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MONETARY INTEGRATION IN EAST ASIA: WHY DOES IT TAKE SO LONG?

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Abstract

The launch of the economic and monetary union in Europe and the 1997 financial crisis that underscored the disadvantages of currently employed exchange rate regimes raised questions about the feasibility of a similar monetary unification project for East Asia. Being one of the most dynamically growing regions in the world, East Asia has the potential for a successful implementation of a monetary union. The paper examines why, despite substantial political emphasis being placed on the issue of monetary integration, the progress to date has been slower than could be expected. The major finding is that, although East Asia may actually benefit from establishing its monetary union in the long run, a specific political culture that prevails in the region and misconceptions about the sequencing of the process prevent the East Asian monetary union from materialising. Possible short and mid-term policy solutions follow.

Keywords: Monetary union, East Asia, Sequencing monetary reforms, Monetary unification
JEL Classifications: E42, E52

1. Introduction

East Asia, one of the most dynamically growing regions in the world, has long been thought to be a potential candidate for a regional monetary union. Amid the successful launch of the European monetary union, the debate on the issue of regional monetary integration (or at least close monetary cooperation) in East Asia heated up in the aftermath of the financial crisis that hit the region a decade ago in July 1997.[1]

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1 For instance Williamson (2000), Berben et al. (2002), Kawai and Takagi (2002), Ogawa (2002), Kawai and Motonishi (2004), Ogawa and Kawasaki (2006), Ito and Park (2004), Zhang et al. (2004), Ogawa and Ito (2002), Kwack (2004), Chan-Lee (2005), Kim (2004) and others.

The crisis underscored the danger of running fixed exchange rates (or managed exchange rates), with independent monetary policy and open capital accounts, and resulted in a growing awareness of the importance of regional monetary cooperation in East Asia. There is now a strong perception that, had an effective regional monetary cooperative institutional framework been implemented, the crisis itself might have been prevented or at least mitigated and that the benefits of the intra-regional cooperation could not be fully accrued without a well-established monetary cooperative framework. Accordingly, a group of East Asian countries[2] engaged in a series of appropriate initiatives that aimed at enhancing the region's monetary cooperation.

Yet in spite of high priority given to the issue of monetary unification at least during high-level meetings of regional bodies, East Asia's progress towards its common currency seems to be falling short of expectations. Furthermore, there is evidence showing that, after the immediate post-crisis initial switching to floating rates, the East Asian countries have gradually returned to the *de facto* dollar peg.[3]

Looking for answers about the reasons for slower than expected progress towards monetary unification in East Asia, this paper examines three possible explanations. First, East Asia may really not need the monetary union after all. Second, there may be the lack of political will to implement the agreed policies. Third, East Asia may be following its original path to monetary unification that need not necessarily be identical to the approaches adopted in Europe or in the Persian Gulf area. The rest of the paper is organized as follows. The second section presents arguments in favour and against alternative exchange rate regimes for East Asia. Next, the following section questions the desirability of the region's monetary union using a basic optimum currency area framework. The main political initiatives towards the monetary union in East Asia are presented in the fourth section. Section five argues that, it is mainly Asia's original path to monetary unification that is to blame for the slower than expected progress. Finally, the concluding section, after having answered the paper's main question, provides a set of necessary, in this author's opinion, steps that may lead to achieving monetary unification in the region.

2. Alternative Exchange Rate Regimes for East Asia

The debate whether the exchange rate should be fixed or flexible has remained unresolved ever since Milton Friedman began championing the cause for exchange rate flexibility. Advocates of both corner solutions can be found on either end of the economic theory spectrum. A Keynesian economist would argue for instance that a flexible exchange rate could absorb external and internal shocks without affecting domestic price and wage levels, while his support for

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[2] For the needs of this paper, I refer to the ten ASEAN countries together with China, Japan and (the Republic of) Korea (known as ASEAN+3) and Hong Kong and Taiwan as East Asia.

[3] For instance Fukuda (2006), Ogawa (2002), Ogawa and Kawasaki (2006).

a fixed exchange rate regime would be based on the belief that it provides a necessary protection from speculative attacks (that result from imperfect foreign exchange markets): the later being a defence for his devising and supporting the Bretton Woods. On the other hand, a market economy believer would argue that flexible exchange rates are a necessary condition for retaining independence of domestic monetary policies under free capital movement (that is indispensable for efficient functioning of a market). Yet fixed exchange rates could, in his reasoning, provide a nominal anchor necessary for stabilising flexible domestic prices and wages. The debate is far from being resolved and in practice a wide range of intermediate regimes has been in place.

