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**Distribution, Domestic Politics, and  
Monetary Cooperation in East Asia**

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**Abstract**

Since the financial crises of 1997, East Asia has made modest but nonetheless significant steps towards greater regional integration and cooperation in the areas of finance and trade, accompanied by progress on institution-building at the regional level. Monetary cooperation, however, has not proceeded to anything like even the modest levels registered for other functional areas of cooperation. This paper investigates this discrepancy. It asks whether monetary cooperation is simply an unattractive proposition because it promises fewer net gains than cooperation on other issues, or whether there are other explanations for the absence of monetary cooperation in the region. Based on a review of estimates of the aggregate economic gains and losses arising from monetary cooperation, the paper argues that there is a *prima facie* puzzle to be explained: monetary cooperation does hold out the prospect of real gains and, although these gains are not cost-free, neither is the status quo. The paper then turns to the domestic level of the major East Asian countries, in order to assess the relative strength of the domestic economic interests that are likely to be either advocates or opponents of monetary cooperation. It shows that domestic distributional politics—the processes by which gains and losses within countries are distributed—are a plausible reason for the low priority placed on regional monetary cooperation to date. International-level political concerns and the potential supply of institutional solutions to collective action problems are additional reasons for the lack of monetary cooperation, but the domestic demand for such cooperation is analytically prior to these more conventional explanations for the lack of cooperation in East Asia.

**JEL Classification: E5, F3, F5**

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## 1. INTRODUCTION

Why have the countries of East Asia been more willing to cooperate on trade, finance, and general regional institution-building than on monetary matters? Analyses of prospects for monetary cooperation in East Asia have largely focused on developing models that estimate the potential aggregate gains from cooperation, or aggregate losses arising from competitive monetary policies. These models suggest that the status quo in terms of monetary policy, considered here to include management of the external value of a country's money, carries some significant costs. Cooperative solutions that should reduce these costs are potentially workable, but for the most part, the region has not pursued them.

International politics, particularly the rivalry between the largest countries of the region and the relative weakness of institutions that facilitate the resolution of collective action problems in East Asia, present obstacles to achieving cooperative outcomes (e.g. Grimes 2009). However, without an understanding of national preference formation, it is premature to draw conclusions about the relative weakness or undersupply of regional institutions. Policy choices and national-level expressed preferences regarding cooperation are rarely based on anticipated aggregate national welfare gains, but reflect the preferences and political influence of domestic actors. Monetary policy, both domestic (in terms of the domestic price of money and monetary conditions) and external (in terms of currency values and exchange rate regimes) is not distributively neutral. Thus, despite attempts to “depoliticize” monetary policy, it remains subject to distributional pressures that manifest either formally or informally through the political system. These distributional pressures remain very much under-studied in East Asian countries, despite the high visibility of contemporary international monetary conflicts.

This paper presents a preliminary analysis of the politics of monetary cooperation in East Asia. Chapter two presents an overview of regional financial and monetary cooperation to date. The third chapter reviews the literature on the aggregate economic gains and losses of different monetary cooperation scenarios, and argues that some forms of monetary cooperation would represent an overall improvement on the status quo. Chapter four presents a basic specification of domestic preferences in selected East Asian countries, tracing the demand for monetary cooperation to the structure of domestic interests and the institutions that differentially empower specific groups. Finally the paper concludes with a preliminary assessment of the different factors that drive regional cooperation outcomes. Given that the policy process surrounding national-level monetary policy formation is opaque, any assessment of national-level influences on regional monetary cooperation must be tentative. Nonetheless, there is some evidence that the low level of demand for monetary cooperation owes something to the domestic politics surrounding the distribution of gains and losses arising from the status quo. The persistence in much of the region of export-driven growth models that call for a degree of “monetary mercantilism” (Aizenman and Lee 2008) serves the interests of politically dominant domestic actors. The costs of this orientation have largely been borne by domestic groups with much less political influence, which explains why the potential demand for monetary cooperation predicted by some aggregate models is not politically significant.

## 2. FINANCIAL AND MONETARY COOPERATION: INITIATIVES AND ACHIEVEMENTS

Substantive initiatives for regional cooperation on financial and monetary issues developed in the wake of the financial crises that hit many East Asian countries in 1997 and 1998. Prior to the crisis, there was only one region-wide dialogue forum that explicitly focused on financial and

monetary issues, in the form of the Executives Meeting of East Asian Central Banks, established only in 1991. It has held bi-annual meetings at the senior official level since then, and the first Executives' Meeting of East Asia-Pacific (EMEAP) central bank governors was held in July 1996.<sup>1</sup> Other institutions dealing with finance were similarly low-profile, such as the South East Asia, New Zealand, Australia (SEANZA) and

SEACEN) central bank groups centered on Southeast Asia. Southeast Asia's premier regional organization, the Association of Southeast Asian Nations (ASEAN) did not have a regular finance ministers' meeting until 1997. After the crisis, given the consensus that the region had been under-prepared to deal collectively with issues of common interest, East Asia (Southeast Asia and Northeast Asia) emerged as a relatively new arena for regional cooperation, under the banner of "ASEAN Plus Three" (APT, also known as ASEAN+3), which brought together the members of ASEAN with the People's Republic of China (henceforth, PRC), Japan, and the Republic of Korea (Stubbs 2002). Regular Asia-Europe (ASEM) meetings have also been a forum for regional dialogue on financial cooperation.<sup>2</sup> The Asian Development Bank (ADB), headquartered in Manila, initially took the lead in hosting nascent efforts at regional surveillance, financial monitoring, and generating research relating to regional integration (Rajan 2001; Kuroda and Kawai 2004; ADB 2010).

## 2.1 Financial Cooperation

Regional financing facilities that might be drawn on in a crisis were very limited before the 1997 crisis. There existed a (never used) small intra-ASEAN swap arrangement that had been agreed to in 1977, and some bilateral repurchase arrangements were signed in the 1990s, mostly one-way facilities provided by Japan (Hamilton-Hart 2003). Japanese officials had been considering the merits of some kind of regional crisis management facility before the regional crisis and in the early stages of the crisis they raised the idea of an "Asian Monetary Fund" (AMF) privately with Asian governments (Amyx 2004). Strong opposition from the United States (US) and a lack of support from the PRC meant that the proposal was shelved.

