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Discussion Paper 02-09

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Executive Summary

The purpose of this paper is to provide a view on the current process and future prospects for regional financial and monetary cooperation in East Asia. Looking forward, financial cooperation in East Asia will be evolutionary. For over a half century, European countries worked hard to develop various institutional frameworks which encouraged their cooperation on monetary and financial matters. If the European experience is any guide, it may take many years to develop effective cooperative arrangements and institutions in East Asia. However, there may be a breakthrough over the next few years as we gain a better understanding of the economic consequences of European monetary unification. The enlargement of the EU in 2004, when eight central and East European countries are expected to be admitted, will also have a large impact on the way East Asian policymakers think about regionalization in East Asia.

JEL Classification: E32, F36, F41

Key Words: ASEAN+3, Chiang Mai Initiative, economic integration

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I. Introduction

Before the Asian financial crisis broke out in 1997, few would have seriously argued for the creation of a system of regional financial cooperation in East Asia. Only a market-led integration process was taking place in the region. However, the 1997 financial crisis was a major watershed that gave East Asians a strong impetus to search for a regional mechanism that could forestall future crises. After a financial crisis broke out in Thailand in July 1997 and started spreading to other East Asian countries, Japan proposed the creation of an Asian monetary fund (AMF) as a framework for promoting financial cooperation and policy coordination in the region. A regional monetary fund, it was argued, would provide a means of defense, in addition to the IMF lending facilities, against financial crises in East Asia. Although the proposal received a positive response from a number of

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East Asian countries, it was shelved at the objection of the U.S., EU, and the IMF.

The idea of an AMF was revived when the finance ministers of China, Japan, and South Korea, along with the 10 members of the Association of Southeast Asian Nations (ASEAN) agreed on May 6, 2000 in Chiang Mai, Thailand to establish a system of swap arrangements within the group.[1] This regional scheme for financial cooperation—known as the Chiang Mai Initiative (CMI)—is now gathering momentum and opening the doors to possibly significant policy-led integration in East Asia.

Since then, the deputy financial ministers of the thirteen ASEAN+3 countries have negotiated the details of the initiative to produce a basic framework of the ASEAN Swap Arrangement (ASA) and Bilateral Swap Arrangements (BSAs) and repurchase agreement. The framework was approved at the meeting of the deputies on November 7, 2000 in Beijing. A progress report on the CMI was then presented at the summit meeting of the thirteen countries two weeks later.

The CMI swap arrangements have been designed and implemented to provide liquidity support to member countries that experience short-run balance of payment deficits. By preventing an extreme crisis or systemic failure in a country and subsequent regional contagion as occurred in the recent East Asian financial crisis, this facility is expected to contribute to financial stability in the region.

1) The ASEAN members are Brunei Darussalam, Cambodia, Indonesia, Laos, Malaysia, Myanmar, the Philippines, Singapore, Thailand, and Vietnam. The group of China, Japan, and South Korea, along with the 10 members of the ASEAN is known as "ASEAN+3."

However, emergency support facilities such as the CMI, which are similar in nature to other regional and international "lender of last resort" facilities, are primarily for systemic purposes and as such would likely be used very infrequently. Since the intent of the CMI is to be proactive, there is a need to define a mutually agreed framework for inter-country cooperation amongst the ASEAN+3, that can quickly and effectively implement emergency assistance at required levels when the need arises. Moreover, a group approach would ensure that any conditionality associated with the financial assistance is consistently applied across countries.

Although the adoption and implementation of the CMI could be counted as a major step toward strengthening financial cooperation among the thirteen ASEAN+3 countries, these countries will face much tougher challenges and tasks in exploring developments beyond the CMI. East Asian countries need to clarify to the international community what their motivations are, how they will develop an action plan, and how they believe it fits in with the existing global financial system. And furthermore, it remains to be seen whether East Asia can emulate the policy-led economic integration that took place in Europe through this kind of financial cooperation framework.

