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Financial Regionalism in East Asia

Ulrich Volz

This article provides an overview of the current state of financial regionalism in East Asia and discusses why and how the East Asian countries should go forward in terms of financial and monetary regionalism. It highlights intra-regional exchange rate stability as an important regional public good and makes the case for greater exchange rate cooperation. To this end, East Asian countries should gradually reduce their exposure to the US dollar and move towards currency basket regimes which would sustain relative intra-regional exchange rate stability while allowing for sufficient flexibility to accommodate idiosyncratic shocks. Against the backdrop of the global and European financial crisis, the article also urges a reconsideration of the costs and benefits of international – and regional – financial integration and calls for a further strengthening of East Asia's regional financial architecture.

Keywords: financial regionalism, East Asia, financial integration, monetary integration

Financial regionalism has been on the agenda of East Asian policymakers since the outbreak of the Asian financial crisis of 1997–98.[1] While the region had already developed close trade and investment linkages before the crisis, regional economic cooperation initiatives were primarily focused on trade cooperation and facilitation. Financial cooperation hardly played a role in East Asia before the crisis. The contagious effects of the Asian financial crisis demonstrated very painfully that, in a region as closely intertwined as East Asia, a local crisis can quickly spread from one country to another. The crisis also showed that the region was not at all prepared to deal with such a crisis and hence was left at the mercy of the international community, with the International Monetary Fund (IMF) as the major

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[1] Throughout this article, the term 'East Asia' refers to the ASEAN+3 grouping, which consists of the ten member countries of the Association of Southeast Asian Nations (ASEAN) – Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, the Philippines, Singapore, Thailand and Vietnam – plus China, Japan and Korea.

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crisis manager. The IMF's crisis response and the harsh conditionality demanded from crisis countries received a lot of criticism in the region and led to major discontent with the IMF, fostering the widely held belief in East Asia that the region needed to engage in a process of financial cooperation and create its own regional crisis mechanism to be prepared for future crises.

Since the late 1990s, numerous initiatives aimed at increasing the region's resilience to financial market shocks have been launched. There has also been intensive discussion of exchange rate cooperation in East Asia, but no formal agreements in this respect have been reached thus far, so the region continues to live under an informal dollar standard.

After an overview of the current state of financial regionalism in East Asia, this article goes on to argue why and how the East Asian countries should go forward in terms of financial and monetary regionalism and how they might avoid the pitfalls of integration as they become increasingly obvious in the current European crisis.

The current state of financial cooperation in East Asia

While the East Asian economies have become increasingly integrated in terms of trade and investment over the past decades, the current level of regional financial integration in East Asia, measured in terms of cross-border financial flows and holdings, is still relatively low.[2] As a matter of fact, East Asian countries are much more financially integrated with the financial centres of the West (United States, United Kingdom and euro area) than with each other. This is in part due to the relatively low level of development of capital markets in most Southeast Asian countries, regulatory hurdles that hamper cross-border investment across the region and the dominant role of the dollar throughout the region (not least as a reserve currency), which makes US financial markets a natural destination for East Asian financial investments.

East Asian countries were long noted for their lack of interest in regional economic cooperation in general, and monetary and financial cooperation in particular. While embracing an export-led strategy of development, they were more oriented towards world markets than those of their regional neighbours. For a long time, the only forum for regional cooperation in the region was ASEAN, established in 1967 in Bangkok by Indonesia, Malaysia, the Philippines, Singapore and Thailand as a "zone of peace, freedom, and neutrality", with little emphasis on economic cooperation. The end of the Cold War and the related ideological conflicts between capitalism and communism, and ASEAN's inclusion of the other Southeast Asian nations gradually broadened its agenda towards

[2] Pomerleano, "Developing Regional Financial Markets".

economic issues. The first notable government-driven attempt at regional economic integration was the creation of the ASEAN Free Trade Area (AFTA) in 1992, with the aim of positioning ASEAN as an attractive production base and destination for foreign direct investment through the elimination of tariff and non-tariff barriers within it. Efforts at cooperation, however, were limited to the real sector. The recognition that cooperation in the real and financial sectors need to be extended in tandem had not yet reached ASEAN.