Since then, the development of regional financial facilities or lines of support that could be activated during a crisis has been the major focus of regional financial cooperation (Amyx 2004, 2008; Chey 2009; Rajan 2008; Katada 2008). The plan to establish bilateral swap facilities, known as the Chiang Mai Initiative, was announced by the APT finance ministers in May 2000 and the ASEAN swap facility was increased to \$1 billion later that year. A series of bilateral swap arrangements were negotiated over the next years, creating a headline "envelope" of total financing under the Chiang Mai Initiative (CMI) that exceeded the amounts disbursed by the International Monetary Fund (IMF) during the 1997–98 crisis. However, the significance of the CMI swaps was much more limited in practice. First, the amount available to any one country should the swap lines be activated was a great deal smaller than the total envelope suggested (Amyx 2008). Second, as widely noted, the release of all but 20% of the financial resources were dependant on having an IMF program in place.

An officially-sponsored study, published in 2004 and presented to APT officials in March, recommended options such as "multilateralizing" the swaps, earmarking a portion of each country's foreign reserves for use under the CMI, a comprehensive regional surveillance system and centralized reserve pooling (ADB 2004). Initially, APT finance ministers did not endorse any of these proposals, merely referring the issue of financial cooperation for further discussion and study. Several of the ideas for further cooperation proposed in the ADB report were, however,

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<sup>1</sup> The group comprises Singapore; Malaysia; Indonesia; Thailand; the Philippines; the PRC; Hong Kong, China; Republic of Korea; Japan; Australia; and New Zealand.

<sup>2</sup> See, for example, speeches at the 2001 finance ministers' meeting (available at [www.mof.go.jp/english/asem](http://www.mof.go.jp/english/asem)).

taken up over the next years (Kawai 2010). A major step was when the agreement to multilateralize the CMI came into force in March 2010. This provided for a total pool of resources of \$120 billion, with contributions adjusted so that each country would contribute equally (ASEAN Plus Three 2010).<sup>3</sup>

In parallel, and in order to support the potential option of de-linking CMI funds from IMF conditionality, a capacity for regional surveillance has slowly been developed. Despite a lack of enthusiasm by some regional countries, initiatives for information-gathering and analysis were initially located within the Asian Development Bank, which developed a prototype for a regional early warning system (Bergsten and Park 2002; de Brouwer 2004). After having been referred by finance ministers to various working groups over the years, a significant further step towards institutionalizing a regional surveillance capacity was made with the agreement to set up an ASEAN+3 Macroeconomic Research Office (AMRO) in 2010, for which a director was appointed in 2011 (APT 2010, 2011). Although not explicitly linked to the issue of monetary cooperation, the development of a surveillance capacity is an important part of the institutional infrastructure for collective action on monetary issues as well as crisis management. Lessons from other regions suggest that effective monetary cooperation should include a mutual surveillance mechanism and a regional financing facility, in addition to a common unit of account and exchange rate coordination (Kawai and Takagi 2005).

Another crisis prevention initiative aims to improve the region's self-sufficiency in long-term finance and reduce its reliance on bank financing. Towards this end, in 2001 the APT in association with the ADB took up an initiative to develop regional bond markets and close the gap between ratings on Asian bonds and the needs of local institutional investors (Chan 2001). This developed as the Asian Bond Markets Initiative, under which a multilateral Asian Bond Fund to guarantee bond issues was launched, along with a series of working groups that have carried out numerous studies on credit guarantee mechanisms, regional clearing and settlement mechanisms and impediments to cross-border bond investments.<sup>4</sup>

## 2.2 Monetary Cooperation

Monetary cooperation remains at a very preliminary stage, with no official initiatives for cooperation currently on the agenda apart from the sponsorship of research. Japan gave attention to the idea of increasing the use of the yen as an international currency from late 1980s and, in 1994 and 1995, the Japanese Ministry of Finance, the Ministry of International Trade and Industry (MITI), and the Economic Planning Agency all released reports mentioning the desirability of greater international and regional use of the yen (Kwan 1996: 3). One of the earliest intellectual proponents of some kind of a yen bloc, C.H. Kwan, argued in the mid-1990s that the idea was "no longer ahead of its time" (Kwan 1996: 15). In early 1999, Miyazawa Kiichi, then Japanese finance minister, suggested that Asia adopt a currency basket based on the yen, the dollar and the euro (*Asian Wall Street Journal*, 18 January 1999), an idea that Japanese Ministry of Finance officials took up in public speeches.

Research projects investigating the viability of monetary cooperation in the region have received official support and funding. One of the earliest, the Kobe Research Project, was endorsed by the ASEM Finance Ministers' meeting held in January 2001 and presented its reports in July the following year. The Research Project's reports contain several technical studies pointing to the benefits of greater monetary cooperation, as well as discussions of preconditions and

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<sup>3</sup> On the negotiations surrounding CMIM contributions, see Kawai 2010.

<sup>4</sup> Developments regarding to the ABMI and ABF, along with related studies and commentary, are available through the website of the ADB.

modalities. The Japanese Ministry of Finance also co-sponsored a major research project on future financial arrangements in East Asia, which included studies of cooperative currency arrangements in the region. The APT finance ministers have continued to sponsor research relating to the feasibility and desirability of various forms of monetary cooperation, including technical studies on the construction of currency basket alternatives and a virtual regional currency unit. The initiative by the ADB to construct a virtual currency unit index for monitoring purposes in 2006 was, however, suspended due to the objections of some member governments (Kawai 2010).

Overall, while the idea that Asia might benefit from various forms of monetary cooperation has periodically been raised by policymakers and commentators in several East Asian countries, others remain dismissive of prospects for monetary coordination, relegating the possibility to the distant future.<sup>5</sup> For now, the idea remains largely in the realm of academic study and quasi-official technical discussions. Among officials, even one of the more optimistic proponents of greater cooperation, Joseph Yam of the Hong Kong, China Monetary Authority, guessed that while Asia would move towards monetary union in a shorter time than the half-century it took countries of the Euro area, “I do not think that many of us in this room will be around long enough to see how many years it really does take” (Yam 2005). The gap between cooperation on money and finance is noticeable. Regional cooperation on financial issues has proceeded slowly, but it has led to substantive (albeit modest) achievements over what is actually a relatively short time period. Considering the virtual absence of regional financial cooperation as of 1997, the construction of an agenda and architecture for such cooperation over the decade that followed does not suggest that the region is generally incapable of cooperation, or particularly slow in achieving it. Progress has also been made in terms regional trade integration and regional institution-building more generally. When it comes to regional monetary cooperation, however, not only has cooperation failed to progress, there is no clear agenda for cooperation. While countries in the region appear to agree in general terms about the desirability of trade integration, there is no such consensus as to what a desirable trajectory for future cooperation on monetary issues might look like. Why is monetary cooperation different?

