Report

NEAT Working Group on East Asian Financial Cooperation

Beijing

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Introduction

The NEAT Working Group on East Asian Financial Cooperation organized a meeting on East Asian Financial Cooperation in Shanghai from April 1 to 2, 2005. Participants included scholars and experts from 10 of the ASEAN +3 countries (Brunei，Cambodia and Malaysia were absent). Ambassador Wu Jianmin, NEAT Co-Interim Coordinator and China’s Country Coordinator，chaired the meeting. The discussion was candid, fruitful, and down to earth. It focused on the East Asian financial cooperation, the main obstacles, and the ways for strengthening such cooperation.

The most important consensus reached at the Meeting is that it is high time that East Asian nations take practical measures in financial cooperation. As a Track II process, NEAT has the responsibility to build on this consensus. After establishing common parameters of the prevailing conditions, participants of the Meeting put forth their policy proposals for promoting financial cooperation in the region.

I. Three Outstanding Issues in the Region’s Economic Development

1. A high level of economic growth and a low level of

risk-management capability. East Asia has witnessed rapid economic growth. The growth rate of East Asia's GDP reached over 7% in 2004, exceeding not only the world's average, but also that of the two major economies – NAFTA and EU. East Asia is now the most dynamic region in the world. The economic dynamic, however, has not been accompanied by the expected risk-management capability. Some of the important factors that caused the 1997 financial crisis have continued to exist. Underdevelopment of an internal financial market and inappropriate exchange rate mechanisms are among the factors that keep the region's risk-management capability at a low level. The continued depreciation of the US dollar has made these deficiencies more conspicuous, further exposing the region's weakness in risk-management. People expect Asian currencies to appreciate with the amount of hot money flowing into the region. The risks are there.

2. A high level of foreign exchange reserves and a low level of effective utilization. In the past few years, the foreign exchange reserves of East Asia have soared. By the end of 2004, the figure reached close to US$2.3 trillion. Within only four years, it has more than doubled, accounting for 2/3 of the world's total. It is true that the high level of foreign exchange reserves has made East Asia more competent and laid a more solid foundation for financial cooperation. But at the same time, it has not been used effectively. In addition to the low return rate, the continual depreciation of the US dollar has caused a huge loss to East Asian nations; it is likely that the US dollar will continue to slide. According to a rough estimation, a 10% depreciation of the US dollar would cause East Asia to lose US$130 billion. This is tantamount to a 2% loss in East Asia's GDP. Therefore East Asian nations, while respecting each other's sovereignty, would do well to combine their efforts in improving the utilization of foreign exchange reserves.

3. A high level of intra-regional trade and a low level of financial cooperation. The development of intra-regional trade is one of the most remarkable events in East Asia: It had reached 54% by 2003, ranking below the 64% of the EU, but above the 46 % of NAFTA. In recent years, trade cooperation centering on FTA has accelerated. The FTAs between ASEAN on the one hand and ROK, China, and Japan on the other will be completed by 2009, 2010, and 2012 respectively. An East Asia FTA (EAFTA) is also under way. The more integrated the regional trade, the more need for regional financial and monetary cooperation. But in East Asia, the latter has been lagging far behind. In the past few years, especially since the 1997 crisis, East Asian nations have realized the necessity for such cooperation and made efforts to promote it. The Chiang Mai Initiative is a telling example. However, the overall level of cooperation in this field is still very low. It has increasingly become the weakest link in the process of East Asian economic cooperation.

II. Policy Recommendations

1. Strengthen and Build on the Chiang Mai Initiative

CMI's Swap Arrangement is the most important mechanism for monetary and financial cooperation in East Asia. It has laid the foundation for further cooperation. Its expansion to include the 10+3 countries has produced positive results. By the end of 2004, the overall size of the swap, including 16 bilateral arrangements, had reached US$27.5 billion. On May 4, 2005, a Joint Communiqué was made at the 8th Meeting of 10+3 Financial Ministers, in which member states agreed to double the overall size of bilateral swap arrangements and subject the size of specific bilateral swap arrangement to the countries involved. Despite the commitment of CMI's Swap Arrangement to financial cooperation, its inadequacy was revealed along with the rapid development in other areas of economic cooperation.

