

# **Challenges and Development Path to Regional Financial Cooperation in Asia**

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## **I. Introduction**

Over the past decade since the late 1990s when the financial and foreign exchange crisis broke out, financial cooperation within the Asian region has centered around regional financial fora. These endeavors have achieved considerable results, although somewhat slowly.

These results include the setting up of a regional liquidity support arrangements through the CMI, the establishment of the ABF, and the progress of the ABMI. These accomplishments have been largely the work of various regional financial fora, especially ASEAN+3 and EMEAP.

Moreover, all initiatives for financial cooperation are being undertaken at a time when Asian countries, especially Korea, China and Japan, have already accumulated experience in regional financial cooperation. Therefore, to some extent the foundation needed to continue these cooperation efforts is already in place.

Meanwhile, there has been an increasing number of financial fora on regional financial cooperation, and the range of their discussions has also been broadened. Selection and concentration of topics related to cooperation is therefore required. A gap has also been exposed between the reality of and the expectations for regional financial cooperation, as the expectations of visible accomplishments growing.

Using our empirical knowledge, therefore, we need to examine what challenges there are to be overcome in order to achieve efficient regional financial cooperation. It is also important that we determine the direction we should take in improving our regional financial cooperative system.

## **II. Progress of Asian regional financial cooperation**

### **1. Background of Asian regional financial cooperation**

The Asian financial crisis in 1997 was a direct momentum for countries to recognize the need for regional financial cooperation. Experiencing the financial crisis, Asian countries reached consensus that they needed to enhance their own risk management abilities, in order to prevent and resolve any future financial crises. They needed to do so by strengthening regional financial cooperation, instead of depending merely upon support from international financial organizations including the IMF and advanced countries.

The strengthening of regionalism around the world, with the launch of the European Monetary Union (and the euro) in 1999 and the advancement of economic integration in the Americas, has also led Asian countries to participate actively in regional financial cooperation for protecting the region's interests and boosting its status in the international community.

As a result, they started to engage in active discussions of regional financial cooperation since the 1997 crisis. In their efforts to come up with means of preventing and effectively coping with financial crises in the region, the countries had achieved visible results, including the setting up of a regional emergency liquidity provision regime.

The financial crisis was attributable mainly to regional countries' increasing dependence upon foreign capital and bank loans, due to their relatively underdeveloped financial markets. It was due as well to the maturity mismatches in overseas market such as long-term lending and short-term borrowing. In recognition of this fact, countries have focused on looking for ways of developing regional financial markets, for example by fostering regional bond markets.

## **2. Outline of regional financial cooperative bodies**

Financial cooperation in the Asian region is currently being led by ASEAN+3 and EMEAP, in addition to many other cooperative bodies (and organizations), including ASEAN, APEC, ASEM, SEACEN, and SEANZA.

First of all, the ASEAN+3 and EMEAP play central roles in the current regional financial cooperation projects.

In the ASEAN+3, countries have established a regime of regional emergency liquidity provision by bilateral swap arrangements (BSA) under the CMI. They have also sought to develop the regional bond markets through the Asian Bond Market Initiative (ABMI).

In EMEAP, the cooperative organization of regional central banks, members have set up and operated the Asian Bond Fund (ABF), as a way of fostering regional bond markets. They recently also established a Monetary Financial Stability Committee (MFSC), to strengthen financial and economic monitoring and risk management in the region.

In the ASEAN, comprising the 10 South East Asian countries, coordination of views and agreement among members based upon close cooperation since the 1960s have also contributed to the smooth promotion of the financial cooperation projects of the ASEAN+3.

Unlike the cases of the ASEAN+3 and EMEAP, the region's other cooperative bodies have not engaged in concrete cooperative projects. Rather, they have carried out limited research on regional cooperation-related themes and shared information through annual meetings and irregularly scheduled workshops.

The East Asia Summit (EAS), comprising the ASEAN+3 members, Australia, New Zealand and India, has been seeking ways of strengthening regional economic cooperation among its members, with help of the ASEAN Secretariat.

