

Report

NEAT Working Group on East Asian Financial Cooperation

Beijing

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Introduction

The NEAT Working Group Meeting on East Asian Financial Cooperation was held in Shanghai, China on 7-8 April 2007. The participants included scholars and experts from 12 of the ASEAN Plus Three countries (Brunei was absent). The Meeting consists of 3 major parts, namely, the Opening Ceremony, Keynote Speeches and Panel Discussions.

Amb. Wu Jianmin, President of the China Foreign Affairs University, chaired the Opening Ceremony. Vice Finance Minister of China, Mr. Li Yong, Executive Vice Mayor of Shanghai, Mr. Feng Guoqin and President of the Shanghai Academy of Social Sciences, Mr. Wang Ronghua gave speeches on East Asian financial cooperation and Shanghai's role in it.

Keynote speeches were given by Mr. Makoto Utsumi, President and CEO of the Japan Credit Rating Agency, Ltd., Mr. Jusuf Wanandi, Vice Chairman of the Centre for Strategic and International Studies, Indonesia, Mr. Zhumin, Vice President of the Bank of China and Amb. Wu Jianmin, the Co-interim Coordinator and President of the China Foreign Affairs University.

Panel discussions were conducted in a candid and down-to-the-earth manner, and focused on 5 major themes:

- Assessment of the latest development of East Asian financial cooperation;
- Post-Chiang Mai mechanism: objectives and roadmap;
- East Asian bond market: domestic building and regional cooperation;
- Institution building and risk prevention in regional financial cooperation; and
- Other aspects of financial cooperation.

I. Significant Progress in East Asian Financial Cooperation over the Last Decade

Participants all agreed that significant progress has been made over the last 10 years in East Asian financial cooperation. Three areas are worth particular mentioning.

1. Swap arrangements were made under the framework of Chiang Mai Initiative.

In May 2000, the ASEAN Plus Three Finance Ministers' Meeting reviewed the lesson from East Asia financial crisis and expressed willingness to cooperate in four aspects—capital flow monitoring, regional surveillance, swap arrangements network and personnel training. Ever since then, swap arrangements under the CMI have made great headway. In 2005, the Istanbul meeting set forth four particular areas to be

improved. First, the ASEAN Plus Three economic surveillance shall be enhanced and integrated into the CMI framework. Second, collective decision-making shall be adopted in the system of bilateral swap arrangements. Third, the swap arrangements shall be expanded in size and shifted from one-way and bilateral cooperation to a two-way and multilateral mechanism. Fourth, the automatic withdrawing rate shall be raised to 20%. Up to now, progress has been made in increasing two-way arrangements, expanding swap size and raising automatic disbursement. By the end of last year, the swap size had reached US\$ 79 billion. The participants were also informed at the Meeting that an important step has been taken toward the multilateralisation of CMI through reserve pooling.

2. Asian Bond Markets have been developing, driven by 2 important mechanisms, namely, Asian Bond Markets Initiative (ABMI) and Asian Bond Fund.

On 7 August 2003, the ABMI was concluded at the ASEAN Plus Three Finance Ministers' Meeting in Manila, and later, six working groups were assigned to study technical issues. The Executives' Meeting of East Asia-Pacific Central Banks proposed in 2002 to set up an Asian Bond Fund (ABF) financed by foreign exchange reserves. Afterwards, the ABF was issued twice to the amount of 3 billion. This fund has given impetus to the growth of Asian Bond Market. On the one hand, the scale of ABM has been expanded, with the outstanding volume of local currency-denominated bonds and outstanding volume-to-GDP ratio up to USD 2,400 billion and 54.2% by the end of June 2006 from the USD 355.5 billion and 19% in 1997; on the other hand, infrastructure development and institutional innovation have kept moving ahead.

3. Various dialog and coordination mechanisms have been set up, greatly improving information-sharing and consensus-building.

