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1 ■ Introduction: Key Issues

Ten years have passed since the Asian financial crisis that devastated not only the currency values and the financial systems of Indonesia, the Republic of Korea, Malaysia, and Thailand, but also their overall economic activity, social conditions and, in some countries, political systems. Since the crisis, these economies have restored financial resilience through (i) financial sector restructuring and reforms aided by corporate debt resolution and the introduction of more effective insolvency procedures, (ii) reductions of short term external debt and accumulation of foreign exchange reserves, and (iii) adoption of greater flexibility of exchange rates among the crisis-affected economies.

The financial crisis and contagion revealed how closely financial systems and economic conditions were inter-connected across East Asia. Reflecting this, East Asian governments and central banks have embarked on several new initiatives for regional financial cooperation.¹ This paper explores the background and progress of recent financial cooperation initiatives in the region, the new opportunities provided, and possible evolution of a new regional financial architecture.

¹ East Asia in this paper refers to Japan, People's Republic of China, the Asian newly industrialized economies (NIEs - Hong Kong, China; Republic of Korea; Singapore; and Taipei, China), and ASEAN member countries (Brunei, Cambodia, Indonesia, Lao PDR, Malaysia, Myanmar, Philippines, Singapore, Thailand, Viet Nam).



2. Factors behind Regional Financial Cooperation in East Asia

There are several factors behind recent financial cooperation in East Asia.²

Deepening regional economic and financial interdependence.

The most important reason behind recent moves towards regional financial cooperation is the deepening regional economic and financial interdependence. Over the past twenty-five years, East Asia has witnessed rapid market-driven economic integration through trade, foreign direct investment (FDI), and finance. Japan, the Asian newly industrialized economies (NIEs), and the middle-income Association of Southeast Asian Nations (ASEAN) countries were early drivers of this process and, more recently, the People's Republic of China (PRC) has been an active participant in the region's trade and FDI activities. In the past few years, India has also been trying to strengthen linkages with East Asia. As a result, macroeconomic interdependence has been rising, with more synchronized business cycles, among major economies in the region. Deepening interdependence has raised awareness among the region's national authorities that they cannot achieve economic and financial stability by themselves and that some collective action is essential for this purpose.

² See Kawai (2005, 2007b).



Response to the Asian financial crisis of 1997–98. The Asian financial crisis was the result of a combination of financial globalization and weak national financial systems. Crisis-affected economies have learned several hard lessons from the crisis. First, to strengthen national financial systems there is a need to share information within the region about common issues and concerns, and ways to address them at the national level. Second, in the face of rising financial globalization, there is a need to create regional self-help mechanisms for effective prevention, management, and resolution of financial crises particularly given the revealed shortcomings of the existing global financial architecture and the limited Asian voice in, and for, global financial management. Third, because regional financial stability is a basis for global financial stability, effective regional financial cooperation is complementary to the role of global financial institutions such as the International Monetary Fund (IMF).

European monetary integration. The overall success of European monetary and exchange rate policy coordination, which culminated in the introduction of the euro as a single currency in 1999, has also prompted the East Asian authorities to consider regional financial cooperation as a viable tool of regional self-help mechanisms for financial stability. As in the case of Europe, regional cooperation—rather than a regional hegemonic arrangement—is important in East Asia as Japan, PRC, Korea, and ASEAN countries are equally important partners in the region. As the Japanese yen or the Chinese yuan alone cannot fulfill the role of a regional key currency, a basket of regional currencies can potentially play an important role.



3. Recent Progress on Regional Financial Cooperation in East Asia

There are three regional groups for East Asian financial cooperation: ASEAN, ASEAN+3, and East Asia Summit.