### Regional Monetary and Financial Fora

Forum	No. of members	Member countries
Central Bank Cooperation		
EMEAP(1991)	11	Korea, Japan, China, Australia, New Zealand, Hong Kong, Singapore, Malaysia, Indonesia, the Philippines, Thailand
SEACEN(1966)	16	Thailand, Malaysia, the Philippines, Singapore, Sri Lanka, Indonesia, Nepal, Myanmar, Korea, Taiwan, Mongolia, Brunei, Fiji, Papua New Guinea, Cambodia, Vietnam
SEANZA(1956)	20	Australia, New Zealand, India, Pakistan, Sri Lanka, Japan, the Philippines, Malaysia, Thailand, Korea, Iran, Indonesia, Singapore, Nepal, Bangladesh, Papua New Guinea, China, Hong Kong, Mongolia, Macau
Finance Ministry-led		
ASEAN(1967) <sup>2)</sup>	10	Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, the Philippines, Singapore, Thailand, Vietnam
ASEAN+3(1999)	13	10 ASEAN countries, Korea, China, Japan
APEC(1994)	21	Korea, the U.S.A., Japan, China, Russia, Hong Kong, Taiwan, Brunei, Thailand, Indonesia, Malaysia, the Philippines, Singapore, Vietnam, Canada, Mexico, Chile, Peru, Australia, New Zealand, Papua New Guinea
ASEM(1997)	43	27 EU countries, ASEAN+3, India, Pakistan, Mongolia
Others		
EAS(2005)	16	ASEAN+3, Australia, New Zealand, India
ACD(2002)	30	ASEAN+3, India, Pakistan, Bangladesh, Sri Lanka, Bahrain, Qatar, Oman, Kuwait, Kazakhstan, UAE, Mongolia, Bhutan, Iran, Russia, Saudi Arabia, Uzbekistan, Tajikistan

\* 1) Figures in parentheses are years of foundation

2) AFMM and ACBF started after 1997.

SEANZA and SEACEN, regional financial cooperative organizations of central banks, have focused on training and research activities to enhance member central bankers' capacities.

APEC and the ASEM, in which countries from the Americas and Europe also participate, have pursued financial cooperation in a limited range.

The APEC Finance Ministers' Meeting has been working on projects to strengthen regional financial cooperation, increase provision of technical support, and develop a regional bond market. Especially, the Asia-Pacific Finance and Development Center in China has led the APEC Finance and Development Program.

The ASEM, whose objective is to strengthen economic cooperation between Asia and Europe, has also established the ASEM Trust Fund in its Finance Ministers' Meeting. Recent financial cooperative projects include the operation of systems of cooperation among member countries in times of economic and environmental emergencies such as financial crisis or, for example, tsunamis.

### **3. Regional financial cooperation agenda**

Regional financial cooperation can be sub-categorized into three areas. These are strengthening crisis management regimes, developing a regional bond market, and studying regional exchange rate cooperation and monetary integration.

#### **A. Strengthening crisis management regimes**

Since the financial crisis in the late 1990s, Asian countries have made joint efforts to create cooperative schemes for resolving and preventing any future crises. They have focused on two pillars — establishment of a regional financing arrangement and strengthening of the surveillance and monitoring framework.

Measures to establish a regional financing arrangement include the conclusion of the Bilateral Swap Arrangements (BSAs) under the Chiang Mai Initiative (CMI) of the ASEAN+3. As the financing network of BSAs among regional countries has been successfully established, members are discussing multilateralization of the CMI to set up a more advanced regional liquidity provision framework based upon it.

Strengthening of regional surveillance and monitoring regimes has been dealt with as major challenges in both ASEAN+3 and EMEAP.

#### **(Establishment of a regional financing arrangement)**

The CMI, adopted in the ASEAN+3 Finance Ministers' Meeting in May, 2000, establish a network of BSAs, under which in times of financial crisis member central banks provide liquidity to their counterparts up to certain agreed upon amounts.

Under the CMI, Korea, China and Japan have concluded BSAs with each other, and also with five ASEAN countries. The ASEAN countries have expanded volumes of the existing swap arrangements, which had been maintained since 1977, instead of concluding separate bilateral arrangements with each other<sup>1</sup>.

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<sup>1</sup> ASEAN adopted a 200-million-dollar ASEAN SWAP Arrangement (ASA) in August 1977 to promote regional monetary cooperation among the central banks of five ASEAN members, Indonesia, Malaysia, the Philippines, Singapore and Thailand. In May 2000, it expanded the number of ASA participants from 5 to 10 countries, and the amount from \$200 million to \$1 billion. The amount was further expanded to \$2 billion in April 2005.

As of December 2007, the number of BSAs reached was 17, amounting in total funding volume to \$84 billion.

The ASEAN+3 countries have made great efforts to develop the BSAs of the CMI into a more efficient regional financing framework.

Members agreed to double the amounts of their BSA funding support in 2005. In 2006, they increased the effectiveness of the financing framework by introducing a collective decision-making process, in which financing countries are called upon within two days from outbreak of a crisis, and fully provide the support required after deciding upon financing within one week.

Most notably, in the May 2006 ASEAN+3 Finance Ministers' Meeting, member countries agreed to initiate discussions on developing the framework into a more advanced one (in a process designated as CMI multilateralization or Post CMI).

Members subsequently completed the first stage of discussions in May 2007, by deciding to pool their reserves through a Self-managed Reserve Pooling Arrangement under a contractual agreement, and to strengthen their surveillance of financial and economic trends through the ASEAN+3's Economic Review and Policy Dialogue (EPRD).

In the second half of 2007, countries held working-level discussions on concrete plans for multilateralization of the current BSAs, including financing methods.