### **3. TRADE-OFFS AND INCENTIVES FOR MONETARY COOPERATION: AGGREGATE ESTIMATES**

Monetary cooperation includes a range of measures, from ad hoc temporary coordination of macroeconomic policy to monetary union. Monetary cooperation thus potentially encompasses commitments which are informal and temporary (and which thus call for only a limited reduction in policy autonomy), to those which are in principle irrevocable and involve a high degree of supranational institutionalization. For simplicity, four major types of monetary cooperation are identified here:

- exchange rate commitments to limit currency changes by a given amount, whether against an internal or external anchor currency, or a composite basket currency;
- monetary union in the form of a single currency, with the associated supranational institutional infrastructure;
- ad hoc coordination of macroeconomic policies (domestic monetary policy, exchange rate intervention and fiscal policy);

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<sup>5</sup> See, for example, the speech by Singapore's finance minister (and now deputy prime minister), Tharman Shanmugaratnam (2006).

- collective agreements on international currency use (the currency used for trade settlement, debt issuance and reserves management).

The first type of cooperation—exchange rate commitments—is generally seen as a transitional arrangement leading towards a common currency, such as occurred in Europe. In contrast, macroeconomic coordination and cooperation on currency use do not necessarily imply any such trajectory. Because the incentives and trade-offs are somewhat different, this section first discusses the two forms of cooperation involving variants of a common exchange rate regime, then discusses macroeconomic coordination and cooperative currency use policies.

### 3.1 Common Exchange Rate Regimes

Variants of cooperative fixed exchange rate regimes falling short of a common currency are generally out of favor in both academic and policy circles. One objection is that cooperative fixed exchange commitments represent “intermediate” exchange rate regimes, falling unsustainably between either “corner” solution of a freely floating rate or a hard currency peg. However, a large number of countries in Asia (as elsewhere) do in fact actively manage their exchange rates unilaterally—exhibiting a so-called “fear of floating” that suggests that intermediate exchange rate regimes have not been fully relinquished (Calvo and Reinhart 2002; Cohen 2008). Rather, the real objection to cooperative fixed exchange rate commitments is that they demand almost the same sacrifices of national policy autonomy as a common currency, without the safety and stability advantages of a supposedly irrevocable peg. As a transitional arrangement they are thus likely to be inherently unsustainable, as suggested by the European experience with the European Exchange Rate Mechanism that preceded currency unification (Eichengreen 1997).

What then, might be the costs and benefits of currency union among East Asian countries, or a subset of them? The benefits include first, reduced transaction costs and risks relating to intra-regional trade and investment. As well as being relatively open economies, most countries are becoming progressively more *regionally* integrated in trade and direct investment (but not portfolio flows or bank lending). In terms of overall trade volumes, regional exports to the US dropped from a peak of 29% of total regional exports in 1986 to average less than 20% of total regional exports in the years immediately preceding the financial crisis (Henning 2004: 85). As shown in the tables below, this trend of declining importance of the US market has been re-established after the initial postcrisis period. While intra-regional trade is lower than in Europe, it has for more than a decade been significant enough to make the *de facto* weight of the US dollar in foreign exchange regimes suboptimal (Shin and Wang 2003).<sup>6</sup> Currency regimes which give overwhelming predominance to the US dollar expose countries to fluctuations in exchange rates vis-à-vis markets which are collectively more significant. In dynamic terms, a common currency has considerable potential to contribute to welfare gains by stimulating intra-regional trade and investment further (Shirono 2009).

While the trend towards great regional integration is significant, two caveats are in order. The first is that regional integration has not meant de-coupling from the rest of the world. As noted in a recent assessment, ‘the process of economic integration within emerging East Asia is also tightly linked to global integration, rather than signalling a departure from it’ (Kim, Lee, and Park 2011: 50). The second, and related, caveat is that raw measures of regional trade integration overstate the reliance on regional markets because of the high proportion of intermediate goods trade in East Asia (IMF 2011: ch. 3). This, as discussed below, has implications for both macroeconomic coordination and currency management, both because of the extent to which

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<sup>6</sup> See also discussion of the issues in Kawai 2009; Park and Wyplosz 2010; Volz 2010.

final consumer demand still lies outside the region and because of the impact of intra-regional exchange rates on both regional intermediate goods trade and extra-regional trade imbalances (Thorbecke 2011).

A common currency may also have the potential to redress the destabilizing imbalances and inefficiencies associated with current exchange rate and monetary policies. The extraordinary and prolonged transfer of savings from East Asia to developed economies, principally the US, has attracted a great deal of critical attention. Although there is contention over the degree to which the US imbalances are essentially home-grown, the current situation—in which enormous consumption transfers are being made from emerging markets in Asia to the US—is clearly far from optimal. Given the declining marginal utility of consumption at higher income levels, economic theory would suggest the reverse situation. Given that postcrisis current account surpluses have been accompanied by steep rises in foreign exchange reserves, East Asian economies have in addition been paying the considerable quasi-fiscal costs of extensive sterilization (e.g., Suryadarma and Sumarto 2011). Despite uncertainty over the optimal level of precautionary reserve holdings, in most calculations current reserve holdings by East Asian countries well exceed optimal levels.

**Table 1: Foreign Exchange Reserves**

2003	2005	2007	2009	2010			
PRC			409.2	822.5	1531.3	2417.9	2889.6
India			99.5	132.5	267.6	266.2	292.3
Developing Asia, excl. PRC & India			161.6	201.1	329.8	393.7	476.5

Source: IMF, *World Economic Outlook*, April 2011, Table A15.