The Asian currency crisis constitutes a milestone in the debate on the optimal exchange rate regimes for East Asia. Most of the region had adopted a *de facto* dollar peg before the 1997 crisis (despite official claim of managed float or basket peg). Undoubtedly, the fixed exchange rates helped to encourage capital inflows that contributed to the excellent performance of East Asian economies before 1997. Yet even then the vulnerabilities of the system were quite obvious; the high interest rates necessary for stabilising rapidly growing economies were encouraging more portfolio investment that in turn contributed to the overheating in the region (the impossibility to maintain fixed a exchange rate, capital mobility and independent monetary policy at the same time). After 1997, while leaving the debate on two corner solutions still largely unresolved, the focus of the debate here has shifted to costs and benefits of three alternative exchange rate regimes, a return to the dollar peg, a currency basket regime and a monetary union for East Asia.

Aside from the return to the *de facto* dollar peg after the crisis, some analysts have argued in favour of explicit adoption of a dollar peg (Hong Kong chose to do so ahead of the uncharted days post-merger with China).[4] For reasons ranging from transaction costs, direction of trade flows to historical conditions at least some countries of East Asia could be considered as a part of a "greater dollar zone" (with Canada, Mexico and parts of Latin America being a "natural dollar zone"). As Fukuda (2006) convincingly shows, for reasons of history and expectation, invoicing in dollars dominated in Thai (85.7 percent in 2001, down from 92.0 percent in 1997) and Korean (87.43 percent in 2001 down from 89.21 percent in 1997) transactions in spite of the fact that their trade with the United States amounted to only 20.3 and 20.9 percent respectively (against 49 percent of East Asia share in Thailand and 44.3 percent share of East Asia in Korea's trade). History, lower transaction costs, and a nominal anchor for stabilisation policies constitute the main arguments in favour of a dollar peg. On the other hand, the arguments on the loss of independent monetary policy and the possibility of asymmetric shocks still hold (Table 1).

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[4] For instance McKinnon (2004) or Barro (2004).

Table 1: The Dollar Peg in East Asia

Benefits	Costs
An efficient medium of exchange (lower transaction costs)	If a country does not satisfy the OCA criteria, the economy would suffer from asymmetric shocks
A nominal anchor (low inflation)	
It can be carried out unilaterally by a small economy. Regional cooperation is possible if all economies peg to the US dollar	
Currency attack would be weaker and contagion would be contained	The entire region becomes dependent on the third party (FRB) monetary policy decisions
If Japan joined (China is in) the entire region would be unified optimally	

Source: From Loosely based on Wyplosz (2002) and Ito and Park (2004).

Although being the second best solution, the *de facto* dollar peg has returned in practice as the first choice of an exchange rate regime in East Asia. But much more attention has been paid to a currency basket peg and to a currency union as optimal forms of monetary unification in the region. Many academicians would prefer the former while the policy makers in the regions apparently favour the latter one. One of main arguments in favour of a basket regime is its ability to stabilise real effective exchange rates (as such a basket would contain currencies of major trading partners). Regarding quite high trade weight with Japan and the European Union, the argument that a basket, apart from dollar, containing the euro and Japanese yen could mitigate the 1997 crisis looks fairly plausible. Another argument in favour of a currency basket peg is its moderating influence on capital flows. Comparing to a single currency peg, a basket peg contains a higher exchange rate risk and therefore has a depressing influence on capital flows. A basket peg provides an economy with some stabilising anchor (compared to a flexible exchange rate) and with more flexibility than would happen under a fixed exchange rate regime.[5]

There are, however, also some difficulties associated with a currency basket peg. First, complicated basket calculations would certainly result in a loss of transparency. Given difficulties in immediate evaluating the actions the monetary authorities undertake, the credibility of the basket peg may be adversely affected. Needless to say, interventions within the currency basket

[5] While the idea of the currency basket for East Asia that comprises three major world currencies has been promoted mainly in Japan, it does not seem to have been given a lot of consideration in other countries of the region. Instead, an alternative of a basket that would be composed of regional currencies has been suggested. I am grateful to Woosik Moon of Seoul National University for pointing this issue in an earlier version of the paper.

regime may be technically much more complex than those that take place under a single currency peg. Second, since each country's optimal basket is different, adopting a currency basket peg may result in difficulties in policy coordination in the region.[6] Table 2 summarises the main costs and benefits of a currency basket regime.

