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*Possibilities and Challenges for
Financial Integration in East Asia:
Lessons from a Comparative
Regional Perspective¹*

KWAN S. KIM²
SEOK-HYEON KIM³

■ *Introduction*

The 1997 Asian crisis was a rude awakening for the hitherto complacent East Asian countries. Slowly but steadily, a region-wide consensus has been emerging that the East Asian (EA, henceforth) countries need to collectively oversee regional economic issues in a coordinated way or to move a step up for concrete regional arrangements to forestall the outbreak of future financial crises. Before then, the prevailing concerns for many EA countries were with overseas markets outside the region. The export-oriented drive had worked well as the main contributing factor for the region's spectacular economic growth.

Amidst the Asian crisis, Japan attempted the first initiative to develop intra-regional measures for circumventing future financial crisis. Its ambitious proposal was to create an Asian Monetary Fund (AMF), which would be equivalent to a region-based IMF. The Japanese proposal included such a significant sum of facility that crisis-hit countries welcomed it and even envisioned a long-term regional goal of creating a more ambitious, alternative Asian Monetary Union (AMU, henceforth), which would be modeled after the European Monetary Union (EMU).

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Confronted with strong oppositions from the existing international institutions and the United States, the countries of East Asia had to turn their efforts to build an internationally acceptable, more modest framework, which resulted in the adoption of the Chiang Mai Initiative (CMI, henceforth) at the annual meeting of the Asian Development Bank (ADB) in 2000. The CMI envisioned the institutionalization of foreign exchange reserve swap arrangement among the EA countries. The initiative is the first interwoven financial network in the region, which is coercive in the case of emergency. The CMI is the first-ever arrangement that includes the region's economic powerhouses of China, Japan, and South Korea (hereafter, three North East Asian countries or shortly NEA3). Prior to the CMI, ten Southeast Asian (SEA) countries had formed a regional free trade area with the secretariat called the Association of Southeast Asian Nations (ASEAN). In 1977 several ASEAN members concluded swap arrangements, which served as a preliminary model of the CMI. However, ASEAN countries' small economic size and dependence on outside-ASEAN region have limited the extent and significance of their financial cooperation. The inclusion of the three Northeast Asian countries which are strongly influential on the ASEAN countries both in trade and direct investment began to add momentum to effective regional cooperation. The CMI is now seen as a founding step towards a broader and deeper coordination at the regional level, which includes other agendas that would not only contribute to the stability of the regional economy but also build up to a higher degree of integration.

In this regard, it is important to understand the implications for future developments from its details. Above all, in order to fully and successfully utilize the CMI as a corner stone for more effective regional integration, it is necessary to learn from the experiences of the existing regional institutions and the conditions for the success at each step. In this respect, the EA countries are in a position to take advantage of the lessons from the more successful euro experience as well as from the less successful Latin American case. In contrast to Europe, the Latin American countries have not yet established any notable regional institutions, which could have a significant role to play in financial cooperation in spite of a long history of their efforts for regional integration. This paper seeks to add a cross-regional dimension to an already voluminous literature that has emerged on the issues of regional financial cooperation and integration in East Asia. (Goto & Hamada, 1994; Bayoumi & Eichengreen, 1999; Lin & Rajan, 2001; Choi, 2003; Mundell, 2002). More financially integrated European and less financially

integrated Latin American experiences will be reflected as lessons to learn for East Asia. The specific questions to address are what have been done and what can be done at the regional level of cooperation and integration in East Asia. By drawing on other regional experiences, constructive footsteps can be suggested towards a possible financial co-operation and integration for the EA region.

In the following section, we start with reviewing the region's initial efforts for financial cooperation. This paper will primarily be concerned with the countries of ASEAN group plus Japan, China, and South Korea. Among the ASEAN countries, our analysis will be more or less confined to the Philippines, Indonesia, Thailand and Malaysia, and Singapore. They initiated the formation of ASEAN in 1967 and have since been actively engaged in global markets.⁴ Section 3 discusses Chiang Mai swap arrangements as their ramifications for subsequent regional co-operation. Section 4 surveys and evaluates the counterpart experiences in financial cooperation and integration outside East Asia, focusing on the scenarios in Europe and Latin America. This is followed in Section 5 by an overview from a comparative perspective of the EA economy's structural features to assess whether the Asian economy meet the necessary preconditions for financial integration. Discussions further explore possibilities of further developments for East Asia. Specific policy issues beyond Chiang Mai and prospects for EA financial integration are examined in Section 6. Main findings and policy implications are highlighted in the concluding Section 7.

■ *The Earlier Cooperation Models: AMF and AMU*

The post- Asian crisis era has witnessed a surge of proposals for financial cooperation and integration in the East Asian (EA, hereafter) region. Among them, two noteworthy but related proposals for integration were the Asian Monetary Fund (AMF) and the Asian Monetary Union (AMU). Both proposals emerged in the midst of the financial crisis in 1997 to cope with the worsening situations and to reduce possibilities of a crisis in the future.

The AMF proposal gained its momentum of its support during the crisis because of the urgent need for prompt actions to contain the crisis. It took more than a month for the IMF to unveil the rescue package of US\$16 billion after the Bank of Thailand decided to abandon

4. The rest of countries are Brunei Darussalam, Cambodia, Laos, Myanmar, and Vietnam.

the pegging of the baht to the dollar. The delayed rescue by the IMF contributed to the rapid spread of the currency crisis across South East Asian (SEA) countries and prompted criticism within and out of the region. Rather than waiting for the rescue decisions by the international institution, which was often too slow and untimely, the crisis-affected SEA countries came up with the idea of creating an Asian monetary fund, which would function as a region-based funding institution to complement the roles of the IMF.

Japan's initiative for the AMF was perceived as critically important since the ASEAN countries alone would not be able to financially afford to build and preserve such a fund. Even before the 1997 crisis Japan took the initiative in exchanging uncomfortable dialogues with the international financial policy makers concerning the potential financial woes for Asia. In spite of the mounting international demands for thorough restructuring of Japanese banks and banking system, Japan had kept its characteristic approach: implicit and slow. At the time of the outbreak of the crisis, Japan had a distinct view, diverging from that of the IMF, on the approach to the resolution of the future crisis. While the IMF, represented mostly by the US and the EU, urged on the market reform of the economy as well as the restructuring of the country's financial sector, Japan focused on a much bolder rescue package to create regional funds. Having invested heavily in the region, Japan had a much bigger stake in the EA economy than the IMF's influential member countries. The needs from both sides of Japan and ASEAN resulted in Japanese Finance Minister Miyazawa's open announcement that Japan would offer facilities to a regional fund during the Bangkok meeting of finance ministers of 25 Asian and European countries in 1998. In addition to that, he expressed his view that amidst breaking up the pegs with the dollar, the yen could have a larger role in the region. The amount of facility was unveiled as US\$ 100 billion at the IMF-World Bank meeting in Hong Kong a few days later. This proposal can be seen as the first step toward currency integration in the region.

The reaction from the IMF, the US, and the EU was far from being enthusiastic, eventually contributing to the short-life of the Japanese plan. Many issues led to a sharp confrontation. The IMF placed priority on avoiding moral hazard; the Japanese initiative was perceived to make a bailout too easy. While the IMF pressured the SEA countries to accept more stringent conditions including macroeconomic restructure, the SEA countries complained about those conditions. The IMF was also concerned with the huge size of proposed funds that might dwarf any IMF package for the region, allowing the SEA countries for an easy

bailout without having to negotiate with the IMF. The IMF could not simply allow other institutions to weaken its role of leadership amidst a financial turmoil.

The moral hazard issue aside, the political economy on the exchange rate regime was also another factor forcing the chasm. Japan envisioned its own initiative and its substantial contribution to the IMF as providing an opportunity to seek a new exchange regime for the region that would take the yen as an additional key currency. This would imply the retreat from the dollar in the region and the reshaping of the global exchange regime toward the dollar-euro-yen tripod. The EU, whose major concern was a successful launching of the Euro due in 1999, did not wish to see the ongoing currency regime disturbed by an unexpected advent of a huge currency block. Since the EA currency block based on the yen would imply the eventual replacement of the US dollar as an anchor currency, neither could the US welcome the idea of the AMF, which could be seen as Asia's first step toward the formation of a currency block.