Especially, in the Deputies' Meeting in Lijiang, China in late November 2007, members discussed the volume of the multilateralized CMI fund, borrowing quotas by groups and details including payment methods and borrowing conditions.

**Schedule and Major Agenda items for CMI Multilateralization Discussion**

	Schedule	Major items
<b>Stage 1</b>	Completed ( ~ 2007.5.5)	<b>Basic items for CMI multilateralization</b> ① Means of participation ② Legal forms ③ Surveillance framework
<b>Stage 2</b>	2007.5.6 ~ Ministers' Meeting in 2008	<b>Core items for CMI multilateralization</b> ① Size of funds and additional financing ② Quotas for borrowing and lending(borrowing) conditions ③ Financing mechanism
<b>Stage 3</b>	Ministers' Meeting in 2008 ~	<b>Detailed implementation plan</b>

Other regional financing frameworks established after the 1997 crisis include the New Miyazawa Initiative (NMI), proposed by Japan in 1998, the ASEM Trust Fund (ATF, or Asian Financial Crisis Response Fund) established by the ASEM based upon a proposal by the UK, and a system of US treasury bond repo agreements among EMEAP countries.

Japan concluded several individual financing arrangements with regional countries based upon the NMI. Only a 2.5 billion-dollar swap arrangement with Malaysia remains in place currently, as the other arrangements have either reached maturity or been cancelled prior to maturity.

The ATF was designed to provide technical assistance related to financial restructuring in countries hit by the Asian financial crisis. The fund amounts to a total of \$800 million, and has been provided to regional countries<sup>2</sup>.

The system of US treasury bond repo agreements among EMEAP members was started in November 1995, to establish a framework for cooperation among central banks to secure regional foreign exchange market stability. The amount of the agreement was expanded after the 1997 financial crisis, but it has never been implemented so far<sup>3</sup>.

### **(Reinforcement of Surveillance and Monitoring System)**

For independent and efficient operation of the regional funding system in times of financial crisis, it is essential that conference bodies build their own surveillance and monitoring systems so they can observe financial and economic developments in each regional member country.

In the current CMI-BSA system, 80% of the amount agreed for funding is linked to the IMF's decision, which greatly limits the independence in fund operation<sup>4</sup>. This is because, unlike the IMF, the CMI lacks independent and credible surveillance and monitoring.

Accordingly, countries in the region have made efforts to build systems for surveillance and monitoring of regional financial and economic developments and to strengthen their policy cooperation through these systems.

The Manila Framework was launched in 1998 in the aftermath of the 1997 financial and foreign exchange crisis, with the goal of strengthening financial stability in the Asian region. It began building a surveillance mechanism in the region as part of its major

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<sup>2</sup> Nine European countries and China raised \$45 million to form the ATF I (1998-2002) and supported seven Asian countries. ATF II was created by eight European countries, Korea and China, totaled \$35 million, and was provided to five Asian countries.

<sup>3</sup> Under the repo agreements, countries have been to provide financial support in US dollars, with US treasury bonds as collateral, during a very short period. Therefore, the agreements have not been so useful as a crisis resolution measure.

<sup>4</sup> Funding through the CMI-BSA is mostly limited to cases where IMF programs/funding have already been executed or will soon be executed. However, for up to 20% of the contracted amount, funding can be provided at donor's discretion without linkage to an IMF program.

projects, to complement the IMF's global surveillance. Even though it had lasted for six years, the Manila Framework was terminated at its 12th meeting in November 2003, without having achieved any concrete results.

Since April 2002, the ASEAN+3 has examined regional economic and financial developments through its Economic Review and Policy Dialogue (ERPD) and sought ways of policy cooperation. However, the ERPD, which remains merely a means of examining country-specific macroeconomic indicators, has no surveillance functions and cannot demand any actions from member countries. The ERPD is thus inadequate as a regional economic surveillance system.

In May 2006, therefore, the Technical Working Group on Economic and Financial Monitoring (ETWG) and the Group of Experts (GOE) were created. These groups support member countries in building policy collaboration through regular monitoring of economic and financial developments, and at the same time enhance their crisis-coping capabilities through facilitating early detection of crisis symptoms.

During the Finance Ministers' Meeting in May 2007 in Kyoto, Japan, the ministers agreed to tighten the connections among the ERPD, ETWG and GOE, to further promote their functions of surveillance of regional economic and financial developments.

EMEAP is also working on building a system for regional monetary and financial monitoring. In April 2007, the Monetary and Financial Stability Committee (MFSC), composed of deputy-governor level staff of member central banks, was launched. This committee handles regional monetary and financial monitoring, and also performs such activities as risk and crisis management and resolution.

In May 2007, the MFSC decided to launch a regional monetary and financial monitoring system<sup>5</sup>. Then in November 2007, its members agreed to build a regional crisis management and resolution network<sup>6</sup>.

