

# What to Do with the Chiang Mai Initiative<sup>1</sup>

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## 1. Introduction

In May 2000, at their meeting in Chiang Mai, Thailand, the ASEAN+3 countries (the members of the Association of South East Asian Nations together with China, Korea, and Japan) agreed to establish a network of bilateral swaps for countries in financial difficulty. Their Chiang Mai Initiative was hailed as an important first step toward creating a system of common currency pegs, an East Asian monetary fund, and ultimately a common Asian currency (Park 2000). As a result of its announcement, the idea of a single currency for East Asia was transformed from a “laughable concept” to a “possible policy goal.”<sup>2</sup>

For many, the Chiang Mai Initiative is indicative of an historic shift in Asia’s approach to regional integration. The event responsible for this change was, of course, the 1997-8 financial crisis. That crisis fostered the belief that Asian countries need to band together in order to create a framework for economic, financial, and political stability in which the contagious spread of crises is minimized and they are insulated from destabilizing impulses emanating from outside. As three Korean authors (Moon, Rhee and Yoon 2000) have put it, “...when East Asian countries

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<sup>2</sup>Castallano (2000), p.9.

were attacked by vagrant international capital and were temporarily short of liquidity, they could not depend on the IMF or other international organizations as lenders of last resort. Thus, in order to avoid the detrimental effects of exchange rate crises due to unstable capital flows, East Asian countries must protect themselves.”<sup>3</sup> Charles Oman has written that regionalism should be understood not just as an attempt to achieve specific economic objectives but as a broader effort to regain political control over the process of economic globalization that has curtailed the effectiveness of national policy instruments.<sup>4</sup> Nowhere does this observation, penned in 1994, have more salience than in post-crisis Asia.

Moreover, in Asia today there exists not just the desire but also the basis for economic, monetary, and financial cooperation. Efforts to cultivate closer ties can build on existing regional institutions such as ASEAN, ASEAN+3, PECC, APEC, and the ADB, which bring together officials and technocrats to discuss issues of common interest.

The beginning of the new century may be an especially propitious time for advancing the process of regional integration.<sup>5</sup> Japan, seeing its currency weaken and becalmed in macroeconomic doldrums, fears losing its place in the region and the world. Its market-led approach to regionalism, which relies on exports and foreign investment to bind Asia closer together -- and closer to Japan -- has grown less effective as the Japanese economy has grown

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<sup>3</sup>They continue, “Monetary cooperation is also needed to overcome the crisis by preventing the devastating effect of competitive devaluation and by stabilizing currencies and enlarging economic potential in the region.” Or, as Webber (2001, p.257) puts it, the crisis “greatly strengthened perceptions of mutual economic interdependence and vulnerability between Southeast and Northeast Asia.”

<sup>4</sup>Oman (1994), pp.11, 35.

<sup>5</sup>See Munakata (2002) for a strong statement of this view.

less dynamic. Tokyo has consequently sought to supplement market-led regionalism with policy-led regionalism. It seems less deterred from proposing regional initiatives by the fear of reawakening historical antagonisms. It thus tabled the Miyazawa Plan, advanced its proposal for an Asian monetary fund, and launched the Chiang Mai Initiative.<sup>6</sup>

The crisis seems to have had much the same effect in China, which is now more willing to engage its Asian partners. Beijing's early opposition to Tokyo's proposal for an Asian monetary fund, reflecting wariness that this would increase Japan's influence in the region, has given way to active participation in ASEAN+3 and support for its policy dialogue and credit lines, as Chinese leaders increasingly see their country playing a leadership role internationally. Indonesia, Malaysia, Singapore, and Thailand, for their part, see ASEAN+3, which takes their Association of South East Asian Nations as the platform for wider initiatives, as elevating the stature of a troubled grouping that has failed to deliver on the promise of deep integration.<sup>7</sup>

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<sup>6</sup>Officially known as "The New Initiative to Overcome the Asian Currency Crisis," the Miyazawa Plan set up a \$30 billion support fund for Asian countries with financial difficulties. It was announced by the then Japanese finance minister in a speech at the IMF-World Bank meetings in 1998.

<sup>7</sup>At the beginning of the 1990s ASEAN earned credit for its role in resolving the Cambodian conflict and securing Vietnam's withdrawal from the country. The effort to establish an ASEAN Free Trade Area (AFTA) was then launched, the ASEAN secretariat was strengthened, and the organization was enlarged. But ASEAN's unifying principle, anti-Communism, then dissolved, confronting the association with the challenge of transforming itself from an entity concerned mainly with the politics of security to one concerned with economic issues. Its image and credibility were then tarnished by its failure to respond effectively to the Asian financial crisis, the coup in Cambodia, and the haze crisis in maritime Southeast Asia due to huge forest fires in Indonesia. It then failed to play much of a role in addressing the crisis in East Timor (which was left to the UN and the IMF). Webber (2001) points out that the common element in all these failures was Indonesia, which is the largest country in the grouping. First ASEAN was weakened by the fact that Suharto did not speak English (Lee Kuan Yew 2000). Then the country descended into political and economic crisis.

Those unconvinced by this discussion of factors and trends need only consider concrete economic and political achievements in the last 12 months. Tokyo and Beijing successfully used consultation to resolve their dispute over Japan's safeguards on agricultural imports, averting the threat of Chinese retaliation. In November 2001 China and ASEAN committed to negotiating a free trade agreement (FTA), and Japanese Prime Minister Koizumi responded not with warnings but by proposing a parallel Japan-ASEAN FTA. Koizumi emphasized that cooperation between ASEAN and Japan in developing deeper links should extend to both other issues (besides trade) and other countries (notably China, Korea, Australia, and New Zealand). Meanwhile, the prospective depreciation of the yen, which is widely seen as a necessary part of Japan's economic recovery strategy, has intensified the pressure on other East Asian countries that fear that their competitiveness will be eroded, providing a further motivation for cooperation and intensifying the dialogue among regional monetary authorities. If this was not enough, later this month Korea and Japan will serve as joint hosts of the World Cup.

For all these reasons, East Asia is changing. As Fred Bergsten (2000a) has put it, the region may be on the threshold of a revolution in integrationist thought and policy not unlike that of Western Europe 50 years ago.

The Chiang Mai Initiative, or CMI, is a case in point. Gauged by the number and economic weight of the participating countries, it is more encompassing than any previous East Asian initiative.<sup>8</sup> The financial commitments exceed anything that has been attempted before. And, by addressing problems of money and finance, the CMI speaks to issues brought to the fore

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<sup>8</sup>One might argue that APEC is even more ambitious in terms of number and economic weight of the participating countries, but it is not an exclusively Asian grouping.

by the Asian crisis. It illustrates that more serious efforts are being made to advance the process of regional integration than at anytime in living memory.

Yet key questions regarding the structure and operation of the CMI remain to be answered. In part, this reflects the stance of “constructive ambiguity” adopted by Asian officials to deflect the objections directed at their earlier proposal for Asian monetary fund. But this stance has costs; in particular, governments are unlikely to invest significant resources in a new regional arrangement unless its objectives are made explicit and hence the returns on their investment are clear.

The central question from this point of view is on what concrete objectives the CMI should focus – the stabilization of intra-regional exchange rates, or something else? And how should this regional initiative be structured to conform to the constraints and opportunities posed by the distinctive histories and circumstances of the participating countries? What, moreover, is the relationship between these two questions – in particular, what are the implications of institutional form for the kind of cooperation that can be successfully sustained?

My answer is that Asia’s history and current circumstances make the kind of strong institutions and close cooperation needed for successful exchange rate stabilization and monetary integration unlikely anytime soon. The existence of historically-rooted sources of resistance casts doubt on the advisability of forcing the pace -- of first negotiating an exchange-rate stabilization agreement and hoping that this then encourages closer monetary and exchange-rate cooperation. It suggests that moving ahead with a system of collective basket pegs as a first step toward monetary integration would be a costly mistake whose failure could discredit the wider process of cooperation.

The gist of the argument is as follows. Exchange rate stabilization is an expensive proposition in a world of liquid financial markets. A successful exchange-rate stabilization agreement must therefore be rooted in deep political commitments on the part of the participating countries. Beating back market forces requires pooling reserves, and pooling reserves presupposes a willingness to pool political control over financial resources. The ability to anchor market expectations requires the participating countries to continuously move down the road toward deeper monetary integration. In turn, this requires a political commitment to deeper integration and the creation of supranational institutions with agenda-setting power. These are demanding preconditions; not even Western Europe could satisfy them continuously in the final quarter of the 20<sup>th</sup> century.<sup>9</sup>

The kind of cooperation that is feasible under these circumstances is not cooperation to hit a quantitative target -- not an effort to stabilize a set of exchange rates against which financial markets can take aim -- but cooperation in promoting a process. I have in mind the process of developing the financial markets and institutions needed to repair the defects in the Asian development model that set the stage for the 1997-8 crisis. Asia requires deeper and more liquid securities markets in order to reduce its dependence on bank finance. It needs to strengthen market discipline on banks and to distance them from governments. Building deeper and more liquid financial markets is integral to enhancing financial stability and limiting vulnerability to future crises. That process can be pushed forward by sharing expertise, applying peer pressure, and collectively mobilizing financial resources, things that regional cooperation can promote.

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<sup>9</sup>A fact reflected in the recurrent crises that disrupted its own efforts to establish a regional system of currency pegs.

At the same time, this kind of cooperation does not require the same compromises of sovereignty that are essential to a successful exchange-rate stabilization agreement. It does not require governments to make incentive incompatible financial commitments. It can be fostered without invoking the unrealistic goal of a single Asian currency within ten years. And it will have the corollary benefit of delivering a greater degree of exchange rate stability, the concrete objective that many of the advocates of regional integration so passionately wish to achieve.

## **2. What is Different About the Context for Integration in Asia?**

Any attempt to promote economic and financial cooperation in Asia must confront a number of respects in which the regional context is distinctive.

**Asian countries are heterogeneous.** Asian countries differ widely in terms of their economic structures and stages of development. Per capita incomes vary more dramatically than in Europe and North America, other places where there is considerable momentum for regional integration. They range from \$1,471 in Laos to \$24,898 in Japan in 1999 U.S. dollars at purchasing power parity.<sup>10</sup> (See Table 1.) Market structures vary from the concentrated, in South Korea, to the atomistic, in Taiwan. Exports as a share of GDP range from more than 100 per cent in city states like Singapore and entrepot centers like Hong Kong to a mere ten per cent in

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<sup>10</sup>One can argue that these all-inclusive comparisons exaggerate the point by placing excessive weight on Asia's very small, very poor economies. Of course, much of the heterogeneity that is evident in Europe is also due to differences between some of the continent's smaller, poorer economies -- Portugal among the incumbents and the transition economies of Central and Eastern Europe as potential new members. And, if one limits the comparison to the large countries that have been the historical drivers of the integration process in Europe -- France and Germany -- and the large countries (China, Korea, Japan) that will have to play this role in Asia going forward, the point continues to apply.

Japan (Table 2). By this measure, openness is considerably more variable than in North America, another region seeking to reconcile growing trade and investment interdependencies with the existence of distinct national currencies. Some national economies and financial systems remain heavily regulated -- China and the new members of ASEAN are examples -- while others are extensively deregulated -- New Zealand is a world leader in this regard.<sup>11</sup> Asian economies differ in terms of transparency and shareholder rights, as illustrated by Table 3, which displays PriceWaterhouseCoopers' (2001) Opacity Index. Singapore is virtually at the bottom of the PWC scale (where bottom denotes least opaque), whereas China is close to the top.<sup>12</sup>

The implication that I am inclined to draw is that regional initiatives based on the assumption that the same monetary and financial arrangements are appropriate for all Asian countries make little sense. Since their economic circumstances differ, so too should their monetary and financial arrangements. To put the point another way, an initiative whose goal is to place all countries in the same monetary and financial straitjacket is unlikely to succeed.<sup>13</sup>

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<sup>11</sup>New Zealand, like Australia, not being a member of ASEAN+3, is not always regarded as an obvious participant in the region's integrationist efforts. Whether this is sensible is unclear. I return to this issue below.

<sup>12</sup>Many of these characteristics are changing rapidly, as Asian economies integrate further into the world economy and remake their structures in the wake of the 1997-8 crisis. One can imagine that this will lead to greater institutional homogeneity down the road. But the speed of change is itself a challenge to the aspiring architects of regional arrangements, for a set of regional institutions well suited to the economic circumstances of today may be entirely inappropriate to those of tomorrow.

<sup>13</sup>Some will object that the exchange rate stabilization agreement they had in mind is not intended for all Asian countries. Williamson (1999), for example, omits the new members of ASEAN, which would begin to limit the heterogeneity of the countries adopting a common basket peg. But he includes everyone from China and Indonesia to Singapore and Japan. The Chiang Mai Agreement envisages monetary cooperation encompassing China, South Korea, Japan and all of ASEAN.



**Asia is less economically self-contained than other regions.** Many Asian countries rely as heavily on the United States and Europe for export markets as they do on other Asian countries, including Japan. To be sure, intra-East Asian trade has grown as the per capita incomes of the economies in the region have risen. Both ASEAN's early steps toward the creation of a free trade area and the web of bilateral free-trade agreements that honeycombs the region have reduced barriers to transactions. The growing volume of inter- and intra-company trade associated with Japanese foreign direct investment in East Asia, together with rapidly rising direct investment in China, is having a profoundly positive impact on intra-regional trade.

Both the level and growth of intra-Asian trade must be interpreted cautiously. Regions differ not just in terms of openness but also in terms of size. They account for different shares of world trade. As a result, simple comparisons of the share of the trade of a group of countries that remains within the grouping can mislead; the larger the grouping, other things equal, the closer its share of world trade will be to unity.

