NEAT Working Group on East Asian Financial Cooperation in Response to Post-crisis Challenges

Report

Beijing, China
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Introduction

NEAT Working Group Meeting on East Asian Financial Cooperation in Response to Post-crisis Challenges was held in Beijing, China on 21 May 2010. NEAT members and experts from 9 of the ASEAN + 3 countries and the ASEAN Secretariat took part in this meeting. There were an opening session, three panel discussions, and a wrap-up session.

Amb. Zhao Jinjun, President of China Foreign Affairs University, Mr. Zhao Jinping, Deputy Director-General of the Foreign Economic Relations Research Department, Development Research Center of the State Council of China, and Mr. Pan Wenxing, Director of International Economic Relations Division II, Ministry of Finance of China, delivered keynote speeches at the Opening Session.

The participants had candid discussions on three panel topics: 1) post-crisis challenges for East Asia; 2) strengths and deficiencies of current East Asian financial cooperation mechanisms; and 3) policy recommendations for deepening East Asian financial cooperation.

Professor Qin Yaqing, Country Coordinator for NEAT China and Executive Vice President of China Foreign Affairs University, wrapped up the meeting.

I. General background

After the NEAT Working Group Meeting on East Asian Financial Cooperation in 2009, three emblematic events took place in the process of regional financial cooperation. First, the Chiang Mai Initiative Multilateralization (CMIM) came into effect on 24 March 2010. The CMIM participants in times of payments and short-term liquidity difficulties are entitled to swap their local currencies with US dollars in accordance with the procedures and conditions stipulated in the agreement. Second, with all its key elements agreed upon by ASEAN+3 Finance Ministers at the meeting on 2 May 2010, the ASEAN+3 Macroeconomic Research Office (AMRO), the regional macroeconomic surveillance unit of the CMIM, is expected to be put into operation in early 2011. Third, the ASEAN+3 Finance Ministers announced to establish the Credit Guarantee and Investment Facility (CGIF) in early 2011, as a trust fund of Asian Development Bank (ADB) with an initial capital of US$700 million. These joint actions in East Asia will enhance regional capacity to safeguard itself against risks from the changing global economy and finance, make up for deficiencies in the current global financial safety net mechanisms, facilitate the development and deepening of local-currency bond markets, and thus strengthen East Asian financial system.

However, in the post-crisis era, East Asia still faces a number of emerging challenges, such as uncertain global economic recovery, volatile international capital flows, and an uncertain international financial architecture under reform, which should be dealt with through more concrete action and deeper financial cooperation, so as to maintain financial stability in the region.

II. Post-crisis challenges for East Asia

In the post-crisis era, there emerge new challenges that need to be responded to through deeper financial cooperation in the region.

1. Overall global economic recovery is underway but remains quite uncertain. Asia has outperformed the rest of the world in economic recovery. Thanks to the expansionary fiscal and monetary policies and a modest recovery in global trade, developing Asia is expected to have a robust growth of 7.5% in 2010.[1] However, economic recovery in the US and the EU has been weak, and the Greek sovereign debt crisis—despite the subsequent international support actions—has added downside risks to the EU's economic recovery prospect. Those external uncertainties have cast shadows on the sustainability of rebound in East Asia, as most East Asian economies are still reliant, at least partially, on external demand for their growth.

2. Investors' risk preference changes with the adjustments of global finance, which implies high volatility of capital flows in the region. During the crisis,

[1] ADB "Asian Development Outlook 2010: Macroeconomic management beyond the crisis," Asian Development Bank, 2010.

confidence loss, de-leveraging and investors' risk appetites for safety resulted in a sharp decline in inflows of bonds, equities and loans in most East Asian economies. However, the resurgence of global liquidity—with the start of crisis countermeasures—began to stimulate international capital flows searching for destinations with quicker economic bounce, stronger currency expectations and higher asset returns.[2] Asia has become one of the first recipients of short-term capital inflows since early 2009. Several risks associated with the inflows emerged in most East Asian economies: upward pressure on currency values, foreign reserve accumulation, goods price inflation, and assets price bubbles. When the risks become unmanageable, the economies will be in danger of becoming overheated. Furthermore, the potential risk of sudden reversal of short-term capital flows could endanger financial and economic stability. Country specific measures are the first defense line against the unwanted inflows. Meanwhile, regional collective actions are necessary to act as the second defense line.

