

A Monetary Union in Asia? Some European Lessons

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1. Introduction

Some ten years ago the European Union countries agreed in Maastricht to launch a monetary union. To many, the project was deemed unrealistic and doomed to failure. Yet, it came about, on time and as planned. To be sure, the first two years have not been free of trouble and controversies, but few now doubt that it is viable. Indeed, it is sometimes seen as a blueprint for other regions in the world. Some in Asia, Oceania and Latin America have started to express interest in this kind of undertaking. While it is far too early to assess the experience with the European Monetary Union (EMU), much less to call it a success, such international interest is testimony to how quickly monetary orthodoxies can shift.

The attraction of EMU lies less in its own demonstrated successes than in the recent popularity of the hollowing-out hypothesis. According to Eichengreen (1999), this hypothesis holds that, in a world of high capital mobility, the only sustainable exchange rate regimes are purely flexible rates and hard pegs (monetary unions, currency board, dollarisation). In this view, arrangements that fall in the middle, fixed and adjustable exchange rates with constant or crawling pegs, are ultimately open to lethal speculative attacks.

Of course, the hollowing-out hypothesis is nothing but an implication of the stainless Mundell-Fleming model, previously christened the impossible – or unholy – trinity: the incompatibility between capital mobility, monetary policy independence and a fixed exchange rate regime. The new twist is that limiting capital mobility is not seen as an option anymore; full capital mobility is axiomatically taken as the world's destiny. If that is indeed the case – a view that is challenged further below – the choice now comes down to either monetary policy independence with freely floating exchange rates, or a complete loss of monetary policy independence. In this brave new world, commitments to a fixed-but-adjustable exchange rate are not seen as credible enough. Monetary unions – or dollarisation – become less outlandish options.

Until recently, fully giving up monetary policy was seen as a curiosity circumscribed to special cases like Panama or Liberia. The experience with currency boards in such diverse countries as Argentina, Estonia or Hong Kong, has started to shake that view. EMU further suggests that 'normal' countries (i.e., countries not plagued by

1. I am grateful to David Begg, David Gruen and conference participants for helpful suggestions, and to Nadia Ivanova for research assistance.

endemic hyperinflation, transition challenges or larger than a city-island) may reasonably elect to give up monetary policy altogether.

Fischer (2001), summarises the new conventional wisdom:

The trend away from softly pegged exchange rate regimes toward floating rates and hard pegs appears to be well established, both for countries that are integrated into international capital markets and those that are not. This is no bad thing and it looks set to continue.

Yet, Calvo and Reinhart (2000) observe that there is a gap between what countries say and what they do. In particular, many floaters keep a close eye on their exchange rates and, one way or another, limit their variability. This is not surprising. The choice of an exchange regime involves a wide range of economic and political trade-offs, and the best response to trade-offs is typically to be found in the middle, not at the corners. This is where collective arrangements become appealing. Both the European Monetary System (EMS) and EMU can be seen as a combination of exchange rate fixity (among members of the arrangement) and flexibility (*vis-à-vis* the rest of the world). The shift from EMS to EMU can be further interpreted as the socialisation of monetary policy, initially in the hands of the Bundesbank and now shared within the European Central Bank (ECB).

It is a far cry, however, from the observation that 'normal' countries give up monetary policy to the conclusion that it is a desirable policy option. In many respects, Europe is unique. This paper attempts to examine more precisely what has been unique to Europe, with a view to drawing lessons for the east Asian countries that contemplate to travel the same route. A few papers have previously examined this question. Kwan (1994) presents the case for adopting the yen as the anchor of east Asian countries. Eichengreen and Bayoumi (1996) review the optimum currency area arguments and cautiously conclude that the time is not ripe. Their conclusion is based less on economic than on political considerations, a view largely shared by the present paper. Williamson (1999), who also favours some degree of exchange rate fixity, shares Eichengreen and Bayoumi's doubts that the political will to move far in this direction is there. He suggests the implementation of his long-held proposal for basket pegs, a roundabout way to stabilising regional exchange rates. Coleman (1999) looks at another part of the broad region, Australia and New Zealand. Reviewing the modern literature, he concludes that for New Zealand the costs of a monetary union are smaller than often believed and the benefits larger, making it a viable, possibly desirable option.

The present paper takes the view that optimum currency area arguments have not been prominent in the European debate, a point also noted by Eichengreen and Bayoumi. Exchange rate stability has been the paramount objective among countries seeking to achieve and maintain a high degree of trade integration. Fear of competitive devaluations and of the protectionist reactions that they create has always been a key concern and the incentive for a cooperative approach to interdependence. Achieving a high degree of exchange rate stability was made relatively easy by a fairly extensive use of internal and external financial repression.²

2. Financial repression in post-war Europe is documented in Wyplosz (2001).

Once the commitment to full capital mobility was made, and set in concrete in the *Single European Act* adopted in 1988 for implementation in 1992, the authorities gradually realised the full implication of the hollowing-out principle. Unique political conditions made it possible to quickly take the step and cement the by-then shaky EMS. Sections 2 and 3 provide a more precise discussion of these points, looking first at the role of exchange rate stability and then at the irrelevance of optimum currency area criteria in the European debate, as well as presenting some comparative evidence on Europe and east Asia. Section 4 moves to the political economy and develops the view that Europe has followed a unique path of institution-building. The lessons from the European experience are applied to Asia in Section 5. Section 6 concludes.

2. The Goal of Exchange Rate Stability

2.1 Why exchange rate stability?

When the choice is between a peg – soft or hard – and a floating rate, the burden of the proof now lies on those who argue for a peg. Tying the exchange rate requires the loss of an important policy tool and we certainly do not have too many macroeconomic policy instruments to deal with shocks. This cost is further increased by the fact that fluctuations of the currency to which the peg is established can represent an additional disturbance, as has been the case with the east Asian (soft and possibly unofficial) pegs during the period leading to the 1997–1998 crisis. Implicitly, free floating is the natural benchmark, if only because the authorities cannot be blamed for making the wrong choice.

In fact, there is no reason for adopting such a lopsided view. After all, the founding fathers of the Bretton Woods agreement based their strong preference for fixed-but-adjustable pegs on dramatic inter-war evidence of the dangers of floating rates. They identified the mismanagement of floating rates as a major source of inefficiency and frictions that ultimately led to tariff wars. In today's world, such drastic outcomes are hopefully ruled out, yet large exchange rate fluctuations remain conspicuous and are quite problematic, for both economic and political reasons.

It has long been a puzzle as to why the intuitive presumption that exchange rate variability hurts trade could not be empirically supported. Part of the difficulty is that the post-war period does not offer long enough sample periods, prompting researchers to examine high-frequency volatility. The usual result that high-frequency exchange-rate volatility does not hurt trade is not surprising since there exist cheap financial instruments that offer hedging against currency risk at horizons up to one year. More interesting are longer-term currency cycles which durably shift competitive advantage, allowing firms to invest in entering markets and to close down some production units to open others elsewhere. Frankel and Rose (1996) and Froot and Rogoff (1995) provide evidence of long exchange rate cycles, and Pozo (1992) finds a non-negligible adverse effect of low-frequency exchange rate variability on trade.

Some recent studies have established the presence of a 'border effect', as summarised in Coleman (1999) for example. For reasons which remain unclear,

international trade is much less developed than intra-national trade. One potential explanation is the presence of exchange rates, which could operate via conversion costs but also exchange rate variability. Another piece of evidence is provided by Rose (2000) who reports a powerful trade-enhancing effect of common currencies. Put together, such evidence increasingly confirms that exchange rate volatility discourages trade. For countries that seek regional integration, the costs could be significant.

