

## **FINANCIAL COOPERATION AND INTEGRATION IN EAST ASIA**

### **CURRENT STATE OF THE ASEAN+3 PROCESS BEYOND CMI AND ITS CHALLENGES <sup>1</sup>**

#### **I. Introduction**

The financial crises that first hit Thailand in mid 1997 and then spread to other countries in the region have given a valuable lesson not only for the crises-hit countries, but also for other countries. The factors that triggered the crises as well as the severe impact on the crisis-hit countries had distinguished the crises notably from the previous ones and made it difficult to tackle when they first started. The severe economic and financial difficulties experienced by Thailand, Malaysia, South Korea, Indonesia, Russia, and Brazil in the financial crisis of 1997-98 are not triggered by merely a single cause. What we saw, in various combinations, were large and growing current account deficits, excessive reliance on short-term borrowings, overvalued fixed exchange rates, weak domestic financial systems, and macroeconomic imbalances. The unprecedented scale of the crises have caused enormous damages to the countries in the region as it was followed by sharp depreciation of real exchange rates, precipitous falls in asset prices, collapse in investment and in consumer confidence, as well as the destruction of incomes and increased poverty in the region. The crises have brought not only grave economic but also social and political impacts.

To resolve the crises, each individual hit crises country took several policies measures, among others widening the intervention band, abandoning the fixed and managed float exchange rate regimes, establishing capital control, restructuring their corporate and banking sectors, and even going to the IMF for financial assistance. Nevertheless, the complexity of the problems has blunted the effectiveness of those measures in achieving its objectives. What have been done by each crises-hit country to resolve the financial crises which was proved less effective shows that there is an urgent need to strengthen regional financial cooperation and integration.

To this end, governments of the crises countries supported by the international financial institutions (IFIs) such as ADB and the IMF have started to make serious efforts to strengthen regional cooperation so as to resolve the crisis and to prevent a similar crisis in the future. There is a broad consensus among countries in the region that collective response is needed to overcome and prevent the crisis.

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## ***II. Current State of the ASEAN +3 Process beyond CMI***

Subsequent to the 1997 crisis, there has been a wide range of regional cooperation proposed by individual countries in East Asia as well as international financial institutions as regional self-protection measures to crisis. In relation to this, the ASEAN + 3 countries has established meetings for Finance and Central Bank Deputies as well as Finance Ministers to integrate various initiatives on monetary and financial cooperation in East Asia. The various initiatives on the framework of the ASEAN+3 process cover several broad areas, including:

- i. Regional Self-Help and Support Mechanism
- ii. Monitoring of Capital Flows
- iii. Strengthening Surveillance Mechanism
- iv. Early Warning System
- v. Finance Cooperation Fund
- vi. Capital Market Development
- vii. Strengthening the Effectiveness of Economic Review and Policy Dialogue
- viii. Technical Assistance
- ix. Voluntary Research Groups
- x. Regional Exchange Rate Arrangement

The followings elaborate these areas of initiatives:

### **i. Regional Self-Help and Support Mechanism**

The earlier effort to develop regional self-help mechanism is reflected in the establishment of the Chiang Mai Initiative (CMI) in the year 2000. The CMI is the first significant regional financing arrangement to enable countries to cope with disruptive capital flows and maintain exchange rate stability. A framework on the design of CMI comprises two components, namely the expansion of ASEAN Swap Arrangement (ASA), and the establishment of Bilateral Swap Arrangement (BSA). The ASA, which was created in 1977 by the original five ASEAN member countries, was modified in November 2000. The objective of establishing ASA was to provide unconditional and immediate short-term swap facilities to members facing temporary liquidity or balance of payments problems. The ASA was enlarged to include all ten ASEAN countries and increased its size from US\$200 million to US\$1 billion.

Subsequently, to complement the existing financing cooperation at the regional level, members of the ASEAN+3 countries agreed to establish BSA as a means to provide short-term financial assistance to a country in need of balance of payments or short-term liquidity support, and to be complementary and supplementary to IMF facilities. To date, 13 bilateral agreements amounted to USD31.5 billions have been signed

between the big five ASEAN member countries and the “+3 countries” (Japan, China and Korea).

