Monetary and Financial Integration in East Asia:
The Relevance of European Experience

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Chapter 3

Assessment of the Initiatives for Financial Cooperation and Macroeconomic Surveillance

The 1997 Asian financial crisis marked a watershed in East Asia's recent economic history. It signaled the end of the East Asian economic miracle and opened up a long and painful period of economic reform and restructuring. As part of their efforts to build resilience to external shocks, most of the East Asian countries including the crisis-hit ones have voluntarily or under external pressure increased the pace and scope of domestic financial reform to liberalize and open their financial markets and also to improve soundness, corporate governance, and risk management at financial institutions. The 1997 financial turmoil has also served as a catalyst for a movement for building a region wide defense system against future crises as well as financial market and monetary integration. This movement has culminated in the institutionalization of two regional initiatives: the Chiang Mai Initiative (CMI) and Asian Bond Market Development Initiative (ABMI).

Before the Asian financial crisis broke out in 1997, few had seriously thought about the need for establishing regional arrangements for financial cooperation and market integration in East Asia. To many a market-led integration process was in fact taking root in the region. The financial crisis that erupted in 1997 shattered the region's confidence in such a process, giving a strong impetus to searching for a regional cooperative mechanism that could help safeguard the region against future crises. This search gathered momentum and opened the door to significant policy-led integration in East Asia (Bergsten 2000 and Henning 2002).

1. Economic Rationale for a Regional Financial Arrangement in East Asia

While the Asian financial crisis provided a strong impetus for regional financial integration in East Asia, other developments have encouraged the formation of regional arrangements for financial cooperation and financial market integration. One is the limitation of the ability of the IMF in managing a capital account crisis. Another is the slow progress in reforming the international financial system that makes it difficult to expect the emergence of a global mechanism of defense against future crises. A third is the lack of confidence in the free floating system.

1.1. IMF and Capital Account Crisis Management

A review of the Asian crisis management by the Independent Evaluation Office of the IMF (2003) makes it clear that the 1997-8 capital account crisis required a management and resolution strategy different from the traditional IMF recipe for crises originating from current account deficits. A large increase in capital inflows into some of the East Asian countries set off an asset market boom and a precipitous increase in the current account deficit, thereby making these countries vulnerable to speculative attacks. The perception of vulnerability of these countries triggered a sharp and large capital outflow, which was further aggravated by the panic and herding behavior of foreign investors. Once the dollar peg had become indefensible, the value of the currencies plummeted. Many banks and corporations with balance sheet mismatches could not service their foreign currency denominated debts and eventually became insolvent. A sharp contraction in the level of output then followed.

The crisis resolution strategy of the IMF was twofold. First, it imposed tight monetary and fiscal policies with the aim of stabilizing the exchange rate and generating current account surpluses by contracting domestic demand. High interest rates together with weak currencies were expected to contribute to luring back foreign investors. Second, the IMF required these crisis countries to undertake a wide range of institutional reforms of the corporate, financial, and public sectors, with the aim to strengthen the structural foundation of the economy and, therefore, to restore the confidence of international lenders.

Once the crisis broke out, output contraction and the turbulence of the foreign exchange and other financial markets in one country were rapidly transmitted to other economies in the region through trade and financial market linkages. The pronouncements by international financial institutions and policymakers that the crisis countries had serious structural problems in their financial, corporate, and public sectors did not help inspire confidence in these economies. In some sense, the IMF crisis management program was fueling contagion of the crisis.

Even before the crisis, cynics would often express their doubt by saying that nothing short of a major shock could force East Asian economies to accept reforms that were badly needed and overdue. It was not surprising therefore that the IMF rescue programs for the crisis countries mandated structural reforms along the lines of the Washington consensus without a careful scrutiny of their appropriateness and of reform capacity. Implementing deep reforms in the midst of a crisis is a questionable objective. As a result, many of these reforms have been ignored, put on the backburner, or at best resulted in cosmetic changes. The view that structural problems were the root causes of the crisis has not been borne out by subsequent events.

It has also became known that, when a crisis in a country originates in the capital account, policy coordination or at least policy dialogues and reviews among neighboring countries is essential in preventing contagion. Without a constant exchange of information and policy dialogues among close economic partners, individual countries often find it difficult to understand the causes of large changes in capital flows and exchange rates. The crisis brought home the lessons that the IMF did not have the institutional capacity to prevent or manage properly capital account crises and that monitoring of developments in regional financial markets crucial for fending off crisis contagion would not be effective unless an efficient mechanism of policy coordination is constructed at the regional level. Even smoothing-out of high frequency movements of the nominal exchange rate in individual countries may have to be coordinated at a regional level in order not to send wrong signals to other countries.

This is one of the functions fulfilled by the EMS in Europe. Exchange rate realignments must be agreed upon by all members of the Exchange Rate Mechanism (ERM), i.e. those countries that are party to the fixed exchange rate arrangement.[1] This implies that a country that wants to change its exchange rate must convince its partners and negotiate the size of the adjustment. This feature does not just imply a significant loss of sovereignty, it also means that each country must present to the other members detailed information on its economic situation. Mutual surveillance, therefore, is part of the mechanism. It can be noted that the IMF is not involved in this process.

The IMF can monitor capital flows within and between regions and also the behavior of market participants but it is difficult to imagine that it could establish close working relationships with individual member countries and coordinate their policies.

[1] All European Union members are de facto members of the EMS. The ERM applies only to those countries that agree to peg their currencies.

Furthermore, as an institution entrusted with monitoring economic developments in the member countries, the IMF may have to maintain an arm's length relationship with them. Moreover, to the extent that it cannot serve as a lender of last resort, the IMF cannot serve notice to the international financial markets that it is ready to supply whatever amount of liquidity it takes to thwart an impending speculative attack.

1.2. Contagion of Financial Crises

At the time of the crisis, the ASEAN + 3 countries jointly held about US$700 billion in foreign reserves. The total amount of financing required to restore financial stability in Indonesia, Korea, and Thailand by the IMF, other international financial institutions, and a number of donor countries amounted to US$111.7 billion. If the thirteen countries had established a cooperative mechanism in which they could pool their reserves and immediately supply liquidity to stave off speculative attacks when they see one, they could have nipped the Thai crisis in the bud and minimized contagion by making available a small fraction of their total reserves and more so the total amount of financing needed to resolve the Asian crisis. In view of the large loss of output and employment that followed, such a cooperative response was indeed desirable.

In managing a liquidity crisis, an effective management strategy would have focused on squelching the speculation by supplying a large amount of short-term financing to replenish foreign exchange reserves, instead of tightening monetary and fiscal policy. But there were neither regional nor global lenders of last resort. The IMF resorted to standard remedies it had relied on managing current account crises. Then, with limited financial resources, the IMF could not manage the East Asian crisis by itself; it had to enlist the financial support of the G-7 and other countries.

The lesson is that regional support is logical when contagion is geographically concentrated. In addition to providing financial assistance in tandem with international support, a regional financial cooperation mechanism may conduct policy reviews and initiate a dialogue process. Policy dialogue, including monitoring and surveillance, is the bedrock on which coherent policy formation under regional financial arrangements rests. Monitoring and surveillance processes are needed to provide prompt and relevant information and to assess the situation of countries in trouble and potential contagious effects.

In doing so, the East Asian countries regard Europe as a model. As already noted in the previous chapter, most of their objectives have so far remained timid in comparison with the degree of cooperation that has been gradually deepened in Europe since the end of the Bretton Woods system. Reserves pooling, automatic support under EMS, mutual surveillance, were all part of the process that eventually led to the adoption of the euro, as we explain further below. Why, they ask, have these efforts been hailed then when similar projects now in Asia are regarded with suspicion? It may well be that the East Asian countries are not prepared to go that far, at least for the foreseeable future, and that financial markets have changed deeply since then, making the slow European process ill-adapted. Alternatively, the rapid pace of development is deeply affecting the balance of costs and benefits of deeper monetary and financial integration; as a result, Europe's experience may be becoming more relevant.

1.3. Limited and Slow Progress in International Financial Reform

For years following the collapse of Argentina, acute instability in Brazil, and economic slump in East Asia, the G-7 countries have not shown much interest in reforming the international financial system. As a result, the East Asian countries feared that they will remain as vulnerable to future crises as they are now (Park and Wang, 2002). Interest in reform has only grown as the result of global current account imbalances, because these imbalances affect the US and, via the dollar decline, Europe. To make matter worse, token gestures – minimal increases in IMF quotas – are accompanied by strong demands that directly affect policymaking in China and therefore throughout Asia.

Some of the progress that has been made is asymmetrical in the sense that the reform has focused on strengthening financial and corporate sectors of emerging market and developing economies instead of rectifying imperfections of international capital markets. Developing countries remain excluded from the key institutions and fora involved in international financial reform.

It is not surprising, therefore, that many emerging market economies have begun to develop their own mechanisms of defense against future financial crisis. Instead of waiting until the G-7 creates a new architecture, whose effectiveness is at best questionable, the East Asian countries have concluded that they need to work together to create their own defense system.

2. The Chiang Mai Initiative

2.1. Origins

At the IMF and World Bank annual meetings in Hong Kong right before the outbreak of the crisis in 1997 Japan proposed a plan to create a regional monetary fund known as the Asian Monetary Fund (AMF) modeled after the IMF. The proposal was withdrawn because of the strong objections from the US and the IMF. This did not stop the leaders of ASEAN from seeking other forms of regional economic cooperation. They invited China, Japan and the Republic of Korea to join in an effort to build a regional mechanism for economic cooperation in East Asia, which resulted in creating the grouping known as ASEAN+3. The Joint Statement on East Asian Cooperation released by the ASEAN+3 summit in November 1999 covered a wide range of possible areas for regional cooperation. One area was in creating regional financial arrangements to supplement the existing international liquidity support facilities at the IMF.

Following up on the summit, the finance ministers of ASEAN+3 agreed at their meeting in Chiang Mai, Thailand, in May 2000 to set up a system of bilateral currency swap arrangements (BSAs) among the eight members of ASEAN+3 under what has come to be known as the Chiang Mai Initiative (CMI). The eight countries participating in the CMI have also institutionalized, in addition to the annual ASEAN+3 summit, regular meetings of finance ministers (the ASEAN+3 Finance Ministers' Meeting, AFMM+3) and deputy ministers (the ASEAN+3 Finance and Central Bank Deputies' Meeting, AFDM+3) for policy dialogue and coordination and concerted regional efforts at financial reform in the region.[2]

CMI rests on three pillars: liquidity assistance, monitoring and surveillance, and exchange rate and other policy cooperation. It is anticipated that cooperation will evolve over time, much as has been the case in Europe. It has started with a mutual credit arrangement in the form of bilateral swaps, which is being restructured into foreign reserve pooling without any commitment to exchange rate coordination.

