Toward a Financial Architecture in East Asia: A Proposed Roadmap

YU Yong-ding

Director, Institute of World Economics and Politics (IWEP),
Chinese Academy of Social Sciences (CASS)in Beijing;
Former Member of Monetary Policy Committee, People's Bank of China

Abstract

This paper deals with a proposed roadmap for strengthening financial architecture in East Asia. We discuss the goals, driving forces and obstacles in short- and medium-term and correspondingly suggest possible steps that would be taken at different stages. A long-term vision is also briefly presented. The main points we have are as follows. (1) An East Asia monetary union can be an ultimate long-term objective for the region. (2) In order to achieve this, we shall start with amending the current CMI mechanism and fostering the need of regional local currencies in trade and financial transactions through establishing regional bond market in the short-term. (3) A regional bond market with local currencies involved and a greater stable exchange rate arrangement are likely in the medium-term. (4) In this process, China will be playing an active role.

Executive Summary

The purpose of this paper is to provide a roadmap for strengthening financial architecture in East Asia. The structure of the paper is split into four parts.

Part one analyzes the possible moves in the short-term: strengthening the CMI and fostering regional bond market. More specifically, we identify the driving forces and obstacles in achieving these goals.

The major driving force for taking further step in strengthening the CMI mechanism lie in the crucial moment that the CMI is facing: to maintain it's symbolic essence; to be abolished along with diminishing interests in cooperation among member countries; or to progress forwardly by amending its current arrangement. The need of new impetus is apparent. We optimistically perceive that there exists the willingness of the member countries to increase the liquidity for bailouts and to build up a platform and framework for high-level policy dialogues and possible exchange rate cooperation in the medium- or long-term. After taking into account a number of barriers, we suggest two steps in strengthening the CMI: institutionalizing the process of information exchange and policy reviews and dialogues, and re-thinking the linkage with the IMF conditionality.

The driving forces for fostering regional bond market in the short-term are apparent, such as: (1) the need arose from the rapid development of intra-regional trade and investment; (2) as a supplement to the CMI in assisting short-term financial liquidity; (3) a catalyst to reduce heavy dependence on the banking sector in the region; (4) a help for recycling the accumulated substantial foreign exchange reserves in the region; (5) a first step for encouraging the use of local currencies in financial transactions. The obstacles for establishing a regional bond market are twofold. One is that underdeveloped and various types of capital controls exist in low-income countries. The other is that the technical issues needed to be solved among participating countries, which is hardly to be done overnight.

Therefore, the roadmap of developing regional bond market would have two parts: one is to develop domestic market, especially in the countries where domestic markets are still at infant stages; the other is to build up a regional market, which would consist of well-designed and sequencing procedures. The Asian Bond Fund implemented in July 2003 was the first effort to foster regional bond market. It can be seen as a transitional stage, as none of local currencies involved and it lacks of secondary market. However, it is a necessary step, given constrains of usage of local currencies for the time being.

In part two we discuss the plan in the medium-term. We propose that a greater degree of intra-regional exchange rate stability, a regional liquidity supporting facility, and a more sophisticated regional financial market including money market and bond market are likely in the medium-term.

A number of driving forces can be predicted in the medium-term, among which, the critical ones are as follows. (1) The prospective EU enlargement in Europe and the prospective NAFTA expansion to the FTAA would become a catalyst for Asian to move forward in shaping a "third economic bloc" in the world. (2) The main barriers exist in the short-term, such as under-developed domestic financial market and various types of capital controls existing in lower income countries would be lessened in the medium-term, given that no severe economic or political crisis occur in the region. (3) The financial facilities created in the previous stage would lead to the need of a regional coordinated exchange rate mechanism and a need of regional integrated financial market in which local currencies are expected to play dominant roles.

However, the success of reaching the goals in the medium-term would largely rely on the degree of convergence in the economic and financial indicators and on the willingness of economic policy coordination and political compromise among member countries. The formation of a leadership in the region would take a fair long time in East Asia. Meanwhile, a transitional cost is likely to incur when countries decide to shift to a common exchange rate arrangement, especially for the countries that lack of sophisticated financial market.

Part three draws a rough long-term picture in which an EA monetary union is possibly to create, given that the goals in the short- and medium-term have been successfully achieved. In this part, we emphasize two points: the long-term goals of financial architecture in East Asia will be increasingly politics-motivated, which requires a region-wide political commitment; there is a long way to go to achieve ultimate goals for the countries that are far lagged behind in terms of economic development, and for the countries that have yet realized trade and financial liberalization.