At present, the CMI does not require a new institution like the proposed AMF, and it is also tightly linked to IMF conditionalities. At this stage of development, East Asians may not be well prepared to negotiate an international agreement that includes provisions for sanctions and fines for countries that do not adjust their domestic policies accordingly. In this regard, the CMI and its follow-up implementation are acceptable to many detractors of the regional monetary fund. At the most elementary stage of zero institutional integration, the moral hazard problem associated with mutual liquidity provisions can be addressed by the linkage of the CMI with IMF conditionalities. As long as the CMI is simply a source of financial resources supplementary to the IMF, the size of the swap borrowing does not have to be sufficient to meet potential needs, because members can always rely on the deep pocket of financial resources provided by the IMF.

Under the CMI framework, East Asian countries have not yet specified common policy objectives toward economic integration. Joint efforts for crisis prevention in the region is rather ambiguous as a policy objective toward promoting economic integration in the region. In this regard, the CMI lies between cooperation and coordination, but closer to cooperation on the spectrum of economic integration. Two main components are being implemented under the ASEAN+3 framework. One is a regional financial facility under the CMI, while the other is the development of a regional surveillance and policy dialogue mechanism to complement the CMI. However, neither of these components has yet been completed and many members feel they are still in need of significant amendments. The BSA under the CMI will be reviewed in 2004. At that time, the ASEAN+3 may decide to maintain, amend or abolish the current arrangements. The various modalities of a regional surveillance mechanism are now under discussion, but it is highly unlikely that an effective surveillance mechanism will be put in place any time soon.

The purpose of this paper is to provide a view on the current process and future prospects for regional financial and monetary cooperation in East Asia. Looking forward, financial cooperation in East Asia will be evolutionary. For over a half century, European countries worked hard to develop various institutional frameworks which encouraged their cooperation on monetary and financial matters. If the European experience is any guide, it may take many years to develop effective cooperative arrangements and institutions in East Asia. However, some observers note that East Asia may be on the brink of a historical evolution, as Europe was half a century ago. When the regional group agrees on deepening regional integration through financial and monetary cooperation, it remains to be seen whether East Asia can successfully emulate the European integration process through solid institution building.

This paper is organized as follows. Section II provides an overview of the current structure of the CMI and discusses a number of its pitfalls. Section III explores the issues related to the creation of a monitoring and surveillance mechanism. Section IV addresses major barriers to financial cooperation and integration. Finally, Section V concludes with a discussion of the future prospects for financial and monetary cooperation in the region.

II. Overview of the Chiang Mai Initiative (CMI)

The Chiang Mai Initiative (CMI) has two components: (i) an expanded ASEAN Swap Arrangement (hereafter ASA) encompassing the ten ASEAN countries; and (ii) a network of Bilateral Swap Arrangements (hereafter BSA) and repurchase arrangements basically encompassing the thirteen ASEAN+3 countries.

In 1977, the five original ASEAN countries—Indonesia, Malaysia, Philippines, Singapore, and Thailand—agreed to establish the ASA in pursuit of their common objective of promoting financial cooperation. Since then, the ASA has been renewed several times, but it has remained a very primitive financial arrangement, mainly due to the loose financial cooperation in ASEAN. The utilization was very low. Even during the Asian financial crisis, countries did not turn to the ASA.

An expanded ASA became effective in November 2000 to include the five new members of ASEAN, and the total amount of the facility was raised to US$1 billion from the initial amount of US$200 million. The currencies available under the ASA are the U.S. dollar, yen, and euro. The euro, yen and Euro LIBOR interest rates are used as the base rates for swap transactions. Each member is allowed to draw from the facility a maximum of twice its committed amount for a period not exceeding six months, subject to an extension for another period not exceeding six months.