After the financial crisis, ASEAN members designed the ASEAN Surveillance Process (ASP), and have drawn up monitoring reports on members' and regional economic developments, with help from the ASEAN Finance and Central Bank Deputies' Meeting, the surveillance and coordination body of the ASEAN secretariat, the ADB, etc.

This ASEAN surveillance report includes policy recommendations concerning regional financial and economic developments. Finance ministers of the ASEAN member

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<sup>5</sup> This monitoring system comprises the following: macromonitoring done by dedicated resources from each member central bank; monitoring performed by the three working groups in their respective fields; and the Dealing Room Network, connecting the network of the IFIs (e.g., the IMF and the BIS) and the EMEAP member central banks.

<sup>6</sup> The crisis management network is composed of the High-level Team and the Technical-level Crisis Management Team (CTM). The High-level Team advises members on policy alternatives in dealing with crises, and also provides them a point of contact with the IFIs. The CTM supports the High-level Team through data collection and execution of business continuity plans (BCPs) in times of crisis.

countries exchange their opinions and information through peer reviews, and discuss measures needed to cope with potential risk factors, in order to enable members to be prepared for emergencies.

## **B. Development of Regional Bond Markets**

Since the Asian financial crisis, there have been active discussions in most regional financial fora regarding development of Asia's financial markets, that had been relatively backward. There has been remarkable progress especially in discussions concerning development of regional bond markets, particularly during EMEAP and the ASEAN+3 meetings, which aimed at depending less on funding from outside the region and cultivation of funding from within the region.

EMEAP has created the Asian Bond Fund (ABF), a fund comprising foreign exchange reserves held by regional member central banks. Its investment in regional bonds is contributing to development of the regional bond markets.

ASEAN+3 is seeking ways to spur issuance of bonds within the region and member countries, through the Asia Bond Market Initiative (ABMI), and to build a common substructure (a credit guarantee, credit rating and settlement system) that can foster regional bond market development.

APEC is also searching for ways to strengthen member countries' capacities to develop their regional financial markets, including bond markets, through discussions on how to promote securitization and credit guarantee markets.

### **(Creation of the Asia Bond Fund)**

EMEAP has created bond-type funds, invested in jointly by member countries, to boost regional bond markets and diversify the investment targets of members' foreign exchange reserves. As a result, the ABF-1 and ABF-2 were launched in July 2003 and April 2005, respectively, and have been in operation since those times.

The ABF-1 is a bond-type fund with a total size of 1 billion dollars. It limits its investments to only USD-denominated bonds issued by EMEAP member governments (except Japan, Australia and New Zealand) and governmental institutions.

The ABF2 is composed of the Pan-Asian Bond Index Fund (PAIF) and the eight Single-market Funds. Its investment targets are bonds issued by governments and government institutions of eight EMEAP member countries (Korea, China, Hong Kong, Singapore, Thailand, Malaysia, the Philippines and Indonesia) and denominated in their currencies<sup>7</sup>. Japan, Australia and New Zealand, whose bond markets are already advanced, are excluded.

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<sup>7</sup> The PAIF is a unified fund that invests in local currency denominated sovereign and quasi-sovereign bonds of eight EMEAP bond markets. The eight Single-market Funds are country funds that invest in the same bonds of the respective markets.

The ABF-2 started out as a 2 billion-dollar bond-type fund created with foreign exchange reserves of EMEAP members. However, through listing and public offerings, it now also attracts private funds.

**(Discussions Regarding Regional Bond Market Development)**

Remarkable progress has been made in discussions of ways to foster regional bond markets. The ABMI of the ASEAN+3 has organized working groups dedicated to work in various relevant fields.

The Working Group on New Securitized Debt Instruments is devoted to finding ways for issuance of bonds to finance infrastructure, for securitization of loans and charge sales bonds, and for issuance of regional medium-term notes (MTNs).

The Working Group on Credit Guarantee and Investment Mechanisms has confirmed (November 2007) that a regional credit guarantee and investment organization will be established, in the form of a fund operated under the ADB, and it is now working on detailed plans for its implementation.

The Working Group on Foreign Exchange Transactions and Settlement Issues has discussed how regional foreign exchange settlement risks can be minimized, although due to conflicts of interest among members not much progress has been achieved.

**Activities of ABMI Working Groups**

Working Groups	Activities
New Securitized Debt Instruments	Finding ways to provide tax incentives for regional currency-denominated bond transactions to promote efficient supply of these bonds, ways to issue ABSs, and ways of joint response to withholding taxation
Credit Guarantee and Investment Mechanisms	Discussing ways to establish a single credit guarantee and investment institution to facilitate more active issuance of regional bonds
Foreign Exchange Transactions and Settlement Issues	Studying ways to improve the regional payment/settlement system; organizing a group of experts to study establishment of a regional depository organization
Rating Systems and Information Dissemination on Asian Bond Markets	Studying ways to improve the regional credit rating system and reinforce the credit information dissemination system
TA Coordination Team for FG	TA for globalization of members' bond markets and for improvement of human resource quality in these markets

The Working Group on Rating Systems plans to come up with ways to improve the comparability and level of standardization of regional credit rating agencies, and boost their functions by May 2008. Its aim is to enhance the credibility and transparency of regional credit rating agencies.