Table 2: A Currency Basket Regime

Benefits	Costs
Fewer fluctuations in trade balance	No currency crisis prevention
Moderate capital flows	Loss of transparency (due to complicated basket calculations)
Some flexibility in managing external shocks	Loss of flexibility (compared to a free float)
Gives some anchor to prevent misalignment (compared to a free float)	Loss of nominal anchor (compared to a fixed exchange rate), hence higher risk premium
Allows for joint appreciation and depreciation in the region	Policy coordination problems

Source: From Loosely based on Wyplosz (2002), Ito and Park (2004), and Ogawa et al. (2004).

The successful launch of the economic and monetary union in Europe has provided an additional argument for those who support a similar project in East Asia. Some, especially those involved in policy making, seem to take for granted that East Asia will have its own version of a common currency introduced in the (relatively) near future.[7] The advantages and drawbacks of a monetary union are relatively well known (Table 3). A monetary union arrangement provides exchange rate stability necessary for promotion of trade and investment within the region while, at the same time, avoiding dependency on a third party monetary policy (one of the drawbacks of the dollar peg). Here the monetary policy would be conducted by an independent (regional) central bank. A monetary union also provides a firm anchor both in a monetary and institutional sense (peer pressure for meeting policy coordination goals if a framework such as the Europe's Growth and Stability Pact has been established).

One can also expect that, once in place, a monetary union may deepen the economic correlation within the region. The loss of an independent monetary policy for each member country has been the most pronounced cost of the monetary union. However, long before the debate on currency union emerged, the proponents of currency board arrangement had argued that the loss of an independent monetary policy measures associated with establishing a currency board was actually overstated. It happens because the growing interdependence of the world economy does not allow for a completely independent monetary

[6] Ogawa and Ito (2002) show that the probability of a sub-optimal outcome is not negligible under such circumstances.

[7] For instance Chino (2004) or Asahi Shinbun (2005).

policy and, in addition, even the independence of a monetary policy does not warrant its optimality.[8] Moreover, as Wyplosz (2002) argues, there is a possibility that a common monetary policy performed by a regional central bank may not vary significantly from each member country's optimal monetary policy. Needless to say, in order to implement a monetary union successfully, the region needs to meet the optimum currency area criteria.

Table 3: A Monetary Union

Benefits	Costs
Exchange rate stability (trade and investment promotion) A (regional) central bank independence	Loss of independent monetary policy
Peer pressure for macroeconomic policy coordination	Asymmetric shocks may cause problems without sufficient capital mobility and fiscal transfers

Source: From loosely based on Wyplosz (2002), and Ito and Park (2004).

Most of research done on the issue of monetary integration in East Asia seems to be quite in favour of establishing a monetary union in the region. Even critical papers (Chan-Lee, 2005 or Kim, 2004) predict that a monetary unification of some sort will eventually emerge in the region over a longer time horizon. Yet in spite of the favourable comments and various political initiatives, the monetary integration in East Asia still seems to be decades away. The following sections will attempt to search for reasons behind the slower than expected progress.

3. Is a Monetary Union Desirable for East Asia?

The benefits of monetary union outweigh its costs when the union's partners are trading intensively with each other, when their economies business cycles are correlated and they suffer from symmetric shocks, when there is high degree of policy coordination in place, production factors mobility between member states is high, financial markets well developed and so on. In other words, when the entire region constitutes an optimum currency area (OCA). This section attempts to address briefly this issue.

Most empirical evidence seems to suggest that the region does indeed satisfy the OCA conditions, more or less. Trade openness indices for East Asian economies (defined as a share of total trade in a country's GDP) show that, with the notable exceptions of Myanmar and Japan, the economies of the region are as open as the EU-15 and more open than the EU economies were in 1990 (before the Maastricht Treaty, Table 4).

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8 For instance Hanke and Schuler (1993).