ASEAN financial integration. Ten ASEAN members are now striving toward economic and financial integration. In 1977 the original five ASEAN monetary authorities created an ASEAN Swap Arrangement with the initial facility of US\$100 million, which has grown in size and country coverage over the years. The ASEAN finance ministers, who met for the first time in 1997, introduced the ASEAN Surveillance Process in 1998. Following the adoption of ASEAN Vision 2020, the Initiative for ASEAN Integration (2000), and the Roadmap for Integration of ASEAN (2001), the ASEAN leaders declared ASEAN Concord II (or Bali Concord II) and agreed to establish an ASEAN Economic Community by 2020, a goal that was recently brought forward to 2015. In this context, the finance ministers agreed in 2002 on the Roadmap for Financial and Monetary Integration of ASEAN by focusing on capital market development, capital account liberalization, financial services liberalization, and ASEAN currency cooperation. The Vientiane Action Programme signed at the 2004 ASEAN Summit identified three financial cooperation initiatives: (i) strengthen surveillance mechanisms including the setting up of an early warning system; (ii) enhance domestic financial systems through capacity building; and (iii) develop and integrate financial markets.



ASEAN+3 financial cooperation. ASEAN+3 finance ministers from ten ASEAN countries, PRC, Japan, and Korea, who met for the first time in 1999, have pursued regional financial cooperation in three areas: (i) regional economic surveillance; (ii) regional reserve pooling; and (iii) regional bond market development.³

First, the Economic Review and Policy Dialogue (ERPD), introduced in May 2000, is a regional economic surveillance process, intended for information exchange, policy discussions, and peer reviews which are the basis for enhancing regional monetary and financial cooperation. It facilitates analysis of economic and financial conditions of the global, regional, and individual national economies; monitoring of regional capital flows and financial market developments; assessment and management of vulnerabilities and risks; and undertaking of joint actions on issues affecting the region. This process is expected to induce better macroeconomic policymaking and implementation of desired financial sector policy and institutional reforms through peer pressure.

Second, the Chiang Mai Initiative (CMI), also introduced in May 2000, is a liquidity support facility intended to reduce the risk of currency crises and manage speculative attacks or contagion against currencies. It comprises (i) bilateral swap agreements (BSAs) among PRC, Japan, Korea, and between any of these plus-3 countries and a core ASEAN member and (ii) the ASEAN Swap Arrangement (ASA). The total bilateral swap size reached

³ See Kuroda and Kawai (2002).



US\$83 billion with 16 BSAs and the total ASA stood at US\$2 billion as of July 2007.

Continuous progress has been made to strengthen ERPD and CMI. Some of the major developments over the last few years include (i) integration and enhancement of ERPD into the CMI framework (May 2005); (ii) raising the ceiling for withdrawal without an IMF program in place from 10 percent to 20 percent of the total (May 2005); (iii) adoption of the collective decision-making procedure for CMI swap activation, as a step toward multilateralizing the CMI (May 2006); and (iv) agreement in principle on a “self-managed reserve pooling” arrangement governed by a single contractual agreement as an appropriate form of CMI multilateralization (May 2007).

Currently, ASEAN+3 finance and central bank deputies are studying some key elements of CMI multilateralization (self-managed reserve pooling)—including surveillance, reserve eligibility, commitment size, borrowing quota, and activation mechanisms.

Finally, ASEAN+3 policymakers are promoting local-currency bond markets through the Asian Bond Markets Initiative (ABMI). The region’s central banks are also making efforts through the Asian Bond Funds—particularly ABF2. These are expected to help make the Asian financial system more balanced so as to promote efficient allocation of financial resources and risks, and facilitate the recycling of regional savings for regional investment—particularly for physical infrastructure, SME



businesses, and housing. It is estimated that there is a potential need for infrastructure investment, amounting to US\$300–US\$400 billion per year in Asia over the next ten years. At the same time there is a need to promote an efficient asset management industry given the rapid pace of aging in several economies.

EAS financial cooperation. The East Asia Summit (EAS) was launched by 13 ASEAN+3 members, Australia, India, and New Zealand in 2005. This group is expected to focus on financial cooperation as one of the five priority areas for cooperation (the other four being energy, education, combating avian influenza, and natural disaster mitigation) but its exact nature has yet to be identified. EAS financial cooperation needs to complement and support the existing cooperation arrangements under ASEAN and ASEAN+3. Some of the suggested functions of EAS financial cooperation may include (i) playing the role of an Asian voice caucus in larger international forums like IMF, G20, etc.; (ii) establishing an East Asian forum for capital market regulators which may evolve into the Asian version of the Financial Stability Forum involving the region's finance ministry and central bank officials; and (iii) providing capacity building support for weaker countries.⁴

⁴ See Hew, et al. (2007).



