AFTER THE CMI:

THE FUTURE OF ASIAN MONETARY COOPERATION AND CHINA'S ROLE

He Fan Zhang Bin Zhang Ming

Institute of World Economics and Politics

Chinese Academy of Social Sciences

Abstract: After the Asian financial crisis, the pace of regional monetary cooperation in Asia has picked up. Entering the new century, Asian economies are facing new external risks. Without coordinated efforts these risks can easily developed into financial crises. The CMI is a stepping-stone for launching full-fledged Asian monetary cooperation, but is also has problems and defects. This paper reviews the development of the CMI and suggests how to enhance the functioning of the CMI. We also discuss the issue of exchange rate coordination. Several proposals have been compared and we discuss the sequencing of exchange rate coordination and harmonization. Finally, we analyze the role of China in Asian monetary cooperation.

Keyword Asian monetary cooperation CMI exchange rate coordination

Introduction

After the Asian financial crisis, the pace of regional monetary cooperation in Asia has picked up. That crisis fostered the belief that Asian countries need to band together to protect themselves from the contagious spread of financial crisis and the destabilizing impulses emanating from outside. In May 2000, the Financial Ministers of ASEAN countries plus China, Japan and Korea met in Chiang Mai, Thailand and launched the Chiang Mai Initiative which involves an expanded ASEAN swap arrangement and a network of bilateral swap arrangement among the ASEAN+3. The development of the CMI has caught much attention not only because it is the first significant regional financial arrangement in Asia but also because it can be a stepping-stone for full-fledged regional financial cooperation.

With the recovery of the Asian economy, however, the momentum for regional financial cooperation may be lost. The design of the CMI was to provide liquidity support to member

economies when they are facing external dis-equilibrium. Since there is unlikely to repeat a similar Asian financial crisis, why do we bother to establish a “war-time” crisis rescue arrangement during the “peace-time”? We believe that regional financial cooperation becomes even more relevant than before, because in the new millennium, Asian economies are facing new external risks like US dollar depreciation, US interest rate hike, and the surge in oil price. Without coordinated efforts these risks can easily developed into financial crises. On the other hand, the CMI is more than just a “war-time” crisis rescue arrangement and we should enhance its functioning so that it can better serve the region’s “peace-time” needs. Exchange rate coordination, for example, should become the main theme of Asian monetary cooperation and to launch on the full-fledge integration, the CMI can be utilized as a platform.

New External Risks and the Desirability of Enhancing Asian Monetary Cooperation

The lessons of the Asian financial crisis revealed that financial crises in this region can come from two aspects. On the one hand, East Asian economies are vulnerable to external shocks such as changes in exchange rate and interest rate of major international currencies, fluctuation of international commodity price and reversion in international short-term capital flow. On the other hand, East Asian economies are also plagued by the undeveloped and fragile domestic financial system, misalignment of their exchange rate, and sometimes an oversized fiscal deficit. Ideally, both the external vulnerability and internal fragility should be addressed simultaneously to avoid future crisis, but domestic reform take more time and may encounter political resistance, regional monetary cooperation, however, can be more effective in safeguarding against the contagion of financial crisis, fostering consensus among policy makers and in turn stimulate domestic reform in individual countries.

East Asian economies usually adopt the export-led strategy, and may depend too heavily on outside markets like the U.S. They are small economies in the sense that they are price taker in the global market. Their currencies are not international currency, so they are also plagued by the problem of “currency mismatch” and “maturity mismatch” since they can not borrow and lend freely with their own currencies in the international financial market. Most of the Asian economies

are scarce with resources like crude oil, so their economic growth is sensitive to the price fluctuations of the international commodity market. Typically, East Asian economies already liberalized their capital account and financial sector, so they are exposed to the international short-term capitals and can easily be attacked by speculative capitals. Furthermore, most Asian economies have rather small domestic markets and when facing external shocks, they can not offset the negative impacts by adjusting their domestic economy.