A major drawback of the ASA stems from the "equal partnership" condition, which stipulates that the amount to be granted to a swap-requesting member country shall be provided by the other member countries in equal shares. In addition, a participant may refrain from providing the committed lending by merely informing the other member countries of its decision, and may, at its discretion, provide reasons for the decision. Under such circumstances, other participants, on a voluntary basis, can increase their shares. If the total amount of swap committed collectively by the participants does not sufficiently meet the requested amount, the amount of swap granted is to be reduced accordingly. Considering these conditions, the ASA would not help much to minimize the disruption caused by a financial meltdown in the event that massive scale liquidity provisions are required.

If ASEAN members fail to find a country to contribute a meaningful amount of credit, they will have to link the ASA to global liquidity facilities provided by the IMF or other regional facilities. The ASA could be further expanded to encompass the three Northeast Asian countries—China, Japan, and South Korea. However, as long as the two problems of disproportionate contribution obligations and non-compulsory commitments remain unsolved, the effectiveness of the ASA may be seriously undermined. Major revisions should be undertaken to secure the firm commitment of participating countries and enlarged contributions. Alternatively, the second component of the CMI—the network of BSA (hereafter NBSA)—could be a useful source of complementary financial resources.

The BSA is a facility that provides short-term liquidity assistance in the form of swaps of U.S. dollars with the domestic currencies of participating countries.[2] The maximum amount that can be drawn under each BSA is to be determined through bilateral negotiations.

However, disbursements to a member in need of liquidity assistance are expected to be made in a concerted manner through consultation among the swap providing countries with one of the swap-providing countries serving as the coordinator for the consulting process. The BSA allows a disbursement of up to 10 percent of the maximum amount of drawing without an agreement, or even a prospective agreement, with the IMF. Such a disbursement would represent "short-term liquidity support," and would be renewable only once, and thus repayable within 6 months of the original transaction. However, countries drawing more than the 10 percent are required to accept an IMF program of macroeconomic and structural adjustments. In this sense, the BSA is complementary to the IMF's financial assistance.

A number of the participating countries have expressed reservations about the linkage of the BSA with IMF conditionalities and have proposed to increase gradually the 10 percent limit on independent disbursements and also abolish the IMF linkage after a period of transition. For instance, Malaysia advocates complete independence of the CMI from the IMF. Severance of the IMF linkage requires the creation of a regional surveillance mechanism for the CMI. At the fifth ASEAN finance ministers' meeting in April 2001 in Kuala Lumpur, however, there was consensus that the BSA should remain complementary and supplementary to the IMF facilities until a regional surveillance system is established. The ASEAN ministers also agreed that "the terms and modalities of the BSA should take into account the different economic fundamentals, specific circum-

2) The one exception is the Japan-China BSA, which would swap yen for renminbi.

stances, and financing needs of individual countries." This agreement implies that the contracting parties of the BSA could deviate from the basic framework on setting terms and conditions of the swap agreements.

Participating countries are able to draw from the BSA for a period of 90 days. The first drawing may be renewed seven times. The interest rate applicable to the drawing is the LIBOR plus a premium of 150 basis points for the first and first renewal drawings. Thereafter, the premium is increased by an additional 50 basis points for every two renewals, but not exceeding 300 basis points.

A repurchase agreement was also established to provide short-term liquidity to a participating member through the sale and buyback of appropriate securities. Securities of the repurchase agreement are U.S. Treasury notes or bills with a remaining maturity of not more than 5 years and government securities of the counterparty country. The period of the repurchase agreement is one week, but could be extended on the termination value date by agreement between the contracting parties. The minimum amount for each transaction requested is five percent of the total amount of the repurchase agreement. In each transaction, the buyer is given a margin of 102 percent for U.S. Treasury notes or bills and 105 percent for government securities of the counterparty country. At the inception of the CMI, the participating countries considered expanding these facilities through bilateral negotiations between the contracting parties. However, no new repurchase agreements have been made since the Chiang Mai meeting. Instead, ASEAN+3 governments have focused on negotiating and concluding BSAs.