I follow Eichengreen and Frankel (1997) by comparing two measures of the share of intra-regional trade: trade within the region as a share of the total trade of the region; and that same ratio normalized by the region's share of world trade. The first measure summarizes in the simplest possible way how dependent a group of countries is on trade with one another. The second measure, by controlling for the size of the grouping, sheds some light on whether preferential measures have heightened the same countries' dependence on intra-regional trade.<sup>14</sup> It is not clear which measure better captures the incentive that intra-regional trade creates for

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<sup>14</sup>Intuitively, it controls for the fact that as countries grow richer and trade more in general, they naturally tend to trade more with their regional neighbors.

exchange rate stabilization and monetary cooperation. The first measure is probably what most observers have in mind, insofar as the incentive to prevent trade flows from being disrupted by erratic exchange rate changes will be stronger when those trade flows are larger as a share of the participating countries' trade, regardless of why those trade flows are large. If intra-regional trade is small because the country grouping is small, so be it; that is an entirely valid reason why the impulse for monetary integration may be weak. But the second measure may also be relevant insofar as it captures, at least partially, countries' prior investments in regional integration.

Table 4 shows that which measure we choose can be important for inference. The first one confirms that the share of intra-ASEAN trade in that grouping's total trade rose slowly but steadily over the 1990s. For ASEAN+3 and APEC, this movement was concentrated in the first half of the decade, reflecting the subsequent slump in Japanese trade.<sup>15</sup> This simple measure also confirms that Asia's share of intra-regional trade remains low by the standards of the European Union (although not by the standards of the three NAFTA countries). There are hints here of how powerfully economic motives are likely to drive integrationist processes (less powerfully than in Europe, but not necessarily less powerfully than in North America).<sup>16</sup>

The second measure shows that the difference between ASEAN and the other groupings is more than fully accounted for by the small size of its members. ASEAN countries actually trade more with one another than their small size and the behavior of comparably-sized groups of economies elsewhere in the world would lead one to predict. This adjustment tells us that the

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<sup>15</sup>Here I track all 10 current ASEAN members throughout the 10 years in question, although some only joined the grouping after the beginning of the decade.

<sup>16</sup>I return to this when discussing "structural imperatives theories" of regional integration below.

ASEAN economies have made some progress in creating their free trade area.

For ASEAN+3, in contrast, substituting one measure for the other has no implications for the comparison with the EU and NAFTA. The dependence of the ASEAN+3 countries on intra-regional trade remains low in comparison with the EU and roughly comparable to that of NAFTA. Both measures thus suggest that pressure for monetary integration in support of trade is likely to be more limited than in Europe.

For both ASEAN and ASEAN+3, the two measures moved upward by roughly the same extent between 1990 and 2000. In other words, the increase in intra-regional trade cannot be accounted for simply by the catch-up growth of these economies and their associated tendency to trade more with their regional neighbors.<sup>17</sup> Evidently, their regional trade initiatives had some modest positive effects.

I conclude that the complementarities between regional commercial and monetary initiatives are likely to be less pronounced in ASEAN and ASEAN+3 than in Europe. Minimizing intra-European exchange-rate volatility promised to sustain precisely those trade and factor flows on which the members of the European Union depended most heavily.<sup>18</sup> Because

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<sup>17</sup>The different time profile of the two measures for ASEAN and ASEAN+3 suggests a somewhat different story for the two regions. For ASEAN+3, both measures rise steadily across the two halves of the decade, consistent with this interpretation. For ASEAN, on the other hand, the first measure rises steadily, while the second one falls in the first half of the 1990s, before more than fully recovering in the decade's second half. The obvious interpretation is that rapid catch-up growth was driving the rise in the intra-regional trade share in the first half of the decade, but not in its second half when growth slumped as a result of the crisis. The modest rise in the intra-regional trade share between 1995 and 2000 reflects instead progress in implementing ASEAN's free trade area.

<sup>18</sup>This is sometimes characterized as a Eurocentric interpretation, but it has adherents in Asia. Thus, the authors of a joint French-Japanese government study of the exchange rate question write that "the implementation of the single market made the costs of nominal exchange

the economic stakes were high, leaders were prepared to commit considerable political and institutional capital to their regional exchange-rate stabilization agreement. Its lower level of intra-regional trade suggests that this is less likely to be true of Asia.

What is true for trade is even more true for finance. To be sure, countries tend to borrow and lend to regional neighbors, because the information and communications costs associated with financial transactions rise with geographic and cultural distance.<sup>19</sup> But such cost differentials are of declining importance in a world of digital finance. Financial markets are increasingly global, not regional.

Japan's chronic economic and financial difficulties can be seen as accelerating the globalization of Asian finance. Japanese banks, which played a large role as a source of portfolio capital flows for East Asian countries in the first half of the 1990s (second only to Europe as a source), have drawn down their exposures as their problems festered. East Asia now depends more heavily on international finance originating outside the region than international finance originating inside. (See Table 5.) The implication is that any initiative to promote regional monetary and financial cooperation needs to be dovetailed with global initiatives in this area. Failure to anticipate this objection was, of course, part of what torpedoed the Japanese government's proposal for an Asian monetary fund. Whether the Chiang Mai Initiative can successfully address this concern remains to be seen.

**Compared to other regions, Asia has less appetite for political integration.** Any

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rate volatility in an integrated trade area more apparent and thus speeded up the pace of monetary unification." Government of France-Government of Japan (2000), pp.4-5.

<sup>19</sup>Three studies demonstrating this pattern are Buch and Piazzolo (2000), Gosh and Wolf (2000) and Portes et al. (2001).

institutional arrangement for promoting monetary and financial cooperation must recognize the value that Asian countries attach to their sovereignty. In a year when the European Union is embarking on a constitutional convention and discussing political federalism, it is important to acknowledge that Asia is different in this regard.<sup>20</sup>

These differences have historical roots. Asian countries did not conclude from their experience in the 1930s and during World War II that the way to prevent a recurrence of such difficulties was by forging deeper economic and political links.<sup>21</sup> This was a logical conclusion for Europeans to draw because economic interdependencies were already so extensive and their disruption in the 1930s was seen as setting the stage for political and military conflict.<sup>22</sup> This is the “structural imperatives interpretation” of European integration, which argues that the process gained steam after World War II because European countries were already so interdependent economically.<sup>23</sup> In Asia, in contrast, intra-regional trade and intra-regional transactions generally were less important. In the 19<sup>th</sup> century, China and Japan had been closed to international

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<sup>20</sup>I have been criticized for overemphasizing the importance of political commitment to monetary union and for questioning whether the requisite political commitment is likely to develop in Asia. In committing this sin I am not alone; Cohen (1998) and Bordo and Jonung (1999) both emphasize this point. Both connect up with “an older strand of argument in comparative integration research that broadly identifies the degree of -- cultural, social, political and economic -- homogeneity (or strength of a common identity or ‘sense of community’) among member states as a critical determinant of the probability of regional integration” (Webber 2001, p.346).

<sup>21</sup>Here I revisit a set of arguments made in Bayoumi and Eichengreen (1999).

<sup>22</sup>Other European countries imported many of their capital goods from Germany, while the western part of the continent imported many of its grains from Central and Eastern Europe.

<sup>23</sup>The classic statement of this view is Milward (1984). A recent restatement of the thesis is Morvcsik (1998).

transactions for extended periods, while other economies oriented their trade, for reasons not of their own volition, toward the western colonial powers. Japan's use of force to forge closer economic relations in the 1930s did nothing to lend respectability to the idea of economic ties as a bulwark against conflict.

The notion that economic integration could encourage and in turn be encouraged by closer political integration is similarly distinctively European. There already existed before World War II the idea that political integration was desirable in and of itself and useful for containing potential conflicts. An illustration is the Pan-European Union, a 1920s lobby that inculcated future generations of European leaders with the desirability of political integration and numbered among its members the young Konrad Adenauer and Georges Pompidou. This movement and this organization had no significant analogs in Asia.<sup>24</sup>

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<sup>24</sup>While its significance should not be exaggerated, the United States and the Cold War also played a role in shaping regional attitudes toward cooperation and integration. Starting with the partition of Berlin, the U.S. saw Western Europe as the major front for the Cold War and encouraged European countries to band together in order to protect themselves from the Soviet threat. Not only did the U.S. accede to preferential regional initiatives like the European Payments Union, despite the tendency for these to discriminate against U.S. exports, but it positively encouraged regional integration (making steps toward European unification a condition for the disbursement of Marshall Plan aid). In Asia, in contrast, the U.S. organized its security arrangements bilaterally; it encouraged Asian countries to cooperate with Washington, D.C. more than with one another. In the words of Katzenstein (1996, pp.141-3), "After 1945 the United States enshrined the principle of bilateralism in its dealings with Japan and other Asian states." When the Southeast Asia Treaty Organization (SEATO) was closed down in 1977, he continues, "hardly anybody noticed." Moreover, the fact that the U.S. was more powerful vis-a-vis individual Asian states than vis-a-vis France or Britain strengthened its hand when it wished to block initiatives to create strong Asian regional institutions from which it feared being excluded. (This was still evident in the early 1990s, when Washington, D.C. blocked Mahathir Mohamed's proposal for an East Asian Economic Group. Mahathir's proposal was also met by Japanese hesitation and mixed support from other Asian states, so it is probably not fair to lay blame for its failure entirely at the doorstep of the United States.) Finally, and perhaps most importantly, the Cold War divided China and Japan rather than forcing them together. "Sino-Japanese relations have not been transformed in the way that Franco-German relations were

From the jealousy with which Asian countries guard their sovereignty flows Asia's low-key approach to peer pressure and its consensual model of decision making.<sup>25</sup> Governments are reluctant to reproach their regional partners. Surveillance exercises shy away from criticizing the policies of neighboring countries, and even those criticisms that survive intensive vetting are rarely released to the public. In these respects Asian surveillance differs from its counterparts in the European Union, the OECD, and the IMF. The implication is that initiatives for monetary and financial cooperation that require naming names and intervening in the affairs of other nations are unlikely to gain traction in Asia. It is hard to imagine an Asian analog of Bundesbank President Schlesinger's criticisms of British government policy in the summer of 1992, or the kind of frank discussion of German and Portuguese budget deficits by other governments that took place in the winter of 2002.

**Asian governments are suspicious of strong supranational institutions.** One consequence of the priority that Asian countries attach to their autonomy is that regional integration tends to be organized on the basis of what some scholars refer to as "soft institutionalism" and others describe more bluntly as "weak formal institutions."<sup>26</sup> Their concern

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transformed in Western Europe after the Second World War, resulting in the formation of a probably uniquely intense bilateral intergovernmental relationship," in the words of Webber (1999, p.2).

<sup>25</sup>Some would say that this reflects the value Asian culture attaches to politeness and good manners. I prefer to root it in countries' more concrete concern with their sovereignty.

<sup>26</sup>On the difficulty of building strong institutions, Katsenstein (1996, p.125) writes, "In comparison to Europe, Asian regionalism is not well institutionalized. Operating by consensus in regional organizations Asian states exercise effective veto power over collective actions. Indeed the history of formal regional institutions is a history of failures so conspicuous, in comparison to Europe, as to beg for an explanation."

with sovereignty leaves Asian governments reluctant to delegate significant authority and decision-making power to a supranational body. Asian governments evince “a shared distrust... that international bureaucratic structures might become independent of their state sponsors.”<sup>27</sup> Institutions of regional cooperation therefore tend to be inter-governmental rather than autonomous. Their officials have little independent decision-making power. Asian countries have been reluctant to cede significant powers to a trans-national body of experts like the European Coal and Steel Community, established in 1952 and given significant power to “rationalize” (e.g. close down segments of) national steel industries, and the European Commission, which has very considerable power to shape competition policies, social policies, and a variety of other policies of EU member states.

This difference is important in the view of the “institutionalist” interpretation of European integration (which is the main rival of the “structural imperatives” interpretation described above).<sup>28</sup> In the institutionalist interpretation, it was the creation of strong formal institutions that lent momentum to the process of European integration.<sup>29</sup> Structural imperatives may have played a role at the initial stage, but what propelled the process forward subsequently was an institutional design that delegated power to “supranational agents” who in turn crafted new projects and mobilized new coalitions in order to extend their domain. These supranational entities not only carried out an agenda-setting function but provided “centralized monitoring” and

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<sup>27</sup>Katzenstein (1996), p.140. See also Crone (1993).

<sup>28</sup>This is the taxonomy of scholarship on European integration laid out in Parsons (2002).

<sup>29</sup>The classic statement here is Haas (1958), while the definitive recent restatement is Sandholtz and Stone Sweet (1998).



“third party enforcement” which helped to solve information and agency problems that often hinder effective cooperation (Mattli 1999).

This view is not uncontroversial. But the example most relevant to this paper -- monetary union, a project of the European Commission and the political elite which had to drag a sometimes reluctant European citizenry along behind it -- is a case in point.<sup>30</sup> Had the decision to create a monetary union been left to governments and their electorates, rather than having the process propelled forward by the European Commission and its independent technocrats, it is entirely possible that we would still be waiting for agreement to proceed.<sup>31</sup>

Is this a selective and glorified reading of European history? To be sure, the literature on European integration sometimes displays an uncomfortable sense of triumphalism and inevitability. But it is unanimous in emphasizing historical conditions, institutions and ideas in shaping that unfolding process.<sup>32</sup>

Is this description of conditions in Asia a subjective caricature far removed from the reality of modern east Asia? I see it not as a caricature of Asian culture but an analysis of the implications of concrete features of Asia’s political and economic past for its future as a region. It focuses not on culture but on the enduring legacy of historical interdependencies and political experiences. It does not imply that opportunities for cooperation are set in stone -- recall the

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<sup>30</sup>The constitutional convention currently underway in Europe is another striking example.

<sup>31</sup>It is possible that Asia could complete this transition in a different way -- if Asian governments took the impetus by volunteering to cede their decision-making powers, or if Asian electorates voted out of office politicians who proved reluctant to do so -- but the plausibility of these scenarios is even more dubious.

<sup>32</sup>The title of Parsons (2002) is indicative.

discussion earlier in this paper of how the Asian crisis has altered attitudes toward cooperation -- but it does suggest that historical factors and structural characteristics are too important to ignore.