In the last 20 years, East Asia has sped up its pace of trade integration. Intra-regional trade accounted for 51% of its total trade values in 2001 from 34% in 1980. Although this ratio was still lower than that of the EU (62% in 2001), it was already higher than that of the NAFTA (46% in 2001). In the last 20 years, relaxation of financial regulations and liberalization of capital accounts have promoted the financial integration in East Asia. The further trade integration may facilitate the contagion of international payment crisis, while financial integration makes it more easily and quickly to spread. The regional integration ties the East Asian economies together more closely. East Asian economies are confronted with similar and synchronous external risks and the benefits of collective action on building regional early-warning system, policy coordination mechanism and common exchange rate regime also increased.

New External Risks

In the new millennium, Asian economies are facing new external risks. For the time being, there is no signal showing that East Asia will break out another crisis, but these external risks indicate that world economy is undergoing a dramatic change. East Asian economies, unfortunately, is in the eye of the typhoon

Global imbalance and the Depreciation of the USD The U.S. accumulated substantive current account deficit while East Asian economies accumulated large amount of foreign exchange reserve. By the end of 2004, America's current account deficit reached an historical high of $600 billion, 6% of its GDP. The US dollar need to be depreciated substantially to correct the imbalance of the U.S current account. But the sharp decline of the USD will have great negative impacts on the Asian economy. The sudden depreciation of the dollar would shrink East Asian economies' dollar-nominated foreign reserves and cause huge lost. Most of these economies are burdened with yen-nominated or euro-nominated debts, the depreciation of the USD to Yen and Euro would weigh on their debt burdens and even lead to debt crisis. After the Asian financial crisis, many East Asian

economies adopted de facto peg-to-dollar exchange rate regime McKinnon and Schnabl, 2003 . Now, if they stop pegging to the dollar, their currencies will appreciate, their exporting competitive edge be impaired, and the importing demand of the US decrease. This would lead to deterioration of their current account, or even international payment crisis at worst. If these countries chose to continue pegging to the dollar, it may introduce speculative capitals which debt that the fixed exchange rate regime is unsustainable.

US interest rate hike and the reversion of international capital flows Since June 2004, the US Federal Reserve has successively lifted its benchmark interest rate from 1 to 3.25%. This move might continue and the US benchmark interest rate is expected to reach the equilibrium level of 3%-5% within one or two years.

We can see from Table 1 that interest rates of the East Asian economies are closely correlated with the US interest rate. Once there was a substantial increase of the US interest rate, the East Asian countries would face a dilemma: Some East Asian economies are still worried about the un-solid recovery and a sudden increase of interest rate may slow down their growth, but keeping their interest rates unchanged would decrease or even reverse the capital inflows. More capitals will flow out to the U.S which can cause short-term liquidity shortage.

Table 1: Correlation between the East Asian and U.S. interest rate

	Japan	**China**	**South Korea**	**Indonesia**	**Malaysia**	**Thailand**	**Philippines**	**Singapore**
US	0.599	0.826	0.445	0.431	0.377	0.385	0.847	0.731

Note Interest rate used for the U.S. is the benchmark interest rate; Interest rate used for Asian countries except China are money market rates; Interest rate used for China is interest rate on loans.
Source IMF database, from 1998 to 2003

Surge of the oil price Since 2002 international crude oil prices have been on the increase, from $24 per barrel in November, 2002 to $55 per barrel in October, 2004. In less than 2 years, international crude oil prices have risen by more than 200%. For oil-importing East Asian countries, oil price surge is an impending threat to their growth and macroeconomic stability. High oil prices would eat out the profits of manufacturing enterprises and reduce the consumption of households in these countries. Oil price increase can also lead to cost-pulling inflations. With the high oil price,

Asian economies have to pay more for their import, which might reduce their current account surpluses or even cause current account deficits.