In principle, a common currency would reduce the precautionary and status elements behind excessive reserve holdings, as well as intra-regional competitive reasons for reserve accumulation, which appears to have elements of what has been called “monetary mercantilism.”<sup>7</sup> The global imbalance problem may also be redressed to the extent that a common currency promotes intra-regional trade and financial intermediation. However, much of these potential benefits would depend on how any common currency or cooperative exchange rate mechanism was managed. Further, a large part of these benefits could be derived not through currency unification (or transitional fixed exchange rate arrangements), but through currency diversification, discussed further below, which offers some of the potential benefits of a common currency without some its principal costs.

What then are the costs associated with adopting a common currency? Even if some flexibility is built into the arrangement, to the extent that currency values are fixed, individual countries lose monetary policy autonomy. The more economies are similar in terms of trade structure, sensitivity to external shocks and inflation rates, the fewer trade-offs they face in adopting similar monetary policies. The conventional approach to determining whether this loss of autonomy is worth it is to employ some variant of optimal currency area (OCA) criteria to a group of prospective members of a common currency area. Different calculations and models produce different answers to this question in the case of East Asia. An early assessment by a proponent of monetary cooperation judged Japan; Taipei, China; Singapore; the Republic of Korea; and Hong Kong, China to be better candidates for monetary cooperation than the whole of East Asia, which is much more diverse (Kwan 2001: 162–69). Even an otherwise negative

<sup>7</sup> On the precautionary and status-related impulses behind reserve accumulation, see Cheung and Qian 2009. On the evidence for monetary and financial mercantilism in East Asia, see Aizenman and Lee 2008. On other evidence of exchange rate-related competition, see Xing and Wan 2006; and Ito 2008.

early assessment of the prospects for currency cooperation concludes that, “On standard optimum currency area grounds, then, the economies of East Asia would seem to be more or less as plausible candidates for internationally harmonized monetary policies as the members of the European Union” (Eichengreen and Bayoumi 1999: 360). Several more recent studies argue that a larger subset of regional countries satisfies OCA conditions.<sup>8</sup> Other models employing different techniques come to contrary conclusions, finding it difficult to identify a group of countries that would unambiguously be suitable candidates for a common monetary policy (e.g., Genberg and Siklos 2010). Regardless of the model employed, a common problem with most analyses of OCA conditions is that they do not take into account dynamic effects of currency cooperation. Many of the preconditions for monetary cooperation as set out in OCA approaches are in fact endogenous, in particular as asymmetric shocks will decline with currency unification.<sup>9</sup> Standard OCA approaches are thus likely to overstate the costs of cooperation in terms of monetary autonomy losses.

Even if it is agreed that, on balance, economic analysis suggests currency cooperation is feasible, there is still a question to be answered about the desirability of losing national monetary policy autonomy. A conventional case for exchange rate flexibility argues that it is an important cushion and a necessary complement to an effective domestic inflation targeting (IT) regime. An influential advocate has gone so far as to argue that inflation targeting constitutes a durable, stable international monetary regime based on national interests without “observable international costs” in terms of exchange rate volatility, abrupt capital flow reversals or different balance of payments structures (Rose 2007: 678). It is clear that inflation targeting policies have become increasingly popular, and some inflation targeting countries in Asia, particularly the Republic of Korea, have shown less commitment in recent years to managing the external value of their currency (e.g., Sanchez 2010; Cavoli 2010; Kim and Lee 2008).

On the other hand, not only have the PRC and Hong Kong, China maintained largely fixed currency regimes, the degree of flexibility exhibited by a number of other emerging market economies is limited. Even formal IT countries employ mixed strategies and a degree of managed floating (Aizenman, Hutchison, and Noy 2010; Cohen 2008; Rajan 2009). Rather than a generalized shift towards floating rates, the region appears to be more than residually wedded to managing the value of currencies against the US dollar—an approximation of what has been called the “Bretton Woods II” system (Dooley, Folkerts-Landau, and Garber 2008). Unlike in the case of the original Bretton Woods system, however, there is no evidence of a cooperative commitment among regional countries—let alone other emerging market countries as well—to collectively share the burden of maintaining the dollar’s position (Eichengreen 2004). Rather than representing a cooperative solution, the current situation is essentially one of ad hoc national management of exchange rate policies. It is unlikely that countries in Asia collectively would have accumulated their current foreign reserves if they did not care about the external value of their currencies, nor, as advocates of exchange rate coordination argue, would there be evidence of a degree of intra-regional competition with respect to currency management. Given that this situation does in fact impose costs on the countries running consistent large trade surpluses and accumulating excessive international reserves, it should raise the question of why monetary cooperation is in fact virtually absent from the regional agenda.

### 3.2 Currency Diversification

Currency diversification presents, on the surface, less severe coordination problems. The current regional cooperation agenda has folded the issue of currency diversification into

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<sup>8</sup> See, for example, Ahn, Kim, and Chang 2006; Kawai 2009; Ogawa and Kawasaki 2008).

<sup>9</sup> See Eichengreen and Frieden 2001: 8; Shin and Wang 2002; Volz 2010.

discussion of a regional currency unit such as the ADB's former ACU or the notional AMU (a basket of the ASEAN Plus Three currencies) tracked by the Japanese Research Institute of Economy, Trade and Industry. Much of this discussion, however, has focused on the potential for a notional currency unit to serve as a step towards reducing intra-regional exchange rate instability and, potentially, ultimately monetary unification (e.g., Ito 2008; Kawai 2009; Rajan 2009). Its functionality in this respect is likely to be limited, as a notional within-region basket raises a number of difficulties given the divergent exchange rate regimes of the two largest economies and offers few advantages over individual countries' current practice of managing their currencies against their own choice of currency basket (Wyplosz 2010). However, a regional currency unit need not be seen solely in terms of its contribution towards exchange rate management. It would also give economic agents the opportunity to transact in such a unit, hence reducing their reliance on the dollar and possibly promoting the regional intermediation of finance. Despite these benefits, notes Ramkishan Rajan, coordinated agreement to use the currency unit is essential, "failing which no one will want to take the first step" (Rajan 2008: 41).

