

NEAT Working Group on East Asian Financial Cooperation

Report

Beijing

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Introduction

The NEAT Working Group Meeting on East Asian Financial Cooperation was held in Shanghai, China, on May 26 and 27, 2006. The participants included scholars and experts from twelve of the ASEAN+3 countries (Cambodia was absent). The discussions, candid, lively, fruitful, and down to earth, focused on three major themes, namely, Changes in the Backdrop of East Asian Financial Cooperation, Assessment of the Latest Development of East Asian Financial Cooperation, and Prospects and Policy Recommendations.

I. Progress in East Asian Financial Cooperation

1. Expansion of Chiang Mai Swap Arrangements

Agreements were made at ASEAN+3 Finance Ministers' Meeting in Istanbul in May 2005 to further develop the Chiang Mai Swap Mechanism. As of early May 2006, the mechanism had increased by 90% in size from US\$39.5 billion to US\$75 billion. Moreover, the percentage of automatic drawing has risen from 10% to 20%. The latest ASEAN+3 Finance Ministers' Meeting clearly stated that the CMI should be multilateralized and efforts should be made to establish a Post-CMI cooperation framework.

2. Intensified Efforts to Build the Asian Bond Market

The domestic bond markets of East Asian economies are growing rapidly. In 2005, the overall size of the bond markets in East Asian economies (excluding Japan) expanded by 14%. The share of local currency bonds increased from 13% to more than 19% as various international financial institutions have increased their issuance of East Asian local currency-denominated bonds. Asian Bond Fund II officially started operation in May 2005, with a capacity of US\$2 billion.

3. Growing Government Attention on a Regional Monetary Unit

The Asian Development Bank is continuing its effort to create an Asian Currency Unit (ACU). If the ACU were created, it would be a significant advancement in regional monetary cooperation. The recent ASEAN+3 Finance Ministers' Meeting clearly recognized for the first time the importance of research on the creation of a regional monetary unit. A similar view was also expressed at the latest Ministerial Meeting among China, Japan, and ROK.

II. Changes in the Backdrop of East Asian Financial Cooperation

1. An Even More Urgent Need for East Asian Financial Cooperation

1) Regional trade and investment integration, as well as the flow of capital, has been greatly accelerated. Financial and monetary cooperation is required to provide a stable

financial environment and necessary financial support.

2) Global imbalances in economy and finance have intensified. The U.S. twin deficits have reached another record high. One of the risks caused by this is depreciation of the U.S. dollar, resulting in the appreciation of East Asian currencies. Foreign exchange reserves in East Asia continue to grow, amounting to US\$2.6 trillion and more than 60% of them are held in U.S. dollars.

3) The US Federal Reserve Board has increased the interest rates successively for as many as 16 times in the past two years and is continuing to do so, causing a new round of interest rate increases worldwide. Together with it is the surge in global oil prices and real estate bubbles which pose new problems for the East Asian economic development and financial stability.

2. A More Favorable Environment for East Asian Financial Cooperation

1) A growing economy provides a solid foundation for East Asian financial cooperation. East Asia is still the fastest growing region in the world. Its growth rate in 2005 was 2.5% higher than the world average. The recovery of the Japan's economy helps the region continue to grow.

2) Multi-level and multi-dimensional East Asian cooperation provides a favorable overall environment. Examples include the first East Asia Summit in 2005; the growing possibility of the untied FTA in this region with the separate FTAs processing fluently and the active roles of related parties in promoting East Asian investment cooperation.

3) The rapid growth of trade, large inflow of international capital, and especially the dramatic increase in foreign reserves provide the region with an environment for regional cooperation. The increase in the proportion of intra-regional trade and investment may create additional dynamics for financial cooperation.

4) Reforms and improvements in the foreign financing policies of East Asian economies provide an institutional environment for the financial cooperation. Among them, the most important include the adjustment of the Chinese RMB exchange rate mechanism and progress in opening capital accounts in East Asia.

III. Prospect and Policy Recommendations

1. Launch a Study on the East Asian Monetary System

1) East Asian financial cooperation is making progress in the following three aspects:

A. Promotion of the regional monetary units;

B. Improvement of coordination and dialogue mechanisms on exchange rates at all levels; and

C. Upgrading of the Chiang Mai swap mechanism from a bilateral system to a

multilateral system.

2) A corresponding mechanism for coordination and interaction among the three aspects is yet to take shape. It is desirable that studies on the East Asian monetary system be launched in a more comprehensive way and be incorporated into the framework of NEAT with reference to the study by the ASEAN+3 Research Group. The following are important for such studies:

A. Make further studies on the East Asian currency units. At present, discussion should be focused on the countries that the East Asian currency unit should cover and on the share of each currency in the regional currency basket. Starting with the 13 currencies of ASEAN 10, China, Japan, and the ROK, the studies may also include the currency basket system for the stabilization of East Asian currencies, and the possibility of having an Asian dollar market.

B. Study coordination mechanisms on exchange rates. Discussions should be conducted first of all on the relationship between the currencies of the member states and the proposed East Asian currency unit. Then a study should be made on how to coordinate exchange rates and carry out market intervention in terms of such relationship. Before an East Asian currency unit is put into effect, further in-depth studies should be conducted on the existing coordination and dialogue mechanism for policy coordination and economic surveillance.