East Asian economies do similarly well on account of the intra-regional trade. For instance Kawai and Motonishi (2005) as well as Yano and Van Anh (2006) show that the intra-regional trade in East Asia has already reached the level comparable to the pre-Maastricht European Union (Fig.1). The caveat is that the ASEAN economies do not trade much between themselves; in 2003 only 24 percent of their trade was reaching other ASEAN countries. The same applies to the Asian New Industrialised Economies (NIEs; Hong Kong, Korea, Singapore and Taiwan); only 16,1 percent of their trade was directed to the region in 2003. But the trade between the ASEAN, the NIEs and China already accounted for 44.1 percent of their total trade in 2003. When the trade with Japan is included the intra-regional trade amounts to 54 percent of the region's total trade. Figure 1 (based on Kawai and Motonishi, 2005) shows that this is more than the intra-regional trade within NAFTA and it is comparable to the intensity of the intra-regional trade in the European Union in 1990 (before the Maastricht Treaty).

Even more support on the OCA criteria comes from the estimated correlations of real sector macroeconomic variables (real GDP, real personal consumption, and real gross fixed capital formation) as well as financial variables (real money supply, real stock price, and real effective exchange rates) and price variables (GDP deflator, consumer price index, and wholesale price index). Kawai and Motonishi (2005) estimations for the period 1983-2000 as well as Yano and Van Anh (2006) results for 1980-2002, show that East Asian economies do on this account no worse than European countries. A similar conclusion emerges from estimations of demand and supply shock correlations for East Asia, EU-15 and NAFTA. The results[9] show a similar level of correlation for all groups of countries. Given the specific character of the criteria in question (i.e. once a monetary union has been formed, economic integration will deepen and the degree of asymmetry of shocks will decline) the results support the plausibility of an East Asian monetary union.

Some problems arise when the labour mobility criterion is tested. Although limited availability of data constitutes a serious difficulty, Yano and Van Anh (2006) conclude that the labour mobility in the region is rather low. For major economies (Japan, Korea, Taiwan, and Thailand), the approximate stock of migrant workers in 2000 did not exceed 1-2 percent of the labour force in spite of enormous income disparities between labour exporting and labour importing countries (PPP adjusted income per capita in Japan, Singapore, and Hong Kong is 8-9 times higher than that in Indonesia or Philippines). Only Hong Kong (5-7 percent), Malaysia (10-15 percent), and Singapore (25-27 percent) have shares of migrant workers higher than average. In the presence of high capital mobility (except for Malaysia and China) one may argue that, similarly to Europe, labour mobility has largely been replaced with trade and capital flows.

The quality of institutional framework constitutes another serious difficulty for East Asia as shown in Chan-Lee (2005). In spite of a relatively high level of capital account openness, the quality of the financial sector prevents capital flows

[9] Kawai and Motonishi (2005), Kwack (2004), Yano and Van Anh (2006) and Zhang et al. (2004)

from being efficiently utilised. Table 5 (based on data from Chan-Lee, 2005) presents, apart from the capital account openness, the assessment of the quality of financial systems (scale 1 to 10) and the perception of business environment (here the reversed Price Waterhouse and Coopers' "business opacity" index). While some of the East Asian countries (Hong Kong, Japan, Singapore or Taiwan) managed to establish relatively sound financial systems, much is to be done to match the level of the EU "southern periphery" (Greece, Portugal, Spain) not to mention the United States. The problems are aggravated by phenomena common for most of emerging market economies such as insufficient property rights protection and contract enforcement, poor transparency, low level of corporate governance and widespread corruption.

Table 4: Trade Openness in East Asia and The European Union (Total trade as a percentage of GDP)

East Asia	1990	2002	EU-15	1990	2002
Brunei	88.5	113.4[a)]	Austria	56.4	69.7
China	24.2	49.1	Belgium	111.1[b)]	169.1
Cambodia	17.4	101.8	Denmark	50.3	61.0
Hong Kong	218.3	248.8	Finland	39.1	59.3
Indonesia	42.2	53.6	France	37.0	43.1
Japan	19.8	21.1	Germany	50.0	55.4
(Rep. of) Korea	51.4	65.2	Greece	33.6	31.1
Laos	30.5	40.9	Ireland	93.7	114.2
Malaysia	124.1	177.2	Italy	31.9	41.8
Myanmar	3.1	1.0[a)]	Luxembourg	129.4	95.4
Philippines	46.0	87.7	Netherlands	87.2	99.1
Singapore	300.8	273.7	Portugal	60.2	52.4
Taiwan	74.6	83.5	Spain	29.0	43.6
Thailand	61.4	98.1	Sweden	46.8	61.1
Vietnam	54.1	115.0	United Kingdom	41.2	39.1

[a)] 2001.
[b)] 1993.
Source: Kawai and Motonishi (2005).

