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**Financial, Monetary and  
Economic Cooperation in East Asia:  
Where We Are, Where We Want To Be, and  
How We Get There from Here**

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# **Financial, Monetary and Economic Cooperation in East Asia Where We Are, Where We Want To Be, and How We Get There from Here.**

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## **1. Introduction**

The idea of developing and strengthening regional institutions to support financial and economic integration has taken hold in East Asia. This is a largely positive shift. The issue is where it will lead to and how it will be achieved.

This paper focuses on the financial and monetary dimensions of regional development. It first sets out some background and context to the rise in financial regionalism. It describes some basic policy aims from this process, looks at the current state of play, and outlines three steps forward in achieving these aims. The final section briefly summarises the paper.

## **2. Background and context**

In recent years there has been a notable shift within East Asia to develop regional cooperation and build up regional economic and financial infrastructure, with the aim of promoting economic development and reducing economic and financial instability. Regional capacity and institution building is evident at the official, business and academic levels. It is most clearly evident in the formation of ASEAN+3 and the Chiang Mai Initiative in regional financing arrangements. The grouping of ASEAN and the +3 countries (China, Japan and South Korea) is genuinely regional, in contrast to earlier groupings, such as APEC and Manila Framework Group (MFG), where non-Asian members play important roles. The ASEAN+3 meetings have been spreading from the leaders to finance ministers, to foreign ministers, and to other ministers.

This trend towards intra-regional groupings is fundamentally positive, constructive and welcome since it addresses something that has been (and still is) missing in the region.

The motivation behind financial regionalism is complex. It reflects, on the one hand, a sense of regional frustration with the way the East Asian

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financial crisis evolved. The region's disappointment with the way the United States and the IMF dealt with key aspects of the crisis is well known.<sup>1</sup> But this is old news, even if there are strong residual effects on East Asia's perceptions of the need for a regional financial architecture.

Regionalism reflects many other more positive developments. Most especially, the rise of financial regionalism reflects increasing trade and economic interactions and integration within East Asia. There is widespread recognition that deepening integration on the real side of the region's economies has raised the importance of financial market development and stability, since finance is important to economic development and growth.<sup>2</sup> It also raises questions about exchange rate regimes. As the region's economies change, has the nature of shocks that affect them also changed? Is variability in intra-regional exchange rates more costly now and, if so, how should it be reduced? As integration deepens, should regional economies (or some sub-set of them) adopt a common monetary policy and currency?

Regionalism is also a useful device for East Asia to deal constructively and inclusively with the prospect of the economic rise of China, with the aim of minimising tensions between China and Japan (a traditional political rival) and ASEAN (its most recent economic competitor). China has a rapidly developing economy and has increasing economic influence in the region and beyond. It has the potential to be an economic superpower. China is following an ambitious plan over this decade to marketise, modernise and internationalise its financial system. If successful, by implication, China could be a financial superpower. Any program of regional financial development and integration, therefore, must actively involve and constructively engage China.<sup>3</sup>

The word 'regionalism' connotes inward-lookingness. One of the criticisms of regionalism is that it can be a second- or third-best phenomenon if it comes at the cost of less (or weakened) global integration. This is right. But given that NAFTA and the EU are integrating more deeply, there is a need

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<sup>1</sup> See de Brouwer (2003) for a summary. Henning (2003) argues that European regionalism, like East Asian regionalism, was also motivated by a desire to balance US power and influence; see also de Brouwer and Wang (2003).

<sup>2</sup> See, for example, Levine (1997).

<sup>3</sup> This process is not straightforward because it affects the national strategic positioning of major powers within the region and beyond. It is also complicated by the heterogeneity of political systems in the region.

for deeper integration in East Asia. It is vital that East Asian economic and financial integration not become, either in reality or appearance, insular and inward-looking. Overwhelmingly, East Asia's trade, economic and strategic interests are best served by full participation in global institutions and markets, as they are also for NAFTA and the EU. This is well understood in the region, even if the rhetoric may at times run the other way. East Asian regionalism is fundamentally outward oriented. This is best illustrated by China's accession to the WTO in 2001 and the region's ongoing commitment to the WTO, IMF, APEC and ASEM.