3. Sharp increases of public debt in the US and other major economies have added difficulties for East Asia to manage its foreign exchange reserves. An enormous amount of foreign exchange reserves, which the East Asian economies hold mainly in the form of US dollar assets, may suffer from capital losses caused by long-term depreciation of the US dollar. In addition, the euro, an alternative reserve currency to the US dollar, has shown its high volatility since the Greek sovereign debt crisis. The overall public debt to GDP ratio in G-7 countries has reached a peak in sixty years.[3] The danger of monetization of the public debt and the consequent inflation in reserve currency countries could reduce the value of assets denominated in these reserve currencies. How to mitigate the capital loss of their foreign exchange reserves is a common challenge that the East Asian economies should address.

4. The reform of the international financial system is yet to unfold. The functions of the international financial institutions are reinforced through expanding the IMF's funding sources, introducing Flexible Credit Lines as a new instrument of the IMF, increasing capital of major multilateral development banks, and creating the

[2] IMF "Global Financial Stability Report: Meeting New Challenges to Stability and Building a Safer System," International Monetary Fund, April 2010.

[3] IMF " World Economic Outlook," International Monetary Fund, April 2010.

Financial Stability Board (FSB) which is hosted by the Bank for International Settlements (BIS). The US dollar's position as a leading international reserve currency has been challenged, and the international reserve currency system could be reformed in one of the two directions: creation of a super-sovereign reserve currency, for instance, by giving the SDR a greater role as a reserve currency; or diversification of reserve currencies. Beyond as a way to achieve financial stability in the region, the East Asian financial cooperation process should be viewed as an integral part of the holistic reform of the global financial system.

5. The outward-oriented growth model needs to be transformed for post-crisis global rebalancing. East Asia needs to rethink its growth model in a way of rebalancing sources of growth towards domestic and regional demand in order to achieve sustained and balanced growth in the years to come.

III. Strengths and deficiencies of the current regional financial cooperation efforts

Over the past decade, regional financial cooperation in East Asia, with the aim of deepening regional economic integration and as a response to the Asian financial crisis of 1997-98, has achieved a great success, especially in the following four aspects: setting up the regional liquidity support mechanism; conducting regional policy dialogue and economic surveillance; developing regional financial markets; and exploring the possibility of regional exchange rate coordination. However, some salient weaknesses still exist in each of these areas.

1. Liquidity support mechanism

The Chiang Mai Initiative (CMI), signed in 2000 by ASEAN+3 Finance Ministers, became the landmark liquidity support mechanism in East Asia. For about a decade, the initiative had provided an important platform for East Asian financial cooperation. The CMI has developed from the initial limited bilateral currency swap arrangements into the current multilateral mechanism with a self-managed reserve pool, a process in which a series of decisive measures were taken by the member countries over time. In 2004 − 2005, the member countries conducted a comprehensive review of the CMI. They identified the weaknesses in the structure of the CMI, assessed its effectiveness and asserted the necessity for its existence and further development. Without this review and the consensus reached then, the subsequent multilateralization process would not have started. Between 2005 and 2008, step-by-step measures were taken to improve the effectiveness of the CMI, transform the CMI into a multilateral arrangement, and strengthen the multilateral CMI. In 2009, the Chiang Mai Initiative Multilateralization (CMIM) was implemented. This move reflected East Asian Finance Ministers' will to address the global financial crisis by taking joint action through financial cooperation, which was instrumental in stabilizing market expectations in the region.