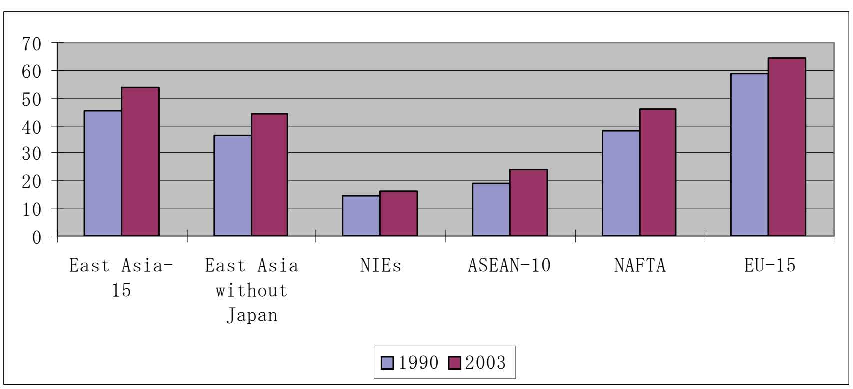

Figure 1: Intra-Regional Trade (as percent of total trade)

Table 5: Quality of Financial Markets

	Quality of financial systems (1-10), 2003	Business environment (1-10), 2001	Capital account openness (1-4), 1999
China	2.7	1.3	1.5
Hong Kong	6.9	5.5	4.0
Indonesia	1.9	2.5	3.5
Japan	6.9	4.0	3.5
(Rep. of) Korea	5.4	2.7	3.5
Malaysia	5.7	n. a.	3.0
Philippines	4.3	n. a.	3.0
Singapore	7.1	7.1	4.0
Taiwan	6.6	3.9	2.5
Thailand	3.9	3.3	2.5
Greece	3.8	4.3	3.0
Portugal	4.6	n. a.	3.0
Spain	6.2	n. a.	3.0
United States	9.1	6.4	4.0

n. a. – data not available.

Source: Adapted from Chan-Lee (2005).

Except for Hong Kong and Singapore, the perception of the business environment in East Asia is not encouraging. Poor condition of the region's financial markets damages East Asia's image as an optimum currency area.

To summarise, on most of accounts East Asia (or at least its parts) seems to be satisfying the OCA criteria. Even if not matching the level of the EU monetary union member countries, East Asia is close to the levels the EU member states had reached before they started the process of monetary unification (i.e. before the Maastricht Treaty). However, the disparities between the East Asian countries are much bigger than in Europe and much is to be done in the area of institution building. Nevertheless the answer to the question whether East Asia needs its monetary union seems to be largely positive (at least for parts of the region).

4. A Lack of Political Will?

This section attempts to address the issue of whether it is the lack of political will to implement a monetary integration that is responsible for the slow progress in achieving the goal. There may be no straightforward answer to this problem. On the one hand, there is abundance of political initiative towards deepening integration in the region. ASEAN+3 heads of state have met annually since 1997. Even before their first meeting took place, the Manila Framework Group, a regional surveillance body had been established in November, 1997. Other initiatives include a bilateral swap arrangement (Chiang Mai Initiative) in May, 2000, establishing an inter-governmental East Asia Study Group or the non-government East Asia Vision Group (both agreed at the November, 2000 meeting in Singapore), the Asian Bond Initiative of 2003 and so on. A series of bilateral negotiations has produced a handful of bilateral free trade agreements between countries of the region.

Despite being often highly publicised, many of those initiatives never develop beyond the stage of a study group or a political statement: see Table 6. Even the most successful one, the Chiang Mai Initiative still does not seem to be fulfilling its entire potential. Verbal support and statements of good will do not change the fact that, in contrast to Europe, East Asian governments seem to be very reluctant to delegate parts of their prerogatives to supranational institutions.