Is this analysis meant to suggest that there is just one route to integration -- that Asia's prospects are poor because the region is ill positioned to adopt the European model? To the contrary, my analysis suggests multiple routes -- some heavily institutionalized, others less so; some which focus on monetary cooperation, others which focus on different issues. It emphasizes that Asian regionalism must follow a different path than Europe. Regional initiatives should be designed with Asia's distinctive conditions in mind. Mechanically transferring the European model is unlikely to work. As I show in the following sections, this point is directly applicable to monetary and exchange-rate cooperation, where more than a few have recommended following the European model.

### **3. The Status Quo**

I start with the scope for monetary and exchange rate cooperation. The Asian crisis clearly transformed that status quo, although how systematically is a subject of debate. Table 6 shows the official International Monetary Fund classification of exchange rate arrangements before and after the crisis. This must be interpreted cautiously; among other things, it places considerable weight on what governments say as opposed to what they do. In 1999 the IMF switched to a mixed *de jure/de facto* classification that places more weight on actual behavior. In contrast to the earlier classification, it distinguishes countries that declare that they are pursuing managed or independent floats but peg their exchange rates in practice. While this is a step in the direction of greater accuracy, it poses problems for intertemporal comparison. For what it is

worth, the Fund classification suggests movement in direction of greater exchange rate flexibility.

The problems with the IMF classification have led Levy-Yeyati and Sturzenegger (2002), among others, to focus on de facto flexibility. In the present context, McKinnon (2001) argues that Asian governments and central banks continue to intervene heavily to limit the flexibility of exchange rates, against the U.S. dollar in particular. It is important therefore to analyze not what they say but what they do. The simplest approach to this problem is classify countries by the degree of nominal exchange rate flexibility. But exchange rates can be volatile not just because governments and central banks are reluctant to react to currency movements, but because some economies and currencies are subject to disproportionately large shocks that overwhelm the authorities' stabilization efforts. Average exchange rate flexibility will reflect both factors and therefore tell us little about the authorities' intentions.

This has led various authors, a la Bayoumi and Eichengreen (1998), to consider the variability of exchange rates relative to the variability of reserves as a way of capturing the authorities' use of sterilized intervention, and the variability of exchange rates relative to the variability of interest rates as a way of capturing their willingness to adjust policy to limit currency movements.<sup>33</sup> In effect, these ratios measure the extent to which shocks are allowed to find reflection in the exchange rate instead of being neutralized by sterilized and unsterilized intervention.

The results in Table 7 are surprisingly consistent with the IMF classification: they suggest

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<sup>33</sup>See for example Calvo and Reinhart (2000), Hernandez and Montiel (2001), and Park and Song (2001).

a general movement toward freer floating, notwithstanding considerable heterogeneity within the region.<sup>34</sup> Rising ratios indicate freer floating -- they indicate that shocks are being absorbed to a greater extent by exchange rate fluctuations and to a lesser extent by monetary policy adjustments and intervention. Table 7 confirms the existence in Hong Kong and Malaysia of a continued commitment to peg in an increasingly volatile macroeconomic and financial environment. Singapore and Taiwan show little change. But the Thai and Korean central banks appear to have begun allowing their exchange rates to move more freely in response to shocks. For Indonesia, the evidence again suggests that despite the increasing volatility of reserves and interest rates, reflecting unsettled financial and political conditions, exchange rate movements have been relied on more heavily to accommodate shocks. The same is true of the Philippines.

Thus, contra Ogawa (2000) and McKinnon (2001), more data and analysis suggest significant increases in the degree of exchange rate flexibility in countries like Korea, Thailand, Indonesia and the Philippines. The standard measures used in the “fear of floating” literature do not in fact indicate fear of floating. That said, the contrast between the aforementioned countries on the one hand and Hong Kong and Malaysia on the other underscores the importance of not painting all of Asia with one brush. The revealed preference uncovered by this exercise thus raises further questions about the advisability of schemes that seek to squeeze all Asian countries into a single exchange rate box.

Probing deeper, we can decompose financial market outcomes, starting with real interest rates, into the contributions of currency risk, political risk, and terms-of-trade risk. Following

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<sup>34</sup>Thereby illustrating one of the central points of Section 2. These are exchange rates relative to the U.S. dollar, since that is the bilateral rate emphasized by McKinnon.

Frankel and MacArthur (1988), I express the real interest rate (denoted  $r$  for the home country and  $r^*$  for the United States) as follows:

$$r - r^* = (f_d - \Delta s^e) + (i - i^* - f_d) + (\Delta s^e - \pi + \pi^*) \quad (1)$$

Equation (1) takes advantage of the fact that  $r - r^* = (i - \pi) - (i^* - \pi^*)$ , where  $i$  is the nominal interest rate and  $\pi$  is the inflation rate, and adds and subtracts  $\Delta s^e$  and  $f_d$ . The first term is the currency premium, which captures risk in foreign exchange markets. The second term is the covered interest differential, which captures capital controls, the risk of future capital controls, and default risk. I refer to this as political risk. The third term is expected real depreciation, which captures relative price shocks affecting the foreign exchange market.

Table 8 compares the mean and standard deviation of these components (along with other summary statistics) before and after the crisis. The mean of the currency (or exchange risk) premium rises across periods for all the crisis countries, as if investors demanded additional compensation in order to hold Asian currencies. This is consistent with the view that greater exchange rate flexibility has had costs for these countries, costs that show up in financial markets. In fact, however, this effect is limited to 1998. I regressed annual data on the exchange risk premium covering the period 1990-2001 for 39 countries (12 Asia, 15 European and 12 Latin American) on a constant, a measure of the presence of capital controls, an Asian dummy, an a vector of year dummies interacted with the Asian dummy (for each year from 1997 through 2001). Only in 1998 did this last interaction term enter with a coefficient that differed

significantly from zero at standard confidence levels.<sup>35</sup> Thus, it would appear that the additional currency risk associated with the move to greater exchange rate flexibility had died out by 1999.<sup>36</sup>

Moreover, the standard deviation of the exchange risk premium does not rise across the board. It rises for Hong Kong, South Korea and Taiwan, while falling for Malaysia, Singapore, Thailand and Indonesia. If what one is interested in is the variability of the exchange risk premium because this is what contributes to the variability of the exchange rate (and of other financial variables), then it is not necessarily the case that greater exchange rate flexibility adds volatility.

It is no surprise that the impact of capital controls, possible future capital controls and default on domestic-currency-denominated assets, as measured by the mean of the covered interest differential, increases dramatically in Indonesia between the pre- and post-crisis periods. Surprisingly, however, there is little sign of this in the other Asian countries. A number of these countries responded to the crisis by accelerating capital account liberalization, something that would show up as a smaller covered differential. Others such as Malaysia adopted capital controls, but any positive impact of that measure appears to have been more than neutralized by the perceived decline in default risk.<sup>37</sup> The standard deviation of the covered interest differential,

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<sup>35</sup>The t-statistic on that interaction term was 5.36. None of the subsequent interaction terms had a t-statistic that exceeded 0.6.

<sup>36</sup>That the exchange-risk premium can be larger under fixed than flexible rates is hardly surprising; one need only recall Argentina in 2001.

<sup>37</sup>This is of course consistent with the view of those, like Kaplan and Rodrik (2001), who conclude that the controls had a positive impact on balance on Malaysia's economy and financial markets. A regression analysis structured identically to that for the exchange risk premium, but using the covered interest differential as the dependent variable, suggests that the covered interest differential was significantly lower on average in 1998 in Asia than in other regions.

on the other hand, suggests that the volatility of political risk increased virtually across the board, contributing to the greater volatility of financial variables in Hong Kong, Korea, Malaysia, Thailand, and Indonesia.<sup>38</sup>

Finally, I consider expected real depreciation, which captures relative price shocks. The results here come as something of a surprise: while the standard deviation of this measure rises marginally in Hong Kong, South Korea and Taiwan, it falls in Malaysia, Philippines, Singapore, Taiwan, and even (slightly) in Indonesia. It would appear that relative price shocks, whether to global semiconductor prices or other something else, have always been a fact of Asian life. They were not obviously aggravated by the move to greater exchange rate flexibility. If anything, there are suggestions here that greater flexibility has insulated Asian economies and helped them to adjust to foreign price shocks.<sup>39</sup>

Overall, these findings are something of a mixed bag. They provide some ammunition to the critics of exchange rate flexibility insofar as there is evidence of an increase in exchange risk, although defenders of greater flexibility will be reassured by the fact that this increase is transient, and that the variability of the currency premium is consistently lower after the crisis than before. They offer some reassurance to the proponents of flexibility insofar as they do not indicate widespread fears that governments would resort to controls to defend their currencies or be forced by the combination of balance-sheet mismatches and depreciation to default on their debts. There is little evidence that greater exchange rate flexibility after the crisis made for more

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<sup>38</sup>Taiwan and Singapore are the exceptions.

<sup>39</sup>This, of course, cannot be the interpretation for Malaysia, which did not move to greater exchange rate flexibility.

volatile real exchange rates, although the direction of causality (whether flexibility facilitated adjustment, or whether real stability facilitated the operation of flexible rates) remains a matter of interpretation.

It is not clear on balance, then, that greater exchange rate variability is a problem. If it is, the question is what to do about it.

#### **4. Can Asia Live with Floating Rates?**

The case for using the Chiang Mai Initiative as the basis for a regional currency arrangement is predicated on two assumptions, one positive, one negative. The negative assumption is that Asian countries cannot live with floating rates. The positive one is that currencies can be stabilized by a properly designed regional exchange rate mechanism -- if expert advice is only taken on the composition of pegs, the surveillance of policies, and the provision of credit lines. This section challenges the first presumption; the next one critically scrutinizes the second.

The conventional arguments against floating are two: floating rates encourage competitive depreciations that are a mechanism for the contagious spread of crises, and floating rates are incompatible with Asia's export- and investment-led growth and development model. Ogawa and Ito (2000) epitomize the argument, generalizing from the Asian crisis, that contagion spreads more quickly and virulently when currencies are unpegged. The devaluation of the baht, Indonesia's abandonment of its band in response to instability spreading from Thailand, and Taiwan's decision to devalue its dollar in October 1997 in response to mounting competitive pressure from its neighbors are portrayed as the key events transforming a country crisis into a



regional disaster. Once currencies began to move, countries lost control of their economic destinies. This sequence of events, whether causal or not, created an understandable reluctance to contemplate further exchange rate flexibility.

With the passage of time it has become more common to argue that the pegs rather than their abandonment were at the root of the problem. What caused the devaluations of 1997 to be so destabilizing was not that exchange rates were allowed to move but that their movement discredited prior policy commitments. Governments' entire economic policy strategies had been organized around their currency pegs. To abandon those pegs called into question the coherence of those strategies and planted doubts about official promises. This is the familiar "exit problem," in which exiting from a peg around which the authorities had previously organized their economic policy strategy -- and to which they had repeatedly reiterated their commitment -- damages their credibility and therefore undermines consumer and investor confidence. Eichengreen and Masson et al. (1998) show that exits from pegs have typically been associated with significant output losses. Those losses are greater when banks and firms, taking the authorities' commitments at face value, accumulate unhedged foreign exposures that are a source of balance-sheet distress when the exchange rate moves. They are greater when the authorities are slow to substitute an alternative operating strategy for monetary policy and to install a new anchor for expectations, thereby failing to reassure households and firms.

It is too simple to simply assert that these problems will disappear once countries embrace greater flexibility. Large exchange rate movements and/or reserve losses -- the constituents of currency crises -- can occur with a floating rate. Historically, they have been at least as common under floating as fixed exchange rates (IMF 1998). But the reason, to repeat, is

that countries historically have failed to put in place an alternative anchor and new monetary-policy operating strategy. It can be argued that subsequent experience with inflation targeting has largely solved this problem.<sup>40</sup> And, with the crisis-induced abandonment of pegs, exit has already occurred. Its costs have been sunk. Agents have begun to adapt to the reality of greater exchange rate flexibility, hedging previously unhedged exposures and more carefully managing their balance sheets.<sup>41</sup> There is no reason to go back.

The experience of countries like South Korea with inflation targeting provides evidence for this view. Following the crisis, Korea revised its central banking law to enhance the institution's independence. Price stability was singled out as the primary goal of policy, relieving the central bank of its previous responsibility for the soundness of the banking system. Each year the Bank of Korea now sets a price stability target in consultation with the government and elaborates a plan for achieving it. It publishes its target, its plan, its monetary policy board minutes, and its annual report to the National Assembly. Thus, the country has installed all of

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<sup>40</sup>I discuss inflation targeting at more length below.

<sup>41</sup>Thus, de Brouwer's (2001a) time series evidence for Japan, Korea, Malaysia, Singapore and Thailand seems to suggest that the effects of volatility on consumer and business sentiment die out as households and firms become more accustomed to living with exchange rate variability. It is not variability per se but sudden increases in variability -- what we call crises -- that have strongly negative effects on such sentiment. This is consistent with the view that moving to greater flexibility at an early date encourages hedging and other forms of adaptation that ease life with flexible rates. Martinez and Werner (2001) report evidence that Mexican firms took steps to more carefully manage their foreign currency exposures as they become accustomed to operating in an environment of greater exchange rate flexibility. None of this implies that as the exchange rate becomes more flexible the markets can be relied on to solve the mismatch problem, or that the level and composition of capital flows can be treated with neglect. Goldstein (2002) argues convincingly that the authorities can credibly target inflation only if doing so, and allowing the exchange rate to move, does not subject the financial system to serious distress. And, ensuring that the financial system remains reasonable robust may be aggressive prudential policies to limit currency mismatches.

the essential elements of an inflation targeting regime.<sup>42</sup> And now that it has adopted inflation targeting, Korea's flexible exchange rate has become part of the solution rather than part of the problem. The won depreciated in 2000-1, on a nominal and real effective basis, just as the textbooks suggest it should have, in response to the slowdown in the global electronics industry. It then recovered in 2001-2 along with the electronics sector, again as predicted by textbook models. (See Figure 1.). All the while, the recovery of Korean economy, partially insulated from this external disturbance, proceeded apace.