There are some major deficiencies. Its function cannot satisfy the expanded need. Its initial design was to provide short-term liquidity assistance to solve immediate payment problems. Even for this function, its start-up procedure, which links 90% of capital to the conditionality of the International Monetary Fund (IMF), is often too complicated to be effective. An agreement was reached at the recent 10+3 Financial Ministers Meeting to raise percentage of the capital unlinked with the conditionality of the IMF from 10% to 20%.

In addition, its size is insufficient. The sum of US$27 billion is not enough for short-term liquidity assistance, let alone preventing and solving other related problems in the region. Based on the experiences gained from the 1997-1998 financial crisis, even if the size of swap arrangement doubles according to the recent 10+3 Financial Ministers Meeting requirement, it still cannot play its role effectively.

In addition, its bilateral arrangements reveal inadequacies. Since 2001, 16 bilateral agreements have been signed. A more effective multilateral framework needs to be set up to coordinate the 16 bilateral agreements. Such a framework is more likely to meet the need of the region as a whole and strengthen the risk-management capability of East Asian nations.

To strengthen the CMI mechanism, three specific measures may be considered.

First, explore the possibility of expanding the functions of the CMI such as enhancing short-term liquidity assistance, stabilizing the exchange rate, sustaining the development of the financial market and strengthening surveillance on the financial and economic situation. These complement the functions of existing international financial arrangement at the regional level.

Second, expand the size of the CMI. The committed financial assistance from the international community during the 1997-98 financial crisis was US$110 billion and the size of the proposed Asian Monetary Fund was US$100 billion. A reasonable size for performing the functions mentioned aforesaid is thus between US$100 and US$110 billion.

Third, set up a multilateral framework. Upgrade existing bilateral agreements to a more effective multilateral framework within the 10+3 nations for facilitating the coordination and provision of sufficient funds when necessary. If a member state without adequate short-term liquidity suffers from a capital attack before the multilateral framework is built, countries that have bilateral arrangements with it shall make a collective decision to make relevant swap arrangements or otherwise so as to avoid multiple negotiations and to improve efficiency.

2. Further Develop the Asian Bond Market

At present, major problems concerning the development of the Asian Bond Market include institutional barriers and technical hindrances. Tight exchange control, underdevelopment of the credit grading system, imperfect settlement mechanisms and lack of attractive investment projects have impeded the healthy development of the Bond Market. In 2003, the Asian Bond Market Development Initiative (ABMI) was signed and six working groups were set up, under which some actions had been taken or are going to be taken to tackle the aforesaid issues.

To further develop the Asian Bond Market, the following possibilities may be explored.

First, enhance the coordination mechanisms. The terms of reference for the six working groups need to be expanded to include in-depth research on infrastructure development, investment opportunities, accounting systems, and information sharing. Finance ministers and central bank governors should put them on their meeting agenda and coordinate the development of domestic and regional bond markets.

Second, increase the size. Asian Bond Fund II should be completed at the earliest possible time and expanded to 8 billion dollars to enable an increased investment in the regional bond, especially the bond issued by governments and financial institutions. Measures shall be taken to attract investors both in and outside the region.

Third, increase the bond supply. The Asian Development Bank may issue more bonds in denominations of local currencies or basket currency in East Asia so as to boost the regional bond market and provide benchmark bond prices for the development of the bond. Well-performing transnational corporations are encouraged to issue regional bonds to expand the size of the bond market.

Fourth, enhance information exchange and surveillance. It is necessary to entrust an independent institution or use existing secretariat arrangements to gather information and monitor the progress of the Asian Bond Market.

3. Deepen the Dialogue on Exchange Rate Policy Coordination

Policy coordination, information exchange, and surveillance are important. At present, there are 8 policy dialogue processes, involving finance ministers and central bank governors. They have played an important role in coordinating policies, but they perform overlapping functions. Thus the lack of coordination among these coordinating processes is itself a big problem. In addition, since exchange rate is a more sensitive issue for sovereign states, the lack of institutional discipline and self-restraint seems to be a problem faced by East Asian states now. Thus the dialogue mechanism at the ministerial level and other existing process shall be strengthened for discussion and coordination of the exchange rate policy.

Conclusion

Financial cooperation is a critical, yet very weak link in the process of economic integration in East Asia. The Meeting agreed to welcome all positive contributions to the process on the basis of open regionalism. The Meeting was also keenly aware that efforts of 10+3 should be concerted to make financial cooperation a facilitator rather than a hindrance to regional integration.