Reducing reliance on the dollar—currency diversification—would serve the collective interests of the East Asian region. What Barry Eichengreen (2011) has termed the 'exorbitant privilege' of the US—the ability to live for decades beyond its means by recourse to issuing currency that others are prepared to accept in payment for real goods and services—rests on the dollar's unique status as an international currency. This not only represents a significant transfer of consumption from emerging to developed markets, the global imbalances have the additional cost of adding fuel to the regulatory failures behind the US financial crisis of 2008. In addition, the current recycling of liquidity back to emerging markets threatens to reproduce many of the macroeconomic pressures associated with short term capital inflows that create incentives for perverse monetary policy choices and potential financial fragility in Asia. The quasi-fiscal costs of sterilization are large, and the perverse incentives created by such intervention (which make the intervening country more attractive to short-term foreign investors) compound the problem. Overall, reduced reliance on the US dollar would serve as a way of reducing the potential for the US to abuse its position as the issuer of the world's most widely used currency (Kwan 2001).

If the dollar's international role significantly declines, the US would become a much more ordinary country, subject to the same risks (and hence perhaps incentives for prudence) that other countries are, subject to the "original sin" of having to issue foreign currency-denominated debt (Eichengreen and Hausmann 2005). Although, as Eichengreen (2011) argues, the world will almost certainly move to a multipolar currency system in the future, the lack of an alternative, equally attractive currency has so far limited options for moving away from the dollar. Thus despite the imminent decline of the dollar having been predicted for many years, so far there has been relatively little diversification away from the dollar. This situation has proved itself "sustainable" in the sense that nothing so far has replaced the dollar's dominance; it does not follow that it is optimal.

**Table 2: Currency Composition of Foreign Exchange Reserves**

	1995	2000	2005	2010
<b>World</b>				
Total foreign exchange holdings	1389.8	1936.3	4320.1	9258.2
Allocated Reserves	1034.2	1518.2	2843.6	5119.7
US dollars (%)	59	71	67	61
<b>Advanced economies</b>				
Total foreign exchange holdings	932.2	1217.2	2078.7	3092.8
Allocated Reserves	766.5	1107.0	1819.7	2704.3
US dollars (%)	54	70	69	64
<b>Emerging and developing economies</b>				
Total foreign exchange holdings	457.6	719.1	2241.4	6165.4
Allocated Reserves	267.7	411.3	1024.0	2415.5
US dollars (%)	74	75	63	58

Source: IMF, Currency Composition of Official Foreign Exchange Reserves. Updated 31 March 2011

One can ask whether currency diversification regarding market transactions and investments is really an issue for policy at all—is it not largely driven by economic agents making currency transactions and longer-term decisions about the currency denomination of assets and liabilities? If market participants see a currency as undesirable to use as either a medium of exchange or a store of value, official exhortations are likely to be ineffective. Nonetheless, private decisions regarding which currency to use in international transactions are influenced by government choices regarding exchange rate baskets, official reserves, and intervention currencies (Kwan 2001: 146–147). Their ability to use a particular currency is also subject to policy decisions regarding convertibility and capital market development. Further, private decisions regarding which currency to transact, invest and issue debt in are also subject to a significant status quo bias: because there are advantages to using the most widely-used currency, the advantages of incumbency are large (Eichengreen 2011). As Eichengreen has also argued, however, no Asian currency currently possesses the attributes of an international currency, which include the requirement for large and liquid financial markets and capital account convertibility. A composite regional currency is not a solution to this problem, but would have additional problems of credibility and the full demands of currency unification to contend with.

The different functions served by money are relevant to the issue of currency diversification. Countries in East Asia could do more to promote regional currencies as transaction currencies, and could cooperate to this end—consistent with, for example, Malaysian initiatives to promote local currency use for settling regional trade in goods and services (Bank Negara Malaysia 2011). While there is certainly scope for governments to take the lead in providing incentives for greater use of regional currencies as transaction currencies, coordinated moves out of the dollar in terms of its store of value function would be counterproductive—it would compound the severe dilemma already facing large holders of dollars, which do not wish to provoke a precipitous decline in the value of the dollar.<sup>10</sup> In addition to providing support for the use of

<sup>10</sup> The “cooperative” solution would be a shared commitment to maintain what has been called the current “Bretton Woods II” system (as proposed by Michael Dooley, David Folkerts-Landau and Peter Garber), in which surplus countries collectively share the burden of maintaining the dollar’s position. For a critique of the alleged sustainability of any such “Bretton Woods II” system, see Eichengreen 2004.

alternative currencies (and suitably liquid and open markets in the country of the alternative currency), an orderly emergence of a less dollar-dominated international currency system thus requires coordinated commitment to redressing the underlying macroeconomic conditions that are implicated in global imbalances.

Although there is a global dimension to any redressing of global imbalances, as repeatedly urged in G20 meetings, there is also an intra-Asian one. First, because of the level of intermediate products trade within intra-regional trade flows, any currency realignments need to be sensitive to this (Thorbecke 2011). Although there is dispute about the degree to which currency revaluations would redress these imbalances, it is clear that in the short term many countries in the region see currency values as secondary to more structural characteristics of their economies (e.g., Zeti 2005). Secondly, therefore, on the underlying issue of where final demand lies, the region could move further towards an expansion of regional demand, and thereby wean itself off large trade surpluses. Given the openness of most regional economies, doing this sustainably needs intra-regional coordination. This type of coordination does not require the kind of supranational institution-building or loss of sovereignty implied by currency unification. Although there is the potential for free-rider concerns to inhibit cooperation, the free rider problem is less acute—contingent commitments can be much more easily made and monitored, and no irrevocable sacrifice of autonomy is required.

Given the potential gains from different types of monetary cooperation and the apparent sub-optimality of current exchange rate and macroeconomic management, it is reasonable to ask why the region has not been more proactive in developing alternative arrangements. These alternative arrangements would not be cost-free, but then neither is the status quo. Since international political obstacles that might account for coordination failure among a group of countries are only relevant if there is domestic demand for cooperation, the next section attempts to specify the domestic factors that might explain the existence or otherwise of political will regarding regional monetary cooperation.

## **4. DOMESTIC PREFERENCES AND DISTRIBUTIONAL POLITICS**

The interests and political power of particular sub-national economic actors in East Asia are likely to influence national policies regarding regional cooperation. As yet, the structure of domestic interests regarding financial and monetary cooperation has received very little attention in the case of East Asia, even though the European case suggests that it is likely to be among the determinants of cooperation (Henning 2004; Gabel 2001; Moravscik 1998). The reason for examining the interests and influence of sub-national sectors lies in common problems of institutional design and collective action which can produce perverse policy outcomes. What promises gains for the country as a whole is not necessarily in the interests of particular economic groups, which may well enjoy political influence that is disproportionate to their economic significance. The influence of Japan's agricultural sector in preventing substantial agricultural trade liberalization is a widely-cited example of how even relatively small sub-national groups may, if the political system empowers them sufficiently, steer national policy in a direction that benefits the group but inflicts overall losses on the country as a whole.