The implication is that a more flexible exchange rate, backed by inflation targeting, can be part of the solution as opposed to part of the problem. It can help to buffer economies against external disturbances. Figure 2, inspired by Condon (2002), is consistent with this view. It shows that it is now Asian countries with flexible exchange rates that are favored by investors. It is their stock markets that held up best in the face of the global recession.<sup>43</sup>

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<sup>42</sup>Inflation targeting is conventionally defined as a monetary policy operating strategy with four elements: an institutionalized commitment to price stability as the primary goal of monetary policy; mechanisms rendering the central bank accountable for attaining its monetary policy goals; the public announcement of targets for inflation; and a policy of communicating to the public and the markets the rationale for the decisions taken by the central bank. Institutionalizing the commitment to price stability lends credibility to that objective and gives the central bank the independence needed to pursue it. Mechanisms for accountability make this pursuit politically acceptable and impose costs on central banks that are incompetent or behave opportunistically. Announcing a target for inflation and articulating the basis for the central bank's decisions allows these mechanisms to operate. Analysts further distinguish strict inflation targeting (where the authorities are concerned only with the behavior of this one variable) from flexible inflation targeting (where the trade off deviation of inflation from target against deviations of other variables of interest, such as output, employment, and growth). For most countries, including those of Asia, flexible inflation targeting is the policy-relevant case.

<sup>43</sup>Some readers will recall a similar figure from Eichengreen and Sachs (1985), which compared countries with fixed and flexible exchange rates in the 1930s and where the conclusion was essentially the same.

Figure 2 is not easily reconciled with the second rationale for a regional exchange-rate stabilization arrangement, namely, that floating is incompatible with Asia's export- and investment-led model of growth. There is no question that stable exchange rates were integral to that model once upon a time. They encouraged firms to move into the export sector, facilitating efforts to move down the learning curve and providing the hard currency needed for imported capital goods.<sup>44</sup> By minimizing exchange risk, they made it easier for Asian banks and corporations to borrow abroad.<sup>45</sup> They served as a focus for wage negotiations, facilitating the wage moderation that made possible export-market penetration and high levels of investment. It is sometimes said that no Asian country has developed on the basis of a floating rate. Asian policy makers evidenced their own conviction in this belief through their reluctance to abandon pegged rates when they came under strain in the 1990s.

But for the region's middle- and high-income countries, this model has now outlived its usefulness. As an economy matures, manufacturing as a share of GNP goes into decline. The advantages of stable exchange rates for promoting exports of manufactures, allowing firms to exploit scale economies, become less compelling. As the production of nontraded goods for the domestic market becomes more important, exchange rate stability matters less. Wage moderation for which a stable exchange rate provides a focal point becomes less essential for

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<sup>44</sup>On whether exchange rate volatility discourages trade and investment flows, the evidence has been surveyed and augmented many times but remains ambiguous. De Brouwer (2002b) shows that there is little significant correlation between intra-East Asian trade and intra-East Asian exchange rate variability (for those who insist on knowing the point estimate of the correlation, it is positive rather than negative). Avoiding persistent misalignments and subsequent crashes may be more important than stability per se.

<sup>45</sup>Jeanneau and Micu (2002) provide some evidence that stable exchange rates increase the volume of international bank lending to emerging economies.

growth than increased total factor productivity, something for which exchange rate is relevant less directly, if at all.

This analysis suggests that economic flexibility commands an increasingly high premium in economies exiting the stage of extensive growth for the subsequent stage where innovation rather than low wages and brute force investment matter for growth. And economic flexibility is something that is facilitated by a more flexible exchange rate. This is Condon's (2002) vision of Asian growth in the post-crisis era, in which the countries that do the least restructuring continue to rely most on exports and consequently have relatively weak exchange rates (which are needed to price their exports into international markets), while countries that restructure most extensively rely more on internal demand and consequently have relatively strong real rates. This is another reason why a system of Asia-wide pegs is unlikely to suit all the countries of the region unless they all happen to restructure at the same pace.

With benefit of hindsight, many experts now contend that they anticipated the problems with the traditional growth model. A few observers perhaps did (see e.g. Young 1994 and Krugman 1994), although this forecast was not exactly the professional consensus at the time. The question, then, is why Asian countries remained so reluctant for so long to abandon the model. Condon suggests that Asian governments were encouraged to retain the status quo by the Plaza Accord of 1985, which led to the creation of a dollar bloc in Asia. Asia's high-performing economies were pegged to the dollar, and the Plaza inaugurated a decade in which the Japanese yen appreciated by 70 per cent against the U.S. dollar (from 250 to 80). As the dollar depreciated by some 50 per cent against the G-10 currencies, Asian economies enjoyed an artificial boost to their competitiveness. This encouraged them to stick with the export-led model after it had

outlived its usefulness. Successive GATT rounds reinforced this incentive to grow manufacturing industries beyond what was efficient or sustainable. And, the strength of the yen encouraged the relocation of Japanese production to other East Asian economies, providing large quantities of foreign direct investment (FDI) to sustain the model. Given all this, the recovery of the dollar starting in the middle of the 1990s was the trigger that brought this unsustainable configuration crashing down.

For a long time the mantra was “if it ain’t broke, don’t fix it.” Now, of course, there is plenty of evidence that the old model is “broke” -- that its applicability to the region’s more advanced economies has passed. Policy makers in middle-income countries acknowledge the need to shift away from export-oriented industrial policy toward a more decentralized model centered on domestic demand. In the less-developed, lower-income countries of the region, in contrast, the traditional model may have some way to run. This in turn suggests that the argument for exchange rate stability to facilitate export-led growth and associated learning is stronger for some Asian countries than others. It is stronger for China and the four new members of ASEAN, for example, than for Korea, Thailand and Singapore. Again, the implication is that a single exchange rate arrangement is not suitable for the entire region.

This observation is distinct but complementary to the familiar argument that low-income countries with shallower financial markets, weaker policy-making institutions, and less developed supervisory capacities should wait before moving to a more flexible exchange rate and opening the capital account. A monetary policy operating strategy like inflation targeting that can be substituted for the now abandoned exchange rate peg relies on stable links between asset prices and quantities on the one hand and the level of activity on the other. It is unlikely to

operate reliably where financial markets are underdeveloped and undergoing rapid change -- where inflation cannot be accurately forecast or reliably controlled. Since the argument for continuing to organize monetary policy around an exchange rate peg is correspondingly stronger for such countries, so too is the case for retaining capital controls to limit the pressure on the peg.<sup>46</sup>

Thus, inflation targeting is likely to be feasible and attractive for more developed Asian countries like Korea, Singapore and Taiwan. Inflation is not noticeably harder to forecast than in Europe or the United States (Hoffmaister 2001). Financial markets are sufficiently well developed that there exists a stable relationship between the central bank's instruments and its targets. The adverse balance-sheet effects of exchange rate movements, while present, do not dominate all other effects of policy.

In the less developed countries of the region, like Cambodia, Laos, Myanmar and Vietnam, these conditions are unlikely to prevail for some years yet. Foreign borrowing means foreign currency borrowing, amplifying balance-sheet effects. Financial systems are fragile and underdeveloped. Since inflation targeting is not feasible, these countries will want to continue pegging and to support their pegs with capital controls.<sup>47</sup>

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<sup>46</sup>This is consistent with the now conventional wisdom that countries should wait to remove capital controls until they have strengthened the operation of their financial markets and upgraded their supervision and regulation. But, to repeat, none of this implies that countries which have strengthened their financial markets to the point where they can move to more flexible rates can regard currency mismatches and capital flows with benign neglect.

<sup>47</sup>Leblang (1997, 1999), Milesi-Ferretti (1998), Bernhard and Leblang (1999) and Garrett and others (2000) all find that countries that peg their exchange rates are more likely to utilize capital controls. It is surely no coincidence (and directly relevant from this point of view) that Malaysia and China are two of the Asian economies, besides Hong Kong, that have successfully maintained currency pegs.

Countries like Thailand, Indonesia and the Philippines do not yet fall into either camp. Indonesia has committed to moving to inflation targeting, but lingering financial weaknesses continue to limit the ability of the central bank to credibly commit to a target. The Philippines has begun to prepare for inflation targeting but continues to feel that the time is not right (Kongsamut 1999). Thailand has moved furthest in the direction of formal inflation targeting. There, inflation targeting with a heavy emphasis on the exchange rate has a reasonable track record, although the central bank has come under periodic pressure from the government to disregard its inflation target and “go for growth.” Still, if these countries are not yet fully in the inflation-targeting camp, there are grounds for thinking that this will happen before long.<sup>48</sup>

There is no reason to doubt that inflation targeting is compatible with the Asian approach to growth and development. It is simply not true, as sometimes alleged, that export-oriented economies are adverse to inflation targeting (Mishkin and Schmidt-Hebbel 2001). There is ample evidence (viz. Fischer 1993, Bruno and Easterly 1998) that low inflation is good for investment and productivity growth, the two pillars of the Asian model. Moreover, the recent record indicates that inflation targeting is more widely feasible than predicted by early certain analyses (e.g. Masson, Savastano and Sharma 1998). It is not obvious either theoretically or empirically that inflation targeting has more demanding fiscal prerequisites than other monetary regimes.<sup>49</sup> Latin American experience does not suggest that it is necessary to bring inflation

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<sup>48</sup>Malaysia shares many characteristics with these countries, but it may go with those that will prefer pegging and controls for political as much as economic reasons.

<sup>49</sup>Thus, Mishkin and Schmidt-Hebbel (2001) show that fiscal stance is not significantly correlated with the successful adoption of this regime. If anything, there is some sign that countries that adopt inflation targeting actually have weaker fiscal positions than the control group of countries with other monetary regimes.



down to very low levels before starting the transition to inflation targeting.<sup>50</sup> Chile was able to embark on inflation targeting despite an inherited inflation rate of more than 20 per cent. Peru succeeded in putting in place elements of an inflation targeting regime well before reducing inflation to target levels.<sup>51</sup> As Goldstein (2002) observes, inflation targeting can deliver presumptive benefits even before the central bank has full independence and even if it does not adopt the full formal apparatus, including announcing an inflation forecast and publishing an inflation report.<sup>52</sup>

Nor does experience suggest that countries that adopt inflation targeting must accept high levels of exchange rate volatility. Leaning against the wind in foreign exchange markets is integral to the operation of inflation targeting in open economies. Exchange rate movements contain information about future inflation and unemployment. For example, pressures that imply a future acceleration in inflation will tend to lead to currency depreciation now, and an inflation-targeting central bank will respond by tightening, in order to damp down future inflation. That, in turn, will minimize the volatility of the currency.

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<sup>50</sup>The generalized decline in inflation in emerging markets works in this same direction by moving more countries closer to the neighborhood of their presumptive target range. By 2000 inflation in emerging markets had fallen to eight percent, down from triple-digit levels only a decade or so before (Goldstein 2002)..

<sup>51</sup>Mishkin and Schmidt-Hebbel (2001) distinguish two groups of countries: those which started at moderate inflation rates in the range of 7 to 20 per cent (the Czech Republic, Colombia, Mexico, Poland) versus those that started at higher inflation rates in the range of 15 to 45 per cent (Chile, Israel, and Peru). Fischer (2001) describes emerging IMF practice as recommending formal inflation targeting when the inflation rate has fallen to 20-25 per cent. He suggests, in addition, that countries set out an inflation target even when inflation is as high as 40 per cent and begin moving to an informal inflation targeting framework.

<sup>52</sup>Recent analyses to this effect are at odds with the presumption in the earlier analytical literature (e.g. Schaechter 2000).

But, unlike a central bank committed to the defense of a peg or band, an inflation targeting central bank will not follow a rigid rule for altering policy when the exchange rate approaches the edge of any preannounced zone.<sup>53</sup> How it will respond to exchange rate movements depends on why the exchange rate moved and on what its movement implies for output and inflation. The authorities will respond differently to exchange rate fluctuations depending on the source and nature of the shock. A real shock that requires a different long-run equilibrium level of net exports will require a different long-run equilibrium exchange rate. Even a central bank that cares deeply about inflation will not prevent the exchange rate from moving in response to such a disturbance, although it may attempt to smooth the currency's

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<sup>53</sup> Attempts to reduce its response to a hard-and-fast exchange-rate rule have not been successful. The best known case in point is the so-called Monetary Conditions Index, which is sometimes suggested as the basis for the reaction function of an open-economy central bank. The typical MCI is a weighted average of the exchange rate and the interest rate. A central bank targeting the MCI will raise the interest rate when the exchange rate weakens and vice versa so as to keep the index constant. This approach to open-economy inflation targeting is only likely to work if the source of disturbances is financial. If instead disturbances are real (to the terms of trade or to export demand, for example), then the MCI sends the wrong signal. In response to a negative aggregate demand shock, the exchange rate will weaken, absent intervention, since export revenues will have declined while nothing else affecting the foreign exchange market has yet changed. Assuming that inflation rises due to higher import prices and that the authorities attach a high weight to deviations of inflation from target, the central bank will raise interest rates to limit currency depreciation in the short run, while still allowing the exchange rate to adjust eventually to its new long-run equilibrium level. Thus, an inflation targeting central bank confronted with this shock to the foreign exchange market will smooth the adjustment of the exchange rate, but it will not prevent the currency from moving down to its now lower warranted level. The weaker is aggregate demand as a result of this shock, the more limited will be that interest rate response. The MCI, unfortunately, does not take the weakness of aggregate demand into account; it suggests raising interest rates to prevent the exchange rate from moving and thereby prevents depreciation from crowding in aggregate demand. Mishkin (2000) cites cases such as New Zealand in 1997 and Chile in 1998 where the central bank either utilized a monetary conditions indicator or attempted to limit the variability of the exchange rate as part of its inflation targeting regime, inducing precisely the wrong response to a shock to external demand (tightening when the economy was weakening).

adjustment. At the same time, an inflation targeting central bank will want to neutralize temporary financial shocks and will use interest rates aggressively to offset fluctuations in the currency.