Another platform for regional cooperation is the Asia-Pacific Economic Cooperation Forum (APEC), which was established in 1989. Despite an economic cooperation agenda and numerous declarations on fostering trade and investment, APEC's progress has been rather poor. And, just like ASEAN, APEC ignored financial and monetary cooperation prior to the Asian financial crisis. This oversight proved fatal. When Thailand was hit by crisis in July 1997, the region was completely unprepared for what was to come.

The Asian financial crisis can be described as "the key catalytic event to propel regional cooperation" in East Asia for two reasons.[3] First, the financial contagion highlighted that the region is closely tied together economically and that a financial and currency crisis in one country can quickly spread across the region – and that financial policy coordination was important for preventing future crises. Second, the international community's response to the crisis caused resentment and created a feeling that the region needed to build its own crisis prevention and response mechanisms so that it was not left to the mercy of the international community and the IMF.

A first, unsuccessful, attempt at regional financial cooperation was made during the crisis itself. In August 1997, shortly after the outbreak of the crisis in Thailand, the Japanese government proposed the creation of an Asian Monetary Fund (AMF) as a framework for financial cooperation and policy coordination in the region. But the proposal for the AMF, which was to be endowed with USD 100 billion of central bank reserves and which was supposed to be a lender to countries in financial distress, was rejected by the US government and the IMF and then withdrawn by the Japanese government. Instead, in November 1997, the so-called Manila Framework for Enhanced Asian Regional Cooperation to Promote Financial Stability, which recognised "the central role of the IMF in the international monetary system",[4] was launched, involving both the United States and the IMF.

Nevertheless, the idea for a regional financing arrangement re-emerged in May 2000 when the ASEAN finance ministers met with their counterparts of China, Japan, and Korea in Chiang Mai, Thailand, where they agreed to establish a system of bilateral short-term financing facilities within the group "to supplement the

[3] Padoa-Schioppa, "Regional Economic Integration", 30.
[4] Asian Finance and Central Bank Deputies, "Framework for Asian Regional Cooperation".

existing international facilities".[5] This agreement, called the Chiang Mai Initiative (CMI), provided for mutual assistance in the event of a financial crisis. The original CMI consisted of an expanded ASEAN Swap Arrangement (expanded from USD 200 million to USD 2 billion) among the ASEAN countries and a network of Bilateral Swap Arrangements (BSAs) among the ASEAN+3 countries. The CMI agreement included the so-called IMF linkage, a provision that allowed member countries to draw only 10 percent of the agreed amounts under the BSAs for a maturity of 90 days (renewable once) without an IMF programme.[6] The remaining amount could only be drawn – also for 90 days, but with an option of renewal of up to seven times – with an IMF programme in place or under negotiation. The amount disbursable without an IMF programme was raised to 20 percent in 2005. Over time, 16 BSAs were successfully concluded with a combined total size of USD 90 billion.

At their tenth meeting in May 2007 in Kyoto, the ASEAN+3 finance ministers decided to multilateralise the CMI, that is, to transform the BSAs into a multilateralised, self-managed reserve pooling scheme governed by a single contractual agreement. The final details of the governing mechanisms and the implementation plan for the Chiang Mai Initiative Multilateralisation (CMIM) were agreed two years later, in May 2009, at the 12th ASEAN+3 Finance Ministers' Meeting in Bali. The size of the CMIM was set at USD 120 billion, 20 percent of which are provided by ASEAN members and the remaining 80 percent by the 'Plus Three' countries.