### **3. Policy aims and financial arrangements to deliver growth and stability**

East Asia's aim is a stable, wealthy, and dynamic regional economy which is world-class, outward-looking, and fully integrated with the rest of the world. It should enjoy a fair distribution of income. The aim is that by 2020 the region's national economies should be fully developed and fully integrated into the international economy.<sup>4</sup> Underpinning this, the region should have well-developed and innovative financial markets, strong financial institutions, and the necessary range of policy structures to underpin them.

There are four key elements to regional financial arrangements which are necessary to support further economic growth and development as well as financial cooperation. They are:

1. Policy dialogue and surveillance. Policy dialogue refers to discussion between policymakers (possibly with academics) from different national jurisdictions on policy issues. Surveillance ranges from sharing information about national, regional and global economic and financial issues to open and frank discussion of issues and policy options at the national, regional and global level. Policy dialogue and surveillance are necessary conditions for prompt financial cooperation and assistance extended by regional neighbours during a financial crisis in one country.
2. Financial markets and institutions. Countries need well functioning financial markets and institutions that suit their level of economic development. As economies develop, markets and institutions need to be able to change in a stable manner to meet the new, more complex

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<sup>4</sup> 2020 is the endpoint, consistent with the focus of APEC, ASEAN and particular countries' development objectives.

financial and risk-management needs of households, firms and governments.

3. Financial cooperation. Financial cooperation covers instruments, techniques, and institutions for the provision of liquidity support between countries in a financial crisis.
4. Monetary policy and exchange rate systems. An effective monetary policy regime and consistent exchange rate regime are essential for economic growth and stability. As is well understood, no single regime is right for all types of economy.

It is essential that policy structures are designed with respect to each of these four elements of financial arrangements to best deliver economic stability.

With respect to East Asia, policy arrangements with the following characteristics will likely best deliver stability to the region:

1. A strong regional framework of policy dialogue that includes all core economies in East Asia, and which maintains dialogue with major economies outside the region. Policy dialogue should be embedded in the ASEAN+3 process, supported by its own secretariat. The surveillance process should be both constructive and respectful on the one hand, and open and frank on the other, on par with the discussions that currently take place in the OECD WP3 group.<sup>5</sup> To underpin stability, regional policy dialogue should also have mechanisms by which it interacts regularly and openly with private and market participants.<sup>6</sup>
2. A set of strong, extensive, developed and outward-oriented financial markets, with capital-strong, diversified and open financial institutions.
3. A flexible institutionalised form of regional financial cooperation to provide liquidity support to countries to prevent and/or resolve possible future financial crises in the region. Such an institution could be called an Asian Financial Stabilisation Fund (AFSF). It would:
  - be based on effective surveillance with a robust system of terms and conditions for the provision of regional finance in a financial crisis;

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<sup>5</sup> See Ito and Narita (2003) and Grenville (2003).

<sup>6</sup> See Gai (2003).

- stand independent of the International Monetary Fund (IMF) with respect to conditionality, but would work intimately and cooperatively with the IMF to ensure seamless treatment of crises at the regional and global level; and
  - have a contemporary institutional base which would bring senior policymakers from national jurisdictions together to make decisions, informed by a respected and expert staff.<sup>7</sup>
4. A set of focused and transparent monetary policy frameworks with mutually consistent exchange rate regimes. The first step toward monetary cooperation may be to adopt a common (or at least similar) basket exchange rate regime among ASEAN countries, and then with other countries. A longer term aim, as judged appropriate, would be monetary union in East Asia or parts of it.

To a large extent, these are cumulative and sequential conditions. For example, substantive policy dialogue and surveillance (condition 1) are essential for strong financial markets in the region (condition 2) and effective financial cooperation arrangements (condition 3) to work. Similarly, conditions 1, 2 and 3 are all necessary for common cooperative monetary policy and exchange rate systems to work. Condition 4 will more likely occur once the other conditions are well in place.

While the conditions are cumulative and sequential in the sense outlined above, they are to some extent separable. For example, financial cooperation does not require a common exchange rate arrangements or monetary union. This means that the set of countries that may want to participate in financial cooperation and integration may not necessarily be the same as those that want to participate in monetary cooperation or union.

#### **4. The current state of play**

While there is certainly an emerging infrastructure to support financial development, cooperation and integration in East Asia, it is still in its infancy and falls far short of its potential. In terms of the four areas outlined above, the current state of play is as follows.