Although the AMF plan was seemingly dead with the acknowledgement from Japanese officials, Japan and the ASEAN countries continued to whisper their wishes for the AMF or for other form of regional cooperation. The Manila-based Asian Development Bank (ADB) and Japanese institutes began to come up with compromised plans. For example, Japan-based Institute for International Monetary Affairs produced a research in March 1999, according to which funds can be organized, not as an independent pool of capital but commitment arrangements of borrowing both from the central banks and the markets.

As critiques began to question the IMF policy of untimely and excessive intervention, the IMF and the US have softened their opposition to Asian initiatives for regional financial arrangements and would more or less be ready to accept a modest version of the plan so far as it does not detract from the IMF authority. The Chiang Mai Initiative (CMI) in May 2002 was such a compromised plan. The Finance ministers of 10 ASEAN countries plus China, Japan, and Korea agreed to institute a facility for bilateral currency swaps in case of the crisis affected country's need for short-term liquidity assistance. The assisted countries are required to accept the IMF conditionality. The CMI clearly falls short of the original plan of the AMF. But the importance of the CMI must not be underestimated; it can be viewed as the initial step leading toward financial integration in the region.

To some policy makers in the region, the ultimate goal of creating a regional monetary union has been perceived as reasonable. For in-

stance, one idea is to build an Asian Monetary Union (AMU) with a common currency following the line of the European Monetary Union model. Since this ambitious goal is seen as a long-term aspiration, the proposal for an AMU has been presented as an addendum to a more realistic short-term plan. Nonetheless, there have been strong voices for the AMU by Japanese officials who continued to revive the idea of a common currency in the region. Their idea is to mobilize regional currencies into transactions, to make the yen as an anchor currency, and eventually to transform it into a single regional currency. Although such neighboring nations as China and South Korea have reservations about the yen as the anchor currency, the idea of a single regional currency as an ultimate goal has easily been agreed upon. As the European currency union has demonstrated, regional financial integration is believed to infuse vitality and momentum into the East Asian economy.

In passing, it is worth noting that there is another view on the currency union. Nobel laureate Robert Mundell (2002) considers the creation of a common currency as a contemporaneous issue rather than a futuristic one. He questions the effectiveness of the yen as an anchor currency in Asia. Given the current financial sector problems and inadequate macroeconomic policy decisions in Japan, the necessary preconditions for the yen to become the anchor currency are not met. Besides, the US dollar has long been served as an anchor currency in the region and there is no substantial need to replace it with the yen. Moreover, deciding on the anchor currency is not purely based on economic rationale but also on geopolitics. This makes it very hard for the former Asian colonies of Japan to accept Japan's leadership in a monetary union. A hasty enforcement of a currency union could lead to devastation rather than a blessing. Unrealistic exchange rate arrangements could make some currencies vulnerable to the speculative attacks or macroeconomic fallout as seen in the speculative attacks for some currencies belonging to the European Monetary System in 1992. The problematic issue of a regional common currency and the failed proposal for the AMF or the AMU demonstrate the importance of a careful and patient approach to regional cooperation. Regional financial integration per se is an admirable motive. But to harvest fruits from regional cooperation, it is crucial to prepare for the details on what aspects of cooperation would be achievable and agreeable in and out of the region.

■ *Chiang Mai Initiative (CMI) as a Cornerstone*

The American rejection of Japan-initiated AMF proposal called for a more modest approach based on a liquidity support program. The CMI was given a birth from this perspective. The CMI did not run into a strong opposition from outside the region. There was the realization of the shortcomings of the Fund in dealing with the contagious effects of financial crises on other countries. The resources that the Fund could offer in a short period have not simply been large enough to meet the liquidity needs (Agosin, 2001).⁵ A substantial portion of lending to the Asian countries came from elsewhere. The Fund must arrange for alternative, multiple sources of credit resources, which would delay a rescue operation. In the light of these doubts concerning the Fund's capacity to safeguard financial stability, the CMI to create currency swap arrangements was readily welcomed by the thirteen countries of ASEAN plus Three. The arrangements stipulate the methods and procedure of channeling funds for emergency use among member countries; they can make contracts to borrow and reimburse exchange reserves.

There are two kinds of swap arrangements: ASEAN Swap Agreements (ASA) and Bilateral Swap Arrangements (BSA) (Park and Wang, 2003). ASA encompass ten ASEAN countries with the endowment of US\$1 billion. They are multilateral in scope and nature; in principle, swap arrangements in emergency are to be provided by participating countries in equal shares. Such multilateral provision of swaps may help to share risks. Nonetheless, since participation is not compulsory, some countries may decide to withdraw from the arrangements. As an alternative, supplementary device, ASEAN plus NEA3 agreed on BSA. BSA consist of swap agreements between two individual member nations, which are bound by the general terms and conditions in swap transactions; the currencies negotiated for swap are typically dollars and domestic currencies;⁶ and the interest rate for borrowing is the LIBOR plus the premium that starts with 150 points and increases by 50 points for every two renewals. By August 2003, twelve BSA amounting to US\$ 32 billions had been contracted (Table 1), with three of them contracted among the NEA3 countries. Japan accounts for the largest share in total contracts.

5. The author argues for creation of a regional reserve fund in Latin America – an idea similar to the Chang Mai initiative.

6. Exceptionally, China-Korea and China-Japan swap agreements are based on domestic currencies.

TABLE 1
Progress of the Chiang Mai Initiative on the Bilateral Swaps,
August 31, 2003

<i>Bsa</i>	<i>Currencies</i>	<i>Conclusion Dates</i>	<i>Size</i>
Japan-Korea	\$/Won	4 July 2001	\$7 billion*
Japan-Thailand	\$/Baht	30 July 2001	\$3 billion
Japan-Philippines	\$/Peso	27 August 2001	\$3 billion
Japan-Malaysia	\$/Ringgit	5 October 2001	\$3.5 billion*
Japan-prc	Yen/Renminbi	28 March 2002	\$3 billion
Japan-Indonesia	\$/Rupiah	17 February 2003	\$3 billion
Japan-Singapore	Under negotiation		
Korea-China	Won/Renminbi	24 June 2002	\$2 billion
Korea-Thailand	\$/local currency	25 June 2002	\$1 billion
Korea-Malaysia	\$/local currency	26 July 2002	\$1 billion
Korea-Philippines	\$/local currency	9 August 2002	\$1 billion
Korea-Indonesia	Under negotiation		
China-Thailand	\$/Baht	6 December 2001	\$2 billion
China-Malaysia	\$/Ringgit	9 October 2002	\$2 billion
China-Philippines	\$/Peso	Negotiation completed	\$1 billion
China-Indonesia	\$/Rupiah	Under negotiation	

Source: Park (2003) Table 1.

* The US dollar amounts include the amounts committed under the New Miyazawa Initiative: US\$5 billion for Korea and US\$2.5 billion for Malaysia.

Contrary to the moral hazard argument of the CMI, the terms of bilateral Swap Arrangements (BSA) are not at all that indulgent. Given that resources for the swaps are supplied by other member countries, these creditor members need to safeguard risks in lending. The conditionality set up under the BSA reflects cautious approach. Depending on the size of disbursement requirements, the IMF type of more stringent conditionality can be invoked.

The CMI is structured to play the role supplementary and complementary to that of the IMF. It provides additional resources to the IMF work and accommodates the basic conditionality stipulated by the Fund (Henning, 2000, p. 50). In this regard, the US has endorsed the CMI, accommodating the CMI within the framework of the IMF system. The US, nonetheless, will continue to monitor the development of the CMI in order to assure that its goals remain consistent with those of the IMF. As for EA countries, however, their position as a potential creditor contrasts with that of a potential borrower in the IMF system. Asian

quotas in the IMF windows are relatively small. While the criticism of the CMI as encouraging to play the role of a proliferate lender can be questioned, a harsher criticism can be leveled at the current IMF practice in which small countries do not have to be responsible in deciding the terms and restrictions in lending because of their minor positions in policy-making.

While proposing the BSA as a core achievement of the CMI, the ministers convened at Chiang Mai also agreed to pursue three additional goals of monitoring capital flows, regional surveillance, and training personnel (Henning, 2002: 12). There are already a number of regional institutions, such as ASEAN and Asian Development Bank (ADB), and Asia-Pacific Economic Cooperation Forum (APEC). But none of them is responsible for a consistent and systematic surveillance of individual countries' macroeconomic and financial matters related to regional financial stability. Since the successful operation of the BSA would be contingent on the correct financial information, the EA countries need to have a centralized institution that collects, directs, and mandates financial information from each country. Individual states would inform each other on major policy changes that can have impacts, in particular on exchange rates and interest rates. Although it is too early for the EA countries to follow codified and mandated policies, the presence of discussion channels and regional forum can reduce the risk of disorder caused by an unexpected policy change of a country.

