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Sequencing Trade and Monetary Integration: Issues and Applications to Asia

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Issues and Application to Asia

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SEQUENCING TRADE AND MONETARY INTEGRATION
Issues and Application to Asia

Regional integration for at least the last sixty years has focused on trade integration. In the 1980s the concept of deep integration went beyond trade with its focus on policy harmonization, which came to include monetary integration, but it presupposed trade integration as the first step in the regional integration sequence. Indeed, the five levels of integration developed in the early 1960s by Bela Balassa (1961) - preferential trading arrangements, free trade area, customs union, common market, economic union - are often treated as a sequencing pattern towards closer integration as well as a taxonomy of deeper and deeper integration. In western Europe, the regional integration program which dominates all empirical discussion, the sequencing could - at a pinch - be squeezed into this pattern.

In Asia there has been very little policy-driven trade integration. ASEAN is the most ambitious project, but actual achievements in trade integration have been limited. In South Asia (SAARC/SAFTA) or western and Central Asia (ECO) there has been even less progress in implementing regional trade integration. In northeast Asia regional trade arrangements (RTAs) were non-existent in the second half of the twentieth century.[1] When discussion of monetary integration began in East Asia after 1997, it was in the absence of trade integration. Indeed, some proponents saw monetary integration as a step towards promoting trade integration, reversing the orthodox sequence. The aim of this paper is to analyse these two sequences in order to determine whether the orthodox sequence is inevitable or whether the "Asian sequence" is viable.

The two theoretical literatures dealing with trade and monetary integration (customs union theory and optimal currency area theory) developed along distinct tracks, and there remains a disconnect between the trade and monetary integration literature. This paper evaluates the global cross-country evidence on the two-way relationship

[1] In this paper RTAs include all geographically discriminatory trade policies. The post-2000 bilateral agreements have sometimes been regional, eg. Singapore-Japan or South Korea-Japan, but often have not been, eg. Thailand-Bahrain, South Korea-Chile, Japan-Mexico, USA-Jordan). The terms regionalism and regional trade integration are used to describe a policy-driven process, in contrast to market-driven regionalization. Thus, the increase in intra-Asian trade in the decades before 2000, as the regions' economies grew faster than world trade and hence provided the fastest growing markets for one another's exports (Fukasaku, 1992), is not considered to be evidence of regional trade integration.

between trade integration and monetary union. It then applies the results to the prospects for monetary union before trade integration in East Asia, and to the consequences of monetary union for regional economic integration.

1. Regional Integration: Trade

The first article of the General Agreement on Tariffs and Trade, signed in 1947 and still the basis of international trade law under the World Trade Organization, affirms the nondiscrimination principle; in trade relations all WTO members must be treated equally. Nevertheless, over the whole GATT/WTO era there has been a tug-of-war between nondiscriminatory multilateralism and discriminatory trading arrangements. Such arrangements are, of course permitted under the GATT/WTO rules, notably under Article XXIV and the Enabling Clause for special treatment for developing countries, but they are contrary to the spirit of the GATT and the stringent conditions have seldom been fully met in practice. Nevertheless, there is a paradox between the political economy forces encouraging politicians to embark on preferential trade policies and the strong economic forces working in favour of global adherence to the nondiscrimination principle, such that despite dozens of plans for regional trading arrangements many failed to come to fruition, and among those that did many failed to survive long or exercise a significant influence on trade flows.

The ambiguity in trade law captures the classic insight by Viner (1950) that any discriminatory trade policy, such as a customs union, is by its nature second-best. One distortion is removed, the differential treatment between a member's domestic products and products from other member countries of the customs union, but a new distortion is introduced between imports from member and non-member countries which were previously treated equally. The trade creation and trade diversion effects of customs union accession work in opposite directions to leave the direction of change in welfare of the country joining a customs union and of the world theoretically ambiguous. Thus, although a discriminatory tariff reduction, as in a customs union or free trade area, may be welfare-improving, the presumption is that, with competitive markets, removal of trade barriers on a nondiscriminatory basis would be first-best. Politicians are often

attracted to regional trading agreements for political reasons, but Viner's analysis explains why economic forces works against such arrangements in practice.

Since 1947 three waves of regionalism have swept the world trading system. During the 1950s and 1960s the "rush to discrimination" was led by Western Europe, which founded the only substantial new customs union of the second half of the twentieth century and also established a complex network of preferential arrangements with other trade partners.[2] The European customs union was taken as a model by groups of developing countries in Africa, the Caribbean, Central America, and South America, but even the most promising of these arrangements, the East African Community and the Central American Common Market, collapsed during the 1970s. The customs unions agreed among developing countries all failed because they were based on a regional form of import substitution which inevitably led to conflict over trade diversion; each member wanted a regional market for its own inefficient industries, but was unwilling to buy the expensive or poor quality import-substitutes being developed by their partners.[3] The European customs union had similar strains, especially with respect to farm products, but the political will for greater economic union overcame these trade-diversion costs even in large net economic losers from membership such as the United Kingdom or the Scandinavian countries.[4]

The first wave of regionalism was resisted by the USA, which remained committed to the multilateral system, and was receding in the 1970s as the European Union became established as a single actor in the global trading system. Successful conclusion of multilateral trade negotiations in the 1961-4 Kennedy Round, in which the members of the European customs union negotiated with a single voice for the first time, and in the 1973-9 Tokyo Round, which first seriously addressed the issue of non-tariff barriers to trade, sent important signals of the leading trading nations' commitment to multilateralism.

A second wave of regionalism was initiated by the United States' departures from the GATT nondiscrimination principle in the first half of the 1980s and peaked with the

[2] For more details on the trading arrangements mentioned in this paper, see Pomfret (2001).