These mechanisms include the biyearly ASEAN Finance Ministers' Meeting, the Manila Framework Group, the Executives' Meeting of East Asia-Pacific Central Banks and the annual Finance Ministers' Meeting under the Economic Review and Policy Dialogue (ERPD). In addition, ASEAN has started to build a mechanism for multilateral information exchange and early warning.

II. Favorable Conditions for Further Financial Cooperation in the Region

1. East Asia remains the fastest growing region in global economy, which provides a strong dynamic for further cooperation. In 2006, the region registered a GDP growth of 8% and Southeast Asia alone 5.9%.

2. Intra-regional trade has created an even greater need for financial cooperation.

Intra-regional trade in East Asia has amounted to over 55% of its total trade volume, getting closer to that in EU (64%).

3. There is a stronger political will. Leaders of all the economies have repeatedly voiced their willingness to promote financial cooperation. The agreement reached among the ASEAN Plus Three Financial Ministers in Chiang Mai in early April 2007 is a good example for strengthened political commitment, which is crucial for the success of East Asian regionalism at this crucial time.

. Challenges and Difficulties on the Way Ahead

Ten years' cooperation has pushed forward East Asian regional integration up to a new stage, which has brought about new challenges as well as new opportunities. During the discussion, some of the most serious difficulties have been brought up.

1. Some old problems remain unsolved.

1) International capital flow in East Asia is even bigger in size than 10 years ago and still lack effective supervision and utilization. According to the IMF statistics, the total amount of security investment in East Asia's emerging economies was over US\$ 2 trillion in 2005, more than twice of that in 2001, and with a net inflow of US\$ 470 billion. We have to be alert because it was the reversion of private capital that triggered the Asian financial crisis 10 years ago. Two major problems, over-liquidity and over-dollarisation, call for our careful consideration.

2) The financial systems in East Asian nations are still vulnerable and bond markets underdeveloped. Banks continue to play a dominant role in regional financing, but very often inward looking. Housing credit not only makes up a large percentage of GDP, but also continues to grow at a high speed. Risks are apparent. Corporate bonds are underdeveloped, firm-level cooperation needs further strengthening, and the rating and guarantee systems do not serve the region well.

3) The intra-regional exchange rate coordination is still far from adequate. Before the Asian financial crisis, currencies were under the pressure of depreciation. And now with serious global imbalances, trade surplus is high in some of the East Asian economies and some currencies are under the pressure of appreciation.

2. New challenges emerge.

1) Financial cooperation is going on at a relatively low level, lagging behind trade and investment. The ASEAN FTA and several 10+1 FTAs have established closer ties among East Asian economies. A vertical supply chain is emerging in East Asia. However, the increase of mutual bond investment within Asia is slow and the mutual investment scale small.

2) There is a huge amount of money on the one hand and a lack of intra-regional investment on the other. By the end of 2006, East Asian foreign reserves reached US\$ 3 trillion, making up 60% of the world's total. And 65% of East Asian foreign reserves are kept in the US dollar. Infrastructure alone in East Asia needs an investment of US\$ 1 trillion in the next 5 years. "Asian money for Asian projects" is more a hope than a reality. If there should be no effective guarantee and assessment mechanisms, this situation may well continue into the distant future.

3) Growing global imbalances have incurred serious risks. The trade deficit of the US and the EU reached 764 billion US dollars and 173 billion euro respectively. Last year the global foreign exchange reserves tripled that of 1996, amounting to US \$ 5 trillion, which caused worldwide overliquidity and the price surge in housing, stocks and raw materials. Pressure from the global imbalances has serious impacts on the region, but how to use and effectively use the money is yet to have practical solutions.

IV. Policy Recommendations

1. Chiang Mai Initiative

Chiang Mai Initiative is a good mechanism that provides the basis for further institutionalized cooperation. It is proposed that its scale be enlarged, its arrangements multilateralised, and its functions expanded. Some specific proposals are as follows:

1) The bilateral swap arrangements under CMI should be turned into standby credit under a multilateral framework and the total credit line should be increased.