An additional consideration lies in the political economy domain. Truly free floating is the exception, not the rule, as convincingly shown by Calvo and Reinhart (2000) and Reinhart (2000). That most of the floaters are dirty floaters raises the following question: why agree on detailed trade agreements if relative prices can be freely changed by large amounts? When the exchange rate can be manipulated it is inevitable that trade partners become suspicious of each other, thus threatening the best-crafted trade agreements.³

2.2 What kind of stability?

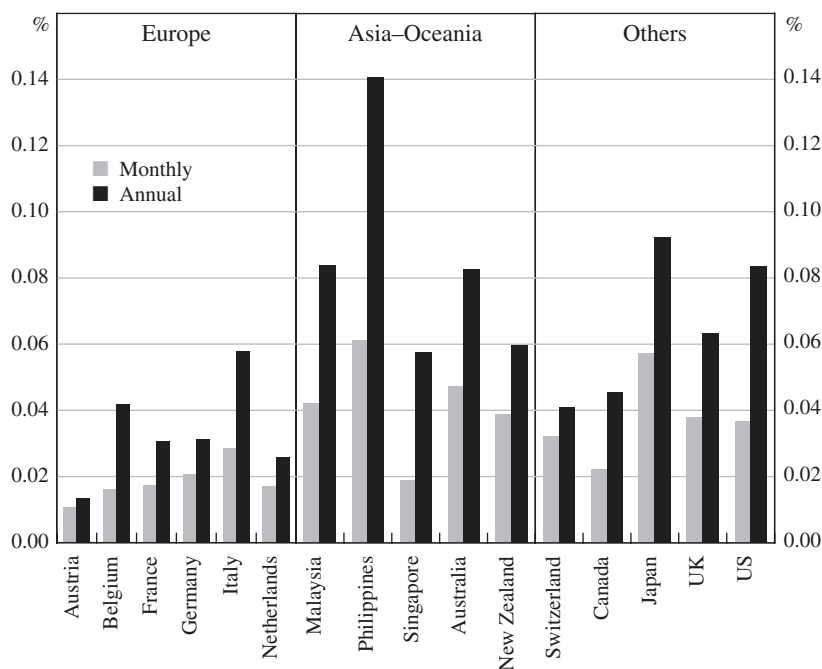
Once the option of some degree of exchange rate management is rehabilitated, we need to consider the various ways of achieving it. The new wisdom states that the only sustainable fixed exchange rate regime is a hard peg – dollarisation or a currency board. Indeed, Eichengreen (1999) observes that normal pegs (fixed-but-adjustable exchange rates, crawling bands) have never lasted very long. On the other side, the hard pegs currently in vogue are a recent phenomenon and it is far too early to conclude that their endurance significantly exceeds that of previous peg arrangements. The Argentine experiment, for example, is shaky. The Estonian currency board is scheduled for reinforcement as the euro is adopted. Hong Kong's resilience has been impressive but not free of speculative attacks. It can be noted that the closest equivalent to modern currency boards, the gold standard, did not last for very long either. In fact, its abandonment is often considered as a major step forward. At any rate, in the case of Europe, soft pegs have been an important transition step – and a period of learning how to deepen cooperation – towards hard pegs (the monetary union).

Another view is that fixed-but-adjustable exchange rates do not deliver the sought-for stability. This view argues that the sharp changes which occur sporadically at the time of realignments introduce as much, if not more, volatility as the small movements inherent in floating rates. Hopefully, Figure 1 should dispose of this view. It reports the standard deviation of exchange rate fluctuations around their trends, at monthly and annual frequencies.⁴ Two main conclusions can be drawn. First, by adopting an explicit system of fixed-but-adjustable rates, the European countries have achieved more stability than the other countries shown in the figure: the standard deviation of their effective exchange rate is on average half of that

3. A good European example is the Italian devaluation of 1992. The French Prime Minister then publicly stated that he suspected foul play.

4. The trends are calculated using Hodrick-Prescott filters.

Figure 1: Effective Exchange Rates
Standard deviations, 1975–1999



observed in the main countries with floating rates (the ‘others’ group), themselves about 50 per cent less volatile than those of the Asia–Oceania group. Second, the lower-frequency volatility, which matters most for trade, is typically higher (on average 90 per cent) than the higher-frequency volatility.

Two conclusions can be drawn at this stage. First, exchange rate stability is increasingly found to enhance trade. Second, the choice between soft and hard pegs is less of a foregone conclusion that current fashion suggests. Fixed-but-adjustable rates deliver exchange rate stability. While their shelf-life is undoubtedly limited, they can be an efficient arrangement during a transition period. Bretton Woods can be seen, in retrospect, as a transitional arrangement set up to last until the largest economies were ready to float. The EMS achieved its aims until the European countries were ready for a single currency, having restored trade links and built up adequate institutions.

2.3 Costs of exchange rate stability

None of the above should be read as implying that exchange rate stability comes for free. Three important costs need to be examined. First is the loss of the monetary policy instrument. This affects both the short and the long run. In the short run, the macroeconomic stabilisation function can be precious, especially once it is recognised that the fiscal policy instrument is blunter and more politically sensitive. In the long

run, the main difficulty lies with inflation, which becomes endogenous with hard pegs. Hong Kong has long had a higher inflation rate than it wished while Argentina is undergoing a painful deflation. With soft pegs, the cost is largely eliminated since realignments or crawling bands allow a country to choose its trend rate of inflation.⁵

The second cost is specific to soft pegs: realignments invite speculative attacks which can be extremely costly.⁶ This is certainly Europe's experience, since most EMS realignments have been accompanied – usually anticipated – by speculative attacks. On the other side, the costs of crises are likely to have been modest in Europe, largely because they did not translate into banking crises where most of the costs usually lie.

The last cost is associated with one antidote to crises, the use of capital controls. Whether capital controls mitigate the crisis problem is a highly controversial view. The most extreme statements, that controls are useless or that they are highly effective, are certainly unwarranted (see Eichengreen, Rose and Wyplosz (1995), Edwards (1998), De Gregorio, Edwards and Valdés (1998) and Bordo *et al* (2001)). A more nuanced assessment is that controls increase the frequency of currency crises while reducing the incidence of banking crises. Moral hazard may explain both results. Controls embolden authorities to conduct undisciplined macroeconomic policies while they may deter imprudent risk-taking in the banking sector. But how costly are controls *per se*, especially concerning growth? The evidence on the growth effects of capital liberalisation (Rodrik 1998; Arteta, Eichengreen and Wyplosz 2001; Wyplosz forthcoming) is inconclusive. A plausible interpretation is that the much celebrated efficiency cost of capital controls is more a theoretical result than a reality in a world where financial markets suffer from serious failures associated with pervasive information asymmetries.

2.4 Strategies for exchange rate stability

Summarising so far, I argue that some degree of exchange rate stability may be desirable for countries that trade heavily – or wish to expand trade links – among themselves. Both trade and political economy considerations call for transparent rules of the game, which implies a verifiable approach to the exchange rate. Free floating simply does not fit the need. Currency boards make adjustment to serious shocks extremely costly. Monetary unions are less demanding, but require considerable preparation. This is why soft pegs were invented in the first place and remain an appealing option for many small open economies, especially those which have good reasons to pursue a regional strategy.

The remaining question concerns the way exchange rate stability is established. Hard pegs include dollarisation and currency boards. For soft pegs, the available menu is wide, ranging from fixed-but-adjustable rates, to crawling pegs and large or

5. Exchange rate pegs are often used to discipline monetary policy. In that case, the endogeneity of inflation is precisely what is desired.

6. Bordo *et al* (2001) find that the costs of crises are on average close to 10 per cent of GDP.

fuzzy bands. As a first order of approximation, differences among soft pegs matter little. More important are the procedures to enforce and verify the arrangement. If the adoption of a peg is to be part of a regional agreement, it must be supported by adequate institutions (see Section 4).

Another question concerns the choice of the anchor. The role of the US dollar as an anchor has been dominating, partly as a reflection of the importance of the US economy and particularly its financial markets, and partly as a legacy of Bretton Woods. The danger of mechanically adopting the dominating financial currency for arrangements that primarily affect trade has been exemplified by the Asian crisis. This has led Williamson (1999) and others to argue in favour of a basket. While a basket goes some way towards solving the problem at hand, its main drawback is that it fails to recognise the regional dimension. The EMS solution has been to agree on *internal* pegs, letting member currencies float jointly *vis-à-vis* *external* currencies.

3. Optimum Currency Area Principles: Are They Relevant?

One lesson from the European experience is that the priority bestowed upon exchange rate stability was part and parcel of a commitment to develop trade links. Another lesson is that, up until the mid 1980s, monetary policy was not entirely ditched thanks to the preservation of restrictions to capital mobility and, when capital controls were repealed, monetary union was preferred to national monetary policies.