[3] The only East Asian attempt at such a strategy, ASEAN's promotion of Asean Industrial Projects broke down for similar reasons in the early 1980s.

[4] The UK, Denmark and Sweden are, however, notably more sceptical of the enterprise than are most of the

North American Free Trade Agreement negotiations in the early 1990s, which coincided with the European Union's 1992 project for completing the internal EU market. Although NAFTA was signed and implemented, the EU completed its 1992 program and Australia and New Zealand deepened their free trade area into the Closer Economic Relations, the major trading nations reaffirmed their commitment to the nondiscrimination principle with the successful conclusion of the 1986-94 Uruguay Round of multilateral trade negotiations and the establishment in 1995 of the World Trade Organization as the successor to the GATT. Supporters of the deeper EU, NAFTA or the CER argued that these were new forms of regionalism going into areas where the Vinerian analysis was inapplicable, such as increasing-returns industries, service activities, or policy harmonization. As in the first wave, there was a demonstration effect as groups of developing countries worried about the need to establish and strengthen their own regional groupings.[5] The geographical scope was wider than in the first wave as Latin American regional arrangements such as Mercosur and African customs union in various overlapping incarnations were joined by Asian regional organizations; among the regional organizations introducing tariff preferences in the 1980s or early 1990s were ECO, SAARC and ASEAN. The practical outcomes were, however, minimal for much the same reasons as in the first wave; each partner was unwilling to grant other partners non-trivial preferential access to its own protected markets.[6]

In the opening years of the twenty-first century, a third wave of RTAs has been gathering force. This is led by Asian countries, which had previously been the strongest bulwarks of nondiscrimination – Japan and South Korea within the WTO and China and Taiwan outside the WTO – who were joined, especially under the G.W. Bush administration, by the USA. The emergence of Asian regionalism can be dated from the

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other EU members, a position reflected in their remaining outside the euro zone.

[5] Although it was outside the ambit of the WTO, the biggest change in this period was the collapse of a very large regional arrangement, the Soviet-led CMEA.

[6] The Asian RTAs were especially ineffective. The two largest economies in SAARC, India and Pakistan, withheld MFN treatment from one another. ECO was in effective abeyance while Iran was at war with Iraq. Most studies find minimal effects on trade for SAARC and ECO or for ASEAN (Greenaway and Milner, 2002, 577). The implausible findings of Clarete et al. (2003) that ECO and SAARC were among the few RTAs which led to higher intra-bloc trade during the 1980s and 1990s, in contrast to RTAs like the Closer Economic Relations between Australia and New Zealand or NAFTA which they found to have little impact on intra-bloc trade, appear to be due to their gravity equation's specification rather than capturing real phenomena.

aftermath of the 1997 Asian Crisis and was partly in reaction to dissatisfaction with the role of the Bretton Woods institutions, but the collapse of the 1999 WTO meetings in Seattle and the diminishing significance of APEC (including the half-hearted attempt by the USA to kick-start further trade liberalization at the 1999 APEC summit through its P5 initiative with Australia, Chile, New Zealand and Singapore) led to new approaches to trade liberalization in the Asia-Pacific region. Bilateral negotiations were begun in 1999/2000 by Japan with Singapore, South Korea, Canada and Mexico, by South Korea with Chile and New Zealand as well as with Japan, and by Singapore with New Zealand (concluded in 2000), Australia, Canada and other countries. [7]

As with the second wave, which was characterized by proponents as a "new regionalism", the third wave has novel features. With respect to tariffs and some non-tariff barriers to trade, the post-Uruguay-Round bar is lower, so effective discrimination requires focus on other aspects. The bilateral agreement negotiated between Singapore and Japan in 2000 focused on areas such as financial services, capital flows and coordination of regulatory systems, which are analytically more difficult areas, often with inherently less transparency than the traditional trade barriers of tariffs or quotas. Although negotiations towards bilateral trade agreements are mushrooming in the Asia-Pacific region, the agreements' coverage and actual implementation are often limited.[8] Singapore and Japan could happily leave agriculture outside their bilateral, but omitting agriculture is more contentious when they negotiate with a country like Thailand.[9]

Despite the novel features of the third wave of regionalism, the thrust of the analysis of the first two waves remains valid. Even in the new areas, multilateral non-

[7] On the genesis of the new bilateral agreements see Rajan, Sen and Siregar (2001). Bonapace (2004) provides a recent assessment of agreements in the Asia-Pacific region. Although the third wave is seen as a recrudescence of regionalism, many of the bilaterals are not regional. When Thailand under Thaksin, for example, embarked on a policy of negotiating bilateral trade agreements, it began with Bahrain and Australia before moving on to the USA and Japan; this pattern is weakening Thailand's regional trading arrangements by eroding preferential treatment negotiated within ASEAN. South Korea's experimentation with bilaterals started with Chile and New Zealand, willing collocutors, but hardly regional neighbours and never likely to generate large bilateral trade flows.

[8] In general, it is difficult to monitor the progress of these bilateral negotiations. Many countries have long had bilateral arrangements on double taxation, coordinated strategies to fight money laundering and other financial matters without making the claims to be furthering liberalization that the recent bilateral negotiations have attracted. Some negotiations appear to be driven by a desire for progress on a single contentious issue, eg. China has demanded as a precondition for entering into a FTA with Australia that it be granted market economy status by Australia.