This example points to the importance of sub-national distributional issues in explaining cooperation outcomes. Different groups at the domestic level form preferences regarding cooperation on the basis of the perceived distribution of its costs and benefits. Their preferences, as aggregated through formal and informal political institutions, frequently have a significant effect on cooperation outcomes (Gourevitch 1996). National policies are likely to be

somewhat affected by the relative *economic* importance of particular domestic groups (Rogowski 1989). Their *political* weight, however, will often be a function of domestic institutions that privilege or exclude certain actors. Work on regional cooperation that has taken national-level interests and political coalitions seriously in the Southeast Asian context has so far concentrated on trade (e.g. Solingen 1999; Nesadurai 2003). We know very little about the domestic political economy of cooperation on money and finance in the region.

Models of domestic preferences on monetary policy (e.g., Frieden 1991, 1997; Gabel 2001) hold that the distributional consequences of monetary cooperation are likely to lead to a basic division of interests on two critical issues. First, producers of traded goods and cross-border investors and traders will favor exchange rate stability over monetary independence, because they are relatively sensitive to exchange rate fluctuations and risks.<sup>11</sup> They are thus likely supporters of monetary cooperation that will stabilize exchange rates with important trading or investment partners. Conversely, producers in the nontradables sector (and those producers of traded goods who are relatively insensitive to international prices) depend more on domestic economic conditions and are thus likely to prioritize monetary independence over exchange rate stability.

**Table 3: Export and Foreign Investment Profiles**

	Exports		Regional exports FDI stocks			
	(% GDP)		(% total exports)		(% GDP, 2008)	
	1995	2008	1995	2008	inward	outward
PRC	20	35	57	37	8.7	3.4
Hong Kong, China	143	213	49	61	388.1	360.3
Taipei, China	-	-	50	64	11.6	44.6
Japan	9	18	43	48	4.1	13.9
Rep. of Korea	29	53	45	47	9.8	10.3
Singapore	-	221	54	61	179.3	103.9
Indonesia	26	30	60	62	13.1	5.3
Malaysia	94	103	55	58	33.0	30.4
Philippines	36	37	41	61	12.7	3.4
Thailand	42	76	47	53	38.4	4.0
Viet Nam	33	78	66	43	53.8	-

FDI = foreign direct investment

Sources: World Bank, World Development Report; ADB, Integration Indicators Database; UNCTAD, World Investment Report.

As shown in table 3, on basic measures of internationalization, all East Asian countries are relatively open. The importance of exports varies widely, but is high in all cases and the proportion of exports going to the region is very significant. Discounting the trade hubs of Singapore; and Hong Kong, China, the outlier in the region is Japan, for which exports are less important, although the growth of the Japanese export sector does increase the size of the domestic constituency concerned with stabilizing external currency values. International

<sup>11</sup> The level at which exchange rate is set introduces distinctions between importers and exporters (and between import-competing producers of traded goods). This issue is ignored in the following discussion on the basis that gains from currency over- or under-valuation are short run and are therefore less likely to affect decisions regarding long-term institutionalized exchange rate arrangements.

investment, another indicator of whether domestic groups are sensitive to exchange rate movements, is moderate for most countries if one uses a broad measure of cross-border capital exposure (assets and liabilities, bank loans, as well as direct investment). Again, however, the situation varies across the region in terms of the composition of international investments and liabilities. With the exception of Japan, direct investment outflows show some regional concentration, but liabilities are more widely disbursed (Hamilton-Hart 2004). Of particular relevance is the wide variation in foreign direct investment (FDI) stock as a percentage of gross domestic product (GDP), with most regional countries recording significantly less outward FDI than the world developing country average (of 14% in 2008) and the world average (33%). Some of this discrepancy may reflect the intermediation of some outward investment via the capital and trade hubs of Singapore and Hong Kong, China (as well as other offshore centers), as well as deliberate efforts to minimize the visibility of outward investment flows. However, it also likely to reflect the Southeast Asian region's traditional reliance on inward FDI, with the accumulation of overseas direct investment assets being much more recent, and still comparatively modest, development.

Domestic preferences regarding monetary cooperation will also depend on how cooperation is likely to affect macroeconomic policy settings. While in theory the requirement that countries in a common currency zone adopt similar macroeconomic settings is neutral as to what these actually are, in the European case the convergence criteria for cooperation dictated prioritizing low inflation and fiscal restraint. In the foreseeable future, monetary cooperation in Asia would also be likely to include commitments to moderately low levels of inflation. The distributional consequences of low inflation favor the financial sector and savers in particular, who tend to favor conservative monetary and fiscal policies (Kirshner 1998, 2001). These groups are thus more likely to support monetary cooperation that entrenches a commitment to low inflation than mass-based political parties with left or labor constituents, who tend to favor more expansionary macroeconomic policies.

In East Asia, left-right political balances in most of the region tend to favor preferences for relatively low inflation. More populist politics in the Philippines and post-1998 Indonesia are exceptions. If actual inflation levels are taken as a proxy for the preferences of dominant domestic actors, average inflation rates 1982–99 show that Indonesia; the Philippines; the PRC; and Hong Kong, China had averages above 6% per year; the Republic of Korea; Thailand; Malaysia; Taipei, China; Singapore; and Japan had average inflation rates of below 6% (Kwan 2001: 169). As can be seen from Table 4, gaps have narrowed significantly since then, with Indonesia, Viet Nam, and the Philippines now the only outliers. Not only is inflation at relatively low levels, real interest rates (based on lending rates) are positive in most cases, although whether official statistics on lending rates accurately capture the cost of finance—let alone returns to savers—is much less certain.

