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A perspective to an Asian Monetary System and related issues

—Transalation of "Monetary and financial cooperation in East Asia, Chapter 6," Keiso Shobo, 2007—

Introduction

The level of regional integration of the East Asian economy has steadily risen since the beginning of the 21st century, boosted by movements to conclude free trade agreements, and has begun to approach the level in Europe. In terms of monetary and financial cooperation, however, while crisis management mechanisms are being gradually established as a way of preventing and responding to future currency crises, regional cooperation in the sense of providing exchange rate stability is still only at the stage of a research study under the ASEAN+3 framework[i].

From the perspective of the integration of the real economy of East Asia, and taking into account global trends such as the growing scale and imbalance of international capital and the formation of regional economic zones such as the European Union, one can see why the establishment of a regional monetary system is not only in common interests, but also crucial for the long-term economic development of the region. In order to realize this goal, the political consensus and strong leadership in the region are required. Conditions must also be created through strengthening financial systems, establishing financial markets (money and foreign exchange markets), and promoting capital liberalization among countries in the region, so that policy coordination on exchange rates becomes possible.

The section 1 gives an overview, pointing out some issues to overcome, of the current situation of the real economy and exchange rate regimes of East Asia. The section 2 proposes the establishment of an Asian Monetary System, referring to the experience of Europe. The section 3 describes essential issues in establishing a regional monetary system, such as the importance of political will, and the need for strengthening domestic financial systems of member countries and liberalizing capital accounts in a well-sequenced and gradual manner. Lastly as a conclusion, a roadmap is drafted as a possible scenario towards bringing about an Asian Monetary System.

1. Regional Integration of Real Economy and Exchange Rate Regimes

1.1 Growing Interdependence of the real economy

Since the 1970s, the economy of East Asia succeeded, except for the temporary setback during the Asian crisis, in both maintaining a high level of economic growth and in realizing a relatively even distribution of income through the combination of proper political frameworks and private economic activities, something that the World Bank has referred to as the 'East Asian miracle' [ii]. Through that process, East Asia was almost completely incorporated into the world economy (Wyplosz [2006] p.18), simultaneously deepening the mutual interdependence of the regional real economy.

In contrast to the regional integration of Europe, which was driven by political leadership with the political aim of securing peace after two world wars, the market integration of East Asia has been fostered largely by the private sector. The market-led economic integration' [iii] of East Asia proceeded spontaneously under the multilateral free trade system within and outside the region, as shown by the fact that no bilateral free trade agreements had been concluded by countries of East Asia before the Asian crisis.

The catalysts for market integration are foreign direct investment (FDI) and trade. Multinational companies have carried out FDI in East Asia to look for competitive advantages for the manufacturing industries that have lost competitive edge in their home countries. The targets for investment have spread from the newly industrialized economies (NIEs) to the countries of ASEAN, with China emerging as the largest recipient of FDI from the mid-1990s onwards. Not only does FDI lead to an increase in exports to the world, but it also triggers imports of parts and raw materials from within the region as a result of supply chain management. There is a clear synergy effect between FDI and trade in the sense that an increase in demand for parts and raw materials leads in turn to new direct investments[iv].

Analyzing the trends of FDI in nine economies of East Asia (NIEs 4, ASEAN 4 and China), the combined share of FDI coming from the NIEs and Japan is approximately half of total FDI, with 48% between 1985-89, 56% between 1995-97 and 49% between 2000-02. Even if we take into account the fact that some Western direct investment goes through Hong Kong, the fact that the intra-regional FDI is dominant would not change. The total amounts of FDI in relation to GDP among ASEAN+3 reach into double digits but for Japan and Korea (2.1% and 7.8% respectively in 2003), with 14.5% in the Philippines, 25.8% in Thailand, 27.5% in Indonesia, and 35.6% in China. This shows how important FDI is to national economies in the region (Kawai [2006] p.14).

Table 1. FDI classified by investing/recipient countries

Investment Recipient Country (Host countries)		Annual Investment (100 million USD)	Investing Country (%)				
			Intra-Region (mostly NIEs)	Outside Region	Major outside-region investing countries		
					Japan	USA	EU
NIEs (Hong Kong, Korea, Taiwan and Singapore)	1985-89	33	7%	93%	38%	26%	16%
	1995-97	116	12	88	21	34	21
	2000-02	235**	17	83	25	39	20
ASEAN 4 (Thailand Philippines, Malaysia and Indonesia)	1985-89	84	21	79	25	23	15
	1995-97	146	24	76	18	7	21
	2000-02*	54	25	75	28	20	19
China	1985-89	33	50	50	9	7	3
	1995-97	415	68	32	9	8	7
	2000-02	468	46	54	7	11	9
East Asia 9	1985-89	149	24	76	24	20	13
	1995-97	677	42	58	14	11	15
	2000-02*	757	35	65	14	20	13

* The figures for ASEAN 4 for 2000-02 also include Brunei and the four new members.
** Total inflow amounts from NIEs, Japan, the USA and EU have been used because of an obvious mistake in the original NIEs total for 2000-02.
(Source) IMF "IFS" OECD "International Direct Investment Statistics Yearbook," 2000—02 only, Kawai Masahiro (*Kokusai Kinyu* No. 1163, p.14)

In terms of East Asian trade, not only is its share in the world trade gradually increasing (it is already above a quarter of the world trade), the intra-regional trade is increasing at an even faster pace. The world trade in goods and services grew at an annual average of 7.0% from 1988—97, while export volumes expanded at a rate of 13.3% from developing countries of Asia (the Asian region as a whole, including China and India) over the same period. The trend has remained unchanged between 1998 and 2007, with the IMF predicting annual growth of 6.4% for the world and double that figure (12.8%) for developing countries of Asia (WEO [2006] Tables 20-22). The world's top 15 exporting countries and areas for 2005 includes China (3rd), Japan (4th), Hong Kong (11th), Korea (12th) and Singapore (14th), with the total exports of 2,165 billion US dollars, or 21% of the world export of 10,393 billion US dollars (Hong Kong Trade Newsletter, April 11 2006).

The ratio of the intra-regional trade increased from 37.1% to 55.5% in two decades between 1985 and 2004 for the 15 economies of East Asia including Japan. This constitutes a growth rate of more than double that of other economic regions of the world, and shows how rapidly the market integration in East Asia has progressed. As a result, the intra-regional trade ratio of East Asia has approached that of the European Union and has already surpassed that of the North American Free Trade Agreement (NAFTA). In comparison with the figure of 14 or 15 economies of East Asia including Japan and China, the intra-regional trade ratios of NIEs and the ASEAN Free Trade Area are markedly low. This shows that Japan and China have been the major forces behind the increase. It should be noted that because the trade of Hong Kong and Singapore is largely made up of entrepot trade, the actual intra-regional trade ratio for East Asia might be about 10 percentage points lower than the figures suggest.

Table 2. Intra-Regional Trade Ratios in the World's Major Regions (unit: per cent)

	1985	1990	1995	2000	2004	Intra-Regional trade ratio increase (1985-2004)
East Asian 15 including Japan	37.1	43.1	52.0	52.2	55.5	18.1 points
Emerging East Asia 14	27.5	32.9	39.2	40.7	44.2	16.7
NIEs 4	6.5	11.9	15.5	15.5	14.4	7.9
ASEAN 10	20.3	18.9	24.1	24.7	23.9	3.6
NAFTA	38.7	37.9	43.2	48.8	46.4	7.7
MERCOSUR	7.2	10.9	19.2	20.3	15.2	8.0
EU 15	59.8	66.2	64.2	62.3	62.1	2.3
EU 25	59.8	67.0	67.4	66.8	67.9	8.1

(Note) East Asian 15 is Japan plus Emerging East Asia 14. East Asia 14 is NIEs (Hong, Kong, Singapore and Taiwan) plus the ASEAN 9 and China.
(Source) Kawai Masahiro (*Kokusai Kinyu*, No. 1163 p.13)

Up until the 1990s, few free trade agreements were in force in East Asia, with the exception of ASEAN, in the framework of global multilateral free trade and the open regionalism of the Asia Pacific Economic Cooperation (APEC). APEC member countries declared to achieve the unilateral and voluntary liberalization of trade and investment by 2010 among developed countries and by 2020 among developing countries (the 1994 Bogor Declaration), and adopted a non-binding action agenda for its implementation (the 1995 Osaka Action Agenda).

ASEAN agreed to the establishment of the ASEAN Free Trade Agreement (AFTA) in 1992, and succeeded in reducing import tariffs under the Common Effective Preferential Tariff (CEPT) to 0-5% between the six founding members in 2002. The four new members are to reduce their CEPT import tariffs to 5% or less by 2007. AFTA is scheduled to cut import tariffs to zero between the original ASEAN members by 2010 (for new members by 2015). Furthermore, ASEAN agreed to establish an ASEAN Economic Community by 2015[v].

Since the beginning of the 21st century, negotiations for free trade agreement (both FTA and EPA) have advanced rapidly in East Asia bilaterally or in the form of 'ASEAN plus One.' Japan has placed an emphasis on bilateral EPA negotiations with countries both within and outside the region[vi]. In contrast, other East Asian countries such as China, Korea, Thailand and Singapore have carried out bilateral FTA negotiations mainly with countries outside the region such as Australia, New Zealand, the USA, India and countries of South America, with bilateral agreements within the region being exceptions.

Countries in the region other than Japan have placed an emphasis on 'ASEAN plus One' agreements such as China-ASEAN's FTA (effective in 2005) and Korea-ASEAN FTA (effective in 2006). China-ASEAN FTA aims to complete the trade liberalization by 2010 with the developed countries of ASEAN (by 2015 with its new member countries), whereas Korea-ASEAN FTA aims to do the same by 2009. Under the Japan-ASEAN Comprehensive Economic Partnership that was agreed upon in October 2003, discussions began for an 'ASEAN plus One' agreement involving Japan in parallel with its bilateral negotiations with the major ASEAN countries, with an aim for trade liberalization by 2012 (2017 for newer member countries). It is reported that plans are in place to conclude an 'ASEAN plus Japan, China and Korea' economic partnership agreement that would encompass the whole East Asian region by 2011[vii].

In East Asia, unlike the case in Europe, trade and investment liberalization negotiations are carried out by individual countries independently with the focus on ASEAN. There is a concern that with differences in the targeted areas and timings, the so-called 'spaghetti bowl' phenomenon might arise. However, despite some problems, by the mid-2010s East Asia will be covered by a network of free trade agreements that will undoubtedly lead to an even greater level of mutual interdependence of real economies in the region.

1.2 Exchange rate regimes and problems of the status quo

Most of the currencies hit by the Asian crisis, while officially employing managed float systems, were in reality pegged to the dollar. After the crisis, a 'two-corner solution or bipolar view' was emphasized by the IMF and others, which insisted that the intermediate system of a soft dollar peg (an adjustable peg) was difficult to maintain, and that for currency stability a hard peg (currency board system or dollarization) or an independent float system were the best for currencies of developing countries (Fischer [2001] p.2)[viii]. These arguments receded somewhat after the collapse of the currency board system in Argentina in January 2001, and the IMF took the stance that 'peg systems and strong managed float systems need to be paid sufficient attention' in respect of the intermediate choices between the two-corner solution (Köhler [2002] p.2). Later the former Chief Economist of the IMF, Kenneth Rogoff, was to revise the stance by saying that 'the popular bipolar view of exchange rates is neither an accurate description of the past nor a likely scenario for the next decade. While the study confirms that emerging market countries need to consider adopting more flexible exchange rate regimes as they develop economically and institutionally, it also finds that fixed or relatively rigid exchange rate regimes have not performed badly for poorer countries' (Rogoff et al [2004] Overview).