Even if there is no assurance that the BSA will be much effective in preventing a financial crisis, they are bound to enhance the spirit and environment for a close cooperation among involved states for regional financial stability. It is to be noted that setting up institutions and organizing international forum are not the sufficient conditions for a broad and deep regional integration although they serve as the necessary preconditions for further integration. This point becomes evident when we consider the case of Latin America. The continent has had many regional institutions and financial arrangements. There is no evidence suggesting that a regional cooperation has made a substantial contribution to regional financial stability. In many cases of the crisis in LA, specific bilateral deals between the involved country and the international financial institutions had to be drawn to resolve the issues. The less than successful cases of regional cooperation in LA provide a contrast to the more successful cases of Europe, which finally led to the single currency, Euro.

Successes and failures in other regions' experiences should provide useful lessons to Asia. The next section highlights European and Latin American experiences in regional cooperation and integration.

■ *European and Latin American experiences in financial cooperation and integration*

The European Union (EU)⁷ has set itself as a textbook model for regional integration. While other regions may take it as a role model to learn from, its long history of ups and downs in the path toward integration and its superior economic fundamentals compared with other regions are often overlooked. A hasty glance at the EU is likely to lead to a mistaken belief that an organized set of policy codes could bring a regional integration into reality. Even though the EU members have in recent past been in a situation conducive to seek a regional financial integration, the path to the integration to date was not predetermined, nor was foreseen in an optimistic mood. The simple fact to note is that the path to the current integration has taken a half-century from the formation of the European Economic Community with six member countries to the current integration structure - the EMU with 12 member countries (Tsoukalis 1993, Chapter 2).

In case of Europe, while the financial aspects mark the recent history of integration, economic integration in the early period had been motivated by interests in regional free trade. The major goal of the EEC, founded in 1958, was to create a common market to assure free movements of goods and factors of production across national borders. By 1961, the intra-region exports among the major Western European countries already accounted for more than fifty percent of their total exports, and creation of a custom union with uniform external tariffs was easily agreed on.

The focus on the real- sector regional integration continued until the collapse of the Bretton Woods system in 1973. Under the Bretton Woods system, the Western world enjoyed the period of economic and financial stability as reflected by stable exchange rates and sustained economic growth. The breakdown of the fixed exchange rate system subsequently turns the attention of European countries to the problems of stabilizing exchange rates. The first attempt for exchange rate arrangements was to organize bilateral exchange- rate coordination

7. The EU comprises 25 countries, including the latest entrants of 10 East European countries in 2004.

between the six EEC countries. In this so-called 'snake' plan (Tsoukalis, 1993: 39), they intended to maintain the exchange rates relative to each with each within the certain margins for deviation. This diversified approach gave way to the German mark as a *de facto* anchor currency. After a short period of a flexible and/or a managed float system in the global financial world throughout the 1970s, the European nations agreed on the need to set up a systematic exchange rate arrangement, which resulted in creation of the European Monetary System (EMS) in 1979. A trend of economic recovery started after the late 80s and brought a confidence to the European countries, encouraging taking a much bolder move toward the Maastricht Treaty in 1992, by which a single currency union was to be in place as of January 1999.

The EMU has a single currency called Euro and a central bank called European Central Bank (ECB) with a full monetary authority. Although it is still premature to foretell the success of the EMU, its successful launch was already impressive enough to inspire other regions to share the EU experience.

As for the efforts toward regional integration, the Latin American countries were as enthusiastic as the European countries were. However, the motivation and background for regional cooperation were quite different. Unlike the case of Europe, many Latin American countries suffer from the small size of their domestic markets. In the 1950s, the small size of the economy was perceived as a stumbling block to the success of import substitution industrialization. To overcome the country's limited market size, a number of the Latin American countries initiated a move toward creation of sub-regional free trade areas. The Latin American Free Trade Association (LAFTA, later to become the Latin American Integration Agreement, LAIA), Andean Group, Central American Common Market (CACM), and Caribbean Community (Caricom) are four major free trade frameworks (listed in the descending order of size), which have been grouped more or less by geographical location.

Though those countries showed some expansion in intra-regional trade during the 60s and the 70s, the ratio of intra-regional trade has continued to remain very small compared to that of the European counterpart. For LA as a whole, the intra-trade ratio rose from 7 or 8 percent in the early 60s to 16 or 17 percent in the late 70s. For the same period, the largest export market was the US whose share always exceeded 30 percent of the total trade volume (IMF, *Direction of Trade Statistics*, annual). A number of reasons can be advanced to explain the LA setback in their intra-regional trade. First, their ambitious plans

were not followed by consistent implementations given the unstable economic and political situations. Second, the low-value added commodity composition in exports has worked against the terms of trade and as a result against the region's balance of payments. Third, the weakened LA currencies due to unstable financial conditions have made the LA countries to focus their exports more on extra-regional markets. And fourth, the ISP approach has resulted in the resource drains for LA's export-oriented sector. Both the inner and external imbalances of the LA countries led to chronic financial crunches or crises, and consequently to structural adjustments as prescribed by the IMF.

With the conventional ISI policy completely debunked, under the new neoliberal economic order supported by the US, various attempts have been made to create free trade areas in Latin America. Mercosur with Brazil and Argentina as the major members and the NAFTA consisting of the US, Canada and Mexico were given birth to in 1991 and 1994 respectively. Currently, under the initiative of the US creation of the Free Trade Area of the Americas (FTAA) that covers the whole American continent is being envisaged (Bethel, 1998).

While their efforts to expand free trade in the region have been active, the move toward financial integration has not been successful notwithstanding several attempts made at the sub regional level. Among them have been the Latin American Reserve fund (FLAR) and the Mutual Payments and Credit Agreement (CPCR) of the Latin American Integration Association (ALADI).

The FLAR was set up as a regional fund for the Andean Community in 1978 and reflects a small scale IMF in the region. This regional fund is now open to other Latin American countries. It has assets amounting to about US\$ 1 billion as of 1998 whose sources are made up from the member country quotas. Although limited in size, member countries have more effectively used the regional fund. They have drawn more liquidity from the FLAR than from the IMF given the regional fund's more favorable terms in borrowing. The CPCR, which was instituted in 1969, comprises two arrangements: the clearing house (monitored by the Central reserve bank of Peru) and the mutual lines of credit. Unlike the FLAR, the CPCR does not own its own fund but only oversees the allocation of available credits from the member countries' central banks to the countries in need. During the LA crisis in the 1980's, the CPCR played a useful role in helping member banks to some extent, but the amount of available credit to offer is too small to be effective in preventing the contagious effects of a financial crisis (Agosin, 2001).

As seen from the above cases, LA efforts for regional financial cooperation can be doubted for their effectiveness, and as such have failed to attract serious attention for further development. This can be explained by the importance of US participation in a regional arrangement. Given the dominance of the US in LA capital and financial markets, any attempt for financial integration without the active participation of the US can be questioned for its feasibility as well as for its sustainability.

■ *Lessons and Possibilities for East Asia*

Other regions' experiences in financial cooperation should shed some light on the possibilities for East Asia. In this section, we draw lessons from their experiences to reflect on the East Asian circumstances, exploring at the same time possible avenues for financial cooperation in East Asia. The integration experiences in Europe and Latin America show contrasting patterns in the importance of a country's economic fundamentals in determining the outcome of financial integration. From a theoretical perspective, the preconditions for a successful financial integration can be summarized simply as larger benefits and smaller costs (Bayoumi *et al.*, 2000). Larger benefits may draw on the mutual dependence of the economies. The greater the amount of transactions of products and factors, the greater will be the benefits from stability and predictability of such regional economic variables as the exchange rates. On the other hand, the integration costs are negatively linked to the degree of symmetry of the regional economies. If the macroeconomic conditions and institutional structures were alike, the burden from negative economic shocks would spread more evenly across the countries. If the costs are small, a financial integration is more sustainable and is ready to reap its benefits. One caveat about the similarity of the economies is that the sum of bad economies does not make a good economy.

