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## **East Asian Economic Integration: China's Perspective and Policy**

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AUSTRALIA—JAPAN RESEARCH CENTRE  
ASIA PACIFIC SCHOOL OF ECONOMICS AND GOVERNMENT

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# EAST ASIAN ECONOMIC INTEGRATION: CHINA'S PERSPECTIVE AND POLICY

East Asian economic integration has become a hot topic since the Asian financial crisis. Countries in the region have increasingly moved in favour of closer cooperation and coordination. Various proposals for free trade areas and Asian monetary cooperation have emerged. Regionalism in East Asia has been encouraged by the worldwide tendency to move to regional integration and by increasing interdependence in the region.

The Asian financial crisis was a turning point for this awareness. However, institution building for regional integration has been slow, due to lack of political will, different development levels and needs, different opinions on the best mechanisms for cooperation, and contradictions between multilateral and regional arrangements.

China was sceptical about regionalism until 1999. At that time, accession to the World Trade Organization, increasing trade and financial flow with East Asian economies and financial system reform and further opening to the world market led China to become more confident about and supportive of regional cooperation and integration in the hope that integration would provide more opportunities for China to realise its comparative advantages and a more secure environment in which to maintain stability. In this paper, the author argues for the need for decision makers in East Asian countries to show greater political will to implement such changes, in particular pointing to the need to develop mutual trust between China and Japan. He also makes some suggestions for speeding up free trade agreement negotiations and monetary integration.

## **Introduction**

This paper discusses East Asian economic integration from the perspective of China and in the context of East Asian regionalism. Integration in the region has been encouraged by increasing regionalism in the world arena, by the economic interdependence of East Asian countries and by the potential for East Asian countries to be an important economic bloc. However, institutional arrangements for regional integration are yet to be seen, for political, social and economic reasons. China was once sceptical about regional economic integration but is now supportive. In this paper, I discuss the reasons for this and suggest some ways to promote East Asian economic integration.

## **Increasing tendency for regional economic integration**

Economic integration in Asia has been encouraged and stimulated by increasing regionalism in other parts of the world. Since the establishment of the North American Free Trade Area (NAFTA) and the successful launch of the euro, regional economic integration has gathered new momentum in the global arena. NAFTA will expand to include more Latin American countries and a new American Free Trade Area is under discussion. The eastward enlargement of the European Union (EU) is accelerating the pace of integration. At the time of writing, 163 free trade agreements (FTAs) had been completed in the world and there were proposals for new initiatives for different kinds of regional agreements in many parts of the world. In Asia, however, only Southeast Asian countries have formed an institutional organisation (ASEAN) for regional integration. People in East Asia are increasingly aware of the importance of regional integration and regret that South Korea, Japan and China are among the few exceptions to the move towards regionalism. APEC's broad membership and flexible mechanisms mean that it functions more as a forum than as a regional institution of integration. East Asia includes the most important and fastest growing economies in Asia and is the central force driving the Asian economy. People in Asia generally believe that if Asia is going to compete with North American and European regionalism, East Asia should play the central role and there should be closer regional economic cooperation among its members. The economic scale of ASEAN is too small for it to compete with the other two regional blocs. If South Korea, Japan and China plus ASEAN established a body for economic collaboration, it would be a major economic bloc, able to compete with NAFTA and the EU.

This challenging economic background has led to economic integration in East Asia becoming a hot topic among academics and government officials and to the development of the ASEAN+3 framework. ASEAN+3 was an initiative of ASEAN generally, but especially of the former Malaysian Prime Minister, Dr Mahathir Mohammad, who a decade ago proposed the formation of the East Asian Economic Group (EAEG) with the same members as ASEAN+3. In December 1997 the second informal ASEAN summit was held in Kuala Lumpur; China, Japan and South Korea participated for the first time, as a response to the Asian financial crisis. In 1999, the ASEAN+3 framework was formalised. Since then ASEAN+3 has been institutionalised; it holds annual meetings of heads of governments and also meetings of ministers of foreign affairs, finance and trade. One of the group's most important achievements has been the Chiang Mai Initiative, which came out of the ASEAN+3 summit meeting in November 1999 in Manila.

In the Joint Statement on East Asia Cooperation formulated at this summit, ASEAN, China, Japan and South Korea agreed to strengthen dialogue, coordination and cooperation in the development of financial, monetary and fiscal policies. In accordance with the spirit of the joint statement, ASEAN+3 countries reached a currency swap agreement in May 2000 at the ASEAN+3 Finance Ministers Meeting in Chiang Mai; this was the starting point of East Asian monetary cooperation.