Asymmetry of external impact on East Asian economies

Although East Asian economies have some common external risk exposures, but the impacts of these external risks on individual economy are not symmetric. The most fundamental reason lies in notable differences between Japan, China and the ASEAN members in business cycle and economic structure. This is both a bad news and a good news for Asian monetary cooperation. If we adopt the standard criteria for optimal currency area, it's clear that East Asia do not fulfill the requirement. But, the asymmetric response of the external risks implies East Asian economies are unlikely to burst into crises simultaneously. Therefore, it is reasonable and desirable for some countries to provide aid for other crisis-hit countries.

We use a structured VAR method to analyze the external impacts on East Asian economies. We divide external impact into demand impact and supply impact and analyze different effects these two kinds of impact on production and price fluctuations.

Table 2. Correlation of external demand impacts between Asian economies

	China	**Japan**	**South Korea**	**Indonesia**	**Malaysia**	**Philippines**	**Singapore**	**Thailand**
China	1.00							
Japan	0.04	1.00						
South Korea	0.38	0.19	1.00					
Indonesia	0.04	0.25	0.48	1.00				
Malaysia	0.00	0.28	0.10	0.40	1.00			
Philipines	0.18	0.25	-0.27	-0.03	-0.22	1.00		
Singapore	-0.05	-0.23	0.30	-0.14	-0.32	-0.31	1.00	
Thailand	0.18	0.09	-0.36	-0.32	-0.28	0.52	-0.38	1.00

Source IMF database, from 1978 to 2002

Table 3. Correlation of external supply impacts between Asian economies

	China	**Japan**	**South**	**Indone**	**Malays**	**Philipp**	**Singap**	**Thail**

			Korea	sia	ia	ines	ore	and
China	1.00							
Japan	0.12	1.00						
South Korea	0.15	0.59	1.00					
Indonesia	-0.01	-0.42	-0.83	1.00				
Malaysia	0.03	0.45	0.64	-0.80	1.00			
Philipines	0.38	0.08	-0.08	0.19	-0.08	1.00		
Singapore	-0.26	0.34	0.50	-0.59	0.70	-0.32	1.00	
Thailand	0.25	0.19	0.16	0.15	0.08	-0.02	0.16	1.00

Source IMF database, from 1978 to 2002

From the above analysis we have the following conclusions: (1) Nearly all countries involved show weak correlation on demand impact(with the only exception that Thailand Philippines' correlation is above 0.5) which demonstrates that demand impact is asymmetric. The reason for weak demand correlation is that economies in East Asia lack coordination in macro polices. In the Structured VAR model, the more they coordinate their macro policies, the higher the correlation would be; (2) Supply impact correlation is generally higher than that of the demand impacts; (3). China has both weak demand and supply impact correlation with the ASEAN members. This demonstrates that China could act as a stabilizer of the East Asian economy.

Review of the CMI and Suggestions for Further Reform

In May 2000, Finance Ministers from the ASEAN plus China, Japan and South Korea signed the Chiang Mai Initiative (CMI), the significance of which includes two parts: firstly, the expansion in numbers and sums of the ASEAN Swap Agreements; Secondly, establishment of bilateral swap agreements between the ASEAN and China, Japan, South Korea. Great progress has been made ever since. By the end of 2003, China, Japan and South Korea had signed 16 bilateral swap agreements with the ASEAN, which added up to $ 44 billion Table 4 . Members involved in these agreements have reached consensus on their basic framework and fundamental principles, including credit conditionality associated with the IMF, credit period and interest rate, etc.