[9] Similarly, the US refusal to include sugar in its "free trade" agreement with Australia greatly reduced the

discriminatory trade liberalization is usually the best approach not only from a cosmopolitan global perspective, but also often for the net economic welfare of the participants in regional arrangements. The lack of transparency and the selective coverage make it more likely, given the political economy of trade policy, that trade-creating opportunities will be passed over because they hurt domestic producers while trade diversion will be permitted. Such selectivity might facilitate reaching agreement on a RTA, but, as happened with most of the first wave RTAs, it will undermine the sustainability of the new bilaterals

Whether regional/bilateral agreements are becoming a major feature of the global trading system (as opposed to a major preoccupation of trade negotiators) is not as obvious as many observers seem to believe. It is often asserted that, because the number of RTAs reached at an all-time high in the early 2000s, regionalism is more prevalent than ever. Such counting is nonsense because some arrangements are obviously far more important than others and some are totally inconsequential. One reason for the rapid increase in the number of RTAs during the 1990s was the proliferation of bilateral and plurilateral free trade agreements among countries of the former CMEA; these were primarily a response to regional disintegration, rather than a trend towards regionalism. Another illustration of the meaningless of such measures occurred in 2004 when the number of arrangements registered with the WTO declined by about a fifth, mainly due to the accession of eight eastern European countries to the EU;[10] their web of bilateral trading arrangements and preferential agreements with the EU became redundant, although with their incorporation into the EU customs union the degree of regionalism was increased. In contrast, it is arguable that, despite the increased attention being paid to regional arrangements, the hold of multilateralism is stronger than ever as practically all trading nations have now acceded to the WTO, with lower trade barriers and stronger trade dispute settlement procedures.[11]

Perceptions do, however, matter. Supporters of closer economic integration in Asia are concerned that Asia has been left behind in a global movement to regionalism

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trade-creating potential of the agreement.

[10] As a result of the EU enlargement in 2004 the number of RTAs fell from 285 to 229, see the World Bank *Global Economic Prospects 2005*, p.53, n.1.

represented by an expanded European Union and a putative Free Trade Area of the Americas.[12] In contrast to the modest steps towards regional trading arrangements by the East Asian countries, regional cooperation in monetary issues started earlier, in response to perceived shortcomings of the role of the multilateral institutions (especially the IMF) during and after the 1997 Asian Crisis. Since September 1997 several proposals have been floated to form an Asian Monetary Fund or create an Asian currency unit, and, even before that, central banks in the region met to discuss monetary coordination. Substantive progress in monetary coordination (eg. in the Chiang Mai Initiative among the ASEAN+3 group of the ten ASEAN countries plus China, Japan and South Korea) was accompanied by calls from some quarters for even more drastic monetary integration.[13] This priority to monetary integration turns the Balassa sequence on its head, as some writers have seen monetary integration as a way of promoting regional economic integration by differentially facilitating intra-regional trade flows.[14]

2. Regional Integration: Money

The modern theory of monetary integration dates from the seminal papers by Mundell (1961) and McKinnon (1963) on optimum currency areas (OCAs). In OCA theory, the choice of currency area is a cost-benefit analysis trading off microeconomic efficiency against macroeconomic flexibility (Krugman, 1993, 4). Microeconomic efficiency would be maximized with a global currency, so that sub-global OCAs imply the existence of distortions whose negative effects can be reduced by macroeconomic policy. Mundell

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[11] Whether regional agreements are stepping stones or stumbling blocks to multilateral liberalization remains an open question which will not be addressed here.

[12] "Clearly, the Asian FTA effort is a belated example of a trend that has been widespread throughout the world for some time. Regionalism has become a critical part of the new international trade order. The world has seen a surge in regional arrangements since the early 1990s. The GATT-WTO has been notified of over 250 regional trading agreements up to December 2002" (Naya, 2004, 4).

[13] A positive stimulus was the successful adoption of a common currency by twelve European Union member countries; the success of European currency union finally appeared assured in the second half of the 1990s, and was sealed by the issue of euro banknotes in January 2002. Emphasis on the euro as evidence of a pattern towards currency consolidation was, however, a selective reading of the European experience as Eastern Europe was undergoing an even more dramatic monetary disunion with the disintegration of the Czechoslovak, Yugoslav and Soviet currency areas. In total, Europe had more currencies in 2002 than it had a dozen years earlier (Pomfret, 2003).

[14] Wang (2004, 952-4) starts his discussion of the sequencing issue by observing that: "The euro area pursued trade integration first, but from a theoretical point of view there is no clear reason for this. . .

identified the limits of the OCA with breaks in factor mobility. McKinnon focused on openness, which would undermine the money illusion that permits the exchange rate to be an effective policy instrument. Kenen (1969) lengthened the list of criteria which might be relevant. For Alesina and Barro (2002) the trade-off might be mediated by history and by geography, but otherwise their criteria are similar to those in the survey by Tower and Willett (1976) or in the textbook treatment of de Grauwe (2000). The emphasis was on establishing the geographical boundaries at which macro policy becomes effective, and hence the point at which abandoning currency independence becomes costly.

The main benefit from a common currency (or fixed exchange rates) is lower transactions costs. This has long been accepted as the overwhelming argument for mini states (eg. Luxemburg or Brunei) not to have independent currencies, but the argument becomes less potent as the currency area becomes large enough to have well-functioning forex (including forward) markets. A second benefit is that in larger currency areas disturbances are likely to be offsetting, so that exchange rate changes are smaller, with less feedback on domestic prices.[15]

The main disadvantage of adopting a common currency is the loss of monetary independence. Economists (eg. Eichengreen, 1990) compared the adjustment mechanism in US states to that in independent countries. If oil prices fall, for example, output will decline and unemployment increase in Texas or Alaska and these states would like to either (a) increase the money supply, in order to reduce interest rates and stimulate investment, or (b) devalue, in order to encourage non-oil exports and import-competing activities, but they cannot do either. The adjustment problem will be less if capital and labour are mobile, because the unemployed factors will move to other states, and in very open economies devaluation will not work because prices and wages immediately increase to wipe out any competitive advantage; hence the Mundell and McKinnon criteria for OCAs, respectively.