East Asia has thus positioned itself to be a key player in the world economy. The currency swap arrangement lays the foundations for economic cooperation and regional integration that will make the region more competitive in the world economy and help to prevent any recurrence of the 1997–98 financial crisis.

### **Potential strength of East Asian economic integration**

South Korea, Japan and China, with a total of 1.47 billion people, account for 23.4 per cent of the global population. The 10 ASEAN countries have a total population of 0.54 billion, so the population of the 13 ASEAN+3 countries is more than two billion, five times larger than that of the NAFTA countries and 6.1 times that of the EU countries. In 2002, the combined GDP of South Korea, Japan and China was more than US\$7 trillion and that of the 10 original ASEAN countries was US\$609 billion. The combined GDP of South Korea, Japan and China was 88 per cent of Asia's GDP, 19 per cent of global GDP, nearly 32 per cent of the combined GDP of NAFTA countries and nearly 28 per cent of the GDP of EU countries. But in terms of purchase power, the share of ASEAN+3 is even bigger than these figures would suggest. The trade volume of East Asia is 25 per cent of the global trade volume, below the 37 per cent of NAFTA but at the same level as the 24 per cent of the EU. China, Japan and South Korea have a combined foreign exchange reserve of US\$800 billion. If we add ASEAN's foreign reserves of \$123.5 billion, East Asia holds almost 50 per cent of total foreign exchange reserves in the world. The East Asian economy would be even larger and stronger if Hong Kong and Taiwan were added. Some people have estimated that in the next 15 years East Asia's GDP will be above US\$25 trillion, making the region the largest and most influential economy in the world. With these enticing prospects, people in the region have been encouraged to speed up their cooperation and have no reason not to do so.

The world political pattern has changed a great deal since the end of the Cold War. On the whole, the world has had greater chances for maintaining peace. However, regional conflict and



war have not disappeared. In particular, the risk of regional instability has increased since the 11 September terrorist attacks in the United States. East Asia is no exception to this risk. This is especially true for Northeast Asia, where the influence of the Cold War is still felt; here, different countries have very different political and social systems and are greatly influenced by US security interests and global strategies. Some areas are at risk of military confrontation. Against this background, people in the region increasingly hope that the ASEAN+3 countries speed up their efforts for economic cooperation, for the sake of peace, prosperity and stability in the region. In particular, a mechanism for ASEAN+3 economic cooperation would allow countries in the region to understand each other better and trust each other more, making it possible to gradually solve historical problems and build a real Asian community. In the long run, Asian peace and security can be sustained only by close cooperation between Asian countries. The ASEAN+3 framework can contribute to this.

Many people also believe that, unless the Asian continent as a whole shows solidarity, the development of all Asian countries will be restricted to the point where they become the tools of European and American development. For example, a better international monetary system would have allowed the huge foreign exchange reserves in East Asia to be used more efficiently in the economic development of the region. If Asian countries are to safeguard the interests of the region in the environment of global competition, they must present a united front. At present, attaining this united front is the most important task for Asia. East Asian countries should take the lead and unite to form an East Asian Community.

## **Increasing economic interdependence**

The economic interdependence of East Asian countries is the basis of economic integration in the region. Interdependence has increased rapidly in the past decade. This is shown by changes in the intra-regional trade dependence index. For East Asia, the index increased from 22.35 per cent in 1985 to 45.37 per cent in 1999, which is higher than the intra-regional trade level in the EU (Goto 2001). The trade flows of some East Asian economies in Asia are even more impressive (See Tables 1 and 2).

Table 1 shows intra-Asia trade as a whole. However, East Asia and Southeast Asia are the principal traders in the region, so most intra-Asia trade occurs among these economies. Table 2 shows the trade dependence index change for 14 East Asian economies during the last two decades. Trade interdependence is the key indicator for economic interdependence. Some

**Table 1 Intra-Asia trade of some East Asian economies, 1990 and 2000 (per cent of total trade volume)**

	Exports to Asia		Imports from Asia	
	1990	2000	1990	2000
China	68.8	46.0	50.9	60.7
Hong Kong, China	44.1	53.5	73.2	78.3
Indonesia	66.6	58.0	46.3	65.8
South Korea	37.3	43.0	38.9	46.0
Malaysia	59.0	53.8	53.6	64.9
Philippines	35.9	42.1	42.6	53.8
Singapore	48.4	57.2	50.1	57.0
Taiwan, China	41.4	56.4	49.0	65.1
Thailand	38.6	48.9	56.6	60.8

Source: Asian Development Bank, key indicators, 2001.