In terms of liquidity support, a regional cooperative mechanism has a clear advantage. A CMIM member, in a time of crisis, faces four types of official resources to turn to: its national foreign exchange reserves; a bilateral currency swap arrangement with the central bank of a reserve currency country; the regional liquidity facility under the CMIM; and IMF loans. Although foreign exchange reserves can provide a cushion at a time of rapid capital outflows, opportunity cost of holding very large foreign exchange reserves would be huge. A bilateral currency swap arrangement is relatively more prompt and easier to operate, but not all countries would have access to such bilateral support. IMF loans had the problems of providing misdiagnosis and imposing inappropriate policy conditions on a borrowing country in East Asia during the Asian financial crisis of 1997-98. Many East Asian economies are reluctant to go to the IMF because of the "stigma" associated with their experiences with IMF programs during 1997-98. From this perspective, strengthening a regional liquidity support mechanism under the CMIM is essential in order to preserve financial stability in East Asia.

The global financial crisis which originated in the US in 2007 and then spread to the rest of the world was the first test case for the liquidity support mechanism in Asia. This crisis did not start from Asia, and the Asian financial markets were not significantly affected as they had invested little in subprime-related products, other structured financial instruments, and financial derivatives. These features, combined with capital controls in some Asian countries, insulated Asian financial systems from the developments in US and European capital markets and saved them from suffering heavy losses. As a result, a large scale liquidity crisis did not occur in East Asia, and no country was forced to go to the IMF or the CMI for help in this crisis. But financial markets of certain countries such as ROK were vulnerable to external shocks. ROK had large amounts of external short-term debt, as a result of receiving large inflows of banking fund and securities investment from abroad. Consequently, in the aftermath of the collapse of Lehman Brothers in the fall of 2008, ROK was severely hit and its banking sector encountered a serious liquidity problem. It is known that ROK is one of the major initiators and advocates of the CMI and its multilateralization, and was a member of the CMI. However, when it faced liquidity crisis in the late fall of 2008, ROK did not seek help from the liquidity support mechanism under the CMI. Instead, it asked for help from the US Federal Reserve System in the form of a bilateral currency swap arrangement and actually drew it. This case demonstrated the limited usability of the CMI. To make the liquidity support mechanism more attractive, its member countries should take the following three factors into consideration.

First, low efficiency in the activation of the CMI (or CMIM). Large amounts of foreign exchange reserves are held in East Asia, so adequacy of reserves is not a problem for this region. But reserve scale is not synonymous with reserve utilization efficiency. The absence of an independent body overseeing regional surveillance and the CMI (and CMIM starting with March 2010) makes it hard for the reserve pool under the CMI (or CMIM) to offer timely support in real times of crisis.

The ASEAN+3 Finance Ministers agreed on the setting up of AMRO by early 2011, which is an important step for the effective functioning of CMIM. AMRO is expected to function as an independent surveillance unit. The significance of an independent body lies in the following two respects. First, through its operation, the CMIM members expect to receive timely warning about the emerging risk of a financial crisis, translate the crisis lending plan into action when a crisis actually occurs, and provide policy conditions for countries in need of help. Second, an independent management body is critical in making the CMIM a solid institution. With such an independent body in place, effective mechanisms for policy dialogue and economic surveillance can be introduced, and the CMIM can be developed into a real regional monetary fund.

Second, limited attractiveness for the members due to its link with IMF. One factor behind the establishment of the CMI was the disappointment and dissatisfaction of East Asian countries towards IMF about its intervention during the 1997-98 financial crisis. But the activation of more than 20% of the CMIM support has to be linked to IMF loan conditionality, which puts the CMIM in a dilemma. The CMIM link with IMF was introduced because the CMIM members did not have effective surveillance mechanisms or capacity to formulate independent conditionality in the event of a crisis. The IMF link goes against the original intention of the CMIM, and prevents it from becoming a full-fledged regional financing arrangement in East Asia. In reality, reducing the IMF link over time has become a consensus among the CMIM members.

The key to overcome this dilemma for the CMIM lies in whether the members can conduct effective regional surveillance and establish independent conditionality in the event of a currency crisis in accordance with the economic conditions and features of the crisis country. Policy conditionality is an effective means to prevent moral hazard in loan utilization, and also a guarantee for the rights and interests of loan providers. So enhancing the effectiveness of economic surveillance and strengthening its capacity to formulate its own conditionality is a crucial step in reducing CMIM's link with IMF. The CMIM's evolution, including its multilateralization and institutionalization, will be accompanied by greater de-linking with IMF. So, once complete de-linking is achieved, how to coordinate its relationship with IMF will become vital for the CMIM to develop into a credible regional monetary fund in East Asia.