The most commonly used arguments to study the desirability of an increasingly limited role for monetary policy is the optimum currency area (OCA) approach. For the Asian countries, Eichengreen and Bayoumi (1996) develop an OCA index that takes into account the extent of asymmetric shocks, the composition of the export structures, bilateral trade intensity and country size. Based on their index, they conclude that some pairs of countries achieve scores comparable to those in Europe: Singapore–Malaysia, Singapore–Thailand, Singapore–Hong Kong, Singapore–Taiwan, and Hong Kong–Taiwan. Other pairs, those including Indonesia, South Korea and the Philippines, do not rank well, and the Malaysia–Thailand pair displays a very weak score. A problem with the Eichengreen-Bayoumi indicator is that some of the explanatory variables are clearly likely to change in the event exchange rates are stabilised. More generally, Frankel and Rose (1998) have warned that *any* OCA criterion is potentially endogenous.

Another problem is that the choice of an exchange rate regime is never a black-or-white issue. Typically arguments for and against any arrangement are finely balanced. Average behaviour over a sample period, as explored in the OCA index approach, fails to recognise that ‘big’ shocks, even if rare, may be more important than frequent minor shocks. It may well be that Malaysia and Thailand are, on average, subject to mostly asymmetric shocks but, over 1997, they faced the same massive shock that revealed more commonality of interest than may have been suspected beforehand.

In this section, I proceed along the same reasoning as Eichengreen and Bayoumi (1996) but I do not attempt to develop a synthetic indicator. In Section 3.1 I look at trade integration, while I look at output shocks in Section 3.2.

3.1 Trade integration

A good starting point is to examine how much trade integration has already been achieved in east Asia. Trade integration is believed to be an important OCA argument for it reduces the likelihood of asymmetric shocks and enhances the transmission of any shocks. Trade integration is typically examined by looking at direct bilateral flows. Table 1 presents bilateral trade as a per cent of total trade for Asian and European pairs. On that measure, the Asian countries appear to be at least as integrated as the European countries.

This comparison is not fully informative, however, because it omits a huge range of potentially important ‘special effects’. For example, distances between Asian countries are often larger than within Europe, with sea instead of land connections. Looking at trade to GDP ratios also assumes that the effect of size on trade is linear. A more accurate assessment requires a model of bilateral trade to set a benchmark. Over recent years, the gravity model has emerged as a successful empirical model (see Leamer and Levinsohn (1995)), with reasonably convincing theoretical underpinnings (Anderson 1979). The gravity model has been used by Rose (2000) to study the effect of monetary unions on bilateral trade. I use Rose’s specification and database to predict what trade among the Asian and European countries ‘should be’. These are within-sample predictions based on estimates which are obtained from a modified version of Rose’s model.

Rose uses a sample that includes 186 countries, some of which are dependencies, or very small islands, or both. His quest is driven by the need to include geographical units that share the same currency in order to measure the currency union effect. My purpose is different: I am interested in determining a ‘normal’ level of bilateral trade as justified by each pair’s characteristics. To that effect, I have restricted the sample quite drastically by focusing only on reasonably advanced and large economies from the two areas under examination, east Asia and Europe, along with North America and Oceania. Appendix A lists the 31 countries that have been retained, sampled every five years over the period 1975–90. Given some missing observations, the sample includes 2 351 pairs/years out of the theoretical 4 650.

The dependent variable is the log of bilateral trade (in US dollars, deflated by the US GDP deflator). The independent variables are those used by Rose with the exception of the common currency dummy, which does not apply. The results are shown in Table 2 (year dummies not reported). With this sample, two explanatory variables are not significant: the common coloniser dummy (which is quite reasonable) and the common border dummy (which is more surprising) and they are dropped in the second column. Otherwise, the results are quite similar to those reported by Rose with a few differences: the exchange volatility effect is stronger, maybe because the countries in this sample do not share a common currency; the free trade area and

Table 1: Bilateral Trade
Per cent of total trade, 1999

	China	Japan	Korea	Malaysia	New Zealand	Philippines	Thailand	Hong Kong	Indonesia	Singapore			
Australia	2.1	4.0	3.2	2.3	10.0	1.1	2.0	1.8	2.6	3.4			
China		9.1	6.3	1.4	0.3	0.8	1.4	25.7	1.8	2.7			
Japan			6.9	4.2	0.7	3.0	4.2	5.3	3.4	4.7			
Korea				2.7	0.5	2.3	1.4	3.7	3.1	3.3			
Malaysia					0.5	2.3	3.4	2.0	2.0	16.5			
New Zealand						0.3	0.4	0.3	0.4	0.5			
Philippines							1.9	1.8	0.9	3.5			
Thailand								2.0	1.9	5.9			
Hong Kong									0.9	4.5			
Indonesia										5.1			
	Denmark	France	Germany	Italy	Netherlands	Sweden	UK	Austria	Finland	Greece	Ireland	Portugal	Spain
Belgium	1.1	10.9	8.3	4.0	12.3	2.5	7.1	1.2	1.0	0.7	1.9	1.3	3.6
Denmark		1.5	3.2	1.3	2.1	7.7	2.4	0.9	3.0	0.8	1.1	0.8	1.3
France			13.2	11.1	7.3	1.1	11.4	1.7	1.1	1.0	2.2	2.5	11.8
Germany				10.2	12.3	3.4	9.3	8.7	2.0	1.0	1.9	1.9	5.9
Italy					4.4	1.8	5.6	3.8	1.0	2.5	1.2	1.7	7.2
Netherlands						3.4	8.8	1.7	1.6	0.9	2.1	1.2	3.6
Sweden							3.9	1.1	6.7	0.8	1.1	0.9	2.2
UK								1.4	1.9	0.8	9.1	1.8	5.2
Austria									0.9	0.6	0.4	0.6	1.7
Finland										0.8	0.7	0.7	1.0
Greece											0.4	0.4	1.2
Ireland												0.4	1.5
Portugal													11.1
	Asia			Asia—Oceania			Europe			Average			
	4.2			3.4			3.5			3.5			

Table 2: Gravity Equations
 Dependent variable: log of bilateral trade
 1970–90, 5-year frequency

	Regression (1)	Regression (2)
Output	0.745 (0.015)	0.745 (0.015)
Output per capita	0.637 (0.039)	0.633 (0.039)
Distance	-0.843 (0.030)	-0.850 (0.028)
Contiguity	0.094 (0.122)	
Language	0.823 (0.065)	0.860 (0.075)
Free trade area	0.240 (0.069)	0.243 (0.069)
Same coloniser	0.263 (0.442)	
Colonial relationship	1.515 (0.134)	1.489 (0.138)
Exchange rate volatility	-0.145 (0.019)	-0.145 (0.019)
Number of observations	2 351	2 351
\bar{R}^2	0.744	0.744
SEE	1.216	1.216

Note: Standard errors in brackets beneath coefficients

distance effects are smaller, an indication that more advanced countries tend to trade more than the others; the common language effect is stronger.

The regression shown in the second column is used to predict trade for all pairs. Table 3 reports the ratio of actual to predicted bilateral trade in 1990 for three country groupings: North America, Asia–Oceania and Europe. The striking result is that, on average, the European pairs seem less integrated than predicted, while the opposite is true for most Asian country pairs. Interestingly, Australia and New Zealand are also more integrated with the Asian countries than predicted by the gravity model.

Obviously, scepticism is called for in considering these results. To check their robustness, I have explored various different specifications: using the whole sample, eliminating the large number of small geographical units (the six lower deciles in terms of population size), allowing for non-linear effects of distance. Table 4 reports

**Table 4: Ratio of Actual to Predicted Bilateral Trade – Summary Statistics
1990**

	Benchmark regression		
	North America	Europe	Asia–Oceania
Average	0.79	0.92	3.83
Standard deviation	0.56	0.41	3.98
	Average of all regressions		
	North America	Europe	Asia–Oceania
Average estimates	0.58	0.87	4.15
Standard deviation of estimates	0.20	0.34	1.60

the average ratios of actual to predicted trade, along with the standard deviations of these ratios, obtained from six regressions. They confirm the results shown in Table 3.

As suggested by the R-bar-squareds in Table 2, gravity equations do not fully explain bilateral trade, even though the coefficients are estimated with a high degree of precision. This suggests that the within-sample forecasts are inaccurate. Yet, the differences between the Asian and European countries reported in Tables 3 and 4 are too large to be attributed to inaccuracies. The conclusion that trade integration is deeper in Asia than it is in Europe, more than 40 years after the creation of the Common Market, is likely to be robust. If so, it is conceivable that the trade effect from forming a currency union could be smaller than those expected in Europe.

