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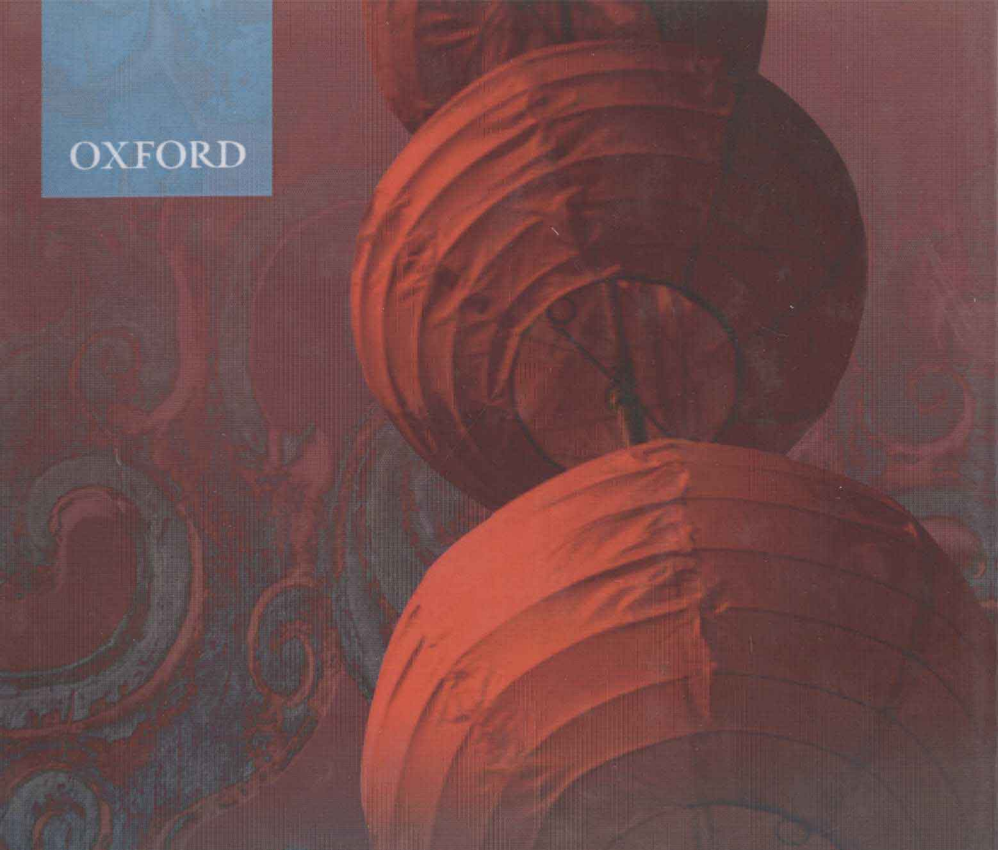

MONETARY & FINANCIAL INTEGRATION IN EAST ASIA

THE RELEVANCE OF EUROPEAN EXPERIENCE

YUNG CHUL PARK & CHARLES WYPLOSZ

Monetary and Financial Integration in East Asia

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Monetary and Financial Integration in East Asia

Preface

This book is the outcome of many years of discussions and joint work. Both of us have long been closely following, and in different ways involved in, economic policy cooperation efforts in our respective regions. We soon realized that we share a common understanding of how macroeconomies function—partly through things that we learnt from the late Rudi Dornbusch—and that we both strongly feel that regional cooperation can make a very positive contribution to our respective countries. We also both have a tendency to speak openly on what we perceive as policy mistakes or policymakers' shortcomings. It was therefore unsurprising that we should learn from each other about regional integration and that we should embark on joint work on this topic. A few years later, a more ambitious project was in order.

The opportunity came from the European Commission. Every year, finance ministers and other officials from Asia and Europe meet to discuss issues of common interest. As it prepared for the 2008 ASEM (Asia–Europe Meeting) to be held on Jeju Island in Korea, the European Commission wanted a report on what light Europe's experience might throw upon Asian financial integration and cooperation. That was our topic, and the Commission's initiative presented us with the ideal occasion to work together. This book is a revised and updated version of the report that was presented to the finance ministers in June 2008.

Our idea was to look at Asia's integration from both an Asian and a European perspective. In many ways, East Asia is travelling down the same road that Western Europe went through a few decades earlier. Western Europe started its economic integration process in the immediate aftermath of the Second World War, while, in East Asia, cooperative efforts really took off after the 1997–8 crisis. Although half a century and thousands of kilometers apart, the debates have often been strikingly similar, involving economic, political, and historical considerations, as they should. Not coincidentally, misguided solutions have been similar too. But "similarity" means that there are also differences. The differences concern the economic situation, national and regional politics, and the historical baggage. For these reasons we do not think that European recipes can be applied to East Asia. Yet there are lessons to be learned; at least previous mistakes can be avoided. This is why we try to identify the similarities and the differences, to analyze the policies and projects, to warn against pitfalls, and to suggest solutions.