Since the ASEAN+3 summit meeting in November 2000, Japan, China, and South Korea have been negotiating BSAs with each other and with the ASEAN countries. Japan has been most active: it has concluded five agreements with China, South Korea, Malaysia, the Philippines and Thailand, and is currently negotiating two more agreements with Singapore and Indonesia. Korea also concluded two agreements with China and Thailand in addition to the Japan-Korea BSA. Korea is also expected to conclude BSA negotiations with Malaysia and the Philippines. (See Table 1.)

Table 1. Progress on the Chiang Mai Initiative

(as of June 25, 2002)

BSA	Currencies	Conclusion Dates	Amount
Japan-Korea	USD/Won	July 4, 2001	US$ 7 billion (a)
Japan-Thailand	USD/Baht	July 30, 2001	US$ 3 billion
Japan-Philippines	USD/Peso	August 27, 2001	US$ 3 billion
Japan-Malaysia	USD/Ringgit	October 5, 2001	US$ 3.5 billion (a)
China-Thailand	USD/Baht	December 6, 2001	US$ 2 billion
Japan-China	Yen/Renminbi	March 28, 2002	US$ 3 billion equivalent
China-Korea	Won/Renminbi	June 24, 2002	US$ 2 billion
Korea-Thailand	USD/Baht	June 25, 2002	US$ 1 billion
Korea-Malaysia	Under negotiation		
Korea-Philippines	Under negotiation		
Japan-Singapore	Under negotiation		
Japan-Indonesia	Under negotiation		
China-Malaysia	To be negotiated in the near future		
China-Philippines	To be negotiated in the near future		

Note: (a) The US dollar amounts include the amounts committed under the New Miyazawa Initiative, US$5 billion for Korea and US$2.5 billion for Malaysia.

From the beginning, Singapore and Brunei have shown little enthusiasm for the CMI, largely because they believe the BSAs with their neighboring countries will be one-way arrangements in which they will be asked to provide a large amount of liquidity in case of a crisis affecting the ASEAN region. However, Japan has made progress in bringing Singapore to the negotiating table by proposing a BSA that uses local currencies rather than the U.S. dollar. In fact, Japan has concluded a similar local-currency BSA with China.

Indonesia has not shown any strong interest in negotiating BSA arrangements because of its preoccupation with domestic economic issues and the management of its huge foreign debts, not to mention escalating political instability. Recently, Indonesian has indicated its intention to negotiate a BSA with Japan, though it does not appear to place a high priority on contracting additional BSAs with other members of the CMI.

At present, the total amount of BSAs covering all 13 countries is estimated to be around US$20 billion. The maximum amount any individual country can draw varies a great deal. In the case of Thailand, the maximum is about US$6 billion. Given such a relatively small amount of liquidity available through the CMI, doubts have been raised as to whether the BSA system could truly be a credible and effective system of defense against future speculative attacks. Participants of international financial markets are not likely to be impressed with the amount of liquidity available and hence ignore the CMI, unless the ASEAN+3 are prepared to increase the number of BSAs and expand the swap amount of each BSA. However, financial significance does not matter as long as the CMI maintains the linkage with the IMF. If the CMI goes beyond its supplementary role to the

IMF by establishing a regional fund and seeking independent conditionalities, then its financial position will have to be significantly enlarged so it can effectively prevent financial crises in the region.

In comparison with the European facilities, the CMI has had a different motivation from the outset. The European facilities were created with the purpose of limiting exchange rate fluctuations under a coordinated exchange rate mechanism. The CMI started with high capital mobility and flexible exchange rates, although some members of ASEAN+3 have maintained relatively fixed exchange rate regimes. Even now, the CMI does not presume any manifest exchange rate coordination.