3.2 Correlations of shocks

Trade matters mostly because it raises the probability that shocks will be symmetric, either because of a common origin or because idiosyncratic shocks will be transmitted. This is why a standard practice is to look at the degree of correlations of shocks.⁷ The shocks are identified here as the residuals from simple AR(2) regressions of real GDP for the Asian and European countries, as well as Australia and New Zealand, using annual data over the period 1961–98. Table 5 reports the bilateral correlations of these residuals. The table suggests two main observations.

First, the shocks are significantly more correlated within the European sample than within the Asian sample, with Australia and New Zealand clearly on their own *vis-à-vis* the Asian countries. Thus, a high degree of trade integration does not translate into strong output correlations, a healthy warning that OCA arguments are far from straightforward. Second, in Asia: Korea, Malaysia and Thailand seem to

7. The EMU project has led to a large literature in the early 1990s, e.g. Cohen and Wyplosz (1989) or Calmfors *et al* (1997).

Table 5: Correlations of GDP Shocks
1961–98

	China	Hong Kong	Indonesia	Japan	Korea	Malaysia	New Zealand	Australia	Philippines	Singapore	Thailand				
China	█														
Hong Kong	-0.010	█													
Indonesia	-0.041	0.387	█												
Japan	0.081	0.303	0.341	█											
Korea	0.022	0.470	0.540	0.446	█										
Malaysia	0.022	0.470	0.540	0.446	█										
New Zealand	0.132	0.383	0.034	-0.098	0.281	0.286	█								
Australia	0.026	0.106	0.132	0.250	0.123	-0.077	0.241	█							
Philippines	-0.258	0.405	0.152	0.166	0.274	0.291	0.072	-0.054	█						
Singapore	-0.027	0.439	0.305	0.150	0.296	0.554	0.172	0.167	0.324	█					
Thailand	0.215	0.478	0.478	0.527	0.460	0.460	0.003	0.128	0.318	0.413	█				
Minimum	-0.258	-0.010	-0.041	-0.098	0.022	-0.160	-0.098	-0.077	-0.258	-0.027	0.003				
Maximum	0.215	0.554	0.656	0.527	0.540	0.656	0.383	0.250	0.405	0.554	0.527				
Average	-0.002	0.352	0.298	0.238	0.343	0.325	0.151	0.104	0.169	0.279	0.353				
	Austria	Belgium	Switzerland	Germany	Denmark	Spain	Finland	France	UK	Greece	Ireland	Italy	Netherlands	Portugal	Sweden
Austria	█	0.636	0.682	0.579	0.467	0.427	0.302	0.601	0.121	0.183	0.026	0.518	0.510	0.530	0.256
Belgium	█	█	0.782	0.590	0.531	0.522	0.434	0.776	0.198	0.329	0.225	0.722	0.741	0.631	0.533
Switzerland	█	█	█	0.495	0.373	0.448	0.355	0.639	0.113	0.134	0.232	0.654	0.665	0.551	0.280
Germany	█	█	█	█	0.633	0.374	0.239	0.558	0.358	0.524	0.021	0.439	0.646	0.509	0.365
Denmark	█	█	█	█	█	0.314	0.411	0.631	0.386	0.494	0.030	0.385	0.644	0.361	0.425
Spain	█	█	█	█	█	█	0.442	0.540	0.227	0.226	0.233	0.513	0.241	0.353	0.204
Finland	█	█	█	█	█	█	█	0.510	0.361	0.374	0.283	0.226	0.229	0.177	0.618
France	█	█	█	█	█	█	█	█	0.372	0.423	0.204	0.678	0.595	0.567	0.478
UK	█	█	█	█	█	█	█	█	█	0.555	0.135	0.230	0.215	0.476	0.438
Greece	█	█	█	█	█	█	█	█	█	█	0.016	0.184	0.283	0.308	0.394
Ireland	█	█	█	█	█	█	█	█	█	█	█	0.051	0.220	0.135	0.168
Italy	█	█	█	█	█	█	█	█	█	█	█	█	0.531	0.627	0.403
Netherlands	█	█	█	█	█	█	█	█	█	█	█	█	█	0.445	0.436
Portugal	█	█	█	█	█	█	█	█	█	█	█	█	█	█	0.247
Minimum	0.026	0.198	0.113	0.021	0.030	0.204	0.177	0.204	0.113	0.016	0.016	0.051	0.215	0.135	0.168
Maximum	0.682	0.782	0.782	0.646	0.644	0.540	0.618	0.776	0.555	0.555	0.283	0.722	0.741	0.631	0.618
Average	0.417	0.546	0.457	0.452	0.435	0.362	0.354	0.541	0.299	0.316	0.141	0.440	0.457	0.423	0.375

form a subgroup of more tightly linked economies, displaying some correlation with Japan. China stands apart, with fairly frequent negative but small correlations.

These results are not directly comparable to those obtained by Bayoumi and Eichengreen (1994) who propose a decomposition between demand and supply shocks as they study both output and price shocks, using the Blanchard-Quah identification approach. Bayoumi and Eichengreen find little difference – for both types of shocks – between Europe and Asia, and they identify different country groupings: Hong Kong, Indonesia, Malaysia, Singapore and Thailand for demand shocks and, for supply shocks, one group comprised of Japan, Korea and Taiwan, and another group including Hong Kong, Indonesia, Malaysia and Singapore. The difference can be related to the different methodology or to the sample period (Bayoumi and Eichengreen's sample covers the years 1972–89).

This difference reveals the limited reliance that one can put on historical shocks as a guide to the choice of an exchange rate regime. One interpretation is that these shocks are partly endogenous to the exchange and capital regimes. Another is that OCA arguments are relatively uninformative, indeed, OCA principles have played a limited role in the European debate which has rather been dominated by political economy considerations.⁸ This is the issue now taken up.

4. Political Economy Considerations

This section argues that EMU came about as the pragmatic response to a wider process of economic and political integration.

4.1 Europe's choice between exchange rate stability and capital mobility

It has been argued above that a mainstay of European thinking about exchange rate regimes has been the conviction that stability is the key to economic integration. This should have implied a willingness to give up the use of monetary policy for domestic purposes. That has not been the case. Until the mid 1980s, most European countries fully intended to retain their monetary policy instrument. The first country to completely and explicitly give up monetary policy independence, the Netherlands, did so only after 1982. In fact, in a large number of countries, monetary policy was not only seen as a macroeconomic tool, but also as an instrument to support fiscal policy through the financing of budget deficits, and even to conduct industrial policies. Bank lending was often directed to favoured sectors and to firms identified as national champions, and interest rates were generally kept low, often negative in real terms.

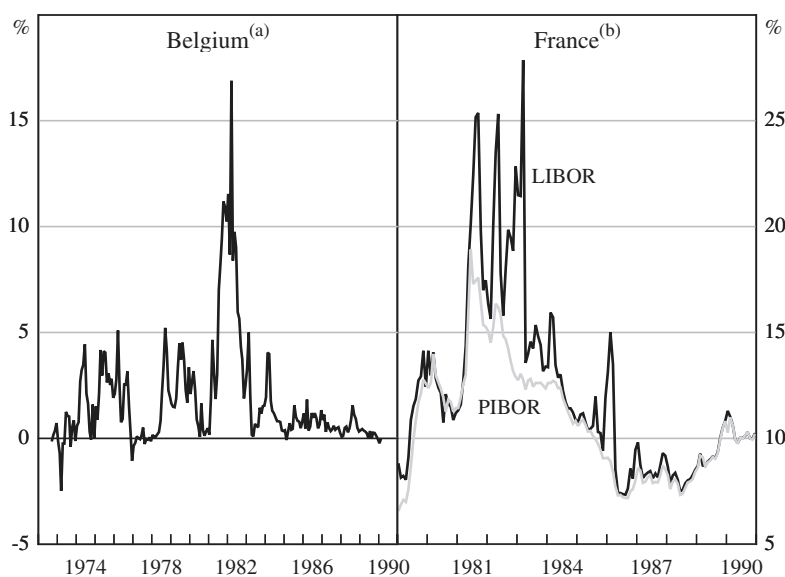
8 . It may be that OCA principles should have been taken more to heart and that having ignored them may result in serious difficulties once EMU is in place. Indeed, in Wyplosz (1997) I argue that the costs of EMU will be highest where Europe ranks most poorly on the OCA scale (labour mobility and, more generally, labour market flexibility).