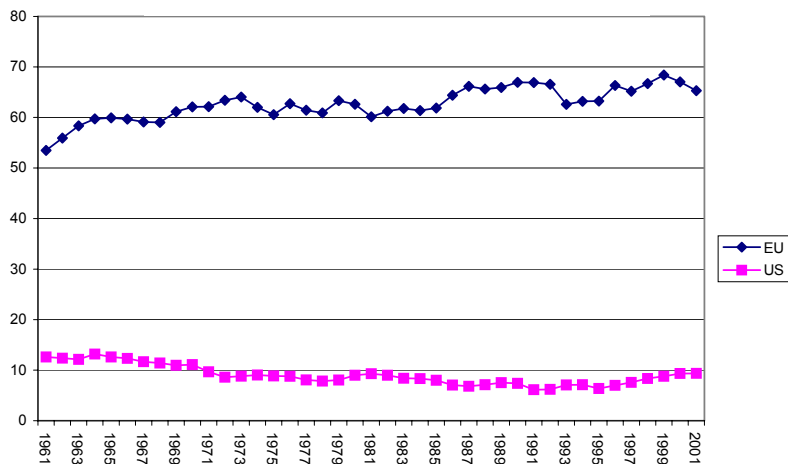
A well-known theory on the preconditions necessary for regional financial integration is Optimal Currency Area (OCA). One aspect of OCA theory is to analyze the relationship between bilateral exchange rates and other major variables such as growth rates and regional trades. According to Bayoumi *et al.* (2000) the exchange rate movements turn out to be less stable in the ASEAN countries compared to the EU countries but the differences are too small to discourage regional integration for Asia.

Bayoumi *et al.* (2000) and Yuen and Ling (2001) additionally developed a pattern analysis in which the impacts of shocks on such vari-

ables as output and price level are investigated using VAR forecasting methods. According to Bayoumi *et al.* (2000), the ASEAN countries are not very different in shock response although the differences are more prominent compared with the EU countries. Yuen and Ling (2001) broaden the coverage of countries including Japan, Korea, Taiwan, and China and look into the sub-regional characteristics using the impulse analysis. Their results show that geographical neighbors tend to response in a similar way, for example, in the case of Japan and Korea. Accordingly, their analysis supports in favor of sub-regional level integration than of regional-level one.

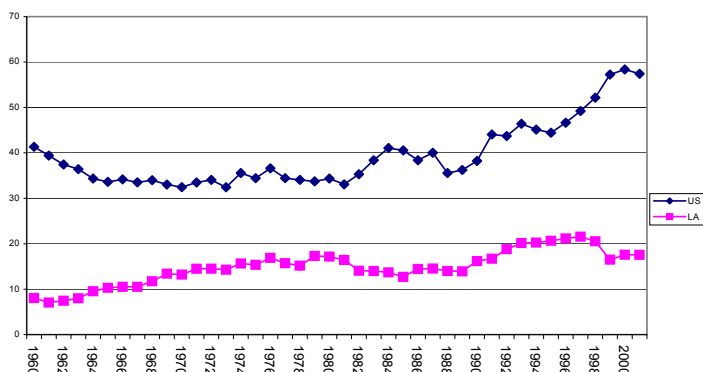
While their studies shed light on possible theoretical criteria for regional integration, it must be noted that their use of the variables are limited in numbers and the research is based on a simulation model. Thus it will be useful to analyze economic problems in a broader context, focusing in particular on institutional aspects. We will begin with two key transaction data including trade and direct investment.

FIGURE 1
EU'S Intraregional exports and exports to the US



Note: Figures represent the shares of exports to designated markets in EU's total exports.
Source: OECD, 1997.

FIGURE 2
Latin America's intraregional exports and exports to the US

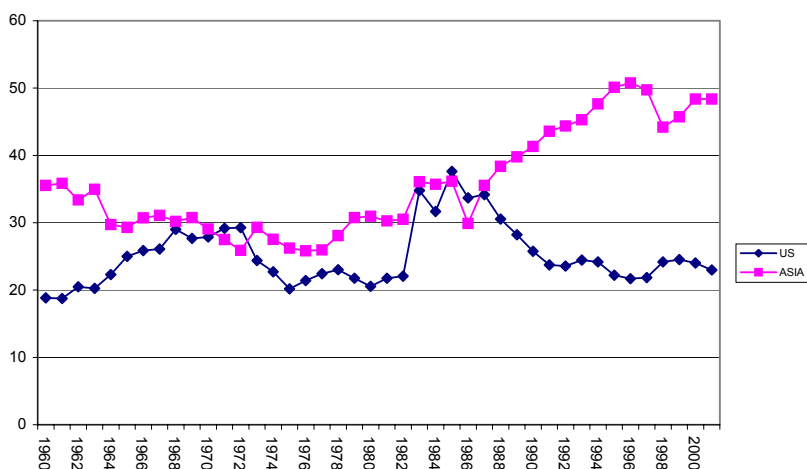


Note: Figures represent the shares of exports to designated markets in LA's total exports.

Latin America is the Western Hemisphere in the IMF's definition.

Source: IMF's *Direction of Trade Statistics* (annual).

FIGURE 3
Asia's intraregional exports and exports to the US



Note: Figures represent the shares of exports to designated markets in Asia's total exports. Asia covers both South and East Asia including Japan.

Source: IMF (annual).

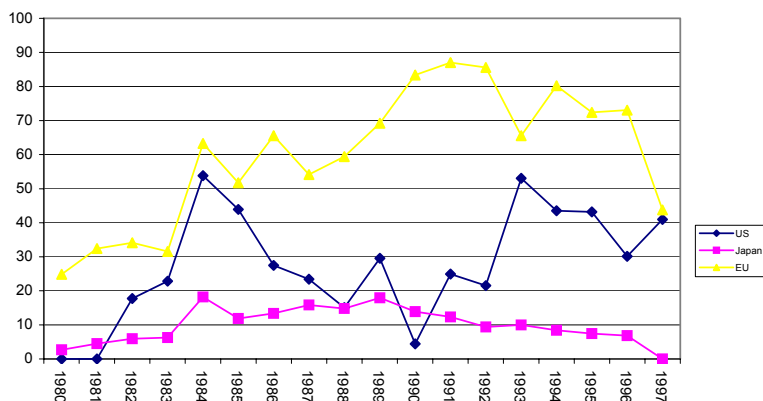
Intra-regional exports and foreign direct investment (FDI) for East Asia are then compared as an indirect indicator of minimum feasibility of achieving regional financial integration. Data for exports show notable differences across the regions. The EU shows increases in intra-regional exports and has reached between 60 and 70 percents of the total exports while its dependence on the US market continues to stay below 10 percent (Figure 1). In contrast, LA countries' intra-regional exports are still less than 20 percent except for a few years although the intra-regional trade has slightly increased over time (Figure 2). Nonetheless, their dependence on the US market has risen remarkably over the past decade, reaching almost 60 percent of the region's total exports. On the other hand, EA countries show a rapid rise in their intra-regional exports up to 50 percent while their dependence on the US market has been less than 30 percent over the decade (Figure 3).⁸

Latin American countries' interest in regional cooperation has been linked to the US initiative for regional trade liberalization while EA has achieved an increasing autonomy from the US market, shifting more toward regional interdependency. This is noticeably the case with Japan. Japanese exports to Asia have reached more than 40 percent of their total exports while those to the US have decreased throughout the past decade.

Examination of FDI data shows similar patterns for each region. As the EU, US, and Japan occupy a dominant portion of FDI in the world, how each player sets its position in each region decides the regional pattern in foreign investment. In the EU, the EU itself is the largest investor (Figure 4). In LA, the US has been the largest investor (Figure 5). In Asia, Japan has played the largest role in investment (Figure 6). As FDIs are long-term projects in the recipient country, the investing countries have deep interest in the host country and are sensitive to the economic conditions. In this regard, FDI is a "readiness indicator" for integration, even better than the intra-regional trade measure. In particular, performance of FDI would be affected by the degree of financial liberalization in the recipient countries. *Ipso facto*, a large FDI inflow in the recipient country would imply the evidence that its domestic economy is already integrated into the global economy.

8. The data for Asia includes South Asia. However, this does not result in significant bias since South Asia is not prominent in Asia's total exports.