2.2. Objectives and Structure

The CMI consists of two regional financial arrangements: a network of bilateral swaps and repurchase agreements among the eight members of ASEAN+3 and an expanded ASEAN swap arrangement (ASA) created by the original five ASEAN countries in 1977. In May 2000, the ASA was expanded to include the other five new ASEAN members and the total amount of the facility was raised to US$ 1 billion from the initial

[2] The eight members include the five original members of ASEAN (Indonesia, Malaysia, the Philippines, Singapore and Thailand) plus China, Japan, and Korea.

amount of US$ 200 million.[3]

- Structure

The bilateral swap arrangements (BSA) provide for liquidity assistance in the form of swaps of US dollars for the domestic currencies of the participating countries[4]. In the initial agreement, for each BSA, the contracting parties determine the maximum amount of swap. A member country can draw automatically up to 10 percent of the contractual amount (now 20 percent) When exceeding the limit, the member is placed under the IMF surveillance including a macroeconomic and structural adjustment program. The BSA network is thus complementary to the IMF lending facilities. Participating countries are able to draw from their respective BSAs for a period of 90 days. The first drawing may be renewed seven times. The interest rate applicable to the drawing is the LIBOR (London interbank offered rate) plus a premium of 150 basis points for the first drawing and the first renewal. Thereafter, the premium rises by an additional 50 basis points for every two renewals, but it is not to exceed 300 basis points.

The BSAs include one-way and two-way swaps. China's and Japan's initial contracts with the five Southeast countries were one-way BSAs from which only the ASEAN five can draw. The first round of CMI contractual agreements was completed in May 2004 with sixteen BSAs totaling US$ 36.5 billion having been concluded (see Table 1). Japan contracted seven agreements and China and Korea six respectively. Korea, which is the largest beneficiary of the CMI, could draw a maximum of $13 billion from the system, including the resources made available under the Miyazawa initiative. However, the amount of liquidity available from the CMI was seen as insufficient to support members suffering from short run balance of payment problems and hence to prevent contagion of future crises in the region. This realization led to doubling the total size of the CMI in 2005. Since then further contributions have been made to increase the total amount to US$84 billion by April 2008.

- Surveillance

Most participating countries agree that, in principle, the BSA network needs to be supported by an independent monitoring and surveillance system. At this stage, however,

[3] The five new members of ASEAN do not participate in the Chiang Mai Initiative.

[4] China chose swaps between local currencies with Japan, Korea, and Indonesia. With Indonesia, it has also a dollar-local currency swap (see Table 1).

they do not seem prepared to establish such a system, although collective efforts are being made in this regard.[5] In the initial agreement, surveillance is not required because up to 10 percent of each BSA swap can be disbursed without the consent of swap-providing countries and any additional drawing is subject to the IMF surveillance. Hence, there is no collective mechanism for the resolution of repayment default problems. This deficiency effectively puts the onus of surveillance on the lending countries and the IMF. With the increase in the size of the BSAs and the automatic drawing limit, however, there has emerged widespread agreement that the CMI would need in the future its own surveillance mechanism to deal with operational matters such as the activation, execution, and default resolution.

In fact, a number of participating countries have proposed to sever the CMI from its linkage with the IMF conditionality and to replace it with an independent regional monitoring and surveillance system that also serves as an institutional framework for policy dialogue and coordination among the members. At the 2005 annual AFMM+3 ASEAN+3 finance ministers reaffirmed the necessity of enhancing the ASEAN+3's economic surveillance capacity and integrate it into the CMI, but was not able to make any decision on the structure, role and the location of the proposed surveillance institution. The joint statement of the AFMM+3 at the 2006 ADB annual meeting once again reiterated their commitment to improving the regional surveillance capacity, but all they could do was to establish a group of experts and an technical working group composed of finance ministry officials to study further the feasibility of constructing a regional economic and financial monitoring and surveillance system.

5 For instance, the ASEAN surveillance process is built on the basis of consensus and informality in keeping with the tradition of non-interference (Manzano, 2001).

Table 1 Progress on the Chiang Mai Initiative

Bilateral Swap Arrangements (BSA)[a]	Currencies	Conclusion dates	Amount as of[b]	
			May 30, 2004	Apr 1. 2008
Japan-Korea[c]	US$/Won (one-way)	Jul 04 2001	US$2 bn.[d]	
Japan-Korea	US$/local (two-way)	Feb. 23 2009		US$15 bn.
Japan- Korea	Yen/Won (two-way)	Jul 3 2010		US$6 bn.
Japan-Thailand[c]	US$/Baht (one-way)	Jul 30 2001	US$3 bn.	
Japan-Thailand	US$/local (two-way)	Nov 8 2010		US$9 bn.
Japan-Philippines[c]	US$/Peso	Aug 27 2001	US$3 bn.	
Japan-Philippines	US$/local (two-way)	May 3 2009		US$6.5 bn.
Japan-Malaysia	US$/Ringgit (one-way)	Oct 04 2007	US$1 bn.[d]	US$1 bn.[d]
Japan-China	Yen/ RMB (two-way)	Sep 20 2010	US$6 bn.	US$6 bn.
Japan-Indonesia[c]	US$/Rupiah (one-way)	Feb 17 2003	US$3 bn.	
Japan-Indonesia	US$/Rupiah (one-way)	Aug 30 2008		US$6 bn.
Japan-Singapore[c]	US$/Sing.$ (one-way)	Nov 10 2003	US$1 bn.	
Japan-Singapore	US$/local (two-way)	Nov 07 2008		US$4 bn.
Korea - China[c]	Won/ RMB (two-way)	Jun 24 2002	US$4 bn.	
Korea - China	Won/RMB (two-way)	Jun 23 2010		US$8 bn.
Korea-Thailand	US$/local (two-way)	Dec 11 2007	US$2 bn.	US$2 bn.
Korea-Malaysia[c]	US$/local (two-way)	Jul 26 2002	US$2 bn.	
Korea-Malaysia	US$/local (two-way)	Oct 13 2008		US$3 bn.
Korea-Philippines[c]	US$/local (two-way)	Aug 09 2002	US$2 bn.	
Korea-Philippines	US$/local (two-way)	Oct 16 2010		US$4 bn.
Korea-Indonesia	US$/local (two-way)	Dec 26 2009	US$2 bn.	US$4 bn.
China-Thailand	US$/Baht (one-way)	Dec 05 2004	US$2 bn.	US$2 bn.
China-Malaysia[c]	US$/Ringgit (one-way)	Oct 08 2005	US$1.5 bn.	US$1.5 bn.
China-Philippine	RMB/Peso (one-way)	Apr 9 2010	US$1 bn.	US$2 bn.
China-Indonesia	Rupiah/RMB (one-way)	Dec 03 2003	US$1 bn.	
China-Indonesia	US$/Rupiah (one-way)	Oct 16 2009		US$4 bn.

Source: Asian Development Bank, "Progress Report on the Chiang Mai Initiative: Current Status of the Bilateral Swap Arrangement Network as of 10 November 2004"; Japan Ministry of Finance, "Network of Bilateral Swap Arrangements under the Chiang Mai Initiative (as of February 24, 20006)"; Japanese Ministry of Finance, "Japan's Bilateral Swap Arrangements under the Chiang Mai Initiative (as of February 24, 2006)"; and various press releases from central banks of ASEAN+3 countries.

Notes: a. The total size of a two-way BSA is double the face value of the BSA.

b. The total size of all BSAs amounted to US $36.5 bn. as of May 2004 and to $71.5 bn. as of February 2006

c. This contract has been replaced

d. The US dollar amounts shown do not include the amounts committed under the New Miyazawa Initiative: US$5 bn. for the Republic of Korea, which expired on February 24, 2006, US$2.5 bn. for Malaysia, and the ASEAN Swap Arrangement (US$2 bn.)

e. US$/local (two-way) is US$/yen and US$/won in this case and analogous for other countries

- The CMI as a Policy Coordination Mechanism

As is currently structured, the CMI is a small regional source of financial assistance. And there is no guarantee that bilateral swaps will be activated in times of crisis. These deficiencies do not mean that the CMI is irrelevant. To the contrary, in addition to providing liquidity, it has been evolving into an important forum for policy dialogue and even coordination for regional financial stability that has been wanting in East Asia for a long time. Most CMI members are not likely to draw from the BSAs in the foreseeable future as they have managed to reduce some structural weaknesses of their financial systems through reform and more importantly they have amassed large amounts of foreign exchange reserves. At the end of 2007, the seven CMI members excluding Japan held more than $2.5 trillion in reserves. Table 2 provides the ratios of foreign exchange reserves to GDP. Some of these ratios are very large, possibly even excessive. We return to this issue below.

Table 2 Foreign Exchange Reserves in 2007 (% of GDP)

China	Indonesia	Japan	Korea	Malaysia	Philippines	Singapore	Thailand
47.2	12.7	20.1	26.9	54.1	21.0	103.1	34.7

Source: International Financial Statistics, IMF

Notes: Japan, Korea and Singapore: figures for 2006.

Now that they feel more secure and hence less in need for regional liquidity assistance, the ASEAN+3 members have turned to policy dialogue and coordination. They have institutionalized a peer review mechanism known as “Economic Review and Policy Dialogue (ERPD)” which assesses regularly the overall economic outlook of the region. They have also established an early warning system for crisis management and formal and informal channels of communication within the framework of the CMI for the exchange of information on significant market changes such as a large appreciation or depreciation of any regional currency caused by speculative capital inflows or outflows.

Regional cooperation may open other formal and informal channels of liquidity support in addition to the BSAs among the ASEAN+3 countries. For example, when Indonesia and the Philippines showed signs of financial strain in 2005, which was deemed contagious, ASEAN+3 policymakers considered short term public sector loans to serve as a first line of defense before activating the BSAs, although in the end these loans were not needed.

2.3. Enlargement and Multilateralization

Since its inception, the eight participating members of ASEAN+3 have gone through several rounds of discussion for enlarging the size and improving operational procedures of the CMI. The discussions have mainly dealt with the expansion of the swap amounts, increasing the limit of automatic drawing, and severing the linkage with the IMF. As pointed out in the previous section, the total size of the BSAs has been raised to $84 billion. Several members of the CMI had previously proposed that the 10% limit available without IMF conditionality be raised to 20 or 30 percent. The limit was lifted to 20 percent in 2005. The enlargement of the CMI membership to non-member countries, including Australia, New Zealand, and India, which have expressed interest in joining the CMI, has also been considered. Japan favors the inclusion of these countries, but at present, there is broad consensus that enlargement should be differed until some of the operational issues of the CMI are settled.