III. Creation of Monitoring and Surveillance System

From the inception of the CMI, some member countries have opposed the idea of linking the CMI with the IMF program. Other members, in particular Japan and China, have argued for the importance of forging a cooperative relation with the IMF at an early stage of CMI development to enhance its credibility. They have succeeded in persuading Malaysia and other opposing members to accept the linkage of the BSAs with the IMF conditionality as a temporary scheme until a formal surveillance mechanism is put in place. Malaysia agreed to the IMF linkage with the condition of establishing a study group to examine the types of monitoring and surveillance systems the CMI would require to function as an independent regional financial arrangement.

Most participating countries agree in principle that the CMI needs to be supported by a surveillance system that 1) monitors economic developments in the region, 2) serves as an institutional framework for policy dialogue and coordination among the members, and 3) imposes structural and policy reform on the countries drawing from the BSAs. The ASEAN+3 finance ministers agreed to organize a study group to produce a blueprint for an effective mechanism of policy dialogues and economic reviews for the CMI operations at the ADB annual meeting in Honolulu on May 9, 2001. Japan and Malaysia were chosen to co-chair the group. The study group met in Kuala Lumpur November 22, 2001 to discuss the report on possible modalities of surveillance prepared by Bank Negara Malaysia and Japan's

Ministry of Finance. However, the member countries could not reach an agreement on the surveillance issues, agreeing only to institutionalizing the ASEAN+3 meetings of deputies for informal policy reviews and dialogues. At this stage of development of the CMI, many countries feel uncomfortable about creating an independent regional monitoring and surveillance unit as part of the CMI.

In the long run, however, the participating countries are likely to wean themselves from their reliance on the IMF. If the CMI develops into an independent regional financial arrangement from the IMF, the architect of the CMI will have to decide whether the arrangement could be supported by a surveillance mechanism based on peer reviews and pressure instead of formal policy conditionalities. In our view, economic policy dialogues and peer monitoring may not provide an institutional framework that can minimize the moral hazard problem. In this regard, it is worthwhile to distinguish conceptually two different types of moral hazards in conjunction with regional financial arrangements and related surveillance processes. One is related to liquidity assistance, while the other is related to collective actions required for common policy objectives. Peer pressure may not be effective in rectifying the moral hazard related to liquidity assistance and may have to be supplemented by surveillance and conditionalities attached to the liquidity provision. If the CMI develops into more or less an independent financial arrangement from the IMF, then the regional financial arrangement should be designed to discipline the borrowers to adhere to sound macroeconomic and financial policies by imposing conditionalities.

On the other hand, peer pressure may be an effective means of achieving the objective of economic policy coordination among members. The surveillance and policy coordination may have a double-decker structure in policy formation and implementation. Under the European Monetary Union (EMU), only specific common policies such as monetary and exchange rate policies are binding at the Community level, while economic policies such as budgetary and structural policies largely remain under the national sovereignty of member countries. In the European Union, the framework of broad economic policy guidelines (BEPGs) provides a basis for policy coordination. This structured surveillance process has contributed to assessing the consistency of each member country's economic policies. The ASEAN+3 countries at the current stage do not seem well prepared for establishing a policy coordination mechanism in the surveillance process. In the case of European integration, a more effective and structured surveillance process started only when the European countries sought monetary integration in the 1990s (Wang and Yoon, 2002). The long history of European surveillance shows that an effective surveillance process cannot be achieved overnight but needs many years of constant interaction and mutual trust building. Thus, it will take more time for the ASEAN+3 countries to establish more comprehensive and structured surveillance systems like those under the EMU.

IV. Barriers to Financial Cooperation and Integration

East Asian policymakers who conceived the idea of the CMI would easily concede that the BSA system as it is currently structured has a long way to go before it can be accepted as an effective mechanism of defense against financial crises. Although two years have passed since the system was established in May 2000, the leaders of the CMI group have yet to produce an operational structure for BSAs, in particular a monitoring and surveillance mechanism. And it is highly unlikely that they will do so any time soon.