The conflict between exchange rate stability and the active use of monetary policy was reconciled through internal and external financial repression, i.e., the use of widespread regulation limiting the normal activities of financial markets. Domestic financial repression included quantitative limits on bank credit, ceilings on interest rates, directed lending, priority to budget financing, limits on the development of stock markets, etc. External financial repression took the form of capital controls, including administrative restrictions on inflows and outflows, the interdiction of lending to non-residents, the banning of forward transactions, the obligation for exporters to remit foreign-currency earnings, etc. Domestic financial repression allowed the authorities to control the interest rate independently of credit and money supply growth. External financial repression supported domestic repression by preventing arbitrage relative to the world interest rate. It also limited the ability of markets to attack the currency. Thus, while Europe has been quite fast at deepening its internal trade, it has been notoriously slow at liberalising its financial markets, both internally and externally.

External liberalisation occurred several years after internal liberalisation. Various measures were in place to restrict capital movements. They mostly relied on direct administrative controls affecting citizens, firms and financial intermediaries. Belgium operated a dual exchange market separating commercial from financial transactions. Full, unconditional liberalisation was not mandatory until the *Single European Act*, with accelerated effect from July 1990, except for Greece, Portugal and Spain which were granted grace periods.

The main aim was to keep domestic interest rates lower than implied by the interest parity condition. While it is often asserted that capital controls are ineffective, this has not been the case in Europe, as documented in Figure 2. The figure shows that the controls succeeded in creating long-lasting wedges between the two exchange rates (commercial and financial) in Belgium, and between the internal and external franc interest rates in France. Such deviations represent large, riskless profit opportunities. Their existence is proof that, even though capital controls were routinely evaded, markets were unable to arbitrage away profit opportunities for significant periods of time – often more than one year. The figure also indicates that, in quiet periods when controls were not needed, the wedge disappeared. This is clear evidence that the controls were effective. Even if this observation runs against today's conventional wisdom, it is not surprising. Because evasion is costly, immediate full arbitrage is not profitable. When needed, capital controls achieve the aim of insulating domestic financial markets. In the longer run, or when they are lifted, the effect rubs off, but the controls can be reactivated at will.

Thus, Europe's experience is fully compatible with the principles underlying the hollowing-out view. But it puts trade integration and exchange rate stability at centre stage, in lieu of financial integration. It sets the choice of an exchange rate regime as part of a package that may include, if needed, some degree of financial repression. Nor does it deny that soft exchange rate regimes are inherently unstable. But Europe's experience runs against the view that financial markets ought to be liberalised and if that means giving up the exchange peg, so be it. It provides support

Figure 2: Effectiveness of Capital Controls

- (a) Percentage difference between commercial and financial franc
 (b) 3-month offshore and onshore interest rates. LIBOR – London interbank offered rate; PIBOR – Paris interbank offered rate.

Sources: Belgium – Bakker (1996); France – Burda and Wyplosz (1997)

for a strategy of regional integration that starts with trade opening and exchange rate stability, leaving capital mobility as a distant goal.

4.2 The building-up of institutions

EMU is sometimes seen as a long-planned step in the unfinished process that ultimately aims at creating the United States of Europe. This is not quite accurate. Divergence of opinions about the ultimate aim of European integration runs deep, and cuts across countries and traditional party lines. For that reason, each step has always been discussed on its own merits. Any attempt to link any step to a broad master plan would most likely trigger lethal opposition. Pragmatism is the first ingredient of Europe's successful integration progress.

The second ingredient is institution building. The main institutions today are the European Commission and the ECB. The Commission was created along with the Common Market. With limited powers initially, it has been the repository of each abandonment of national sovereignty, in trade matters initially, progressively extending its role to industrial and antitrust policies, agriculture, research, diplomacy, etc. The Commission's natural role is to be the main advocate of the

integration process, which often brings it into conflict with its member governments. The Commission's arcane functioning is often derided, for good reason, but it reflects the inherent difficulty of its mission: it represents the common interest which often comes at the expense of national or corporate interests. It uses the powers grudgingly given up by member countries to try and force them to act in a way that is collectively desirable. Its legitimacy is devolved by member governments, which are prompt to call it into question when they feel threatened.⁹ Its task is thankless but essential.

The ECB's structure well reflects the fundamental ambiguity in relinquishing national sovereignty. It is the $(n+1)$ th central bank, forming the European System of Central Banks (ESCB or Eurosystem) along with the n national central banks ($n = 12$ at present). The policy decisions are taken by the ESCB's Council which includes the n central bank governors and the six members of the ECB's Board. The Council is clearly too large to be efficient, and its size will increase with each new admission. Officially the ESCB is prevented from taking into account national interests and, yet, n of its $n+6$ Council members serve as representatives of national central banks. No wonder then that it often appears adrift and slow to move.

The European Parliament is the only pan-European elected body. Yet, elections are conducted at the national level, the candidates are appointed by national parties, and the issues debated at election times always refer to national politics with lip service paid to European issues. The Parliament's powers are mostly advisory and jealously restricted by the national parliaments. But it exists and is likely to see its role grow whenever it is politically expedient.

For all their shortcomings, the mere existence of European institutions has been crucial. They embody the principle of a common good and common aims which transcend national interests and objectives. They make retrenchment, never far below the surface of national instincts, virtually impossible. Importantly, their staff can develop analyses and proposals that match those carried out by national governments. They provide neutral grounds for dealing with conflicts among member countries. They give integration forces a name and a face.

In the end, Europe's integration has always been characterised by a process of muddling-through, two steps forward and one step backward, with deep and lingering divergences as to what the end objective is. But each integration step makes the next one more likely. The existence of institutions ready to transform projects into reality has been essential.

For example, when the liberalisation of capital movements was decided upon, it was soon realised that the EMS was under immediate threat, which was itself perceived as a clear danger to the very existence of the Common Market. The desirability of adopting a monetary union was being discussed and studied, but it was staunchly opposed by Germany, Britain and a few other countries. What made a crucial difference was that the project was available on the shelf when the Berlin

9. This is why European integrationists have long called for an elected Commission, which would then have democratic legitimacy.

Wall fell and Germany was ready for an historic political deal in return for support for its unification. The Commission had done all the preparatory background work and could carry the plan to the next step, the Delors Commission that recommended adopting a common currency.

Thus, integration can be seen as a dynamic process, but one that is not predetermined, at least in policy-makers' eyes. It makes bold, unplanned moves possible when the occasion arises unexpectedly. Time is not of the essence, opportunities are.

4.3 A centre country?

A common view is that EMU has only been made possible by the presence of a strong currency, backed by a large economy. The role of Germany is, thus, often seen as pivotal, with the implication that other regions cannot proceed as far as Europe unless they can rely on a large champion. As discussed further in Section 5, this could be a serious problem for east Asia (and for Latin America as well given the traditional rivalry between Argentina and Brazil). This view is, at best, partly correct.

There is no doubt that it was crucially important that Germany was both the largest economy and home to the anchor currency within the EMS. Furthermore, the Bundesbank had many features that have become the hallmark of modern central banks and could be used as a blueprint: a clear price stability objective and an independent monetary policy committee (the Direktorium) that was designed for a federal state.

On the other side, the central role of Germany and of the Deutsche Mark was never planned and, when it existed, was studiously underplayed. For example, the EMS would never have been created had it been built as an asymmetric arrangement based on the Deutsche Mark. In fact, the EMS formally was a set of identical bilateral arrangements with no centre currency. Intervention rules were explicitly symmetric, with parallel obligations on strong and weak currency countries. It took several years before the Deutsche Mark organically emerged as the system's centre. It did so because the other large countries had failed to develop responsible monetary policies, thus having only themselves to blame for the speculative attacks that sapped their positions. In retrospect, it could be seen as clever strategy on the part of Germany but this would be a revisionist view. Much of this evolution was unplanned and, most likely, unforeseen.

What is true is that some form of leadership is needed, but one that is not seen as threatening. Historical experience counts a great deal. Germany's post-war acceptance of a subdued role – the self-imposed price to pay for Nazism – largely removed suspicions that it wanted to exert leadership. Its professed desire to develop its influence only within the context of a united Europe has been, and will remain, crucial. In practice, Europe has been driven by the Franco-German partnership. Being the two largest countries made their joint positions influential. That they had been bitter foes for centuries quieted down fears of national dominance. Their own disagreements – fundamental in most relevant issues – were seen as a guarantee that

the leadership would be balanced. Importantly, all these national influences are mediated through institutions that guarantee that important decisions cannot be forced upon reluctant minorities.¹⁰

The crucial lesson is that, more than a leading country, deep integration requires confidence-building steps and safety mechanisms backed by strong institutions. This is a slow, evolving process.