This book differs from our report to the European Commission in three ways.[1] First, we went through the whole text one more time and, as always, we saw many tiny improvements that could be made. Second, we completed this review one year after the report was finalized. In between, East Asian leaders have taken some decisions that we report on and evaluate. And, finally, in the meantime, we all went through the great global crisis. This historical event has taught us many important lessons, and it will gradually change the landscape. We share some of our conclusions at various places in the text, but we have also added a brief postscript that is entirely devoted to what we learnt from the global crisis.

In working on this project we have benefited from in-depth discussions with Antonio de Lecea, Moreno Bertoldi, and Caroline Gaye at the European Commission Directorate General for Economic and Monetary Affairs. We are grateful to them for providing very useful comments of various drafts of the report. We also benefited from detailed and challenging remarks from Lucas Papademos. Simone Meier provided efficient research assistance. We are also indebted to the European Commission for making it possible to turn the report into a book. We are also grateful to Oxford University Press for having supported our project, in particular to our publisher Sarah Caro, who once again has provided support and encouragement, and to Aimee Wright, who patiently prodded us to complete the manuscript "not too late."

Y.C.P. and C.W.

Seoul and Geneva
November 2009

[1] Yung Chul Park and Charles Wyplosz, "Monetary and Financial Integration in East Asia: The Relevance of European Experience." Economic Papers 329, *European Economy*, European Commission, Brussels, June 2008.

List of Abbreviations

ABF	Asian Bond Fund
ABMI	Asian Bond Market Initiative
ACU	Asian currency unit
ADB	Asian Development Bank
AFDM+3	ASEAN+3 Finance and Central Bank Deputies' Meeting
AFMM+3	ASEAN+3 Finance Ministers' Meeting
AMF	Asian Monetary Fund
AMU	Asian monetary unit
ASA	ASEAN swap arrangement
ASEAN	Association of Southeast Asian Nations
ASEM	Asia–Europe Meeting
BIS	Bank for International Settlements
BSA	bilateral (currency) swap arrangement
CESR	Committee of European Securities Regulators of the EU
CGER	Consultative Group on Exchange Rate Issues of the IMF
CGIM	Credit Guarantee and Investment Mechanism
CJK	China, Japan, Korea
CMI	Chiang Mai Initiative
CMIM	Chiang Mai Initiative Multilateralization
CPIS	Coordinated Portfolio Investment Survey
EA	East Asia
ECB	European Central Bank
Ecofin	Economic and Financial Affairs Council of the EU
ECU	European currency unit
EFC	Economic and Financial Committee of the EU

EIB	European Investment Bank
EM	emerging market
EMCF	European Monetary Cooperation Fund
EMEAP	Executive Meetings of East Asian and Pacific Central Banks
EMS	European Monetary System
EMU	European Monetary Union
EPC	Economic Policy Committee of the EU
ERM	Exchange Rate Mechanism
ERPD	Economic Review and Policy Dialogue
ESC	European Securities Committee of the EU
ETWG	Technical Working Group on Economic and Financial Monitoring of ASEAN+3
EU	European Union
FCL	Flexible Credit Line (arrangement of the IMF)
FDI	foreign direct investment
FoBF	Fund of Bond Funds
FSAP	Financial Services Action Plan
FTA	free trade agreement
GDP	gross domestic product
GGF	Greenspan–Guidotti–Fischer
GOE	Group of Experts of ASEAN+3
IMF	International Monetary Fund
LIBOR	London inter-bank offered rate
MTN	medium-term note
NAFTA	North American Free Trade Agreement
NDI	Nominal Deviation Indicator
NIE	newly industrialized economy
OCA	optimum currency area
OECD	Organization for Economic Cooperation and Development
PAIF	Pan-Asian Bond Index Fund
PPP	purchasing power parity

R&D	research and development
RCU	regional currency unit
RIETI	Research Institute of Economy, Trade, and Industry, Japan
RMB	renminbi
RSI	Regional Settlement Intermediary
SCO	Shanghai Cooperation Organization
SDR	Special Drawing Rights (IMF units of account)
SRPA	Self-Managed Reserve Pooling Arrangement
STMF	Short-Term Monetary Facilities
TFP	total factor productivity
UNCTAD	United Nations Conference on Trade and Development
US Fed	US Federal Reserve
VAR	Vector autoregression