In part four we give a very brief discussion on China's perspective. By examining China's current trade and investment ties with the rest of the world, we conclude that although the US and European market take a large share in China's external transactions, China's close link with other Asian economies is a strong driving force for China to get involved with regional financial arrangement. This force would be strengthened by the potentials that China have in the longer-term. However, the domestic matters, such as the fact that China has immature domestic financial market and less-competitive domestic financial sector, the gradual pattern of the shift of RMB's exchange rate regime and a careful sequencing of capital account liberalization, would have significant impact on its external policy choices.

Introduction

The painfulness of the financial crisis in 1997/1998 and the reflection afterwards triggered much consideration on the need of a close financial cooperation in the region. There are some common thoughts shared by the countries in the region, such as: (1) financial crisis in the region has a strong contagious effect; (2) regional economies have been integrated rapidly through trade and investment, although the diversity of the degree of economic development and maturity of financial market and system exist in the region; (3) some countries that had to de-link their currencies from the US dollar-peg regimes during the crisis moved back to the US dollar-linking regimes again after the crisis, which illustrates that those countries do not want excessive exchange rate movement; (4) Asian countries cannot completely depend on the IMF; (5) domestic financial systems in most countries are fragile.

In line with the above thoughts, the policy makers in the region have made great efforts since 1997, which started with the "Asian Monetary Fund (AMF)" proposal (1997), "Manila Framework"(1997), and proceeded by the "Chiang Mai Initiative (CMI)" (2000) and the most recent launching of Asian Bond Fund (2003). There are also plenty of discussions among the academia on various proposals of strengthening East Asian financial architecture and designing regional exchange rate arrangement.[1]

However, it appears difficult to draw a clear picture for the development of the regional financial cooperation and to clarify which proposals are feasible in the short-term and which are practical in the longer-term. This might be partly due to the lack of ultimate long-term objectives for regional financial cooperation and a roadmap showing different targets and moves in different phases.

In our study, we try to provide a proposed roadmap for regional financial architecture in East Asia, which starts with the possible moves in the short-term, followed by a medium-term plan and a long-term vision. We also give a brief discussion of the Chinese perspective on strengthening regional financial architecture.

1. Possible moves in the short-term

(1) Goals

After re-thinking what we have learnt from the crisis of 1997/1998 and what we have achieved after the crisis in strengthening regional financial cooperation in East Asia, we come to the following three points regarding the goals that we would possibly achieve in the short-term within the ASEAN+3 countries:

- Continuing to promote crisis prevention and strengthening policy dialogs;
- Improving investment facilities in compliance with rapid growth of regional economic and investment linkage;
- Fostering a regional fundamental need for local currencies and correspondingly the need of reducing over-dependency on the US dollar.

(2) Possible moves

A number of proposals have been made for strengthening the regional financial architecture. Two of them seem feasible in the short term: strengthening current cooperative mechanism-CMI; fostering regional bond market.

Strengthening the CMI

Driving forces

There are two driving forces that can be identified for taking a further step to strengthen the CMI mechanism:

- CMI is at a crossroad.

The purpose of the CMI is to strengthen the self-help and support mechanisms in East Asian economies by establishing a regional financing arrangement to supplement existing international facilities. It is considered a major step toward strengthening financial cooperation among the East Asian countries.

However, there is an increasing concern about the direction of future evolution of the CMI. This concern arises mainly due to the problems in the structure and operation of the CMI. The key problems include two aspects. One is that the CMI's symbolic feature "reflects the stance of 'constructive ambiguity' adopted by Asian officials to deflect the objections directed at their earlier proposal for Asian monetary fund. But this stance has costs; in particular, governments are unlikely to invest significant resources in a new regional arrangement unless its objectives are made explicit and hence the returns on their investment are clear."(Eichengreen 2002). The other is that from the practical point of view, the limitations include an incomplete backup facility and lack of effectiveness of surveillance and financing.

Therefore, the CMI is at a crossroad: to maintain it's symbolic essence; to be abolished along with diminishing interests in cooperation among member countries; or to progress forwardly by amending its current arrangement.