In redesigning the CMI the member countries have been mostly preoccupied with the creation of a multilateral surveillance system for the BSAs. Multilateralization has been of particular concern, because there is no guarantee that, under the existing system, the BSAs will be activated promptly, in time to support a member in need of short term liquidity. Some of the swap-providing countries could exercise their right to opt-out. Any country wishing to obtain short-term liquidity must negotiate the activation with all swap-providing countries individually. If a large number of the members refuse to provide swaps and different swap providers demand different terms and conditions, then the CMI may cease to be an efficient liquidity support system. Swap activation with multiple parties may take time and hence may deprive the swap requesting country of the ability to mount an effective and prompt defense against a speculative attack. In order to avoid this inherent bias in the system, it has been proposed to create a secretariat or committee that would determine joint activation of all swap contracts of the swap requesting countries, so that swap disbursements could be made in a concerted and timely manner (ASEAN+3 2005b). In 2006, at their 9th annual meeting (ASEAN+3 2006), the finance ministers of ASEAN+3 agreed to establish a collective decision-making mechanism or multilateralization for simultaneous bilateral swap activation.

However, the CMI members realize that neither the multilateralization of the CMI nor an increase in the drawing limit will be possible unless an effective surveillance system is established. This has been a controversial issue. As noted before, the working group assigned to produce recommendations for surveillance has not been able to produce a system acceptable to all members. Indeed, the member countries are divided on its role and structure. The bilateral swap arrangements, when activated collectively and supported by a surveillance system, can function as a de facto regional monetary fund and could lay the foundation for monetary cooperation and integration in the long run that follows in the footsteps of European monetary integration At this stage of development, it appears that at least some members of the ASEAN+3 are not prepared to restructure the CMI into an Asian Monetary Fund, an idea that was proposed by Japan in 1997 and quickly abandoned.

2.4. CMI and the European Experience

The CMI sharply differs from support arrangements in Europe before the creation of the monetary union in 1999. These arrangements evolved over time, mainly starting after parity changes in France, Germany and the UK in 1967-9. The first step was the setting up in 1970 of Short Term Monetary Facilities (STMF). The six members of the European Community pledged to lend each other, on demand, pre-declared amounts. Medium and very short-term facilities were added in 1972. These arrangements resemble the CMI with the important difference that the facilities were not bilateral; each country's pledged amounts were available to all other countries, up to some quotas. Real reserve pooling took the form of the European Monetary Cooperation Fund (EMCF), which in effect collected the funds pledged under the Very Short Term Facility agreement. The Fund was set up as an independent body managed by the central bank Governors. In addition to administering the funds, the Governors were meant to harmonize their policies, an arrangement that supposed some surveillance. In the end, the EMCF never really functioned. The amounts were small and the Governors displayed no willingness to exercise surveillance over each other.

The EMCF was meant to underpin the "European Snake", in existence between 1973 and 1978. The Snake called for exchange rate stability but it relied on individual governments to enforce self-declared parities vis-à-vis the US dollar. The inability of the EMCF to function led several countries to withdraw from the Snake, which convince European policymakers that a tighter arrangement was required. This explains the key feature of the ERM:

- Parities were set bilaterally, not vis-à-vis the US dollar.
- Parities had to be agreed upon by all members, and included an explicit margin of fluctuation of +/-2.5% (which extended to +/-15% in the wake of the 1992-3 crisis).
- Any time a bilateral exchange rate reached its limit of fluctuation, both countries were bound to intervene, and to do so in unlimited amounts.

- If one country felt that the bilateral parity under stress could not be upheld, it had to secure an agreement with all other countries to adjust the parity.

Thus, the CMI bears some resemblance with the STMF and the EMCF, which never played much of a role, but not to the ERM intervention mechanism, which has been effective.[6] To start with, the motivation is different. The ERM aimed at limiting bilateral exchange rate fluctuations, initially under capital account restrictions, while the CMI started with high capital mobility and flexible exchange rates, although some members of ASEAN+3 have maintained a relatively fixed exchange rate regime. In the absence of exchange rate coordination, incentives for mutual surveillance are limited since a member country facing a speculative currency attack is free to float its exchange rate (Wang and Woo 2004). In addition, the principle of unlimited mutual support under ERM contrasts with the East Asian view that the size of the swap does not have to be large enough to meet the potential liquidity need because they are supplementary to IMF resources. Yet, the European evolution from arrangements in the spirit of the CMI to the much tighter ERM may suggest that ASEAN +3 will eventually follow a similar path.

The ASEAN+3 countries are following a path not entirely different from Europe. They explicitly link a multilateralization of reserve pooling to surveillance, as did Europe when moving from its financing facilities to the EMCF and to the ERM. What is currently missing in Asian plans, though, is an anchor for surveillance. In Europe, the anchor was the fixed and adjustable exchange rate system. The requirement that every country's exchange rate be accepted by the other countries implied an in-depth discussion of many parameters such as inflation, monetary policy, production costs, the current account, etc. The debate was not whether national policies were "right" or "wrong", but whether they were compatible with the exchange rate regime and which parity was justifiable. In the absence of a criterion, such as the exchange rate anchor, surveillance inevitably involves value judgments. Interestingly, cooperation within the ERM was natural because the currency parities were fixed internally, not vis-à-vis the dollar.

[6] During the 1992-3 crisis, the Bundesbank refused to be dragged into unlimited support. This was the first and only failure of the mutual support agreement. The new ERM, put in place after the launch of the euro, does not include an unlimited support system.

2.5. CMI Multilateralization: Self-Managed Reserve Pooling Arrangement (SRPA)

In recognition of the structural deficiencies of the BSAs, ASEAN+3 began a review of the system to develop a more effective multilateral framework of regional liquidity support in 2005. The proposal for multilateralization that was approved at the 9th meeting of finance ministers in 2006 has culminated in the conversion of BSA bilateral contracts into a single contract informally known as a common fund or a self-managed reserve poling arrangement (SRPA). At their 10th meeting held in Kyoto, Japan, the ASEAN+3 finance ministers "agreed in principle that a self-managed reserve pooling arrangement governed by a single contractual agreement is an appropriate form of multilateralization" of the existing swap system (ASEAN+3, 2007a). They also agreed to carry out further in-depth studies on the key elements of the multilateralization including surveillance, reserve eligibility, size of commitment, borrowing quota, and activation of a new system. For these studies a task force was established in November 2006.

The SRPA, which is meant to replace the BSAs, essentially replicates the model of reserve pooling of the European Monetary Cooperation Fund (EMCF) previously described. From the Asian perspective, the innovation of the SRPA is that it is meant to be legally binding and enforceable contract, which would give effective protection to participating members. Even when finance ministries or the central banks manage the system, unlike the BSAs, the new reserve pooling system would require a single contractual agreement to be governed by a third country's law so as to make it a multilateral arrangement.

Constructing an efficient system of surveillance would be crucial to garnering public credibility of the SRPA. For them to contribute sizable amounts to the fund, the ASEAN+3 countries need reassurances that moral hazard will be contained. Unless an effective system of surveillance is established, there is the danger that the SRPA may not serve as an efficient liquidity support system. In Europe, surveillance was, in principle, to be exercised by the central banks' Governors. The pooled reserve amounts were probably too small to overcome the Governors' distaste for surveillance. This suggests that the circle can be virtuous or vicious. In a virtuous circle, large amounts of reserves are pooled together, which provides an incentive for effective surveillance and eventually makes the system effective. This is why the ERM worked in Europe. The EMCF failed because it was caught in a vicious circle of small reserve commitments, no surveillance and, therefore, a strong reluctance to make the system operational for moral hazard reasons.

At the 11th meeting of finance ministers in Madrid in May 2008, some of the features of the SRPA, such as the size, the respective shares of the members, the modality of decision making, and terms and conditions of borrowing were formalized (ASEAN+3 2008). On other issues, such as the borrowing accessibility, the activation mechanism, custody and surveillance, the ministers could not reach consensus and decided to wait for recommendations to be made by a task force. The size of the pooled reserves was agreed to be at least \$ 80 billion with the 20 and 80 proportion of the amount of contribution between ASEAN and Plus Three. The shares of individual countries will be determined through negotiations among the members belonging to the two respective groups.

The ASEAN members agreed in principle that the maximum amount of borrowing in US dollars against collateral in local currency could be equal to a multiple of the member's contribution to the pool. However, the exact figures remain undecided, except that multiples are likely to be higher for the ASEAN members than the Plus Three. On the pooling structure of reserves, four options have been proposed: 1) pooling of investment assets; 2) cash contributions to the SRPA in return for a claim on the arrangement; 3) pooling of promissory notes to be issued to the ADB or ASEAN secretariat which acts as an administrator; 4) pooling in a single global custodian. As for the conditions and covenants of borrowing from the pool, ASEAN+3 has decided to adopt those of the BSAs. They will also retain the 20 percent IMF rule. On the decision making process, the members appear to be divided between a majority and unanimity rule when making management decisions. They are likely to adopt a consensus base rule on important matters such as lending, but other routine management issues could be decided by majority rule. There are two critical issues on which the members have not been able to obtain consensus: the pooling structure and surveillance. On the poling structure, they are debating the feasibility and relative merits of two options: pooling of promissory notes and pooling in a single global custodian.

As previously emphasized, surveillance has been a major concern ever since the establishment of the CMI. It has become critical with the introduction of the reserve pooling arrangement. Despite much discussion, the members have not been able to agree on a modality of surveillance. At present ASEAN+3 relies on informal surveillance conducted through ERPD when finance ministers and their deputies meet (once a year for the ministers and twice a year for their deputies). The ERPD will serve as the normal mechanism for monitoring and for exchange of information, but when a request for borrowing is made by a member, it will be decided by other members either by a majority or unanimity rule. There will be more ERPD meetings and more standardized information and data will be shared among the members. Obviously, this type of peer review and informal exchanges on policy coordination will not be sufficient. The member countries have no intention of setting up an independent surveillance, but could not agree on the extent to which they are going to rely on the IMF and other IFIs for surveillance.

The SRPA has a tiered sharing arrangement. Given their large economic size and reserve stocks, China and Japan will be the two largest contributors to the arrangement. Since these two countries are not likely to borrow from the reserve pool, there will be a clear line of demarcation between potential lenders and borrowers. China and Japan will be lenders and four ASEAN members – Indonesia, Malaysia, the Philippines, and Thailand – are potential borrowers, while South Korea and Singapore can be either lender or borrower. As the two major contributors, therefore, cooperation between China and Japan, which has been wanting in recent years, will be crucial to a successful launching of the SRPA.