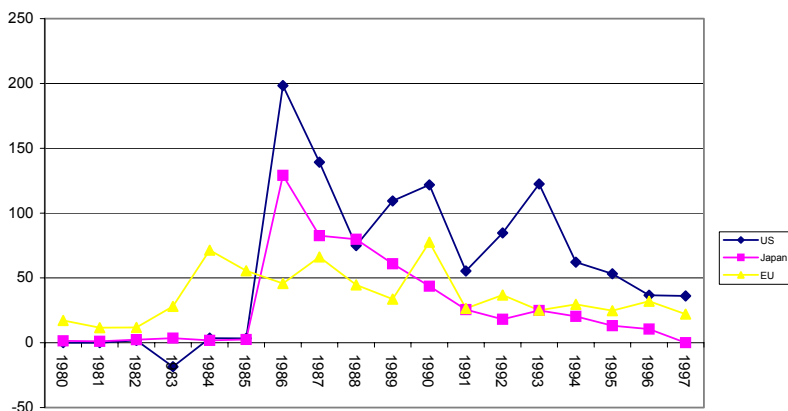
FIGURE 4
EU's FDI inflow from regions



Note: Figures represent the shares (in percentage) of regions in FDI inflows to EU. The sum of shares can be larger than 100 because of different data sources.

Source: OECD (1997) and World Bank (2002).

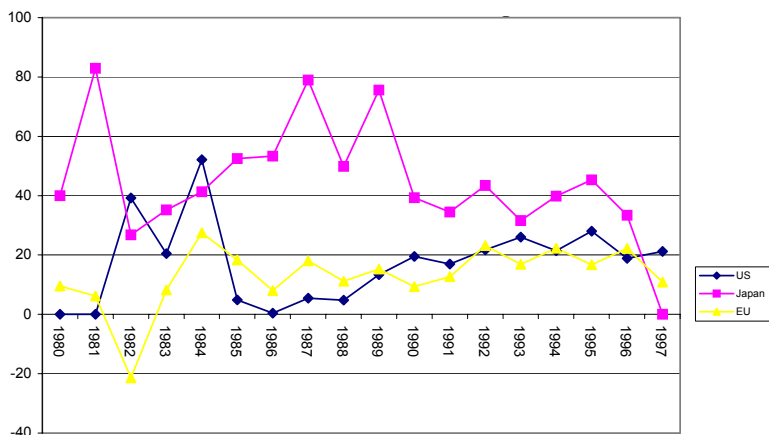
FIGURE 5
LA's FDI inflow from other regions



Note: The sum of shares may exceed 100 because of different data sources.

Source: OECD (1997) and World Bank (2002).

FIGURE 6
EA's FDI inflow from other regions



Note: Figures represent the shares (in percentage) of other regions in total FDI inflows in EA. EA is ASEAN plus China and Korea. The sum of shares may exceed 100% because of different data sources.

Source: OECD (1997) and World Bank (2002).

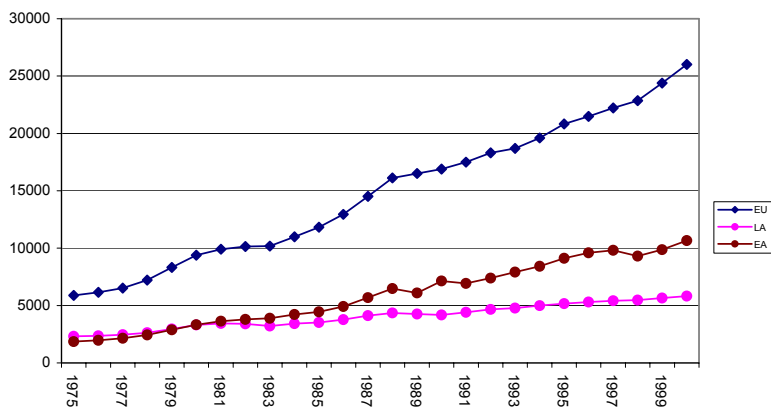
Japan and the US's dominance in foreign investment in East Asia and Latin America, respectively, have important implications for regional integration. As evident from the currently limited efforts for sub-regional integration in Latin America, a financial integration without the participation of the US cannot exercise a significant influence on the region and as a result, does not draw much attention or participation from the countries in the region. For the EA region, in contrast, Japan has been an enthusiastic partner in initiating regional financial integration. Given its influential linkage to the EA region in trade and direct investment, Japan is indeed in a position to create a regional financial institute. In this regard, compared with Latin America, the EA countries may be in a better position to pursue financial integration in the region.

The analysis of the costs of integration is based on major macroeconomic indicators of the countries. The Maastricht stipulation of the key macroeconomic variables can serve as a reference (Zahler, 2001). The agreements required five convergence criteria for inflation rates, interest rates, exchange rates, government debts, and budget deficits (Pentecost, 2001). These criteria are made as minimum condition to prevent financial instability of a country, contamination to other countries and a

possible breakdown of the integration. In the case of the EA region with a number of less developed economies, it is desirable to use other indicators in addition to the Maastricht variables. The crucial difference of the EU from other regions is that the EU has already achieved a high level of economic development and sophisticated markets. Thus the key concern is convergence in standard macroeconomic variables. In contrast, the EA regional economy is faced with other problems related to economic development, besides regional harmonization of economic policies. Typical problems are low standards of living and vulnerability to the external shocks. In this context, we start with the examinations of per capita GDP and external variables such as trade balance, external debt and foreign reserves.

The data about the average of per capita GDPs in each region show that both EA countries and LA countries have not yet caught up with that of EU (Figure 7). Indeed, EA countries' living standard rose until 1997 crisis but deteriorated onward. LA countries continued to lag behind from the EU and the gap has been widened. As a result any region could not reach 35% of the EU's average GDP since 1960s when European countries initiated to create a common market in Europe.

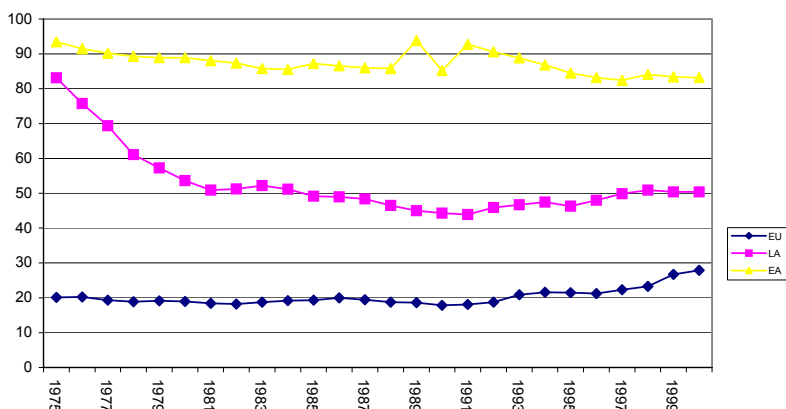
FIGURE 7
Per capita GDP by region



Note: East Asia consists of large ASEAN countries plus Japan, China and S. Korea.
Source: World Bank (2002).

The data about the standard deviation of countries' per capita GDPs normalized by the average show that EA countries are far more diverse in standard of living than LA countries which in turn are more diverse than European countries (Figure 8). This means that European countries are not only rich but also homogeneous and that East Asian countries show a huge deviation in standard of living among countries. This result is not at all unexpected considering that European countries occupy to rank in standard of living and that East Asia covers from world-class rich countries like Japan to subsistent-level countries like Vietnam. Not only the absolute level of standard of living but also the relative differences in East Asia and Latin America cast a pessimistic foresight about a high degree of regional integration.

FIGURE 8
Ratio of standard deviation to average of per capita GDP by region



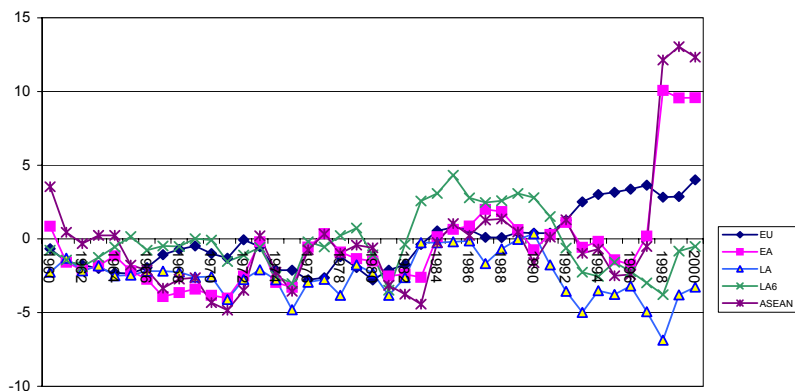
Source: World Bank (2002).

The country variables that are widely employed in measuring the robustness to external shocks are trade deficit, external debt, and size of reserves. And finally, since effective policy coordination for regional cooperation is predicated upon mutual trust among involved countries, the reliability and transparency of governments and the financial sectors can be called into the question. In this context, some relevant indicators are also presented for comparisons.

