

**Final Report of the Network of East Asian Think-Tanks (NEAT)
Working Group on East Asian Financial Cooperation**

April 12, 2008, Shanghai, China

Introduction

NEAT Working Group Meeting on East Asian Financial Cooperation was held in Shanghai, China on 12 April 2008. NEAT members and experts from 11 of the ASEAN + 3 countries took part in this meeting (Brunei and Cambodia are absent). There were an opening session, a keynote session, 3 panels and a wrap-up session.

The keynote speakers were Dr. Jusuf Wanandi, Vice Chairman of the Centre for Strategic and International Studies of Indonesia, Dr. Masahiro Kawai, Dean of the Asian Development Bank Institute, and Amb. Wu Jianmin, Co-interim Coordinator of NEAT.

The three panels were:

1. The Impact of Global Financial Turmoil on East Asia
2. Policy Recommendations I:
CMI Multilateralization, Asian Currency Cooperation, etc.
3. Policy Recommendations II: ABMI, Cooperation among Financial Sectors, etc.

After one-day discussion, the meeting reached consensus in general on the assessment of the challenges and opportunities East Asia faced against the backdrop of global financial turmoil. The meeting also put forward action-oriented policy recommendations.

I. Impact of Global Financial Turmoil on East Asia

It was the shared understanding of all participants that global financial turmoil triggered by the US sub prime crisis can have serious impact on East Asia.

1. It endangers regional financial security and stability.

The global financial turmoil not only caused direct losses of regional financial institutions, but also impaired and will continue to impair the financial system and financial markets in East Asia. As the effects of the subprime crisis are gradually felt and the global credit squeeze aggravates, East Asia faces the risk of greater financial volatility—such as the bursting of stock prices and the housing markets.

2. Global financial turmoil hinders sustained economic growth of East Asia.

The global economy is falling into a new slow growth era. The slowdown of U.S. economy results in a significant decrease of exports of East Asian economies to the US, and hence seriously influences the sustainability of high economic growth. The U.S. Federal Reserve has dropped the interest rates several times over the last several quarters, which together with hikes in oil and food prices, makes it more difficult for East Asian economies to check inflation.

3. Global financial turmoil heightens the risk of macroeconomic and financial sector vulnerabilities in East Asian.

The global financial turmoil has led to continued depreciation of USD, which raises various types of risks in East Asia. One is the huge capital losses for East Asian authorities holding large foreign exchange reserves. A more serious risk is the continued accumulation of foreign exchange reserves in the face of a declining USD, which expands domestic liquidity, stimulates investment excessively, and generates goods inflation and asset price bubbles. Many economies are reluctant to let their currencies appreciate vis-à-vis the USD due to the fear of loss of export competitiveness.

II. Impact of Global Financial Turmoil on East Asian Financial Cooperation: Challenges and Opportunities

Opportunities for cooperation have arisen along with the challenges against the backdrop of global financial turmoil. The working group hence identified 4 urgent challenges for East Asian economies.

1. A stronger monitoring system reduces risks posed by volatile capital flows.

The large-scale inflow of international capital is to some extent responsible for the generation of bubbles in East Asian stock markets and real estate. And the global financial turmoil following the sub prime crisis has reduced capital inflows and thereby helped trigger the bursting of the bubble in some Asian stock markets. Therefore, East Asian economies have to strengthen the monitoring of international capital flows and the early warning system. Although regional cooperation on capital flow monitoring is an agenda, no significant progress has been made in this respect.

2. Intensive economic policy dialogue is key to effective macroeconomic policymaking and coordination.

As production networks and supply chains take shape within East Asia, economic interdependence is rapidly growing, and the economic cycles of regional economies are increasingly aligned. Meanwhile, the global financial turmoil has made it more difficult for East Asian economies to control inflation and maintain economic growth simultaneously. Therefore, East Asian economies must jointly assess the state of the global economy and its transmission to the regional economies by strengthening policy dialogue for better macroeconomic policymaking and coordination.

3. Coordinated use of foreign exchange reserves provides greater opportunities for financial stability and infrastructure development in East Asia.

Countries in the region are in the process of pooling their foreign exchange reserves for prevention and management of financial crisis/contagion under the framework of CMI multilateralization, making it an effective cushion against external shocks. They can also enhance regional monetary cooperation by using more local currencies in intra-regional trade and reducing reliance on the USD and other non-local currencies. Countries in the region can jointly invest part of their foreign exchange reserves for sustained economic growth in infrastructure construction, poverty reduction and low-carbon economic development.

4. Expansion of internal demand in the region reduces over-reliance on US and EU markets.

Boosting domestic demand in countries with large current account surpluses is a serious policy challenge. Cooperation may be carried out in finance, trade and investment to accelerate economic integration and increase the internal demand of the region. Countries with insufficient domestic investment can strengthen policies, such as improvements in the investment climate, to stimulate investment, and countries with excessive domestic savings can pursue policies to encourage consumption.