Table 4: Bilateral swap agreements under the CMI by December,2003

Bilateral sides	Currency	Date(year/month/day)	Scale(US$,billion)
Japan ——South Korea	USD-Won	2001/7/4	7 (a)one way
Japan ——Thailand	USD-Baht	2001/7/30	3 one way
Japan ——Philipines	USD-Peso	2001/8/27	3 one way
Japan ——Malaysia	USD-Ringgit	2001/10/5	3.5(b)one way
China ——Thailand	USD-Baht	2001/12/6	2 one way
Japan ——China	Yen-Renminbi	2002/3/28	3(c)double way
China ——South Korea	Renminbi-Won	2002/6/24	2(c)double way
South Korea——Thailand	USD-Won or USD-Baht	2002/6/25	1 double way
South Korea——Malaysia	USD-Won or USD-Ringgit	2002/7/26	1 double way
South Korea——Philipines	USD-Won or USD-Peso	2002/8/9	1 double way
China ——Malaysia	USD-Ringgit	2002/10/9	1.5 one way
Japan ——Indonesia	USD-Rupiah	2003/2/17	3 one way
China ——Philipines	Renminbi-Peso	2003/8/29	1(c)one way
Japan ——Singapore	USD-Singapore dollar	2003/11/10	1 one way
South Korea——Indonesia	USD-Won or USD-Rupiah	2003/12/24	1 double way
China ——Indonesia	USD-Rupiah	2003/12/30	1 one way

Notes: (a) Including $5 billion in the New Miyazawa Initiative June 17, 1999 ;

(b) Including $2.5 billion in the New Miyazawa Initiative August 18, 1999 ;

(c) calculated in dollar.

However, CMI still has several shortcomings and without reform, it will not provide a meaningful regional mechanism. As a financial arrangement, the CMI has several shortcomings:

Lack of a central body. CMI is composed of a set of BSAs, without a coordinating institution. This arrangement is good for creditors to have discretion over the activation of the swap. But no central body in charge of overseeing or administrating the arrangements means the crisis-hit country has to negotiate with every member countries to activate the fund, this may cause the increase of negotiation costs and maybe a miss of the best timing.

Shortage of available funds. The size of CMI already exceed other swaps like G10 ($38.4 billion), EMS financing facilities, North American Framework ($8.6 billion) but the current maximum amount that can be provided is still a drop in the ocean compared with the amounts that global financial markets. It is also much smaller than the past financial rescue packages for the East Asian crisis-hit countries. Suppose that in 2005 Thailand will be struck with another financial crisis

like that of 1997, other East Asian countries have not been affected and are willing to provide financial assistance. Thailand has signed 3 currency-swap agreements with Japan, China and South Korea, with the total value of $ 6 billion. But with 90% of the swap capital linked with the IMF credit, Thailand could only get an immediate credit of $600 million. This is much smaller than the $17.2 billion credit that Thailand borrowed from the IMF in August 1997.

Linkage with the IMF. The CMI allows a 10% automatic draw in case of emergency but the rest 90% is linked with the IMF rescue plan. This practice helps to safeguard the funding provided by member countries. The conditionality of the IMF is to encourage macroeconomic stabilization and structural reform, and discourage moral hazard. But the linkage reduced the available funding and the conditionality of IMF may not always be flexibly adapted to local circumstances.

Exploring ways to enhancing the functions of the CMI in the medium term

With the strong recovery of the Asian economy, the enthusiasm on regional financial cooperation tends to be waded off. However, it would be presumptuous to assume that there will not be any crisis in the region in the future. We mentioned that Asian economies are facing with a series of external risks that could easily degenerate into crisis. We argued that in order to solve these problems, CMI need to be reformed and be transferred from the "fire fighting" mode of a liquidity assistance to a self-regulating mechanism (SRO) for the region.

First, A central body needs to be established and the functions of this central body include: (1) organize and supervise a 10+3 monitoring unit; (2) responsible for the disbursement of the fund and the terms for disbursement (maturity, baseline rate, currency, and other conditions). 10+3 members should have regular as well as temporary meetings to discuss these issues. At the same time, a regional surveillance system must be put in place and we suggest establishing a 10+3 monitoring unit. 10+3 monitoring unit is under the leadership of the central body and its function include: (1) following up with the world economy and regional economic situation; the change on the international financial markets and energy markets; (2) identify the potential external risks of each members and provide up-to-date reports; (3) work on specific rescue project with the central body. Experts in 10+3 monitoring unit should include economists from both 10+3 and outside.