In East Asia Hong Kong and Brunei, which both have currency board systems[ix], have adopted the hard peg system. Hong Kong, as a small open economy, takes the position that the basis for its prosperity lies in its currency stability, and has employed the present system since 1983. As an international financial center, whilst Hong Kong allows free capital movement, it has abandoned the autonomy in monetary policy by following the lead of the US Federal Reserve System.

China and Malaysia, which had pegged their currencies to the dollar, switched to managed float systems with reference to a currency basket in July 2005. While movement of the Chinese RMB after the switch became slighly more flexible than the previous microscopic band of 0.01%, RMB has followed closely the dollar rate by appreciating only 3% through the year 2006.

The exchange rate regimes of the rest of East Asian currencies are either independent or managed float systems. The current exchange rate regimes were adopted after the Asian crisis, and given East Asia's high level of trade dependency it is doubtful whether they constitute appropriate systems. For medium-sized open economies, it is problematic to suffer from the volatility and misalignment in the exchange rate, which cannot be avoided with a loosely managed or independent float system. Hedging instruments against exchange risks are limited, and transaction costs are high, even when forward exchange contracts or non-deliverable forwards (NDFs) [x] are available.

Table 3. Exchange rate regimes in East Asia (As of end 2005)

	Currency unit	IMF Article 8 or 14 Country	IMF classification	Forward exchange market	Access to home currency by non-residents
Brunei	Brunei $	Article 8 (1995)	Currency board	None	Unknown
Cambodia	Riel	Article 8 (2002)	Dualrate system*	None	Unknown
China	RMB	Article 8 (1996)	managed float **	Small scale	Lending/exchange banned
Hong Kong	H K Dollar	Article 8	Currency board	Exists	Free
Indonesia	Rupiah	Article 8 (1988)	Managed float	Limited	Lending banned, exchange for hedge purposes only
Japan	Yen	Article 8 (1964)	Independent float	Yes	Free
Korea	Won	Article 8 (1988)	Independent float	Yes	Upper limit to lending, exchange only nominal
Laos	Kip	Article 14	Managed float	None	Unknown
Malaysia	Ringgit	Article 8 (1968)	Managed float	Limited	Lending banned, exchange hedge purposes only
Myanmar	Kyat	Article 14	Dualrate system *	None	Unknown
Philippines	Peso	Article 8 (1995)	Independent float	Limited	Limited
Singapore	S. Dollar	Article 8 (1968)	Managed float	Exists	Free in effect
Thailand	Baht	Article 8 (1990)	Managed float	Limited	Upper limit to lending, real demand for exchange
Vietnam	Dong	Article 8 since Nov 2005)	Managed float **	Limited	Unknown

*IMF classifies as managed float. **IMF classifies as conventional fixed peg.

(source) IMF 'Annual report on exchange arrangements and exchange restrictions 2005,' 'De facto exchange rate arrangements and anchors of monetary policy as of July 31, 2006,' IIMA 'Regional Coordination of Policy Measures Forward,' 2006

Before the Asian crisis, an unintentional fixed exchange rate system prevailed among a large number of East Asian currencies, which were effectively pegged to the dollar. This fact suggests how important currency stability is to the East Asian economy. It has been pointed out that some currencies that permitted free fluctuations against the dollar after the crisis seem to restrengthen their correlation with the dollar[xi]. Assuming the progress of further capital liberalization in future, it is not recommendable for countries of East Asia to fix individually their exchange rate regimes, as it may carry the risk of inviting currency speculation. The Asian crisis taught us that it is difficult for any country to protect currencies alone from the massive movement of international capital.

The 'coordination failure' can be seen behind the fact that many currencies of the region maintain effectively some linkage to the dollar, while employing different exchange rate systems (Ogawa et al. [2002] p.4). The 'coordination failure' means that when neighboring currencies have linkage to the dollar, it is difficult for an individual country to switch to a new exchange rate system, even if that system excels in providing a stable effective exchange rate such as a currency basket peg. By doing so it risks losing international competitiveness to their neighboring countries. This may be described as the currency version of 'prisoner's dilemma'.

Regional economic integration in trade and investment in East Asia will steadily advance, spurred on by multilateral and bilateral free trade agreements. The integration of real economies will require regional currency stability and financial integration. Regional countries need to overcome the 'coordination failur' and move in tandem to create a regional mechanism for exhange rate stability.

Whether a regional monetary system that aims at a common exchange rate policy should ultimately lead to a single common currency such as the euro is debatable. As a practical objective for a consensus in the region, it should be worth investigating a gradual approach that would begin with either individual or common currency basket pegs in East Asia, and would then lead to an Asian Monetary System (an Asian version of the European Monetary System).

1.3 East Asia as an Optimum Currency Area (OCA)

When considering a regional monetary system with fixed exchange rates for East Asia, we need to see how far ASEAN+3 satisfies the requirements for an optimum currency area. Common requirements for optimum currency areas include a) the openness of the economy, b) the mobility of production factors (labor and capital) and c) symmetrical responses to economic shocks.

It is commonly recognized that the current situation in East Asia satisfy largely the same conditions that were in place in Europe in the 1980s and 1990s (this argument was put forward for nine countries including Japan and China by Park, Y.C. [2002] p.30, seven and nine countries including Japan but excluding China by Goto [2002] p.14., and by Eichengreen & Bayoumi [1999] p.360 respectively). According to Eiji Ogawa[xii], a regional currency bloc employing a currency basket of the dollar, yen and euro is conceivable for the five major ASEAN countries, China and Korea. As to a common currency basket for ASEAN+3, whilst the participation of the Japanese yen was difficult before the Asian crisis, it has now become possible for a number of countries including Japan to participate.

The intra-regional trade ratio and level of trade dependency can be seen as indicators of the openness of the economy. The intra-regional trade ratio for 2004 reached 55%, overtaking NAFTA and approaching that of the European Union. Trade dependency in ASEAN+3, at 50%, has reached the level of the EU in the mid-1990s, and given that the trade dependency of 12 countries excluding Japan (which has a trade dependency of 24%) is above 80%, the economy of East Asia can be seen as being mutually open and incorporated deeply into the world economy at the same time.

Table 4. Trade Dependency of East Asian Countries (Units: billion USD, %)

Country	Year	GDP	Exports	Imports	Trade Dependency	Notes
Indonesia	2004	257.6	71.6	46.5	45.8	
Singapore	2004	106.8	163.8	179.6	321.5	
Thailand	2004	163.3	96.1	94.4	116.7	
Philippines	2005	105.2	41.2	44.9	81.8	GNP
Malaysia	2005	70.1	142.7	116.1	369.2	
Brunei	2004	5.5	5.1	1.4	118.6	
Cambodia	2002	3.9	1.7	2.5	107.4	
Vietnam	2004	39.0	26.5	320	150	
Myanmar	2000	11.3	2.4	2.2	40.7	Trade in 2004
Laos	2004	2.3	0.4	0.5	37.8	
Korea	2004	752.1	284.6	261.1	72.6	Trade in 2005
China	2005	2,225.7	762.0	660.1	63.9	
Sub-total		3,742.8	1,598.0	1,441.3	81.2	
Japan	2005	4,460.2	576.8	491.9	24	GDP year
Total		8,203.0	2,174.8	1,933.2	50.1	

(Source) Made by the author from the Ministry of Foreign Affairs website, the Mitsubishi UFJ MIX and other sources.

The free movement of production factors (labor and capital) is also one of the conditions of an optimum currency area. Concerning labor, whilst the percentage of foreigners in relation to the regional population is relatively low at 1.2% compared to 5.0% of Europe, there has been an increase in labor movement within Asia from 1 million in the early 1980s to 6.5 million in 1997. Many foreign workers were repatriated during the Asian crisis (Goto [2002] p.6, Agarwala & Prakash [2002] p.11). The major labor providing countries (with 1 million workers or more) are the Philippines (4.75 million in 2005: working in the Middle East, Malaysia, Thailand, Korea, Hong Kong and Taiwan), Indonesia (2 million in 2001: working in Malaysia, Saudi Arabia, Taiwan, Singapore and Korea) and Myanmar (1.1 million in 2001: working mostly in Thailand), with workers from Vietnam, Laos and Cambodia also in countries such as Thailand, Malaysia, Korea and Japan (Chia [2006] pp.21-22).

Table 5. Number of Foreign Workers (estimates) (Unit: person)

Country	Year	Number of foreign workers	Percentage of total workforce	Country	Year	Number of foreign workers	Percentage of total workforce
Japan	2004	870,000	1-2 %	Macau	2000	27,000	na
Korea	2004	423,597	1-2 %	China	2003	90,000	negligible
Taiwan	2003	600,177	4-5 %	Vietnam	2001	30,000	negligible
Singapore	2004	580,000	about 30%	Indonesia	2004	91,736	negligible
Malaysia	2004	1,359,500	about 12%	Philippines	2003	9,168	negligible
Thailand	2004	1,623,776	5-6%	Bhutan	2004	40,350	na
Brunei	1999	91,800	na	Total		6,053,967	na
Hong Kong	2003	216,863	about 6%				

(Source) CHIA Siow Yue "Labor Mobility and East Asian Integration" (*Hugo, G. Migration in the Asia Pacific Region, 2005*)

Concerning the symmetrical response to economic shocks, results measured by Junichi Goto concerning the ASEAN Five and Korea, as well as responses to supply/demand shocks in eleven countries including Japan and Australia measured by B. Eichengreen suggest that the degree of symmetrical responses in East Asia is similar to that in Europe. However, attention is needed to the fact that China has not been included in the scope of either research[xiii].

The extent to which economies in the region respond symmetrically to aggregate supply shocks that affect production factors (e.g. oil price hikes) is of particular importance. An anaylsis by the Asian Development Bank showed a strong positive correlation to aggregrate supply shocks in Japan, NIEs and some of the major economies of ASEAN (Kawai & Motonishi [2005] pp. 244-251). China and the Philippines had negative correlations with almost all other East Asian countries, indicating that economic interdependence of these two countries with the rest of East Asia is relatively weak.