The voting rights of each country are proportional to its individual contributions and were allocated in such a way as to prevent any of the Plus Three countries, or ASEAN as a group, from holding veto power. The Bali agreement also divided the decision-making mechanism between fundamental issues, which require consensus, and lending issues, which will be subject to majority ruling. The CMIM Agreement came into effect on 24 March 2010.

As part of the CMIM, the ASEAN+3 also established its own independent regional surveillance agency, the ASEAN+3 Macroeconomic Research Office (AMRO) in April 2011. AMRO, which is based in Singapore, is in charge of monitoring and analysing regional economies and supporting the CMIM decision-making process.

In May 2012, the CMIM was further developed in several ways. The central bank governors of the ASEAN+3 countries, plus Hong Kong, were asked to join the ASEAN+3 Finance Ministers Meeting to form what subsequently became the

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[5] ASEAN+3 Finance Ministers, "Joint Ministerial Statement". On the CMI, see Henning, *East Asian Financial Cooperation*, Sussangkarn, "Chiang Mai Initiative Multilateralization", and McKay *et al*. "Regional Financing Arrangements".

[6] The number of possible renewals of the IMF delinked portion under the CMI was later increased to three.

ASEAN+3 Finance Ministers and Central Bank Governors Meeting. At their first meeting in May 2012, the ASEAN+3 Finance Ministers and Central Bank Governors agreed to double the CMIM contributions to USD 240 billion and "increase the IMF de-linked portion to 30% in 2012 with a view to increasing it to 40% in 2014 subject to review should conditions warrant".[7] Moreover, a decision was taken to "lengthen the maturity and supporting period for the IMF linked portion from 90 days to 1 year and from 2 years to 3 years, respectively; and those for the IMF de-linked portion from 90 days to 6 months and from 1 year to 2 years, respectively".[8] It was also agreed to introduce a 'CMIM Precautionary Line', a facility modelled upon the IMF's recently developed crisis prevention facilities.[9]

With the CMIM, the ASEAN+3 have effectively established a system for regional cooperation that is self-governed, with a collective decision-making mechanism and an independent regional surveillance agency. As such, this regional financing arrangement, while stopping short of being a full-fledged AMF, epitomises the region's commitment to regional financial cooperation.

A further important regional initiative in the field of money and finance is the ASEAN Surveillance Process (ASP), which the ASEAN finance ministers agreed on in Washington in October 1998. The objective of the ASP is to strengthen cooperation by 1) exchanging information and discussing the economic and financial development of member states in the region, 2) providing an early warning system and a peer review process to enhance macroeconomic stability and the financial system in the region, 3) highlighting possible policy options and encouraging early unilateral or collective actions to prevent a crisis, and 4) monitoring and discussing global economic and financial developments that could have implications on the region and proposing possible regional and national level actions.[10] The ASP reviews global, regional and individual country developments and also includes initiatives (supported by the Asian Development Bank, ADB) for training of officials from finance ministries and central banks. For the ASP, ASEAN finance ministers meet annually; deputy finance ministers and central bank deputies meet semi-annually. In 2011, the ASEAN Secretariat also established a new ASEAN Integration Monitoring Office (AIMO), which is carrying out macroeconomic surveillance and monitoring of regional economic integration.

A similar scheme to ASEAN's ASP is ASEAN+3's Economic Review and Policy Dialogue (ERPD), which was launched in May 2000 to strengthen cooperation in the area of regional surveillance and foster dialogue on global, regional and national economic developments. Under the ERPD, finance ministers and deputies meet twice a year to discuss economic and financial developments in the region. In 2001,

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[7] ASEAN+3 Finance Ministers and Central Bank Governors, "Joint Statement of 15th Meeting", 7, iii.
[8] *Ibid.*, ii.
[9] See Marino and Volz, *A Critical Review*.
[10] ASEAN Finance Ministers, "The ASEAN Surveillance Process".

the ASEAN+3 finance ministers also agreed to exchange data on capital flows to facilitate an effective policy dialogue. In 2005, the ASEAN+3 finance ministers integrated and enhanced the ERPD with the CMI framework. While there is considerable overlap between the ASEAN and ASEAN+3 initiatives for regional financial surveillance, both provide value added insofar as the smaller ASEAN group allows a stronger focus on Southeast Asian issues (including topics related to ASEAN integration), while participation of the 'plus three' countries allows ASEAN countries to discuss financial stability-related matters directly with the region's dominant economic powers, especially China and Japan.