Would the $80 billion reserve pool will be enough to make it a credible liquidity support system? Would it not be dismissed outright by the market as its size is so small compared with the total amounts of foreign exchange reserves held by the ASEAN+3 members? More generally, when markets can take huge position, is the pool likely to deter speculative attacks? Answers will not be known until the SRPA is subject to market tests in the future. However, as noted earlier, the ASEAN+3 members are going to increase their contributions as they have done with the BSAs and at present may not need a large regional liquidity support system.

Because of their small size and complicated activation procedure, the BSAs have been very much ignored. The new system could well meet the same fate. As long as the reserves remain under respective members' custody and management instead of being centrally managed by an independent third party, the activation mechanism becomes crucial. The mechanism under discussion does not appear to be a major improvement on that of the BSAs. This raises concern that liquidity will be no more readily available than it was the case with the BSAs. Furthermore, to be helpful, the new facility needs to raise the maximum amount a member can draw well above the level of the BSAs. It may be necessary to include an opt-out clause but this clause should only be available under exceptional circumstances. If the IMF link were to be maintained, precise and transparent agreements between the IMF and ASEAN+3 would need to be spelled out.

The new system signals a desire to deepen financial and monetary integration through an advanced institutional structure. Few details are known about and how long it will take to construct an operational framework. The shortcomings of the BSAs have long been well known, but what is not known is how effective they can be because the system has never been activated. ASEAN+3 are introducing a new system without having had the opportunity of learning the advantages and drawbacks of the bilateral swap system.

Europe's multilateral EMCF was too limited to be effective. Even though it represents an undeniable progress, the SRPA is even more limited. In today's world, to be credible to the markets, available reserves must be considerably larger than in the 1970s when most European countries imposed tight capital account restrictions. The reserves, which were deposited with the BIS, were not managed nationally but by the EMCF Board, composed of the central bank governors. Even if some surveillance is accepted within the SRPA framework, much like it was the case with EMCF, the lack of an anchor around which surveillance can be conducted is likely to undermine the whole construction.

In the end, it seems that the SRPA is not designed so much as a regional liquidity assistant mechanism as it is a regional forum for policy cooperation. Now that the original CMI has been restructured into a multilateral system, it will become a more effective forum for regional cooperation and policy coordination in the future.

3. Asian Bond Markets Initiative

3.1. Origins

Since the 1997-98 East Asian crisis, many countries in the region have given priority of financial reform to developing domestic capital markets as part of the strategy to diversify their bank-based financial systems. Underdevelopment of both domestic and regional bond markets are often argued to have exacerbated capital outflows, thereby deepening the crisis and multiplying the loss of output and employment during the 1997-98 financial crisis. For instance, one year after the crisis, Donald Tsang, then the financial secretary of the Hong Kong Special Administrative Region (SAR) of China, cited the failure to establish a strong and robust Asian bond market as a key reason for the turmoil. His question, "How is it that we in Asia have never been able to replicate the success of the Eurobond market in this part of the world?" hit a raw nerve.[7] Since then, the development of local bond markets has been one of the major objectives of financial reforms proposed by the IMF, World Bank, and the Asian Development Bank (ADBI 2002).

While there is a clear need to develop domestic bond markets in the region, smaller economies may not have developed the capacity to support efficient domestic capital markets that are broad and deep in terms of the variety of financial instruments, issuers and investors. Even to more advanced economies, the inertia and large costs of constructing market-supporting infrastructure may prevail on staying with the bank oriented system rather than investing in the capital market. To overcome these efficiency and cost problems of fostering domestic capital markets, repeated calls have been made for East Asian countries to join forces to develop larger and more efficient regional capital markets[8]. The question is how to proceed.

The ASEAN+3 took up the challenge of constructing regional bond markets by launching the Asian Bond Markets Initiative (ABMI) in 2003. For the promotion of a new initiative, ASEAN+3 organized six working groups on a voluntary basis to conduct detailed studies on the construction of market infrastructure: a clearing and settlement mechanism, credit guarantee institutions, and credit rating agencies- and creating new debt instruments including bonds denominated in local currencies issued by foreign government agencies, multilateral development banks and multinational corporations.

7 See Tsang (1998). It has also been asserted that the absence of broad local bond markets has in part been responsible for the massive increase in the region's overseas portfolio investment(ASEAN+3). For example, Kuroda (2005) also claims that developing efficient domestic bond markets in Asia will reduce the global imbalances by ensuring that more of Asia's savings are invested in the region.

[8]There has been some confusion concerning the definition of Asian bond markets or Asian regional bond markets. As the term is used in the ABMI and other documents of ASEAN+3 it does not necessarily refer to new off-shore regional bond markets to be created in Asia, although one of the objectives of the ABMI is claimed to create regional bond markets(ASEAN +3 2004) or an international bond market in the region (ASEAN+3 2006). In general, it is a collective term for domestic bond markets of East Asian economies, some of which may already serve or have developed into regional financial centers for bond trading and listing.

The first progress report of the six ABMI working groups presented to the 8th meeting of the ASEAN+3 finance ministers in Istanbul in May 2005 (ASEAN+3 2005) suggests that most of the groups did not make any headway in their studies and were in need of new directions. In order to sustain the momentum for the ABMI, the ASEAN+3 finance ministers introduced a roadmap. As part of the roadmap, two new studies were launched: one was on Asian Bond Standards, which was to identify necessary market infrastructure and introduce market procedures comparable to those of global bond markets, and the other on the possible issuance of Asian currency basket bonds. They also endorsed a new research area which would "collectively look at capital flow liberalization and institutional arrangements" (ASEAN+3 2005).

By the time of the 9th meeting in Hyderabad in May 2006 the six working groups had been reorganized into four engaged in the development of the market infrastructure-credit guarantee and investment mechanism, settlement system, credit ratings, and the Asian Bond Standards. In the following 10th meeting in Kyoto in 2007, several new studies were endorsed, which included exploring new debt Instruments for infrastructure financing, promotion of securitization of loan credits and receivables, and promotion of Asian medium term note (MTN) program. By then, however, there was growing recognition that after four years of studies, proposals, and numerous official meetings for the development of regional bond markets the overall progress in the ABMI did not meet the initial expectations and the initiative was in need of new directions and renewed commitment on the part of the of ASEAN+3 leadership. This recognition led to the promulgation of a new ABMI roadmap at the 11th meeting in Madrid in May 2008, which created four task forces on "(1) promoting issuance of local currency-denominated bonds, (2) facilitating the demand of local currency-denominated bonds, (3) improving regulatory framework, and (4) improving related infrastructure for the bond markets" (ASEAN+3, 2008).

As far as the ABMI is concerned, market liberalization and opening is a necessary condition to fulfill Donald Tsang's vision, but it is not enough. Also needed is a system of clearing and settlement, credit guarantee institutions, harmonization of legal and regulatory systems, hedging facilities, and regional credit rating agencies. If individual Asian countries compete to attract a regional financial center, bond markets in East Asia will remain separated from global financial markets. Unless their linkages with global financial markets are diversified and strengthened, Asian bond markets will not become efficient enough to compete on a global scale.

3.2. What Are Asian Bond Fund I and II?

The eleven central banks of East Asia and Pacific belonging to EMEAP (Executive Meetings of East Asia and Pacific Central Banks) have launched Asian Bond Fund (ABF) I and II.[9]

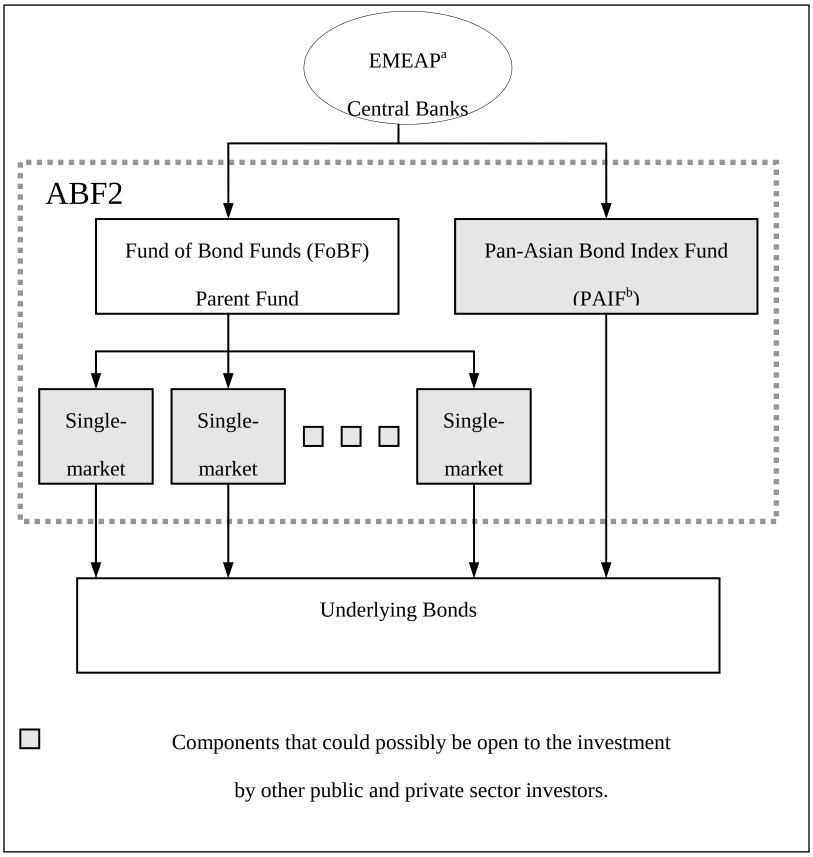
While ASEAN+3 has been primarily engaged in constructing market infrastructure for Asian bond markets and harmonizing various financial standards, regulatory systems, and tax treatments throughout the region, EMEAP has taken the initiative of creating funds that invest in bonds issued by Asian governments and corporations. ABFI and ABFII were intended to serve as low-cost catalyst for domestic financial reforms in Asia.

Announced in June 2003, ABF I is mandated to invest in dollar-denominated Asian sovereign bonds whereas ABF II invests in Asian bonds denominated in local currencies. The EMEAP central banks invested in ABF I at its launch, which had a capitalization of US $1 billion. The initial subscription has been fully invested in bonds issued by sovereign and quasi-sovereign issuers in eight EMEAP economies (China, Hong Kong, Indonesia, Korea, the Philippines, Malaysia, Singapore and Thailand). Introduced on December 16 2004, ABF II consists of two components: a Pan-Asian Bond Index Fund (PAIF) and eight country sub-funds (see Figure 1). The PAIF is a single bond index fund that invests in the eight EMEAP economies previously mentioned. It also serves as a parent fund for sub-funds.