.Furthermore, there are many good reasons for forming a monetary union before a FTA".

[15] The greater price stability is usually ascribed to random shocks being offsetting. Other mechanisms include reduction in weights of outliers in the CPI and reduction in the ratio of trade (or rather transactions denominated in, potentially volatile, foreign currencies) to GDP.

The outcome of the western European policy debate was the establishment of a common currency, the euro, around the turn of the century, but the process did not parallel predictions of the OCA literature.[16] Although the EU did become more integrated with greater factor mobility and more open national economies, the pace of monetary integration did not follow these trends, and in the endgame capital controls were abolished as a step towards monetary union rather than monetary union being driven by greater factor mobility (Pomfret, 2003). Meanwhile, during the 1990s eastern Europe witnessed substantial monetary disunion as several currency areas disintegrated, despite high levels of economic integration (including factor mobility and the absence of money illusion) among their members.

How to explain these outcomes? Monetary union not only reduces private transactions costs, but also public sector transactions costs. As the EU moves closer to a federal state it is too difficult to make common polices if internal exchange rates fluctuate. This was first apparent in trying to manage the common agricultural policy after the collapse of the first effort at monetary union in 1976, and this led speedily to a renewed effort to fix internal exchange rates through the European Monetary System which started operation in 1979 (Pomfret, 1991; Basevi and Grassi, 1993). On the other hand, monetary union is impossible among countries wishing to pursue differing monetary policies. That is why the EU's first effort collapsed in the early 1970s; the large EU members wanted to address problems raised by oil crisis and recession through differing monetary policies and the fixed exchange rate system (the S nake) collapsed. After the political dissolution of Czechoslovakia, Yugoslavia and the Soviet Union, disagreements arose over the conduct of monetary policy which made a common currency unsustainable in each case (Pomfret, 2003). In the European experience of the 1990s, the crucial issues concerned who determines the conduct of monetary and fiscal policy, rather than the more technical issues emphasized in OCA theory of whether macro policy will be effective or not.

Helleiner (2003) is one of the most perceptive critics of the inadequacy of OCA theory in capturing actual monetary arrangements. Explaining currency domains in pure

[16] Attempts to quantify and synthesise the OCA criteria in the 1970s, such as Kreinin and Heller (1974), predicted that Sweden and Switzerland were am ong the top candidates for adoption of a European common

political terms, as part of the Westphalian nation state system or for national identity, will not do either; territorial currencies were only established in the 1815-1914 period, long after the first emergence of the nation state.[17] Technical change in minting coins and printing notes in large standardized and hard-to-counterfeit batches was a precondition, but national motives varied Helleiner focuses on four motives: the macropolicy motive of OCA theory, creating national identity, and the desire to reduce transactions costs in the private sector and in public finance. The transactions costs motives became more important as the monetized economy spread to the working classes and as the state took on more functions and cast its revenue net more widely. These are motives with an economic dimension, which, together with the crucial technical change in using steam presses to mint coins, are firmly rooted in the historical situation following the industrial revolution. Helleiner's explanation of the timing of the formation of monetary domains contrasts with the predictive incapacity of OCA theory.

A pressure for monetary union in the EU was the problems caused for common polices by exchange rate volatility, ie. the transactions costs in public finance identified by Helleiner as a major reason for creating national monies in the nineteenth century. If the European Union is becoming a territorial unit as Germany or Italy or Canada did in the nineteenth century and this was a significant motive behind the introduction of the euro, then it is *sui generis* in the current world economy and the euro cannot be seen as a harbinger of further monetary unions. This analysis has implications for the prospects for monetary union in East Asia insofar as discussing the matter as a technical one of economic benefits versus economic costs misses the point of whether any of the independent countries, apart from the very small states are willing to cede national autonomy over monetary and part of fiscal policy to a supranational institution.[18]

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currency and Italy was one of the countries which least satisfied the OCA criteria (Pomfret, 2004).

[17] Dichotomous generalizations like "economics matters but politics matters more" (Benjamin Cohen in Salvatore, Dean and Willett (2003) are just as oversimplified as the OCA literature.

[18] Currently Brunei has ceded monetary policy authority to Singapore and Timor Leste uses the US dollar. Future developments could include a baht zone, incorporating Laos, or a Greater China currency zone with monetary policy determined in Beijing, but it is difficult to imagine many other Asian examples. The new members of the EU in 2004 were willing to accept eventual adoption of the euro as a condition for EU membership, because they had similar monetary policy goals to existing EU members and because they recognized that they were joining a union with common policies.

3. Regional Integration in Asia

Although the heads of some Asian central banks had met on a fairly structured basis before 1997, the Asian Crisis provided the stimulus for new proposals. In particular, the International Monetary Fund's handling of the Asian Crisis came under criticism in the region for the amount and timing of IMF assistance and for inappropriate conditionality. The lead in proposing new institutional responses was taken by Japan, which floated the idea of an Asian Monetary Fund (AMF) at the ASEM Finance Ministers' meeting in Bangkok in September 1997.[19] Subsequently the head of the Hong Kong Monetary Authority, Joseph Yam, raised the possibility of an eventual Asian currency unit and the Philippine President Joseph Estrada put the issue on the Agenda of the 1999 ASEAN summit, and several academics, including Robert Mundell, advocated creation of an Asian euro.[20]

The Japanese arguments in support of the AMF have been fourfold (Ogawa, 2001). First, the IMF financial support for the crisis-hit countries was too little and too late. Second, East Asian countries are underrepresented in the IMF. This apparent inequity is, however, solely a Japanese issue. Third, an AMF could help prevent regional contagion in future crises. This argument is related to criticisms of the tardiness of the IMF's responses in 1997:

> "A 'currency meltdown' occurred on July 24 when all of the countries faced severe speculative attacks. Thus, the Thai baht crisis had the contagion effects on the other ASEAN countries before the IMF decided its financial support to Thailand" (Ogawa, 2001, 235).