APEC members have continued discussing cultivation of regional bond markets for the past ten years. They have launched several initiatives, namely: the Initiative on Securitization Promotion (1997~1998) launched in April 1997, the Initiative on Regional Bond Market Development (1998~1999) launched in May 1998, and the Initiative on Development of Securitization and Credit Guarantee Markets (2002~2004) launched in September 2002.

It has been recognized that one of the elements undermining development of regional bond markets is the credit quality gap — i.e., regional issuers' credit rating levels do not meet investors' expectations. In line with this awareness, APEC has tried to find ways of encouraging more active credit guarantees and securitization.

Even until recently, APEC has striven to strengthen regional members' capabilities in developing their financial markets, by initiatives such as the AFDP(APEC Financial Development Program), the APEC Public-Private Dialogue on Bond Market Development, and the Initiative on Strengthening Capital Markets in the APEC Region.

### **C. Studies on Regional Foreign Exchange Cooperation and Regional Monetary Integration**

The basic goal of regional financial cooperation since the financial crisis has been to build an emergency funding system in preparation for future possible financial crises. At the same time, however, studies have also been continuously done on how major regional countries can cooperate in their foreign exchange-related policies and unify their currencies. These studies have been conducted, based on a mid- to long-term perspective, with the aim of such as preventing competitive devaluations of currencies in times of foreign exchange crisis.

Recently, systematic studies have been conducted by regional development financial organizations (e.g., ADB) and conference bodies (e.g., ASEAN+3), based on academic studies carried out by major research institutes. The ADB has been conducting research on development of an Asian Currency Unit (ACU) since 2005<sup>8</sup>.

During the Korea-China-Japan Finance Ministers' Meeting in May 2006, the participants agreed that the three governments together initiate research on an Asian common currency basket.

The ASEAN+3 has been studying development of a single regional monetary unit since 2006. In the ASEAN+3 Research Group, led by a private research institute, Japanese

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<sup>8</sup> The ACU would be a weighted average index of an Asian regional monetary basket. It would be an indicator used to monitor the movements of regional currencies as a whole against currencies outside the region (e.g., the USD and the euro) and against the currencies of individual regional countries.

researchers have since 2006 been studying adoption of a regional monetary unit (RMU) in Asia, by considering the EU's adoption of the EMU<sup>9</sup>.

The ASEAN Central Bank Forum (ACBF) has also, since 2000, been studying the prospects of adopting a single monetary and foreign exchange system for the ASEAN region.

In 2000, the Forum organized a task force team to do research on the feasibility of a single monetary and foreign exchange system in the ASEAN region. In 2007, it set up a new task force team for research on the foreign exchange system in the ASEAN region<sup>10</sup>.

### **III. Challenges for the strengthening of regional financial cooperation**

The foundation for setting up a regional financial cooperation framework seems to have been laid, as Asian countries have pursued financial cooperation for a decade since the 1997 financial crisis. In order for this framework to develop more and produce substantial results in the future, however, the following challenges must be overcome.

#### **1. Creating synergy through division of work among major regional financial fora**

##### **(Problems from diverse cooperation channels and leading institutions)**

The channels of regional financial cooperation have become very diverse, as Asian financial cooperation has been conducted through a variety of fora that are different from each other in terms of their structures and the natures of the institutions leading them.

Concerning the structures of these fora, ASEAN has 10 Southeast Asian countries as its members, while APEC and ASEM have 21 and 43 members, respectively, including countries from outside the Asian region.

ASEAN+3, APEC and ASEM are government-led (central banks might participate depending upon the areas of cooperation), while EMEAP, SEACEN and SEANZA are fora of central banks. SEACEN and SEANZA mainly focus on providing training programs to enhance the capacities of member central bankers.

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<sup>9</sup> Japan has categorized its research in line with four objectives: first, a currency composition plan for the RMU, in accordance with the purposes of its adoption; second, a plan for using the RMU to stabilize regional foreign exchange rates; third, a plan for encouraging use of the RMU in regional financial markets; and fourth, a roadmap for RMU adoption.

<sup>10</sup> The task force team has concluded in its research that it is yet premature to adopt a single monetary and foreign exchange system in the region, since it remains difficult for the macroeconomies of all ASEAN countries to converge under such a system.

As multiple fora conduct discussions on similar themes in similar areas due to the existence of such diverse channels, human and physical inefficiencies might arise. Especially, as EMEAP has focused more on regional financial cooperation since 2007, its agenda overlaps much with that of the government-led ASEAN+3<sup>11</sup>.