ABF I has had relatively little effect on the market for East Asian sovereign dollar bonds, since non-EMEAP investors are precluded from investing in it. With $2 billion in capital, ABF II could have more impact. The ABF II funds are passively managed against a set of transparent and pre-determined benchmark indexes. In 2005, the PAIF and the single-market funds of Hong Kong, Malaysia, and Singapore were listed. The remaining five single-market funds were offered to the public in the first half of 2006.

9 The central banks of Korea, China, Japan, Hong Kong, Singapore, Thailand, Malaysia, the Philippines, Indonesia, Australia and New Zealand.

Figure 1 Asian Bond Fund II



Notes: (a) Executives' Meeting of East Asia-pacific Central bank; (b) Pan-Asian Bond Index Fund

3.3. Rationale for the ABMI

The under-development of bond markets and the resulting excessive dependence on bank-intermediated and foreign short-term financing were seen as major causes of the 1997-98 crisis. Several bond markets already existed in East Asia. In theory, East Asian corporations could raise resources in other countries of the region, including Samurai bonds denominated in yen or Shogun bonds denominated in a foreign currency and issued in Japan, but these markets never really took off. Furthermore Singapore had actively sought to develop a corporate bond market to allow foreign entities to issue Singapore-dollar-dominated bonds. Hong Kong had taken the lead in organizing an Asian clearing and settlement networks by linking its system with those of other countries in the region, which strengthened its status as a regional financial center.

In spite of considerable progress since the crisis, by 2003 Asian bond markets still lagged in both breadth and depth. The huge current account surpluses that followed spurred demand for financial instruments, especially bonds. In the absence of deep bond markets in the region, a substantial portion of savings have been invested in bonds denominated in major foreign currencies. This pattern was inherently unstable. Fund flows out of Asia were often recycled back into regional institutions managed by foreign financial intermediaries, mostly as equities and derivatives, which are more volatile instruments than bank lending or debt financing. These foreign financial intermediaries are usually large international financial institutions with considerable market power and influence because of the volumes they can mobilize relative to the size of emerging economies' financial markets. When the market is under duress, they can "push" prices in a particular direction. The implications for the emerging markets are market volatility, a strong tendency to overshoot, and consequently, daunting challenges to maintaining monetary and financial stability. There is no reason, however, to believe that the Asian bond market will be immune to these problems.

An additional motivation has been the need to develop the capacity to support efficient domestic capital markets that are broad and deep in terms of the variety of financial instruments, issuers and investors. Constructing market-supporting infrastructure is often hampered by inertia and large costs. Joining forces to develop larger and more efficient regional capital markets has been seen as the way to overcome these obstacles.

As we will see in Section 3.6, this strategy faces serious limitations. A natural question is why there has never been such an endeavor in Europe. One reason is the maintenance of capital controls until very late in the integration process. With few exceptions, most countries in effect bottled in national savings. This allowed the development of local financial markets with instruments denominated in the local currencies. Capital controls were often accompanied by – explicit or implicit – domestic financial repression, which reduced the role of financial markets and led to a large intermediation role for domestic banks, in the absence of competition in that sector. As a result, there was little financial instability and no currency mismatch. Obviously, there must have been a cost in term of allocation efficiency, but it was invisible. It is only in the late 1980s that these restrictions were very gradually lifted. This came as a result of a coordinated effort – the Single Act of 1992. In sharp contrast with the ABMI, the effort concentrated entirely on lifting national restrictions, with no common market-building ambition, at least until the Single Act was signed.

3.4. Institutional Aspects

It was always expected that the ABMI would have to overcome many institutional hurdles so that laying the foundation for an integrated regional bond market in East Asia would be painstakingly slow. After five years of efforts, the momentum for market building is slowing down. Except for the agreement to create a Credit Guarantee and Investment Mechanism (CGIM) as an in-house organization of the ADB and the plan for establishing a settlement mechanism known as Regional Settlement Intermediary (RSI), other proposals such as Asian Financial Forum for regional monitoring of financial supervision, Asian Bond Standards and long term development strategies for the ABMI are slated for further study and discussion. One reason for the slow progress is the failure of the ABMI architects to articulate the structural characteristics and ultimate objectives of the markets that they propose to create, along with a lack of leadership. Many small member countries have been indifferent to the ABMI as benefits from constructing regional bond market are rather abstract to them. It is not clear either which country, or group of countries, has the moral authority, influence, and money to lead the region-wide financial reform and the construction of a regional financial infrastructure.

Few of East Asian economies are able or prepared to issue bonds denominated in their own currencies on global or even regional bond markets. Many still do not allow non-residents to hold large amounts of their currencies for fear that it could erode their control over monetary policy and make them susceptible to currency speculation. This illustrates the difficult relationship between financial integration, the exchange rate regime and mutual support. The European approach has been easier because each country gradually developed its own financial market, which attracted foreign investors while, in parallel, monetary cooperation was being developed. Monetary cooperation is only meaningful if it affects the outcome, which means that decisions are different from what they would have been absent cooperation. In other words, meaningful cooperation means that some independence is lost. Once the EMS was in place, national central banks were already constrained, with only margins of flexibility: the ability to devalue/revalue within the ERM – subject to collective approval – and some capital controls. Most Asian countries fiercely resist any restriction to monetary policy autonomy, implicitly refusing meaningful cooperation.

As also shown by the European experience, even with a common currency, financial integration can be derailed unless market distortions are removed and practices in different countries are harmonized. For this reason, the emergence of a regionally integrated market in East Asia is a long-term prospect that is at best uncertain.

Another development is the emergence of regional trading centers for Asian bonds as a number of countries open their bond markets to foreign borrowers and investors. Japan, Hong Kong, China, Singapore, and Korea all have plans to develop regional markets in their own currencies. We may well observe the development of several bond markets with regional ambitions but differentiated by the currency denomination (yen, Singapore dollar and Hong Kong dollar).

Along with the growth of onshore bond markets, a number of offshore regional bond markets may also become new sources of bond financing in East Asia. These off-shore markets are likely to resemble the old Euro bond market. New or already existing off-shore regional bond markets may become deeper and wider as financial market deregulation and opening permeate through East Asia. Bonds issued in these markets are likely to be denominated in major international currencies and some of the currencies of the East Asian countries with open domestic bond markets. Issuance of Asian bonds in these off-shore bond markets are likely to be private placements offered by underwriters via dealers to institutional and private investors. These offshore bond markets will be subject to little regulation from host regulators and withholding income taxes. Disclosure, likely to depend on the prominence of the issuers, is likely to remain less stringent than on the onshore markets.

It is not clear which markets will survive the ongoing competition to become major trading centers for Asian bonds. In view of the European experience, it appears that countries with deregulated and open financial markets and with an efficient system of payment and settlement will win over. At present, the requisite infrastructures for regional bond market hardly exist and it may take years to build them. Cooperative efforts to integrate different local clearing and settlement systems are needed, but may not be easily organized and may not succeed even if they are organized.

3.5. The Role of Central Banks

At present there is no shortage of demand for high quality Asian sovereign bonds denominated in Asian currencies. This means that both the PAIF and its country sub-funds are competing against private and institutional investors for a relatively limited supply of these instruments. Because of its small size, ABF II is not a major market player, and hence does not pose any serious crowding out problem. However, if the EMEAP builds up the size of the investment portfolios of both the PAIF and the country sub-funds as it plans to do, the probability of squeezing out private investors will increase in the future.

EMEAP (2006) reports that both the PAIF and the country-sub-funds have invested in local currency sovereign bonds of Indonesia and the Philippines with a rating below the minimum investment grade that private and institutional investors might not normally include in their portfolios. This investment strategy raises the question of prudence in central bank reserve management. Although the EMEAP central banks are not directly involved in managing ABF II, they may be viewed as taking undue market risk even if investment in Indonesian and the Philippines bonds is currently seen as safe. The planned increase in size of ABF II may raise concern that the participating central banks hold risky assets in their reserve portfolios. If indeed it is acceptable for EMEAP to invest, albeit indirectly, in non-investment grade bonds, then the EMEAP needs to answer the questions of whether it is equally acceptable for its member to do the same individually and if so, what the prudent share of these speculative bonds in their total reserves is. In addition, if demand is substantial, EMEAP will compete with private investors. Then if the risky bonds are not marketable to private and institutional investors, then the EMEAP central banks may end up subsidizing non-investment grade issuers.

Insofar as ABF II invests in East Asian sovereign bonds denominated in local currencies, it may serve as a vehicle of mutual financing of fiscal deficits among the EMEAP members. If ABF II grows to be of considerable size, ABF II investment operations will be carefully monitored by the markets, which is bound to affect the foreign exchange and interest rate policies of the eight EMEAP member countries where ABF II operates. Even if the amount of a sale or purchase is relatively small, the operations of the PAIF and its country funds may send wrong signals to the financial markets against the wishes of the EMEAP central banks. A solution would be for a private institution to manage the funds, but this would not fully eliminate the signaling problem as long as the central banks retain a controlling stake.

Finally, central banks’ investments in the bond funds ought to be considered as foreign reserves. Since these instruments are illiquid, central banks cannot invest too large amounts in ABF II. The future growth of ABF II would then depend on its attractiveness as an investment vehicle to institutional and other private investors.

Despite these concerns, the EMEAP member central banks could contribute to the development of Asian bond markets, if they used the ABF II leverage to strengthen the regional financial infrastructure and to remove institutional constraints on the supply of high-grade Asian corporate and sovereign bonds as well as existing restrictions on cross border investments. In evaluating the performance of ABF II, the EMEAP emphasizes that one of the objectives of the bond fund is indeed to promote financial integration in the region. It further claims that, despite its relatively short history, ABF II has been a catalyst for the deregulation and opening of local bond markets in several member countries (Ma and Remolona 2005 and EMEAP 2006). Many pieces of evidence, most of which appear to be rather anecdotal, have been presented to substantiate the claim, but, given the small amount of ABF II investment in designated countries, it is unclear whether and to what extent the ABF II initiative has had a serious influence.

The amount of ABF II investment for a given local market is determined by such factors as the market size, turnover rates, and credit ratings, which carry a 20 percent weight each, and the market openness, which receives 40 percent. This weighting scheme suggests that the investment strategy of ABF II favors financially open economies. This may encourage bond market opening in EMEAP's emerging member economies, but it may also be criticized for being biased against financially underdeveloped members, which may not have the ability to manage and speed up the needed reform. While few would object to the EMEAP efforts, they could be more effective if coordinated with similar programs of other regional institutions such as the ASEAN+3 and its member governments, and tailored to take into account the structural constraints of the targeted countries. This is important because normally central banks are not directly involved in formulating or implementing financial reform.