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East Asia's Response to the 1997 Crisis

Economic Reforms, Growth, and Integration in East Asia

1 Introduction

For most of East Asia there is a before and there is an after. The 1997 crisis has not just been profound, it has left a long-lasting imprint, both in terms of economic performance and in the way the countries of the region relate to the rest of the world. As Figure 1 shows, the four crisis-affected countries of the region have not recovered their growth performance of the three previous decades. There is much debate about whether this disappointing outcome is still a delayed effect of the crisis. It has been widely noted that the relative underperformance of the 2000s is associated with lower investment rates. Kramer (2006), among others, argues that lower investment after the crisis reflects the overinvestment that characterized the pre-crisis period, and partly caused the crisis. Others, including Park and Lee (2004), note that several East Asian countries were nearing the technology frontier so that the catch-up growth performance could not have been sustained anyway. This view, which implies that lower investment is a consequence, not a cause, of the growth slowdown is shared by the Asian Development Bank (2007).

None of these arguments is fully convincing. Pre-crisis overinvestment could have been a problem for quite a while, but much of the excess capital must have depreciated ten years later. As for the end of the catch-up phase, it is undeniable that slower growth had to occur, but the precise conjunction with the crisis is surprising, especially

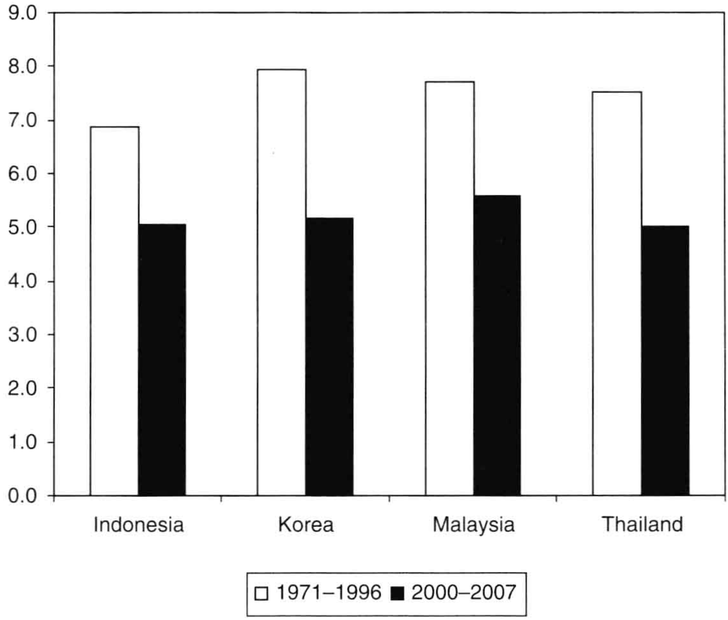

Fig. 1 Real GDP growth rates (%)

Source: *International Financial Statistics*, IMF.

since the four countries displayed in Figure 1 are not at the same distance from the technology frontier.

This apparent break in trend growth is reminiscent of what happened in Europe after the oil shock of the early 1970s. Then, too, most European countries were nearing the end of the post-war catch-up phase when the first oil shock occurred. Growth declined and never recovered. Considerable research has been devoted to this coincidence. The consensus, as presented in Blanchard (2005), for example, indicates that relatively minor pre-existing distortions, which mattered little at a time of rapid growth and low unemployment, started to take their toll when the situation worsened. In retrospect, Europe should then have taken the road to financial and labor market reform and removing industry regulations. Instead policy attempts to limit unemployment became the source of additional distortions that transformed temporary shocks into a permanent decline in growth. Is this what is also happening in East Asia?

A definitive answer is not available, and is unlikely to be available any time soon. According to Ghosh (2006), most of the emerging East Asian countries, including the four crisis-affected economies, have made great strides in pursuing Washington consensus based reforms: restructuring the financial and public sectors, reforming governance institutions, and deregulating and opening markets, including financial ones. But, then, the disappointing growth performance of the early 2000s would suggest that these reforms have not had the hoped for effect. It could be that some of the pre-existing distortions still remain; in that case, wider overall reforms would still be required and the challenge would be not just to reduce distortions, but to avoid introducing new ones. Yet, even a decade after the crisis, it may still be too early to conclude that growth has permanently declined. Despite the slowdown over the last several years preceding the great global recession of 2008–9, East Asia is again the fastest-growing region in the world.

It is too early to tell whether this growth resurgence is permanent, whether it is the delayed effect of past reforms, or whether it is driven by the Chinese locomotive. We do not attempt to answer directly the question of whether reforms have been effective. Instead, we review the situation before the 1997 crisis and the measures taken after the crisis, comparing these changes to the reform process in Europe during a similar high-growth period of the 1960s and early 1970s.