Table 6. Supply (Real Output) Shock Correlations (1980-2002)

	USA	EU15	Australia	NZ	India	Japan	Korea	China	Taiwan	Hong Kong	Singapore	Malaysia	Thailand	Philippines	Indonesia
USA	1.00														
EU15	0.51	1.00													
Australia	0.34	0.21	1.00												
NZ	0.19	0.14	0.35	1.00											
India	0.20	0.23	0.28	0.29	1.00										
Japan	0.10	0.42	0.04	0.10	0.35	1.00									
Korea	-0.1	0.32	-0.2	0.29	0.12	0.63	1.00								
China	0.36	0.20	-0.1	0.00	-0.3	0.06	0.01	1.00							
Taiwan	0.39	0.50	0.07	0.29	-0.1	0.31	0.43	0.14	1.00						
Hong Kong	-0.0	0.32	-0.3	0.49	-0.1	0.45	0.71	0.08	0.68	1.00					
Singapore	-0.1	0.24	-0.2	0.24	0.22	0.52	0.52	-0.1	0.50	0.63	1.00				
Malaysia	-0.2	0.15	-0.3	0.20	0.10	0.53	0.69	0.05	0.41	0.66	0.86	1.00			
Thailand	-0.2	0.21	-0.2	0.30	0.27	0.65	0.81	-0.0	0.28	0.54	0.51	0.64	1.00		
Philippines	-0.4	-0.3	-0.4	-0.3	0.28	-0.1	0.00	-0.4	-0.3	-0.2	-0.0	-0.1	0.07	1.00	
Indonesia	-0.2	0.02	-0.2	0.35	0.06	0.48	0.82	-0.0	0.33	0.68	0.55	0.80	0.67	0.02	1.00

(Source) M. Kawai & T. Motonishi "Macroeconomic Interdependence in East Asia"

2. Outlook for a Regional Monetary System

2.1 Monetary union as the ultimate monetary system

The ultimate form of a regional monetary system is a monetary union (currency union or economic and monetary union (EMU)) as can be seen in the case of EU member countries sharing a single currency euro. The fact that a monetary union with major economic powers at its core has an effect of protecting participating countries from currency speculations was proved in August 1998, when the Asian crisis spread to Russia. When the Russian ruble depreciated sharply, out of the four Scandinavian currencies, the Norwegian krone and Swedish krona suffered from heavy speculative selling, at one point dropping by 15%, whereas Finland, which had been promised its participation in the EMU, suffered no currency speculation aginst the markka, in spite of sharing a border directly with Russia. There was no fluctuation either in the Danish krone, which was to be pegged to the euro through the ERM II.

In addition to this passive effect, a monetary union also has an active effect of creating trade, employment and income. Out of data from over two hundred countries, J. Frankel and A. Rose concluded that when a small-scale economy introduces the currency of a large and geographically close economy (natural trading partners), it receives significant economic benefits. Specifically, such a monetary union leads to a tripling of trade volumes, with an estimated increase of 0.3% in income per capita for every 1% increase in trade versus GDP over a period of twenty years (Frankel & Rose [2000] p.22).

Whilst the creation of a monetary union has significant economic effects in both passive and active terms, its realization first becomes possible, only when other conditions such as political, historical, cultural, social and religious elements come together in addition to the preconditions for an optimum currency area. This is why the EMU in Europe has been called as a historical experiment, and also why, with the expansion of the EU in 2004 and 2007, which will eventually result in the enlargement of the EMU, worried voices can be heard about the future of the euro.

In East Asia, although the level of integration of the real economy has approached the EU level and financial cooperation is progressing, it is still at an early stage in terms of institutionalization. It is difficult to paint a realistic picture of East Asian countries that transfer a large part of their sovereignity to a regional community, establish a supranational institution equivalent to the European Central Bank to issue a single currency, and implement a single monetary policy throughout the region. The introduction of a monetary union and a common currency in East Asia should be envisaged as a long-term objective of future generations.

2.2 A gradual approach to an Asian Monetary System

Even if East Asia fulfills the preconditions for an optimum currency area to a large extent, the identity as a region has a relatively short history, with great diversity in political systems, levels of economic development and social values. Taking this diversity into account, national currencies should remain, and a regional monetary system with the objectives of exchange rate stability and prevention of currency speculation would be more realistic and easier to achieve politically.

The monetary integration in Europe reached the goal of the Economic and Monetary Union through two stages of the joint float of EC currencies (the snake of 1972-1979) and the European Monetary System (EMS: 1979-1998). One conceivable scenario for East Asia would be a gradual approach to the establishment of an Asian Monetary System (AMS) that draws lessons from the EMS. A common basket system is initiated first, followed by an Asian Monetary System (AMS) with an Asian Currency Unit (ACU) at its center after certain preconditions are satisfied in the region.

1) Common basket peg to the dollar-yen-euro

Various calculations for the viability of a common basket peg to the dollar-yen-euro of East Asian currencies have indicated positive results. J Williamson argues that the use of a common basket peg, made up of 38.1% dollar, 32.6% yen and 29.3% deutschemark, would be desirable for a common exchange rate policy among the nine East Asian countries (China, NIEs 4 and ASEAN 4). The fluctuation band can be fixed flexibly using appropriate systems such as a crawling peg[xiv] or a currency board system, depending on the circumstances of the pegged currency. Williamson argues that the merit of this policy would be the expectations that fluctuations of global currencies would not affect the relative competitiveness of the countries of East Asia (Williamson [1999] p. 342). The analysis of Eiji Ogawa also shows that the formation of a common monetary area would be possible for the seven countries of ASEAN 5, China and Korea through the use of a common basket (weighted more heavily towards the dollar than the trade ratio) composed of the dollar, yen and euro (Ogawa & Kawasaki [2006]).

There are arguments that ASEAN, China and Korea should initially employ individual basket peg systems with the dollar-yen-euro composition ratios that match the trade patterns for each country, and then move towards a common basket peg system (dollar 6; yen 2; euro 2) that matches the trading partner balance of East Asia as a whole (Mori et al [2002] p.14). This argument takes into consideration the difficulty in reaching an agreement over a common basket. On the other hand, the need to solve the problem of 'coordination failure' and to come up with joint crisis measures would suggest that it would be preferable to employ a common currency basket from the beginning and to establish a flexible fluctuation band to respond to differences in the trading patterns of each country.

Even if the yen is to form a part of a currency basket, it will not and cannot participate in the peg system. Pegging the yen to a dollar-yen-euro basket would effectively create a target rate zone between the yen and the world's two major currencies, but it is unlikely that Japan, the USA and Europe would meet necessary conditions for policy coordination in the near future. The yen has no choice but to continue with an independent exchange rate system in the current manner. The adoption of a common basket peg, however, has an advantage of bringing about greater stability in the yen's effective exchange rate through its closer ties with fellow regional currencies.

The Singapore dollar has traditionally been pegged to a currency basket, but the breakdown of the basket has not been disclosed. In July 2005, the Chinese RMB and Malaysian ringgit switched from dollar pegs to managed floating rate systems with reference to a basket of currencies. Accordingly, there are at present four currencies including the Brunei dollar (par to the Singapore dollar) in East Asia that have a linkage with a basket of currencies. It could be argued that in practice individual currency basket systems have been partially established. Although it is difficult to see this trend leading directly to a common basket peg system, it may have a certain advantage of providing a learning effect.

Both political and emotional backlash can be predicted against a common basket composed of out-of-regional currencies as a value standard for a regional monetary system. It should be possible that some countries within the region (for example major ASEAN countries) approve to a dollar-yen-euro common basket peg as an interim measure on the route to an Asian Monetary System (AMS). If an agreement on a common basket peg cannot be reached, the choice remains of concentrating efforts on meeting common preconditions in each country and the region with an objective of aiming directly at the AMS.

If a common basket peg system is to be introduced, credit facilities as well as surveillance mechanisms would have to be established, even if the system is designed only for a limited number of countries within the region. The ASEAN+3 should improve and enhance the Chiang Mai Initiative. The surveillance would also be important, not only as an instrument of monitoring the economies of participating countries for policy coordination, but also for drafting conditions attached to the financial support during crises.

2) Asian Monetary System

In contrast to a dollar-yen-euro basket peg system, which ties East Asian currencies to an external value standard, an Asian Monetary System brings an Asian Currency Unit (ACU) [xv], an internal value standard, to the center of the system. In order to switch from a monetary system with a basket of nonregional currencies to a system with a regional currency basket, strict disciplines in macroeconomic policies, especially inflation control for currency stability, is required, in addition to achieving conditions such as efficient financial and capital markets and financial integration in the region.

The ACU is composed of convertible currencies in East Asia. Full convertible currencies of East Asia as of 2007 are limited to the yen, Hong Kong dollar and Singapore dollar, with the Korean won approaching to such a level in recent years. The convertibility of the majority of currencies in the region is limited to current account transactions. Many countries have put restrictions on foreign exchange or fund transactions by non-residents after the Asian crisis, as a part of 'de-internationalization' in fear of currency speculations.

The ACU is used for fund settlement, credits and as reserve assets among monetary authorities (an official ACU). It is also expected to be widely used for trade invoicing and as a means fund procurement and investment (a private ACU). A private ACU needs to be created by bundling regional currencies in foreign exchange and money markets. Accordingly, the precondition to be an ACU component currency is that restrictions on capital transactions be abolished or relaxed so that it can be traded in international financial centers. However, even if foreign exchange controls remain, if financial authorities allow non-resident banks either direct or indirect access to their home foreign exchange and money markets to enable the composition or decomposition of an ACU, those currencies can be seen as having enough convertibility to become a part of an ACU.

The following two types of exchange rate mechanisms for an AMS are conceivable, a) a grid system formerly used in the European Monetary System (EMS) as the Exchange Rate Mechanism (ERM), or b) a peg system (currently used by the EU in the form of ERM II).

a) The grid system

Participating countries mutually fix central rates for their currencies, and monetary authorities intervene in the market to keep market exchange rates within given limits above and below the central rate (e.g. ±2.25%, 6% or 15%). Currencies participating in an AMS grid system fluctuate freely against currencies outside the region such as the dollar or euro, while maintaining a fixed exchange rate among themselves.

The ACU is used simply as an accounting unit for the purposes of calculating the central rate, and does not function as a criterion for market intervention to maintain fixed exchange rates. In effect, the strongest currency among participating currencies would become an anchor currency (the deutschmark in the EMS). The official ACU is created through foreign reserve swaps and is used by monetary authorities for credits and settlements, in addition to its role as an accounting unit for calculating central rates.

Currencies that do not compose the ACU can also participate in the system. However, participating countries need to keep the convergence of macroeconomic policies because participating currencies are tied in a grid-like manner. In particular, monetary policies (e.g. interest rates) would tend to follow those of the anchor currency central bank. Should the fundamentals of participating economies diverge, and the central rates no longer correspond to appropriate levels for economies, it would lead to an adjustment of the exchange rate system as a whole.

b) The peg system

Participating countries fix (peg) their central rates to the ACU, and market exchange rates fluctuate within a certain range against the ACU central rate. The ACU fluctuates freely against currencies outside the region such as the dollar and euro. Currencies participating in the system are split between those pegged currencies making up the ACU and those that are simply pegged. The countries whose currencies make up the ACU are required to manage their home economies carefully because exchange rate alignments of ACU component currencies would have an effect on all pegged currencies through variations of the value of the ACU itself.

On the other hand, currencies that are simply pegged to the ACU would not only be able to stay non-convertible, but would also enjoy a higher level of flexibility in their economic managment than economies of countries that make up the ACU. For example, developing countries can choose a crawling peg that enables exchange rates to adjust regularly according to differences in inflation rates.