A third field of cooperation directly resulting from the crisis experience is the development of regional capital markets in order to enable firms to refinance themselves in local or regional markets. For instance, ASEAN+3 countries have developed the Asian Bond Market Initiative (ABMI), which was originally proposed by Japan in 2002 and endorsed by the ASEAN+3 finance ministers in 2003. The aim of the ABMI is to develop efficient and liquid bond markets in Asia to enable Asian savings to be used more effectively for Asian investments and to avoid the currency and maturity mismatches in financing that exacerbated the financial crisis. The ABMI includes efforts to modify existing regulations to facilitate the issuance of and investment in local currency-denominated bonds, as well as the development of new securitised debt instruments, credit guarantee and investment mechanisms, foreign exchange transactions and settlement issues, and rating systems. In May 2008, five years after the launch of the ABMI, the 'New ABMI Roadmap' was endorsed. Its four key goals are promoting issuance of local currency-denominated bonds (supply side); facilitating the demand of local currency-denominated bonds (demand side); improving the regulatory framework; and improving related infrastructure for bond markets. These are addressed by separate task forces.[11] In November 2010, a Credit Guarantee and Investment Facility was established as a trust fund in the ADB, which shall provide credit guarantees for local currency-denominated corporate bonds issued in ASEAN+3 jurisdictions. In May 2012, the ASEAN+3 Finance Ministers and Central Bank Governors also endorsed another roadmap for the ABMI that aims to strengthen capital markets by developing a regional credit rating system, securitisation markets for small and medium-sized enterprises, and raising the level of financial education. Complementary activities to foster bond markets in East Asia are the launch of the Asian Bond Funds 1 and 2 by the Executives' Meeting of East-Asia and Pacific Central Banks (EMEAP).[12]

[11] Cf. Schou-Zibell, "Regional Development of Bond Markets".
[12] On the experiences with ABF1 and ABF2, see Ma and Remolona, "Learning by Doing".

Strengthening the regional financial architecture and advancing monetary cooperation

The overview in the previous section shows that East Asian countries have been quite active in strengthening regional financial cooperation since the Asian financial crisis. Even though agreeing on and implementing the various initiatives has been slow, important steps forward have been made and an ongoing policy dialogue and exchange at the level of finance ministers and central bank governors have been established. Nevertheless, East Asian countries still have some way to go to build a stable regional financial architecture that can weather the *next Asian* crisis. The regional surveillance structures that have been created thus far, be it on the ASEAN or ASEAN+3 level, are nowhere close to where they need to be in order to provide comprehensive macroeconomic and financial monitoring and surveillance. AMRO, for instance, has been staffed with only a few more than a dozen professional economists.

The CMIM, now equipped with USD 240 billion, is still too small to deal with a full blown crisis in East Asia. Moreover, the IMF link has thus far prevented the CMIM from becoming fully effective: given the stigma that the IMF still carries in the East Asian region, it would be political suicide for any government in the region to seek an IMF programme, which is a condition for drawing on the agreed amounts beyond the first 30 percent. When Korea, for instance, needed liquidity support during the 2008 crisis, drawing on the CMI (the CMIM was not operational yet) was not considered an option. While Korea could have accessed USD 18.5 billion from various countries under the BSAs it had agreed within the CMI at the time, it could have drawn only 20 percent of this amount (USD 3.7 billion) without seeking an IMF programme.[13] As Lombardi points out, "although definite progress has been made, the reliability of the CMIM is still, technically, untested".[14] To make the CMIM fully operational, ASEAN+3 countries need to discuss changes to the current provisions. This may not necessarily mean scrapping the IMF link, as suggested by Sussangkarn or Kawai,[15] but could also include recognising the IMF's new precautionary facilities (the Flexible Credit Line, FCL, and the Precautionary and Liquidity Line, PLL) as a sufficient condition for drawing on the CMIM beyond the first 30 percent, without having to undergo a standard IMF programme.[16]

