annually. In contrast to APEC, the ASEM Finance Ministers launched the Kobe Research Project in January 2001 when ministers gathered in Kobe. The project was designed to facilitate inter-regional research cooperation on the issues of monetary and financial cooperation in East Asia, taking into account the lessons learned from the European integration experience. Six subjects were chosen and a number of academic researchers were invited to carry out the joint research.³ The research was concluded

³ Six subjects include (i) exchange rate regimes for emerging East Asian and EU accession countries, (ii) currency regime: European experience and implications for East Asia, (iii) strengthening financial cooperation and surveillance, (iv) enhancing regional monitoring and integration, (v) the European and Asian financial systems in perspectives, (vi) China in a regional monetary framework.

and will be presented to the Fourth ASEM Finance Ministers Meeting, to be held in Copenhagen in July 2002. Although ASEM is not an institution for pursuing economic integration, it has the potential to provide a value-added contribution to East Asian monetary and financial integration in the future.

5. Barriers to Financial Cooperation and Integration

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

As for institutional and political constraints on further expansion of the CMI, the most serious one has been that the thirteen countries have failed to articulate the ultimate objectives of the CMI arrangement. The participating countries themselves are still unclear about whether the CMI is going to be fostered as a regional liquidity support program or as a building block for a full-fledged regional monetary system in East Asia. If bilateral swap arrangements are activated collectively and supported by a surveillance system, then they constitute a de facto regional monetary fund. The CMI could then be used as the base on which an elaborate system of financial cooperation and policy coordination is built by following in the footsteps of the European monetary integration.⁴ At this stage of development, many countries in East Asia are not prepared to accept the idea of or may feel uneasy about restructuring the CMI into a forerunner of the AMF.

A second institutional constraint is related to the need to coordinate the activities of the CMI with other regional arrangements such as the Manila framework supported by the U.S., Australia, and New Zealand. Most of the CMI countries also participate in the Manila framework and APEC. At some point in the future, the leaders of the ASEAN+3 countries may have to decide on the mode of cooperation and division of labor in promoting regional growth and stability between these institutions and the CMI. All

⁴ From the theoretical point of the neo-functionalists, initial steps toward integration trigger self-sustaining economic and political dynamics leading to further cooperation. Economic interactions create spillovers or externalities that need to be coordinated by governments involved. Such economic policy coordination at the regional level can be seen as an inevitable response to the increased economic interactions within the region. Once integration process starts, spillovers deepens and widens integration by working through interest group pressures, public opinion, elite socialization or other domestic actors and process (George, 1985).

thirteen countries have been engaged in policy reviews and dialogues through the various APEC meetings and the Manila framework. Unless the CMI is developed into a credible financing mechanism by increasing swap amounts, it will take on a role similar to other regional economic forums. The coherence of the group will then be weakened, as questions are raised as to whether the thirteen countries constitute an appropriate grouping for a regional financing arrangement in East Asia.

A third hindering factor is that as the fear of another round of financial crisis has receded with the recovery that has been faster than predicted on the basis of previous episodes of crises. With the speedy recovery, the ASEAN+3 countries have become less interested in enlarging and institutionalizing the CMI operations. Instead, their focus has recently shifted to creating free trade areas in East Asia. [See Table 3] The ASEAN states have already agreed to establish a free trade area among them. Japan has concluded a free trade agreement with Singapore and proposed negotiations on a similar agreement with Korea. China has announced its interest in negotiating free trade with the ASEAN and other neighbouring countries.

Insert Table 3

The free trade movement is undoubtedly a desirable development, and the CMI could facilitate further liberalization of trade by stabilizing bilateral exchange rates of regional currencies and minimizing the disruptive effects of financial market turbulence. This advantage suggests that the ASEAN+3 countries may have an incentive to broaden the scope of the CMI in parallel with negotiations on establishing free trade areas in the region. In reality, however, it appears that free trade discussions have rather distracted many East Asian countries from their CMI negotiations.

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

China and Japan are expected to provide leadership in forging regional consensus for expanding and consolidating the BSAs as a regional institution, but they have not been able to agree on a number of operational issues including the surveillance mechanism. Except for Japan, no other potential swap lenders including China are

prepared to increase the amounts of their bilateral swaps with other contracting parties. Japan could increase its swap amounts with the ASEAN states and Korea (under the presumption that China will not borrow from Japan) to make the CMI a more credible financing scheme. However, unless Japanese authorities receive some sort of assurance that their short-term lending will be repaid, they are not likely to lead an expansion and institutionalization of the CMI. As a minimum condition for expansion of the CMI, Japan would demand the creation of an effective surveillance mechanism for the region in which it can exercise influence commensurate with its financial contribution. However, China may feel that it cannot play the second fiddle to Japan in any regional organization in East Asia. This concern appears to be the most serious roadblock to further development of the CMI.