2) Research should be done on the conditions for disconnection between automatic withdrawing and the IMF terms so as to speed up sound decision-making and prevent financial crises more timely and efficiently.

3) Setting up a unified swap management institution should be considered. For the current stage, discussion should be held within the ASEAN Plus Three framework on the possibility for transforming the standby credit into an East Asian reserve cooperation fund.

4) It is suggested that efforts be made to strengthen the functions of CMI on information exchange, policy coordination and capital flow monitoring. It is desirable to expand the ASEAN Plus Three Finance Ministers' Meeting into a meeting of Finance Ministers and central bank governors, to set up working groups to study how to improve capital flow monitoring and early warning on risks. Once a more effective institution is put into operation, it shall make the CMI an efficient cooperation mechanism for prevention, response and assistance efforts against risks.

2. Asian Bond Market

Efforts to develop the Asian bond market shall be made to strengthen both capacity and system building within participant economies, as well as the integration of bond markets in the region.

Major measures for capacity-building may include: establishing a more effective steering body to guide domestic bond markets; perfecting the domestic institutions to provide a firmer basis for regional cooperation; promoting the development of the bond exchange market and an efficient information exchange system; improving guarantee and rating systems required in a sound bond market; and improving credit, taxation and legal environments to create favorable conditions for bond market development.

Major measures for integration of bond markets may include: reducing barriers in cross-border bond-trading in the region; carrying out coordination on legal and supervision issues relating to bond markets; encouraging cooperation among securities exchanges.

3. Interaction between Governmental Cooperation and Private-sector Cooperation

1) It is proposed that we establish a Promotion Institution for East Asian Monetary and Financial Cooperation, to strengthen infrastructure building and institutional capacity building in the financial service sector, to unify technical and supervisory standards and to promote cooperation among financial sectors in the region.

2) Governments and governmental mechanisms should facilitate private financial and monetary operation. On the one hand, each nation should adopt a freer financial policy in line with the supervision principle of efficiency and stability; on the other hand, policy barriers restricting regional financial business should be lifted and firm-level cooperation should be particularly encouraged.

3) It is suggested that governments mobilize private financial institutions and encourage them to participate actively in existing investment and trade cooperation. Governments shall inform private financial institutions of the latest developments at the regional level as well as policies on investment and trade integration. Each country shall formulate policies to encourage cooperation among financial institutions.

4. Asian Currency Unit or Asian Currency Unit Index

An agreement is yet to be reached on this issue. While it is widely believed that an

Asian Currency Unit could greatly facilitate intra-regional economic and trade cooperation, stabilize the regional currencies, and benefit the nations in the region in general, some suggest that conditions are not ripe for such a unified currency. Despite the different ideas about it, it is agreed that an in-depth study of the Asian Currency Unit Index is of high necessity for the further development of the region and will provide insight and produce more practical proposals on this issue.

It is suggested that research and planning of the Asian Currency Unit be carried out and a specialized body designated by ASEAN Plus Three lead this study. It is also suggested that Asian Currency Unit is a long-term goal to be realized progressively and evolutionarily. In the short term, it is wiser to define the function of this “index” as an indicator of average foreign exchange fluctuation among currencies in East Asian nations.

5. Study Groups

It is suggested that study groups be set up to carry out in-depth and strategic study of certain key issues, for instance, Asian Bond markets. These study groups shall be able to make forward-looking, strategic and practical policy recommendations to decision-makers in the region so that some breakthroughs could be made in realizing the goal of “Asian money for Asian projects.”

Conclusion

The NEAT Working Group on East Asian Financial Cooperation agrees that financial cooperation is a crucial part in regional integration process. Over the last decade, East Asian nations have initiated and carried out regional financial cooperation at various levels. These efforts have facilitated the region’s economic recovery and development. Now East Asia is at a crossroads. The Working Group expressed their optimism about East Asian regional community building and believed that East Asia is now having the best opportunity in its modern history for building a peaceful, prosperous, and progressive regional community. For the realization of this goal, the process of East Asian regional cooperation shall not lose its momentum.