In contrast to the grid system, in which the most stable currency in the region effectively becomes the value standard, in the peg system it is the weighted average of currencies making up the ACU which becomes the value standard. Accordingly, unless the fundamental policy orientation of the countries which make up the ACU is closely coordinated, the system cannot operate smoothly. Should the ACU be composed of two groups of currencies, those of stability-oriented economies and those of growth-oriented economies (in which economic growth is prioritized even at the sacrifice of price stability), the former may be dragged along by the latter and will risk losing its stability policies[xvi]. In East Asia with different stages of economic development among countries, this is a point to which particularly close attention needs to be paid.

Regardless whether an AMS adopts a grid system or a peg system, an Asian Monetary Fund needs to have a sufficiently large scale, with functions such as the creation of an ACU through swapping foreign reserves, the settlement of funds among participating countries, the operation of credit facilities, the surveillance and the role as a secretariat. The surveillance becomes a key facor for the stability of the AMS. In particular, the policy coordination between the countries making up the ACU and also with the pegged countries needs to be strengthened.

Table 7. Development Stages of Regional Monetary System in East Asia

	Phase 1: Common Currency Basket Peg System	Phase 2: Asian Monetary System (AMS)
Structure	・ Basket composed of dollar, yen and euro ・ Composition ratio to be discussed (e.g. three currencies with a third each) ・ Fluctuation band differs among participating countries (e.g. between ±2.25% and ±15%) ・ Peg countries from East Asia (Oceania) However, Japan maintains a floating rate. ・ Liquidity support and credit facilities - Surveillance and policy dialogue - Credit facilities and settlement sytem for market intervention and crisis measures - Secretariat	(1) Creation of ACU (Asian Currency Unit) Composing currencies limited to convertible currencies in East Asia (and Oceania) Functions as an accounting unit, means of settlement and value storage (2)Design of an Exchange Rate Mechanism (ERM) - Parity grid used by EMS or - Participating currencies pegged to ACU (3) Establishment of an Asian Monetary Fund Creation of an offcial ACU, fund settlement, surveillance, credit facilities and secretariat
Merits	Regional currency stability Rise in need for the yen's internationalization	Realization of a tri-polar monetay system of the dollar, euro and ACU
Notes	・The yen does not participate in the system because its peg to the basket effectively sets a yen target zone against the dollar and euro, which is unlikey to work. ・ Interim measure in transition to the AMS (implementation by a small number of countries within the region would still be meaningful).	・ Integration of real and financial economies as a precondition ・ Policy coordination between countries composing ACU is essential ・ Participation of China is important (the RMB needs to become a convertible currency) ・ Japan must compare carefully pros and cons of grid and peg systems.

2.3 Criticism and problems

Initiatives are needed on the governmental level for the regional financial cooperation and intergration that are necessary for the creation and circulation of an ACU. With the backdrop of progressing intra-regional trade, there is an argument that the marginal benefits of financial intergration would be greater than those by further efforts to remove trade barriers (Agarwala & Prakash). On the other hand, there is a sceptical view about the implemetation of measures for regional financial integration in East Asia, regardless of what an ultimate benefit it might bring about. According to the sceptics, while the the financial and capital markets of East Asian countries are increasingly interconnected with the markets of the West, the incentives for establishing common infrastructure for regional market integration are poor, and the costs would become prohibitive (Park [2002] p.68). In particular, it has been pointed out that a large-scale institutinal reform would be necessary for the regional integration of bond markets (Elson [2002] p.32).

When regional currencies are pegged to a fixed value standard, problems would arise that the autonomy in monetary policy becomes limited, given the free movement of capital. In the case of a dollar-yen-euro common basket peg, while the countries participating in the peg would undoubtedly be influenced by the moentary policies of the three major economies, this would not be a major problem because the same is the case anyway regardless of exchange rate regimes.

A problem arises when an Asian Monetary System adopts a grid system. Candidates for an anchor currency would be limited to the Japanese yen and Chinese RMB when considering the overwhelming economic strength of both countries. If the yen is to become an anchor currency, the Bank of Japan would lead the monetary policy in the region. There are, however, negative opinions about the possible Japanese leadership from concerns about the ability of economic management by the Japanese government and Bank of Japan after the experience in the 1990s (Dornbusch & Park [1999] p.14, and Dieter & Higgot [2002] p.19). In other words, the trust of the international community in Japan's ability for economic management must be restored. Should the Chinese RMB become an anchor currency, there would be problems with the uncertainty about the ability of the Chinese government to implement macroeconomic policies, as well as with the issue of independence of the People's Bank of China from the Chinese government.

In order to realize an Asian Monetary System with an ACU at its center, major currencies of the region must have de facto convertibility, making them internationally tradable, even if there remain differences in levels of progress. Many of the currencies in East Asia only have limited convertibility today. These countries need to satisfy first domestic conditions for making their currencies convertible, and further to allow the internationalization of currencies.

Problems remain whether an Asian Monetary System should choose a grid system or an ACU peg system, and which system is preferrbale for Japan's participation. There is a possibility that a grid system may be too rigid for developing economies of the region. An ACU peg system can be seen as relatively easier to accept for developing economies. However, either system may pose problems for the Japanese economy in future. For the mature Japanese economy, the direction of the yen rate movement in the medium-to-long term is unclear due to savings shortage and current account deficits that may result from its dwindling birthrate and aging population, and possible repatriation of Japan's net foreign assets. The pros and cons of both systems for the Japanese economy, whose future outlook stays unclear, and their impact for East Asian economy as a whole, is something that needs to be carefully debated.

3. Challenges facing a Regional Monetary Zone

3.1 Political commitment and institutionalization

The two political goals of the European integration and lasting peace have been achieved through economic means. Conversely, the economic integration of Europe was only possible thanks to noneconomic political appeals for the 'promise of peace' (Wyplosz [2006] p. 19). For over thirty years, France sought to stabilize the EC common market and currencies in order to tie Germany into the European framework and maintain the common agricultural policy. Likewise, West Germany exerted leadership in creating a zone of monetary stability and in bringing about a single market along with France so that it could become reaccepted into Europe after the Second World War. However, it was the political decision and the aspiration of the German people for the reunification of Germany in 1990 that West Germany agreed to give up the symbol of its prosperity, the deutschmark, and to open the way to the common currency of the euro.

The monetary integration is essentially a political process. Even if East Asia is an optimum currency area to the extent that Europe used to be in the 1990s, the future of a regional monetray system necessarily brings with it the conflicting interests of participating countries and limitations to their sovereignty. Whilst the banner of a 'promise of peace' does not exist in East Asia, there is still a common experience of the Asian crisis. The Asian crisis was a terrible incident, but it could be turned on its head and seen in the positive light of bringing about a regional identity as 'East Asia'. For the common interests of East Asia, that is, monetary stability and prevention of a financial crisis, countries must overcome their differences in national interests, accept limitations to their sovereignity and display a clear political commitment therefor.

In the past, the approach to regional cooperation in East Asia has been characterized by an informal approach, as represented by ASEAN and the Asia-Pacific Economic Cooperation (APEC) (Dieter & Higgot [2002] p.11). ASEAN-style regional cooperation is loose and open-ended, avoiding institutionalization wherever possible, and its characteristic principles of consensus and sancty of national sovereignty have been described as the 'ASEAN way' (Soesastro [2006] p.10). However, during the Asian crisis, both APEC and ASEAN were utterly powerless.

In contrast to the functional and institutional integration of Europe, led by politicians and the bureacracy, the economic integration of East Asia is the result of an independent development of the market focused largely on trade and investment and led by multinational corporations. With minimum governmental intervention, it made best use of the international framework of nondiscriminary free trade, typified by the GATT (WTO). This framework of real economy met with significant changes after 2000, with a network of free trade agreements taking shape under the leadership of the governments of East Asian countries. In such a way, the economic integration of East Asia has enhanced further.

The integration of real economy naturally demands corresponding responses in terms of finance and money. Regional cooperation in finance and money cannot be expected to occur spontaneously in the same manner as trade or investment. In the past, most of East Asian savings have been channeled into Western financial centers such as London and New York, often being reinvested into East Asia as Western and sometimes speculative capital. This was the backdrop of the Asian crisis. Reviewing such causes, financial cooperation began in the form of the ASEAN Bond Markets Initiative (ABMI), implemented by ASEAN+3. In order to stabilize currencies in the region and create common financial and capital markets, both hard- and software infrastructure must be built, and close cooperation between monetary authorities is indispensable. Put another way, regional cooperation and integration in the fields of money and finance will not advance without the political leadership and bureacratic support.

Future monetary and financial cooperation in East Asia must be 'institutionalized' through the establishment of credit facilitities (the mulilaterlization of the Chiang Mai Initiative) and the creation of a standing secretariat responsible for surveillance, based on binding governmental agreements. Although the European experiences cannot be applied to East Asia as such, it is obvious that without a clear political commitment and a certain degree of institutionalization, an East Asian regional monetary system cannot be realized nor be expected to be effective.

Table 8. Comparison of Integration in East Asia and Europe

	East Asia	Europe
Integration type	Market integration dominant	Functional and institutional integration
Rules	Flexible, consensus	Binding agreements
Driving force	Multinational corporations	National politicians and EU bureacrats
Government role	Facilitator	Leader
Trade	World market and intra-regional both growing	Intra-regional
Investment	Production networks growing	Dense links
Monetary integration	Still weak	Tight (euro)

(Source) Soesastro "Regional integration in East Asia: Achievements and future prospects", 2006 (Adapted from Pascha (2004))

In order to bring about an Asian Monetary System, such conditions must be fulfilled as the improvement of financial environments and policy coordination, in parallel with a strong political commitment, the institutionalization in form of intergovernmental agreements and a standing secretariat. For a regional monetary system to function in a stable manner, issues such as the strengthening of cooperation between central banks, which is essential for regional exchange rate stability, and the harmonization of macroeconomic policy need to be dealt with, in addition to the wide-ranging financial cooperation in the sense of establishing sound domestic financial systems, creating efficient financial markets (money and foreign exchange markets) and the gradual liberalization of capital transactions.

3.2 Sound financial systems and regional cooperation

During the Asian currency crisis, which was characterized by the sudden outflow of short-term capital, damages differed according to the robustness of financial systems among countries. Hong Kong, Singapore and Taiwan, which had strict financial supervision and relatively sound financial institutions could withstand the currency crisis. On the other hand, in Thailand the failure of financial institutions had preceded the outbreak of the crisis, and in Indonesia ill-judged bank closures led to the worsening of the economy. In Korea, foreign liquidity shortage among commercial banks resulted in the currency crisis. The commonality between these three countries was that the vulnerability of financial systems led to the deterioration of a currency crisis into a financial and economic crisis, creating a vicious cycle in which the worsening of the real economy led to further paralysis in financial functions.

(1) The impact of currency crises on the domestic financial system and real economy

Currency crises destabilize domestic financial systems in three channels, a) the damage to balance sheets (financial institutions and corporates) through exchange losses and the drop of asset prices, b) the decline of domestic demand due to austerity measures (in particular interest rate hikes), company bankruptcies leading to bad loans and the inverse rate of bank lending and liabilities, and c) the decline and eventual suspension of financial intermediary functions. Particularly when a domestic capital market is underdeveloped and the long-term capital must be financed through short-term foreign funding, these problems become even more serious (the double mismatch of currency and maturity). In East Asia, where the reliance on indirect finance is high, the destabilization of financial systems that accompanies currency crises brings about serious damages to the real economy.