As the number of BSA concluded is increasing, the bilateral financial cooperation may eventually cover the entire region. In light of this likely future, consideration has been put forward to extend the liquidity provision beyond the existing swap arrangements to the form of regional reserve pooling arrangement. This multilateral arrangement could take the form of accumulated foreign exchange reserves derived from a certain percentage each country’s central bank in the region, which in turn could be used in case it is needed to cover significant short-term capital flow reversals. To enhance the effectiveness of the reserve pooling, this regional reserve facility could be further institutionalized to the form of an Asian Reserve Bank (ARB) which would accumulate and manage these reserves more effectively.

## **ii. Monitoring of Capital Flows**

Monitoring of Capital Flows under ASEAN+3 Finance Minister Forum covers two main areas:

- *Bilateral Exchange of Capital Flows Data*

This covers data exchange on short-term capital flows on a bilateral, voluntary and dynamic basis. For this purpose, ASEAN Secretariat has made up a data template on capital flows. So far a number of bilateral data exchange has been conducted although the exchange may not involve the complete data template due to data availability.

- *Monitoring System for Cross Border Short Term Capital Flows*

A more comprehensive approach has been conducted to provide a systematic system for monitoring and reporting movements of short term capital flows in the region, as well as analysis on market behavior, development of policy measures for capital flows and constructing appropriate method for forecasting short-term capital flows. To date, the project is progressing with reporting and monitoring system prototype conducted in several countries.

## **iii. Strengthening Surveillance Mechanism**

In surveillance aspect, a Manila Framework Group (MFG) was established soon after the crisis in mid 1997 occurred. The MFG, established in November 1997, was set up to provide a basis for intensive and high-level surveillance and dialogue among participants, help identify potential risks to growth and financial stability, advise on appropriate policy responses to reduce such risk, and undertake initiatives to enhance economic and technical cooperation, particularly in strengthening domestic financial systems and regulatory capacities. Following the establishment of MFG, other similar cooperation was launched such as the establishment of ASEAN Surveillance Process in 1998 with an overall objective is to strengthen policy-making capacity within the

grouping. In this regard, peer review and surveillance were extended to cover not only the major macroeconomic aggregates but also sectoral and social policies so as to improve policy coordination in the broadest sense, particularly in the light of adverse development.

#### **iv. Early Warning System**

Under the support of technical assistance approved by Asian Development Bank (ADB), efforts to develop a Regional Early Warning system (EWS) and the implementation have been conducted. To date, a regional EWS prototype has been adopted, and a second technical assistance on Capacity Building for implementing Early Warning System has been approved in December 2002 for the purpose of assisting countries to implement and operationalize the regional EWS, including developing country-specific EWS models.

#### **v. Finance Cooperation Fund**

To support the ASEAN+3 economic review and policy dialogue, the ASEAN+3 Cooperation Fund (the Fund) has been established to provide financial support for the ASEAN +3 finance meetings. The Terms of Reference of the Fund was now already finalized and agreed. The Fund will be derived from ASEAN+3 member countries ranging from USD 20,000 to USD 40,000 each country per year and administered by the ASEAN Secretariat.

#### **vi. Capital Market Development**

The main focus of capital market development in the region at the moment is on developing an Asian Bond Market. A regional bond market is expected to strengthen the region's financial system with better utilization of aggregate savings in the region and minimize the risk of maturity and currency mismatches. For this purpose, 6 working groups (WG) have been established i.e. WG on: (i). creating new securitized debt instrument, (ii). credit guarantee mechanisms, (iii). settlement and foreign exchange regulations, (iv). issuance of bonds denominated in foreign currency, (v). local and regional credit rating agencies, (vi). technical assistance. The last 4 WGs are joint initiative with the APEC forum. In the near future, the first Asian bond is expected to be issued.

Under the EMEAP forum, the Asia Pacific member countries have recently form an Asian Bond Fund (US dollar denomination) with total investment of USD 1 billion, expect Japan, Australia and New Zealand. This fund will be invested in sovereign and quasi-sovereign bonds issued by participating countries. ABF is managed by the Bank for International Settlement (BIS). To date, the ABF is in the stage of pooling funds from participating countries. Furthermore, the second ABF is expected to be established in the near future, this ABF II will be denominated in the local currencies of participating countries.