Moreover, there are also good arguments for strengthening regional monetary cooperation to increase the region's resilience. Thus far, there has been no formal cooperation of East Asian countries in the field of monetary and exchange rate

[13] Sussangkarn, "Chiang Mai Initiative Multilateralization".
[14] Lombardi, *Financial Regionalism*, 9.
[15] Sussangkarn, "Chiang Mai Initiative Multilateralization"; Kawai, *East Asian Financial Cooperation*.
[16] Henning, *Coordinating Regional and Multilateral Financial Institutions*; Volz, *Need and Scope for Strengthening Co-operation*.

policy, even though different proposals have been discussed by policymakers, and an ASEAN+3 Research Group was launched in 2004 to explore the possibility of a regional exchange rate arrangement for East Asia and creating regional monetary units.[17]

While no formal exchange rate cooperation is in place, basically all East Asian countries (with the exception of Japan) have operated under an informal dollar standard, where East Asian currencies (with the exception of the Japanese yen) are basically linked to the USD through pegs or soft pegs, with different degrees of flexibility. This informal system is sometimes referred to as the "East Asian dollar standard"[18] or the "Bretton Woods II system".[19]

It is frequently argued that East Asian countries have linked their currencies (at undervalued rates) to the dollar to promote export growth, especially to the US.[20] The strategy to maintain an undervalued exchange rate is definitely part of the East Asian export-led growth model. But it is only one part of the story. Besides mercantilist motivations, there are two main reasons why the current dollar (soft) pegging is entirely rational from the East Asian perspective.

First, McKinnon and Schnabl argue that, rather than undervaluing their currencies to promote exports, East Asian governments, in particular China, are trapped into maintaining (soft) dollar pegs.[21] Because most East Asian economies have transformed themselves from dollar debtors into dollar creditors since the Asian crisis, they face what McKinnon and Schnabl call "conflicted virtue", that is pressure to appreciate their currencies that would create significant balance sheet losses. Prior to the Asian crisis, when many East Asian countries ran current account deficits and were net debtors with debt denominated almost exclusively in dollars, stabilising the exchange rate vis-à-vis the dollar was rational for central banks to facilitate financing from abroad. The resulting currency mismatches caused big problems when the devaluation spiral started after the fall of the Thai *baht*. Having transformed themselves into net creditors, several East Asian countries have now accumulated huge amounts of foreign currency holdings, both in the private and public sectors, given their inability to lend in domestic currency. An appreciation of the national currency would hence bring about significant balance sheet losses.

The second main reason why basically all East Asian countries, with the exception of Japan, have either pegged their currencies to the dollar or otherwise closely manage the dollar exchange rate is that the common link to an external anchor has

[17] The ASEAN+3 Research Group is a network of 22 research institutes in ASEAN+3 countries, http://www.asean.org/19834.htm.
[18] McKinnon, *Exchange Rates under Dollar Standard.*
[19] Dooley *et al.*, *The Revived Bretton Woods System*.
[20] See, for instance, the Bretton Woods II argument by Dooley *et al.*, *The Revived Bretton Woods System* and "East Asia's Role in Revived Bretton Woods".
[21] McKinnon and Schnabl, "Current Account Surpluses in East Asia".

provided the region with relative intra-regional exchange rate stability. This has enabled the development of an extensive regional trade-production network, which makes use of a division of labour across East Asian economies by which parts and components are shipped from one East Asian country to another, often with China as the final destination, where they are processed and assembled, before the final goods are exported to the market of final demand, often the US or Europe. Arguably, the regional trade-production networks would not have been able to develop in the face of volatile exchange rates. Given that intra-regional trade now accounts for about 60 percent of the total trade of East Asian countries and that East Asian countries also compete against each other in external markets, intra-regional exchange rate stability is an important regional public good and an important reason for East Asian countries to continue to stabilise their currencies against the dollar.