**Table 2 Index of trade dependency among East Asian 14 economies, 1980–99**

	1980	1985	1990	1995	1996	1997	1998	1999
Brunei Darussalam	17.03	27.20	33.63	59.88	62.05	62.41	33.93	36.47
Myanmar	4.43	2.19	2.20	2.24	1.76	1.40	0.89	0.84
Cambodia			5.47	53.53	48.67	38.96	41.91	52.67
Indonesia	7.64	5.96	9.91	11.41	12.02	13.70	27.12	23.41
Lao PDR		1.89	18.28	31.26	34.82	24.42	43.31	45.13
Malaysia	26.78	30.36	49.72	62.36	61.05	62.42	70.72	78.53
Philippines	6.92	8.55	11.03	16.73	15.93	22.59	29.11	29.99
Singapore	140.24	107.65	112.06	130.61	125.91	124.86	112.95	122.74
Thailand	11.62	11.31	15.76	21.80	20.36	24.01	26.06	29.71
Vietnam		0.98	23.03	37.98	45.79	43.46	38.00	38.76
Taiwan, China	12.81	10.77	14.71	24.14	23.50	24.96	23.75	25.55
Hong Kong, China	47.40	71.24	106.56	138.20	130.86	123.69	117.09	121.72
South Korea	6.11	7.23	6.84	12.66	13.57	15.77	18.80	17.63
China	3.36	5.23	14.73	14.26	12.36	13.33	11.73	12.06
Average	25.85	22.35	30.28	44.08	43.47	42.57	42.49	45.37

Source: IMF direction of trade statistics, World Bank Database; also see Goto (2002).

people have suggested that the increasing intra-regional flow of goods and services among the economies in East Asia should be accompanied by the formation of a stable exchange rate arrangement, the creation of a key currency and the formation of well coordinated relationships between monetary authorities in the region. For example, Dutta (1998) put forward a proposal for Asian monetary integration on the basis of increasing interdependence among countries in the region. Similar arguments were put forward by South Korean and Japanese scholars during Asian development forums. In 2001, Robert Mundell suggested<sup>1</sup> that East Asian countries should begin to establish monetary cooperation by creating a monetary unit and should strengthen monetary coordination by establishing an exchange board that would permit countries to gain the benefits of optimum currency areas without monetary union. Mundell also mentioned the need to increase trade flows within the region.

Like intra-regional trade, capital flows are increasing within Asia. In 1990 China attracted 54 per cent of its total foreign direct investment (FDI) from adjacent partners – Japan, Hong Kong, Taiwan and Singapore – compared with 58 per cent in 1996 and 61 per cent in 1999. Japan contributed ¥712 billion in FDI to Asian countries, 27.8 per cent of total Japanese FDI outflow. In 1996, Japan's FDI in Asia increased to ¥1,305 billion, 52.7 per cent of its total FDI outflow. During the 1990s, South Korean FDI outflow to Asian countries was more than 43 per cent of its total FDI; in contrast, its FDI to North America dropped from 34.6 per cent in the early 1990s to 24.6 per cent in the late 1990s (Lee 2002). China's officially approved investment in Southeast Asia increased from US\$72 million in 1999 to US\$108 million in 2000,<sup>2</sup> reflecting an annual increase of 60 per cent in recent years.<sup>3</sup> Increased intra-regional capital flows reflect regional industrial integration and result in increased industrial and technological transfer, another important aspect of regional interdependence. They also make regional economic integration more likely.

The increasing mobility of human resources in the region adds to the economic interdependence of East Asian economies. In 1980, there were 734,500 registered Asian foreigners in Japan, compared with 1,086,400 in 1997 (73.4 per cent of all registered foreigners) (Goto 2002). This compares to Thailand (94,100 in 1993, rising to 148,800 in 1997, representing 80.3 per cent of all registered foreigners) and the Philippines (90,800, representing 27.1 per cent of all Asian foreigners, in 1990 and 221,300, representing 39.3 per cent, in 1998 (Goto 2002). Other East Asian countries are likely to show similar patterns. The figures reflect the fact that more and more people are moving across East Asian countries, creating favourable conditions for economic cooperation and integration in the region.