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[1] Various discussion can be found in recent literatures, such as, Kawai 2002, Kruda and Kawai 2002, Kawai 2004, Ito 2003, Ogawa and Kawasaki 2003, Oh and Park 2003, etc..

- The new impetus

The new impetus for the necessary amendment to the current CMI arrangement lies in the willingness of the member countries to increase the liquidity for bailouts when crisis occurs, the effectiveness and credibility of the arrangement, and to build up a platform and framework for high level policy dialogues and possible exchange rate cooperation in the medium- or long-term. In this context, the next move of the CMI is quite crucial in the sense that it will have a significant impact on the direction of the East Asian financial cooperation in the medium- and long-term.

Obstacles

- There is a need of concrete objectives of the CMI agreed by participating countries.

It is still not clear what objectives the CMI should focus: the stabilization of intra-regional exchange rates, or something else? Joint effort for crisis prevention in the region is ambiguous as the policy objective toward promoting economic integration in the region. Also, there is no clear vision on the scope and modality of financial cooperation through the CMI. In comparison with the European facilities, the CMI has had a different motivation from the beginning. The European facilities were created with the purpose of stabilizing exchange rates through a coordinated exchange rate mechanism. The CMI started with high capital mobility and flexible exchange rates, although some members of ASEAN+3 have maintained relatively fixed exchange rate regimes. Even now, the CMI does not presume any manifest exchange rate coordination (Eichengreen 2002).

- Although the objections from the outside region, such as the US and the IMF, to an East Asian self-help facility have softened, there are still uncertainties that are likely to be incurred by new moves.

Possible steps

Given the driving forces and obstacles mentioned above, the further steps might be pursued in two main areas:

- Institutionalizing the process of information exchange and policy reviews and dialogues.

This needs further discussions on technical measures that would be possibly undertaken. There are numbers of existing proposals, such as, a deeper involvement of central bankers in member countries with the ASRAN+3 process; establishing an ASEAN+3 Secretaries, or a surveillance unit. However regarding the modalities, no common agreement has been reached yet.

- Re-thinking the linkage with the IMF conditionality.

From the beginning of the CMI, some participating countries opposed the idea of linking the CMI with the IMF conditionalities and have proposed to increase the limit gradually and also to abolish the IMF linkage after a period of time. This needs a further discussion on two alternatives: to what extent that the linkage should be kept, and whether it's the right time to de-link completely. The response to this move from the IMF should be taken into account.

Fostering regional bond market

Driving forces

The driving forces behind this move are quite obvious, such as:

- The rapid development of intra-regional trade and investment requires a deepened and integrated regional financial market and well-established financial infrastructures.

- It can be a supplement to the CMI in assisting short-term financial liquidity to countries facing crisis, meanwhile the possible political and operational conflicts among member countries of the CMI can be avoided.

- The Asian financial crisis in 1997 indicated the fragility of the financial system in Asian countries: the over-dependence on bank-intermediated financing and huge foreign-currency denominated short-term financing. Developing regional bond market can minimize the problems of maturity mismatch and currency mismatch, at the same time reduce heavy dependence on the banking sector.
- It can be a help for recycling the accumulated substantial foreign exchange reserves in the region, as most of the reserves have been first invested in the developed markets, including the U.S. and Europe, and later recycled back to the region in a form of risky assets, such as equities and foreign direct investments.
- It can be seen as a first step for encouraging the use of local currencies in financial transactions.

Obstacles

- The main barrier for establishing a regional bond market is the fact that the domestic bond markets are underdeveloped and various types of capital controls exist in low-income countries.
- There are many technical issues needed to be solved among participating countries, which is hardly to be done overnight.

Steps

Some of the proposal gained a broad recognition, such as Korea proposed to undertake a full-scale discussion on the ways to develop a regional capital market under ASEAN+3 Finance Ministers' Meeting at the Informal ASEAN+3 Finance and Central Bank Deputies in 2002. In the ASEAN+3 informal session was held in Chiang Mai on 17 December 2002, Japan presented a comprehensive approach to foster bond markets in Asia, "Asian Bond Markets Initiative (ABMI)". Korea made a proposal for fostering an Asian Bond Market by using Securitization and credit guarantees. Thailand proposed creating securitized debt instruments that can be called "Asian Bond" and the establishment of an Asian Credit Guarantee Facility. Singapore also proposed the establishment of an Asian Credit Rating Board (Park 2003).