C. Make careful studies on an East Asian monetary fund. The purpose is to promote the multilateralization of the Chiang Mai mechanism. Studies should be carried out on how CMI can best serve as the key initiative and the first foundation for regional integration. Studies should also be carried out on the possibility and the roadmap of the CMI being upgraded fully into being a regional monetary fund.

D. Explore interactions between regional economic processes and economic globalization, including major international financial institutions and other actors outside the region, and study what positive and negative impacts such interactions may have on regional financial cooperation.

E. Pay attention to the gap between economies in the region. Narrowing the development gap should be an important goal of regional cooperation.

2. Further Develop the Asian Bond Market

The Asian bond market has obvious weaknesses, which include its insignificant size, the uneven development of the individual domestic bond markets, the low level of market liquidity, and the low degree of market integration. All these problems reflect the insufficiency in capacity building of the East Asian bond market and the inadequacy in infrastructure, supervision systems, and market players.

Therefore, the following measures should be taken to further develop the Asian bond market.

1) Promote the use of credit guarantee and investment mechanism. Under the ASEAN+3 Finance Ministers' Process, the study should be launched to look into business model of the mechanism and feasibility of the preferred organizational options. The Asian Development Bank may be an alternative for the time being. A new East Asian Bank concentrating on credit guarantee and investment may be taken into account in the later study and discussion. Comprehensive dialogue and consensus building are expected among all the member countries regarding the future direction of the possible mechanism. No matter what the new credit guarantee and investment mechanism is, successful experiences of private international investment banks should be applied.

2) Provide the business circumstances where the private sector activates its sales of similar products as ABF and ABF 2. Explore some further possibilities where similar trials such as ABF and ABF 2 make sense in terms of improving the infrastructure of financial markets. It is proposed that the Fund expand its size suitably, increase its frequency of issuances, optimize its investment targets, and strengthen its guarantee function in order to make advantage of the Fund's leading role to the private sector participants.

3) Enhance the capacity building of the Asian bond market. The infrastructure of the financial market should be strengthened. The member states, in particular, the less developed members, should make vigorous effort to seek technical assistance from various resources and build up their capacities in the following aspects: the infrastructure of bond markets, transaction platforms, and settlement systems; tax reduction and other preferential policies; credit rating institutions and other intermediary organizations in the bond market; laws, regulations, and supervision mechanisms.

4) Integrate bond markets in Asia. It is proposed that member states should step up their cooperation on settlement and transaction systems and supervision standards. They should work out relatively consistent market standards and enhance their cooperation on taxation and foreign exchange regulations so as to facilitate the investment by East Asian countries in each other's bond markets. Asian bonds denominated by the East Asian currency basket should be issued as soon as possible. Cooperation can be expanded from bond market to stock market with an aim to integrate the capital market in this region.

3. Establish an East Asian Finance Association to Promote Financial Cooperation and Exchange

The proposed East Asian Finance Association should be a joint organization made up of the representatives from the central banks, financial supervision institutions, and private financial institutions of the economies in the region. East Asian countries shall

designate their leading organizations and representatives and hold an annual meeting (the proposed name is “East Asian Financial Conference”) to discuss and exchange views on major issues concerning the development of East Asian financial integration. Policy consensus and action plans are expected to be reached at the conference. Due to the wide domain of the financial sector, sub-associations can be set up, such as a “East Asian Banking Association,” “East Asian Securities Association,” and “East Asian Insurance Association.”

The East Asian Finance Association and its sub-associations should focus on the following tasks:

1) Promote cooperation among financial supervision institutions. The financial supervision institutions in East Asia should take the lead in building the cooperation mechanism. They should better exchange and share their expertise and information on financial products and financial technology, enhance cooperation on supervision technology, and unify financial supervision standards. They should also gather to discuss the timetable for the opening financial sector to each other.

2) Encourage cooperation among banks and other financial institutions on trade, financing, syndicate credit, bond issuance, guarantees, and insurance. Restrictions that hinder banks from opening branches in other countries of this region should be removed or reduced. Multilateral institutions, finance policy-making institutions and other official institutions should offer more credit guarantees and insurance for trade and investment in this region, thus diminishing the risks of private financial institutions.

3) Build a regional settlement system. In the context of increased intra-regional trade, the use of local currencies in this region should be encouraged in intra-regional trade, so as to reduce the transaction cost and shrink exchange rate risks. Since some of the 13 currencies in East Asia are not freely convertible, a multilateral settlement and payment system should be set up in this region on the basis of the existing bilateral settlement agreements. When the East Asian currency unit is mature, it can be taken as the pricing currency or basic pricing measure.

Conclusion

The NEAT Working Group on East Asian Financial Cooperation agrees that financial cooperation is a crucial part of the regional integration process. Although the overall environment for financial cooperation has grown more and more favorable, risks are not low and obstacles are by no means slight. East Asian financial cooperation should be carried out further in the spirit of consensus and consultation so as to make great headway and bring practical benefits to the people of this region.