## **Institutional arrangements**

There has been a steady increase in bilateral trade and investment between countries in East Asia, but the increase could have been greater. Proponents of East Asian integration have suggested that one reason for this is the absence of sufficient institutional arrangements for cooperation in the East Asian region. Without proper governmental agreement, closer economic cooperation is very difficult to shape. FTAs bind European and North American countries, but ASEAN FTAs have been very slow to develop. The ASEAN–China FTA can be regarded as a first step towards East Asia economic integration, but similar arrangements are needed among big economies in the region. One problem may be that China and Japan often seem to distrust each other. Japan ranks China last in the list of countries with which it seeks free trade. China still believes that Japan is not really interested in Asian unity and prefers to follow US policy. South Korea seems more interested in free trade with Japan, but mainly as a solution to trade deficit problems. Governments in East Asia generally seem conservative and unenthusiastic about taking steps towards pan East Asian regionalism. ASEAN+3 is paving the way to cooperation and integration in the region, but it is not yet a trade or economic bloc, let alone a common market or economic union. Meanwhile, most initiatives and suggestions for wider East Asian FTAs have been put forward by civilian organisations and academic scholars.

There are many reasons for the lack of progress in developing institutional arrangements for East Asian integration, and they present real difficulties for those seeking to push East Asian economic cooperation forward. Real progress will require us to rapidly overcome at least four major difficulties: lack of political will and lack of incentives; differences arising from countries' different stages of economic development; tensions between the concepts of globalisation and multilateralism vs regionalism; and the existence of different opinions about the best mechanism for East Asian economic cooperation and the pace at which to develop it.

### ***Lack of political will***

The countries of East Asia show a vast range of different social structures and economic systems – from mature market economies such as Japan and South Korea to countries in transition and market economies such as China and Vietnam. As a result, there are many ways of thinking about economic interests. As mentioned earlier, there is now greater cooperation on security and strategy interests than there has been in the past, but residual Cold War attitudes continue to

hold cooperation back and induce distrust. As a result, political considerations are sometimes the first priority in decision making. Moreover, countries in the region have very different statuses in the world political arena and usually have different political orientations. And the US strategic interest in East Asia creates ambiguity for those pursuing East Asian regionalism. Many countries want to make sure they do not provoke the United States. Some countries, such as China, think that countries in the region should give priority to dismissing out-of-date ideology left over from the Cold War rather than forming a regional economic bloc. Others maintain the old patterns of thinking for security reasons. On the whole, countries in the region have not yet adapted to globalised economic and political patterns, despite their awareness of the importance of regionalism.

### ***Stage of economic development***

Countries at different levels of economic development have different interests in moves toward cooperation, especially FTAs, even though such differences create economic complementarities. Developed countries in East Asia usually welcome free trade in the manufacturing industries and are reluctant to open their agriculture and fisheries markets. In contrast, developing countries usually want to protect their industrial and service sectors while hoping that FTA arrangements will help them to export labour-intensive processed and agricultural products to other countries. Mismatches between interest and demand have slowed the development of institutional arrangements for free trade in the region. Domestic political patterns sometimes add to the difficulties of structural adjustment that free trade requires (Shin and Wang 2002).

### ***Globalisation and multilateralism vs regionalism***

Some people believe that East Asia has gained considerable benefits from globalisation and multilateralism and that East Asian regionalism, especially south–south regionalism, would result in a net loss in welfare. For example, Goto (2001) argues that open regionalism arrangements such as APEC stand the best chance of success because Japan and the United States are more likely to participate in such arrangements than they are to participate in close regionalism arrangements such as an East Asian FTA and monetary union. Such arguments have influenced many countries in the region and have discouraged them from taking the political decisions needed for closer cooperation.

### ***Mechanisms for economic cooperation***

There is no consensus about how to shape an East economic bloc or about the best central mechanism to achieve regional integration. Many believe that free trade is the core of East Asian economic cooperation. Others have doubts, because of the obstacles that free trade must overcome. One problem is the pace at which free trade in East Asia can be realised. Some hope to accelerate the pace; others believe we need more time and should only gradually achieve a high level of free trade. Many Chinese scholars believe in two tracks of cooperation: free trade and technology transfer. They argue that, without technological cooperation, less developed regions lack incentives to engage in free trade. Other people believe that East Asia can take the first steps to integration by creating a monetary fund and a regional monetary unit. Since the 1997–98 Asian financial crisis, there has been a huge demand for monetary cooperation; East Asia can make use of this situation.