## **vii. Strengthening the Effectiveness of Economic Review and Policy Dialogue**

To enhance the current peer review process within the region, a study group has been established, namely the ASEAN+3 Study Group to Examine Ways of Enhancing the Effectiveness of Economic Reviews and Dialogues. The phase I of the study group has resulted in the proposed regular and formal meetings. The enhancement of regional policy dialogue is envisaged to deepen and broaden the process by securing a more effective regional policy dialogue process for the ASEAN+3 countries to share experiences in managing economic and financial concerns as well as the detection of emerging vulnerabilities. The aim of enhancing the process is therefore to provide a complementary mechanism to focus on future enriching of the existing process in two areas, i.e. (i) in obtaining a third party assessment of regional issues to complement assessment made by the IMF and other regional institution, and (ii) in identifying and analyzing regional issues if concern to all ASEAN+3 countries.

## **viii. Technical Assistance**

On September 2001, the Japan – ASEAN Financial Technical Assistance Fund was established. The TA Fund has supported a number of projects and research activities including project of Monitoring Short Term Capital Flow and Promoting Research for Appropriate Financial Support Mechanism. For fiscal year 2003 – 2004, Japan has agreed to provide technical assistance to two research projects. i.e. Capacity Building in Macroeconomics Statistics and Assistance for Developing Markets.

In addition, projects under the ASEAN+3 process are also supported by the Asian Development Bank in the form of technical assistance, such as technical support for the implementation of the Asian Bond Fund as well as for the capacity building to put in place an early warning system in participating member countries.

## **ix. Voluntary Research Groups**

A voluntary research group has been set up recently to explore ways to further strengthen financial cooperation and promote financial stability in the region. For this purpose, selected experts and scholars in the region have agreed to collaborate on two common themes, namely: “Toward a Regional Financial Architecture for East Asia” and “An Exchange Rate Arrangement for East Asia”. Japan has made significant financial contribution for this research activities.

## **x. Regional Exchange Rate Arrangement**

The growing cross border capital movements have increased the risk of uncertainties of exchange rate. This, along with waves of speculations, has made individual

country's central bank monetary policy in creating price and exchange rate stability even more difficult. Drawing lessons from the euro area, the introduction of euro currency, preceded by locking bilateral exchange rates between countries in the region has significantly diminish speculative capital movements. This is supported by appropriate mechanism for adjusting the balance of payments. Moreover the establishment of a central authority, the European Central Bank fully supports the area's exchange rate arrangement.

Similarly, an exchange rate arrangement for East Asia is worth considering. In addition to strengthening the region's economy and financial market, a formal form of regional exchange rate coordination would enhance the financial integration in the region and determine further the direction of the "unity" of East Asia. To this end, a number of researches both under the framework of the region's Finance Minister forum or conducted independently have studied the possibility of an Asian Currency Unit or Asian Single Currency. A study funded by the Japan-ASEAN Financial Technical Assistance Fund consider proposal that focuses on two alternatives for regional exchange rate arrangements, i.e. a common single-currency peg and a common basket peg. This would further determine the amount of reserves pooling for liquidity provision that the region needs.

At ASEAN level, a task force designated the ASEAN countries has conducted a study to analyze the feasibility of establishing a common currency. The study conclude that the idea of forming n ASEAN single currency cannot be realized in the near future since the region has not completely met the Optimum Currency Area, particularly in terms of the low level of intra regional trade, the existence of idiosyncratic disturbances, and inflexible rules o labor and immigration, the absence of appropriate lead to be picked for anchor currency, and lack of political commitment.. This study similarly reflects on the condition in the ASEAN+3 area, hence the prospect for Eat Asia common currency thus far.

### **III. Challenges for East Asian Financial Cooperation and Integration**

With refreshed spirit of cooperation, the East Asia region has entered a new dimension of financial cooperation and integration, drawing from the lessons learned from the financial crisis in the late 1990s. However, unlike the more advanced progress achieved in some other areas such as trade liberalization, a lot of works remain in order to achieve strong and robust financial cooperation and integration in the region. As a number of initiatives on financial cooperation have emerged within the region, a clear framework to integrate all of these and other initiatives to come is needed. By far, it is of the utmost important to agree on the direction in which the financial cooperation and integration should aim. Obviously, reaching an agreement on a clear roadmap would by itself pose as a challenge. Other than that, there are still a number of other challenges to cope with. The followings elaborate some of those challenges.