Second, a careful monitoring system is much needed. Liquidity management is best positioned as a pre-emptive tool rather than a remedial policy. To be able to anticipate the liquidity needs, the CMI needs to develop a robust EWS capability. First, this monitoring system can identify the

source of instability to see whether the instability is exogenous change or internally generated. Lending under the CMI is meant to respond to external shocks, i.e. hot-money flows. The monitoring system also needs to distinguish short-term portfolio capital flows from long-term capital flows. Second, Legal framework of capital markets registrations and reports should be established to facilitate the monitoring of short-term capital movements. It involves the imposition of limitations on residents' holding of financial assets and liabilities denominated in foreign currencies, and non-residents' holding of similar instruments denominated by local currencies.

Third, developing an earmarking agreement or a regional reserve polling mechanism. The large amount of foreign exchange reserves that Asian economies are holding are not blessing but burden for them. Monetary authorities of all the ASEAN 10+3 members could set aside an earmarking fund out of their foreign reserves to support medium-term volatility. Such a pool would need to substantially exceed the CMI in size. To ensure daily safety and profitability of the fund, it could be entrusted to the Asian Development Bank or some other independent intermediary organizations.

Fourth, gradually de-link with the IMF conditionality. It is a basic premise that financial transactions require some amount of conditionality to avoid moral hazard. But to the extent that swaps and repos are the instrument of choice, the lender should have the leeway to negotiate for these conditionalities since the credit risk is borne by the lending economy. To avoid possible moral hazard of the recipient, we should adopt a gradual approach to de-link with the IMF conditionality.

Sequencing of East Asian Exchange Rate Coordination

After the Asian financial crisis, exchange rate coordination becomes a heatedly debated topic. Exchange rate stability should also be one of the main themes in the medium term of regional monetary cooperation. Without exchange rate coordination, the region will be perennially vulnerable to contagion just by the mere fact of the correlated nature of both the capital flows and the structural shocks. Contagion exacerbates liquidity risk because it complicates the timing (herd-like flows) and magnifies the volume needed to stem the correlated action of market players. Also, exchange rate coordination would bring potential benefits for inter-regional trade and

investment.

There are already some proposals on East Asian exchange rate coordination mechanism. Williamson (1999), Ogawa and Ito (2000), Kawai and Takagi (2001) suggested East Asia countries should peg to a G-3 currency common basket; Oh and Harvie (2001) and Wyplosz (2002) proposed that Asia Exchange Rate Mechanism may be the least costly and most feasible option for East Asia exchange rate coordination solution; Ohno and Shirono (1997), Dornbush and Park (1999) and Kwan (2001) suggested a "Yen Bloc" in East Asia; Mckinnon (2002) suggested that "Dollar Zone" is still the most reasonable and feasible solution for overcoming the existing shortages of East Asia exchange rate system. It has to be mentioned that due to various economic structures and preferences in East Asia economies, different scheme means different costs and benefits for individual countries. Some maybe ready for a close exchange rate coordination arrangement in East Asia, such as a common basket peg, while others need more time to prepare for it. Up to now, we can hardly find any exchange rate coordination scheme that can be fully accepted by all the economies.

Common basket peg

The main features of a common basket peg include[1]: (1). Targeting a common basket of currencies (US dollar, Japanese Yen and EEC's Euro). (2). A common set of weights attached to these currencies based on regional (rather than country) trade share. Thus, explicit or implicit idiosyncratic trade-based weights currently being used will have to be removed. (3). Each member announces a central parity vis-à-vis the basket and pledges to keep the central parity within a unilaterally chosen band. (4). The allowance of a range of formal exchange rate regimes such as the currency boarding in Hong Kong, China; the fixed parity in PRC and Malaysia; or various types of managed floating in Korea, Singapore. (5). Adoption of McKinnon's "restoration rule" that the national authorities, when confronted with speculative attack, are allowed to temporarily suspend the peg provided a pledge to return to the original sin is credibly made. (6). Since changes in economic fundamentals and basket currency misalignment are a fact of life, and these impact on the member country competitiveness, member countries may allow central parity and the band to crawl as a response to these fundamental changes. (7). A financing analogue to the European VSTFF (Very Short Term Financing Facility) to help member currencies under attack from speculators is

[1] The features of different schemes are summarized by Fabella (2002).

envisioned.