There are, however, serious problems with the current arrangement.[22] First, maintaining fixed parities with the dollar automatically causes problems when there are swings in the dollar-euro and dollar-yen rates. Since most East Asian countries (except, of course, Japan) have roughly equal trade shares with the US, Europe and Japan, neither the dollar, the euro nor the yen are a good candidate for a single peg. As Mundell observes, "[a] major threat to the [current] system arises from gyrations of the major exchange rates. The instability of exchange rates between the large currencies has been enormous."[23] An East Asian Bretton Woods II arrangement, however, would be more sustainable if Japan were also to peg its currency to the dollar, as suggested by McKinnon.[24] This would provide a uniform exchange rate policy for the *whole* region, as well as stability towards the dollar. It would also preclude instability in the dollar-yen rate, the results of which were painfully felt in the Asian crisis. A Japanese decision to link the yen to the dollar again, however, is very unlikely.

Second, maintaining dollar (soft) pegs diminishes the monetary independence of the pegging country and makes it vulnerable to potential monetary instability originating in the anchor country. That is, the stability of the current East Asian dollar arrangement depends not only on efforts of East Asian countries to keep the dollar exchange rate stable, but also on the monetary policy of the US Federal Reserve Bank and the international value of the dollar. The Fed's quantitative easing policy efforts to revive the US economy after the great contraction of 2008–09 and the resulting monetary expansion have significantly boosted dollar liquidity and increased depreciation pressure on the dollar and inflationary pressure in countries pegging their currencies to the dollar. While pegging to the dollar made a lot of sense for East Asian countries when this was a way of importing

[22] Cf. Volz, *Prospects for Monetary Cooperation*.
[23] Mundell, "Prospects for an Asian Currency Area", 2
[24] McKinnon, *Exchange Rates under Dollar Standard.*

macroeconomic stability and anchoring inflation expectations, East Asian policy-makers are becoming increasingly nervous about the prospect of importing instability through the dollar peg.

Yet, even if the dollar maintains its strength, the question remains why a region as economically potent as East Asia should continuously bind itself to an external anchor. As noted earlier, the East Asian dollar standard also constitutes a form of implicit exchange rate coordination. While this system has served the majority of East Asian countries very well (excepting, of course, the period preceding the Asian crisis), a continued pegging to the dollar involves all the costs, but not all the advantages of regional monetary integration. The current dollar pegging might well be feasible for a considerable amount of time, as claimed by Dooley *et al.*,[25] but as a long-term strategy it is a dead end.

It is therefore time to discuss alternatives to the East Asian dollar standard that might provide the benefit of intra-regional exchange rate stability without the problems of the current practice of dollar (soft) pegging. Safeguarding relative intra-regional exchange rate stability, while allowing for more flexibility vis-à-vis non-regional currencies like the dollar and the euro, should be the central aim of East Asian countries' exchange rate policies. Intra-regional monetary and exchange rate cooperation provide a sensible way forward.