The weight to be placed on this argument depends on the extent to which one accepts the contagion hypothesis, as well as on whether one believes that faster or bigger or better

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[19] The Asia-Europe Meeting (ASEM) format had been proposed by the EU, which wanted a dialogue with the ASEAN countries plus China, Japan and South Korea, and the first ASEM summit was held in March 1996. The Asian participant list revived the East Asian Economic Caucus grouping, proposed by Malaysia in 1990 and subsequently overshadowed by APEC because other countries, notably the USA and Australia, feared that the EAEC would be the nucleus for an East Asian regional trading arrangement. Instead, in the late 1990s, the group's members, now called the ASEAN +3, formed the nucleus of Asian monetary coordination.

[20] For references see Henning (2002) and Eichengreen (2004). More limited currency union has also been considered, especially within Southeast Asia (Madhur, 2002).

directed assistance could have forestalled contagion. Fourth, an AMF could better conduct regional surveillance and muster peer pressure to forestall crises than could an institution based in Washington DC.

The four arguments have some merits and struck some chords with policymakers outside Japan, but they are not conclusive arguments for a new institution. Some of the suggestions could be handled within existing institutions. For example, in 1998 the Southeast Asian countries proposed an ASEAN Surveillance Process and requested ADB technical support, and the ADB has subsequently taken on a regional surveillance role through its Asia Recovery Information Center.[21] The fundamental reason for the AMF's lack of progress has been the opposition from other IMF members, notably the USA, to duplication of roles. Support within the region has also been lukewarm, although the episode has generated new initiatives and thinking about Asian monetary arrangements.[22]

A weaker version of the AMF proposal emerged at a meeting of Asia-Pacific finance ministers and central bankers in Manila in November 1997.[23] The Manila Framework called for a regional surveillance mechanism, enhanced economic and technical cooperation in strengthening domestic financial systems and their regulation, and measures to strengthen the IMF's response to financial crises. Although the topics are reminiscent of the AMF proposals, the tone is in terms of supplementing the central role of the IMF.

A more important forum for regional financing arrangements emerged out of meetings begun in March 1999 among the ASEAN plus Three countries (the three being China, Japan and South Korea).[24] The most significant of these meetings was that of the

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[21] The IMF's surveillance mechanism is bilateral, so the regional nature of the ASEAN proposal was innovative. The ASEAN Surveillance Process became operational in March 1999 with a coordinating unit at the ASEAN Secretariat in Jakarta and national units in the ten member countries (Manupipatpong, 2002, 112-5). At a meeting in Sydney in March 1999 the Australian government proposed that a regional surveillance information facility be based at the ADB in Manila, and provided financial assistance through AusAID. Staff of the ADB's Regional Economic Monitoring Unit now prepare the *Asia Recovery Report* twice a year and maintain a website at http://www.adb.org/REMU/aric.asp.

[22] The following paragraphs draw on Henning (2002), Manupipatpong (2002) and Murase (2002) for information about the various developments and on Bird and Rajan (2002) for policy options raised in the process.

[23] The fourteen economies represented in Manila were the first six ASEAN members, China, Hong Kong, Japan, South Korea, Australia, New Zealand, Canada and the USA.

[24] China had supported the IMF's approach to the 1997 crisis and its "mainstay" role was acknowledged at the December 1998 APEC summit in Kuala Lumpur. China, however, felt that it received little practical reward and relations with the USA soured in the first half of 1999 over the US intervention in Kosovo and

thirteen countries' finance ministers in Chiang Mai in May 2000, where a regional financing arrangement was established with one billion US dollars in commitments. The Chiang Mai Initiative (CMI), which became effective in November 2000, allows countries to swap their local currencies for major international currencies for up to six months and for up to twice their committed amount.[25] The CMI is framed in terms of supplementing the IMF's role insofar as countries seeking liquidity support must also look for IMF assistance although bilateral swaps under the CMI are not conditional on IMF negotiations being completed. By March 2002 six bilateral swaps, worth $14 billion, had been concluded under the CMI (Manupipatpong, 2002, 118), and by the end of 2003 this had increased to sixteen bilateral swaps amounting to $35.5 billion (Wang, 2004, 944). The CMI has the potential to evolve into the role foreseen for the AMF as lender of last resort in crises, and, with combined forex reserves of around $800 billion, the ASEAN Plus Three countries have the resources which dwarf the assistance given in 1997-8. Nevertheless, from the participating countries' public pronouncements, it remains unclear how far some of them are willing to see the CMI evolve towards an AMF.[26]

Monetary coordination is less advanced. A case is often made for exchange rate fixity to forestall competitive devaluations by countries competing with one another across a range of traded goods and also to encourage direct foreign investment. In the years before 1997 such fixity was more or less maintained among the ASEAN countries, China, Hong Kong, South Korea and Taiwan by their *de facto* pegs to the US dollar, but this led to, disastrous in some cases, swings against the yen.[27] Proposals for a common currency see that as the best solution to the competitive devaluation threat.[28] The

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bombing of the Chinese embassy in Belgrade. Bowles (2002) contrasts the coolness of Jiang Zemin's visit to Japan in December 1998 with the conciliatory nature of Zhu Rongji's visit in October 2000. Although there is strong evidence of China's willingness to play a leadership role in Asian regionalism since the 1997 crisis, some commentators (eg. Medeiros and Fravel, 2003) interpret China's more active diplomatic engagement since the mid-1990s in a global rather than a regional context.