China and Japan have different interests and hence different strategies for economic integration in East Asia. As far as China is concerned, economic integration with the ASEAN 10 members, South Asian and central Asian countries may be more important both economically and geo-politically than financial cooperation or free trade with either Japan or South Korea. While China is a super military power in the world, it is still a developing economy with a huge gap to narrow in terms of technological and industrial sophistication vis-à-vis Japan. Although China has been growing rapidly, it has a long way to go before catching up with Japan. These differences in the economic and military status of the two countries suggest that, even if they manage to reconcile their troubled memories of the past, China and Japan may find it difficult to work together as equal partners for regional integration in East Asia.⁵

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

⁵ France and Germany also had a wartime legacy. Although de Gaulle's nationalism was generally popular within the country, he also appreciated that membership of the common market would benefit France Economically. However, de Gaulle remained implacably opposed to any increase in the powers of the European Commission, or to any other increase in supranationalism. He showed just how opposed in 1965, when he precipitated the most dramatic crisis in the history of the European Community (George, 1985). It was German Chancellor Helmut Schmidt and French President Giscard d'Estaing that accelerated stalled integration process at the end of the 1970s. The joint initiative of Chancellor Helmut Kohl and President Francois Mitterand resulted in a great leap towards EMU in the beginning of the 1990s. The Franco-German alliance formed the core for the integration process in Europe, as it was the political will of these two countries that motivated further integration.

between Russia, Kazakhstan, Kyrgyzstan, Tajikistan, and Uzbekistan and China.⁶

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

There is also the suspicion that Japan is not interested in free trade and financial arrangements per se in East Asia for purely economic reasons. Instead, Japan is engaged in the discussion of those regional arrangements with other East Asian countries to maintain its leadership role as the region’s largest economy by checking and balancing China’s expansion. Many analysts believe that Japan’s active involvement in regional economic integration is therefore motivated by its desire to maintain its traditional pole position.⁷ On top of this suspicion, Japan is perceived to be a country insensitive to and unwilling to resolve wartime legacies and disputes on historical and territorial claims. Japan has also been gripped with a decade long recession and unable to restructure its economy.⁸ These developments combined with its lack of a strategy for East Asian development seem to undermine Japan’s ability to pull East Asian countries together for regional cooperation and integration.

6. Future Prospects

What are then the likely courses of development of the CMI? How would regional financial integration proceed in East Asia? One possible scenario is that China and Japan will come to realise that despite the differences in their strategies, the consolidation of the CMI group would serve their interests. This realisation could soften their positions to compromise on an institutional setting and augmentation of the existing BSAs. For instance, China may accept Japan’s demand for de facto control over monitoring and surveillance in return for Japan’s pledge for a substantial increase in

⁶ In June 2001, the presidents of five countries signed the Declaration of the Shanghai Cooperation Organization (SCO). The SCO aims at strengthening mutual trust and friendly relations among member states, encouraging their further effective cooperation in politics, economy, science and technology, culture, education, energy, transportation, environmental protection and other fields, jointly ensuring regional peace, security and stability, and creating a new international political and economic order.

⁷ See David Wall, “Koizumi Trade Pitch Nests,” the *Japan Times*, April 21, 2002.

⁸ Uncertain economic prospects may make Japan unlikely to be the driver in the region’s integration movement as it was in the past. China is emerging both as a strong competitor and as a promising market.

financial assistance in the form of one-way swaps and ODA to ASEAN members. China could agree to this scheme, if it is confident about concluding a free trade agreement with the ASEAN members in the near future. China's free trade pact with ASEAN could circumscribe Japan's influence on ASEAN affairs even if Japan is a major provider of financial resources to the region.

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

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

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

Table 1. Progress on the Chiang Mai Initiative

(as of September 30, 2003)

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

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

Table 2. Regional Fora for Finance Ministries and Central Banks

	Financial Ministries and /or Central Banks					Central Banks		
	ASEAN (10)	ASEAN+3 (13)	MFG ^a (14)	APEC (21)	ASEM ^b (25)	SEANZA (20)	SEACEN (11)	EMEAP (11)
Year Established	1967.8	1999.4	1997.11	1994.3	1997.9	1956	1966.2	1991.2
Japan		o	o	o	o	o		o
China		o	o	o	o	o		o
Korea		o	o	o	o	o	o	o
Hong Kong			o	o		o		o
Taiwan				o			o	
Singapore	o	o	o	o	o	o	o	o
Brunei	o	o	o	o	o			
Cambodia	o	o						
Indonesia	o	o	o	o	o	o	o	o
Laos	o	o						
Malaysia	o	o	o	o	o	o	o	o
Myanmar	o	o					o	
Philippines	o	o	o	o	o	o	o	o
Thailand	o	o	o	o	o	o	o	o
Vietnam	o	o		o	o			
Mongolia						o	o	
Macao						o		
Papua New Guinea				o		o		
Australiz, New Zealand			o	o		o		o
Nepal, Sri Lanka						o	o	
Bang., India, Iran, Pak.						o		
USA, Canada			o	o				
Chile, Maxico, Peru				o				
Russia				o				
EU-15					o			

Source: Kuroda and Kawai (2002)

Note: (a) MFG includes the IMF, World Bank, ADB and BIS.

(b) ASEM includes European Commission.

Table 3. Free Trade Agreements in East Asia

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

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