There has been no similar central bank involvement by central banks in Europe. The only similar institution is the European Investment Bank (EIB). Initially, the EIB was designed along the lines of the World Bank: it borrows on most favorable terms on international banks because it benefits from government guarantees, which allows it to lend at attractive rates. Over time, it has shifted its lending to non-European countries, becoming an aid instrument. It was never in its mission to foster the development of financial markets. As for central banks, they have always invested their reserves in safe US dollar-denominated short-term instruments. On the other hands, European central banks have long been involved in the regulation and supervision of their domestic markets. It was always felt that this function ruled out the kind of involvement assumed under the ABMI, precisely to avoid the difficulties raised in this section.

3.6. Objectives and Misconceptions

From the beginning, the ABMI has suffered from a lack of clarity of its objectives.

Although the bond suppliers are meant to be mostly borrowers from East Asia, the buyers include global as well as regional investors. Because of this global investor base, Asian bond markets will not be geographically segmented markets: they will inevitably be linked up with global bond markets. This observation underscores confusion between Asian bond markets and international bond markets. ABMI and other documents of ASEAN+3 indicate that the aim is to create both regional bond markets (ASEAN +3, 2004) and an international bond market in the region (ASEAN+3 2006). Some domestic bond markets already serve or have developed into regional financial centers for bond trading and listing. The continuing globalization of financial markets and advances in financial technology, which allow financial firms in international financial centers to reach investors and borrowers in remote corners of the world, raise questions as to the need and rationale for creating regional capital markets.

It is also true, however, that given the dynamism of the East Asian economy and its enormous pool of savings, the region could accommodate large and efficient markets. As noted earlier, ASEAN+3 has been involved primarily in building institutions such as regional credit agencies, cross-border securities borrowing and lending mechanisms, credit enhancement and guarantee agencies, clearing and settlement systems, a centralized depository system, and exchanges and over-the-counter bond markets. In addition, the six working groups are devising plans to harmonize various financial standards, regulatory systems, and tax regime throughout the region.

However, cooperative efforts must not be undermined by institutional weaknesses and regulatory controls at the national level. A lack of professional expertise in the securities industry, inadequate financial and legal infrastructure, low accounting and auditing standards and opaque corporate governance are pervasive. Unfortunately, these issues are not addressed because they are considered as internal affairs.

One hoped-for effect of the ABMI is peer pressure to speed up financial reforms. Withholding tax must be harmonized. A bewildering array of controls over domestic capital markets and market practices that stand in the way of cross border investment remain to be removed. Some indirect evidence to that effect is provided in Table 3 below. The Chinn-Ito index includes several dimensions of restrictions to capital mobility; it shows a wide gap between Singapore, which is free from restrictions, and Korea and Malaysia, not to mention China.

Table 3 Chinn-Ito Index of Restrictions to Capital Account Openness

China	-0.44
Indonesia	0.47
Japan	0.79
Korea	-0.04
Malaysia	-0.04
Philippines	0.06
Singapore	1.00
Thailand	-0.04

Source: Chinn-Ito (2007) and authors' calculation.

Note: The index, which averages 0 for the whole world, has been rescaled to be 1.0 for the most open countries (e.g. the US, France, the UK, etc.).

Unfortunately, the rhythm of financial reforms, which began after the 1997 crisis, is slowing down. In fact, several countries are relapsing into old practices and outmoded financial policies. Another objective, which has been seldom mentioned, is that the ABMI and CMI can reinforce each other. If the CMI can be developed into a mechanism for stabilizing bilateral exchange rates, it will facilitate financial market integration by reducing exchange rate risks.

ASEAN+3 has so far skirted around these critical reform issues, engaging instead in rather peripheral matters such as the creation of regional credit rating and credit guarantee institutions and diversification of bond instruments. Despite many studies on impediments to cross-border bond issuance and investment, results and reform recommendations have not been taken up.

On these issues, Europe has followed a radically different path. As noted before, the Single Act was designed to enhance the openness of all domestic markets, including the financial markets. In the area of openness and competition, in principle, there are no internal affairs in Europe.[10] A first consequence is that national bond markets have been brought into direct competition with each other and with world markets. The presence of large returns to scale has led to several rounds of consolidation. The Amsterdam, Brussels and Paris markets have formed Euronext, which has recently been merged with

[10] "In principle", since services have remained largely outside the Single Market purview. This includes banking services, despite numerous efforts by the European Commission.

the New York Stock Exchange. Unsuccessfully so far, Frankfurt has tried to merge with London, and such an evolution may be unavoidable. A second consequence is that national authorities have had every incentive to implement the best possible regulations and that tax regimes must be efficient. For instance, to compete with the German Treasury papers (Bunds), which have become the euro area benchmark, the French Treasury has become very innovative in recent years, floating indexed and very long term notes that are becoming benchmarks as well. Thus, by agreeing to open their markets, the European countries have relied on market forces to drive the reforms on national markets, solving the problems that are likely to undermine the ABMI.

3.7. Assessment

In retrospect, it appears that the objectives have not been defined clearly enough, which has led to a number of misconceptions. It remains, in particular, to articulate precisely what is a regional or an international bond market. Is the intention to create an offshore bond markets like the old Eurobond market or to transform some existing on-shore domestic bond markets into regional financial centers where Asian bonds are issued, listed, and traded? Will these regional bond markets be distinct from the existing ones or from the planned global bond markets? In an increasingly globalized financial system, domestic and regional bond markets will eventually have to be integrated into the global bond markets in Europe and the US. It can be argued that a first step should be to integrate existing domestic bond markets into the global markets instead of going through the round-about way of creating regional bond markets. If this is not feasible, ABMI advocates need to explain why. They also fail to specify whether regional bond markets are meant to be integrated into the global financial system.

Second, it is often felt that the global bond markets cannot meet the financing needs of Asian governments and corporations. Indeed, these markets have not done much to identify credit-worthy East Asian borrowers and to help them issue local and foreign-currency denominated global bonds. A possible explanation is the existence of a large number of restrictions on bond issuance and trading that have seriously limited the access of many East Asian borrowers to the global bond markets and of global investors to East Asian domestic and regional bond markets. These restrictions are also largely responsible for the narrowness, shallowness, and illiquidity of East Asia's domestic and regional bond markets. ABMI advocates still have to explain why East Asian borrowers whose low credit ratings preclude them from issuing investment-grade bonds denominated in their own currencies in the global bond markets would be able to do so in regional bond markets, unless they are proposing the construction of high-yield (junk) Asian bond markets.

In addition, ABMI advocates argue that Asian savers and investors rely much more on regional markets than on global financial markets. Indeed, a substantial portion of Asian savings is invested in short-term foreign government bonds, only to be recycled back by selling risky assets to finance Asian investment. Importing safe assets and exporting risky short-term assets could make the region vulnerable to speculative attacks, thereby increasing the likelihood of the recurrence of financial crisis because of the resulting currency mismatch (Rhee 2000 and Tsang, 1998). Currency mismatches are an undeniable source of vulnerability. Yet, many other countries are also subjects to currency mismatch and do not face crises. In the end, there is no substitute to sound macroeconomic policies.

It is also argued that the channeling of practically all official reserves from Asia to developed markets is both a consequence and, albeit to a lesser degree, a cause of the underdevelopment of the Asian bond market. But it should be also pointed out that much of the reserve accumulation has been for self-insurance. The ASEAN+3 countries collectively hold more than USD 3.5 trillion in reserves, the bulk of which is invested in US short-term Treasury and agency securities. Some of these reserves, it is claimed, could be used to finance Asian investment, with better returns, at a time when East Asian borrowers pay high interest rates. If they are used for domestic investment financing then the ASEAN+3 members will be risking appreciation of their currencies and hence losing export competitiveness

The Asian and European approaches differ in many ways. The Asian approach can be described as regional-defensive. It aims at strengthening bond markets in the region, but without interfering with national sovereignty. It is, partly at least, motivated by the currency mismatches that triggered the 1997-8 crisis. This legacy means that the building up of regional markets is seen as a defense against currency instability, which explains the involvement of central banks. This involvement, in turn, is the source of many ambiguities regarding foreign exchange reserve management, exchange rate policy and the usual arm-length relationship between central banks and financial markets.

In contrast, the European approach has gone through three phases. First, financial repression, both domestic and internal, has led to the development of (often distorted) local markets in local currencies, which eliminated the currency mismatch problem.

Then, market opening in the late 1980s, mandated by the Single Act, has brought national markets into direct competition, including regulatory competition. Harmonization efforts now follow in an effort at establishing a European level-playing field. Thus, European bond markets have become spontaneously part of the global market once the restrictions were lifted. This has not prevented some national attempts at promoting local markets, but these efforts could only take the form of the search for the most efficient regulatory environment since the referee was the global market itself. In Asia, on the other hand, the combination of a process driven by the authorities and of an unwillingness to agree on binding harmonization measures, competition does not automatically lead to the elimination of politically-motivated inefficiencies.

A question of interest to East Asia is what triggered the market opening in Europe and what form did it take. One reason for opening, which is even more powerful today, is the world evolution towards large and effective financial markets. Many European countries did not want to be left out, even though domestic lobbies were clearly opposed to the move. Another reason is that financial opening was cast within the overarching framework of the Single Market. The European Commission could argue that financial markets ought to be treated as other markets. While being part of the expanding world financial markets is a clear motivation behind the ABMI, there is no Single Market and no Commission in East Asia.

The main conclusion, therefore, is that Asian efforts at developing regional markets through government-led institutional efforts are likely to be disappointing. Assuming that they manage to adopt a common set of regulatory practices designed to increase capital flows within the region, either these practices are compatible with global markets and the local markets will become parts of the global markets, or these practices end up being restrictive and they will develop secondary local markets, losing market shares to the global markets. Europe, instead, has relied on a market-driven process to develop its markets, which are now fully integrated in the global markets.

The remaining issue concerns harmonization. European financial markets were opened to world competition, without fully harmonizing at the regional level. Implicitly, the hope of several countries was that they could build up their own financial center to become the regional center. This was a natural approach because market structures and regulations differed significantly from one country to another. In particular, the financial markets on the continent were smaller and in many ways different from London. As it turned out, even though the UK did not adopt the euro, financial integration and the monetary union benefited London. As a consequence, while it was initially seen as a strategic instrument to promote domestic markets, non-harmonization came to be seen as an impediment to build a center able to take on London and the other major centers around the world. East Asian countries are following a similar track; there is no reason to doubt that they will eventually reach the same conclusion.

4. Asian Currency Unit[11]

4.1. Origins

One way or another, the Chiang Mai and Asian Bond Market initiatives are designed to foster currency stability. The CMI is meant to provide a collective line of defense against currency turbulence; the ABMI aims at reducing currency mismatches and at building deep and resilient markets, which should reduce both the frequency and impact of financial disturbances. Yet, neither initiative directly promotes monetary cooperation in contrast to the ERM, and *a fortiori* EMU. In many ways, the Asian countries have focused on treating the symptoms, not the cause of currency instability.