In the absence of a clear vision on the scope and modality of financial cooperation through the CMI, many financial sector experts have expressed doubts about whether any country facing an incipient crisis could draw from the BSAs, and if they could, how much liquidity would be available. Technically speaking, swap-providing countries could refuse any support even within the 10 percent drawing which is not linked to the IMF conditionality. Because this 10 percent of swap can be disbursed only with the consent of swap-providing countries, these countries need to formulate their own assessments about the swap-requesting country. At present, the practices under the ASEAN+3 process cannot effectively identify emerging problems. In this regard, an independent surveillance unit as a standing secretariat to support the CMI operation must be immediately established. However, most participating countries seem to prefer a gradual approach by avoiding institutionalization of the procedures. Negotiations for additional BSAs and also the surveillance system may continue, but unless the deadlock over some of the pending issues on surveillance is broken, the future prospects of the CMI do not seem promising.

There are many economic, institutional, and political barriers to financial cooperation and integration in East Asia. A large number of empirical studies have shown that although the ASEAN+3 countries by no means constitute an ideal group for an optimum currency area, they are as qualified for a common currency as the members of the European union were in the 1970s and 1980s.[3] These studies invariably point to a large increase in intra-regional trade in East Asia in recent years as a development conducive to the region's financial and monetary integration. Trade and investment liberalization has been the driving force behind much of the increase in intra-regional trade. This increase, in turn, has had the effect of synchronizing business cycles across East Asian countries, thereby producing economic conditions favorable for a currency union in the region.

Against these trade and macroeconomic developments, financial deregulation and market opening have drawn East Asia away from regional financial integration. Financial liberalization throughout East Asia has caused many countries to establish closer linkages with international financial markets, but not with other country markets in the region. There is no clear evidence that the financial markets of the East Asian countries are more regionally integrated. The financial markets of the European countries that maintained capital controls were much more integrated in the 1970s and 1980s than the markets of East Asian countries are at present.[4] This difference suggests that

3) See Eichengreen and Bayoumi (1999), Baek and Song (2002) and Lee, Park and Shin (2002)

financial market liberalization and opening may not speed up economic integration in East Asia.

Financial claims are all denominated in U.S. dollars 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, gains from adopting a common currency in terms of lower transaction costs and foreign exchange risks may not be as large as they could be when regional financial markets are integrated. In particular, Singapore and Hong Kong, as regional financial centers, could lose a substantial portion of their income from the financial services industry.

As for institutional and political constraints on further expansion of the CMI, the most serious one has been that the thirteen countries have failed to articulate the ultimate objectives of the CMI arrangement. The participating countries themselves are still unclear about whether the CMI is going to be fostered as a regional liquidity support program or as a building block for a full-fledged regional monetary system in East Asia. If bilateral swap arrangements are activated collectively and supported by a surveillance system, then they

4) Free capital mobility was not allowed until the last stage of currency unification in Europe. This is because the conflict between exchange rate stability and the active use of monetary policy was reconciled through internal and external financial repression. As Europe has liberalized its capital account, such a formal coordinated (fixed but adjustable) exchange rate mechanism was greatly endangered by volatile capital movements. When capital controls were lifted, currency union was preferred to maintaining national monetary policies. See Wyplosz (2002) for more details.

constitute a de facto regional monetary fund. The CMI could then be used as the base on which an elaborate system of financial cooperation and policy coordination is built by following in the footsteps of the European monetary integration. At this stage of development, many countries in East Asia are not prepared to accept the idea of or may feel uneasy about restructuring the CMI into a forerunner of the AMF.

A second institutional constraint is related to the need to coordinate the activities of the CMI with other regional arrangements such as the Manila framework supported by the U.S., Australia, and New Zealand. Most of the CMI countries also participate in the Manila framework and APEC. At some point in the future, the leaders of the ASEAN+3 countries may have to decide on the mode of cooperation and division of labor in promoting regional growth and stability between these institutions and the CMI. All thirteen countries have been engaged in policy reviews and dialogues through the various APEC meetings and the Manila framework. Unless the CMI is developed into a credible financing mechanism by increasing swap amounts, it will take on a role similar to other regional economic forums. The coherence of the group will then be weakened, as questions are raised as to whether the thirteen countries constitute an appropriate grouping for a regional financing arrangement in East Asia.