5. Lessons from Europe for East Asia

5.1 Exchange rate regime

5.1.1 Preliminary observations

The crises of 1997–1998 have opened a window of opportunity as a number of painful lessons have been learnt. First, the east Asian countries have found that economic success (growth) does not automatically bring about financial stability. Financial markets are fundamentally crisis-prone. The likely existence of self-fulfilling crises implies that most countries can be hit even though they do not have to be. Second, once again fixed exchange rates have been found to be fragile. When they fail, misalignment can become massive, with widespread and costly implications. The time to think about the exchange rate regime is when conditions are stable, not when clouds gather. Third, the assistance from international financial institutions is open to criticism. There is more than one way to deal with a crisis and the one that is chosen may not coincide with the one that is preferable from a national viewpoint. In particular, political motives are never far below the surface, which may call for friendly support. The Japanese proposal of an Asian Monetary Fund clearly reflected such concerns.

The first question is whether the Asian exchange rates should be allowed to float freely. The already achieved high degree of regional trade integration suggests that there could be serious costs associated with misalignments. Free floats are clearly undesirable. The quest for some degree of exchange rate stability must consider a wide menu of choices. In considering them, the following principles must be kept in mind.

5.1.2 Which parities must be stabilised?

If trade is the main reason for seeking a degree of stability, Table 6 indicates that about half of east Asian trade is within the region. This is less than in Europe, even if this is more than predicted in Section 2. The contribution of trade with the US is accordingly larger in east Asia than in Europe, hence a higher attractiveness of the

10. Here again, it is worth noting that the decision-making process, now with three required majorities, is extremely cumbersome and often ridiculed for its arcane features. But this is a decent price to pay for having a common, binding decision process at all.

Table 6: Regional Trade Patterns
Per cent

	Trade with region:			Trade with region:		
	East Asia	Asia–Oceania	US	Europe	US	
Australia	42.0	47.8	13.5	Belgium	71.6	6.7
China	54.8	56.5	14.7	Denmark	66.1	4.7
Japan	30.7	33.9	24.8	France	69.2	7.3
Korea	38.0	40.8	19.6	Germany	58.5	8.0
Malaysia	54.3	57.0	17.7	Italy	58.5	7.1
New Zealand	26.5	52.0	13.6	Netherlands	68.6	6.9
Philippines	51.7	53.6	26.2	Sweden	61.4	7.9
Thailand	44.5	46.8	15.4	UK	56.4	13.7
Hong Kong	47.2	48.6	15.5	Austria	65.2	3.8
Indonesia	51.4	55.3	11.4	Finland	61.2	6.6
Singapore	50.9	52.6	17.0	Greece	62.3	5.0
				Ireland	61.9	14.7
				Portugal	83.5	4.1
				Spain	73.5	4.5
Average	44.7	49.5	17.2	Average	65.5	7.2

Note: Each entry for each country is the value of that country's exports and imports with the region as a proportion of its total trade.

US dollar. Presumably, this difference lies behind the proposal by Williamson (1999) to establish a band with a common basket *vis-à-vis* the dollar, the yen and the euro.¹¹ The attractiveness of this proposal is that it would stabilise exchange rates both internally and *vis-à-vis* the other trading partners, the US and Eurozone. The disadvantage, in view of Europe's experience, is that such an arrangement comes without any institutional backup as it solely relies on separate decisions by individual countries.

One possible response to this shortcoming is the Chiang Mai Initiative. Mutual swap arrangements provide for some degree of collective defence against speculative pressure. In association with common basket bands, Chiang Mai comes close to an EMS-type arrangement. But only close, there are two crucial differences. First, the exchange rate mechanism (ERM) of the EMS provided for automatic and unlimited

11. Kwan (1994) argues that a yen link is preferable.

support of bilateral pegs.¹² The arrangement conveyed an essential message to the markets: any attempt at tearing apart any one currency from the others is bound to face strong official resistance since the strong currency central bank is committed to download unlimited amounts of its currency. In contrast, the amounts to be swapped within the Chiang Mai arrangement are limited, hence unlikely to be commensurate with the amounts that markets can mobilise. Worse for the basket proposal, two of the three currencies (the US dollar and the euro) to be included in the basket are not part of the arrangement, which rules out the kind of concerted interventions that gave the EMS its teeth. Thus, the combination of a common currency basket and mutual swaps is unlikely to work in the face of determined speculation. The essential lesson that fixed rates are open to possible self-fulfilling attacks is lost.

The natural response is to aim at a less roundabout approach to the stabilisation of east Asian exchange rates, i.e., to stabilise the bilateral rates. This would still leave the possibility of managing the common exchange rate *vis-à-vis* the dollar and the euro. But, in that case, it would require the setting-up of a coordinating mechanism. Such a mechanism requires an institution, a useful step at any rate.

5.1.3 *How much to stabilise?*

Williamson's response is to propose wide bands. If the bands are wide, the risks of lethal currency attacks decline but, obviously, the stabilising properties of the arrangement are eroded. Bands of ± 15 per cent allow for fluctuations of 30 per cent, far larger than the kind of tariff barriers which are seen as harmful to trade among tightly linked partners.

If it is deemed desirable to limit fluctuations *vis-à-vis* the dollar or the euro, the bands must probably be quite wide, and possibly crawling to account for the Balassa-Samuelson effect. The reason, as already noted above, is that reserves in dollars and euros are inevitably limited, always short of the amounts that speculative attacks typically muster. However, with ± 15 per cent margins, top-to-bottom movements of bilateral parities within the region can reach an amplitude of 60 per cent. If the aim is to stabilise bilateral parities – with trade typically representing a share of 50 per cent – the result is bound to be disappointing. Narrower bands for bilateral parities are obviously desirable. The EMS experience is that bilateral pegs can be stabilised within (much) narrower bands if backed by proper swap arrangements. Such arrangements can only concern the mutual provision of national currencies, not currencies from outside the area. This is another reason why basket pegs are too roundabout.

A monetary union is the next logical step. It delivers complete exchange rate stability and fully dispenses with the need for swap arrangements. In that sense, it

12. When the Bundesbank declined to provide unlimited support to Italy and Great Britain in 1992, the lira and sterling were forced to withdraw from the ERM. It then appeared that the Bundesbank had an agreement with the German government to withdraw from the agreement if it perceived a threat to price stability. This episode and the German arrangement are studied in detail in Eichengreen and Wyplosz (1993).

is the perfect solution. Three difficulties need to be contemplated, however: the depth of the economic and political requirements, the viability of the system, and the need for real exchange rate variability.

The complete renunciation of monetary policy is a major economic and political step. While the economic requirements, the OCA criteria, may be less crucial than often believed, the sudden and irrevocable increase in interdependence calls for a battery of agreements which further erode national sovereignty. These include limits on public debts, the harmonisation of banking regulation and supervision, seigniorage sharing rules, and provisions for lender-of-last-resort operations. Politically, it requires the creation of a powerful multinational institution, the central bank, which is bound to raise delicate issues of delegation of authority and democratic accountability. Finally, it requires an understanding on the management of the common exchange rate. Free floating is the easy way out, but it presumes that the member countries share a commonality of interests. Kwan (1994) reports that exchange rate fluctuations *vis-à-vis* currencies outside the region have divergent effects on the Asian countries, suggesting that an agreement will not come easily.

The creation of a monetary union is properly regarded as a one-way commitment. Its viability is therefore of paramount importance. Since the OCA criteria are unlikely to be fulfilled, there will always be costs in sharing the same currency. At this stage, we simply do not know how to evaluate these costs. A complicating factor is the distinct possibility that fulfilment of the OCA criteria is endogenous to the existence of the monetary union itself.

What is clear, is that real exchange rates are unlikely to remain stable within a monetary union. Asymmetric shocks call for short-run variability. Different stages and speeds of development call for long-run variability. This requires wage and price adjustments, raising two main issues. First, goods and labour markets need to display the required flexibility to permit such adjustments without unacceptably large macroeconomic disturbances. Second, real convergence matters a great deal. The more disparate are the monetary union members, the larger will be the necessary variability of price changes. The choice of a union-wide inflation objective, formal or informal, must allow for such variability without forcing deflation in some countries. Europe's approach has largely ignored this issue, focusing instead on nominal convergence. Real convergence is coming to the forefront now.¹³

5.1.4 Capital mobility?

Most countries in the region have now fully liberalised their capital accounts. The European experience is that such a move greatly endangers any attempt at formally stabilising exchange rates. It also suggests that restrictions on capital movements do not seriously impede growth (Wyplosz (forthcoming)). Should there be any back-tracking from liberalisation? Such a view is clearly seen as unorthodox.