The point is that inflation targeting does not mean benign neglect of the exchange rate. It is compatible with intervention and monetary-policy adjustments designed to “lean against the wind” when the exchange rate moves. It simply means no longer organizing the country’s entire monetary policy around a target range for the currency or basing monetary policy on a rigid reaction function linking exchange rates and interest rates.

Finally, there is reason to think that inflation targeting will reduce the volatility of exchange rates over time. A credible commitment to low inflation will reduce the perceived likelihood that accelerating inflation today implies accelerating inflation tomorrow.<sup>54</sup> Extrapolative expectations being less, exchange rate volatility will be less. To be sure, this does not guarantee that exchange rates will be as stable as when capital flows were restricted and currencies were pegged. But there is good reason to think that as policy makers acquire a track record of successful inflation targeting, exchange rates will settle down.

Inflation targeting thus addresses Park and Song’s (2001) five reasons why Asian countries are reluctant to float. Their first reason is that more volatile nominal rates make for more volatile real rates and a greater risk of misalignment. Misalignment is hard to measure in the absence of a consensus model of the fundamental equilibrium exchange rate, but as Thailand’s pre-1997 experience makes clear (see e.g. Chinn and Dooley 1998) it can arise as

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<sup>54</sup>Thus, Kuttner and Posen (2001) show that inflation targeting is associated with lower levels of inflation persistence than other monetary regimes.

easily under pegged as floating rates. Moreover, the analysis in Section 3 above does not suggest that this problem has worsened following the transition to greater flexibility.

Park and Song's second explanation for Asian countries' historic aversion to greater flexibility is that fluctuations in the exchange rates between the G-3 currencies disturb the exchange rates of emerging Asian economies. Historically, a weakening yen has led to appreciation of their real effective exchange rates and thereby depressed their rates of growth (Kwan 2001). Moreover, the strength of this destabilizing linkage results from the fact that Asian countries have pegged, de facto or de jure, to the dollar (Frankel and Wei 1993), not from the fact that they were floating. It is likely that the power of this relationship has declined now that Asian currencies are no longer forced to follow the dollar up and down but can react to movements in all the G-3 currencies so as to stabilize output.<sup>55</sup>

Park and Song's third explanation for Asian policy makers aversion to greater flexibility is that it complicates inflation management and requires "a higher risk premium for foreign investors to hold domestic currency denominated assets of emerging market economies" (p.142). The evidence in Section 3 does not support the assumption that greater flexibility necessarily raises the exchange-risk premium (which can be large when currencies are pegged, given the possibility that the peg can collapse). Recent evidence does not suggest that inflation rates are

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<sup>55</sup>Thus, Kwan (2002, p.41) shows that Asian GDP growth in the period 1982-97 declined significantly whenever the dollar appreciated significantly against the yen. His regression, which I was able to replicate, uses unweighted averages of annual data for Asian countries. The coefficient on the yen-dollar rate enters with a t-statistic of 2.9 when only the exchange rate is included and one of 2.8 when U.S. output growth is added as an additional explanatory variable. Extending the data set through 2000 causes the coefficient on the yen-dollar rate to decline below standard significance levels in both specifications (to the neighborhood of unity). Whether this reflects a secular trend or only the exceptionally disruptive effects of the Asian crisis only time will tell.

higher under floating than fixed rates; to the contrary, countries with soft pegs tend to display the highest chronic rates of inflation. Flexibility backed by inflation targeting has now been shown to deliver favorable inflation outcomes in a variety of economic settings.

Park and Song's fourth explanation for Asian policy makers aversion to greater flexibility is the perceived tendency of flexible exchange rates to exacerbate boom and bust cycles caused by capital inflows. Capital inflows may induce currency appreciation that sets on foot expectations of further appreciation. The resulting cycle of appreciation and capital inflows may price domestic producers out of export markets and fuel an unsustainable construction and real estate bubble. All this, and more, is true. But it is even more true under a pegged rate. When rates are pegged, capital inflows will still stimulate domestic demand but, importantly, they will not put upward pressure on interest rates.<sup>56</sup> This deactivates the main equilibrating mechanism to damp down excess demand. There will still be real appreciation, although inflation, as opposed to the exchange rate, will be the operative channel. There will still be a bubble in real estate and property markets. Importantly, there will be no exchange rate variability to make foreign investors think twice. While there is no perfect solution to the problem of capital inflows, the professional consensus, increasingly, is that such inflows are even more difficult to manage under fixed than flexible rates.

Finally, Park and Song emphasize the destabilizing balance-sheet effects of currency movements. Large exchange rate movements can cause balance-sheet distress for banks and firms with unhedged exposures, as noted above. Currency mismatches should not be taken as

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<sup>56</sup>Which will remain equal to foreign rates, assuming that capital markets are open and the peg remains credible for the time being.

given, of course; for reasons discussed previously, banks and corporations have incentives to manage them more carefully when the exchange rate is allowed to move. To be sure, they will have less capacity to do so where futures markets in domestic-currency instruments are small and underdeveloped and where counterparties providing forward cover require collateral of a sort that small and medium-sized enterprises find it difficult to provide. But this is precisely why central banks engaged in open-economy inflation targeting will want to tighten monetary policy when the exchange rate weakens. It implies differences in the conduct of inflation targeting, not that inflation targeting is infeasible.<sup>57</sup> It is why Asian countries should adopt Goldstein's (2002) recommendation to aggressively limit currency mismatches.

## **5. On the Viability of a Common Basket Peg**

Notwithstanding these arguments, some remain convinced of the desirability of a regional system of currency pegs. Desirability, however, is not the same as feasibility. The preceding section having focused on the first issue, this one considers the second.

The most popular variant of this proposal envisages common pegs for East Asia ex-Japan, with weights on the dollar, the yen and the euro.<sup>58</sup> Commonality is designed to minimize the intra-regional currency variability which would result from the fluctuation of yen-dollar and yen-

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<sup>57</sup>Except in the extreme case where destabilizing balance-sheet effects dominate all other channels for the transmission of monetary policy (Eichengreen 2001a).

<sup>58</sup>Versions of this proposal include Goto and Hamada (1994), Ito, Ogawa and Sasaki (1998), Dornbusch and Park (1999), Government of France-Government of Japan (2000), Kawai and Kaiyama (2000), Kawai and Takagi (2000) and Kim, Ryou and Wang (2000).

euro rates if countries pegged to different G-3 currencies.<sup>59</sup> Baskets are intended to prevent East Asian exchange rates from being pulled up against two G-3 currencies as a result of a policy of pegging exclusively to the third, and from thereby creating the kind of competitiveness problems that resulted from dollar appreciation when Asian countries were linked to the greenback.

A system of collective pegs entails not just reference currencies and weights but also a bandwidth, a rule for how the band may be shifted, and financial supports. Williamson (1999) would have participating countries declare a fluctuation band vis-a-vis an appropriately weighted average of the G-3 currencies with a width of not less than plus-or-minus 5 per cent or more than plus-or-minus 15 per cent. Rates would be allowed to float within the band, but the authorities would normally intervene to keep them from straying further. The knowledge that they were ready to do so would create bias in the band (that is, stabilizing speculation). To avoid having to defend indefensible positions, governments would adjust the band whenever there was a significant change in the equilibrium rate. These realignments would occur before speculative pressure built up. To avoid speculative attacks and costly reserve losses, jump changes in the exchange rate would be avoided; the old and new bands would overlap sufficiently for the current rate to be contained by both. While there would be a presumption that the authorities would intervene to prevent the rate from straying beyond the band, they could allow the rate to go outside it if market pressures were overwhelming. This would avoid forcing them to commit

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<sup>59</sup>Or even if these peg to the same currencies but with different weights. Obviously, I am dismissing the possibility that the U.S., Japan and EU will agree on target zones for their currencies anytime soon.

their scarce reserves to a battle with international markets that they could not win.<sup>60</sup>

This scheme has its attractions. The common peg would minimize intra-Asian cross-rate volatility, while the basket weights would prevent those pegs and the economies maintaining them from being destabilized by G-3 exchange-rate fluctuations. The commitment to intervene could induce stabilizing market behavior, while the soft margins and allowance for realignments would avoid forcing the authorities to engage in futile battles with the markets. The knowledge that governments have negotiated a collective agreement obliging them to behave in this way would enhance the credibility of their commitment to defend their bands and therefore encourage stabilizing speculation.

But attractiveness, to repeat, is different from viability. A viable system of collective currency pegs must satisfy four conditions.

- **It must have credibility.** It must be supported by credible commitments on the part of participating governments and central banks to defend their exchange rate regime. Otherwise, there will be no bias in the band -- no stabilizing speculation. If market participants instead suspect that a currency will exit the system when it reaches the limit of its fluctuation band, that limit will become a focal point for speculation. If the collective commitment to stabilize rates is abandoned when it is tested, moreover, it will discourage future efforts at cooperation.
- **A viable exchange rate arrangement must be flexible.** Either there has to be scope for periodic exchange rate adjustments, or there has to be adequate flexibility on other

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<sup>60</sup>And, if those market pressures were not justified by fundamentals, then the rate would move back into the band once the speculative flurry has passed.



margins (wage and price flexibility or labor mobility, for example). Otherwise a currency peg will become a straitjacket, as Argentina's recent experience has illustrated.

- **There must be a mechanism for coordinating adjustments.** This is what makes a unilateral peg different -- and in principle less robust -- than a system. Beggar-thy-neighbor adjustments that relieve the pressure on one currency by transferring it to another will do little to support a collective exchange rate arrangement. They will only cast doubt on its rationale.
- **There must be financial supports.** Raising interest rates to defend a weak currency is costly. Consumption and investment will be crunched; corporations and banks with maturity mismatches on their balance sheets will suffer serious financial distress. Hence, currency stabilization arrangements from the Bretton Woods System to the European Monetary System have included swap and credit lines to provide additional financing for countries of having to defend weak currencies.

I now suggest that a system of East Asian basket pegs is unlikely to satisfy these requirements.

**Credibility.** Historically, Asian governments have regarded exchange rate stabilization as a priority. But three factors are likely to temper that commitment in the future: capital mobility, democratization, and the diversification of social goals. The tradeoff between capital mobility and exchange rate stability, assuming that governments attach some value to policy autonomy, is a corollary of the "impossible trinity" of international economics. To put it another way, increased capital mobility makes it necessary to sacrifice other policy goals in order to stabilize exchange rates.

This is where the second consideration enters, namely, that as Asian economies mature and regional relations normalize, governments come under pressure to pursue a wider range of social goals. Following World War II, when the Korean and Taiwanese economies were dominated by subsistence agriculture, raising per capital GNP was a national priority. So long as South Korea was threatened from north of the 39th Parallel and Taiwan was threatened from across the Straits, industrial growth was synonymous with national security, which in turn was regarded as indispensable. A stable exchange rate was integral to the growth model employed to achieve these ends.

In today's richer societies, in contrast, citizens attach greater weight to other social goals, employment security for example. Governments that deliver stable exchange rates by raising interest rates and thereby sacrificing employment are less likely to retain public support. This is where the third factor, political democratization, another corollary of economic development, comes into play. This perspective suggest that Asian governments have more limited scope than in the past for subordinating other goals of policy to the pursuit of exchange rate stability.

Philosophical arguments aside, governments will not commit to defending an exchange rate that they do not see as in their interest. This raises important questions about the weights in the basket peg. Williamson suggests that the weights should be proportional to the relative shares of the G-3 economies in the real effective exchange rates of the participating countries -- in other words, in their relative shares of imports and exports of goods and services. But those shares differ across countries. Ignoring the fact that we are dealing with national governments, it might make sense to aggregate the foreign trade of the region (in, say, dollar terms) and pick the weights accordingly. But the presumption in intergovernmental negotiations that all countries

should receive equal treatment suggests instead taking unweighted averages of national trade weights. Basket weights differ when calculated in these two ways; the weight the U.S. dollar, for example, is 34 per cent when we take unweighted averages but 39 per cent when we weight by GDP (in 1999 purchasing power parity dollars). But, whatever solution is taken, some countries will be unhappy with the result, which will raise questions in the minds of market participants about their readiness to make painful sacrifices in order to maintain the arrangement.<sup>61</sup>

Moreover, East Asian countries are linked to the G-3 not simply by trade but also by investment flows. If they rely on Japan for direct foreign investment, shouldn't they attach a greater weight to the yen than implied by trade in goods and services alone?<sup>62</sup> If they rely on Europe for the bulk of their syndicated bank credits, shouldn't they attach a greater weight to the euro in their basket pegs? And, if the relative importance of these sources of finance -- not to mention the importance of foreign finance generally -- differs among them, will they not prefer different basket weights? Table 9 shows how radically the alternative weights differ. These might seem like technical questions, but they raise concerns about how satisfied the participants will be with the resulting design and therefore about the sacrifices they will be prepared to make to defend it and hence the confidence it will inspire.

This design also rests uneasily with the desire for a single Asian currency, which is part of

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<sup>61</sup>There are even more complicated models of appropriate trade weights for calculating real effective exchange rates, such as the IMF's Multilateral Exchange Rate Model (where trade weights are adjusted by the relevant elasticities of demand). It is not clear whether the advocates of common basket pegs have in mind using such models and, if so, which model should be chosen.

<sup>62</sup>Since exchange rate volatility may tend to discourage investment flows.

what inspires the commitment to regional exchange-rate stabilization.<sup>63</sup> The problem is that it excludes the Japan from the set of countries adopting the common basket peg. This has led Anderson and Steinherr (2001) and Kwan (2001) to suggest that other East Asian countries should peg to the yen rather than a G-3 basket.<sup>64</sup> But doing so would expose their economies to being dragged up and down against the dollar and the euro as a result of yen fluctuations, which could have adverse consequences for competitiveness or inflation. The instability of the Japanese economy and, hence, the prospective instability of the yen make this a less than attractive prospect. Anderson and Steinherr yearn for an agreement that would link the adoption of yen pegs by the countries of East Asia ex-Japan to a commitment by Japan to stabilize the yen to a dollar-euro basket, but such ideas remain in the realm of social science fiction.