Third, limited use because of its focus on crisis, rather than precautionary lending. One important reason ROK did not choose to go to its ASEAN+3 peers for liquidity support under the CMI was that CMI was limited only to crisis situations. ROK then believed that the country had financial turmoil, but not a financial crisis. So if precautionary lending had been available, ROK might have gone to CMI for liquidity assistance. From this perspective, CMIM support should be provided with some flexibility—particularly under turbulent circumstances as in the case of ROK in the fall of 2008—by (i) enabling precautionary lending rather than just crisis lending and (ii) delinking CMIM from IMF programs or requiring that no conditionality be imposed, in a way comparable to the IMF's recently introduced Flexible Credit Line.

2. Policy dialogue and economic surveillance

Effective policy dialogue and economic surveillance is an integral part of regional financial cooperation. Because a financial crisis can be contagious at a regional level, effective economic surveillance is instrumental to identifying early a crisis and contagion and to issuing timely warnings so that preventative national policy can be undertaken in advance and economic policies of the relevant countries can be coordinated in time. First, effective policy dialogue and economic surveillance can prevent a crisis from happening. For example, information exchange—with the use of a collective early warning system—can help countries concerned identify financial vulnerabilities early and take preventative measures to avoid a crisis. Second, effective economic surveillance can ensure timely activation of liquidity support through the CMIM. Third, effective policy dialogue and economic surveillance is conducive to the coordination of its member countries' economic policies, and can prompt them to take joint action in the event of external shocks. Fourth, effective economic surveillance allows the authorities to continuously monitor the financial health of borrowers of the CMIM liquidity.

There exist various forums and mechanisms for policy dialogue and economic surveillance. These include the Economic Review and Policy Dialogue (ERPD) process for ASEAN+3 Finance Ministers, central bank-led forums such as EMEAP and SEANZA, and trans-regional mechanisms such as APEC and ASEM. However, these are not as strong or effective as they should be. Even ERPD under the CMIM lacks effectiveness, and ASEAN+3 Finance Ministers need to take specific measures in this regard. It is important to make the to-be-established AMRO an effective and powerful secretariat in supporting the ERPD process.

3. Regional financial markets

In the aftermath of the Asian financial crisis of 1997-98, the East Asian policymakers realized the importance of regional bond markets and have made consistent efforts to encourage regional bond market development. However, to date, East Asia does not have a deep regional bond market with sufficient magnitude and liquidity. The major regional bond facilities in operation today are Asian Bond Fund I (ABF1) and Asian Bond Fund II (ABF2), respectively launched by the EMEAP in 2003 and in 2005, and a number of other notable initiatives, such as the Asian Bond Markets Initiative (ABMI) proposed by Japan in February 2003.

The Joint Statement of the 13th ASEAN+3 Finance Ministers' Meeting released on May 2, 2010 reiterated the importance of the ABMI in promoting the development of local currency-denominated bond markets, mobilizing regional savings for regional investment, and sustaining economic growth for the region. Local currency-denominated bond market development has become a major area of East Asian financial cooperation.

The reason for the slow development of East Asian regional bond markets is that many East Asian countries, in general, lack a motivation to promote them. Immature domestic financial markets in most of the developing countries and stringent capital controls in some of the low-income countries are also intrinsic constraints holding its growth. However, the huge foreign exchange reserves in East Asia need investment markets, and a major part of them were absorbed in the developed markets, demonstrating a feature of less region-biased capital flows. The absence of a strong regional financial market is one of the key reasons for the holding of the large amount of foreign exchange reserves in the US dollar.

4. Exchange rate cooperation

There have been some serious discussions on the possibility of monetary cooperation in East Asia over the past five years. The most promising one is the idea of creating an Asian Monetary Unit (AMU) proposed by Japanese scholars, and an Asian Currency Unit (ACU) proposed by the ADB.