A third hindering factor is that as the fear of another round of financial crisis has receded with the recovery that has been faster than predicted on the basis of previous episodes of crises. With the speedy recovery, the ASEAN+3 countries have become less interested in enlarging and institutionalizing the CMI operations. Instead, their focus has recently shifted to creating free trade areas in East Asia. The

ASEAN states have already agreed to establish a free trade area among them. Japan has concluded a free trade agreement with Singapore and proposed negotiations on a similar agreement with Korea. China has announced its interest in negotiating free trade with the ASEAN and other neighbouring countries.

The free trade movement is undoubtedly a desirable development, and the CMI could facilitate further liberalization of trade by stabilizing bilateral exchange rates of regional currencies and minimizing the disruptive effects of financial market turbulence. This advantage suggests that the ASEAN+3 countries may have an incentive to broaden the scope of the CMI in parallel with negotiations on establishing free trade areas in the region. In reality, however, it appears that free trade discussions have rather distracted many East Asian countries from their CMI negotiations.

Finally, there is the leadership issue that defies an easy solution. If the thirteen countries have a more ambitious goal of developing a collective exchange rate mechanism similar to the ERM in Europe with the long-term objective of adopting a common currency, they will have to increase the number and amounts of the BSAs. As the European experience shows, such an extension requires leadership that can foster coherence among the thirteen countries by mediating between the divergent interests of the members.

China and Japan are expected to provide leadership in forging regional consensus for expanding and consolidating the BSAs as a regional institution, but they have not been able to agree on a number of operational issues including the surveillance mechanism. Except for Japan, no other potential swap lenders including China are prepared to increase the amounts of their bilateral swaps with other contracting parties. Japan could increase its swap amounts with the ASEAN states and Korea (under the presumption that China will not borrow from Japan) to make the CMI a more credible financing scheme. However, unless Japanese authorities receive some sort of assurance that their short-term lending will be repaid, they are not likely to lead an expansion and institutionalization of the CMI. As a minimum condition for expansion of the CMI, Japan would demand the creation of an effective surveillance mechanism for the region in which it can exercise influence commensurate with its financial contribution. However, China may feel that it cannot play second fiddle to Japan in any regional organization in East Asia. This concern appears to be the most serious roadblock to further development of the CMI.

China and Japan have different interests and hence different strategies for economic integration in East Asia. As far as China is concerned, economic integration with the ASEAN 10 members, South Asian and central Asian countries may be more important both economically and geo-politically than financial cooperation or free trade with either Japan or South Korea. While China is a super military power in the world, it is still a developing economy with a huge gap to narrow in terms of technological and industrial sophistication vis-à-vis Japan. Although China has been growing rapidly, it has a long way to go before catching up with Japan. These differences in the economic and military status of the two countries suggest that, even if they manage to reconcile their troubled memories of the past, China and Japan may find it difficult to work together as equal partners for regional integration in East Asia.

China borders Russia and many of the South Asian and central

Asian countries in addition to several ASEAN members. Therefore, it is natural for China to seek expansion and deepening of its trade and financial relations with those neighboring countries. In fact, for this reason, China has been courting ASEAN for a free trade agreement and joined in November 2001 the Bangkok agreement on a free trade area that includes Russia and the South Asian countries. China has also taken a leading role in establishing the Shanghai Cooperation Organization, a cooperative arrangement between Russia, Kazakhstan, Kyrgyzstan, Tajikistan, and Uzbekistan and China.[5)]

In contrast, Japan has not been able to articulate its strategic interests in East Asia. While Japan has been at the forefront in supporting greater economic cooperation among the East Asian countries, its perspective on the geographical contiguity of East Asia has not been altogether clear. Japan has been promoting integration among the "ASEAN+5," but which are the two countries added to ASEAN+3? At times, the five countries are stated as China, Japan, Korea, Australia, and New Zealand, and at other times Taiwan and Hong Kong replace Australia and New Zealand.