First, East Asian policy dialogue and surveillance take place within ASEAN, ASEAN+3, EMEAP, and the MFG, although the latter grouping is not an exclusively East Asian group since it also includes Canada and the United

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<sup>7</sup> In this sense, the structure of the AFSF would more closely follow that of the BIS than the IMF.

States. The general assessment is that policy dialogue and surveillance in these forums is not satisfactory in terms of the coverage of the dialogue and frankness and depth of the surveillance.<sup>8</sup>

Second, the key innovation in regional financial cooperation has been the Chiang Mai Initiative (CMI) by which a number of countries in the region have made bilateral agreements to extend financing in the event of a financial crisis. In aggregate, the bilateral arrangements total about US\$40 billion.

The CMI is not a comprehensive regional arrangement in three respects: it is overwhelmingly (90 per cent) dependent on IMF conditionality; the amounts are not enough to deal comprehensively with even a small localised financial crisis in the region; and it is a bilateral rather multilateral arrangement. The CMI will be reviewed in May 2004 but substantive changes are unlikely in terms of the attachment to IMF conditionality, amounts, or multilateral structure of the CMI. The key sticking point is inadequate policy dialogue and surveillance in the region

Third, there is a very wide range in the performance, depth and strength of financial markets and institutions in East Asia.<sup>9</sup> Japan's financial markets are the biggest in the region and it has good legal and market infrastructure but its financial institutions have fundamentally weak balance sheets. Singapore, Hong Kong, and Australia have the most developed financial markets and institutions in the region. Malaysia, Taiwan (Chinese Taipei), South Korea and Thailand form the mid-ranking markets and institutions. China, the Philippines, and Indonesia have the weakest market infrastructure and institutions among the emerging economies of the region, although China's accession to the WTO in December 2001 clearly signals an intention to develop the financial system over this decade. Cambodia, Laos, Myanmar and Vietnam have poorly developed financial markets and institutions. The region remains vulnerable to financial shocks and economic crisis because the balance sheets of key institutions (especially financial institutions) are weak.<sup>10</sup>

Finally, there is a wide range of independent monetary policy and autonomous exchange rate regimes ranging from fixed (Malaysia, Hong Kong), quasi-fixed (China), managed floats (Singapore) and relatively-free

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<sup>8</sup> See, for example, Ito and Narita (2003).

<sup>9</sup> See Park and Bae (2002), Park (2002), Bergsten and Park (2002) and de Brouwer (2003).

<sup>10</sup> See Edwards and Frankel (eds 2002).

floats (Thailand, Indonesia, Philippines, South Korea, Japan, Taiwan (Chinese Taipei) and Australia).<sup>11</sup> The only countries that have cooperative exchange rate arrangements in East Asia are Singapore and Brunei. An important aspect is the stability among regional currencies as well as flexibility vis-à-vis outside currencies. If intra-regional currency stability is the only criterion, the pre-crisis reality (of unilateral virtual US dollar pegs by many ASEAN countries) may not be so bad. But the US dollar peg was one of the reasons for the crisis because it made some economies vulnerable to excess capital inflow (stimulated by a false sense of little currency risk) and real effective exchange rate appreciation (driven by the strength of the US dollar vis-à-vis the yen and European currencies).

## **5. Getting there from here: some steps forward**

If the region wants a strong outward-looking economy and financial system, then it is necessary to make substantial advances in economic and financial development and cooperation. The following are three suggestions for moving from where the region currently stands to where it could be.

The **first** is the creation of an institutional base for enhanced regional economic and financial interaction. As noted earlier, ASEAN+3 is the most appropriate grouping for regional interaction. But ASEAN+3 does not have an institutional base to provide the support and resilience the region needs in policy dialogue and surveillance. As a matter of some priority, the region could set up a secretariat base for its pre-eminent policy body. Within the secretariat, it would also be useful to set up a financial stabilisation group which could examine issues on crisis management and work towards setting up an Asian Financial Stabilisation Fund in due course.