[25] The CMI superseded the ASEAN swap arrangement, which had been in place since 1977 but at its maximum the facility only amounted to $200 million.

[26] The relationship of the CMI to the Manila Framework also remains unclear. Although garnering fewer headlines, the Manila Framework remains in place and raises questions of coordinating activities under the CMI and financial activities involving Australia, Canada, New Zealand, the USA and the ASEAN+3.

[27] The third currency phenomenon, as it applies to Southeast Asian countries, is analysed by Bird and Rajan (2002b).

[28] Despite the experience of 1997-8, the attraction of a dollar peg seems to remain strong in these countries.

simplest solution would be region-wide pegs to the dollar, or even dollarization; McKinnon and Schnabl (2002), for example, conclude that East Asia is a "natural dollar zone". In addition, a larger currency area could reduce the required level of forex reserves, because offsetting shocks would reduce the need for a lender of last resort (Stockman, 2001). A single currency is also advocated as allowing the East Asian countries to speak with a single voice in international financial fora.[29] Despite these benefits and the long-attested finding that East Asia satisfies some of the OCA criteria at least as well as western Europe (Goto and Hamada, 1994), many obstacles to Asian monetary union remain.

Advocates of a common Asian currency have not addressed the institutional question of how the common exchange rate is determined (and hence how monetary policy is conducted for the entire currency area), who would determine when the lender of last resort acts, and who would speak with the single voice. Eichengreen (2004) lists four real preconditions for monetary union, in contrast to pseudo conditions such as numerical deficit ceilings or convergence criteria:

1. the capacity to delegate monetary policy to an international institution, which should be accountable, representative, efficient and effective.
2. a culture of monetary policy transparency,
3. open capital accounts,
4. a common transmission mechanism.

East Asia is far from achieving these preconditions. The 1997 crisis exposed the variation and weakness of financial systems, which would make realization of the last two preconditions difficult without substantial financial reform. Political cultures also need to change in many of the Asian countries, including some of the large ones, if the second condition is to obtain. Most distant of all is the prospect of agreeing on an international monetary policy institution; how would the huge variations in economic and demographic size be dealt with and, assuming that China and Japan would be likely to

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McKinnon (2004, 326) points out that by early 2004 "the day-to-day volatility of each country's dollar exchange rate is not significantly different fromits precrisis level".

[29] This point, which addresses the Japanese concern about its low voting weight in the IMF, has also been raised by Korean economists (Oh and Harvie, 2001, 261).

have the largest weight, what are the prospects for genuine trust and cooperation in the near future.[30]

Despite these weighty obstacles to monetary union in Asia, the fact remains that the regional integration agenda in East Asia was kick-started by the post-1997 currency union debate. Moreover, although bilateral trade negotiations have been flourishing in the first half of the present decade, in terms of integrating the broader regional economy they have been limited in terms of both geographical and sectoral coverage and have been bewildering in their bilateral rather than truly regional format.[31] Monetary agreements, the Chiang Mai Initiative in particular, have been more concrete and potentially far-reaching, and the urgency of pursuing regional initiatives towards monetary integration has been underlined since the turn of the century by a feeling that reform of the international financial architecture and the IMF, which was in the air after the 1997 Asian Crisis has now gone off the G8 radar screen (Wang 2004, 940). This juxtaposition raises the question of whether Asian economic integration could be led by monetary integration, with trade integration being pulled along later.

4. Does Monetary Union promote Trade?

There are no convincing empirical estimates of the benefits of currency union in reducing transactions costs. The Commission of the European Communities (1990) in measuring the "costs of non-Europe" estimated large benefits from completing the EU's internal market and from monetary union, but the exercise was clearly biased in the direction of finding such benefits in order to justify the policies. Krugman (1993) drew attention to the absence of serious consideration of the nature or magnitude of transactions costs in debates over the international financial system. Frankel and Rose (1998) analysed the two-way causality between economic integration and monetary union, and one aspect of that paper was addressed in greater depth by Rose (2000), who found that the impact of

[30] While the parallel to the role of former enemies France and Germany in playing a locomotive role in European integration may be facile, the continuing antipathy between China and Japan on many levels (highlighted by the riots at the 2004 Asian soccer championship finals when Japan defeated China in Beijing) suggests how different the Asian situation today is to that of Europe half a century ago.

[31] Scollay and Gilbert (2001) emphasised the tangled web nature of the new wave of bilaterals in Asia, and the pattern has if anything become more confused and less regionally integrated since they wrote.

monetary union on trade was much larger than the impact of fixed exchange rates, but the magnitudes of Rose's estimates have been challenged. Although this indicates movement towards investigating the nature and extent of the reduction in transaction costs, the literature is still at an early stage. Some authors have suggested that globalization and factors such as the growth of e-commerce have reduced the usefulness of minor currencies to their holders (von Furstenbeg, 2002; Costa Storti and de Grauwe, 2002),[32] but there has been no attempt to determine whether the transactions costs of small currency areas have been rising.

Frankel and Rose (1998) argue that a common currency promotes closer trade links and more synchronized cycles. This is not a theoretical result, because more bilateral trade could promote inter-industry specialization and less synchronized cycles, but a hypothesis to be tested empirically. Using various measures of bilateral trade intensity and cycle synchronization for twenty-one developed economies, Frankel and Rose find a robust relationship between the two variables. They interpret this finding as evidence that a common currency promotes bilateral trade and also increases cycle synchronization.[33]

The recent literature is driven by the work of Andrew Rose. Rose (2000), using a large dataset (33,903 bilateral trade observations for 186 countries in 1970, 1975, 1980, 1985 and 1990) and a gravity model with a currency union dummy, estimated that currency union has a large effect on bilateral trade.[34] This result was dramatic. Many economists expected the effect to be small because currency conversion costs are low and estimates of the effect of exchange rate volatility on trade are small (Alesina, Barro and Tenreyro, 2002, 18), but Rose estimated that, *ceteris paribus*, a common currency more than triples bilateral trade. Because Rose follows an admirable open-access policy with his data, the results could be replicated or challenged very quickly by other researchers.

