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**“Regional Architecture for Cooperation in East Asia:
Prospects for Monetary and Financial Cooperation and Integration”**

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If the European experience is any guide, financial cooperation and integration in East Asia needs to begin with regional institution building, which in turn calls for regional leadership that can set forth common objectives, inspire spirit of cooperation and mediate divergent interests between countries. Japan is the second largest economy in the world. It is also the most advanced economy in East Asia. China is a military super power and a rapidly growing economy. Given their economic and political influences in the region, the two countries hold the key to economic integration in East Asia.

However, China and Japan have not seen eye to eye on many regional economic issues: they have been competitors rather than collaborators as they have different interests and hence different strategies for economic integration in East Asia. China has emerged as an active player commensurate with its newly elevated global status in both the international and regional arena. Since the mid-1990s, China has expanded the number and depth of its bilateral relationships, joined various trade and security accords, deepened its participation in key multilateral organizations, and helped address global security issues, stability, and creating a new international political and

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economic order.

China shares a border with Russia and many other South Asian and Central Asian countries in addition to the several ASEAN members. Therefore, it is natural for China to seek expansion and diversification of trade and financial relations with those neighboring countries. China approached ASEAN for its first free trade agreement, joined in November 2001 the Bangkok agreement on a free trade area that includes Korea and the South Asian countries (Bangladesh, India, Laos and Sri Lanka, and also signed with Russia the Treaty of Good-Neighborliness and Friendly Cooperation in 2001. In Central Asia, China has also taken a leading role in establishing the region's first multilateral group, the Shanghai Cooperation Organization (SCO). The SCO founded in 2001 to settle long-standing territorial disputes and to demilitarize borders has shifted its focus to cooperation for counter-terrorism and regional trade among China, Russia, Kazakhstan, Kyrgyzstan, Tajikistan, and Uzbekistan.

In contrast, Japan has not been able to articulate its strategic interests in East Asia. While Japan has been a leading member of ASEAN+3, its perspective on the geographical contiguity of East Asia has not been altogether clear. There is also the suspicion that Japan's participation in regional arrangements for free trade or financial and monetary cooperation in East Asia is not so much motivated by its desire to pursue its economic interests in the region as its attempt to contain China's expansion. Although Japan has managed to break out of a stagnation that lasted more than a decade, prospects for sustained recovery remain uncertain. This uncertainty has combined with its equivocal regional strategy to undermine Japan's ability to rally support for economic integration in East Asia.

Japan's inability will not, however, allow China to assert itself in assuming a

leadership role. China is a major trader and a super military power backed by a rapidly growing economy, but its communist political regime with a dirigiste economic system makes it unprepared for leading economic integration, which is essentially a market driven process. Unless it eschews its communist system for a more liberal political regime it will be severely handicapped in leading a region that has worked rather successfully toward political and economic liberalization. There is wide difference in economic, political, and military standings between the two countries, which suggests that, even if they come to reconcile their troubled past, they may find it difficult to work together as equal partners in managing regional affairs in East Asia.

Japan's unspoken strategy of curbing the influence of China in East Asia has been manifested in its support for the East Asian Economic Summit, which was inaugurated in 2005 with the broad objective of promoting economic cooperation and integration among a group of countries known as "ASEAN+6" or ASEAN+3 plus three more countries from outside the region: India, Australia and New Zealand. The East Asian Economic Summit will be convened annually together with the annual leadership meetings of ASEAN and ASEAN+3. At this stage, there is little agreement on the geographic boundary or about the role of this new group. China has a clear preference for the consolidation of ASEAN+3 whereas Japan insists on the inclusion of the three additional countries that it could ally with to weaken China's influence.

Aside from the question of which countries should be included in the East Asian summit, the mandate of the group is rather unclear. The group may work together to build a giant free-trade area spanning most of Asia and Oceania. But, as the *Economist* (December 14th 2005) points out, "achieving consensus among such vastly different economies, cultures and political systems would be more arduous than anything

encountered in regional community building elsewhere". The same article also notes that the rivalry between China and Japan that would frustrate the realization of such a grand vision.

What are then the likely paths of economic integration in East Asia? One scenario is that China and Japan will come to terms with each other to develop a common political will to lead East Asia. Sakakibara (2003) argues that the role of China and Japan in East Asia's integration process is synonymous with that of France and Germany in Europe's. Similarly, the Kobe Research Project report submitted to the fourth gathering of the finance ministers of the Asia-Europe Meeting (ASEM Finance Ministers' Meeting) held in Copenhagen in July 2002 states that it is essential for the Japan-China cooperation, as a core in East Asia, to lead the process of economic and financial integration, as the France-German alliance played a central role in the integration and cooperation process in Europe. Realizing *sine qua non* of their alliance the two countries could soften their positions to compromise on an institutional setting and augmentation of the existing financial architecture of East Asia. In view of Japan's active support for ASEAN+6 in recent years, this scenario is likely to lose the believers.