### **China's changing attitude**

Until the mid-1990s, China was not very active in regional cooperation. Rather, it placed priority on reform and opening to the outside world in order to attract more foreign investment and gain more access to world markets. It was reluctant to join any regional organisation because it was not sure what the effects would be. Only in 1991 did China join APEC. During the 1997–98 financial crisis, China was active in international efforts to minimise financial damage, but was reluctant to support multilateral arrangements for monetary and financial cooperation in the region: it did not respond positively to Japan's proposal for an Asian Monetary Fund and until 1999 remained doubtful about financial cooperation generally.

There are several reasons for the change in China's attitude towards regional cooperation and integration. Firstly, there was mass national support for accession to the World Trade Organization (WTO), so the government could confidently promote free trade through multilateral or regional arrangements. In particular, China was less fearful of fully opening its market to the outside world, because it gained a lot from the initial policy of opening and will gain even more from the greater opening resulting from accession to the WTO and the negotiation of regional FTAs. China also believed that, because it was now a full member of the multilateral world trade system, its commitment to regional arrangements would not harm its trading status with the rest of the world.

Secondly, after joining the WTO China faces increasing pressure to open its financial market. Capital market opening and full renminbi convertibility is not required by the WTO agreement, but opening the financial service sector would make these inevitable in the long run. This would expose China to the risk of financial instability. China's financial system already has many problems – for example, a huge commitment from non-performing loans in state banks. Such issues have made China change its view on regional monetary cooperation. It has gradually become aware that the potential risk of fully opening its domestic financial market can best be dealt with through regional monetary cooperation. Such cooperation would be an important stabilising factor for China's own financial situation. The Asian financial crisis and the euro experience have shown the importance of regional cooperation in preventing and relieving financial turmoil. At the 1999 ASEAN+3 meeting, China endorsed full regional economic cooperation, including financial and monetary cooperation; it also sponsored the Chiang Mai Initiative and actively participated in the swap agreements.

Thirdly, East Asian countries have become increasingly important economic partners for China, although the United States remains its single most important market. Trade between China and East Asian countries has increased rapidly. For example, China's trade with Japan increased from US\$12.93 billion in 1990 to US\$101.91 billion in 2002 – from 11.2 per cent to 16.4 per cent of total trade volume. Japan is now the biggest source of imports to China and the third largest export market for China – just behind the United States and the EU. China's trade with South Korea has also developed dramatically – from US\$1.9 billion in 1990 to US\$44.09 billion in 2002, or from 1.7 per cent to 7.1 per cent of total trade volume. South Korea is the fourth largest trading partner for China; China is the largest market for South Korea. China's trade with ASEAN countries also grew fast in the 1990s. Bilateral trade rose from US\$7.9 billion in 1991 to US\$54.77 billion in 2002, with an average annual growth of more than 20 per cent. ASEAN is now China's fifth largest trading partner. As for investment, East Asia remains the most important FDI source for China; 60–70 per cent of FDI inflow comes from this region. Against this background, China feels that it is economically getting closer to East Asia; certainly it is trying to maintain better relations with countries in the region through free trade arrangements.

Fourthly, China's economic growth causes concern to neighbouring countries because of its huge population and vast territory. However, China's growth is inevitable and the country needs regional peace and security as well as international peace and security. China has tried to prove to neighbouring countries that it is a responsible and positive factor in the region and is their

friend. Typical examples of this attitude are the maintenance of a stable exchange rate during the East Asian financial crisis and the willingness to make concessions in settling border disputes with neighbours. Moreover, better regional economic cooperation and integration can help to solve historical problems. For example, China supports the enhancement of political and security cooperation in the ASEAN+3 framework and, since the late 1990s, has been active in promoting regional FTAs. In free trade negotiations with ASEAN, China took the initiative despite incurring some immediate costs. Such examples illustrate China's strategy for peaceful development within the region and for a role as an active and positive player in the region and the world.

The Chinese government now supports the idea of a pan East Asia free trade area and a mechanism to stabilise currency exchange rates among East Asian economies. China is interested in regional investment cooperation as a means to promote capital flow and is considering joint mechanisms for the surveillance of financial markets and the establishment of an early crisis signalling system. In other words, China is now generally open-minded about East Asian economic integration.