Aware of this limitation, the ASEAN+3 countries agreed in 2006 to explore steps to create regional currency units (RCU), whose contents remain to be specified. This agreement was preceded by a proposal for the creation of an Asian Currency Unit (ACU). The proposal was developed by the Asian Development Bank and a number of Japanese economists, among them Mori, Kinukawa, Nukaya and Hashimoto (2002), Ogawa (2006), and Ogawa and Shimizu (2006).

4.2. ACU Arithmetic

Both the ADB and Ogawa (2006) define the ACU or Asian Monetary Unit (AMU) as a basket of the thirteen currencies of the ASEAN+3 member countries weighted by their relative importance in terms of GDP, trade volume, population, and the degree of capital account liberalization.[12] These definitions are directly borrowed from the European

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[11] As noted in chapter 1, facing objections from some members, ASEAN+3 has discontinued the study of feasibility of introducing an ACU. However, an in-depth examination of the ACU remains worthwhile as it helps gauge the scope of exchange rate policy cooperation and the prospect of monetary unification in the region. It also points to lessons that ASEAN+3 can learn from the European experience.

[12] The unit of account is variously referred to as ACU or AMU. We use these denominations interchangeably.

Currency Unit (ECU).

In Ogawa (2006), the 13 ASEAN+3 currencies are weighted by their relative GDPs valued at purchasing power parity (PPP) and by total trade volumes (the sum of exports and imports). In order to reflect the most recent trade relationships and economic trends, Ogawa uses the averages of these variables for the most recent three years for which data are available. The value of the AMU is then quoted in terms of a weighted average of the two major international currencies – the US dollar and the euro. The weights are the shares of the US and the Euro area in total trade of the ASEAN+3 countries, 65% and 35%, respectively. The benchmark period of the ACU exchange rate of the dollar-euro , for which the ACU exchange rate is set at unity, is chosen for a period (2000-2001) when the total trade balance of the thirteen countries with the rest of the world and the total trade balance of ASEAN+2 (excluding Japan) with Japan was close to zero. Formally, the "euro and dollar value" of AMU is:

$$E^{(\$,€)/AMU} = a\,E^{\$/AMU} + b\,E^{\$/AMU},$$

where a = 0.65 and b = 0.35, and the dollar and euro exchange rates are:

$$E_t^{\$/AMU} = \sum_{i=1}^{n} w_i E_t^{\$/i} \text{ and } E_t^{€/AMU} = \sum_{i=1}^{n} w_i E_t^{€/i},$$

where w_i is the weight of Asian currency i and $E_t^{\$/i}$ and $E_t^{€/i}$ are the dollar and euro exchange rates of currency i at time t, respectively. This, in turn, defines the dollar-euro exchange rate or currency i as $E_t^{(\$,€)/i} = a\,E_t^{\$/i} + b\,E_t^{€/i}$. The ACU exchange rate of the currency i is then:

$$E_t^{i/AMU} = \frac{E_t^{(\$,€)/AMU}}{E_t^{(\$,€)/i}} = \sum_{j=1}^{n} w_i \frac{E_t^{(\$,€)/j}}{E_t^{(\$,€)/i}}.$$

Still following the ERM divergence indicator, Ogawa defines the AMU Nominal Deviation Indicator (NDI) for currency i at time t as:

$$NDI = \frac{E_t^{(\$,€)/i} - E_0^{(\$,€)/i}}{E_0^{(\$,€)/i}} \times 100,$$

which measures the percent discrepancy from the benchmark rate $E_o^{(\$,€)/i}$ observed in 2000-1.

4.3. What role for the ACU? : The ECU Experience

The ACU is initially presented as a unit of account. Much as was the case for the ECU. However, (Kuroda, 2006a, 2006b) also suggests that it could assist ASEAN+3 policy authorities in the conduct of their exchange rate policies by serving as a surveillance indicator for regional exchange rate policy coordination in East Asia. Several proposals go further. Ogawa and Shimizu (2006) note that the ACU may serve as a common currency basket to which the ASEAN + 3 members, except Japan, could link their currencies. Kuroda (2006) considers that it could facilitate the creation of a regional market for basket bonds denominated in the ACU. It has also been suggested that the ACU could be the first step to making the yen as the anchor currency for the member states of ASEAN + 3.

These various ambitions are remindful of the many views expressed in Europe when the European Currency Unit (ECU) was established. Formally, the ECU was used as an internal accounting unit for all official transactions and accounts of the EU. The central banks did not use it in their transactions. For some advocates, the ECU was a political gesture towards monetary union. In that sense, the ECU was symbolic, just as the SDR is a symbol for a future world currency. In practice, however, there was no such official commitment.

The ECU was introduced as one of the four elements of the ERM in addition to the grid, mutual support, and a commitment to joint decision of realignments. In practice, the ECU played no particular role in stabilizing the ERM currency exchange rates, which were defined on a strictly bilateral basis (the parity grid). Although, initially, the ECU divergence indicator was expected to impose a symmetric intervention burden on weak and strong currencies to intervene, it was never really used. Market interventions were mostly carried out by the weak currency countries well before the limits of the system were reached, so that the burden was largely asymmetric. The only real lasting effect of the ECU is that when the euro became the European Monetary Union's new unit of account, its conversion rate was €1 = ECU 1, as stipulated in the Maastricht Treaty.[13]

Paradoxically, the ECU assumed a larger private role. As bilateral exchange rates became increasingly stable within the ERM in the late 1980s, private borrowers started to issue ECU-denominated bonds. Some governments followed suite and the ECU occupied a modest but nontrivial place among the main currencies used for international bond issues. Technically, it never was a currency on its own, but a basket. It is this

[13] The reason is that many private and public contractual arrangements were denominated in ECUs. The stipulation was meant to allow for a smooth continuation of these contracts, which were all redenominated from ECUs to euros.

feature that was deemed attractive: as an average of several exchange rates, the value of the ECU was generally more stable than that most of its constituent currencies, as was its rate of return.[14] The Deutsche Mark, one of the world's strongest currencies, could have offered even more stability but, as argued by Dammers and McCauley (2006), ECU instruments benefited from active restrictions on its internationalization by the Bundesbank, which (mistakenly) feared inflationary consequences. The EU did little to encourage or otherwise supported the development of the ECU bond market, which shrunk after the 1992-3 ERM crisis.[15]

4.4. ACU-Denominated Asian Basket Bonds

The view that ACU could become the "currency" of choice for Asian bonds seemingly challenges the lessons drawn from the European experience. An important difference, though, is that the advocates of Asian basket bonds, including ACU bonds, envision an active role of the public sector. Indeed, governments could issue ACU-denominated debt as could the ABF. The question is whether there exists sufficient demand for such a product. *A priori,* we would expect that if such a demand existed, private institutions would have exploited the market opportunity. Indeed, it is not difficult for investment banks or other securities firms to create and market ACU-denominated bonds, or for that matter in any currency basket. The fact it has not happened so far casts doubt on the viability of this proposal.

It may seem strange that investors do not seem to demand such instruments, which provide some desirable stability properties. In fact, they do, but they do not need synthetic currencies. They can easily hold a portfolio consisting of bonds in different currencies. Self-made diversified portfolios allow each investor greater flexibility than a basket-denominated bond. For the ACU to capture a significant market share, it should provide some advantages. The most obvious one is transaction cost saving. The weakness of basket-denominated bonds, which affected ECU bonds, is that it requires numerous currency conversion costs. To overcome this disadvantage, the ACU should become a quasi-currency, which would require a commitment by the monetary

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[14] The launch in 2004 of the Bloomberg-JPMorgan Asia Currency Index is remindful of the ECU. Like the ECU it is a basket of Asian currencies, not a currency on its own. Much like the ECU assumed a life of its own as a privately created basket of European currencies, this index may develop a niche market.

[15] It can be noted that the European Investment Bank and several governments have issued ECU-denominated bonds.

authorities. This would come close to the adoption of a common currency in Asia, a step that is currently ruled out.

Another hurdle is the weakness of regulatory controls and of market infrastructure in many Asian countries. The proponents of ACU bonds must identify these restrictions and spell out how they could be mitigated before proposing a public sector involvement in the development of such a market.

4.5. The ACU as a Surveillance Indicator for Exchange rate Policy Coordination

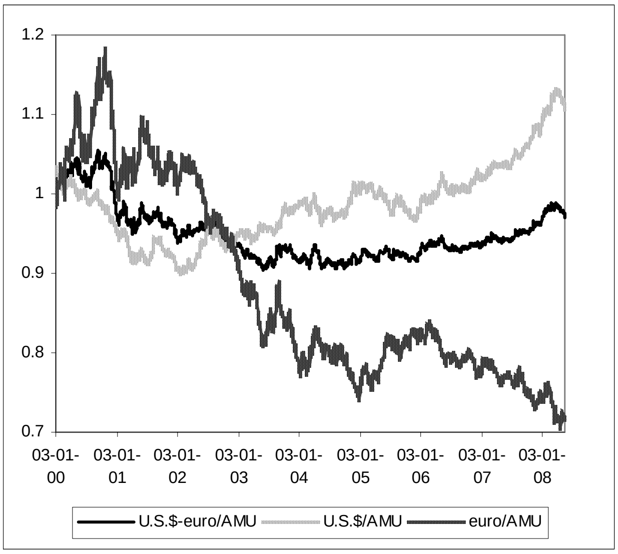
The view that, in and by itself, the ACU could strengthen exchange rate policy coordination runs counter to the European experience. In Europe, policy coordination was based on the Exchange Rate Mechanism (ERM) of the EMS, in which the ECU played no role. As noted above, even the anticipated divergence indicator turned out to be largely ignored. Policy coordination in Europe was based on explicit commitments (bilateral parity pegs, automatic and theoretically unlimited mutual support, consensus on realignments) that significantly reduced the margin for maneuver of national central banks.

The role of the ECU in monetary unification of the EU makes it clear that the creation of the ACU in and by itself will not strengthen exchange policy coordination in East Asia. What is needed for the coordination in East Asia is a collective regional exchange rate regime such as the ERM or a common basket pegging. Recent movements of some of the key East Asian currencies vis-à-vis the US dollar, the Euro (and, therefore, the ACU) illustrate this argument.

The question, then, is whether the Asian countries are willing to move to a tighter form of policy coordination. Even ignoring the deep issue of national sovereignty, the case must be made that it is desirable and possible. The recent evolution of the AMU, depicted in Figure 2, offers an interesting case study. Since early 2005, it has appreciated against the dollar while losing in value vis-à-vis the euro, with an overall appreciation vis–à-vis the dollar-euro basket defined in Section 4.2. The depreciation vis–à-vis the euro is largely explained by a weakening of the yen and by the inflexibility of the dollar-renminbi exchange rate at a time when the dollar has sharply depreciated. With sizeable surpluses, the group of ASEAN+3 countries have no reason to let their currencies follow the dollar in depreciating vis–à-vis the euro. What could they do?