The proposal to create an AMU or ACU has been inspired by the successful experience of the European Currency Unit (ECU), which was a critical arrangement in the progress of European monetary unification. A more fundamental drive for exchange rate cooperation in East Asia lies in the fact that East Asia has an increasing share in the world economy but lacks a regional currency—either in a collective form, or some national currency from the region—that is capable of playing roles of an international medium of exchange, unit of account, and store of value in the region.

The initial purpose of an AMU or ACU—a basket of ASEAN+3 currencies—is to serve as an index to measure volatility of East Asian countries' exchange rates. The ACU exchange rates against the US dollar and the euro indicate the collective movements of East Asian currencies against major international currencies, and each East Asian currency's value vis-à-vis the ACU indicates the degree of its divergence from the regional average. According to the original plan, the ACU would have been put in place by the ADB in 2006. Unfortunately, due to disagreement on some technical details among participating countries, the plan was postponed.

IV. Proposals for deepening East Asian financial cooperation

Maintaining regional financial stability is the primary aim of East Asian financial cooperation, which needs to be realized through three key devices: regional financial cooperation organizations, regional financial markets and regional exchange rate coordination. At the current stage, when the CMIM just came into effect, East Asia should institutionalize its regional liquidity mechanism, and eventually create a regional monetary fund. Meanwhile, efforts should also be made to construct a regional financial infrastructure that allows use of local currencies in payments of regional trade, investment and financial transactions. At an advanced stage, regional cooperation should focus more on regional exchange rate policy coordination. Building a collective regional exchange rate mechanism would require a significant degree of policy coordination.

1. Institutionalization of the CMIM and possible creation of an East Asia Monetary Fund

Judged by its nature, the AMRO, which is still in the process of construction, can become an independent secretariat that manages the CMIM. At its early stage, the AMRO is expected to provide support for regional economic monitoring, and at a later stage, it can concentrate on two functions: economic surveillance and crisis and precautionary lending. To be effective, the AMRO needs a well-functioning CMIM that is supported by a strong governance structure.

1) Governance of the CMIM. First, a mechanism should be put in place to allow dynamic adjustments of the members' quotas and voting rights with the change of their economic weights in the region, as indicated through a set of indexes. Second, a strong governance structure should be established for the CMIM to work effectively. There needs to be an economic surveillance department (currently, it is the AMRO), undertaking technical operations for policy dialogue and economic surveillance (the ERPD process), monitoring various indexes reflecting regional financial health, and producing regional economic surveillance reports.

2) Lending function. Some technical details need to be fixed, such as loan terms, interest rates, credit lines, and, most importantly, loan conditionality. At the initial stage, the loan under the CMIM is linked with IMF conditionality. But gradually over time, larger proportions of automatic draws should be allowed and de-link achieved. When making the detailed terms of loan conditionality, policymakers should keep in mind that the policy conditionality should be simple and focused and should not be too complex or extensive; otherwise, the effectiveness of the CMIM facility could be damaged.

Some flexibility needs to be introduced to CMIM lending to allow precautionary loans to a country which is not in a crisis but faces significant financial turmoil that could potentially lead to a crisis. Such precautionary loans may not require any conditionality, if the borrowing country is fundamentally sound, as in the case of IMF Flexible Credit Line.

3) Economic surveillance. There are three major forms of economic surveillance: information exchange, peer review, and activity related to policy conditionality. Information exchange is a primary form of economic surveillance. The members are required to exchange their economic information prepared according to a set of common statistics and format. At this level of surveillance, an early warning system can be established, which plays an important role in detecting problem countries and problem markets, and serves as an important technical platform for economic surveillance.

Peer review is a higher level of surveillance. It is basically a systematic examination of one country's performance and policy by a third party or other countries, with the aim of helping the country under review improve its policymaking. It is done out of mutual trust among the countries involved. It may also provide policy advice. Since a neutral secretariat can effectively support the peer review process, the AMRO under the CMIM is a good choice to take the job.

Providing policy conditionality associated with crisis lending and monitoring the country's progress is an advanced form of economic surveillance. This requires that the CMIM be managed by a strong secretariat that can formulate loan conditionality in the event of a crisis and can monitor policy developments of the crisis county.