4. Policy Challenges for East Asia's Finance

There are several key policy challenges for East Asian finance.

Strengthening regional reserve pooling and economic surveillance. As the size of the CMI further expands, its IMF linkage is further reduced, and swap arrangements are multilateralized, the quality of economic surveillance (ERPD) needs to improve so that independent lending conditionalities can be formulated in the event of CMI activation. For this purpose, the following recommendations may be made:⁵

- Clarify rules for activating a multilateralized CMI;
- Move beyond the simple “information sharing” stage to a more rigorous “peer review and peer pressure” stage, and eventually to a “due diligence” stage, to improve the quality of economic surveillance.
- Establish a joint forum for East Asian finance ministers and central bank governors to intensify policy dialogue; and
- Set up a professional secretariat that supports regional economic surveillance (ERPD), CMI activation, and independent conditionality formulation.

Development of sound, resilient financial systems. The lack of sound, resilient financial systems was one of the most important factors behind the Asian financial crisis. Establishing resilient

⁵ See Kawai and Houser (2007).



financial systems at the national level is essential to ensure national and regional financial stability. In addition, financial systems must play key roles in channeling the pool of regional savings for regional investment needs. For these purposes it is crucial to accomplish the following:

- Make further progress on ABMI and ABF to deepen the size and liquidity of local-currency bond markets;
- Strengthen the risk management capacity of financial institutions, particularly deposit-taking banks, through better regulatory and supervisory frameworks (including early implementation of Basel II) and greater competition; and
- Improve corporate governance of both financial institutions and their clients—corporate borrowers.

Exchange rate policy coordination. Currently no consensus exists, even within ASEAN or ASEAN+3, on a regional exchange rate arrangement. Given the deepening economic interdependence within East Asia, however, a certain degree of intra-regional exchange rate stability is increasingly desirable. In a possible unwinding process of global payments imbalances, or in the face of large capital inflows to East Asia, there is a risk of sharp and disorderly depreciation of the US dollar against East Asian (and other major) currencies. If East Asian economies must accept currency appreciation vis-à-vis the US dollar, they had better do so collectively, while maintaining intraregional exchange rate stability.



To prepare for this type of policy coordination, East Asian economies may consider adopting policies to stabilize their exchange rates against a common basket of external and internal currencies—comprising the US dollar, the euro, and the Asian Currency Unit (ACU)—to achieve relative stability of their effective exchange rates and intra-regional exchange rates. An ACU index can measure the degree of joint movement of East Asian currencies and the divergence of individual component currencies from the regional average given by the ACU rate.⁶ Once the PRC moves to a more flexible exchange rate regime, ACU movements and divergence indicators may provide more meaningful information.

⁶ Developing an Asian Currency Unit (ACU)—a composite index of regional currencies—is potentially useful for exchange rate management in the region. See Kawai (2007a, 2008) for the concept of ACU and its possible roles.



5. Conclusion

East Asia can contribute to the stability of global finance by achieving sustainable economic growth and financial stability (and by not repeating financial crises) through (i) establishment of resilient national financial systems; (ii) mobilization of regional savings for regional investment; (iii) strengthening of regional liquidity (CMI) and surveillance (ERPD) arrangements; and (iv) adoption of formal or informal exchange rate policy coordination.

What is the most appropriate regional grouping that can deliver these results? ASEAN has the longest history of regional economic and financial cooperation in East Asia and is now on its way toward building an ASEAN Economic Community (AEC) by 2015. ASEAN+3, created in the aftermath of the Asian financial crisis, has been focusing on regional surveillance and liquidity arrangements. EAS is the most recent grouping; its role in regional financial cooperation has yet to be identified. Among the leaders of these groupings, there is an emerging consensus that ASEAN is the “driving force” for the full realization of an East Asian economic community (EAEC), ASEAN+3 is the “vehicle” for this purpose, and EAS is an “integral part” of the overall evolving regional architecture. Though it is difficult to predict the future shape of the regional financial architecture, ASEAN and ASEAN+3 will focus on all issues (i)–(iv) above while EAS as a supporting group can focus on (i) and (ii).



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About this Research Policy Brief

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