Figure 2 AMU Exchange Rates

Jan.3, 2000-May 16, 2008 - Index January 2000 = 1



Source: RIETI (http://www.rieti.go.jp)

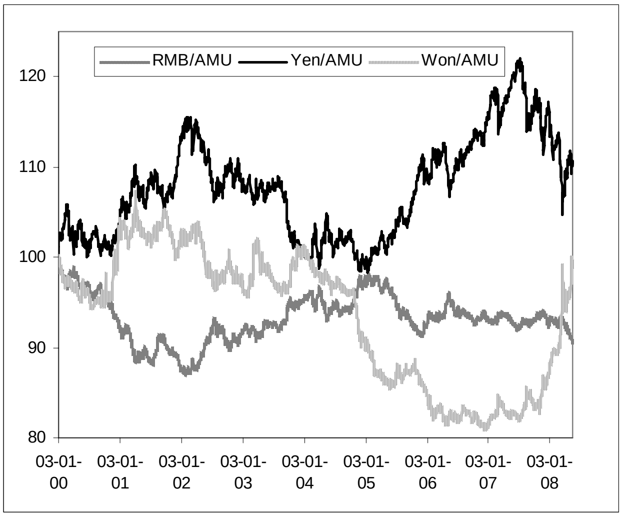
The two currencies with the heaviest weights in the AMU are the yen and the renminbi. Since the yen is freely floating, there is little chance that the Japanese authorities will explicitly try to reverse its depreciation. The renminbi it closely linked to the dollar. Strengthening the AMU then requires the other countries to strongly revalue their currencies against the dollar, but also vis–à-vis the yen and the renminbi. This would mean a serious loss of competitiveness. Regional cooperation without the two regional giants is impossible.

Indeed, so far, the reactions to the dollar depreciation have been individual. Figure 3 shows that the Korean won has strongly appreciated relative to the AMU, that the yen has strongly depreciated and that the renminbi has returned to parity after a period of depreciation. The major cause of these movements is the depreciation of the yen vis-à-vis the dollar, the renminbi and the Korean won. If China and Korea were to stabilize their AMU exchange rates for the sake of coordinating their exchange rate polices, they would have to appreciate their currencies against the dollar. If China does not let its dollar-renminbi exchange rate appreciate, Korea will have to assume an even greater burden of adjustment. More generally, countries like Korea and Thailand face an impossible challenge.

This example illustrates that the AMU cannot be used for regional and the promotion of exchange policy coordination as long as the yen remains a free-floating currency and China is reluctant to revalue its currency. Nor can AMU provide any useful guidelines to individual members of ASEAN+3 in formulating their exchange rate policies. The similarity with Europe is simply missing. By itself, the ECU did not play any coordinating role even though, excluding Sterling, all major country currencies were subject to the tight ERM agreements. Quite to the contrary, the European experience indicates that, even in the unlikely case where the three largest countries – China, Japan and Korea – were to agree to stabilize the AMU exchange rates in term of the US dollar or euro, they would have to agree beforehand to a set of rules governing intra-group exchange rate adjustments. In Europe, the ECU did not matter, ERM rules did. Similarly, for the sake of regional currency cooperation, Asia does not need an AMU or any other common nominal anchor but a collective exchange regime.

Figure 3 Exchange Rates vis a vis AMU: Yen, Renminbi and Won

Jan.3, 2000-May 16, 2008 - Index January 2000 = 100



Source: RIETI (http://www.rieti.go.jp)

4.6. The ACU as a Common Basket of Internal Currencies for ASEAN+3

The regime shift in both China and Malaysia to a basket arrangement in 2005 has underscored the need for closer coordination of exchange rate policy in East Asia. As Kawai (2002) notes, South Korea and Thailand have shifted to a de facto currency basket arrangement similar to Singapore's managed floating since the 1997-98 crisis.

The movements of both the nominal and real effective exchange rates of Indonesia and the Philippines also indicate that their currencies are linked to a basket of the currencies of their major trading partners. Practically all seven emerging market economies in East Asia – the original ASEAN 5, China, and South Korea – are now explicitly or implicitly on some form of basket arrangement.

With similar currency management arrangements and aims, it becomes easy for these countries to monitor the evolution of their respective nominal and real effective exchange rates to make sure there is no erosion in their relative export competitiveness. If any one of them lets is currency weaken vis-à-vis the dollar, competitive devaluations throughout the region could follow. Undoubtedly, these seven countries have a common interest in adopting some coordination.[16]

Williamson (2005) has argued that coordination would be easier, and beneficial, if the East Asian countries were to adopt a common basket of external currencies including the dollar, the euro and the yen, rather than carrying on with different baskets.[17] However Park and Wyplosz (2004) have shown that the difference between a common basket and own-basket pegs is very limited. More convincing, perhaps, is the further argument that a common basket would help adjust exchange rates simultaneously and improve the chance for cooperation on monetary integration in the long run.

This view is shared by Ogawa and Shimizu (2006) as they propose the AMU. In their mind, however, Japan would not peg to the common basket and the yen would remain a free floating currency. Obviously, the yen would still play a dominant role in the evolution of the ACU (especially if the weights are calculated in terms of the nominal GDP instead of PPP-adjusted GDP, as the ADB currently does). With the yen in the basket, a great deal of variations of the ACU vis-à-vis the dollar and euro would result from changes in the dollar-yen or the euro-yen exchange rates. Most of the changes in the ACU exchange rates of the twelve countries of ASEAN+3 will also be caused by

16 With a new regime in place and its growing economic influence in the region as leverage, China may be in a position to initiate the discussion on the coordination of exchange rate policies among the seven countries.

17 Several Japanese economists have also advocated similar arrangements for East Asia's emerging economies. See Kawai and Takagi (2000), Kawai (2002), and Ito and Ogawa (2002). These economists now argue that the ACU is a more appropriate common basket for ASEAN+3.

changes in their bilateral exchange rates against the yen, as has been the case in recent years. The other members may then ask why the yen, which will increase the variability of the ACU against the dollar and euro as well as that of their ACU exchange rates, should be included in a common basket to be chosen for exchange rate policy cooperation.

If Japan cannot or does not want to give up its free floating status, the ACU would have to be based on the currencies of the ASEAN+2. Given the size of China, such an ACU would be dominated by the renminbi. The renminbi would then become the regional anchor currency and the common currency peg would be *de facto* a renminbi bloc. Given China's relatively restricted financial markets and heavy currency management, a renminbi bloc is unlikely to meet the economic needs of the other member countries. In addition, the ASEAN plus Korea will find it politically unacceptable to join a renminbi bloc.

In theory the common pegging to the AMU may serve as a mechanism for internal exchange rate adjustments among the ASEAN+3 members if Japan forgoes its free floating status. But even in this case, it is highly uncertain whether the member countries would be able to agree to a complicated and elaborate mechanism of the kind in place in Europe's ERM. Indeed, one lesson from the European experience is that common pegging requires mutual liquidity support, especially when trade imbalances differ from country to country, as is the case within ASEAN+3. In the end, the creation of a regional currency unit as proposed by ASEAN+3 will mostly be a symbolic gesture that the ASEAN+3 member states are committed to monetary cooperation and integration in East Asia as a long run objective.

5. Conclusion

Why then, in spite often stated intentions to achieve greater monetary and financial integration, Asia has not so far progressed as far as Europe? One reason, obviously, is that it started later. Other reasons are political and institutional, as developed in Wyplosz (2003), but as important are economic considerations. Since 1945, at least on the continent, European policymakers have been driven by two unshakable convictions, born of history: 1) that deep trade relationships are the key to establish and preserve peace; 2) that monetary disorders – as those of the interwar period – represent the biggest challenge to trade. This explains both why the Common Market, now deepened into the Single Market, is non-negotiable and why it has been the key driver of Europe's monetary integration.[18]

As previously explained, policymakers have considered that intra-European trade cannot flourish if internal exchange rates are volatile. In that sense, European monetary integration is inward-looking. In Asia, the aim has long been outward-looking. Officially, ASEAN+3 members too intend to stabilize bilateral exchange rates while collectively floating against the dollar and euro. In this sense they are trying to emulate the European model of monetary integration as reflected in their interest in introducing the ACU. Yet, at least until recently, the export promotion strategy has long focused East Asian policymakers on trade with the rest of the world chiefly the US and Europe. Thus, while they share the European view that exchange rate stability is important for trade, Asian policymakers have thought of stability vis-à-vis the dollar first, and the euro next.

As long as they mostly worry about each other's exchange rate mostly because of competition for access to markets outside the region, the inward-looking approach followed in Europe is ill-adapted to their strategic vision. Things may be changing, though. As they catch-up to the technology frontier, the Asian countries will become less dependent on export promotion; the evolution of Japan is a point in case. As their income levels grow, intra-regional trade will become more intense. In fact, they now trade nearly as intensively among themselves as the EU countries do. Crucially, China has become the largest export market for all East Asian economies and it is only a matter of time until this is the case for Japan as well. As the world's fastest growing region, the Asian market is already attracting increasing attention in the rest of the world. The proximity advantage – strongly captured by gravity trade equations – suggests that intra-East Asia trade is likely to become increasingly important. The reduced link to the dollar (or the euro) – China is the only country rigidly pegging to outside currencies – is an indication that, indeed, things are changing. The various initiatives discussed in this chapter, most of which are partly at least inspired by the European example, reinforce that impression.

Meanwhile, as the domestic financial markets further integrate into world markets,

[18] It also explains why the UK has been a half-hearted actor of the economic and monetary integration process. For many years, Britain looked to the US as its main trade partner. After it finally joined the EU, the UK did not buy into the argument linking trade and exchange rate stability.

increasing returns to scale will encourage the development of one or more large markets in the region. These markets will not be regional, but a key segment of the worldwide network. Mergers with far away markets, similar to the Euronext-NYSE merger, are likely to happen along the way. This will be competitive process, which the monetary authorities will not be able to influence.

Does this mean that the various efforts currently under way are useless? Most definitely not. Developing financial markets in local currency is part of the development process and stabilizing exchange rates is helpful for trade reasons and to reduce the odds of a crisis. Developing a common line of defense against market turbulence also makes sense. These are more modest goals than those often stated as a justification for financial cooperation. The problem is not with currently unrealistic goals. The problem is that these goals may be seen as justifying public interventions where none is needed while delaying badly needed domestic reforms.