Table 6: Asean+3 Declarations on Economic and Monetary Cooperation in East Asia

Venue and date	Agenda
Kuala Lumpur, December 1997	Exchange of views on regional currency problems amid the Asian currency crisis
Hanoi, December 1998	Deepening an economic cooperation aimed at economic recovery in the region
Manila, November 1999	The first official joint statement by the ASEAN+3 summit
Singapore, November 2000	The assessment of the Chiang Mai Initiative Agreement. Establishing the non-government East Asia Vision Group (EAVG) and its intergovernmental counterpart, the East Asian Study Group (EASG) for working-out guiding principles of economic and monetary cooperation in the region
Brunei, November 2001	Accepting the EAVG report. Korea's President Kim Dae Jung announces his country's readiness to establish an East Asian Free Trade Area
Pnom-Penh, November 2002	Accepting the EASG report on establishing a free trade area in East Asia
Bali, October 2003	Accepting a strategy for establishment of the ASEAN Community by 2020 (the Declaration of the 2nd ASEAN Accord)
Vientiane, November 2004	Establishing an official bureau of the ASEAN+3 in the ASEAN structures (ASEAN+3 Unit)
Kuala Lumpur, December 2005	Renewed commitment towards narrowing development gap between member states
Cebu, January 2007	Commitment towards accelerating the establishment of the ASEAN Community by 2015

Source: Compilation based on the ASEAN internet home page (www.asean.org actual as of May 2007).

Europeans' willingness to do so has been the result of their historical experience of two world wars that generated a desire to establish a political and economic institutional framework, and able to prevent a recurrence of conflict. There is apparently a lack of such consensus among East Asian nations. The lack of shared beliefs in political democracy and the presence of unresolved historical disputes result more often in emotional confrontations[9] rather than in compromises based on principles of solidarity and conflict resolution. The resultant distrust translates then into a characteristic pattern of many low profile initiatives.

On the other hand, after the bitter controversy surrounding the IMF Stand-by Agreements with East Asian economies in the aftermath of the 1997 crisis no self-respecting Asian leader would ignore the issue of deepening the regional integration here. East Asia, one of the fastest growing regions of the world economy, is highly under-represented in various international bodies (the IMF, G-8, United Nations and so on). There is a growing frustration over the disparity between the region's own growing economic might and its lack of political clout. Awareness of one's own helplessness can also be an important driving force behind cooperative regional efforts.

Considering the number of undertaken integration initiatives, not necessarily the lack of the real political will, but rather the specific political culture of distrust and lack of commonly shared cultural and political set of values contributes to slower than expected progress of the integration process. The procrastinated negotiations on the free trade agreement between Japan and the Republic of Korea may illustrate the point.

5. Is East Asia Following its Own Specific Path Towards Monetary Union?

Even if East Asia is indeed on its own path towards monetary union, the path is very different from the one the European monetary union has followed. After having achieved its original goal of establishing a customs union the European countries undertook series of attempts to stabilise the intra-European exchange rate (dating back to the pre-EMS days). Then, the leading monetary body (Germany's monetary authority) took over setting the pace of the region's monetary policy and, after relaxing capital movement controls (that did not happen without difficulties) Europe's common currency was finally established.

East Asia's path towards monetary integration differs significantly from the European one. First, East Asia as a region has not pursued any formal trade liberalisation. Instead the region's trade has been regulated on the basis of bilateral liberalisation agreements (notably agreements on free trade between the largest countries of the region, Japan, Korea, Taiwan, and China have yet to be

[9] The latest examples could include angry demonstrations and violent reactions to the statements of public figures regarding historical territorial suzerainty between Korea and China or Thailand and Cambodia, as well as public outrage in China and Korea against Japanese Prime Ministers' visits to the controversial Yasukuni shrine, not to mention the real still unresolved territorial disputes between Japan, Korea, and China.

achieved). Primarily for that reason the monetary integration in East Asia stands for a *policy goal* itself, while in the case of Europe it has been a mere economic *policy tool* used for further deepening of economic and political integration.

A second important difference is the fact that, contrary to the European experience, East Asian countries (with the notable exception of China) had liberalised their capital accounts even before their financial markets were well developed. Although the capital controls relaxation was arguably necessary for achieving high growth rate at the end of the last century,[10] capital mobility makes it difficult to sustain a fixed exchange rate regime (let it be either dollar or currency basket peg) as a precondition for establishing a monetary union in the region.