13. This difficulty is compounded by the fact that several formerly planned economies of eastern and central Europe are knocking at the door.

The debate on restrictions is often presented as black-and-white. Opponents claim that restrictions greatly affect the proper allocation of resources and fail to prevent speculative attacks. Reasonable supporters (e.g., Eichengreen, Tobin and Wyplosz (1995); Rodrik (1998)) argue that restrictions have, at worst, limited effects on the allocation of resources and can help with speculative attacks. Some restriction may thus be an acceptable way of increasing the odds that exchange rate pegs will withstand moderate market pressure. Coupled with disciplined monetary and fiscal policies, they can make all the difference between a stable arrangement and one that withers away when markets, as they occasionally do, over-react. Furthermore, restrictions on capital mobility do not have to rely on old-fashioned administrative measures. Prudential measures, in the spirit of the Tobin tax or Chilean *encaje*, respect the market mechanism while acting as a deterrent to moderate speculative challenges.

Europe's successful integration has been achieved because of a particular sequencing. It started with trade integration and fixed-but-adjustable exchange rates, while keeping domestic and external financial markets under tight control. Once the Common Market was fully developed, a process that took 30 years, financial markets were liberalised and exchange rate stability was enshrined into EMU.¹⁴ Given the Asian resistance to a regional trade agreement (see below) and the high degree of financial liberalisation already achieved, the question is whether the sequencing can be reversed.

In principle, a common currency could indeed be first adopted and fulfil the integrating role that the Common Market played in Europe. The view that OCA characteristics are endogenous provides support for such a strategy, as does the result by Rose (2000) that a common currency powerfully enhances trade. Three difficulties must, however, be taken into account. First, as previously noted, for a monetary union to be viable some minimum degree of real convergence must have been achieved. Europe achieved this level through its Common Market. The results reported in Section 2 reassuringly suggest that Asian trade integration is no less deep than Europe's, but it leaves aside many aspects dealt with below. Second, the irrevocable fixing of exchange rates assumes that we have a reasonably clear view of where the equilibrium lies. Our ability to pin down equilibrium exchange rate levels is very limited. Europe's solution to this problem has been to experiment for decades with fixed exchange rates, ensuring that prices and parities were reasonably aligned. This is unlikely to be case in Asia following the massive shake-up of Asian exchange rates since 1997. Third, the setting-up of a common central bank requires a high degree of political commitment. At present, a common currency looks good only because of the bruising legacy of the 1997–1998 crisis. Such a negative reason is unlikely to withstand closer scrutiny by countries that have so far been unwilling to adopt a less politically demanding regional trade framework.

14. The evolution was not quite so tidy. The 10-year gap between the lifting of capital controls and the adoption of a common currency was marked by a severe currency crisis which all but emptied the EMS of its content. A small mistake in the greater scheme.

5.2 Institutions

It has been argued above that the existence of collective institutions has been instrumental to Europe's continuing integration. Collective institutions become the advocates of integration. They move the debate from the purely political sphere to the technical level, allowing for professional assessments and avoiding costly mistakes. They provide analyses that would not be carried out otherwise. They can prepare blueprints that can be readily put to use when the occasion arises, often unexpectedly. If the support for collective undertakings is limited, such institutions can start with limited terms of references and be allowed to grow once they have established their credentials. A range of institutions, each with a precise mission, may be less intimidating than an all-encompassing one.

5.2.1 Trade

The current pattern of regional trade agreements in east Asia is bewildering.¹⁵ The driving force seems to be various existing groupings in Asia and the Pacific Basin (APEC, ASEAN, CER, etc). The pattern essentially consists of a web of bilateral arrangements, many of which are still on the drawing board. There has apparently been no attempt at building a regional multilateral agreement similar to the Common Market. Given the depth of trade integration this comes as a surprise to a European eye. It suggests the widespread existence of mutual trade frictions that need to be dealt with. For the task at hand bilateral agreements are highly cumbersome. Bilateral bargaining is unlikely to foster a collective framework, i.e., established rules and arbitration processes. Of course, the WTO can fulfil this need but, given the commonality of interests, it seems natural that initial efforts at resolving disputes be first dealt with at the regional level.

The usual explanation for the lack of a broad regional agreement (e.g., Kwan (1994)) is that political sensitivities stand in the way. The three largest economies, Japan, China and Korea, are needed for any arrangement to make a difference, but these countries deal uneasily with each other, and are often viewed with suspicion by the others. This calls for confidence-building steps. A possibility would be to set up a permanent secretariat in charge of mapping various options for comments by the authorities. This could include exploring the list of countries to be included and the minimum set of agreements required to call it a start.

5.2.2 Exchange rate management

The creation of the EMS was not accompanied by the establishment of any new institution. The detailed mode of operation did not require any particular administration, but it was based on identical bilateral agreements and made use of the Commission. Business was conducted during regularly scheduled meetings of finance ministers and central bank governors. Unscheduled meetings were called for by the country holding the rotating presidency of the Community when a realignment

15. Scollay and Gilbert (2001) provide a complete description.

was deemed necessary, at the request of the country seeking to change its parity. Surveillance was conducted routinely by the European Commission.

The setting-up of any exchange rate arrangement in Asia, be it common basket pegs or an EMS-type system of bilateral parities, similarly would not require the creation of a specialised agency. Meetings of ministers and central bank governors already occur on a regular basis. Their role can be enhanced and systematised, possibly including the setting-up of a small, permanent secretariat. A monetary union would of course be considerably more demanding at the outset. It would need the transfer of competence from national central banks to a common monetary authority. It would also require detailed agreement on the governance of this institution.

5.2.3 *Mutual surveillance*

Any common exchange rate arrangement is a source of externality which requires some mechanism to deal with possible threats to the system. Obviously, macroeconomic policies must be compatible with the targets, and the tighter they are, the more exacting must be the surveillance process. Under EMS, as long as capital controls were in place, mutual surveillance was limited to peer pressure at the time of negotiations on the size of realignments when the need arose. Once capital movements were freed, peer pressure was replaced by the determination to avoid realignments, which led to growing imbalances that eventually led to the system's demise, and the adoption of wide bands of fluctuation (± 15 per cent).

The requirements for a monetary union are deeper. Within EMU, the Growth and Stability Pact requires an annual reporting on budgetary matters over the following two years. Clear guidelines and targets allow for a range of sanctions, ranging from private warnings to public statements and, if needs be, fines. Less progress has been reached regarding banking supervision and regulation. Of course, a common core of principles has been adopted but implementation remains at the national level – a growing source of concern (Begg *et al* 1998).

The likely existence of self-fulfilling crises greatly complicates matters in the case of soft pegs. Such crises are hard to prevent for they prey on countries that exhibit fragilities. The list of what counts as fragility grows after each round of crises. The EMS crisis has been linked to weak growth and high unemployment. The Mexican crisis has shown the danger for foreign-currency sovereign borrowing while private borrowing has emerged as a source of fragility during the Asian crisis. No doubt future crises will extend the list further. In contrast, first-generation crises are not left to the whims of the markets, they systematically sanction undisciplined macroeconomic policies. The commitment to pegged exchange rates thus requires adequate macroeconomic policies and a determined effort at reducing fragility.

Europe's lesson is that mutual surveillance works, especially when backed by clear procedures carried out by a multi-national institution to limit the extent of unavoidable politicisation. Such an arrangement can be evolutionary. It can start

with pure peer pressure through regular reviews and move on to ongoing surveillance carried out by a special, less political institution.

5.3 How deep and wide?

Finally, comes the delicate question of which countries should join in a collective undertaking of exchange rate stabilisation, and how far they should go. In theory, the OCA criteria could be used to identify the best suited groupings. It has been argued above that these principles played no role in Europe, probably for good reasons. What other criteria can then be called upon to shed some light? Given the generally high level of trade integration already achieved the economics ought to focus on real convergence, the rest is likely to be politics.

5.3.1 Real convergence

Real convergence mainly refers to the stage of development of a country. While trade integration yields welfare gains irrespective of the differences in economic development, monetary integration is more difficult the wider the gap. Table 7 reports measures of GDP per capita in 1998. It is clear that the Asian countries exhibit considerably more variability than the current European Union and even more than the 'New Europe', i.e., the Union with the five accessing countries (AC5) from eastern and central Europe (the Czech and Slovak Republics, Hungary, Poland and Slovenia). This variability reflects deep differences in terms of economic structure. The absence of real convergence is Asia's Achilles' heel.