III. Policy Recommendations

1. Improve the policy dialogue mechanism and establish an executive body for East Asian financial cooperation.

There exists substantial room for the improvement of the CMI and the economic review and policy dialogue (ERPD) mechanism. The reserve pooling arrangement under the CMI framework shall be fully multilateralized as soon as possible. Central bank governors should be included in the CMI/EPRD mechanism to ensure better assessment of economic situations and effective coordination of macroeconomic policies. The monitoring and early-warning mechanism against cross-border capital flows needs to be strengthened.

To meet the above-mentioned targets, the working group proposed the establishment of a joint mechanism of finance ministers, central bank governors, and an executive secretariat for this mechanism.

This executive secretariat shall be the central body for supporting East Asian financial cooperation. The finance ministers and central bank governors shall jointly meet 2-4 times a year so as to coordinate efforts and make key decisions concerning regional financial cooperation; the executive secretariat shall implement the joint decisions and monitor the implementation process.

This executive secretariat may have four departments, respectively (i) providing surveillance and advice of a member's economic and monetary policies, (ii) managing pooled foreign exchange reserves for crisis lending, (iii) promoting financial—

particularly bond—market development, and (iv) monitoring and evaluation of currencies and exchange rates. The executive secretariat will keep close contact with member governments' ministries, agencies and central banks, and work closely with other existing cooperative mechanisms.

2. Set up an East Asian Investment Fund for Infrastructure Development under the APT framework.

Each member could contribute a certain percentage of its foreign exchange reserves to a newly created "East Asian Investment Fund for Infrastructure Development" as the seed money. Managed by the shareholder governments and operated jointly by a group of professional experts and ADB, the fund should be invested in major infrastructure projects in the region, with priority given to those in less developed economies.

The fund should promote sustainable economic development, strengthen regional economic linkages through integrated transportation, communication and logistics networks, and improve the overall, long-term performance (in terms of returns and risks) of foreign exchange reserve holding in the region. The fund should also accelerate the development of Asian bond markets and promote interactions between financial cooperation and investment and trade cooperation. In addition, the fund can be mobilized to boost internal demand within the region and reduce dependence on external markets.

3. Strengthen cooperation between financial authorities and private financial institutions, including stock exchanges, in East Asia.

Cooperation between public financial authorities and private financial institutions will not only improve domestic financial systems of all member states, but also promote regional financial integration, thus reducing uncertainties brought about by dependency on European and American financial institutions and markets.

The success of Asian bond markets demonstrates the necessity and effectiveness of such cooperation. Therefore, cooperation may be initially pushed forward with its focus on Asian bond markets.

The working group proposed the establishment of a high-level “Asian Forum on Financial Stability” as the main body for cooperation. Against the backdrop of the current subprime crisis, the working group considered it essential to improve the surveillance of financial markets and promote supervision standards and financial transactions regulations. A major task of the “Asian Forum of Financial Stability” participated by finance ministries, central banks and financial sector regulators/supervisors, is to conduct this financial-sector surveillance. This forum should work with private financial institutions as dialogue partners in order to come up with a set of regionally consistent regulatory and supervisory structures.

4. Enhance coordination of major economies, especially that between China and Japan, in East Asian financial cooperation.

Major economies should play a more active role in promoting East Asian financial cooperation. The emerging challenge may provide an impetus for macroeconomic policy dialogue and coordination in the region, especially between China and Japan. The promotion of East Asian financial cooperation shall be incorporated as an important part into the building of a Sino-Japan strategic partnership for mutual benefits. Thus coordination in this regard can be positioned at a strategic level.

The Sino-Japanese High-level Economic and Financial Dialogue could strengthen coordination in financial surveillance and in macroeconomic policies. This coordination can be expanded further to exchange rate policies and eventually monetary and fiscal policy.

China and Japan can also strengthen coordination in the management and operation of their respective foreign exchange reserves so as to mobilize greater financial support for less developed economies in the region. In so doing, both sides can play an active role in building the above-mentioned “East Asian Investment Fund for Infrastructure Development.”

Moreover, considering the importance of the Chinese *renminbi* and the Japanese *yen* in East Asia, it was proposed that China and Japan launch a joint comprehensive study on an Asia Currency Unit (ACU) or and Asia Currency Index from both a long-term perspective and a short-term perspective of practical use for surveillance and monitoring purposes.

It was also proposed that the two countries strengthen coordination in the building of Asian bond markets and cooperation of East Asian financial authorities.

Conclusion

In the first decade of East Asian cooperation, countries in the region successfully turned a crisis into an opportunity and greatly enhanced the cooperation of the governments and the well-being of their peoples. Now, entering the second decade, as members of the region are having heated discussions about whether, where and how the next step should be taken, another crisis looms. While it poses serious challenges as it seems, it is also a blessing in disguise. As long as there is enough political will, courage and action, there will be deeper integration and a stronger sense of community building in East Asia.