Of the different proposals for regional monetary and exchange rate cooperation, proposals based on currency baskets, where the informal East Asian dollar standard could be replaced by an informal basket standard, are particularly appealing for several reasons.[26] First, currency baskets would help to stabilise the nominal effective exchange rates of East Asian countries and prevent negative effects of gyrations between major currencies, especially the dollar and the yen. Second, no radical reorientation of exchange rate policies would be required, as most countries in the region have already allowed for more flexibility vis-à-vis the dollar. Also, a gradual reduction of the dollar's weight in region-wide currency baskets would reduce the risk of a dollar crash. Third, in the early stages of cooperation, political commitment would be very limited, which would make cooperation much easier to achieve. This is also because choosing currency baskets to guide exchange rate policy circumvents the problem of selecting a regional currency to act as an anchor. Countries could gain experience with regional cooperation and develop trust before moving to more formal cooperation which would require sacrificing some of the country's sovereignty.

[25] Dooley *et al., Bretton Woods II Still Defines International Monetary System*.
[26] For an overview of proposals for monetary cooperation in East Asia and a detailed discussion of regional monetary cooperation based on currency baskets, see Volz, *Prospects for Monetary Cooperation*.

Lessons from the European crisis

While the East Asian countries clearly ought to develop their own form of financial regionalism, it will be helpful to take on board the lessons that can be learned from other regions, and in this context Europe can provide particular insights.[27] While the creation of the euro in 1999 stirred a lot of interest in regional monetary integration and even monetary unification in various parts of the world, including East Asia, the current crisis has had the opposite effect, raising the spectre of a break-up of the euro area. Indeed, the European crisis has highlighted the problems and tensions that will inevitably arise within a monetary union when imbalances build up and become unsustainable.

Reconsider costs and benefits of international financial integration, strengthen surveillance and monitoring

An important point that the European crisis has highlighted (once again) is that international financial integration does not automatically lead to an efficient allocation of capital and that it can contribute to the development of unsustainable imbalances. In retrospect, one can assert that the Stability and Growth Pact's belief in the power of free markets to discipline governments was not warranted as markets first underpriced and then overpriced sovereign risk.

Moreover, the European crisis has shown once more that international (including regional) financial integration increases contagion risk: the crisis of a small European economy – Greece – triggered a full-blown European crisis. Given that financial institutions engaging in cross-border activities increase systemic risk and pose a serious regulatory challenge, East Asian countries should be careful about liberalising financial markets too quickly. The experience with European banking integration, and the associated risks to financial stability that have become evident over the past years, should be borne in mind, for instance, in the current discussions about the establishment of a single 'passport' for qualified banks from ASEAN countries under the ASEAN Banking Integration Framework that would allow the banks to operate in any other ASEAN country.

The European crisis has confirmed what was already seen during the Asian crisis: crises can spread quickly among closely integrated economies. East Asian countries should hence heed the lesson that they learned from the Asian crisis, namely that the regulatory architecture has to keep apace with financial integration. East Asian countries should therefore reinforce efforts to strengthen the regional financial architecture. Effective surveillance and monitoring is the best crisis prevention. East Asian countries need to strengthen the newly created AMRO, which needs more resources to effectively carry out regional financial surveillance.

[27] This section draws on Volz, *Lessons of the European Crisis*.

With increasing financial integration, close cooperation of national regulators is also needed. From a certain level of regional financial integration onward, a regional regulatory body is required. An important lesson of both the global financial crisis and the European crisis is that regulatory authorities must not focus only on microprudential regulation and supervision of individual financial firms. Rather regulatory authorities need to try to identify and manage systemic risk, that is the risks imposed by interlinkages and interdependencies in a market, where a triggering event, such as the failure of a large financial firm – be it at home or abroad – can seriously impair financial markets and harm the broader economy. While macroprudential regulation to deal with capital inflows is particularly important in a monetary union where interest rate and exchange rate cannot be used at all, it is also crucial for any kind of fixed exchange rate system where monetary policy independence is constrained (for example, China). As pointed out by Kawai, "[t]here is an urgent need in Asia both to strengthen microprudential supervision and regulation and to establish an effective macroprudential supervisory framework".[28] Towards this end, ADB President Haruhiko Kuroda made a proposal for an Asian Financial Stability Dialogue (AFSD) in September 2008.[29] The AFSD could be thought of as a regional equivalent to the Financial Stability Board to promote coordination and information exchange among authorities responsible for financial stability, including finance ministries, central banks, financial regulators and supervisors.

