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Economic integration and prospects for regional monetary cooperation in East Asia

Nathalie Aminian*

Faculte des Affaires Internationales, University of Le Havre, 25 rue Philippe Lebon, BP 420, Le Havre Cedex 76057, France

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Abstract

The recent Asian currency crisis and the launch of the euro have stirred much interest in regional monetary cooperation in East Asia. This paper discusses the rationale and chances for such cooperation. It is argued that, although regional incentives are not strong enough and the political prerequisites for monetary unification are not yet given, almost all economic indicators suggest that East Asian countries are ready for cooperation on economic grounds. Various proposals and institutional initiatives are examined and shown to be either insufficient to cope with currency crises or too limited in their objectives.

JEL classification: F33; F36; F41; F42

Keywords: Monetary integration; Optimum currency area; Asia

1. Introduction

In contrast to developments in other world regions, efforts to institutionalize regional economic and monetary cooperation in East Asia have been weak until recently. However, the Asian currency crisis of 1997 hit most of the economies in the region with strong shocks to their trade, capital inflows and incomes. Despite rapid recovery in some (but not all) of the affected countries, the crisis may have long-lasting negative effects on economic development in the region. That is one of the reasons why East Asian countries have shown

* Tel.: +33-232-7441-01; fax: +33-232-7441-33.
E-mail address: nathalie.aiminian@univ-lehavre.fr (N. Aminian).

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growing interest in economic and monetary cooperation. The question is what kind of exchange rate regime could provide the stability to support trade and investment. And which form of regional cooperation is required to promote economic growth in the long run?

The purpose of this paper is to discuss the rationale and chances for closer monetary cooperation in East Asia and to consider different options for the corresponding institutional arrangements. In most of the following, the region in question includes Japan, China, the Asian NIEs and the Association of South East Asian Nations 4. The term newly industrialized economies (NIEs) refers to Korea, Taiwan, Singapore and Hong Kong, whereas ASEAN 4 refers to Thailand, Malaysia, the Philippines and Indonesia. With respect to trade integration Brunei, Cambodia, Laos, Myanmar and Vietnam will also be considered.

The paper is organized as follows: Section 2 explains why there has been a growing demand for coordinated monetary and collective exchange rate policy in East Asia. Section 3 provides a brief overview of the theoretical literature on appropriate exchange rate regimes for emerging market economies. The focus is on intermediate regimes and the regional monetary cooperation. Section 4 discusses the major characteristics of East Asian countries with regard to their respective incentives for monetary cooperation and their readiness in terms of trade integration. Section 5 examines whether the East Asian countries qualify as an Optimum Currency Area. Section 6 investigates different paths towards closer monetary cooperation in the region and discusses their economic and political feasibility. Section 7 concludes.

2. Growing interest in regional monetary cooperation

The precise causes of the Asian crisis of 1997–1998 are still being actively discussed. A range of factors contributed to the region's vulnerability:[1]

- the peg to the US dollar rather than a more balanced basket reflecting the region's full trade partners provoked a steep loss of competitiveness *vis-à-vis* Japan, and raised doubts on the sustainability of the current account in the long run;
- financial liberalization that was introduced without an adequate prudential regulation created financial fragility, which sharply limited the scope for tight monetary policy;
- both corporate and financial sectors combined substantial short-term currency liabilities (mostly in US dollars).

While no consensus has yet emerged, various recent studies (Bénassy-Quéré, 1997, Kwan, 1998a, Sazanami and Yoshimura, 1999) tend to view the *de facto* pegged exchange rate systems of the region as a contributing—though not an initiating—factor. Before the crisis, most of the emerging economies in East Asia pegged their currencies gradually, but without coordination, to the US dollar, by overwhelmingly high weights to the US dollar in determining the nominal value of their currencies. The benefits of such fixed but adjustable exchange rate policy was to provide macro-economic discipline by maintaining prices of tradable goods in line with foreign prices (Edward and Savastano, 1999). This exchange rate policy contributed to the relative stability of the real exchange rate in East Asian countries

[1] See Werner (2000) for the case of Thailand.