Rhee and Moon (2002) suggest a symmetrical system in which Asian currencies are pegged to other currencies via a multilateral currency grid, a la the European Monetary System (EMS) of the 1980s and 1990s. This idea is advanced on the grounds that it would be a logical intermediate stage on the path to monetary union, and that the scope for stabilizing intervention would not be limited by Asian countries' holdings of dollar and euro reserves. It is resisted by Japanese officials (e.g. Kuroda and Kawai 2002), however, on the grounds that it would either

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<sup>63</sup>In the words of de Brouwer (2002b), "While the general view is that cooperative or common currency arrangements are still some time off, they are increasingly being thought of as a long-term policy aim."

<sup>64</sup>They are encouraged in this view by the fact that basket pegs are less transparent and therefore less credible than single currency pegs (as demonstrated by Frankel et al. 2000). This is the rationale for McKinnon's (2001) recommendation that the countries of the region, including Japan, instead adopt dollar pegs.

lack a credible anchor or expose the Japanese to open-ended financial obligations.<sup>65</sup>

The analogy with the EMS reminds us that Europe's regional exchange-rate agreement was stabilized in the second half of the 1990s by the fact that governments saw it as a stage on the road to monetary union. They were prepared to defend the EMS because they saw its collapse as jeopardizing that goal. In turn, market expectations were anchored by the recognition that governments were committed to monetary unification at an early date. Governments knew, when deciding whether to defend the EMS, that monetary union hung in the balance, and the markets knew that governments knew.

A system of common pegs in Asia would be similarly stabilized if the participating governments saw it as a way station on the road to monetary unification. Suffice it to say that East Asia is very far from being ready for a single currency.<sup>66</sup> Discussions of this possibility can play a constructive role by reminding governments of the reforms that must be completed before their neighbors will view them as attractive monetary-union partners. But desultory discussion

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<sup>65</sup>McKibbin and Lee (2002) also show that a multilateral currency grid has less desirable performance characteristics in response to a variety of shocks than either a free float or a common dollar-euro-yen basket. One suspects that, in practice, an arrangement styled on the model of the EMS evolve into a less symmetrical system, with the yen playing the role of the deutschmark in Europe, assuming that Japan sorts out its economic and financial problems. Then the hesitation of the Japanese authorities should probably be ascribed to reservations over whether they would be compelled to intervene on behalf of weak currency countries and to mixed feelings about the desirability of eventual monetary union (on both these points, see below).

<sup>66</sup>The prospects for a single East Asian currency are rightly regarded as the subject of another paper. The easiest way of thinking about them is to observe that countries will be willing to cede decision making power over monetary policy to a supranational entity equivalent to the European Central Bank only if that entity is subject to a minimal level of political accountability. In Europe such minimal accountability is provided by the European Parliament and the requirement that the president of the ECB must testify before the EP periodically. Contemplating how much would have to change before Asians were prepared to elect an "Asian Parliament" with even the limited powers of the EP serves to establish the point.

without a credible deadline is not enough to anchor expectations or to stabilize foreign exchange markets. There must be a commitment to complete the transition to monetary unification by a specific date. This is one way of understanding why the Werner Plan failed while the Delors Plan succeeded. It was the commitment in the Maastricht Treaty to complete the transition to monetary union by the end of the 1990s that tied down expectations after 1992 and helped to stabilize the markets.<sup>67</sup>

**Flexibility.** In Williamson's scheme, flexibility is lent by the willingness of the authorities to shift the band when conditions change. The problem is the observed reluctance of governments to adjust the exchange rate when its equilibrium level is altered.<sup>68</sup> To induce stabilizing market behavior, the authorities must reassure the markets that they attach priority to preservation of the peg. This in turn means that their credibility is tarnished when they renege on that promise and change the rate, which deters them from adjusting the latter before market pressures build up. Moreover, if the authorities reassure the markets that they are prepared to effectively minimize exchange risk, they will encourage capital to flow in beyond the point where its social return equals its social cost and set the stage for financial difficulties when the peg collapses (Dooley 1997, McKinnon and Pill 1999, Wilson 2000).

The proponents of currency bands assume that these problems can be solved if governments only recognize the merits of early exchange rate adjustments (thereby solving the "exit problem") and if they commit to restoring depreciated rates to their previous level

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<sup>67</sup>Those who prefer proof by counterexample need only recall the destabilizing impact of Denmark's refusal to ratify the treaty in the spring of 1992 and the instability that resulted from uncertainty about the outcome of the French referendum in the fall.

<sup>68</sup>As emphasized in my earlier discussion of the exit problem.

following each episode of financial pressures (which would limit the financial distress due to unexpected depreciations). But this assumes convenient answers to difficult questions. Officials have to reassure the markets that they have no intention of shifting the band; otherwise, they have no hope of stabilizing speculation. But to then shift the band damages their reputation. This is why virtually every system of pegged exchange rates that has existed through history has been more rigid than envisaged by its architects.

Related to this is the tradeoff between the credibility and flexibility of the band. If the authorities regularly shift the band before the rate reaches the margins in order to prevent speculative pressure from building up, then the regime will differ little in practice from floating. In particular, if the authorities regularly adjust the margins before they are reached, there will be no reason for bias in the band. On the other hand, if they attempt to keep the rate from violating the edges of the band when the latter are approached, they will have to butt heads with currency speculators. This will provide a harsh reminder that their foreign reserves are limited, as is their capacity to put the economy through the wringer of high interest rates. All this limits the likelihood that they will emerge victorious from their contest with the markets.

Williamson (2001) rebuts this point by arguing that the basket nature of the peg avoids the development of many sources of disequilibrium in the first place. Moreover, because the band is wide, there is room for the exchange rate to accommodate any Balassa-Samuelson inflation differential. And, if the band needs to be shifted, the old and new bands can be made to overlap, again avoiding the need for jump changes in the current rate. Together, this “avoids the need that arises under the adjustable peg to defend a disequilibrium exchange rate” (p.117). All this assumes that we know the equilibrium rate with a reasonable degree of confidence. Yet

purchasing power parity, the best model of equilibrium exchange rates we have does not hold even over long horizons and even when tested with large amounts of data. Moreover, Williamson assumes that it is mainly Balassa-Samuelson effects and other relatively slowly moving determinants of competitiveness that alter the equilibrium exchange rate, where in practice we know that it is mainly financial factors (changes in U.S. interest rates, changes in investor sentiment) that determine it. Capital flows are large and can change direction on a dime. Hence, it may not be possible to maintain a smooth crawl and to ensure that the new and old bands overlap in the face of financial shocks. As Goldstein (2000, p.21) puts it, “When the big shocks come...even a 15 per cent band is not likely to be accommodating enough to handle them. In that case, the band will likely be widened farther and farther, chasing the movement in the actual exchange rate -- until the band is ultimately abandoned altogether in favor of a float.”

**Cooperation in Providing Financial Support.** A network of credit lines and swaps that pools the reserves of the participating countries is an obvious response to this problem. The Chiang Mai Initiative is such a network (which is why some observers see it as a platform on which to build a system of regional currency pegs). The CMI is a descendant of the Asian Swap Arrangement (ASA) established established in 1977 by the five original ASEAN members and extended to the five other ASEAN members at the Darussalam ASEAN Finance Ministers Meeting in March 2000.<sup>69</sup> The ASA was then transformed in May of 2000 into the CMI encompassing not just the ASEAN countries but also Japan, China and South Korea. In

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<sup>69</sup>Under the ASEAN Swap Arrangement, each member state originally contributed \$20 million (an amount that was increased to \$40 million in 1978). Swaps could be for one, two or three months and were renewable at most once, again for up to three months. They were activated by Indonesia in 1979, Malaysia in 1980, Thailand in 1980, and the Philippines in 1981 and 1992. They were not activated in 1997-8.



announcing the initiative, Ministers declared their intention to cooperate in four areas: the negotiation of swap networks, strengthening regional surveillance, monitoring capital flows, and training personnel.<sup>70</sup> Support lines are \$1 billion, five times ASA levels. The founding ASEAN members are to contribute \$150 million each, while the new ASEAN members contribute smaller amounts.<sup>71</sup> Countries will be eligible to borrow up to twice their maximum contribution, by swapping their domestic currencies for dollars, yen and euros. These funds will be supplemented by a network of bilateral swap agreements (BSAs) among the 13 participating countries, some of which are in place and others of which are still under negotiation.<sup>72</sup> (See Table 10.) Multilateral swaps can be drawn for up to six months, with one six-month extension possible. Countries can draw from the BSAs for up to 90 days, and renew their drawings up to seven times.<sup>73</sup>

Up to 10 percent of the drawings available to a country under the terms of the bilateral

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<sup>70</sup>“Joint Ministerial Statement of the ASEAN + 3 Finance Ministers Meeting,” 6 May 2000, Chiang Mai, Thailand. The framework agreed to in Chiang Mai was then reaffirmed at a meeting of deputies in Beijing in November 2000.

<sup>71</sup>Vietnam \$60 million, Myanmar \$20 million, Cambodia \$15 million, and Laos \$5 million.

<sup>72</sup>In principle, there could be 30 bilateral agreements between China, Japan and South Korea, on the one hand, and the 10 ASEAN members on the other, plus three additional agreements among the three non-ASEAN participants. In practice, the main agreements under negotiation are between Japan and the relatively high-income members of ASEAN. Further agreements are evidently under negotiation among China, Korea and Japan; between Korea and Malaysia, Thailand and the Philippines; and between Japan and both Singapore and Indonesia. Grants are viewed as a more appropriate form of assistance for the low-income countries than the temporary provision of resources through swap agreements.

<sup>73</sup>Interest rates will rise from LIBOR plus 150 basis points to LIBOR plus 300 basis points, depending on the number of renewals.

swap arrangements can be provided for a limited period without it having entered into an IMF agreement, but subsequent disbursements will be linked to an IMF program or Contingent Credit Lines (CCL) and therefore to the government's success in satisfying IMF conditions, thus meeting U.S. and IMF insistence that a regional support arrangement should not undercut the effectiveness of IMF conditionality.<sup>74</sup> The IMF and the U.S. government both objected to the earlier Japanese proposal for an Asian monetary fund on these grounds. The Malaysian government objected to this linkage of support under the CMI to IMF conditionality; in response the participating governments agreed to review the linkage after three years.

But the key difference between ASA and the CMI is that, under the latter, countries can borrow reserves by against local currencies instead of having to offer U.S. treasury securities as collateral.<sup>75</sup> This means that the creditor countries will be putting money on the barrel head. The absence of hard-currency collateral means that if the financial difficulties of a borrowing country deepen further, the creditor countries could incur significant losses.

Whether these limited resources will ensure the maintenance of a network of common basket pegs is another question. While the combined reserves of the participating countries are large, the liquidity that will be available to individual countries is small. The \$1 billion of dedicated funds is so small relative to the liquidity of financial markets that it can be regarded as token. While there are also bilateral swap lines, the credits available to each country are only a fraction of the total, and in many cases amount to just \$1-3 billion. Recall that short positions on

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<sup>74</sup>While there is evidently some disagreement over the issue, it would appear that a country would have to have drawn a CCL rather than simply pre-qualified for one.

<sup>75</sup>Those domestic securities must carry a government guarantee against default, but this implies no guarantee against depreciation.

the baht were in excess of \$27 billion on the eve of Thailand's devaluation. Thailand was offered \$17.2 billion on 20 August 1997, Indonesia \$40 billion on 5 November 1997, and South Korea \$57 billion on 4 December 1997. Compared to this, \$1 billion of dedicated funds and perhaps \$20 billion of swap lines are drops in the bucket.<sup>76</sup> This suggests that relying on this network of swaps to support a full-fledged regional network of currency pegs would be risky; the authorities will have limited ammunition with which to counter skeptical markets.

Countries could conceivably commit more finance.<sup>77</sup> They could supplement pre-negotiated swap lines with extraordinary finance like that which was extended to Mexico by the United States in 1995 through the U.S. Treasury's Exchange Stabilization Fund. They could expand their system of swaps when the CMI comes up for review in 2004. They could formally pool a portion of their reserves (as contemplated by Kuroda and Kawai 2002). But they will do so only if they are confident that their resources will not be squandered -- only if they are assured that the CMI is accompanied by surveillance capable of anticipating and heading off crises, and only if it is accompanied by conditionality that leads to strong adjustment in the crisis country which will reassure the markets and maximize the likelihood of prompt repayment of any swaps. Otherwise, strong-currency countries will be unlikely to commit significant resources to the support of weak regional currencies. Even in Europe, where the commitment to collective currency pegs was exceptionally strong, mutual surveillance and conditionality were not completely effective, leading to limits on the extent of support. Germany obtained an opt out

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<sup>76</sup>These amounts are large relative to the affected countries' IMF quotas, but this is beside the point.

<sup>77</sup>As Henning (2002) suggests may eventually be the case.

from the provision of the EMS Articles of Agreement obliging it to intervene without limit in support of its EMS partners, reflecting fears of the costs of unlimited interventions and what unlimited support might imply for its creditworthiness. Participants in the Asian Swap Arrangement could also opt out of that arrangement.<sup>78</sup> It is presumably not a coincidence that the ASA was not activated for more than two decades. Under the CMI, activation of the swap is at the discretion of the lender. It is not an unconditional commitment of support.<sup>79</sup> Absent effective surveillance and conditionality, it is not hard to imagine that lenders, fearing that they might not be repaid, would be reluctant to lend. And market participants, cognizant of this fact, would not be deterred by official warnings.<sup>80</sup>

Efforts to marry the financial resources of the CMI to strong surveillance and conditionality thus must confront the tradition in Asia of nonintervention in national affairs, which translates into a low-key approach to surveillance and conditionality. Linking the disbursement of CMI funds after the first 10 per cent to the country's participation in an IMF program and to its success in meeting the IMF's conditions are ways of strengthening conditionality, but the IMF may not support the attempt to defend a country's currency peg. To the contrary, the Fund could insist on a shift to greater exchange-rate flexibility under the terms of its program,

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<sup>78</sup>Opting out under "exceptional financial circumstances" was permitted from the inception of the ASA, and in 1992 the right to opt out became effectively unlimited.