2 Pre-Crisis Distortions

Most of the analyses of economic distortions in East Asia have focused on potential explanations of the crisis, but much less is known about distortions that matter for growth and employment. Yet distortions used to abound, ranging from government-controlled "market" interest rates and public interventions in asset management at financial institutions to under-developed market supporting infrastructure. The lack of professional expertise in securities business, the inadequacy of the financial and legal infrastructure (including the regulatory system), low standards of auditing and accounting, and the weakness of corporate governance may all have slowed the development of domestic capital markets in the region.

2.1 Financial Distortions

A short summary of the situation of East Asian financial markets before the crisis inevitably ignores important differences among countries. Yet, some features were in common.

The first feature is the dominant role of banks in providing corporate finance.[1] This feature makes East Asia more similar to continental Europe than to the US or the UK, where market finance has long taken over the main role. This situation does not have to be a distortion if banks adequately perform their financing role. But banks were often state-owned or under close government control, with the result that lending operations were directed and ended up allocating a large share of loanable funds to state-sponsored, export-oriented firms or to other firms identified as "potential exporters." This meant that there was no guarantee that savings were channeled via banks to their most productive use.

This bears some resemblance with the industrial policies adopted in post-war Europe. Many countries instructed state-owned banks to favor lending to firms or sectors identified as "strategic." A central objective of Europe's Single Act, which came into effect in 1992, was precisely to bring preferential lending to an end. Even today, the European Commission must closely monitor the situation. Not infrequently, the Commission must step in to prevent explicit or implicit subsidies—not necessarily through preferential loans any more, though—to corporations deemed special or strategic.

It should be noted, however, that the argument put forward in the Single Act emphasizes fair competition in the Single Market rather than the more theoretical—and sometimes controversial—view that growth is enhanced when savings are channeled to their most productive use. Lacking any agreement such as the Single Act, East Asian countries cannot therefore monitor each other. This means that reforms to free financial markets must be conducted at the national level, without serious collective pressure, and on the basis of the argument that markets do a better job than governments at channeling savings

[1] There is no commonly accepted measure of bank or market dominance of a financial system. When measured in terms of the share of bank assets in the financial system, banks play a dominant role in East Asia (see Ghosh 2006: 2, table 1.1). Demirgüç-Kunt and Levine (2001), however, argue that this characterization may not be valid. Their assessment shows that, except for Indonesia and Japan, all other emerging economies in East Asia had developed a market-based system prior to the 1997 crisis.

to their most productive use, an argument as controversial in East Asia as it was, and sometimes remains, in Europe.[2]

2.2 Domestic Industrial Policies and Resource Allocation

While the dirigiste strategy may have been successful in both East Asia and Europe at the beginning of the catch-up phase when rapid capital accumulation delivers quick results, it becomes increasingly less efficient when firms climb the quality ladder. At that stage, indeed, access to financial resources to install modern equipment embodying state-of the-art technologies is less crucial than developing smart strategies and carrying out sophisticated R&D; the government can provide the former but is unlikely to pick winning strategies. Worse, large firms tend to develop links to political power, which they tend to use to compensate for weak economic performance. A number of authors have documented excessive capital accumulation in many Asian countries, at the expense of total factor productivity (TFP) growth (Young 1992, 1995; Lau and Kim 1994), but Yoshitomi (2003) shows that, before the crisis, East Asian TFP growth in manufacturing was comparable to that of advanced economies. Studies of Europe's fast growth in the post-war period have not suggested excessive capital accumulation but typically identify capital accumulation as a key success factor, although industrial policy is sometimes identified as having had a negative effect.[3]

The towering position of East Asian banks under government control created moral hazard and worked as an encouragement to undue risk taking by these institutions. One symptom was serious maturity and currency mismatches in their balance sheets as they were engaged in long-term financing and also served as the main conduit for foreign currency financing. Another implication was poor banking regulation and supervision, which resulted in an inefficient regulatory system and poorly trained regulators and supervisors. Yet another implication was the relative shallowness and illiquidity of bond and stock markets, along with poor regulation. Here again, similarities with Europe in the 1960s and even the 1970s abound. The difference is that Europe

[2] Important examples of state-owned banks whose mission is to support "important" industries or firms are the French Caisse des Dépôts et Consignations and the German Landesbanken.

[3] See the collection of studies in Crafts and Toniolo (1996). Sicsic and Wyplosz (1996) report evidence that government interference has led to capital accumulation in industries with comparatively low profitability.