### **Financial cooperation agenda of regional fora**

	APEC	ASEAN	ASEAN+3	ASEM	EMEAP	SEACEN	SEANZA
Liquidity support		√	√				
Surveillance /Monitoring		√	√		√		
Financial market development	√	√	√	√	√		
Monetary integration		√	√				
Capacity building	√	√	√	√	√	√	√

#### **(Creating synergy by enhancing connections between consultative channels)**

Tasks should be reorganized, in consideration of the expertise and driving forces of the different regional fora, while the connections between the fora should be increased, so that they can refer to and utilize the results of each other's discussion for each task.

More specifically, for example, synergy can be created if the government-led ASEAN+3 establishes a financing regime for coping with a regional financial crisis, while the central bank-led EMEAP strengthens its surveillance and monitoring functions.

It has also been argued that some of the fora need to be developed into permanent organizations, or even further into international financial institutions that carry political and economic binding force supranationally.

Most fora other than ASEAN and SEACEN, that have their own secretariats or permanent administrative offices, lack permanent organizations in charge of the implementation and coordination of their cooperative projects and contacting their members. They therefore depend upon the experiences of certain member countries (or the rotating chair countries) or other international organizations such as the ADB and the BIS.

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<sup>11</sup> For example, both ASEAN+3 and EMEAP have promoted stronger surveillance and monitoring in the region.

### **Supportive organizations of regional financial fora**

Forum	Organizations
SEACEN	Enhance capacity of central banks in the region through the SEACEN CENTRE
EMEAP	No secretariat. Depends upon capacities of the BIS and individual members including Hong Kong and Singapore for its major initiatives such as the ABF
ASEAN	ASEAN Secretariat
APEC, ASEM, ACD, EAS, SEANZA	No secretariat. Depend upon other international organizations including the World Bank(ASEM Trust Fund), ASEAN Secretariat (EAS), and ADB
ASEAN+3	No secretariat. Depends upon indirect assistance from other international organizations including ASEAN Secretariat and ADB for the CMI and ABMI

If they continue to depend upon certain specific members or international financial organizations, they will face limitations in achieving regional cooperation results and developing their own capacities through establishment of regional financial cooperation regimes.

It is not easy in reality for member countries to reach consensus to resolve this problem, due to various factors including the additional expense of establishing secretariats, for example, and possible conflicts of interest among members. In the mid- and long run, however, they need to come up with practical measures to increase their activities and the effectiveness of their functions in the region, including planning to set up permanent offices.

## **2. Establishing surveillance and monitoring frameworks**

Some regional fora including ASEAN+3 and EMEAP have worked on establishing regional surveillance and monitoring frameworks, but the current monitoring has not developed beyond an initial stage of peer review of economic conditions of member countries and their major statistical indexes.

Due to its underdeveloped monitoring function, financing through the BSAs under the CMI of ASEAN+3 has relied greatly upon surveillance and monitoring by the IMF, with 80% of its financing linked to the IMF's financing decisions.

The increasing dependence of regional fora upon international organizations outside the region for their surveillance and policy-making decisions may undermine their abilities to respond rapidly and effectively to financial crises in the region<sup>12</sup>.

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<sup>12</sup> Considering that the IMF conducts its surveillance on member countries only once or twice every year, for about two weeks, surveillance on regional countries is not adequate in terms of its intensity and frequency.

To increase the effectiveness of the multilateralized financing framework of the ASEAN+3's CMI and prevent moral hazard in recipient countries in times of crisis, the regional fora need to set up their own surveillance and monitoring frameworks that are more systematic and binding.

EMEAP's Monetary and Financial Stability Committee is working to ensure more rapidity in information exchanges and decision-making by establishing a working-level risk management system. In view of this, ASEAN+3 also needs to increase the linkages between surveillance activities and financing in its CMI multilateralization efforts, so that it can provide actual financing in times of crisis.

### **3. Strengthening cooperation with major international financial organizations**

Regional cooperative fora need to strengthen their cooperative relationship with major international financial organizations. This will help to ensure that the region's common interest is reflected properly in the international community and enable promotion of regional financial cooperation to proceed more smoothly.

For example, when Japan proposed establishing an Asian Monetary Fund (AMF) in the wake of the 1997 Asian financial crisis, that could not be realized due to opposition from the U.S., which was concerned about weakening of the IMF's role. The current financing system of the CMI-BSA is also in a complimentary relationship with the existing international financial organizations such as the IMF.

If the current CMI multilateralization discussion on setting up a regional financing framework develops further to also deal with the possible establishment of a regional financial organization, support from the existing international financial organizations including the IMF and ADB is essential.

In this case, the cooperative relationships between regional fora and international organizations would become closer, and regional fora would also build a more cooperative relationship with each other, with each forum specializing in different areas, for example.

In promoting their cooperative projects, these regional fora also need to utilize the knowledge and experience of the existing international financial organizations including the IMF, BIS, and ADB .

For instance, EMEAP, which has already successfully established the Asian Bond Fund (ABF) in cooperation with the BIS, can fully utilize the experiences of the BIS when developing measures to foster regional bond markets.