Starting with the external shock indicators, we first note that as trade deficit continues without any foreseeable change for a reverse,

such price variables as exchange rates become unstable and vulnerable to domestic and external shocks. Continued trade deficits cannot be fully financed by foreign investment and lead to a rise in the national debt, undermining financial markets by pressuring on interest rates and exchange rates. In particular, for many developing countries that are not competitiveness in exports markets, cumulative trade deficits often lead to financial crisis. For this reason, trade balance data will be compared first. Since the mid-1980s the European countries as a whole had trade surpluses, which facilitated implementation of the ambitious Maastricht Treaty. Latin America has experienced a far longer period of trade deficits than that of trade surpluses (Figure 9).

FIGURE 9
Ratio of net exports to GDP by region



LA6: six largest nations in Latin America.

Source: World Bank (2002).

During the 1980s, Latin American countries as a whole—in particular, six largest countries—⁹ recorded a deterioration in trade balance. If we include most of Latin American countries except several small island countries, the past decade saw a bad situation in trade. This contrasted with the East Asian region as the ASEAN plus three countries had surpluses except several years in the early 90s. After the crisis, trade surplus skyrocketed although this should be carefully interpreted in terms

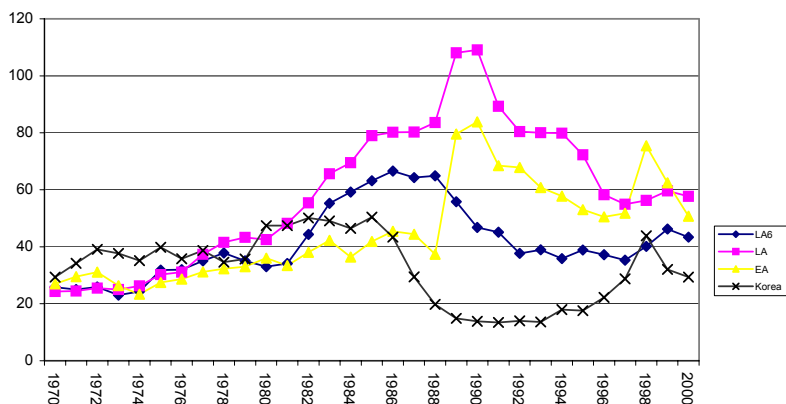
9. Brazil, Mexico, Colombia, Argentina, Peru, Chile, in descending order of population. Venezuela is the sixth in population but was uncouned because its major source of revenue is oil exports.

of cyclical effect as the aftermath of the crisis. The patterns were not that different between the ASEAN only group and the ASEAN plus three group.

Nonetheless, for both regions, there is no assurance that they are on a solid track toward a long-term external equilibrium as the share of high-value added or high-tech commodities in exports are extremely low in most of the countries in these regions. As cumulative trade deficits lead to the rise in external debts, it signals a warning to the investors and makes them hesitate or withdraw from investment activities. As the external debt grows, rising interest rates and debt services suppress the economy, possibly igniting a vicious cycle.

The EU countries are mostly credit suppliers to the developing countries, including Asian nations. This feature implies that the EU's external debt size by itself cannot be used for comparing with other developing countries. As an alternative benchmark for comparison, we use South Korean debt data for East Asia; South Korea never had a debt delinquency problem even though its trade balance had been in deficits for many years and the country's development was financed by foreign debts.

FIGURE 10
Ratio of External debt to GDP by region



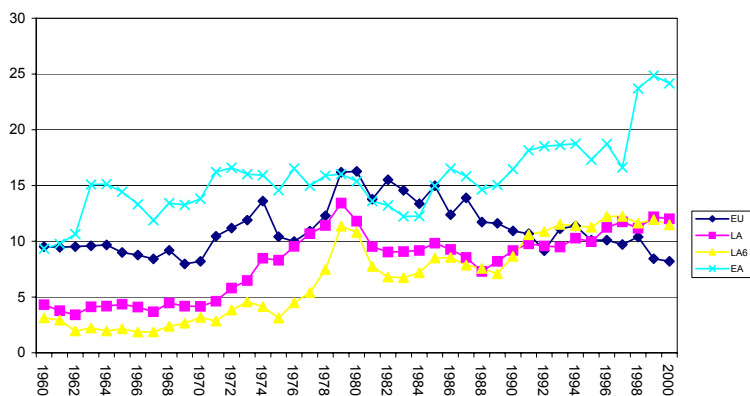
Source: World Bank (2002).

Up to the early 1980s, the average debt-GDP ratios were similar, albeit with generally increasing trends, across the groups of LA and EA (Figure 10). Since then, both groups of countries reached a peak around

100 percent, hovering over 60 percent. In Latin America, the group average of the six largest countries recovered to about 40 percent recently. On the other hand, South Korea showed less than 20 percent for about ten years since the mid-80s. Though it rose around 1997 but still stayed at about 30 percent level. Since what level of debt should be regarded as a warning status would depend on each specific country case, it is not easy to interpret the data in terms of economic security. However, both the EA and LA groups seem to be at high levels of debt, considering that Argentina's debt ratio had been 40 percent since 1996 and had to deal with debt repayment problems with the outbreak of the financial crisis in 2001-2002.

As for exchange reserves, the EA countries have done better. For the past four decades, the EA countries had the highest levels of reserves, even higher after the 1997 crisis than before (Figure 11). In contrast, the LA countries remained roughly at half the level of the EA countries. The EU countries had peaks and similar levels as the EA countries in the early 80s (about 15% on average) and had kept reducing their level since then and now are lower than the LA countries. However, the EU countries are mainly creditors in international finance and the creation of the EMU made them in need of less foreign reserves. Without such a regional finance institute that can systematically protect member countries in case of external shocks, a lower reserve is an important factor that could make the country vulnerable to potential threats from exchange rate adjustments or speculations.

FIGURE 11
Ratio of reserves to GDP by region

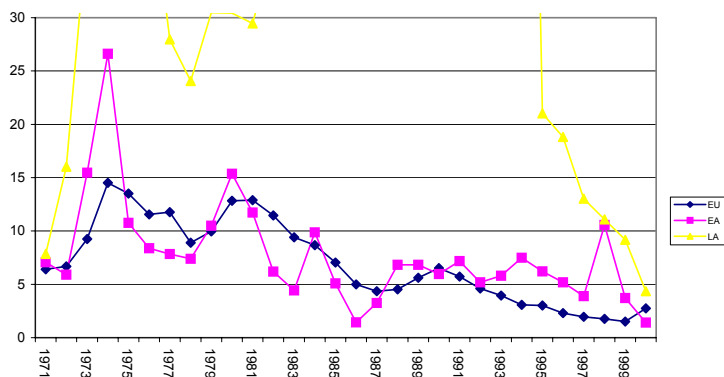


Source: World Bank (2002).

That the EA countries have kept high levels of reserves should make regional financial cooperation easier. Higher reserves could prevent or minimize the risk of being subjected to financial shocks. Nonetheless, the current EA reserves are excessively high with the resulting economic losses. More will be said about the losses later in the paper.

Among the domestic indicators measuring the stability of the economy, inflation is an important one since it gives a referendum to judge whether the economy is on a sustainable path. LA countries were in bad shapes with respect to inflation. For the last three decades, the averages of inflation rates were mostly higher than 10 percents and recorded hyperinflation for many years (Figure 12). After the structural adjustment in the 1990s, inflation has been subdued to the lowest level in history. The EU countries have successfully controlled inflation since the mid-1980s; the average has been lower than 5 percent recently. The ASEAN+3 countries also recorded lower inflation rates except in the smaller states of Brunei, Myanmar and Laos. Though a little higher than that of the EU countries, the average was close to five percent for the past 15 years except during the financial crisis period in the late 1990s. Low inflation rates would help the task of coordinating macroeconomic policy at the regional level much easier.

FIGURE 12
Inflation rates by region



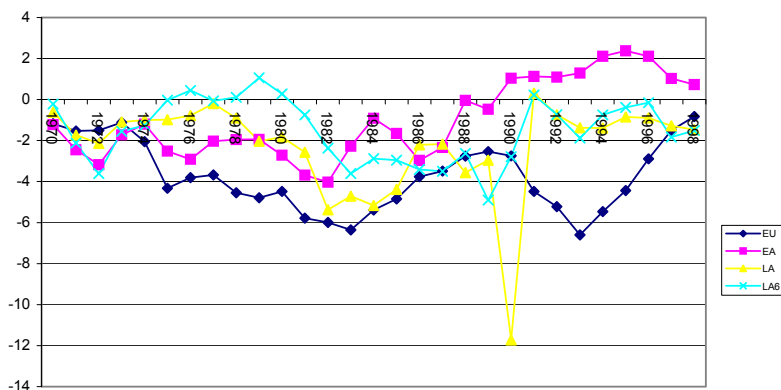
Source: World Bank (2002).