Proceed very gradually with monetary integration

As discussed in the previous section, there is still a strong case for monetary and exchange rate cooperation in East Asia. However, as proven once more by the European crisis, overambitious monetary and exchange rate integration schemes will backfire if the countries entering a rigid exchange rate arrangement are not able to adjust their economies internally. The 1992 crisis of the European Monetary System (EMS), the regional fixed exchange rate system that preceded the monetary union already showed that rigid arrangements are prone to crisis if divergences arise within the system.[30] Taking into account not only the economic differences but also the great differences in terms of political systems and the lack of trust among East Asian governments, it is very clear that East Asian countries are not (yet) ready for a regional exchange rate system, let alone monetary union. A high level of political agreement and commitment is needed among countries to pursue successful monetary integration, as well as close macroeconomic and fiscal coordination. Even though monetary unification is currently not on the agenda in East Asia

[28] Kawai, "G-20 Financial Reforms", 123.
[29] See ADB, *Institutions for Regional Integration* and *Emerging Asian Regionalism*; Kawai, "G-20 Financial Reforms", 139.
[30] Volz, "Feasibility of a Regional Exchange Rate System".

anyway, the recent European experience further supports the view that monetary union in East Asia should not be a goal anytime soon.

Just like the EMS crisis, the current crisis highlights the dangers that advanced monetary integration brings in the face of economic *and* political divergences. Macroeconomic imbalances within any kind of fixed exchange rate system will cause problems at some point. East Asian countries should hence pursue a very gradual approach to monetary integration that allows for much flexibility and room for adjustment. As just mentioned, managed floating regimes guided by currency baskets are one option for achieving relative intra-regional exchange rate stability while maintaining sufficient flexibility and avoiding the speculative attacks to which any fixed exchange rate system is prone.

ASEAN+3 should increase efforts to improve the regional financial architecture *now*. European policymakers were caught on the wrong foot because they believed that a balance of payments crisis was impossible inside a monetary union, a belief that was proven wrong. In a similar vein, there is no time for complacency in East Asia since risks are looming: capital inflows can reverse quickly, and liquidity crises can occur even if fundamentals are all right (for example, Korea in 2008). The CMIM process should therefore be made fully functional as soon as possible. This includes an increase in available lending amounts and the definition of details for cooperation with the IMF – if a big crisis hits, IMF support will be needed.

Conclusions

Since the Asian crisis, the ASEAN+3 countries have engaged in a process of regional financial cooperation aimed at developing and strengthening the region's financial architecture. Major milestones have been the implementation of the CMIM with a pooling of USD 120 billion of foreign exchange reserves in 2010 (and its extension to USD 240 billion in 2012) and the creation of Singapore-based AMRO to carry out macroeconomic and financial surveillance in 2011. While much work remains to be done to develop the CMIM into a fully functioning regional financing arrangement that will help in preventing and weathering future crises, the groundwork has been laid for what could become a full-fledged Asian Monetary Fund. East Asia has come a long way in terms of financial regionalism since the Asian crisis, yet major challenges remain. In particular, East Asian countries should work on alternatives to the still prevailing informal dollar arrangement. A gradual approach to monetary integration based on currency baskets provides a sensible way forward.

To further strengthen the regional financial architecture, East Asia needs more regional monetary and financial cooperation, even if at first sight the European example may be discouraging given the current challenges in the eurozone. Regional financial and monetary cooperation needs to keep apace with the integration of the real economies of East Asia, which is progressing quickly. Cooperation on the regional level should be a complement to global cooperation – both are needed. As seen during the European and Asian crises, crises can spread quickly within highly integrated regions. East Asia therefore needs to have adequate response mechanisms in place before the next crisis hits.

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