The benefits of a common currency basket include: (1) it will reduce the intra-regional nominal effective exchange volatility. Comparing with existing peg-to-dollar system, incorporating Japanese yen and Euro in the peg could help East Asia economies keep more stable bilateral nominal exchange rate between Japan and Euro areas, this will help stabilize East Asia economies' intra-regional exchange rate (by pegging Yen) and even their nominal and real effective exchange rates (by pegging Yen and Euro). All those improvements will help promote intra-regional trade and macroeconomic stability in East Asia; (2) It has less need for policy coordination and surveillance (Kawai and Takagi, 2001). All participants in a common basket peg regime could keep their existing exchange rate regime, only change their US dollar peg to G-3 currency peg.

Although a common basket peg scheme shares lots of advantages, it's not unchallengeable. Firstly, a common basket peg scheme will bring unbearable exchange risks and transaction costs for those East Asia economies that do not own sophisticated bond markets and forward foreign exchange markets. Under the dollar peg exchange rate regime, merchants and investors do not worry about exchange risks because most of their trade is invoiced in US dollar and most of their foreign assets are also US dollar assets. Once their currency peg to US dollar, the exchange rate risk between local currency and US dollar are also be hedged by their monetary authority. By credibly pegging to US dollar, the monetary authority in East Asia economies maximally reduce the exchange risks that may happen in the international economic activities. When East Asia economies switch US dollar peg to a common basket peg, it means that the bilateral nominal exchange rate between local currency and US dollar will be adjusted with high frequency. If there is supplicated forward exchange rate market to hedge the exchange rate risks, it will not be a problem. However, due to under-development of domestic financial market, lots of East Asia economies do not own efficient forward foreign exchange market. Excessive fluctuations between US dollar and local currency will bring merchants and investors unbearable exchange risks and transaction costs.

Secondly, a common basket peg scheme can hardly survive without strong commitment of member countries and an efficient institutional framework. To defend the common peg, member countries must be ready to protect the peg at the expense of scarifying national sovereignty. More over, when the weak currency member is under speculation, there must be an efficient institutional framework to facilitate the policy coordination among member countries and providing unlimited

financial help to them.

Thirdly, the choosing of a common set of weights is also questionable. A common basket for all member countries neglects the fact of life that different economies have different trade structures. If a member country trade mostly with United States, a common basket peg can hardly stabilize its nominal effective exchange rate (NEER). Moreover, even if all East Asia economies have similar trade structures, a simple trade-weighted basket is also contentious. Theoretically, under different policy objectives, there are various weights for each currency in the basket. If the policy objective is to minimize the fluctuation of trade balance, a simple trade-weight basket is right. If there are two or even more policy objectives, such as minimize the fluctuation of domestic price or foreign debt, the weight for each currency in the basket will very quite different.

East Asia Exchange Rate Mechanism

An East Asia Exchange Rate Mechanism may appeal to many policymakers because they are encouraged and could be guided by the evolution of the EMS. The main features of East Asia Exchange Rate Mechanism include: (1). An Asia Currency Unit (ACU) to dovetail the European Currency Unit of EMS is envisioned. The former is a basket of East Asia member country currencies, which will serve as a single basket currency target; (2). The weights assigned to each country are the trade share of the country in total trade of the region; (3) The member country exchange rate are to float within a band of 15 percent plus or minus the central parity just like the post-1993 “soft” EMS, the central parities are not unilaterally determined; (4) A lender of last resort in the form of a quick disbursing loan facility akin to the EMS’ Very Short Term Financing Facility to weather speculative attacks; (5) The central parity is to be approved by an authority, the Asian Monetary Institute, which is like the European Monetary Institute, to manage the East Asia Exchange Rate Mechanism and implement agreed coordination and surveillance policies; (6) The target zone exchange rate regime is obligatory for each country.