The country's ability to manage financial health is generally reflected by government budget status. Persistent deficits over years drain the

resources for the private sector, also affecting interest rates and causing inflation. Not only for successful domestic policy but also for policy coordination, deficits should be constrained to a certain level. For instance, the Maastricht Treaty requires that the budget deficits should be smaller than 3 percent of GDP.

The EA countries' budget deficit has on average been much lower than the other two regions since the early 1980s (Figure 13). During the last decade, their budgets operated on a surplus trend. Many EU countries were in deficits during the 1980s but since the early 1990s their deficits have been reduced significantly, reaching close to a balance recently. Most of the LA countries registered budget deficits, which were lower than two percent of GDP. However, it must be noted that domestic bond markets in developing countries are very thin and budget deficits must be covered by growth in money supply or external debt. Thus a persistent pattern of deficits could undermine the financial stability in the economy.

FIGURE 13
Ratio of government budget balance to GDP



Note: The figures are the averages of ratios of government budget balance to GDP.
Source: IMF (2002).

As for institutional measures of the suitability of a group of countries for financial integration, the transparency in government and business sector activities needs to be taken into consideration. In spite of some differences, the leading indicators currently used for evaluating such institutional aspect seem to indicate largely consistent results. The effec-

tiveness in uses made of funds and credits lines, along with transparency in the intermediary role of the government is the critical components in these measures. The more transparent the public sector agents are, the larger amount of credits can be supplied and the easier the access to international funds will be. As seen from the Table 2, while the EU countries are ranked high, many of the EA and LA countries are at the lower end of the list with a few exceptions of such countries as Singapore and Chile. The low profiles in transparency in both regions will be a hurdle to developing a broader and deeper regional integration.

TABLE 2
Government favoritism*

<i>Europe</i>	<i>Ranking</i>	<i>Latin America</i>	<i>Ranking</i>	<i>Asia</i>	<i>Ranking</i>
Austria	23	Argentina	28	China	51
Belgium	30	Bolivia	18	Indonesia	59
Denmark	2	Brazil	38	Japan	32
Finland	1	Chile	12	Korea	35
France	10	Colombia	37	Malaysia	54
Germany	15	Ecuador	24	Philippines	55
Greece	45	El Salvador	26	Singapore	4
Ireland	16	Mexico	44	Thailand	50
Italy	27	Peru	36	Vietnam	42
Luxembourg	19	Venezuela	33		
Netherlands	3				
Norway	11				
Portugal	31				
Spain	22				
Sweden	7				
uk	9				
Average	16.9	Average	29.6	Average	42.4

Source: *Global Competitiveness Report 1999*.

* Sweetheart deals between well-connected private firms and the government are not common.

Ranking is based on 56 countries in the survey.

There are other institutional arrangements that can be seen as the necessary preconditions for effective regional integration (Bayou, 2000). For instance, the region-wide accessibility and sharing of vital economic and financial information should be made available and compiled for a systematic analysis. Compared to the EA region, the EU and LA coun-

tries have longer experiences in regional cooperation in this area.¹⁰ In East Asia, the ASEAN (since 1967 at Bangkok) and the Asian Development Bank (since 1966 at Manila) have functioned as a regional body. Neither institution has, however, played as a regional body that oversees regional economic matters in a broad scope. The ASEAN includes only 10 member countries in South East Asia and the Dab's major concern has been with anti-poverty and related development programs. In order for regional institutions to successfully coordinate policy issues, mutual sharing of accurate economic information needs to be institutionalized as a precondition for financial integration. Such an institutional arrangement has not yet been established in East Asia.

Other institutional arrangements may include the legal provisions allowing for free factor mobility (labor and capital) across the national borders. Without free factor movements, complete regional integration would be difficult to expect. Free mobility not only helps to achieve a more efficient use of resources but also enhances the effects of the results from policy coordination at the regional level. It is to be noted that largely inhibited by the international differences in ethnic culture and languages, labor mobility even within the European Union, is still limited.

Finally, the Latin American experience involving two large Mercosur countries of Argentina and Brazil in the 1990s suggests the need for macroeconomic policy coordination as an integral part of effective financial integration at the regional level (Ghymsers 2001). When the four countries of Argentina, Brazil, Uruguay and Paraguay agreed to form a free trade area, there were no specific arrangements for coordinating macroeconomic and exchange rate policies at the regional level. Throughout the 1990s Argentina adopted a currency board system by pegging its peso to the US dollar while Brazil continued to float the value of its currency, real. Macroeconomic disruptions caused by trade deficits in an overvalued currency of one country against the undervalued currency of the other had often resulted in heightening trade tensions, reducing the volume of intra-Mercosur trade and thereby undermining the economic basis for an effective regional cooperation. The post-1997 crisis devaluation of the Brazilian real led to Argentina's

10. In Europe, the OECD (Organization for Economic Cooperation and Development, since 1961) and European Community (since 1958) have managed policy coordination. In Latin America, the Economic Commission for Latin America (ECLA, the Spanish acronym is CEPAL) has helped forming regional policy and monitoring information since 1948.

rising trade deficits and debts, eventually culminating in Argentine's debt crisis.

■ *Beyond Chiang Mai: Possibilities and Challenges*

Although potential gains from regional financial integration for the East Asian regional economy with its deepened mutual dependence in trade and investment would be substantial, we have shown that the macroeconomic indices required for EU type of common currency area are grossly inadequate for East Asia. After all, Europeans, starting from trade liberalization, have experimented a long process of financial cooperation, taking nearly five decades for them to establish a single currency system. In contrast, East Asia has still a long way to go (Goto & Hamada, 1994); a regional consensus even on the policy goal and strategies for financial integration has yet to be pursued.

While any suggestion for monetary union for EA appears premature and impractical at this juncture, policymakers' attention needs to be turned to next feasible steps for regional cooperation. The CMI, despite its sizeable reserves accumulated and given the way it is currently structured, can be seen as a liquidity support program in times of the need. Its ability to prevent or minimize the risk of future financial crisis remains limited. Simple swaps of local currencies will not be sufficient to safeguard from recurrence of crises.

There has thus been a strong sense among the policymakers that East Asia should build a more solid framework for cooperation. The following points can be further elaborated. This section highlights the main points concerning the next steps. The questions addressed are: What should be and can be done beyond the CMI.

To begin with, it must be noted that increasing efforts have already been made in East Asia for financial cooperation after the CMI. Beyond the liquidity support of the CMI, the particular areas in which regional cooperation has been sought after are information exchange, and macroeconomic surveillance. First, even prior to the CMI, there had been no shortage of initiative for exchange of information for regional economic surveillance. A few major undertakings in information exchange included the Manila Framework Group (1997), the ASEAN Surveillance Process (1998) and the ASEAN+3 Surveillance Process (1999). Those initiatives were established to discuss issues for peer review and to strengthen policymaking capacity, primarily within ASEAN.

Nonetheless, as suggested by the initial plan of the CMI, there is now a need to establish a more concerted and concentrated institutional

framework for collecting economic data and monitoring the regional economic and financial situation in a systematic and analytical way. The existing regional economic institutions such as the Asian Development Bank could easily handle such a function, or a new institution can be created. The ADB has recently contributed to the study of financial integration in cooperation with Japan, and can be expanded to equip with the technical staffs and resources to manage and disseminate information flows. Alternatively, a new regional institution can be modeled on the likes of Europe's OECD or Latin America's CEPAL rather than more proactive IMF.

Second, information gathering and economic surveillance should form matched agenda in the framework of regional financial cooperation. In forming a regional financial cooperation system, a regional institution can be mandated for financial surveillance of member states. The regional surveillance system must have an evaluation process more or less independent of concerned governments and official agencies. Also, in order to make the surveillance process more effective, local or intra-regional surveillance should be supplemented by cross-regional surveillance. A discussion network of academics and policymakers in member states could serve as a useful supplementary channel for economic surveillance. The practice of the EU is exemplary and might serve as a role model for East Asia. However, the short period of experience in regional cooperation and diverse national interests lie as a barrier to build a surveillance mechanism. As a result, we have not yet seen much progress since the CMI (Park and Wang, 2003).