Given the need of regional bond market and the existing barriers, the roadmap of developing regional bond market would have two parts: one is to develop domestic market, especially in the countries where domestic markets are still at infant stages; the other is to build up a regional market, which would consist of well-designed and sequencing procedures. The Asian Bond Fund implemented in July 2003 was the first effort to foster regional bond market. It can be seen as a transitional stage, as none of local currencies involved and it's lack of secondary market. However, it is a necessary step, given constrains of usage of local currencies for the time being.

2. A plan in the medium-term

(1) Goals

- In the medium-term, a greater degree of intra-regional exchange rate stability is expected to be achieved;
- A regional liquidity supporting facility is expected to be established;
- A more sophisticated regional financial market, including money market and bond market, is expected to develop in order to facilitate the increasing intra-regional trade and capital movement.

(2) Driving forces

- Given the trend of trade and financial liberalization, the deepening of economic interdependence in the region requires supporting financial cooperation mechanisms for financial and economic stability.
- The prospective EU enlargement in Europe and the success of NAFTA and its prospective expansion to the FTAA would become a catalyst for Asian to move forward in shaping a "third economic bloc" in the world.

- The main barriers exist in the short-term, such as under-developed domestic financial market and various types of capital controls existing in lower income countries would be reduced in the medium-term, given that no severe economic or political crisis occur in the region. This will leave more room for further institutional cooperation at a regional level.
- Meanwhile, the facilities created in the previous stage would lead to the need of a regional coordinated exchange rate mechanism and a need of regional integrated financial market in which local currencies are expected to play dominant roles.

(3) Obstacles

The barriers for high-level financial cooperation in East Asia are as follows:

- The differences in culture, religion and political regimes will impeder the process or incur high cost in reaching a compromise among member countries for high degree cooperation, like exchange rate cooperation.
- Although the domestic economic and market conditions in low-income countries would be improved in the medium-term, the differences in the degree of economic development and economic system a cross the region will still exist, which could slow down the speed of achieving institutional arrangement at regional level.
- The formation of a leadership in the region, like Germany and France in Europe, will take a fair long time, which could be an uncertain element for making a mutual political commitment across the region in the medium-term.
- A transitional cost is very likely to be incurred by the shift from over-dependence on the US dollar in t he region.

When formulating national exchange rate policy, Asian economies have, up to now, focused on the bilateral rates between their local currencies and the US dollar. There are four main reasons: (1) Asian exports have been highly dependent on the US market for decades; (2) the creditworthiness of the US dollar has been supported by American political and military power; (3) highly developed, transparent, and open dollar-based financial markets in the US reduce the cost and risk of transactions; and (4) the US dollar is widely used as an international currency. Once a currency becomes a key currency, the inertia is likely to exist. It is the case for the US dollar in Asia. Therefore, there is a kind of transitional cost associated with the shift from one fixed regime (a dollar pegging regime) to another (regional common peg or stabilization mechanism), especially in the countries having less-developed financial market.

(4) Possible arrangements

- A regional bond market with local currencies involved is expected to be established.

By that time, a number of technical issues, such as legal basis, efficient systems of payment, clearing, settlement, depository services in regional trading center, and local rating agencies can be solved. This would accelerate the process of Asian currencies de-linking from the US dollar and lay a solid micro-base for fostering local currencies as regional vehicle currencies.

- It is possible to create an appropriate exchange rate stabilization mechanism within the region, such as a joint stabilization mechanism, like the previous EMS, or other form of a common basket regime.

Considering the diversity of the countries in the region, and the dominant role of the US dollar in the region, the common exchange rate arrangement would be more appealing if it is flexible enough to leave countries initially with sufficient independence in macroeconomic policy. It also requires a belief that unilateral exchange rate regimes can be improved upon through a collective system aimed at reducing intra-bloc exchange rate instability or the anchoring of price levels (Wilson 2002)

3. A Long-term vision

(1) Given that the goals in the short- and medium-term have been successfully achieved,

- A common currency union, or EA monetary union is possibly to create in the long-term.
- A united and single financial market providing is possibly to establish in the long-term.
- Free trade and free labor movement can also be realized in the region in the long-term.

(2) However, the long-term goals for financial architecture in East Asia will be increasingly politics-motivated, which needs a region-wide political commitment. Whether East Asian countries can reach there is yet to be seen.