Table 7: GDP per Capita in 1998
Purchasing power parity (PPP), 1995 US\$

	Asia	Asia–Oceania	Europe	AC5	New Europe
Average	11 624	13 123	20 350	10 841	17 847
Standard deviation	9 008	8 796	3 165	2 563	5 215

Source: World Bank, *World Development Indicators*, CD-ROM 2000

Several conclusions could be drawn. One could conclude that any arrangement should be rather light and flexible (managed floats rather than a monetary union) and limited to a small subset of relatively homogenous countries. Alternatively, one could argue that a strong structure is needed to hold the integrative effort together, and that binding together a relatively homogenous subset of countries would have a disintegrative effect *vis-à-vis* the countries left out. This question mirrors the long-debated question of creating a free-trade area in Asia, a question never resolved. Europe's experience has been to follow a beachhead strategy: start with a small number of homogeneous countries and expand gradually. It may not be the best solution, but it has worked.

5.3.2 Leadership

A closely related question is whether any cohesive move must be carried out around one, or a few leading countries. The role of the Franco-German leadership is discussed above in Section 4.3, where it is noted that political and historical sensitivities are considerably more complex in Asia. From a European viewpoint, the lingering weight of history in Asia is not easy to comprehend. Eichengreen and Bayoumi (1996) interestingly observe that Asia does not share Europe's two-century old legacy of debates about a common destiny and that could well be the answer: deep economic integration will have to wait for decades or more. On the other side, Europe's experience is that old foes can turn history's pages.¹⁶

While it is clear that some form of political commitment is needed before significant components of national economic sovereignty are surrendered, another lesson from Europe is that gradualism and opportunism work. A frequently held view is that Europe's successful integration has only been possible because it was carried out with much wider objectives than just a common market. In that view, the required political will was steadied by an ambitious vision that included, from the start, a monetary union and eventually a federal union. This view is both correct and misleading.

It is true that the underlying logic has been reconciliation after centuries of wars. On the other side, there has never been any detailed master plan, nor any set deadline. For example, a German proposal has recently brought back to life the goal of a 'United States of Europe'. But opposition to this proposal runs deep, with profound national divergences and national public opinions equally divided, an indication that there is no master plan, and there never was any. A telling example is the monetary union. In 1971, the Werner Plan was deemed wholly unrealistic and it was immediately scuttled. As late as 1988, when the idea of a monetary union resurfaced, it was widely met with the same scepticism. It took an exceptional event, the collapse of the Berlin Wall, to trigger a deep reassessment that no political leader would have predicted just a few weeks before.¹⁷ Even the celebrated countdown to monetary union, with a terminal date set in concrete, was only accepted in Maastricht at the last minute.

The only feasible path for Asia must combine confidence-building steps and limited ambitions. In the end, sequencing (in Europe's case, starting with trade integration, stabilising exchange rates, moving on to capital openness and ending up with a monetary union) matters less than the building-up of common institutions. It does not really matter much what is the function attributed to the institutions. Any integration move inevitably brings head-to-head national and common interests.

16. Europe's success in this respect has been based partly on the military defeat and occupation of Germany. Asia may have missed its chance in the aftermath of WWII.

17. Gros and Thygesen (1998) argue that one does not need to invoke a political deal to explain Germany's acceptance of EMU. Once the other countries had recognised the pre-eminence of price stability and central bank independence, they claim, Germany was willing to give up the Deutsche Mark. From an economic viewpoint, this makes sense, but the political costs were considerable and required a 'sweetener'.

What matters is to embody the region's common interests in an institution that acts as a counter-weight to purely national interests. Politics will take care of the pros and cons.

6. Conclusions

Europe's message to Asia is that monetary union is a long way down the path of gradually increasing cooperation. Europe started with trade agreements among a small number of like-minded countries striving to restore trade links in order to replace political (and military) competition with common economic interests. Financial integration, and therefore exchange rate stability and ultimately monetary union, was the means to the end of trade integration, not an objective in itself. Exchange rate stability within Europe was identified early on as a prerequisite to trade integration, and was maintained with the help of capital controls. When controls were lifted, monetary union emerged as the next logical step.

Asia seems to be considering travelling a different route. Stung by the 1997–1998 financial crisis many Asian countries appear to be seeking ways of stabilising their exchange rates, but with four major differences from Europe. First comes sequencing. Europe started with trade cooperation, Asia envisions monetary cooperation while having failed, so far, to develop a framework for common trade agreements.

The second difference between Europe and Asia is that the Asian countries seem to be concerned at least as much with exchange rate stability *vis-à-vis* the world at large (i.e., the yen, the US dollar and the euro) as with stability within the region. The result is plans to adopt common pegs and to establish swap arrangements, rather than plans to jointly float *vis-à-vis* the rest of the world while agreeing to mutual support to defend regional parities. This is surprising given the paramount importance of regional trade links.

The third difference is the apparent reluctance to engage in collective institution-building. Trade agreements are slow to materialise and are left to a complex web of bilateral agreements. Similarly, the Chiang Mai Initiative focuses on bilateral swap agreements, each potentially different in size and mode of operation.

The last difference is that capital liberalisation has been achieved before exchange rate stability. This raises the stakes, making soft pegs – politically easier to establish – a non-starter. One can question this strategy.

There is no reason to believe that the European approach is the only viable one, nor even that regional integration should be an overriding aim. In fact, one interpretation of the Asian approach is a commitment to multilateral integration with the minimum set of regional agreements. In that view, exchange rate stability is more a defensive objective – to avoid a repeat of the crises of 1997–1998 – than a step towards regional integration. This is a perfectly acceptable approach, but is it viable?

Monetary union requires a deep abandonment of sovereignty and the setting-up of a common central bank. In view of the absence of institution-building in the region, such a step seems far-fetched. The Chiang Mai Initiative can be seen as a

pragmatic first step, and Europe's experience is that pragmatism is the only way to proceed. Attempting to embed each step into a more ambitious framework is a good recipe for failure. The problem is that the Chiang Mai Initiative carefully eschews institution-building, thus failing to plant the seeds for an eventual next step. From the point of view of regional integration, the risk is that the initiative will be both a beginning and an end. It does not lead to a monetary union.

Undoubtedly, the Asian experience so far suggests the absence of political will towards the kind of cooperation that Europe has nurtured over several decades of increasing regional integration. One possibility is that only a subgroup of Asian countries undertake to deepen cooperation. Such a subgroup would probably not include initially the three largest economies (Japan, Korea and China). This again would be the opposite of the European experience, but it could set an example and eventually attract the large economies. The role of Australia and New Zealand also needs to be thought through. These two countries are less integrated with east Asian countries than the Asian countries themselves, yet they clearly belong to the region.

Finally, one can ask what can be done short of a regional agreement, be it of the EMS or EMU variety. Freely floating exchange rates are likely to imply too much bilateral volatility given the extent of trade integration. Broad basket pegs may seem to be a better alternative. They could indeed be a pragmatic first step. The problem with such an arrangement is that the devil lies in the details. If these are wide bands with little coordination regarding their design and implementation, they amount to little more than floating. If the bands are narrower they call for far more coordination, in effect not very different from the EMS: intervention rules, swap agreements, and the management of parities *vis-à-vis* third currencies (e.g., the US dollar and yen). Without some institution, it is unlikely to be a lasting experiment.

The last solution is a hard peg, dollarisation or currency boards *vis-à-vis* the US dollar and, possibly, the euro. Relative to an Asian monetary union, this implies the same sacrifice of sovereignty. It carries the distinct disadvantage of tying the Asian currencies to far-away economies. It would be a very roundabout way of mimicking a monetary union, with most of its drawbacks and few of its advantages.

Appendix A

Sample countries

North America	Europe	Asia	Oceania
Canada	Austria	China	Australia
Mexico	Belgium	Hong Kong	New Zealand
US	Denmark	Indonesia	
	Finland	Japan	
	France	Korea	
	Germany	Malaysia	
	Greece	Philippines	
	Ireland	Singapore	
	Italy	Taiwan	
	Netherlands	Thailand	
	Norway		
	Portugal		
	Spain		
	Sweden		
	Switzerland		
	UK		

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