Third, the most challenging aspect of financial cooperation for the EA region will be how to coordinate macroeconomic and exchange rate policies. If the ultimate goal for the East Asian region is a monetary union - something similar to the current EU framework, the daunting, long-term challenge will be to assure that a reasonable degree of macroeconomic convergence in the regional economy is attained. At the current stage, the EA group has yet to come up even with any effective surveillance process to establish a policy coordination mechanism instrumental in regional convergence.

The problem for the countries of East Asia has been how to go beyond rhetoric and identify what can be done in coordinating national policies for regional financial stability. Effective policy coordination will be instrumental in preserving what has been achieved in terms of regional integration in trade and investment (Kwack, 2002). This will be more relevant for the countries of ASEAN or NAFTA whose national governments, despite their FTA agreement, exercise independent trade

and competition policies. Moreover, the economic as well as political economy prerequisites for a monetary union are not present in Asia. A region-wide system of currency pegs or bands would not be sustainable, particularly in today's highly liquid global financial markets. One is reminded of the dire consequences of competitive devaluations by trading partners in global financial markets. A couple of incidents will suffice to illustrate this point. Before the outbreak of the Asian crisis, China's decision to depreciate its currency to stimulate exports contributed to the precipitation of the regional financial crisis. Also, prior to the outbreak of the debt crisis in Argentina, the Brazilian decision to float its real to gain competitive edge in trade had in fact precipitated its neighboring Argentina's crisis.

Thus, distinct from the case of the EU that fits well into a common currency paradigm, it would be more practical for the EA countries to start with mutual policy coordination on a limited, local scale involving only affected countries. For instance, the borrowers of reserves in the context of CMI swaps can be imposed with much expanded conditionality to adopt more prudent monetary and fiscal policies. The surveillance process for policy coordination can focus on such measures as the borrowers' dependence on short-term, foreign-currency denominated debt, central bank autonomy, or inflation targeting. Additional conditionality to have some of these measures in place may well serve to reduce exchange rate volatility at least to levels compatible with regional integration.

In this context, the situation in Latin America is illuminating. Compared to other regions, the Latin American region tends to experience greater macroeconomic volatility. Recently, many LA countries within all of the regional trade groupings become concerned with mutual macroeconomic policy coordination as a prerequisite to negotiations for deeper integration. Particular interest is in the possibility of mutual coordination involving affected trade partners about exchange rate policies.

Fourth, it is worth noting that in an effort to enhance the pool of liquidity reserves, the Chang Mai meeting additionally accepted the Thai proposal to actively develop a regional bond market via the promotion of domestic bond markets, especially in corporate bonds. A regional bond market appeared to have great potential in facilitating the recycling of surplus savings within the region. It should serve instrumental in reducing the need of countries to rely on short-term debt, thereby reducing the risks of a financial crisis. Given the high saving propensity and huge foreign reserves (at present about US\$800 billions) of East

Asian countries, it is not surprising to see a rapid growth in Asian bond markets with increasing diversity of issuers. The total capitalized value of regional bond markets was estimated at \$1.5 trillion by the end of 2003. In a separate effort, the central banks of eleven EA countries additionally contributed US\$ one billion official reserves to establish the Asia Bond Fund (ABF) in 2003. The ABF constituted only a small fraction of the region's total bond market size. Nonetheless, creation of official reserve bond market reflects a beginning regional effort toward financial integration (Eichengreen, 2004).

Fifth, there is a second set of policy measures worth considering as an integral part of policy coordination for regional financial stability. Since in a large number of EA's emerging markets, their financial sector is not yet well diversified and is composed mainly of banking activities.¹¹ As a result, the real and financial sectors likely end up with a high dependence on foreign debt and are vulnerable to external shocks. Since their surveillance mechanism is weak and unreliable, their economy is still exposed to capital flight. Given this reality, the wisdom of a full-fledged capital mobility, which is the key to the success in financial integration, can be questioned. The question that should be addressed is whether there should be a regional discretion in a regional cooperation scheme to allow temporary capital control in special cases involving specific member states.

During the Asian crisis, Malaysia resorted to restrictions in international capital movements to overcome financial instability. Chile, Brazil and Colombia implemented such controls in the 1990s with some success in moderating short-term incoming capital flows and lengthening their maturity. The governments concerned believed that the measures were useful in dealing with problems during periods of capital surges. Capital control would be useful for countries in East Asia with their weak financial sector infrastructure if a cautious weighting between financial liberalization and short-term capital inflows can be applied.

Fifth, in tandem with arrangements for financial cooperation, multilateral efforts should continue to promote regional free trade (Ahn, 2004). EA members' trade with the countries outside the region has historically been important and has in comparison to other regions been more naturally integrated to the global setting.¹² It will be good

11. *Economist*, February 28, 2003.

12. Asian ministers have intensified their efforts to expedite the agreements for trade liberalization. Recently, the ASEAN countries have agreed for expansion of a free trade zone. Japan and Singapore concluded an agreement on bilateral free trade. China

for the region to proceed with trade liberalization based on multilateralism and open regionalism (Lee & Park, 2002).¹³ Unlike the European and Latin American counterparts, the countries of Asia may not need to elaborate legal framework and policy coordination among governments, in so far as trading relations are concerned.

Finally, there are other region-specific challenging constraints in promoting the integration of regional financial markets for East Asia. These hindering factors may help explain why the progress toward regional integration in East Asia that encompasses ASEAN+ 3 and beyond is expected to be slow and often stumbling.

First of all, the EA countries lack in business and economic experiences in regional cooperation, in particular, in financial areas. More importantly, there is the complex geopolitics involving Japan, China, two Koreas, and Taiwan. Given the past history of Japanese colonial rule in Asia as well as the economic threat from burgeoning might of China, it is difficult to expect that EA countries will readily allow a supra-national governance in facilitating regional cooperation. The region is not ready to allow the formation of social capital forging mutual trust and confidence among member states, which would be instrumental in expediting regional financial integration. The post-World War II cooperation between Germany and France is an exemplary case of social capital formation in forging European integration. In contrast, EA nations will likely take a cautious, calculating, pedestrian approach to regional integration.

Another hindering factor is the enormous diversity in macroeconomic conditions and institutional development even among the thirteen ASEAN+3 regional economies. Compared with Europe and Latin America, East Asia has greater political, cultural and economic diversity among the member states. There is the question whether such a grouping of countries in the context of the current, complex geopolitical milieu is appropriate for regional financial integration. The diversity of member states in initial economic conditions makes it important to pay attention to specific individual country problems. Although sev-

and ASEAN have decided to work toward a free-trade agreement. South Korea also has shown interest in bilateral free trade with ASEAN and proceeded for negotiations (Park, 2002a, 2003). Leaders of 10 ASEAN states have lately in 2004 concluded in Bali a landmark accord (dubbed as “Bali Concord 11”) aimed at creating a single market modeled on the earlier European common market by 2020.

13. Using the gravity model, they demonstrated the importance of EA’s trade relations with countries outside the region. EA is shown to be more open to trade with non-members than other regions.

eral selected EA members show solid economic indicators,¹⁴ the rest are still in the stage of economic development and have to deal with such underdevelopment issues as poverty, poor social welfare, underdeveloped financial infrastructure, lack of transparency in government and business. Thus, an effective regional financial arrangement would call for a political commitment from all members for a common policy goal. In order not to further marginalize weaker members, the benefits and costs from regional cooperation should be shared equitably by means of specific institutional arrangements. For the region's least developed countries, such as Cambodia, Laos, Vietnam, Myanmar, special consideration must be given for the possibility of prioritizing development aid in a broad framework of regional financial integration.

■ *Concluding Remark*

Ideally, the East Asian regional economies need to hasten as their collective policy goal their efforts toward regional financial integration in parallel to the region's deepening trade integration. This region-wide aspiration for financial integration aside, this paper takes a more cautious position in approach toward the integration. The current situation in EA does not simply satisfy the real and financial criteria required for effective financial integration. The Chang Mai initiative for swap arrangements provides only a good starting framework for promoting financial cooperation. Simple liquidity support cannot be seen as an effective defense mechanism against potential financial crises. There is still a long way to go beyond swap arrangements in assuring regional financial stability. To begin with, there has to emerge a collective political will at the regional level to develop and promote a solid mechanism for financial cooperation as well as policy coordination.

14. A recent study (Kang, 2004) reports statistical evidence that financial market integration—as measured in interest rate and exchange rate convergence—has noticeably increased among the group of more advanced East Asian countries in the post-Asian crisis period.

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