(2) Strengthening the regulatory framework for financial stability

In today's world where a currency/financial crisis in one country spreads easily across borders, the stability of financial systems is no longer a purely domestic issue. The Asian crisis spilled oaver as far as Russia and Brazil, even putting stress on the American financial system through the collapse of a major hedge fund (LTCM). The financial stability is a common regional issue that affects the interests of other regional and non-regional countries.

Financial supervision (approval of incorporation, prudential and liquidity regulations) is primarily the responsibility of individual countries. The division of roles between supervisory authorities and central banks differs from country to country, and is subject to differences in the financial systems and stages of financial and capital market development in each country as well as differences in the political and economic systems. In the case of Japan, whereas previously the Banking Bureau of the Ministry of Finance and the Bank of Japan were in charge of banking supervision, today the role of the Financial Services Agency has been significantly strengthened. In China, financial supervisory powers were removed from the People's Bank of China, when the China Banking Regulation Commission was established in 2003. The role of financial supervision has been increasingly taken up recently by independent supervisory agencies.

In view of the above situation, it should be meaningful to share a common regional forum for information exchange and capacity building for financial supervisory authorities and central banks. Cooperation is already underway at the Executives' Meeting of East Asia-Pacific Central Banks (EMEAP) and the South East Asian Central Banks (SEACEN) Research and Training Centre, and such efforts need to be further strengthened[xvii].

(3) Financial reforms, liberalization and opening up to the outside

One of the lessons of the Asian crisis was that when the supervisory control falls behind the liberalization of the financial sector, there is a risk of significant damage to the national economy. After the crisis, countries of the region implemented wide-ranging financial reforms, with considerable results achieved in Japan, China and Korea. Whilst financial reforms have been achieved to a different degree in the three countries and ASEAN, the job remains only half-done.

It is possible to divide financial reforms into a) reform of the supervisory authorities, or improving the capacity and increasing the effectiveness of financial supervision, and b) reform of financial institutions and markets. The financial reform is one area where the region's experience and know-how can be shared through the cooperation of authorities. China and Korea have sponsored seminars under the ASEAN+3 framework.

a) The reform of supervisory authorities needs to cover areas of domestic finance (banks, securities, and insurance companies and markets, the regulation and protection of market participants, savers and investors, etc.) and external aspects (foreign assets and liabilities position, monitoring of foreign activities of financial institutions and businesses, etc.) The transparency in financial administration and risk management such as the implementation of BIS regulations are also important issues to address.

b) The reform of financial institutions and markets covers a large scope, as can be seen in experiences of Japan's financial 'big bang' (1996-2001), and is closely linked to the issue of financial liberalization. The main issues are; improving financial indices such as the ratios of non-performing assets and capital adequacy, strengthening corporate governance of financial institutions, and establishing effective and liquid financial and capital markets. It requires a relatively long time before we can expect to see any results.

The financial reform must go ahead of financial liberalization. At the very least the financial liberalization needs to take place in parallel once financial reform has progressed to a certain extent. The opposite scenario contains a risk of destabilizing financial systems. The financial liberalization can be broadly divided into the categories of a) market entry, b) interest rates, c) business lines and financial products, and d) geographical network. If liberalization proceeds with insufficient supervisory capacity in place or with vulnerable financial institutions, the domestic financial system can be destabilized as a whole through the financial collapse caused by excessive competition, unfair trading or a prolonged stagnation of markets. Financial liberalization should not be confused with capital account liberalization, which deals with the flow of cross-border capital.

The opening up of domestic finance to the outside is sometimes carried out as a part of financial liberalization, and can be done for policy reasons as a means of encouraging financial reform and liberalization. There are empirical analyses (BIS and others) that suggest foreign financial institutions contribute to the development of financial markets in developing countries. The foreign access to domestic markets is often admitted under the principle of reciprocity or as a condition for membership of the WTO as in the case of China. Prior to the Asian crisis, the US and other industrial countries put pressure to the countries of East Asia, paying no heed to their particular circumstances, to open domestic financial markets for their own financial institutions along with their demand for capital account liberalization[xviii].

(4) Harmonization of financial systems and regional financial stability

As the Asian bond markets take shape within the region and financial transactions become more closely linked, the issue of the 'harmonization of financial systems' will arise. The harmonization or mutual recognition of financial supervisory standards deserves discussions from the perspective of supervisory authorities in the region. It may be too early, however, to consider the harmonization of the structural components of financial systems such as banking systems, securities markets and money markets, given the current diverse situation in East Asia. (NB, issues of common regional infrastructure such as clearing/settlement systems for funds and securities within the framework of the Asian Bond Markets Initiative should be implemented in the near future.)

There will also be a considerable need to debate whether and how the regional financial stability can be promoted through the regional integration of financial systems. In Europe, the integration of financial markets and the harmonization/mutual recognition of financial regulations in the European Community proceeded during the EMS period in the late 1980s and early 1990s, as part of the measures for the European single market. For example, common rules were established such as a 'single passport' for banks (banks of EC member countries can establish branches freely within the region), and clarification of the responsibility of supervisory authorities of the home country (the location of bank headquarters) for prudential regulations and the responsibility of authorities of host countries where baranchs are located for regulating liquidity. However, the European financial crisis broke out in 1992/93 and several large-scale bank closures were reported such as BCCI[xix]. There is still a room for academic research into the relationship between the 'harmonization of financial systems' and regional financial stability, even in the case of Europe.

3.3 Financial markets (money and foreign exchange) and monetary policy

(1) Function of financial markets

For the stability of a regional monetary system in fixed exchange rates, macroeconomic policies of member countries must function smoothly, allowing for mutual policy coordination. In fiscal policy, issues of controlling excessive budget deficits and public debt loom to maintain the sound management of national economy. The role of monetary policy is of particular importance from the perspective of stable exchange rates. In the medium-to-long-term, exchange rates between two currencies reflect inflation differentials in respective economies, with the currency in the inflationary economy decreasing in value. As the monetary policy is the major policy instrument in dealing with inflation (or deflation), central banks are expected to play the role of guardian of money and prices.

The prerequisite of effective monetary policy through interest rate and money supply controls is the existence of a well functioning short-term money market. The function of money market is also essential for the development of a foreign exchange market. In foreign exchange transactions the currency sold is often borrowed and the currency bought is invested in the money market. The forward exchange rate is determined in principle by the difference in interest rates between two currencies. Through swap dealings, which combine spot and forward exchanges, funds in foreign currencies can be procured with a home currency in markets and vice versa.

In this sense, money and foreign exchange markets are two sides of a coin (financial market). The establishment and development of financial markets are extremely important for the effective functioning of interest rate policy, the exchange rate formation through market supply and demand, and the coordination of exchange rate policies. Furthermore, when an Asian Monetary Systemis is to be founded, financial markets that are open to non-residents will be indispensable to the development of an Asian Currency Unit (ACU), which should play a central role in the system. However, currently in East Asia, markets that function smoothly are limited to Tokyo, Hong Kong and Singapore with the rest in the region still at a developing stage.

Table 9. Foreign Exchange, Money and Bond Markets in East Asia

	Public Bond Balance 100 million USD		Non-government Bond (including bank bonds) Bal. 100 million USD		Short-term Money Market* Balance 100 million (home currency)		Foreign Exchange Turnover (per day) 100 million USD	
	1997	2004	1997	2004	End 2002	End 2005	2001	2004
Indonesia	9	508	37	69	na	na	39	20
Malaysia	194	473	376	634	Ringgit113	Ringgit145	13	20
Philippines	166	350	3	3	Peso2959	Peso3399	11	10
Thailand	3	362	102	318	Bahts5922	Bahts5358	19	30
Singapore	131	440	107	354	S$174	S$375	1007	1250
Hong Kong	131	158	327	625	HK$3950	HK$4100	668	1020
China	674	3318	490	1995	RMB16276	RMB16783	3	10
Korea	216	1705	1088	3972	W210(trillion)	W257(trillion)	96	200
Japan	23827	68917	22252	25112	¥15.1(trillion)	¥21.1(trillion)	1468	1990

(Sources) Public bonds and non-government bonds: ADB "Asia Bond Monitor" March 2006

Short-term Money Market: Websites of central banks. (Note: for countries listed above between and including Malaysia and China (end 2004), accounts due from financial institutions of all commercial banks have been calculated. For Korea (June 2004), the call market + MSB (Monetary Stabilization Bond) + CD + RP + CP has been calculated. For Japan, the balance of call market has been shown.

Foreign Exchange Turnover: BIS "Triennial Central Bank Survey of Foreign Exchange…"

(2) Financial markets in China and problems

It should be useful to describe briefly the present situation of money and foreign exchange markets in China, which can be expected to play a major role in the future East Asian regional monetary system. The Chinese economy is currently undergoing a transition from a planned economy to a market economy, but the control of the Chinese government on monetary policy, financial systems and money and foreign exchange markets remains strong, with much residuum of the planned economy still in place. The domestic monetary policy is secluded from international influence by regulations on capital transactions.

The People's Bank of China, which is in charge of monetary policy, abolished the direct control of commercial loan volumes in January 1998, and made efforts to move away from the direct quota system of commercial bank lending to open market operations, a discount rate policy and other indirect regulatory instruments including minimum reserve ratios. However, with an immature money market, regulated interest rates and problems with fragile financial institutions, macroeconomic policies applied in a developed country do not function fully yet in China.

In terms of its short-term money market, China is still a developing country. In recent years there has been a rapid rise in market transactions amounting to about 10% of GDP, supported by an expansion of interbank market participants such as securities firms and diversification of products such as bond forward contracts. However, with its money markets divided into markets for OTC transactions of 4 months or longer and for transactions of shorter maturities, approximately 70% of the total volume is occupied by short-term transactions of less than 14 days, and the benchmarks are underdeveloped for interest rates for one-, three- or six-months common in the world's major markets[xx]. The market has fundamental challenges to overcome, such as the unevenly structure of fund providers (mainly four state-owned banks) on the one side, and borrowers (mainly other financial institutions) on the other, and the reliance on secured transactions such as bond repurchases.

The foreign exchange market administered by Shanghai's China Foreign Exchange Trade System, is under the strict control of the People's Bank of China (PBoC). Transactions were sluggish since the market was set up in 1994, but activities have gained some momentum as a result of market reforms in 2005 and 2006[xxi], particularly in the area of interbank OTC transactions. The market is composed mostly of spot transactions, with forward contracts limited to those with commercial demands. Swap transactions, which are the mainstay of foreign exchange transactions in major international financial markets, were admitted on the interbank market in April 2006. The PBoC announces the day's middle rate for the dollar-RMB at 9:15 every morning, and the daily fluctuation margin of the dollar-RMB is set at ±0.3% (extended to ±0.5% as from May 2007). Strict regulation and monitoring by thePBoC, market intervention, problems with market infrastructure, and the prohibition of access by non-resident financial institutions are main stumbling blocks that hinder the development of China's foreign exchange market.