There is also the suspicion that Japan is not interested in free trade and financial arrangements per se in East Asia for purely eco-

5) In June 2001, the presidents of five countries signed the Declaration of the Shanghai Cooperation Organization (SCO). The SCO aims at strengthening mutual trust and friendly relations among member states, encouraging their further effective cooperation in politics, economy, science and technology, culture, education, energy, transportation, environmental protection and other fields, jointly ensuring regional peace, security and stability, and creating a new international political and economic order.

nomic reasons. Instead, Japan is engaged in the discussion of those regional arrangements with other East Asian countries to maintain its leadership role as the region's largest economy by checking and balancing China's expansion. Many analysts believe that Japan's active involvement in regional economic integration is therefore motivated by its desire to maintain its traditional pole position.[6] On top of this suspicion, Japan is perceived to be a country insensitive to and unwilling to resolve wartime legacies and disputes on historical and territorial claims. Japan has also been gripped with a decade long recession and unable to restructure its economy. These developments combined with its lack of a strategy for East Asian development seem to undermine Japan's ability to pull East Asian countries together for regional cooperation and integration.

6) See David Wall, "Koizumi Trade Pitch Nests," the *Japan Times*, April 21, 2002

V. Future Prospects

What are then the likely courses of development of the CMI? How would regional financial integration proceed in East Asia? One possible scenario is that China and Japan will come to realize that despite the differences in their strategies, the consolidation of the CMI group would serve their interests. This realization could soften their positions to compromise on an institutional setting and augmentation of the existing BSAs. For instance, China may accept Japan's demand for de facto control over monitoring and surveillance in return for Japan's pledge for a substantial increase in financial assistance in the form of one-way swaps and ODA to ASEAN members. China could agree to this scheme, if it is confident about concluding a free trade agreement with the ASEAN members in the near future. China's free trade pact with ASEAN could circumscribe Japan's influence on ASEAN affairs even if Japan is a major provider of financial resources to the region.

Another scenario focuses on the possibility of China assuming a more aggressive leadership role in regional integration. China may choose to negotiate both the expansion of the BSAs and a free trade pact with ASEAN. In this case, the original CMI will become "ASEAN+1." Realizing that financial integration is an integral part of a successful free trade area, China may indeed seriously consider this option. However, without Japan, ASEAN+1 will not be a viable arrangement for a regional financing scheme simply because China is hardly in a position to commit itself to financing the balance of payments deficits of all ASEAN member states. It is also questionable whether ASEAN will join any regional financial arrangement in which China is the dominant member.

A third scenario is the enlargement of the CMI to include Australia and New Zealand and possibly other countries from South Asia. This is the route favored by Japan in the sense that Japan will find it easier to deal with China when there are more countries supporting its strategy. However, many members of ASEAN+3 believe that at this stage forming a critical mass of the CMI should precede any enlargement discussion. Since the enlargement is not likely to increase substantially the availability of short-term financing, the third scenario is not expected to be taken seriously.

Perhaps the most realistic scenario is that the countries participating in the CMI will muddle through, continuously discussing modalities of policy dialogue, the types of the surveillance system the CMI needs, and also augmentation of swap amounts without making any substantial progress. However, a possible breakthrough may come over the next few years as the economic consequences of European monetary unification become better understood. The enlargement of the EU in 2004, when eight central and East European countries are expected to be admitted, will also have a large impact on the thinking of East Asian policymakers on regionalization in East Asia. If the members of the European monetary union make a smooth adjustment to the single currency and the EU enlargement proceeds as planned, then these developments will give a strong impetus to East Asian integration.

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