**Table 4: Domestic Prices**

	Consumer prices					Real interest rates (av.)		
	1993–2002	2004	2006	2008	2010	1991–95	2001–05	2006–09
Japan	0.2	0.0	0.3	1.4	-0.7	4.1	3.2	2.7
Rep. of Korea	4.2	3.6	2.2	4.7	3.0	1.2	3.5	4.2
PRC	6.2	3.9	1.5	5.9	3.3	-2.2	2.3	2.9
Hong Kong, China	2.8	-0.4	2.0	4.3	2.4	0.1	8.9	5.0
Taipei, China	1.7	1.6	0.6	3.5	1.0	-	-	-
Singapore	1.2	1.7	1.0	6.6	2.8	2.9	5.4	3.6
Indonesia	13.8	6.1	13.1	9.8	5.1	12.3	6.4	1.4
Malaysia	3.0	1.4	3.6	5.4	1.7	5.7	3.3	3.2
Philippines	6.9	6.0	6.2	9.3	3.8	7.0	4.6	4.2
Thailand	3.8	2.8	4.6	5.5	3.3	7.3	3.8	3.1
Viet Nam	5.6	7.9	7.5	23.1	9.2	-5.5*	3.8	1.2

\*1993–1995

Source: IMF, *World Economic Outlook*, April 2011, Table A7; World Bank, data indicators available at <http://data.worldbank.org/indicator/FR.INR.RINR>

Financial sector preferences are likely to favor low inflation environments and positive real interest rates. In the European case, these interests constituted an important source of support for monetary integration, given the convergence criteria. However, the European context prior to monetary unification was very different from the East Asian one today. Whereas several countries in Europe tended to adopt inflationary macroeconomic settings, and therefore financial sector actors could hope that regional cooperation might rein in these tendencies, in East Asia most countries already have relatively entrenched low inflation environments. In this case, the financial sector is more likely to favor continued monetary autonomy, and can be expected to be relatively indifferent to exchange rate fluctuations (and in fact is likely to benefit from the income opportunities generated by exchange rate variability). Although size is not always an indicator of influence, in several East Asian countries the financial sector is relatively large, particularly when broadly defined, as shown in table 5. Private financial sector actors frequently have a comparatively close relationship with national monetary authorities, making it likely that—in the absence of countervailing pressures—financial sector interests are likely to be listened to by national monetary authorities.

**Table 5: Financial Sector Contribution to GDP**

	Financial sector	Finance, business services and real estate
Japan	5.8	18
Rep. of Korea	5.1	-
PRC	-	-
Hong Kong, China	15.3	-
Taipei, China	6.7	16.9
Singapore	11.2	24.4
Indonesia	-	7.4
Malaysia	-	12.7
Philippines	6.9	17.8
Thailand	3.9	6.3
Viet Nam	1.9	5.5

Source: national statistical agencies.

It is not clear how political systems in the region are likely to affect the aggregation of domestic preferences regarding the trade-off between monetary independence and exchange rate stability. According to several analyses, political institutions under-privilege trading interests in much of Southeast Asia and Japan. If true, this might explain national policies that do not support cooperation even if it would yield overall benefits for an economy. In the case of Southeast Asia, a high proportion of trade is accounted for by foreign-owned companies, a legacy of a development model in which export-led growth has been dependent on FDI. Further, politically influential local business actors are frequently concentrated in the nontradables sector, such as property development, generally considered to have more to gain from monetary independence than exchange rate stability. This combination of a politically marginalized trade sector and a privileged nontradables sector was widely blamed for perverse macroeconomic policy choices in Indonesia, Malaysia and Thailand before the 1997–98 crisis (e.g., Jomo 2003). In the case of Japan, the electoral system has until recently privileged the voices of domestically-oriented economic actors, which are not expected to support financial cooperation.

As a general explanation for the lack of support for monetary cooperation, however, it is not plausible that the trade sector is not influential across the region. What seems more likely is that a different type of domestic distributional problem has entrenched the current set of suboptimal macroeconomic settings. This distributional conflict is analyzed in the case of the PRC by Hung Ho-Fung (2009), who points to the disproportionate influence of the export sector as a reason for the persistent inability to reallocate domestic resources and spending power. Although he concedes that the PRC faces a genuine dilemma with regard to its balance of payments imbalances with the US, the country's very limited steps to do anything to reduce these imbalances lies, he argues, in the power of the coastal export industries who have so vociferously opposed revaluation of the yuan. Here we have the domestic political economy story behind the aspects of financial and monetary mercantilism driving suboptimal reserve accumulation strategies (Aizenman and Lee 2008).

**Table 6: Current Account Balances (% GDP)**

	2003	2005	2007	2008	2009	2010
Japan	3.2	3.6	4.8	3.2	2.8	3.6
Rep. of Korea	2.4	2.2	2.1	0.3	3.9	2.8
PRC	2.8	7.1	10.6	9.6	6.0	5.2
Hong Kong, China	10.4	11.4	12.3	13.7	8.6	6.6
Taipei, China	9.8	4.8	8.9	6.9	11.4	9.4
Singapore	22.7	21.1	27.3	14.6	19.0	22.2
Indonesia	3.5	0.1	2.4	0.0	2.6	0.9
Malaysia	12.0	15.0	15.9	17.5	16.5	11.8
Philippines	0.4	2.0	4.9	2.2	5.8	4.5
Thailand	3.4	-4.3	6.3	0.8	8.3	4.6
Viet Nam	-4.9	-1.1	-9.8	-11.9	-6.6	-3.8

Source: IMF, *World Economic Outlook*, April 2011, Table A12.

With some modification, this story can plausibly stretch to much of the rest of the region. As shown in table 6, most of the region remains in export overdrive, with persistent current account surpluses. Although savings rates, shown in table 7, are declining in several countries (but not the PRC), they remain high. Taken together, the export surpluses and savings profiles of most countries in the region represent a significant transfer of consumption—from domestic to foreign consumers, and from the present to the future. This signals the distributional outcome of an underlying political and economic growth model: one that favors export industries and transfers resources from domestic consumers.