3.4 Smooth flow of capital and its monitoring

(1) Objectives and sequence of capital liberalization

Concerning the Asian crisis, the premature liberalization of capital that took place in the pre-crisis period was in some respects responsible for its outbreak and grave consequences. In Thailand, the autonomy of monetary policy was lost under the baht's fixed exchange rate regime, combined with the free flow of short-term capital through the Bangkok International Banking Facility (BIBF). In Korea, there was a rapid increase in short-term foreign debt due to the liberalization of cross-border short-term fund operations in the banking sector before that of long-term capital transactions. In Indonesia, whilst capital transactions had been effectively free, the lack of reporting obligations made it impossible to grasp external debt positions. After the crisis, countries of East Asia are carefully promoting the gradual liberalization of capital transactions according to their own scenarios.

In spite of potential large risks, the ultimate aim of capital liberalization is, as is taught in many textbooks, the increase in economic welfare of a nation. Liberalization allows the efficient acquisition and investment of capital through integrating a national economy into world's financial and capital markets. At the same time, it also leads to an optimum resource allocation and improvements in the nation's living standards by exposing a national economy to foreign competition through trade, direct investment and securities investment.

In addition to these benefits, there is another reason why East Asia as a region should promote the liberalization of capital; that is, the monetary stability in the region. The establishment of an Asian Monetary System, which aims at the monetary stability and coordination of exchange rates, will become a common policy objective in the region, as the real economy becomes increasingly integrated. In view of such an objective, the region's financial systems and markets must develop, and the convertibility of currencies must be realized. It is desirable that necessary policies therefor are implemented among countries in the region with a certain convergence in timing. It would be better for the region as a whole to cooperate in promotng measures for a common objective than to leave capital liberalization simply to efforts among individual countries.

Put another way, in addition to the financial cooperation that aims to absorb disruptions in the exchange rate and financial stability (the Chiang Mai Initiative), the region-wide efforts for capital liberalization not only help in making more effective use of the region's savings, but also prepare a necessary step on the way to a future regional monetary arrangement. The following recommendations should be worth considering:

a) The progress of capital liberalization should not be left entirely to each individual country; rather its objectives and sequences should be set out in guidelines through the ASEAN+3 process. The order of liberalization should as a general rule begin with the foreign direct investment, followed by the medium-to-long-term capital including listed securities, and finally the short-term capital.

b) There should be no discrimination in principle between capital liberalization (or restrictions) within and outside the region.

c) Common monitoring mechanisms and contingency plans should be simultaneously strengthened.

d) It is important to promote in parallel the regional cooperation in financial fields, because capital liberalization exposes domestic financial and capital markets to foreign competition.

e) Capital liberalization guidelines through the ASEAN+3 process should assume a multi-speed approach to objectives by taking into account particular characteristics of individual financial systems, developmental stage of financial and capital markets and balance of payments structures of each country. Member countries adopt such a guideline on a voluntary basis initially, and the issue of binding force should be taken up later.

Looking at the experience of Europe, there were provisions in the Treaty of Rome (Part Three, Titles 1 to 4) for the liberalization of capital transactions, and it required thirty years, divided into three stages, until their full implementaion in 1990[xxii]. The following measures were implemented to avoid unforeseen risks upon completion of capital liberalization: a) emergency measures were allowed when short-term capital disrupted domestic capital or foreign exchange markets; b) the medium-term financing facility was expanded to cope with balance of payments difficulties. The full liberalization of capital aimed at the financial integration as a part of the European single market programs, and one should take note that the European currency crisis of 1992/93 could not be avoided in spite of preventative measures.

(2) Monitoring and contingency plans

Capital liberalization, along with its advantages, brings with it possible risks of currency crises. Given the potential for the outbreak and spread of currency crises, it is important to establish regional monitoring systems and contingency plans. In terms of the types of currency crises, the focus has moved away from traditional crises caused by problems in the current account (e.g. the Latin American currency crisis of the 1980s), and towards so-called 21st century-type currency crises, typically the Asian crisis, which are caused by problems in the capital account. Behind this trend is the accelerated movement of international capital in both flow and stock and the development of information and communications technology. The problem has been compounded in recent years by the issue of global imbalances due to America's current account deficit and the accumulation of its external debt. At the end of 2004, the blances of international bonds and loans/deposits reached 13.3 trillion USD and 13.8 trillion USD respectively, and in April of the same year daily foreign exchange turnover reached 1.9 trillion USD (sources BIS)[xxiii]. Compared to the 11 trillion USD of the world annual trade volume in goods and services (2004), one can see the magnitude of latent risks associated with the movement of international capital.

One of the lessons of the Asian crisis was that even countries with sound macroeconomic management can become victims of currency crises, and that currency crises must be dealt with, not by an individual country unilaterally, but collectively by the region as a whole. In the mid-1990s the developing economies of East Asia were in effect under a quasi-fixed exchange rate system as a result of de facto dollar pegs, but the framework for cooperation in the region was as good as non-existent. Given the risk of currency crises, a regional cooperative framework with both surveillance (in particular monitoring) and contingency provisions will be crucial for the design and management of a future Asian Monetary System.

Projects for monitoring capital flows and early warning systems are already underway, and national monitoring units are running in a number of countries. However, given the size and speed of international capital movements, further strengthening will be necessary that takes the following points into account.

a) The monitoring of cross border capital flows should be established as a part of the ASEAN+3 surveillance process (ERPD). Statistics on cross border capital flows are useful, interpreted with other economic indices, as an early warning system.

b) Given the speed of capital movement and the characteristics of foreign exchange markets, an independent system is necessary to follow daily and real-time trend of market. A telephone network between finance ministries and central banks in the region would probably satisfy this need. Considering the statistical time lag, any information of real use and value in crisis cmanagement can be obtained by monetary authorities through direct dialogues with market participants. The implementation of effective crisis measures would then become possible by sharing such information among monetary authorities regionwide.

c) In order to establish an effective surveillance process, including monitoring of the progress of capital liberalization and compiling timely statistics of cross border capital flows, a standing secretariat with qualified planning and administrative staffs would be indispensable.

The best possible contingency plans are sound macroeconomic management and a robust financial system. Assuming that these are in place, there is still a need for exceptional rulings under the ASEAN+3 guidelines for capital liberalization, and financing facilities big enough in scale to work as a deterrent against sudden large inflows and outflows of short-term capital that disrupt domestic economies.

d) Even if capital liberalization aims at smooth financial and capital transactions within the region, special measures should be allowed for a limited period which restrict capital transactions in cases when unexpected large amounts of short-term capital flows cause a disruptive effect. Short-term bank loans and deposits, and short-term securities dealings can be listed as the targets of these measures.

e) Credit facilitites with a sufficient size to work as a deterrent to the market must be established by redefining the Chiang Mai Initiative into a new fund (a foreign reserve pooling or commitment lines). If countries of East Asia with foreign reserves of over two trillion US dollars set up a mechanism in which they pool, for example, 10% of their reserves for mobilization it would have a significant deterrent effect on speculative activities (at the 10th ASEAN+3 Finance Ministers' Meeting in May 2007, an agreement was reached on CMI Multilateralization, which should be 'a self-managed reserve pooling arrangement, governed by a single contractual agreement (Joint Ministerial Statement)).

(3) Capital liberalization and currency convertibility

In order to realize an Asian Monetary System with an Asian Currency Unit at its center, it is important that major currencies of East Asia become convertible. The convertibility of currencies can be divided into two categories of partial convertibility that is limited to current account transactions and full convertibility with which currencies can be traded freely in international financial centers. Currencies with full convertibility in ASEAN+3 are limited to the yen, Hong Kong dollar and Singapore dollar, whereas currencies with partial convertibility include currencies of the IMF Article 8 countries such as China, Korea and major ASEAN countries.

If capital accounts are completely liberalized, currencies become fully convertible as residents and non-residents can be engaged freely in lending/borrowing and dealing home currencies. Many of the EC countries in the 1980s, with the exceptions of West Germany and the United Kingdom which had already liberalized capital transactions completely, maintained capital account restrictions, but effectively brought about convertibility of their currencies, so far as necessary for the ECU composition, by allowing the participation of foreign banks in their money and foreign exchange markets, or as in the case of Belgium by applying a two-tiered exchange rate system, thereby causing no obstruction to the composition or dismantling of the ECU.

Prior to the Asian crisis, developing East Asian countries permitted a limited scale of lending/borrowing and dealing of their currencies between residents and non-residents (i.e. there was effectively a certain degree of convertibility). The so-called 'de-internationalization' of currencies spread after the crisis not to repeat the abuse of convertibility for currency speculation. The 'de-internationalization' refers to the prohibition of posessing home currency by non-residents and strict restrictions to its lending, borrowing, and trading by non-residents. It aims to prevent currency speculations and the disruption of domestic financial markets by cross-border flows of short-term capital. As a temporary measure, this is probably unavoidable, but these restrictions need to be gradually lifted when a framework of regional cooperation has been well established and once the conditions for capital liberalization are in place, such as sound financial systems and efficient financial and capital markets.

Joseph Yam, Chief Executive of the Hong Kong Monetary Authority (HKMA) advocates the necessity of financial integration in Asia (not only as a solution to the de-internationalization of currencies) and cited the following five challenges: a) regional linkages of financial infrastructure, b) relaxation of non-supervisory restrictions, c) harmonization of financial system to international standards, d) strengthening of cooperative efforts in financial and capital development, and e) relaxation of statutory restrictions on cross-border capital flows[xxiv].

Table 10. Regulations concerning non-residents' lending and foreign exchange transactions in East Asia (as of 2005)

	Lending in home currency to non-residents	Foreign exchange transactions with non-residents
Singapore	Lending to non-resident banks limited in principle up to 5 million S$	No regulations
Malaysia	Banned	Limited to hedging supported by real demand
Thailand	Lending to non-residents limited up to 50 million bahts	Requires confirmation of real demand by domestic bank
Indonesia	Banned	Up to 3 million rupiahs unless supported by real demand.
Korea	Lending of up to 1 billion won to non-residents*	No regulations, but deals with non-residents are effectively banned.
China	Limited to banks approved by the financial authorities.	Banned

* The upper limit was abolished in Jan. 2006, with a shift to a prior application system.
(Source) IIMA "Regional Coordination of Policy Measures Forward: Financial Market

Liberalization and Capital Market Development" 2006 (China was added by author).

(4) Currency convertibility of the Chinese RMB

Concerning the convertibility of the Chinese RMB, with the exception of bank notes bought and sold at airports etc. and the RMB denominated border trade, transactions with nonresidents are strictly regulated. However, the medium-to-long-term policy objective of the Chinese government is to make the RMB a convertible currency. The following comments made by Guo Shuqing, the former director of the Chinese State Administration of Foreign Exchange (SAFE) in an interview in December 2003 with a reporter from the Xinhua News Agency concerning the policy of the Chinese government on capital account regulations and convertibility are of particular interest here (5 December 2003, China Weekly):

'As to the currency convertibility there are three categories of (1)partial convertibility limited to current transactions, (2)basic convertibility where some capital transactions are permitted and (3)full convertibility. The RMB already has the partial convertibility of current transactions, and in the medium-term will realize basic convertibility by easing regulations on capital transactions that fulfill certain conditions.

For that purpose we will look into speeding up China's foreign expansion strategy by permitting foreign direct investment by Chinese firms, the overseas remittance of surplus funds of foreign businesses, the legal overseas transfer of domestic assets by emigrants and non-residents, RMB denominated bond floatations by international institutions, the introduction of a qualified domestic institutional investor system and foreign securities investments by non-bank financial institutions…China will realize basic convertibility in RMB capital transactions as a result of these measures. It will then take a considerable time before full convertibility can be achieved'.