<sup>79</sup>Given that the CMI entails a network of bilateral swaps, it is possible that refusal to activate by any one potential creditor could lead the others to opt out.

<sup>80</sup>Kim, Ryou and Wang (2000) propose establishing a set of Asian Arrangements to Borrow, under which access would be unconditional, though borrowing would be for limited periods and at penalty rates. The present perspective suggests that, absent effective surveillance and conditionality, such a scheme is likely to go nowhere.

making reliance on its conditionality incompatible with the aspiration to defend currency pegs.

Nor is the Asian approach to surveillance obviously compatible with effective pressure on governments to avoid policies that create financial liabilities for their partners. Consider ASEAN surveillance. Since 1998 the association has conducted regional surveillance in the context of the ASEAN Surveillance Process, whose purpose is to facilitate cooperation in the formulation of monetary, fiscal and financial policies through information exchange, peer review, and recommendations for action at the regional and national levels. That process requires all members to provide the ASEAN Surveillance Coordinating Unit (ASCU), based in the ASEAN Secretariat in Jakarta, with the same data supplied to the IMF in conjunction with its Article IV consultations and program negotiations, enabling the ASCU to prepare an ASEAN Surveillance Report.<sup>81</sup> Finance ministers meet twice a year to discuss its findings.

The putative goals of the ASCU are two-fold: to monitor economic and financial developments in order to facilitate early detection of irregular movements, and to exert peer pressure for the policy adjustments needed to head off subsequent difficulties. But “[i]n keeping with the ‘ASEAN way,’” its surveillance “is undertaken on the basis of “consensus and informality,” as Manzano (2001, p.96) puts it. This emphasis on politeness and good manners is not obviously compatible with the issuance of blunt warnings or effective pressure for corrective action. It made for a delay of more than a year in setting up the ASEAN Surveillance Process, since participants could not agree on how much sensitive economic data should be shared with

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<sup>81</sup>The analytical capacity of the ASCU has been augmented in recent years by the establishment of National Surveillance Units in Cambodia, Indonesia, Laos, the Philippines, Thailand and Vietnam, which produce drafts of the country chapters. The ADB prepares an ASEAN Economic Outlook and special studies.

their neighbors. The result has been to give participating countries considerable discretion over the content of their self-generated surveillance reports (Wang and Woo 2002). Few details about the subsequent peer reviews have been published, aside from their mention in official meeting statements.<sup>82</sup>

The heterogeneity of ASEAN as a political unit is an obstacle to significantly strengthening conditionality and surveillance. In 1998, in response to ASEAN's ineffectiveness in response to the crisis, Thailand with the backing of the Philippines proposed curtailing the principle of mutual non-interference in favor of a policy of "flexible engagement." But, as Haacke (1999) notes, the region's authoritarian states feared that they would be subject to criticism by democratic ones. Vietnam, Laos and Myanmar thus succeeded in vetoing the proposal for flexible engagement.

The ASEAN+3 countries are currently developing a CMI surveillance procedure but face many of the same obstacles. ASEAN+3 finance ministers have met since May 2000 for annual Economic Review and Policy Dialogues (in the so-called ERPD process).<sup>83</sup> But the ERPD

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<sup>82</sup>And even this has not uniformly been the case. ASEAN, on its official website, describes the ASEAN Surveillance Process as focusing on special topics (at their Prague meeting ministers focused their peer review on fiscal consolidation and private debt restructuring, while at their Kuala Lumpur meeting they discussed measures to mitigate the risks of the global slowdown).

<sup>83</sup>Deputies meet three times a year. In addition, the Chiang Mai statement that emanated from that first meeting committed to annual meetings of finance ministers and to establishing a "network of contact persons" to facilitate regional surveillance and the goal of creating a "well-coordinated economic and financial monitoring system in East Asia." The official statement of finance ministers at the Fifth ASEAN Finance Ministers Meeting in Kuala Lumpur in April 2001 stated that discussions were underway with the +3 countries on how to enhance and extend the ASEAN Surveillance Procedure, and in Honolulu in May these countries formed a study group, co-chaired by Japan and Malaysia, to study modalities for "enhancing the effectiveness of our economic reviews and policy dialogues." Henning (2002).

Process has no secretariat or formal organization.<sup>84</sup> It is burdened by unanswered questions.

Will findings be released? Will it be possible to publicly reprimand governments and central banks running policies of questionable sustainability that threaten to create financial liabilities for their CMI partners? Will there be other mechanisms capable of forcing weak currency countries to take early policy adjustments?<sup>85</sup>

De Brouwer (2002b) writes that “exchange rate cooperation must be backed by unequivocal financial cooperation if it is to work.” The state of play regarding surveillance and policy conditionality in Asia suggests that the region remains very far away from making cooperation unequivocal. In turn, this suggests that any system of common basket pegs would be fragile. It would be unlikely to last. And its collapse would discredit the wider project of monetary and financial cooperation.

## **6. Financial Cooperation**

Having argued that monetary and exchange rate cooperation is the wrong project for Asia, I now suggest that there is a case for cooperation to deepen and strengthen regional financial markets. Not only does this address the root problem -- weak banking systems and underdeveloped securities markets -- as opposed to one of its symptoms (the volatility of

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<sup>84</sup>Although Kuroda and Kawai 2002 contemplate the creation of one. The Asian Development Bank and ASEAN Secretariats have been enlisted as suppliers of analytical input, but these arrangements have not been formalized. They appear to be left to the discretion of the host government.

<sup>85</sup>Initial soundings are not promising. Efforts to craft a CMI surveillance procedure have become bogged down in terminological disputes that are revealing of regional sensitivities: for example, some countries have gone so far as to insist on replacing all references to surveillance with the cosmetic phrase “economic reviews and policy dialogues.”

exchange rates), but it is better attuned to historical and political conditions in the region

The uneven development of Asian financial markets has attracted considerable attention since the crisis. Following the example of Japan, Asian governments forced financial transactions through the banking system as a way of mobilizing resources for industrial projects that they viewed as national priorities (Hoshi and Kashyup 2001). The result was a system in which bank finance played a disproportionate role in intermediation. The close connections between banks and governments rendered the former too large and politically well-connected to fail, which weakened market discipline on bank owner-managers and encouraged indiscriminate bank-to-bank lending by foreigners in the run-up to the crisis.

A corollary of the importance of banks is the relative unimportance of debt securities. Table 11 shows that only Hong Kong placed in the Trade Association for Emerging Markets' top ten list of the most-traded bonds for 2001.<sup>86</sup> (South Korea featured on this list in 2000 but fell off subsequently.) Given the underdevelopment of equity markets, corporate sectors became highly leveraged -- South Korea, Japan, Thailand, Indonesia and Hong Kong have five of the highest leverage ratios in the world -- increasing their vulnerability to financial disruptions and even moderate slowdowns in economic growth.

While the preceding paints the financial sector with a broad brush, it serves to highlight the financial weaknesses that countries must eliminate in order to limit their vulnerability to financial and macroeconomic disruptions. They must remove nonperforming loans from bank and asset-management-company balance sheets through voluntary debt-equity swaps, eliminate implicit guarantees, and strengthen prudential supervision and regulation. They must put in place

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<sup>86</sup>I owe Goldstein (2002) this reference.



a regulatory framework and protections for minority shareholders that will encourage the development of markets in equity and in domestic-currency-denominated debt securities.

This summary of the reform agenda is not meant to suggest that no progress has occurred since the outbreak of the crisis. South Korea and Indonesia have restructured their banking systems; the number of Indonesian banks, to take the most striking case in point, has fallen by nearly half since 1997. Foreign bank ownership has increased in virtually every Asian country. Capital adequacy ratios have been raised across Asia, partly through foreign acquisitions, partly as a result of domestic injections of share capital. To strengthen their securities markets, countries have upgraded trading and settlement systems, promoted the growth of pension funds, and encouraged corporate issuers to secure credit ratings.

At the same time, serious problems remain. Foreclosure proceedings are unpredictable and time consuming. The rights of outside investors are weak. Reflecting the painfully slow growth of equity markets, corporate debt-equity ratios remain dangerously high, in excess of 200 per cent in Korea, 250 per cent in Indonesia, and 300 per cent in Thailand (Tseng 2002). Bank profitability is low region wide. Impaired assets (nonperforming loans plus loans transferred to asset management companies) remain above 50 per cent of loans in Indonesia and 40 per cent in Thailand. Bank profits are anemic. Bank share prices are correspondingly depressed.

China is an extreme case. Despite the unsated appetite of residents for equity claims and the partial opening of Chinese stock markets to foreign investors, problems of corporate governance and auditing and accounting standards continue to limit equity market capitalization. As a result, bank finance continues to predominate. In the mid-1980s, the financial burden of supporting the country's state-owned enterprises (SOEs) was shifted from the budget to the four

main state-owned banks. Despite the desire to commercialize these banks and create a market-oriented credit culture, pressure continues to be applied to bank managers to meet the SOEs' financial needs. The stock of nonperforming loans (NPLs) in the Chinese banking system is still expanding, despite efforts to commercialize the state banks and the reduced weight of the SOEs in the economy. Lending to SOEs accounts for more than half of the growth in total lending. State banks are now freer to provision and to build reserves against future losses, but progress on both fronts is slow. Of the big four Chinese banks, only the Bank of China has released information on NPLs (a fact that is surely not unrelated to its desire to float a domestic bond and launch an IPO in Hong Kong for its separately incorporated international holdings). Bottelier (2001) estimates the cost of cleansing bank balance sheets at some 45-50 per cent of GDP, a figure that rivals the cost of the most serious banking crises of the 1990s. Here is where the underdevelopment of stock markets will bind, since it limits debt/equity conversions, which are the obvious market-based way of solving this problem.

So, while financial restructuring is underway, the battle is uphill. Progress to date has resulted from national initiatives. More initiatives along similar lines are urgently needed. But is there, in addition, a case for cooperation?

The arguments for regional cooperation are three. First, Asian countries share financial problems as a result of shared historical experience. National histories differ in their particulars, but bank-centered financial systems, high levels of corporate leverage, and close bank-government connections are widespread. Pooling information, analysis, and expertise on these problems has obvious efficiency advantages. Insofar as Asian policy makers and bureaucrats understand these problems better than the employees of multilaterals located in Washington,

D.C., information sharing at the regional level is likely to be more efficient.

Second, insofar as the Asian model is distinct (something that needs to be established rather than asserted), there is a case for cooperation in the design of financial regulations that differ from those developed in other regions. Given the close connections between banks and industrial conglomerates, there may be a case for different regulatory standards for portfolio concentrations than those promulgated by the Basle Committee of Banking Supervisors. Given Asia's continued reliance on family control, there may be a case for different standards for corporate governance, which rely less on outside directors but give minority creditors other (legal) means of protecting their rights. In principle, there is a case for regional cooperation in the design and implementation of such standards.<sup>87</sup>

Third, there is a case for regional cooperation insofar as Asian banks and nonbank financial firms increasingly compete with one another. With the intensification of competition between Malaysian and Singapore banks and Hong Kong and Chinese banks, for example, there will be more pressure on regulators to race to the bottom -- or at least it will become more difficult to race to the top. It will be harder for the regulatory authorities in one country to increase capital requirements for fear that doing so will cause domestic institutions to lose business to the foreign counterparts, since capital is a cost of doing business. The same argument that motivated the negotiation of the Basle Capital Accord in 1988 thus provides a motivation for regional cooperation on capital and other financial standards in Asia. Insofar as proximity matters for the intensity of international financial competition and the structure of efficient

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<sup>87</sup>Whether the case that exists in principle also exists in practice is a separate question, to which I return below.

regulatory standards differs in Asia, the Basle Committee's Capital Standards and Core Principles for Effective Banking Supervision are imperfect substitutes for regional cooperation.

I have my own ideas about how financial cooperation should be organized in East Asia (although one can imagine a variety of different designs). My idea is to establish an Asian Financial Institute on the platform of ASEAN+3.<sup>88</sup> The AFI would provide technical assistance to national agencies seeking to strengthen prudential supervision and regulation. It would run training programs for bank inspectors, securities and exchange commissioners, and accountants, exploiting economies of scale and scope by enrolling students from all of its members, and encouraging the efficient pooling of knowledge and expertise. It would provide reserve management, clearing and settlement services to member central banks, not unlike the central banking services that the Bank for International Settlements provides to its members. Many

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<sup>88</sup>This proposal was first laid out in Eichengreen (2001b). Admittedly, this is not the first time that such an entity was proposed. In 1995 Bernie Fraser, the Governor of the Reserve Bank of Australia, suggested establishing an Asian version of the Bank for International Settlements to carry out some of these functions. The institution envisaged by Fraser would have been responsible for exchanging information regarding international financial and monetary policies and developing contingency plans for dealing with financial crises. It was also expected to offer a venue for sharing information and experience regarding supervision and surveillance of financial systems and to provide central banking services to member central banks. Still, Fraser's vision was more modest than that described here. In particular, the promulgation and enforcement of standards, regulations and policies for promoting financial stability and development, which would be among the key functions of the AFI, were not among the responsibilities of the Asian BIS enumerated by Fraser. Subsequently, Bergsten (2000b,c) proposed the creation of an APEC Financial Institute. Specifically, he advocated the creation of an institution to "provide training to bankers, auditors and accountants, lawyers and credit raters, and supervisors and regulators throughout the region." But while Bergsten's motivation is similar, the responsibilities of the institution he envisages would again be more limited than those of the institute proposed here. Bergsten's institute would provide training, not lending. It would not coordinate regulatory functions. It would not promulgate and monitor compliance with standards. The contrast is not surprising: APEC's heterogeneous membership (including the U.S., Canada, Australia, and New Zealand, among others) is not obviously compatible with standard setting, monitoring and lending functions expressly tailored to Asia's needs.

financial market participants in Asia clear, net and settle their transactions using U.S. and European payments systems; liquidity and technical support for a pan-Asian payments and settlements system would obviate the need for traders and investors to go through third markets.