## **a. *Resolving Differences in Economic, Financial and Infrastructural Aspects***

### **i. Different Economic structures and developments**

The East Asian region covers quite largely diversified economies in terms of the structure and stage of developments from Japan that represents the mature economy to the different levels of emerging economies. This provides challenges as financial cooperation and integration put these countries in the same field. More particularly, these differences lead to a number of difficulties such as:

#### **- *Idiosyncratic disturbances***

The level of economic convergence in East Asia is relatively low as reflected by the wide variation of numerous macroeconomic indicators (e.g. income level, growth, official reserves, inflation, interest rate), varied economic structure, different technological advancement and diverse fiscal strength. These conditions would lead to each country experience different kinds of impact in case there is a common shock to the region. In turn, this may affect each country's ability and preference for the level of cooperation and integration in the region.

#### **- *Difficulties in establishing cooperative exchange rate and monetary policy***

The idea toward a more integrated market and policies such as the establishment of a common currency or East Asian central bank appears to be a long way to go at the moment, due to differences in economic structure and development.

### **ii. Different maturity level of individual financial market**

Aside from affecting the ability to absorb shock, different maturity level of individual financial market would influence the capability of each country to participate in regional cooperation and integration, hence determine the success of various initiatives for cooperation and integration within the region. With regard to bond market, for example, Hong Kong SAR, China and Singapore are considered more advanced, followed by some other emerging countries. Indonesia is more embryonic although the progress has been promising. The size and depth of the bond market as well as tax treatment also vary across the region. This diversified level of maturity would affect the ability of the individual countries to participate in the Asian Bond Market Initiative, and in turn affect the functioning and liquidity of the region's bond market.

### **iii. Domestic Infrastructural differences**

Differences in infrastructure developments may hinder an effective and efficient financial cooperation and integration within the region. Financial institutions, settlement system, legal and regulatory arrangement, governance as well as accounting and tax systems are among the infrastructures which progress varies across the region. Some of these differences may be resolved by efforts directed at following international standards. Each country may have its own set of priorities

in developing various infrastructures. The existence of clear and well-directed financial cooperation and integration would help countries in setting common priorities for infrastructure development.

***b. Establishing regional infrastructures and requirements***

At the regional level, certain infrastructures are needed for a well-functioned financial cooperation. Capital account monitoring system is one of the needed region-wide arrangement that require full-support from each country in the region so as to enable effective monitoring of capital flows intra and inter-region which would in turn support initiatives on regional surveillance and financial support. In other case, the proposal to establish an Asian Reserve Bank for pooling of reserve or further form an Asian Central Bank would require significant resources and institutional support. In the case of bond market initiative, a well-established regional settlement/clearing system is needed in addition to systems set up at individual country level, in order to enable an efficient and well-functioning regional bond market that allow for a smooth trading of bonds between countries. Moreover, a credible regional credit rating agency is also required, while acceptable legal infrastructure would help convince investors and foster a liquid bond market. To date, a few of the needed regional infrastructures such as the capital account monitoring system, have already been in progress, while others would still take a considerable amount of time involving more in-depth studies, and technical preparations and support from countries in the region.

In addition, some other requirements are needed to enable a certain form of financial integration. For example, to establish an Asian currency unit, political willingness is required not only to surrender the monetary policy discretion of each country, but also to resolve other technical issues, such as allowing a certain country's currency to become the anchor currency. Moreover, transparency would become essential to allow for proper monitoring of financial market and capital movements.

***c. Compromising regional financial integration and cooperation with national sovereignty***

While East Asian countries have shown their political support toward financial cooperation, the move toward strong financial cooperation and integration requires more intense political will. It appears that the more economically integrated a region is, the less the individual countries' policy independence will be. One example applies in the so-called "impossible trinity" where the move toward capital account liberalization between nations cannot be followed by both fixed exchange rate and independent domestic monetary policy at the same time. Likewise, steps towards other economic integrations such as Asian Common Currency requires common monetary policies for the region that will undermine domestic policies, in addition to reducing or even eliminating some national "trademarks" such as domestic currency in this instance.



Moreover, advanced economic integration such as the European Union requires further common policies and regulations that force the individual countries to adjust their domestic interest and policies to the common goal and interest of the region. While financial cooperation and integration entail less scope than the definition of economic integration, the same rationale would apply. This illustrates that strong political will is required to reach further financial cooperation and integration in East Asia.