In March 2005 in light of rapid changes in international balance of payments he went on to announce a basic shift of China's policy on foreign exchange management. The former asymmetrical framework, in which capital inflow was encouraged and outflow restricted, will be taken over by a balanced framework which treats imports and exports, capital inflow and outflow, domestic and foreign funded institutions, and state-owned and private companies in the same way. Specifically in terms of capital transactions, while regulations on the inflow and settlement of short-term capital are strengthened, rational flows of capital transactions are encouraged in both directions (4 March 2005, Economic Daily).

Table 11. Issues concerning domestic financial systems, capital liberalization and regional cooperation (conceptual diagram)

<table>
<tr><td rowspan="3">Measures to be taken by individual country</td><td></td><td>Financial reforms</td><td>Financial liberalization</td></tr>
<tr><td>Domestic finance</td><td>- Improvements in skills and effectiveness of supervisory authorities
- Improvements of asset qualitites etc. of financial institutions
- Development of money, foreign exchange and capital markets
- Review of financial regulations, tax and accounting systems</td><td>- Liberalization of interest rates
- Liberalization of business scopes and financial products
- Easing regulations on separation of banking/securities business
- Easing regulations on foreign access to domestic markets</td></tr>
<tr><td>Capital liberalization</td><td colspan="2">→ A. Commercial transactions (trade), and transactions related to the movement of people and establishment of companies (see note below)
→ B. Listed securities transactions (stocks and bonds)
→ C. Non-listed securities transactions
→ D. Short-term money market transactions
Currency convertibility limited to current accounts → Full convertibility of currency</td></tr>
<tr><td colspan="2">Issues pending in monetary and financial cooperation in East Asia</td><td colspan="2">・ Cooperation on information exchange and capacity building by financial supervisory authorities and central banks (EMEAP etc. ongoing issue)
・ Mutual recognition/harmonization of financial regulations and supervision standards (future issue)
・ Formulation of ASEAN+3 guidelines for capital liberalization (future issue)
・ Establishment of an ASEAN+3 central banks governors' forum(future issue)
・ Cooperation on regional capital markets and common infrastructure (ABMI, ABF, future issue)
・ Monitoring capital flows and improving surveillance process such as EWS (ongoing issue)
・ Prevention and management of currency and financial crises (CMI, ongoing issue)
・ Use of an Asian Currency Unit (ACU) (future issue)
・ Cooperation and policy coordination for regional exchange rate stability (future issue)
・ Institutionaliztion of monetary and financial cooperation and establishment of a standing secretariat (future issue)</td></tr>
</table>

(Note) Steps for capital liberalization by the European Community (made by author)

3.5 Establishment of an ASEAN+3 central bank governors' forum

In order to realize a regional monetary system, a wide range of financial issues must first be tackled, including the improvements of financial systems, development of financial markets and promotion of capital liberalization. Central banks will play a crucial role in designing a regional monetary system, and during the actual operational stage in closely following market movements, intervening in the markets when necessary and operating credit facilities to maintain the system. Along with national statistical offices central banks should also be in charge of compling statistics that forms the basis for surveillance.

However, central banks are not involved in the ASEAN+3 framework today as fuly as they should. Although deputy governors of central banks join at the ASEAN+3 Finance Deputies Meeting (AFDM+3), there is no forum in which the judgment of central bank governors is sought. At the Executives' Meeting of East Asia-Pacific Central Banks (EMEAP), Brunei and the four developing countries of Indochina are not members, while Australia, New Zealand and Hong Kong are. EMEAP cooperates in the fields of money and finance in a three-tiered structure of governors, deputy governors and four working groups. An equivalent organization headed by a forum of central bank governors is necessary within the ASEAN+3 framework. Should the creation of a separate organization that duplicates the role of EMEAP be unrealistic, one possible solution might be to create a sixteen-nation organization by seeking participation in EMEAP by the five current non-member countries, with Australia and New Zealand sitting out where appropriate depending on the topic of discussions (the Hong Kong Monetary Authority already attends the AFDM+3 with the People's Bank of China).

The participation of central bank governors at the ASEAN+3 Finance Ministers' Meeting (AFMM+3) is also an option after the model of G7 meetings of finance ministers and central bank governors. However, considering the future prospects for an East Asian regional economic and monetary zone, and taking into account that the position of central banks, whose independence from the government (finance ministry) ought to be respected, is not necessarily the same as that of finance ministers, and further in view of the general division of roles between finance ministries (general orientation of exchange policies) and central banks (exchange policy implementation), it may be more effective to establish a forum of central banks that is separate from the AFMM+3.

In Europe, the Committee of Central Bank Governors was set up in 1964 well after the establishment of the Economic and Finance Ministers Council (Ecofin). During the joint float of EC currencies (snake) of the 1970s and the succeeding European Monetary System, the basic policy was decided by the European Council consitsting of heads of states/governments or the Ecofin, but details and system management were left to the Committee of Central Cank Governors and national central banks. Central rate alignments of the currencies participating in the EMS were decided by the Ecofin ministers (in consultation with central bank governors) after discussions at the Monetary Committee (composed of finance state secretaries and deputy governors of central banks). The Delors Committee, which designed the current European Economic and Monetary Union (EMU), was composed of all of the members of the Committee of Central Bank Governors in personal capacity and three other specialists. Thus, in the case of the European monetary integaration (especially EMS), central banks played the central role, and problems were rather seen in the insufficient cooperation (or policy coordination) among governments of member countries

4. Roadmap for an Asian Monetary System

4.1 From crisis management to exchange rate stability

As to the 'financial stability' of East Asia, one can define 'financial stability' in both narrow and broad senses of the term. Financial stability in a narrow sense can be defined as the prevention of currency and financial crises to secure stable financial systems and other framework for economic growth in the region. In a broad sense, financial stability is a concept that also includes the stabilization of exchange rates among currencies of member countries. The European Monetary System is a system designed to maintain financial stability in a broad sense, with mechanisms in place for both stable exchange rates and crisis management.

We must remain vigilant against risks of 21st century type currency crises, such as the Asian crisis, caused by a large-scale movement and imbalance of international capital. As the regional economy becomes increasingly integrated, stability in exchange rates and a regional monetary arrangement therefor will become necessary, in addition to a mechanism for the prevention of currency crises in order to secure sustained economic growth in the region. By the mid 2010s, with an establishment of a network of free trade agreements and economic partnership agreements, it is expected that a free trade area will effectively take shape in East Asia. The 'financial stability in the region' in a broad sense will then become an important issue on the political agenda.

The Joint Statement on East Asia Cooperation of the 1999 ASEAN+3 Summit meeting stated that leaders of member countries had 'agreed to strengthen policy dialogue, coordination and collaboration on the financial, monetary and fiscal issues of common interest … enhancing self-help and support mechanisms in East Asia.' Following the first joint statement, financial cooperation started with the Chiang Mai Initiative, which was epochmaking in terms of regional financial cooperation. The financial cooperation so far aims at the prevention of currency crises and common responses in the event of a crisis, in other words, cooperation for crisis management.

As the interdependence of the region's economies deepens and regional cooperation for financial stability in a narrow sense of the term advances, we will enter the stage that requires discussions for the next common challenge, that of regional financial stability in a broad sense, or 'exchange rate stability' for the region. Coordination of exchange rate policy means that currencies of the region are tied to a fixed value standard with market rates maintained within a certain margin, in contrast to the today's situation of a wide variety of different exchange rate regimes. It will take a form, for example, of either a common currency basket peg system (as a transitional stage) or an Asian Monetary System (AMS) that stabilizes exchange rates through a common regional arrangement.

To maintain a regional fixed exchange rate system, monetary authorities must cooperate closely and intervene in the market as necessary (short-term credit facilities must be established for market intervention). Discipline in macroeconomic management such as price stability is required of member countries, because the risk of currency speculation would rise dramatically, if economic fundamentals of member countries diverge. When the central rate no longer meets economic fundamentals as a result of accumulated inflation differentials with the passage of time, central rates must be aligned without delay in time. Accordingly, the key to the system's success would be the effective economic surveillance by member countries and coordination of macroeconomic policies, especially monetary policies.

4.2 Roadmap for an Asian Monetary System

In order to move on from the cooperation for crisis management to a regional monetary arrangement that requires policy coordination for exchange rate stability, a sufficient start-up period (preparation period) is needed to satisfy the necessary political and economic conditions.

What needs to be done during the start-up period are, a) strengthening and consoliadation of crisis management systems, and b) formation of domestic and international opinions/understanding about the need and the creation of favorable conditions for a regional monetary system.

a) A regional monetary system with fixed exchange rates must make sufficient provisions for the prevention of currency crises and appropriate counter-measures, as such a system is prone to currency speculations. This includes both the further development of financial cooperation underway after the joint statement of the 1999 ASEAN+3 Summit,and starting new initiatives in fields of financial supervision, development of financial markets, and promotion of capital liberalization under the ASEAN+3 framework.

b) For the formation of domestic and international opinion and creation of a favorable overall environment, a standing secretariat must be set up to strengthen surveillance and to send messages on the progress of crisis management, the strengthening of financial systems, and the financial cooperation on matters such as capital liberalization in the region.

It is also important to deepen understanding in the public on a currency basket and an Asian Currency Unit that play a central role in a future regional monetary system. An educational effect can be expected by using a theoretical ACU to measure and announce the divergence from simulated central rates of actual regional currencies. Furthermore, should major East Asian currencies realize convertibility, it become possible to create an official ACU and to experiment with private ACU transactions in deposits, lending and bond issues.

Concerning political conditions, of prime importance is the political consensus to set up and maintain a regional monetary system and the strong political will to back it up. Policy coordination for exchange rate stability may cause frictions with the participating countries' own policy objectives. Countries whose main priority lies in economic growth and for whom inflation control is only a secondary aim may be faced eventually with the threefold choice of currency devaluation, revision of domestic policy objectives or departure from the regional monetary system. Policy coordination requires the understanding and support from the general public domestically and abroad, that supplements a strong political will.

Political will needs to be seen clearly by citizens and market participants. Whilst a joint statement of the ASEAN+3 Summit is an important means, the 'institutionalization' of monetary and financial cooperation is indispensable to achieve the goal of creating a regional monetary system. In Europe, the institutional arrangements for the community were in place as a result of the framework created by the Treaty of Rome, but in the case of East Asia it is doubtful whether such a strict institutionalization is appropriate or practical. However, as a minimum requirement a standing secretariat must be established as a core of the ASEAN+3 framework either by a treaty or some form of binding intergovernmental agreement[xxv].