In addition, the AFI could be a venue for the negotiation of regional agreements on capital and liquidity standards and regulatory processes intended to promote the stability of banking systems, and of standards for information disclosure, securities listing and corporate governance designed to promote the development of regional financial markets. Such standards and codes are already being promulgated at the global level, by inter alia the Basel Committee of Banking Supervisors (in the case of capital adequacy for international banks), the Financial Stability Forum (in the case of prudential supervision and regulation), the IMF (in the case of data dissemination, transparency, and codes of conduct for monetary and fiscal policies), and the OECD (in the case of corporate governance). But having the AFI organize negotiations on the design of a separate set of regional financial standards appropriate to Asia's special circumstances would address concerns that global standard-setting initiatives are not sensitive to the special features of the Asian model.

ASEAN+3 is the logical grouping to back this initiative. It includes the three large Asian countries and can build on an already extant institutional infrastructure. Not only heads of state but also finance, economics, and foreign ministers as well as central bank governors and senior officials already meet regularly under its aegis. In 1998 its heads of state set up a "vision group" to sketch plans for wider cooperation. At their summit in Manila in Nov. 1999, they agreed to cooperate more closely on a variety of areas, issuing a "Joint Statement on East Asia Cooperation." In Chiang Mai, in May 2000, they announced their initiative to establish a system

of swap lines and credits. In Singapore the following November they agreed to explore the possibility of formalizing their ties and forming an East Asian free trade zone. ASEAN+3 is already in the business of providing technical assistance: at the Fourth ASEAN Finance Ministers Meeting (in March 2000), ASEAN+3 finance ministry and central bank deputies agreed to establish a network of research and training institutions. They have engaged in peer-review exercises and policy dialogues at finance and central bank deputies' meetings and finance ministers meetings, which typically in May at the time of the ADB annual meetings and can be seen as the precursors of a full-fledged surveillance process. As discussed in the previous section, the existing network of swap arrangements among this grouping of countries has already begun to stimulate efforts to establish a unified policy dialog or surveillance group that would meet on a more regular basis than is now the case of finance ministers or deputies. Thus, ASEAN+3 already possesses an infrastructure of regular meetings, a pool of financial resources, and a presumption that national policies are a matter of common concern.

Connecting the AFI with the Chiang Mai Initiative would have the further benefit of removing ambiguity about the purposes of the CMI. Its purposes would be defined as fostering financial stability and development, not stabilizing exchange rates. Whether fixed or flexible exchange rates were more conducive to financial stability and development would then be recognized as a separate question. The focus of the bilateral swaps made available to partner countries under the CMI would be to provide assistance in the event of exceptional disturbances to national financial systems – a stock market collapse, banking panic, or exchange-rate meltdown that threatened to inflict serious balance sheet damage on financial markets and institutions and to thereby set back the process of financial development. Acting as a group,

ASEAN+3 would in effect act as a collective lender of last resort to countries whose financial systems were at risk (countries with limited capacity to engage in LLR activities themselves), while linking financial assistance to the relevant financial conditionality.

Such an arrangement is better attuned to the context for cooperation than an exchange-rate stabilization agreement. It does not require open-ended financial commitments of a sort that are unlikely to be credible given the light touch characteristic of regional surveillance exercises. It does not require Asian countries to execute an about face on their attitude toward surveillance and pretend that they can make blunt public pronouncements about the inadequacies of their neighbors' policies. It does not require them to tie down market expectations by committing to an unrealistic goal like a single currency by the end of the decade. What is required, rather, is sharing information and expertise and coordinating national responses to those problems. What is required is collaboration in the design of regional financial standards and regulations, supplemented by limited financial assistance for countries that encounter difficulties in adjusting to those standards.

Creating an Asian Financial Institute with a permanent secretariat would in principle help to cultivate support for deeper cooperation. A permanent secretariat can always become a bloated bureaucracy, of course. But one can also imagine that the creation of such an institute, made up of a body of experts with agenda-setting power, could push the process of regional integration forward in much the same way that agencies like the Coal and Steel Community advanced Europe's integrationist project.

To be sure, ASEAN+3 is not an ideal basis for this kind of cooperative initiative. It is a

new grouping.<sup>89</sup> It is heterogeneous, encompassing countries as varied as Laos and Japan. It excludes Australia and New Zealand for reasons that are not obvious.<sup>90</sup> Webber (2001) suggests that it has similar structural weaknesses as ASEAN and that the odds are against it developing into a strong regional organization. In particular, it appears to share ASEAN's approach to surveillance in its emphasis on voluntarism and confidentiality.

Be that as it may, other potential institutional bases for this kind of cooperation are even less ideal. ASEAN is too small. APEC is too large, including as it does the United States, Russia and a variety of Latin American countries; that heterogeneity works to take financial issues off the table.<sup>91</sup> Ravenhill (2001) notes that financial issues did not figure at all in APEC's early agendas.<sup>92</sup> PECC (an academic, business and government grouping) shares the limitations

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<sup>89</sup>Its prehistory goes back to 1996, when the ASEAN+3 countries coordinated their preparations for the first Asia-Europe meeting. In offering to meet with East Asian countries as a group (including China, Korea and Japan as well as the members of ASEAN), the Europeans recognized East Asia as a distinct economic and political entity and thus encouraged Asian governments to respond as such.

<sup>90</sup>In contrast, Australia and New Zealand are members of the Manila Framework Group, the 14-member subset of APEC countries that came together in the wake of the Asian crisis to consider a range of monetary and financial issues (on the MFG, see below). They are members of EMEAP, the Executives' Meeting of East Asia-Pacific Central Banks, organized in the early 1990s with leadership from Japan and Australia. The view may be that these countries have rather different financial structures and therefore different financial problems, but if so this view needs to be defended and articulated.

<sup>91</sup>Tussie (1998) provides a number of reasons for doubting that APEC is an adequate platform for wider cooperation that extends beyond technical assistance. In particular, he argues that many Asian countries view APEC, rightly or wrongly, as a forum for extending U.S. rules and procedures to Asia.

<sup>92</sup>"Finance has never been carefully integrated into the APEC framework," as he puts it (Ravenhill 2001, p.195). Before the Auckland meetings in 1999, gatherings of finance ministers were not even coordinated with the annual leaders' meetings or with those of trade ministers. Ravenhill's explanation is bureaucratic politics: trade and foreign affairs ministers rather than



of APEC, as does the Manila Framework Group.<sup>93</sup> Wang and Woo (2002) recommend assigning these functions to the Regional Economic Monitoring Unit (REMU) of the Asian Development Bank, which already provides input into the ASEAN Surveillance Process and extends technical assistance to less developed ADB members. But the ADB has the United States as a shareholder, a number of Pacific micro-states and central Asian republics as members, and a mandate to promote the development of the region's poorest countries, all of which would complicate efforts to use it as a platform for regional financial cooperation. While EMEAP, the Executives' Meeting of East Asia-Pacific Central Banks, has among its objectives regional surveillance, the exchange of information, and the promotion financial market development, its schedule is irregular, and its meetings have lacked coherence and continuity.<sup>94</sup> The SEANZA Group of central banks has many of the same limitations from the present point of view.

It might be argued that the AFI should be established by a new grouping of Asian countries separate from ASEAN, APEC, PECC, SEANZA, EMEAP and the others. It could be

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their treasuries have traditionally dominated APEC meetings and regard them as their turf. In August 2000 an independent group of experts in fact recommended to APEC that it form an APEC Financial Institute. But that suggestion bore little fruit.

<sup>93</sup>Reflective of this fact, the MFG "does not appear to be strongly influential in the region," in the words of Sakakibara (2001). Its founders see it as a mechanism for undertaking regional surveillance, encouraging technical and economic cooperation, and coordinating regional and multilateral financial initiatives. In light of this last goal, meetings have also been attended by representatives of the IMF and the BIS; the IMF's Regional Office for Asia and the Pacific serves as the group's technical secretariat. In practice the MFG appears to function mainly as a forum for the exchange of views. Its inputs and outputs are not made public, aside from a cosmetic post-meeting press release. And, its meetings are attended not by finance ministers but by finance ministry and central bank deputies.

<sup>94</sup>Firm surveillance, peer pressure and constructive criticism feature no more prominently in its discussions than in those of ASEAN.

made up of countries committed to financial openness (leaving out any that prefer to opt for capital controls) and to market-based banking systems (leaving out those that are reluctant to privatize state banks), and at comparable levels of financial development (leaving out the poorest countries with the least developed financial systems). Countries could opt in once they met these preconditions. But this would contribute further to the alphabet-soup problem -- that there already exists a proliferation of cooperative arrangements in the region. There would be no linkage between financial reform and financial supports in the absence of a connection to the Chiang Mai Initiative.

A final objection concerns the contrast I have drawn in the preceding between monetary and financial cooperation. It may be that the problems of exchange rate stabilization and financial development are not really distinct. Exchange-rate volatility, in this view, is one of the principal obstacles to financial-market development. In emerging markets that do not already possess deep and liquid securities markets, exchange-rate variability deters residents from holding domestic-currency denominated claims. They demand bank deposits denominated in foreign currency, resulting in mismatches on bank and corporate balance sheets.<sup>95</sup> As a result of those mismatches, banking systems are more vulnerable, and residents become less willing to hold claims on domestic banks at all, or at least in the absence of government guarantees. Markets in domestic-currency-denominated debt securities are underdeveloped, requiring emerging markets to borrow abroad or at least to issue foreign-currency-denominated or foreign-currency-indexed claims. Only countries that stabilize their exchange rates for long periods, it is argued, have succeeded in escaping this problem and developed deep and liquid financial

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<sup>95</sup>Some evidence to this effect appears in Arteta (2002).

markets in domestic-currency-denominated claims. The key to financial development, in this view, is to peg the exchange rate. Panama and El Salvador, which have gone one step beyond pegging to dollarization and have two of the deepest mortgage markets in Latin America, are widely cited in this connection.

I regard this view as somewhat exaggerated. The cross-country evidence (viz. Levine and Carkovic 2001) suggests that it is chronic inflation and not a flexible exchange rate that hinders financial deepening and development. Inflation-targeting countries have shown that exchange rate flexibility can be compatible with the price stability that is critical for financial deepening and development. Countries like Mexico, which succeeded in developing a reasonably liquid futures market for peso-denominated claims in the second half of the 1990s, suggest that greater exchange rate flexibility can in fact stimulate financial development rather than hindering it, other things equal.

## **6. Conclusion**

The Chiang Mai Initiative is just one manifestation of the broader desire for economic, monetary and financial cooperation in Asia. It reflects the same tendencies that motivate regional cooperation in Western Europe, the Western Hemisphere, and other parts of the world. Globalization, financial globalization in particular, results in a loss of economic control, encouraging countries to band together in an effort to recapture their policy autonomy. Destabilizing impulses can emanate from sources that are foreign in more than one sense of the word. This in turn encourages the desire to ring fence the neighborhood.

That these tendencies are so prominent now reflects the searing experience of the 1997-8

financial crisis. That they developed in recent years also reflects the normalization of Asia's international relations and the maturation of its economies. Now that the battle between capitalism and communism has been relegated to history's dustbin, Asian countries can get about normalizing their economic relations. To the extent that they no longer rely on the United States to meet their security needs, they no longer must heed extra-regional opposition to closer regional links. And, as their economies mature, they develop a deeper and more complex web of regional economic interdependencies, which in turn encourage investments in intergovernmental cooperation.

The question thus is not whether to cooperate, but to cooperate in what, and how. Asia's history is relevant here. That history heightens the value attached to sovereignty and national self-determination. As a result, countries resist the idea of supranational institutions and arrangements that require significant pooling of national powers and intrusive conditionality. This in turn has implications for what kind of commitments would be credible. Commitments that imply the need for close cooperation to stabilize asset prices in the face of market pressure are not likely to be time consistent. This, in a nutshell, is why regional exchange rate stabilization arrangements are unlikely to work. Commitments to develop regional financial markets, on the other hand, do not have to be organized around an asset price on which the markets can take aim. They too benefit from cooperation, but not of the detailed, day-to-day sort. They would address the fundamental problems that Asian economies need to solve to sustain the rapid rates of economic growth to which they have grown accustomed.

Is deep integration possible without exchange rate stabilization? Many Europeans would say no -- exchange rate stabilization has long been at the center of Europe's integration effort.

North Americans would disagree; they would observe that significant steps in the direction of deeper integration have been possible without marrying cooperation to exchange rate stabilization or monetary integration. For Mexico, for example, the key since the Tequila crisis of 1994-5 has been the development of financial markets, in particular the development of forward and futures markets on which the peso can be traded and exposures can be hedged, thereby decoupling the benefits of integration from the risks of exchange-rate fluctuation. To be sure, large companies with collateral find it easiest to obtain cover for their foreign currency exposures, and not surprisingly it is those same large companies that are the staunchest defenders of North American economic integration. But this is not a critique of the argument that financial development limits the importance of exchange rate variability as an obstacle to economic integration, only a reminder that financial development has further to go.

Whether deep integration must have a monetary component depends on the kind of deep integration one is talking about. In Europe, the willingness to pool political sovereignty makes monetary integration feasible. It also makes monetary integration desirable, since the creation of a single monetary policy and a European Central Bank ratchets up the pressure for the creation of regional political institutions with real power to hold Europe's monetary policy makers accountable. In North America, where there is little desire for political integration, an exchange rate stabilization agreement is less obviously attractive on political grounds. It is less obviously feasible, since the absence of deep political commitments would inevitably raise questions about its credibility. It is not hard to see with which case Asia has more pronounced similarities.

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