(3) Whether the differences in the degree of economic development and economic and financial regimes in the region can be gapped in the long-term will be largely determined by whether the low-income member countries can catch up with the advanced member economies in the long-term. In this context, there is a long way to go for the countries that are far lagged behind in terms of economic development, and for the countries that have yet realized trade and financial liberalization.

4. China's perspective

(1) A brief look at China's current trade and investment ties with the rest of the world

Table 1: China's main trading partners (by the end of 2003)

Rank Dec., 2003	Trading partners (% of China's overall export and import)	Import from (% of China's total import)	Export to (% of China's total export)
1	Japan (15%) EU (15%)	Japan (18%)	USA (19%)
2	USA (14%)	EU (13%)	EU (17%)
3	ASEAN (9%)	ASEAN (12%)	Japan (13%)
4	Korea (8%)	Korea (11%)	ASEAN (7%)
5	Others (39%)	USA (8%)	Korea (5%)
6		Others (38%)	Others (39%)

Source: www.cei.org.cn

From Table 1, we can see that,

- By the end of 2003, China's largest trading partners were Japan and European union. The share of trade with these two partners was 15% respectively. The second largest trading partner was the USA, which accounted for 14% of China's overall trade volume. ASEAN and Korea accounted for 9% and 8% respectively.
- China's import was mainly from East Asian and European areas, among which, Japan was the biggest origin for China's import.
- The USA was China's main export destination country, which accounted for 19% of China's overall export. The EU accounted for a fairly high ratio, too.
- It appears that China's export still largely relies on the US market. The share of trade with the EU would not be neglected, too. However, if we take Japan, Korea and ASEAN together as one partner, the share of China's trade with it would overtake that of the USA and the EU.

Table 2: China's main investment partners (year 2003)

Rank Year 2003	Main sources of loans and FDI (% of China's total foreign capital actually used)	
1	HK SAR	(34%)
2	Japan	(9%)
3	USA	(8%)
	Korea	(8%)
4	Taiwan	(7%)
5	Singapore	(4%)
6	Others	(30%)

Source: www.cei.org.cn

- China's investment links with the rest of the world are mainly through FDI and loans. The other types of capital flows, such as equity, bond and many other long- and short-term capitals movement, are very limited in terms of size and scope, given the presence of capital control in China. Table 2 describes the major sources of China's FDI and loans in the year 2003. Apparently, China's capital inflow was mainly from East Asian economies, among which, HK was the dominant part in the composition of China's capital inflow.

In summary, although the US and European market takes a large share in China's external transactions, China's close link with other Asian economies in terms of trade and investment is a strong driving force for China to get involved with regional financial arrangement.

(2) China's potentials

- A peaceful rise of China will be a positive factor for regional integration and cooperation in East Asia, both economically and politically.
- An optimistic prediction is that China's high economic growth may sustain for another 10-15 years at the rate of about 7%, which will provide a considerable potential market for the region.
- China's entry of WTO will be a catalyst for China to be increasingly involved with the other Asian countries financially.
- The success of China's economic reform and opening up strategy is one of the key elements in determining China's role in regional financial cooperation. Currently, there are two major "uncertainties" in China's external economic policies, one is the change of RMB's exchange rate regime; the other is the process of capital account liberalization. These two factors are actually the institutional barriers for China to be more actively involved with the regional financial cooperation. Considering the fact that China has immature domestic financial market and less-competitive domestic financial sector, the shift of RMB's exchange rate regime and the liberalization of capital account will be proceed in a gradual pattern.

Conclusion

An EA monetary union has yet emerged on the horizon. This long-term objective needs a set of quantitative criteria met by the participating countries. In this sense, given the diversity and difference exist in the region in terms of economic development, religion, political regimes and so on, it is still a long way to go to achieve a monetary union in the region.

However, this does not impeder further steps towards closer regional financial cooperation. The possible amendment to the current CMI mechanism and the establishment of regional bond market would be the affordable first steps towards developing regional financial architecture and beginning the long path towards monetary integration.

The trade and investment ties are the fundamentals for the institutional arrangements in the region. In this sense, the development of regional financial market, a possible regional investment bank, and multilateral free trade arrangement would facilitate regional capital transactions and foster regional local vehicle currencies, which in turn tighten the economic linkage in the region.

A greater stable regional exchange rate arrangement is likely in the medium-term, which would be more appealing if it can allow participating countries to have sufficient independence in their macroeconomic policy at the initial stage.

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