There is no shortage of possible locations for a regional secretariat. Indeed, many countries would like to volunteer their own capital city as the choice. There are three guiding principles in the selection of a location. The first is that it not be seen to be 'owned' by a big country (the 'Brussels solution'). This effectively rules out China, Indonesia and Japan. The second principle is that it must balance the broad regional interests of East Asia (particularly of the North and South) and not exacerbate intra-regional rivalry. The third is that it must have a relatively well developed economy that can provide

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<sup>11</sup> Myanmar has maintained a multiple exchange rate regime with a large number of trade restrictions. A multiple exchange rate regime is an extremely inefficient system for any policy purpose. In Viet Nam, Cambodia, and Laos, a substantial part of the economy is dollarised. Cambodia and Laos may need more liberalisation in trade and more development in domestic markets before substantially liberalising their foreign exchange markets.



infrastructure and stability to the region. No location is perfect but, on these grounds (and at the risk of alienating everyone else), Seoul would appear to be the strongest candidate.

The creation of ASEAN+3 was an important step forward in developing a regional approach to key policy issues facing policymakers at the national level. While the name 'ASEAN+3' recognises the importance of ASEAN in the development of East Asia's economy and polity, it does not embody the wider sentiment of regional community building. A more appropriate term to describe the region is an East Asian Community. The secretariat would then be the secretariat of the East Asian Community.

There is also the question of which countries are part of this community and, more specifically, whether ASEAN+3 or an East Asian Community needs to be enlarged. Three sets of economies are discussed in terms of possible enlargement:

- The first set is Hong Kong and Taiwan (Chinese Taipei). These are economies, not countries. As a grouping of nation-states, ASEAN+3 is not the right forum for them. But, that said, they do have deep experience in many areas of great interest to the region as a whole, such as financial and industrial development. Including them in second and 1.5 track processes (which bring the official and non-official sectors together) is one way to bring their insights directly into the debate without causing political upset.
- The second set is Australia and New Zealand. These countries are sometimes referred to as their own separate bloc, Oceania, but they are in fact developed economies which are highly integrated with the rest of East Asia.<sup>12</sup> They are not big economies in the scheme of things, but excluding them for a prolonged time is not a trivial issue. Including them in regional forums expands the set of developed economies with well-functioning economic and financial systems and markets. It is also important for Australia and New Zealand because regional engagement has been a key driver of domestic reform, especially in Australia. It would be desirable to work towards their inclusion in an East Asian community, as Prime Minister Koizumi argued in his January 2002 Singapore speech outlining a vision for an East Asian Community.

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<sup>12</sup> See Costello (2002) on the long and deep engagement of Australia with the rest of East Asia.

- The third set is India and other countries in South Asia. India has a very large and increasingly more open economy, and its links with East Asia are likely to expand over time. But it is not yet deeply integrated with East Asia and it faces deep internal tensions with other countries in South Asia. India is also not part of East Asia. As a result, it may be more appropriate to think about India's possible participation in East Asian forums as an observer. Whatever the case, dialogue and interaction with India and South Asia take place within the Asian Cooperative Dialogue.

The **second** main step is to more actively build up financial markets and institutions in East Asia. The weakness in financial systems is a major source of vulnerability and exposure to shocks in the region. This entails:

- Greater national and regional commitment to building up the infrastructure that supports markets and institutions – including strong legal systems, clean bureaucratic, judicial and government processes, open information, access to high-quality technology, and sound governance and supervision systems. It also requires dealing effectively with non-performing loans in the banking system and valuation of insurance and pension fund assets. Responsibility for financial development and stability ultimately rests with the domestic authorities and institutions.
- Commitment to reform needs to be supported by extensive and deep capacity building. There are many forms through which capacity building is delivered (including IMF, World Bank, ADB, APEC and national aid programs) but there is little overall assessment of what these programs do and how they perform. There is a need for an overall stock-take on capacity building and development assistance in finance in East Asia, as well as creative thinking about future directions in financial market development. This study should be done at the non-official level to ensure that assessment is as objective as possible (with a suggestion below).
- The development of national and regional bond markets. The development of robust deep government and corporate bond markets is essential to healthy financial market development in East Asia and as a viable complement and alternative to bank-based financial systems. Improving issuance, underwriting, and trading in national bonds is important. So, too, is the development of a market in regional bonds issued in local currencies, including as a combination

of regional currencies. The latter in particular may help the development of an Asian currency unit and the management of foreign exchange rate risk within the region. Chaipravat, Ito and Park (2003), for example, propose the creation of an Asian Bond Corporation which would buy sovereign and corporate bonds issued in local currencies in the region and issue its own liability which would be denominated in a weighted combination of the currencies of the underlying national bonds.