## **Priorities for East Asian economic integration**

I now discuss what I believe are the top priorities for the promotion of regional cooperation and integration.

Firstly, countries in the region, especially Japan and China, must show political wisdom by moving towards greater mutual understanding and trust. Existing attitudes of vigilance and mistrust are very harmful for regional cooperation and can ruin the potential for cooperation. Japan and China are the big players in the new Asian regionalism (Katzenstein et al. 2000). They must take some humble steps to consult and share opinions with each other rather than letting commitments to other alliances sabotage genuine regional cooperation. They should also try to understand the point of view of other countries, especially small countries. The EU experience can provide some valuable lessons in this regard despite the many historical, political and social differences between Europe and Asia.

Mutual trust and cooperation between China and Japan are extremely important for close monetary cooperation in the region. Japan was the only Asian member of the Organisation for Economic Co-operation and Development (OECD) until South Korea joined in 1996. Japan played a leading role in the development of the 'flying geese' model. In spite of current economic



eclipse, Japan continues to play an important role as a source of technology and capital in the region. ASEAN countries, and even China, regard Japan as a very important export market. Japan has previously focused on a multinational approach to international cooperation, but since the United States began to follow a two-track approach toward both regionalism and multilateralism, Japan has started to pay attention to regionalism as well. However, some of Japan's neighbours criticise protectionist measures that remain in some sectors, and other Asian countries are sometimes concerned about its special relationship with the United States. China is increasingly playing an active role in regional activities. Its promise not to devalue its currency has gained respect from the rest of Asia. Its trade remains in deficit with most East Asian Economies except Japan. However, other East Asian countries, especially ASEAN countries, feel under pressure because of China's economic size and increasing export potential. They worry about competition and have complex feelings towards a growing China. For example, Chae and Han (2001) noted that China's accession to the WTO could pose a great challenge to developing countries in the Asia Pacific region. In these circumstances, China's proposed ASEAN-China FTA can be regarded as a positive gesture, because China is bound to import more in the future. The value of imports has been estimated at US\$1.5 trillion in the next five years.<sup>4</sup> If Japan and China really care about other's feelings, if they show sincere commitment to common interests of the region and if they work together with ASEAN and South Korea for a win-win result, the East Asian region will really become a promising area for economic development

Secondly, individual countries or groups of countries, particularly China and Japan, must avoid the temptation to compete for leadership. Taking more responsibility and making a greater contribution to economic development in the region would be beneficial but the establishment of a Japanese yen bloc or internationalisation of the Chinese renminbi would not be helpful. My view is that the Japanese yen should play an important role in any future regional monetary integration such as Asian monetary union. That is because Japan is the biggest economy in the region and is the only industrialised economy with the potential to provide credit. However, the Japanese yen would not be a suitable centrepiece of future Asian monetary union because it is not stable in terms of the US dollar and because the Japanese government is not willing to stabilise its exchange rate of the yen at the cost of its own economic interests. In practice, East Asian countries are inclined to use the US dollar as their main reserve currency and for international trade and financial transactions. East Asia does not have a tradition of yen circulation. If the yen is going to play a key currency role in East Asian monetary cooperation,

it will become a burden to the Japanese economy and add to the cost of Japan's economic recovery. Japan is not willing or ready to take the responsibility of playing a regional key currency role because it still prefers to keep its huge current account surplus. Usually, the key currency country should provide its own currency to the rest of the world through a current account deficit or continuous capital outflow. A virtual currency would be preferable to a yen centred bloc. This would not only avoid the negative effect of exchange rate fluctuations of the Japanese yen, but also encourage all participating parties to cooperate. The same reasoning applies to the use of the Chinese renminbi. We should learn from the experience of European Monetary Fund (EMF) and the European Monetary System (EMS). European countries did not make the German mark or the French franc the centrepiece of the EMS; rather, they created a European currency unit to play this role. The reasoning is similar to that for East Asia: the creation of virtual money is the best way to enhance cooperation among participating parties through the balance of power and the sharing of responsibility.

Similar reasoning can be applied to the development of an East Asian FTA. Japan, South Korea and China should together find a way to overcome the obstacles to this. They should not regard FTAs as a means for political competition. After all, an FTA is only an agreement to allow free trade within the WTO structure in order to gain comparative advantages for all participating parties. ASEAN countries should balance their trade policy within ASEAN and in dealing with other East Asian members as well as with the rest of the world.