If the above measures proceed smoothly, it is possible to create an East Asian monetary fund. As an independent and institutionalized organization built on the principles agreed by the members, this fund has some obvious advantages. For instance, it is a legally binding organization with the commitment from the members; it is run on the base of rules and thereby reduces deficiencies in bilateral or decentralized management, such as bias or lag effect; and its members are encouraged to coordinate economic policies more closely, which is a basis for maintaining regional economic and financial stability.

2. Further development of regional financial markets and use of local currencies

East Asian countries may consider taking further steps to develop regional financial markets.

1) Encourage the use of local currencies as alternatives to the US dollar for trade, investment and financial transactions in the region and as payment currencies in activation of the fund under the CMIM. In doing so, the following short-term steps are practical: to encourage use of the strong and stable local currencies in payment for regional trade and investment; to facilitate issuance of local-currency denominated bonds by multinational companies, local firms in East Asian countries, and other private entities of the region; and to increase weights of local currency assets in foreign exchange reserves in the region. These measures can help boost demand for and liquidity of the local currencies in the regional financial markets, promote the development of financial markets, and mitigate the region’s over-reliance upon the US dollar.

2) Set up a regional clearance and settlement mechanism to facilitate use of local currencies in regional financial transactions. **Consider launching an Asian Bond Fund 3** to enlarge corporate bond markets in the region with the help of newly established CGIF. **Initiate a regional financial stability dialogue process**, either as a part of the regional policy dialogue and economic surveillance process under the CMIM, or as a parallel high-level device to the CMIM among East Asian countries’ financial authorities. Finally, **help developing countries in the region to prudently open and liberalize their domestic financial markets**—in a well-sequenced way—in order to promote further financial integration in the region.

3. Exchange rate policy cooperation, an open-end objective

Due to its rapid economic recovery, East Asia has become a favorite investment destination, which causes an influx of international capital, and subsequently, exchange rate appreciation pressure, foreign exchange reserve accumulation, inflation and asset price increases. Regional coordination of exchange rate policies is an important means to tackle these risks. For instance, for the countries seeking ways to mitigate currency overvaluation and maintain market competiveness, collective currency appreciation causes less shock and is more effective than individual currency appreciation. And, needless to say, in the post-crisis era, this mechanism is conducive to adjusting global imbalances. If practical, exchange rate policy coordination can be adopted, and the economic surveillance unit of the CMIM can undertake the relevant research and operational work. It is also feasible to consider constructing and using an ACU to play a role of monitoring currency market developments in the region. This mechanism is open, for it is not necessary for all the members to strictly follow a common exchange rate arrangement; they keep some freedom to decide their own regimes although convergence of exchange rate regimes within East Asia is increasingly desirable.

Conclusion

The post-crisis economic recovery begins with a strong rebound in East Asia. However, whether East Asia can sustain its growth and maintain its financial stability is mainly reliant on how well the countries in the region can address such challenges as uncertain economic recovery in the US and Europe, relocation of excessive liquidity towards East Asia, growing capital losses of foreign exchange reserves in the region and the unsettled agenda of international financial system reform.

The launch of the CMIM with US$120 billion capacity, the agreement on the establishment of the AMRO and the consensus on the development of local currency-denominated bond markets are all great successes of regional financial cooperation. However, the existing institutional weaknesses, such as the link with the conditionality of the IMF, not-so effective policy dialogue and economic surveillance mechanisms, and sluggish development of regional financial markets, have become barriers for the regional financial mechanisms to unleash their full potential to promote regional financial stability.

Therefore, this report calls for deepening East Asian financial cooperation in the coming years. In doing so, the CMIM members need to consider the following steps: to institutionalize the CMIM by turning the AMRO into a secretariat supporting regional policy dialogue and economic surveillance; to explore the possibility of establishing an East Asian monetary fund in the medium term; to further develop and deepen regional financial markets; to encourage the use of local currencies as alternatives to the US dollar for trade, investment and financial transactions in the region and as payment currencies in activation of the CMIM; and to consider a feasible form of exchange rate coordination in the region.

In the post-crisis era, deeper regional financial cooperation in East Asia shall not only be a tool to achieve regional financial stability, but also an inseparable part of the reform of the international financial system.