- The creation of systematic links between officials and private-sector participants from the financial sector and elsewhere to discuss outlooks for regional markets and economies. The key point of this is to build effective working and trust relationships between policymakers and the private sector.

The **third** policy step is to take advantage of the richness in domestic policy think tanks, universities and other research institutions in East Asia by bringing people from these institutions together in a focussed and strategic way. There are two complementary dimensions to this. It can bring policy-focussed researchers together to form a cohesive second-track process. It can also be the basis for policy-oriented researchers (the second-track process) to join with policymakers (the first-track process) in a 1.5 track process to discuss and analyse important policy issues in an informal and constructive manner. In a region of great political, economic and social diversity like East Asia, informal 1.5 track dialogue processes can be a useful face-saving way to approach, analyse and find solutions to sensitive and difficult issues in the region.

There are a number of valuable forums that do bring interested parties from think tanks and universities together in wider country groupings, including PECC, on an infrequent basis. But there is not one for East Asia as a whole. Thinking specifically about the area of financial, economic and monetary integration in East Asia, such a policy-research grouping could be called an East Asian Finance Institute (EAFI).<sup>13</sup> This second-track grouping may exist initially as an informal or 'virtual' entity but it could become more institutionalised over time. It should be as inclusive as possible and its management should represent the key institutes involved (so that it does not come to represent sectional interests).

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<sup>13</sup> This is not an original idea but has been suggested also by Andrew Sheng and Barry Eichengreen, although with different emphases.

An EAFI along these lines could provide a wider range of benefits and services to the official sector:

- It could be a mechanism to provide policymakers with informed analysis of important issues, drawing on the full network of institutions that feed into it. For example, the EAFI could be the mechanism to assess the range of financial development capacity building programs operating in East Asia (suggested above).
- It could develop 1.5 track dialogue processes within the region.
- It could also be a mechanism for policy-oriented researchers in the region to provide support to the region's surveillance process, including possibly the ASEAN+3 (or East Asian Community) surveillance process.

An EAFI would not operate as a bureaucratic entity in its own right. It would be a forum for collecting ideas and analysis, have a special link with the East Asian Community Secretariat, and work closely with all bodies involved in policy research and advice in East Asia, like the ADB, World Bank and IMF. It is one layer of the community that is envisioned for East Asia.

## **6. Final Comment**

We regard the recent focus on financial regionalism in East Asia as a constructive and positive development. Many markets in East Asia, especially in finance, are insufficiently developed and weak. The need to strengthen them, and the institutions which work in them, is self-evident. Cooperation to develop markets and institutions can occur at different levels and through a range of mechanisms. Regional cooperation has the potential to be a very important device to deliver development, growth and stability in a manner fully consistent with the global orientation of the East Asian economies and markets. Since the interests of East Asia are deeply global, we regard regionalism as a complement, not an alternative, to global engagement.

There is scope for greater regional cooperation in a range of financial and monetary areas – in policy dialogue and surveillance, in dealing with financial crises, in developing and integrating well-functioning financial markets, and (once the other bits are in place) in cooperation in monetary policy and exchange rate regimes.

The main recommendations of this paper are threefold. First, cooperation needs a base and it is timely to create a secretariat to support East Asian policy dialogue, surveillance and cooperation. This is better structured within the context of an East Asian Community.

Second, given the ongoing financial vulnerabilities in the region, it is timely to increase the policy focus on the basic infrastructure needed to support stable financial development. This includes a stocktake of financial market and institution assistance programs, the development of national and regional bond markets, and the development of liaison and dialogue mechanisms between the official and private sectors.

Third, it is timely to create a more recognisable second-track process in East Asia, linking policy-oriented researchers from think tanks, research institutes and universities in the region. The second-track could work closely with the first-track (that is, the official sector), including by providing relevant and independent policy analysis and on occasion joining with it in 1.5 track processes. 1.5 track processes are particularly useful in a region characterised by substantial political, economic and social differences and limited experience in cooperative and open dialogue.

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