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[32] Arnone and Bandiera (2004) argue that electronic money will increase the size of OCAs by undermining the efficacy of monetary policy, but conclude that the current level of e-money use does not pose such a threat.

[33] The context of Frankel and Rose's paper was to show why actual currency areas always seem to fit OCA criteria better than potential currency areas; in this view, the OCA criteria are endogenous.

[34] Rose's sample is smaller than it might appear; of his 33,903 bilateral trade observations, only 320 are classified as "within currency union" trade and most of these involve a tiny economy and a much larger neighbour.

In Rose (2000) the countries in currency unions are not from a random draw. Several authors (Persson, 2001; Kenen, 2001; Nitsch, 2004a) have shown that the currency union members are smaller and more open than their natural comparators, and that history (usually in the form of colonial background) matters. When the currency union members are matched with similar countries which are not in a currency union, the differential impact on trade is much smaller than when the currency union members are part of a global dataset. Rose and Engel (2002) also argue that members of currency unions are different, but their case is that currency unions are more integrated with one another than similar pairs of countries with independent currencies.

Alesina, Barro and Tenreyro (2002, Table 8) and Rose (2002) summarize the empirical studies in this recent literature. López-Córdova and Meissner (2003), in a study of trade in 1870-1910, find similar quantitative effects to those which Rose found for 1970-90; López-Córdova and Meissner conclude that "It is reasonable to assert that bilateral trade would be about 3.30 times larger when both countries belonged to a monetary union."[35] Rose and van Wincoop (2001) introduce country-specific trade resistance measures into their gravity model; the currency union effect on trade is smaller than in Rose (2000), but still substantial. In the nineteen studies covered by the meta-analysis in Rose (2002), the average effect of currency union is to more than double trade among the members, and this is robust to variations in sample composition and time period, whether fixed or random effects models are used, and to the exclusion of the six studies involving Rose himself. In their less formal analysis of fourteen studies, Alesina et al. reach essentially the same conclusion; the empirical results are heterogeneous, but the trade coefficient is usually statistically significant, and the median estimate of the trade effect is 100%.

In sum, the cross-section and panel gravity models find that a common currency stimulates trade. Although the magnitude of the common currency effect is still debated, the finding that it is large and statistically significant seems to be robust. The cross-section studies may, however, be failing to address the key policy issue: what happens to trade when countries adopt a common currency or when a currency union dissolves?

[35] Flandreau and Maurel (2001) and Estevadeordal, Frantz and Taylor (2003) also utilize nineteenth century data.

Analysing time series data for correlations between changing currency union status and bilateral trade flows, Glick and Rose (2002) estimate that dissolution of a currency union halves bilateral trade.[36] Currency union break-up is, however, usually associated with other events which disrupt trade. Over two-thirds of the sixty cases of post-1947 currency union dissolutions in the Glick-Rose dataset broke up within a decade of the end of a colonial relationship (Nitsch, 2003).[37] Even abstracting from non-monetary causes of trade disruption, the specific nature of a currency union dissolution and its accompanying monetary arrangements may be more important than a simple generalizable mechanism of currency union dissolution reducing trade. Schoor (2003) identifies a 15-20% decline in CIS trade as being due to the collapse of the ruble zone in 1992-3, but he ascribes this decline mainly to the need for bilateral balancing; if the ruble zone had been replaced by convertible national currencies, as in the Baltic countries, then there would have been no trade loss. In tranquil currency union changes, notably Ireland's secession from its currency union with the UK in 1979 and subsequent participation in the process leading to the euro, the impact on bilateral trade is unclear. Thom and Walsh (2002) find that breaking the currency union did not have an adverse impact on Ireland-UK trade, while Fitzsimmons, Hogan and Neary (1999) find that trade between Ulster and Ireland is greater than predicted by a standard gravity model despite the absence of a common currency after 1979.

The impact on bilateral trade of currency area dissolution and of currency area formation may not be symmetric. For the "East Asian sequence" the key issue is whether currency area formation boosts trade. The difficulty in providing an empirical answer to this question is that the sole example for over a century of large countries abandoning monetary independence in favour of a common currency is the euro. Other cases that have been studied involve unbalanced currency unions or small economies.

The trade effects of episodes of currency union formation other than the euro have been studied, but they are of limited relevance to any substantial East Asian currency union. Nitsch (2004b) reports his research on the Belgium–Luxembourg currency union,

[36] In an earlier time series analysis, Pakko and Wall (2001) found a negative but statistically insignificant trade effect, but their dataset was based on 1970-90, when there were few cases of currency union exit and entry. The dataset used by Glick and Rose goes back to 1948 and contains more cases of exit or entry.

[37] The end of the ruble zone, which is not in the dataset, would increase the percentage still further.

where he found no measurable change in bilateral trade after adoption of the common currency when other factors are taken into account. Nitsch (2004b) analyses the trade effects of currency union on the three countries which entered the CFA franc zone in the 1980s and 1990s; Mali suffered a big decline in trade with other CFA countries, Equatorial Guinea experienced a big increase in such trade, and Guinea-Bissau's trade was largely unchanged, although this may be partly due to the latter's more recent accession (1997, as opposed to 1984 for the other two countries). The net effect of adopting the CFA currency depends entirely on how the three cases are weighted.