Table 12. Roadmap for a regional monetary arrangement

	Monetary & financial crisis management		Exchange rate stability of regional currencies	Note
	Current Framework (CMI/ABMI) New Initiatives	**Permanent Secretariat:**	Designing and planning ACU and regional monetary arrangements	
1999 First stage: Start-up of financial cooperation				**The 1st Joint Statement of ASEAN+3**
2007 Second stage: Strengthening & consolidating cooperation Consensus building for a regional monetary system		Institutionalization of monetary cooperation Establishing a permanent secretariat: Enhancing surveillance, discussion by experts on regional monetary arrangements	Research on ACU (RMU: Regional Monetary Unit) Realization of convertibility of major currencies Creation of ACU Discussion on, preparation for a regional monetary system	**10th anniversary of ASEAN+3, & the 2nd Joint Statement**
mid 2010s Third stage: Creation of Asian Monetary System			Agreement on a regional monetary system	Significant Progress in FTA・EPA network

(Note) The roadmap assumes the establishment of an AMS without the stage of a common currency basket peg system. If some countries in the region can agree, a common currency basket peg system would probably be easier to implement than an AMS among themselvs. Made by author.

In perspective of a future regional monetary system, high-level discussions by a group of experts (in Europe, the Monetary Committee composed of high ranking officials of finance ministries and central banks from member countries) supported by the standing secretariat would be extremely important in transforming the current financial cooperation into a stage of policy coordination for exchange rate stability.

The discussion fields would be wide ranged from exchange rate stability mechanisms, effective surveillance (including policy dialogues and statistical issues), credit facilities (liquidity for market intervention and balance of payments measures), capital liberalization and to the strengthening of financial systems. The group of experts, collaborating with economists from the standing secretariat, discusses their assignments in close contact with relevant bodies in member countries, and submits proposals to be put on the agend of the ASEAN+3 finance ministers. Backed up by personal trust and making use of its information network with monetary authorities, the group of experts would pull a string to persuade politicians and achieve policy objectives.

The mid-2010s, when a network of free trade agreements is likely to be completed, should probably be the target for implementation of an Asian Monetary System (or a common currency basket peg system). Starting from the first Joint Statement of the 1999 ASEAN+3 Summit, which espoused the need for self-supporting efforts, it is possible to divide the period before the initiative for an AMS in the 2010s in two periods as follows. The first period is the eight years or so between 1999 and 2007, during which the regional financial cooperation was put on a track through crisis management measures such as the Chiang Mai Initiative, Economic Reviews and Policy Dialogues, and the Asian Bond Markets Initiative. The second period is the one following the second Joint Statement expected at the end of 2007 up to the time when a political agreement can be reached on an AMS (or other form of monetary arrangement) in the mid-2010s. In other words, the second period is the one, during which the current financial cooperation is consolidated and a consensus is created on a regional maonetary arrangement for exchange rate stability.

Exchange rate stability in East Asia is crucial, and cannot be achieved without the cooperation and coordination of countries in the region. Using the Asian crisis as a springboard, the countries of East Asia have joined in financial cooperation for the first time in the history. However, unlike crisis management, the creation of mechanisms for exchange rate stability involves complex conflicts of national interests. Will the ASEAN+3 come together for the sake of common interests at a time of global dual mega-trends of the growing scale and imbalance of international capital and the formation of regional economies in Europe and the Americas? The trials lie ahead. Japan is expected to fulfill a coordinating role in the area of finance in Asia[xxvi], and the true value of its leadership will come to be tested.

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[i] In 2005, a group led by the Institute for International Money Affairs carried out ASEAN-sponsored research into the theme of 'Future Regional Policy Coordination: Liberalization of Financial Markets and the Development of Capital Markets.' In 2006, the Network of East Asian Thinktanks (NEAT) compiled reports on the theme of 'Regional Exchange Rate Stability in East Asia and Financial Cooperation on the Prevention of Financial Crises.'

[ii] "The East Asian Miracle-Economic Growth and Public Policy" A World Bank Policy Research Report, Oxford University Press, 1993

[iii] This expression can be found in Kuroda & Kawai, 2003, p.8, or Soesastro, 2006, p.3.

[iv] 'There are major expectations that the largest economic benefit of concluding free trade agreements will be an increase in attracting direct investment, in addition to encouraging trade and the movement of people'. (Urata [2004] p.3)

[v] At the Ninth ASEAN Summit held in Bali on 7 October 2003, the Declaration of ASEAN Concord II was announced, with agreement on a framework for an ASEAN Security Community (ASC), an ASEAN Economic Community (AEC) and ASEAN Socio-Cultural Community (ASCC).
http://www.mofa.go.jp/mofaj/kaidan/s_koi/asean＋3_03/2_k_sengen.html
Agreement was later reached to work towards bringing forward the establishment of the AEC to 2015 (38th ASEAN Economic Ministers Meeting of 22 August 2006).

[vi] Former Prime Minister Junichiro Koizumi signed an economic partnership agreement with Philippines President Gloria Arroyo on 12 September 2006, making this the fourth agreement after Singapore, Mexico and Malaysia (*Nihon Keizai Shimbun*, 13

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[vii] 'Economic Partnership Agreement –to Whole East Asian Region by 2011', *Nihon Keizai Shimbun*, 9 August 2006

[viii] Stanley Fischer, the former First Deputy Managing Director of the International Monetary Fund, provided results showing the bi-polar trend and argued that it would continue in the future. The number of countries employing hard peg systems increased by 25 countries to 45 countries and those employing floating rate systems by 36 countries to 77 countries between 1991 and 1999, with the number of countries employing intermediate exchange rate systems decreasing from 98 countries to 63 countries over the same period. Stanley Fischer, "Exchange Rate Regimes: Is the Bipolar View Correct?" (2001), p.2.

[ix] A currency board system is a type of fixed exchange rate system in which the issue of currency is limited to the amount held in foreign reserves (M1 in the case of Hong Kong). This is seen as a typical hard peg.

[x] The NDF (non-deliverable forward) market involves transactions in the currencies of developing currencies, and can be found mostly in financial centers such as Hong Kong and Singapore. With NDFs, a physical delivery or transfer in the traded currency is not sought. The difference between the contracted amount and the market rate is settled in US dollars or another major currency.

[xi] Ono and Fukuda carried out an analysis of the currencies of Singapore, Thailand, Malaysia and Korea between February 1998 and December 2002 using intra-daily rates to track their movement against the US dollar and Japanese yen. Ono Sanae and Fukuda Shinichi, 'Exchange rate policy after the currency crisis in East Asia: the implications from the dat of intra-daily rates', 2004, (published by the International Finance Research Committee of the Japan Society of Monetary Economics)

[xii] Ogawa, Eiji and Kawasaki, Kentaro, 'Optimum Currency Area in East Asia', 2006

[xiii] According to the measurements of Seung-Gwan Baek and Chi-Young Song, China has no correlation with six countries and regions of East Asia (Hong Kong, Indonesia, Japan, Korea, Malaysia and Thailand) in respect of either supply shocks or demand shocks. However, given the small scale of its shocks and the fact that its speed of adjustment is quick, China is suggested as one of nine potential candidates for currency union, along with Taiwan and Singapore (Baek, S.G. et al. [2002] p.127).

[xiv] A crawling peg is a system for maintaining the stability of a fixed exchange rate at the same time as providing the adjustment function of a floating exchange rate system. It aims to allow small parity changes over the long-term to avoid the disruption that accompanies large parity changes.

[xv] The ACU referred to here has no relationship whatsoever with the ACU currently used by Singapore in offshore financial transactions. In 1968, the Singapore government introduced an ACU (Asian Currency Unit) system as an accounting unit for offshore transactions as part of its development as an international financial center. The ACU was an idea that, in contrast to the DBU (Domestic Banking Unit), allowed accounting to be carried out in all currencies other than the Singapore dollar (http://www.mas.gov.sg/masmcm/html). It is said that the Singapore government has opposed the use of the term 'ACU' to mean an 'Asian ECU'.

[xvi] When setting up the former EMS, a compromise was reached between France, which wanted to use an ECU as a value standard, and West Germany, which argued for a grid system, at a summit between French President Valerie Giscard Estang and West German Chancellor Helmut Schmidt in Aachen in September 1978 whereby the EMS would employ a grid system but the ECU would also be referred to as a market rate divergence indicator (the Aachen Compromise). Described in detail in H. Tietmeyer "Herausforderung Euro", Chapter 7, 2005.

[xvii] In 1999, the IMF began the Financial Sector Assessment Program (FSAP) in cooperation with the World Bank. Under the FSAP, the IMF carried out Financial System Stability Assessments (FSSAs), with Japan, Korea, Hong Kong, Singapore and the Philippines among the East Asian countries to have been subject to evaluations up to September 2006.

[xviii] The lobbyist group CSI (Coalition of Service Industries), which aims to reduce barriers to American service exports, carries out activities in pursuit of the opening up of financial markets in developing countries by allocating different countries to its member corporations which then cooperate with the American embassies of the countries to which they have been allocated. When attending a CSI meeting that was being held in conjunction with the IMF and World Bank Annual Meeting in Hong Kong in September 1997, I was surprised to see the then Deputy Treasury Secretary Laurence Summers in attendance. Please refer to http://www.uscsi.org for more details.

[xix] BCCI (Bank of Credit and Commerce International) was a Luxembourg-based Pakistani bank that was closed in 1991 after building up almost 10 billion USD in fraudulent deposits.

[xx] Benchmark interest rates are the published rates used in transactions between first-class banks, such as the LIBOR (London Inter-bank Offered Rate). Because of concerns of the risk to local small-to-medium financial institutions, which are main fund-takers in the Shanghai market, a large risk premium is included in the applied interest ratelevel, and because this cannot be divided from the interest rate, the level itself is not published during market trading times. In January 2007 Shibor started.

[xxi] The CFETS computer systems were comprehensively overhauled in May 2005, allowing flexible responses to a variety of trading forms. In July of the same year, the Chinese RMB abandoned its dollar peg and switched to a managed float exchange rate system whereby the RMB floats against a basket of currencies. Interbank bilateral deals (OTC) were introduced to run in parallel to the existing exchange transactions in January 2006 (however accounts need to pass through the trading center)

[xxii] **Three stages of capital liberalization in Europe**

	Outline of liberalized capital transactions (numbers represent the European Community capital transactions classifications)
1960	(1) Capital transactions directly connected to freedoms in EC (liberalization of trade, the movement of people and setting up of companies)
1986	(2-1) Listed securities (stocks and bonds)
1990	(2-2) Non-listed securities (stocks and bonds), (3) Complete capital liberalization including short-term credit, and money market products

Made by author

[xxiii] There are also statistics suggesting that (as of the end of 2003) total international capital reached 84.9 trillion US dollars. This was composed as follows (trillion US dollars): international bank assets (23.6) + international debt (14.6) + insurance companies (13.5) + pension funds (15.0) + investment companies (14.0) + hedge funds (0.4) + other institutional investors (3.4) = 84.9 trillion US dollars. (Source: Sheng, A. "Exchange Rate Regimes and Global Imbalances" 2006)

[xxiv] Joseph Yam "The Euro: Lessons for European and Asian Financial Markets" 24 February 2006

[xxv] Charles Wyplosz states that "there can be no doubt that the very existence of the European Commission itself was the decisive unifying force behind European integration" (Wyplosz [2006] p.16).

[xxvi] Supachai Panitchpakdi, the Secretary-General of the United Nations Conference on Trade and Development (UNCTAD) stated that "the only country that become the pillar

of coordination in the area of finance in Asia is Japan. Japan is by far the best economy when it comes to the levels of knowledge, excellent supervisory systems, markets, related industries and transparency that are necessary for financial integration". *Asahi Shimbun*, 27 April 2006