Technical advice from the IMF, based upon its diverse experience and expertise in the area of international cooperation, is essential for resolving conflicts of interest and differences of views on countries' shares of funds and reaching consensus among ASEAN+3 members in the CMI multilateralization process.

With regard to the review and adjustment of international standards, including payment and settlement criteria and capital adequacy ratios, regional countries can maintain close relationships with the BIS. They can then utilize the major meetings and expert committees of the BIS to advance their interests by, for example, asking that greater consideration be given to the uniqueness of regional economic conditions.

#### **4. Setting up a long-term vision**

Asian countries have promoted a variety of cooperative projects, in recognition of the importance of regional financial cooperation in an era in which both globalization and regionalism are deepening.

However, there has been no clear consensus, either within a single regional forum or among them all, on a common goal or vision that they should pursue in the long term through regional financial cooperation.

Having a properly set long-term goal would enable them to set up strategies to achieve that goal effectively and with the minimum political and economic costs.

If there is a lack of consensus on a long-term goal or direction among member countries, the driving force to achieve that goal might be weakened, or the process might result in considerable trial and error.

This lack of a long-term vision seems to be one of the reasons that the cooperation pursued recently by major fora in the region has failed to take off, despite their experiences accumulated during the past decade.

Of course, it is not easy for countries to form consensus on long-term visions requiring common understanding and efforts, such as AMF establishment and regional monetary integration. This is because Asian countries differ in their development levels, their cultures and their languages, and there are various historical and political conflicts among them.

For example, countries have tended to avoid officially discussing the issue of regional monetary integration, as they could incur huge political and economic costs in a short term during such discussions, while their benefits would be uncertain and could only be realized over a long period of time.

At the current stage, therefore, member countries need to engage in research and discussions more actively, in order to seek a long-term vision that they can share for regional financial cooperation, and increase their understandings of that vision.

The topics for such research and discussions can include the establishment of a regional foreign exchange cooperation system, regional monetary integration and the scope of the participants to be involved in regional financial cooperation.

## IV. Conclusion

The progress of regional financial cooperation since the Asian financial crisis has been slow, but there have been visible outcomes, although on a limited scope. In this process, Asian countries have also been able to accumulate experience related to regional financial cooperation.

Especially, the ASEAN+3's efforts to set up a financing framework based upon the CMI-BSA, and its multilateralization of that framework, are expected to serve as a cornerstone to strengthening of a regional risk management system.

Efforts in EMEAP to create the Asian Bond Fund, and the ASEAN+3's endeavors to foster a regional bond market including the ABMI, will contribute greatly to improving the region's financial markets and enabling more smooth financing and management of funds.

Obstacles to the long-term cooperation processes have recently emerged in various regional fora, however. Countries therefore need to strengthen their capacities to operate and develop the already established regional financial cooperation frameworks more effectively, rather than trying to find new areas for cooperation.

To reduce inefficiencies, including the overlapping of agendas due to the diversification of regional cooperative fora, the fora need to readjust their projects and focus more on key projects, in consideration of their own areas of expertise and their driving forces.

For instance, establishment of regional surveillance and monitoring frameworks has been pursued by both the ASEAN+3 and EMEAP. The ASEAN+3 could focus on its financing function and strengthening of bilateral surveillance (between the ASEAN+3 and its individual members), in cooperation with the IMF.

EMEAP, meanwhile, needs to learn from the surveillance activities of the BIS as a role model, and focus on information exchange and monitoring of areas in which central banks have expertise, including the financial markets, payment and settlement and banking supervision, to promote greater regional monetary and financial stability.

If the connections between the various regional fora increase, regional financial cooperation can be promoted more effectively through synergy effects. Therefore, the fora need to engage more actively in official information exchanges.

In addition, they would be able to expand the base for cooperation in the long run, by utilizing regional central bank training organizations such as the SEACEN Centre, and thus increasing countries' understandings of and interest in the overall financial cooperation projects being carried out currently.

Just as Germany and France played leading roles during the EU's long economic integration process, major countries in the Asian region need to show their strong leadership and gather the political willpower to make regional financial cooperation

successful in the future.

The leading countries in terms of economic size and level of economic and financial development should show their leadership. At the same time, they need to be careful not to undermine regional financial cooperation by harmonizing all the cooperation processes.

Asian countries can be expected to develop their relationships for regional financial cooperation further in the near future. However, there has been no clear agreement on the ultimate goal of regional financial cooperation, even among the countries participating in it. This is because there are many constraints that cannot be resolved in the short term through the capacities of the cooperative fora alone.

Financial cooperation in the Asian region so far has not been conducted step by step, in accordance with any long-term plan. Instead, for a decade since the Asian financial crisis, it has centered on projects in which countries can actually cooperate with each other, by reflecting and adjusting the interests of many countries.