The euro's trade impact can be estimated by fitting pre- and post-euro values to a model whose coefficients have been estimated independently. Rose and van Wincoop (2001), using coefficients from their gravity model with country-specific trade resistance measures, estimate that adoption of the euro will boost trade among the Euroland countries by 59%. Such an estimate is only as good as the underlying model, which, like any gravity model, may be confounding other determinants of bilateral trade flows in the currency union coefficient.[38]

Alternatively, the euro's impact can be estimated by comparing actual trade flows after currency union with counterfactual flows which would have occurred if national currencies still existed. Micco et al. (2003) find a moderate increase in intra-Euroland trade during the first four years of the common currency. Faruqee (2004) reaches a similar conclusion, with the euro raising intro-Euroland trade by around ten percent on most specifications, and most of the impact concentrated in 2001 and 2002. Such findings are suggestive, but like any such exercises depend upon the plausibility of the counterfactual. Moreover, given the short time period since the introduction of the euro, this result cannot yet be considered robust.

Maurel (2004) analyses the impact of European monetary integration on bilateral intra-European trade by applying a gravity-type model to a panel of 26 European countries' trade from 1990 to 2000. The dataset allows her to discriminate among EU members and non-members and among a variety of exchange rate regimes. Maurel's conclusion is that current account imbalances and their financing are a constraint on the

[38] Rose and van Wincoop observe that in a simpler gravity model the predicted increase in trade due to the euro is 250-400%. Their trade resistance measures pick up some of the non-currency-union determinants

volume of trade. Currency union is associated with reduction of capital market imperfections and reducing or removing the financing constraint, but the constraint could also be relaxed by fiscal coordination within other monetary settings. As case studies illustrating the argument, she points to the Baltic countries who actively used fiscal policy to address current account imbalances. This argument is similar to the analysis by Flandreau and Maurel (2001) of trade integration in nineteenth century Europe. It is also similar to the argument by Schoors (2003) that the dissolution of the ruble zone was associated with disruption of trade among countries whose balance of payments financing was impeded by the limited convertibility of their national currencies, but currency union dissolution did not disrupt trade of countries with convertible currencies (the Baltic case again). The implication is that currency union can promote trade integration by reducing the current account constraint, but there are alternative routes to the same destination.

5. Conclusions

In contrast to the European model of trade integration preceding monetary integration by several decades, is it plausible to consider the opposite sequence and is a money-before-trade sequence applicable to East Asian regional integration?

One negative lesson from the recent history of monetary union and disunion in Europe is that the optimum currency area literature provides little practical guide to the prospects for monetary union. The OCA literature assumes a background of optimum monetary policy. The eastern European and former Soviet Union experience indicated that a currency union without appropriate monetary policy instruments is a far worse evil than the higher transactions costs from independent currencies, even when the independent currency covers a small national economy. Western European monetary union also stalled on the monetary policy hurdle in the 1970s and only overcame the hurdle when, in the 1990s most, but not all, of the EU members accepted the loss of sovereignty inherent in a common central bank.

Monetary union also tends to imbed some degree of fiscal policy cooperation. Kenen (1969) argued that in federal states such as the USA or Canada regional

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of trade, but may not be picking it all up (or may be picking up too much).

idiosyncratic shocks generate automatic and prompt redistribution via fiscal rules, and other federal systems all embody some degree of fiscal insurance.[39] In the EU the problems of operating common fiscal policies when members' contributions and benefits fluctuated with volatile bilateral exchange rate changes were a critical reason for maintaining the momentum for monetary union in 1977-8 and later, when member states appeared to be abandoning the project due to the costs of lost monetary independence.

The close nexus between currency union and both monetary policy and fiscal policy highlights the distance that East Asia has to go before an Asian currency union is seriously on the political agenda. Monetary policy has to be ceded to a single central bank (or equivalently to a rigid rule such as the principle of the Gold Standard embodied). Moreover some degree of fiscal insurance may be necessary to convince all countries of the benefits. Yet, in East Asia the political will to give up national autonomy over macro policies is far away. The situation where an Asian supranational authority would operate a budget on a par with that of the European Commission seems even more distant. On the other hand, many scoffed at the prospects for EMU in the 1970s (and some still failed to recognize its likelihood right up until the introduction of the euro).

Supposing that East Asia did adopt a common currency, would it have the effect of strengthening regional economic ties? The literature inspired by Andrew Rose suggests that this is possible given the large impact of a common currency on bilateral trade flows. On the other hand, doubts linger as to whether the gravity model analysis identifies the effects of forming a currency union or picks up other effects in the currency union dummy. If the key constraint on trade is the current account balance, then monetary union could promote regional trade, but other measures to reduce capital market imperfections which hamper current account, such as creation of Asian bond markets, could play the same role.[40] The case study literature on the trade effects of currency union formation literature provides little empirical evidence either way and is too sparse to be conclusive, mainly because there have been so few cases of currency

[39] Eichengreen (2004), however, rejects this as a "pseudo precondition" for monetary union, by which he seems to mean that it is helpful but not strictly necessary.

[40] This may be an argument for greater integration by Asian countries into global financial markets, centred in the USA and Europe, rather than for regional financial market development. Proponents of the Asian Bond Initiative, however, argue that there is regional bias as well as home bias in financial markets (Wang, 2004, 947), but there is little empirical evidence on this

union among large countries in the last century and the prime example, the euro, was too long in preparation[41] and too recent in implementation to provide readily portable conclusions.

[41] The adoption of the euro was preceded by a lengthy transition period during the existence of the European Monetary System which began in 1979 and especially after the Maastricht agreement of the early 1990s. The introduction of the single currency officially occurred on 1st January 1999, but for many people only became tangible with the appearance of euro notes and coins on 1st. January 2002.

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