**Table 7: Gross Savings (% GDP)**

	1995	2008
PRC	42	53
Hong Kong, China	-	34
Japan	30	27
Rep. of Korea	36	31
Singapore	53	45
Indonesia	28	20
Malaysia	34	37
Philippines	19	35
Thailand	34	29
Viet Nam	-	29

Source: World Bank, indicators database available at <http://data.worldbank.org/indicator/NY.GNS.ICTR.ZS/countries>

Rising incomes achieved through these export-surplus strategies are leading to an expansion of a regional middle class and regional final consumption demand. However, for all the rhetoric regarding the need to develop domestic demand, several factors inhibit more robust moves in this direction. East Asia has developed with a growth structure oriented to mobilizing savings

and low cost labor in support of what can be described national export machines. In addition to the industrial and financial policies that have been involved, entrenched structural and social policies have also favored this type of political economy: generally (until recently) labor-repressive industrial relations regimes, very limited public provision of welfare or social safety nets, and close relations between governments and domestic business interests.

## **5. CONCLUSIONS: WHAT'S DRIVING AND WHAT'S BLOCKING REGIONAL COOPERATION?**

In order to understand the relative absence of monetary cooperation in East Asia, particularly in comparison with financial and other forms of regional cooperation, four general categories of explanation surface frequently. It is important to distinguish among them and assess their relative importance, since some imply the absence of cooperation is suboptimal while others do not. If the absence of cooperation is suboptimal, it is important to locate the level at which obstacles to cooperation lie. This concluding section briefly reviews the different potential explanations.

### **5.1 Elusive net gains from cooperation?**

This explanation posits that monetary cooperation is simply not in the interests of the region. While this does not mean there are no potential gains from cooperation, it suggests that potential costs outweigh the benefits. The two principal lines of argument leading to this conclusion are either that East Asia does not constitute an OCA or that countries simply have more to gain by adopting flexible exchange rate regimes. As discussed in section three, however, neither argument is sufficiently convincing. While some assessments dispute that East Asia constitutes an OCA, a greater number find that it at least a subset of the region satisfies standard OCA criteria at least to the extent that European countries did. OCA models also fail to take into account the consequences of monetary cooperation itself. Further, the costs of monetary cooperation need to be weighed against the costs of the status quo. While the costs of the status quo are difficult to quantify (although the same goes for any attempt to quantify the costs of convergent monetary policies), only a few analyses are sanguine enough to consider the current imbalances associated with the current international monetary system stable, let alone optimal. Finally, even if the loss of monetary autonomy is sufficiently important to make monetary unification undesirable, this does not explain why less costly forms of monetary cooperation—cooperation aimed at securing orderly currency diversification and reducing global imbalances—are not being more seriously pursued.

### **5.2 The overriding importance of sovereignty and autonomy?**

This explanation holds that aggregate economic benefits are simply not determining if they conflict with national sovereignty or autonomy concerns. East Asia is often presented as a region of nation-states that have strong preferences to prioritize sovereignty and domestic autonomy, and hence has eschewed the supranationalism of European-style institution-building. If sovereignty concerns are overriding, economically suboptimal policies may be rationally preferred. Cooperation in this case cannot be said to have “failed”, since there is in fact no real demand for cooperation, regardless of its potential economic benefits. While plausible in some respects, more evidence speaks against this proposition than for it. It is true that there has been no delegation of authority to regional-level institutions in East Asia, and many regional governments frequently refer to the primacy of national sovereignty. However, every

economically significant country in the region has already been willing to accept significant limits to its national autonomy in order to realize economic gains. They have taken on legally binding and highly institutionalized commitments in the WTO, for example, and have engaged enthusiastically in the pursuit of bilateral PTAs, many of which are highly intrusive. They have also signed bilateral investment agreements which on paper give foreign investors extensive rights and constitute legal limits to national policy making autonomy. East Asians have been slow to enter into legally binding regional agreements among themselves, but this cannot be ascribed to any generalized aversion to such agreements.

### **5.3 International conflicts and collective action failures?**

The third potential explanation for the low level of regional monetary cooperation points to international politics—distributive conflicts, rivalries, and collective action failures that persist because of the absence of institutional solutions to collective action dilemmas. This explanation implies that there is real demand for cooperation, but member countries are unable to achieve cooperative outcomes because of intra-regional political dynamics. It is clearly the case that effective and sustainable cooperative monetary policy regimes are particularly demanding, both in terms of the degree of supranationalism that stronger forms imply and in terms of free rider problems (Cohen 1993; Kirshner 2003; Eichengreen 2011). And there is evidence that international rivalries—and concerns not to disrupt alliance relationships with the US—have at times limited regional cooperation (Grimes 2009). As pointed out in such analyses, the fact that in East Asia the two leading economic powers have yet to resolve bilateral differences in favor of a clear commitment to regional cooperation marks a significant difference from the European case, where France and Germany were strongly motivated to cooperate for essentially political reasons. For East Asia, prognoses for regional cooperation depend on how severe and permanent bilateral rivalries and security concerns are taken to be. Unless such concerns are assumed to be immutable (and we have no reason to suppose that they are), this category of explanation points to the way forward as being to concentrate on building regional-level institutions that can both address mutual suspicions and provide more technical solutions to concerns about free riding. This indeed appears to be an approach favored by advocates of closer cooperation (e.g. Nesadurai 2008; ADB 2010). Although regional-level institutions undoubtedly matter, they also to some extent beg the question. If in fact Asia is under-institutionalized, this raises the question of why this should be the case. International politics and collective action problems may be relevant, but the question of domestic-level politics and collective action problems is analytically prior.

### **5.4 Domestic distributional conflicts and collective action failures?**

A full mapping of domestic preferences and political institutions driving policy choices for East Asian countries remains to be undertaken. Since proposals for monetary cooperation have yet to gain much traction, there is so far little direct evidence of political lobbying either for or against regional monetary cooperation. The stylized facts presented in this paper are thus hardly conclusive, and lend themselves to different interpretations. From one perspective, the relatively high levels of internationalization and regional integration in most countries could be taken to mean that there should be important domestic constituencies who would be well served by greater intra-regional exchange rate stability. Further, there is already a high degree of apparent convergence on some basic macroeconomic preferences, suggesting that some of the important obstacles to cooperation in the European case are less relevant in East Asia. On the other hand, the economic weight of sectors that might advocate for greater intra-regional exchange rate stability varies from country and, more importantly, political systems that

aggregate preferences in some cases appear to give disproportionate influence to sectors that are likely to prioritize domestic monetary autonomy. Perhaps most importantly, and somewhat paradoxically, it may be the entrenched influence of the export sector in the context of an institutionalized growth model built on external surpluses at the expense of domestic consumption that inhibits the monetary cooperation.

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