Third, there appears to be no obvious candidate to assume the role Germany has performed in the European Union at the end of 1980s and in the 1990s. The position of Japan, once undisputed candidate for a regional leadership, has been seriously damaged by its prolonged economic depression. As for China, with its low level of economic development, internal discrepancies.[11] under developed financial systems, not convertible currency, and capital account restrictions, it is hard to imagine it taking over a regional economic leadership in the near future.

Fourth, the East Asian political establishment seems to have taken it for granted that the economic integration goes precisely along the Balassa (1962) five-consecutive-steps pattern. It requires first establishing a free trade area (FTA) in order to reach a customs union level. The latter can later develop into a common market and a full-fledged economic union can follow. Finally, the integrating nations can establish a complete political and economic union.[12] Revolutionary as it was half a century ago, the theory neglects the fact that it requires a common policy to reach level two of customs union while the FTA does not require any common policy at all (simply, the abolishing of customs should suffice for the FTA to work). The European Union has never been a free trade association. Already in 1957 it aimed at entering the Balassa (1962) pattern at stage two. Accordingly, given the fact it was not the European Free Trade Association (EFTA) that produced Europe's common currency, forming the network of FTAs around the region will not eventually lead to a monetary union as that would require a common policy, something the FTA actually misses.

6. Conclusion: What is Wrong with East Asia?

The East Asian path to monetary unification suffers from the adverse effects of its reversed order (capital account liberalisation ahead of monetary integration)

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[10] Another way of reasoning would be that they had to liberalise their capital accounts precisely because their capital markets were not developed enough to stem capital inflows necessary for high growth rates.

[11] It is a good question whether we can really think about a single unified China in economic terms; systemic and income differences between the regions (Hong Kong, Shanghai, Beijing, the island of Hainan, Manchuria, Tibet, Inner Mongolia, western provinces etc) are so big that one can think about the country as a group of economic entities (forcibly) unified in political terms as for instance the British Empire once used to be.

[12] It is precisely as the line of argument runs in Nakashima (2006).

that creates a conflict between monetary cooperation (understood by the region's opinion makers as a capital movement liberalisation) and exchange rate coordination (ranging between a single currency or currency basket peg and currency union altogether). Also the misconception about the sequence of economic integration (i.e. taking the Balassa, 1962 theory *prima facie*) has taken its toll on the speed of monetary integration in the region (or may take in the near future). Together with the lack of regional leadership (the role Germany has played in European processes), specific political environment that precludes bold political initiatives, and, to put it straightforward, lack of political vision for the region's future (i.e. political union) probably rules out any monetary union in East Asia in the near future.

However that does not mean nothing can be done in order to deepen monetary integration in the region. In my opinion, the following measures could be helpful for establishing the monetary union in East Asia in the mid- and long run. First, political energy should switch from concluding bilateral FTA towards establishing at least a customs union in the region.[13] Then, building sound financial markets should follow. The character of the optimum currency area theory allows for almost discretional interpretation of results. But, let aside Mundell's original criteria, it is the soundness of the financial system that spells the ability to withstand the adverse shocks that are likely to accompany the monetary unification project. At their current condition East Asian financial markets are as weak as they were at the onset of the 1997 currency crisis and probably could not withstand any similar challenge. Third, through strengthening the Chiang Mai Initiative, the joint surveillance of economic policies and coordination of exchange rate policies could ultimately lead to establishing a decision making framework (or institutions) based on the principle of mutual consent. Only from that point can one realistically think about the East Asian monetary unification process.

Besides, there is the problem of what to do with China. If the country is going to assume leadership in the region, then a phased opening of its capital markets has to take place at some time. But, analogously to the Russia's relations with the EU, there is a well-grounded doubt about the wisdom of creating such an unbalanced integration body.

The monetary unification in East Asia is not a political illusion. However, it is not an immediate necessity either. As the Economic and Monetary Union in Europe has taken half a century to materialise, also here, after having addressed its specific problems, fifty years from now, East Asia may be well on its way to a monetary (and economic) union.

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[13] Or parts of it if political considerations allow for excluding the weak elements of the system

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