Another scenario is that knowing the difficulty in cooperating with Japan, China may decide unilaterally to concentrate on deeper trade and financial integration with Southeast Asian countries to form ASEAN+1. Once it is established, Korea may have no choice but to join it, given its heavy dependence on China for its exports. While many believe this will be the most realistic course East Asia's integrationist movement will follow, there is the question of whether the ASEAN members will be favorably inclined to join a regional organization dominated by a non-democratic super military power even though they need more than ever the vast export market. China promises. A

third scenario envisages trade integration among China, Japan, and Korea through the formation of a three-country free trade area as the core of economic integration in East Asia. China has been active in advancing the idea of creating what is known as a China, Japan, and Korea (CJK) FTA. In principle both Japan and Korea support the idea, but in reality they believe differences in trade structure, the degree of protection of domestic industries, and non tariff trade barriers, not to mention the political system, are too formidable to make the CJK FTA as an alternative engine of integration.

Perhaps the most realistic scenario is that the ASEAN+3 countries will muddle through, continuously discussing modalities of policy dialogue, the types of the surveillance system appropriate for the CMI, augmentation of bilateral swap amounts, and the institutional setting for the ABMI. Although they may be far from new path breaking initiatives, they will ensure a slow but sustained integration in the region. In the meantime economic globalization will continue apace, and the market forces unleashed by the global integration will work gradually to dismantle East Asia's trade and financial market barriers. More than anything else, this market driven liberalization will then assimilate the entire region into the global economy, thereby making the CMI, the ABMI, and FTAs building blocks for global integration.

Regional integration in East Asia has been driven by two distinct movements: trade liberalization through FTAs and financial and monetary cooperation through the CMI and ABMI. The CMI represents an institutional framework for monetary cooperation among a well defined group of countries, namely the eight members belonging to ASEAN+3. Free trade agreements, which have multiplied in recent years, and the ABMI, the other initiative of ASEAN+3 for financial integration, are not bound by membership or geographical contiguity. There is also ambiguity of the causal relations between trade and financial

liberalization on the one hand and monetary integration on the other. These features of the two movements suggest that they may not be complementary to each other in deepening regional economic integration in East Asia.

In Europe, trade integration, which had preceded monetary unification, slowed down whenever there were concerns about exchange rate stability among the member countries. This experience suggests that some form of monetary integration could facilitate trade integration. Trade liberalization through the formation of free trade areas in East Asia, to the extent it occurs mostly within similar industries, will weaken asymmetric shocks across countries and hence decrease the costs of maintaining a monetary union. Financial integration can also accelerate monetary integration even among heterogeneous countries if it leads to consumption co-movement, which might not be realized otherwise.

Since 2000, the CMI and ABMI have spearheaded a regional movement for financial cooperation and development in East Asia with considerable success. ASEAN+3 as the prime mover of regional integration will, however, face much tougher challenges and tasks in exploring developments beyond the two initiatives. In order to win support for its movement from within and outside the region, the ASEAN+3 members will be better advised if they clarify what their motivations are to the international community, how they will develop an action plan, and how they believe the initiatives fit in with the existing global financial system (Park and Wang 2000). This clarification is needed more than ever because the ASEAN+3 members will enter a period of intense discussion of policy coordination and the CMI will be subject to a test of whether it can serve as an institution for that purpose.

Eichengreen and Park (2006) suggest a number of factors that would be attributed to the slow progress in financial cooperation and integration in East Asia by comparing the

two regions – Europe and East Asia. According to their analysis, Europe has gone further than East Asia in the integration of product and factor markets. While the EU has a true single market in goods and services, progress towards the creation of an Asian free trade area remains far from complete. While Europe has removed essentially all barriers to the free movement of capital and most barriers to the movement of labor, in East Asia limits on factor mobility remain pervasive. In Europe, regionalism is motivated in no little part by a desire for political integration that has no counterpart in East Asia. While Europe has built institutions of transnational governance (e.g., the European Commission, the European Parliament, the European Court of Justice, and now the European Central Bank), East Asian integration is “weakly institutionalized.” That is, it is predicated not on transnational institutions but on intergovernmental agreements that defer to the sovereignty of the participating states. Nor is integration in East Asia driven by an alliance of key nations like France and Germany or by a single hegemonic power (the role played by the United States in the Western Hemisphere); it is a more multi-polar process.

Evidently, East Asia has a long way before reaching the level of financial integration in Europe. Financial claims are all denominated in the U.S. dollar and the bulk of foreign lending and borrowing are intermediated through international financial markets in New York and London. As far as finance is concerned, therefore, regional financial arrangements themselves cannot effectively address the inherent structural balance sheet problem. The absence of regional financial integration is closely linked to the absence of regional lender of last resort. In Europe, West Germany provided unlimited supply of short-term liquidity under the European Monetary System (EMS) when weak currency countries were under severe pressure of currency devaluation. In East Asia it is unclear whether Japan is prepared to play a limited role as a regional lender of last resort.

Few East Asian policymakers would be naive enough to believe that they will be able to work out an agreement on creating an Asian monetary fund or a common currency area in the near future. At best monetary unification is a long-term objective, and the ASEAN+3 countries have just taken the first step of a long journey to that goal. East Asia enjoys the latecomer's advantage in promoting financial and monetary integration as it can learn from the European experience. But the success of its integration efforts will in no small measure depend on the support of the US and EU. In the end, the western countries will have to decide whether regional financial and monetary cooperation in East Asia will contribute to global stability and welfare. And the European experience suggests that it is likely to do so. It would therefore be in the interests of both the US and Europe to support ASEAN+3 in a way that will ensure East Asia does not retreat from open regionalism it has committed to.