Thirdly, we should start by identifying realistic aims and adopting concrete policy coordination measures. Impractical suggestions and aims will delay regional integration. FTA is an important vehicle for trade integration. So far, only ASEAN and ASEAN-China FTAs are starting to take shape, although several bilateral FTAs in the region are under discussion and negotiation. It is too soon to propose an ASEAN+3 FTA, but we should make full use of the ASEAN+3 framework and we should conduct a joint study on an East Asian FTA within ASEAN+3 in order to create a favourable climate in which to reach an ASEAN+3 FTA in the future. Bilateral FTAs can provide the basis for this study. If possible, negotiations should begin on a sector-by-sector basis, with agreement on the overall FTA taking account of the different pace of free trade for different sectors in the countries party to the agreement. Of course, the agreement should in essence meet the WTO rule that regional FTAs should cover all substantial sectors.

As for monetary and financial integration, Asian monetary cooperation should not aim for monetary unification of the type that Europe achieved through efforts lasting more than half

a century. People would lack confidence that such an aim could be achieved. Nevertheless, East Asia has taken the first steps toward monetary cooperation, with the Chiang Mai swap agreement.

The Chiang Mai Initiative's main aims are to extend the original ASEAN swap arrangement and to establish a network of bilateral swap and repurchase agreement facilities. China, South Korea and Japan have all been involved in this concrete monetary cooperation. It is based on bilateral arrangements, but overall it has multilateral characteristics. Recently, the ASEAN swap arrangement was expanded to US\$1 billion. Japan added US\$2 billion to the original US\$5 billion amount to South Korea, and signed agreements to swap US\$3 billion with each of the Philippines and Thailand. Japan also agreed to give Malaysia US\$3.5 billion in swap credits. China and Thailand signed a standby credit arrangement for US\$2 billion. Most recently, China and Japan have agreed to a US\$3 billion currency swap arrangement. Some other agreements are under negotiation.

So the bilateral swap arrangements are gradually expanding and more countries in the region are becoming involved under the Chiang Mai agreement. The problem for East Asia now is that the Chiang Mai Initiative carefully eschews institution building, thus failing to plant the seeds for the next stage of development. From the point of view of regional integration, the risk is that the initiative will be both a beginning and an end (Wyplosz 2001). Without arrangements for exchange rate cooperation, the real starting point of monetary integration is not even on the horizon.

I suggest that we should go further and make the Chang Mai Initiative more comprehensive, using a multilateral base. In the first stages, we could make the standby credit a common credit pool. The credit quotas in each bilateral agreement could be pooled to help member states in an emergency situation. In the second stage, we could convert the entire credit quota into an Asian Monetary Cooperation Fund (AMCF) linked with an Asian monetary unit (AMU). At the beginning, this virtual money could be valued in a basket of currencies including the US dollar, the euro and the currencies of member states. Later on, member countries could loosely link their currencies to the AMU according to their wishes and circumstances. When the first two stages work successfully, we could move to the third stage: the AMU currency basket would be limited to member state currencies and the exchange rate fixing requirement could be applied. This is somewhat like the EMS, but the starting point is lower. I believe that this arrangement would be equally good for every country in the region. Moreover, its impact would extend beyond its role as a lending facility, because it would create a favourable atmosphere in the region; it would

greatly reduce the incentives for international financial speculators to hit individual currencies in the region; it would create a base for economic policy coordination in the region; and it would reduce the cost of economic transactions in the region.

## **Conclusion**

Regionalism is gathering momentum in East Asia, but integration is just beginning; further progress will require new institutional arrangements. China has begun to promote regional FTAs and monetary cooperation as it integrates its economy into the world and regional economies. Countries in East Asia should make greater efforts to strengthen their political and economic efforts to work together on both trade and monetary cooperation in order to achieve common benefits for the East Asian community.

## Notes

- 1 At a public lecture in Shanghai in October.
- 2 *Far Eastern Economic Review*, 29 March 2001.
- 3 *United Morning Post*, 12 March 2003.
- 4 Speech by then Chinese Vice Premier, Wen Jiabao, at a seminar on China's economic development, 24 March 2002, Beijing (see *International Finance News*, 25 March 2002).

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