The benefits of the East Asia Exchange Rate Mechanism include: (1) it will bring a greater degree of co-movement of the regional intra-exchange rate, and therefore more stable nominal effective exchange rate within the region. Woplosz (2002) shows that an Asian Monetary System is as effective as pegging to a common basket in stabilizing the bilateral exchange rate of the regional currencies; (2) East Asia Exchange Rate Mechanism will increase the influence of Yen, RMB, or other major currencies within the region. The main difference between a common basket peg

scheme and East Asia Exchange Rate Mechanism is that the former peg to US dollar, Euro and Yen while the later peg to regional currencies. To keep the peg, East Asia economies will tend to hold more regional currencies, such as Yen or RMB or other major currencies in the region. The increase use of regional currencies can also help the development of regional currency denominated bond markets; (3) Just like a common basket scheme, East Asia Exchange Rate Mechanism could reduce the possibility of beggar-thy-neighbor devaluation and strengthen East Asia's voice as a negotiating bloc in the world.

East Asia Exchange Rate Mechanism also has its defects: (1) Like a common basket peg scheme, East Asia Exchange Rate Mechanism will bring high frequency fluctuations between local currency and US dollar, and therefore unbearable exchange risks and transaction for those economies that do not own sophisticated financial markets; (2) East Asia Exchange Rate Mechanism cannot reflect the changes in the alignment between major currencies, such as fluctuations between US dollar and Euro; (3) East Asia Exchange Rate Mechanism will be prone to currency crisis especially when demand and supply shocks are asymmetric. The experience of EMS showed that the weak currency in the system has always been in the danger of currency speculation; (4) East Asia Exchange Rate Mechanism needs strong political commitment and the support of institutional arrangements. Without a widely accepted political consensus and strong commitment, it is impossible for member countries scarifying national sovereignty to defend the ACU. More over, East Asia Exchange Rate Mechanism still need some kinds of institutional arrangements to provide unlimited financial help to those weak currencies under speculation.

Yen Bloc and Dollar Zone

Comparing with above two schemes, Yen Bloc and Dollar Zone are less commented on. both proposals do not have very specific arrangements. The main feature of Yen Bloc is that East Asia economies target Japanese Yen as a nominal anchor. The main feature of Dollar is that East Asia economies target US dollar as a nominal anchor. Since US dollar are already an important nominal anchor for most East economies except for Japan, Dollar Zone proposal ask for Japan to keep more stable bilateral exchange rate with United States.

If Yen Bloc scheme is adopted in East Asia, the main benefits include two aspects. Firstly, Since Japan is the main capital and technology supplier for other East Asia economies, Yen Bloc could increase the investment expectation from Japan and therefore enhance the investment and

technology transfer in the region. Secondly, the actual benefits of Yen Bloc depend on that whether Japanese Yen can be a reliable nominal anchor. If Japanese economy performs very well and the general price level is stable, it will increase the desirability of Yen Bloc.

If Dollar Zone scheme is adopted in East Asia, the main benefits include two aspects. Firstly, due to the prevalent use of US dollar in East Asia and the rest of the world, the Dollar Zone is helpful in reducing the region' exchange risks as a whole. When East Asia economies trade with United States or other economies that use dollar as the main invoicing currency, exchange rate will not be a problem. Even when East Asia economies trade with Euro area or other economies that use Euro as the main invoicing currency, the exchange rate can also be easily hedged through supplicated forward foreign exchange market between these major currencies. Secondly, US economy performs very well in the last ten years, the general price level of US are also quite stable, US dollar could be a reliable nominal anchor for East Asia economies.