Therefore, countries need to start with realistically agreeable tasks, instead of rushing to set up an ultimate goal for regional financial cooperation.

Considering that it took more than four decades for the EU to complete its economic integration, and that Asia's environment for integration is more heterogeneous than that of the EU, it will not be easy to reach agreement on the ultimate goal of regional financial cooperation.

If countries hurry to try to specify such an ultimate goal, conflicts of interest among them could arise, which might hamper many of the monetary and financial cooperation projects currently underway.

If there is no ultimate goal for regional financial cooperation, however, this could lead to negative side effects including weakening of our driving force and ineffective management of human and physical resources. Efforts to minimize these effects are therefore needed.

In selecting and promoting individual financial cooperation projects, consistency with an ultimate goal must be considered from the mid- and long-term perspectives. To this end, countries need to continue research and discussion on mid- and long-term challenges including the establishment of a regional foreign exchange cooperation framework and regional monetary integration, even if it takes considerable time to reach a conclusion.

Member governments can face many constraints to active promotion of tasks that require political judgment, or on which regional countries have differing opinions. In contrast, central banks can advance the related discussions relatively freely, through objective research and review. In this regard, central banks in the region have many contributions to make to regional monetary and financial cooperation.

## < Appendix >

### **Key Reforms to Foster Regional Financial Integration in Asia**

#### **1. Current state of regional financial integration**

Asia's real sector integration has been remarkably advanced, with intraregional trade as a share of total trade accounting for about 50%.

Asia's financial integration with the world is also well advanced by some measures, including net private capital flows, foreign participation in some markets, and stock market correlations.

Meanwhile, Asia's intraregional financial integration - measured by, for example, cross-border capital flows, or cross-border correlation of consumption growth<sup>13</sup> - has been more limited than elsewhere.

The volume of intraregional cross-border portfolio investment in Asia is relatively small compared with that to either North America or the European Union<sup>14</sup>.

Although cross-border interest rate and bond yield differentials have narrowed in recent years, they remain substantial.

Co-movements in Asian interest rates and bond yields have increased, but this could also reflect increasing integration with the global market and/or improving fundamentals.

Empirical studies (Mercerau, 2005) find that consumption growth in most Asian countries has a low or negative correlation with that in other Asian countries. This is in contrast to a correlation of about 0.6 among Euro area countries.

#### **2. Key reforms to foster regional financial integration**

Financial services are conditioned by a host of factors such as cost and availability of funds, transparency, well-developed infrastructures, prudential regulation, and market openness. Considering this, key reforms to foster regional financial integration are as follows :

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<sup>13</sup> Increasing financial integration should reduce the volatility of consumption growth relative to income, through diversified asset holdings and source of income. Therefore, consumption patterns become more correlated across countries.

<sup>14</sup> For example, Asia's intraregional cross-border portfolio liabilities amounted to only 2.25% of its GDP in 2004, less than one third of those to either North America or the European Union.

- o strengthen capital markets so as to increase investor sophistication and improve the investment climate
  - strengthen the investor base by increasing the role of institutional investors such as pension funds
  - strengthen corporate governance for an attractive investment climate
- o build regional infrastructures to facilitate trading
  - link clearing and settlement systems
  - ensure standardized ratings and a more complete coverage
- o minimize risks associated with greater integration
  - move towards risk-based supervision
  - address cross-sectoral and cross-border issues and coordinating crisis management
- o remove impediments to cross-border activities
  - further capital account liberalization
  - further liberalization of the financial services sector
- o harmonize rules and practices across the region
  - address differences in laws, regulations, and tax treatments that prevent investors
  - implement global standards and best practices

**Key Reforms to Foster Regional Financial Integration\***

<b>Greater Financial Market Integration</b>				
<b>Deep and more resilient capital and financial markets</b>				
<b>International and regional cooperation</b>				
<b>Strengthening capital markets</b>	<b>Building infrastructures</b>	<b>Minimizing risks</b>	<b>Removing impediments</b>	<b>Harmonizing rules and practices</b>
<ul style="list-style-type: none"> <li>- Pension sector Reforms</li> <li>- Strengthening corporate governance</li> </ul>	<ul style="list-style-type: none"> <li>- Clearing and payment systems</li> <li>- Credit rating agencies</li> </ul>	<ul style="list-style-type: none"> <li>- Moving toward risk-based supervision</li> <li>- Addressing cross-sectoral &amp; cross-border issues</li> <li>- Safeguarding market integrity</li> </ul>	<ul style="list-style-type: none"> <li>- Capital account Liberalization</li> <li>- Liberalizing trade in services</li> </ul>	<ul style="list-style-type: none"> <li>- Implementing global standards and best practices</li> </ul>
<b>Preconditions</b> (e.g sound economic, legal and judicial, accounting, and auditing frameworks)				

\* Source : David Cowen et al 2006, "Financial Integration in Asia : Recent Development and Next Steps", IMF working paper 06/196