***d. Gaining support for East Asia financial cooperation and integration from other regions***

While part of the financial cooperation and integration in East Asia is directed toward a self-help mechanism including financial support and regional surveillance, support from other region such as the European Union will give much contribution to the success of the East Asia's efforts for strong and robust financial cooperation and integration. It appears that this kind of support is still limited as reflected in the existence of only quite a small number of fora that support this idea.

Support from other regions could be in the form of sharing of experiences and exchange of information on various financial issues so as to enhance the region's financial system including accounting, auditing and disclosure system to the levels of advanced countries. The more developed East Asia as a result of this inter-regional cooperation would contribute to a healthier and more competitive global financial market.

**IV. Conclusions and Recommendations**

The 1997 financial crisis in East Asia has set off the awareness to enhance financial cooperation in the region. Along this line, financial cooperation and integration are needed to move toward a stronger and more resilient East Asia region. The region has gained the political will from the individual countries as they realize the importance of enhancing resilience and utilizing the excess savings / financial resources that the region possess. In addition to efforts by individual economies to improve domestic macro economy and financial system in order to enhance resilience to crisis, measures taken at the regional level are just as crucial.

Moreover, financial cooperation and integration in East Asia should also aim at enhancing the region's level of economic development and financial market, which in itself implies improved economic state and prosperity within individual countries in the region. The more developed East Asia would increase the region's contribution in the world economy and increase the capability of East Asia to become part of the engine of global growth.

A well-defined roadmap and concrete action plan for financial cooperation and integration in East Asia is deemed important as it would provide clear and consistent path and integrated efforts. ASEAN has been more advanced with its Roadmap for Monetary

and Financial Integration which consist of four main elements (Integration of ASEAN Capital Markets, Liberalization of Trade in Financial Services, Capital Account Liberalization and ASEAN Common Currency and Exchange Rate Mechanism). The scope of this roadmap could be broadened to East Asia, with consideration to add more elements, including financial support mechanism and surveillance. This would indeed pose much more challenges as it would involve increased economic diversity and scope of coordination. In addition, it is also important to conduct efforts to strengthen the Asian currency market, enhance regional technological cooperation, enhance cooperation in capacity building for financial infrastructures, and develop Asian capital markets in line with the trend of globalization

Strong and robust financial markets and institutions are indeed necessary, but the openness should be implemented gradually and orderly. The willingness to move toward open market would foster a more efficient functioning of the financial market. But it has to be done with the support of proper policies and infrastructures both at the individual countries as well as regional level in order to withstand the unfavorable impact of shock.

Financial integration should result in a more modern and efficient financial system in the region that would bring economic benefits such as improved and more efficient use of resource allocation, improved intermediation of savings to investment, reduced fluctuations in output, reduced exposure to external economic disturbances, enhanced economic cohesion and enhanced stability within the region.

The way forward should take into account the level of integration and cooperation that the region needs or wishes to take. Hence, it is important to note that reaching the level of integration as in the European Union would require a lot of arrangement agreed by all countries in the region including the regulatory arrangement, infrastructures and institutional aspects, while adjustments are also required in the part of individual countries.

## **OUTLINE**

### **FINANCIAL COOPERATION AND INTEGRATION IN EAST ASIA: PROSPECTS AND A ROADMAP**

#### **I. Introduction**

- Background of the Asia crisis in 1997
- Actions taken by individual country to resolve the crisis → prove less effective
- The need for regional financial cooperation and integration

#### **II. Efforts Taken to Establish Financial Cooperation and Integration in East Asia**

- Establish regional financial arrangement (CMI: ASA, BSA; Asian Bond Market Development), the idea to establish Asian Reserve Bank (ARB)
- Strengthening surveillance in the form of RED presentation, regular reports, policy dialogues, and develop resilience EWS
- Strengthening Regional Financial Market

#### **III. Challenges for East Asian Financial Cooperation and Integration**

- Resolving differences in economic, financial and infrastructural aspects
  - Different economic structure and development
  - Different maturity level of individual financial market
  - Domestic infrastructural differences
- Establishing regional infrastructures
- Compromising regional financial integration and cooperation with national sovereignty
- Gaining support for East Asia financial cooperation and integration from other regions

#### **IV. Conclusion and Recommendation**

- The objective of integrated financial cooperation → crisis prevention + enhancing individual economic development
- The need for strong and robust financial markets and institutions. However, it should be opened gradually and orderly
- Roadmap is deemed important → thus needs to expand the existing Roadmap provided by the ASEAN Secretariat