In Yen Bloc, the main costs include three aspects. Firstly, the fluctuation between Yen and other world major currencies will destabilize the competitiveness of East Asia economies. When Yen appreciate against US dollar, other economies will also lose their competitiveness. If the economies in Yen Bloc compete heavily with Japan in the third market, the negative effects will be less because both Japan and these economies' price all rise in the third market. If the economies in Yen Bloc compete heavily with economies in Dollar Bloc in the third market, the negative effects will be much heavier. Secondly, for those economies that do not own sophisticated forward foreign exchange markets, switching from US dollar peg to Yen Bloc will bring unbearable exchange rate risks and transaction costs in the transitional period.

In Dollar Zone, the main costs are that the fluctuation between US dollar and other world major currencies will destabilize the competitiveness of East Asia economies. The mechanism is similar to that of Yen Bloc.

Sequencing of East Asia Exchange Rate Coordination

Although it is widely accepted the potential benefits of East Asia Exchange Rate Coordination, none of the coordination schemes mentioned above can be widely accepted by all the economies in the near future. From the country-specific perspective, some countries may prefer to a common basket peg scheme, such as Japan, while some countries can hardly formally accept it in the near

future, such as PRC[2]. If major participants can hardly achieve a common consensus toward exchange rate coordination scheme, the exchange rate coordination scheme can hardly put in practice.

The sequencing of East Asia Exchange Rate Coordination should be practical. Due to the endogenous nature of the process of monetary integration, further exchange rate coordination in East Asia depend on infrastructure constructions rather than controversial coordination schemes. East Asia economies East Asia economies may start from limited consensus and proceed in a gradual way. A formal and obligatory exchange rate coordination scheme can only be introduced when most participants are ready for it. To promote the East Asia exchange rate coordination more practically, East Asia economies at least can proceed cooperation in following aspects:

Firstly, further exchange rate policy dialogue and information exchange can be formally introduced for East Asia economies. During the past period, challenges from United States are the main outside concern when major East Asia economies intervene their exchange rates. More policy dialogue and information exchange among East Asia economies could remind the authority's attention toward the East Asia region and therefore increase mutual understandings among East Asia economies and pave the way for more consensus.

Secondly, regional exchange stability can be suggested and jointly announced as an exchange rate policy objective in East Asia economies. Since a formal common basket peg or East Asia Exchange Rate Mechanism can hardly be adopted by all East Asia economies in the near future, a compromise is that Japanese yen is suggested to keep more stable exchange rate with US dollar and other East Asia currencies are suggested to keep more stable exchange rate with both Dollar and Yen. The compromise solution can also help stabilize the intra-regional exchange rate stability.

Thirdly, a set of intra-regional financial integration arrangements[3] and domestic financial reform plans[4] can be introduced to promote further financial integration in the region. These arrangements and plans are fundamentals for further monetary integration in East Asia. By pushing forward these arrangements and plans, the costs of switching from old exchange rate regime to a

[2] There are at least three considerations in the adjustment of RMB exchange rate: stable bilateral nominal exchange rate between RMB and US dollar; comparatively stable nominal effective exchange rate (NEER); and moving toward fundamental equilibrium exchange rate(FEER). A common basket may help in stabilizing RMB's NEER, but this is not the only target. Without the support of sophisticated foreign exchange market, a stable bilateral nominal exchange rate between RMB and US dollar is more important than a stable NEER.

[3] Such as intra-regional banking sector and capital supervision, regional infrastructure for markets (settlements, clearance, depository) etc.

[4] Such as pushing forward capital account liberalization

more cooperative exchange regime could be lessened. East Asia exchange rate scheme will be more acceptable.

Fourthly, a regional investment bank can be introduced to promote regional economic integration and facilitate infrastructure constructions of less development economies in the region. In the process of pushing forward financial integration of East Asia, private sector rather than government play the most important role. The establishment of a regional investment bank could provide financial support for private sectors' economic activities within the region and encourage more private sectors join the line of infrastructure constructions of East Asia economic integration. The difference between a regional investment bank and ADB is that the former is aimed at promoting regional economic integration.

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