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Background Paper

Can East Asia Emulate European Economic Integration?[*]

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Yung Chul Park[**]

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[**] Professor, Department of Economics, Korea University (ycpark@soback.kornet.net)

I. Overview

After a financial crisis broke out in Thailand in July, 1997 and started speeding to other East Asian countries, Japan proposed creation of an Asian monetary fund (AMF) as a framework for promoting financial cooperation and policy coordination in the region. A regional monetary fund, it was argued, would provide a means of defence, in addition to the IMF lending facilities, against future financial crises in East Asia. Although the proposal received a positive response from a number of East Asian countries, it was shelved at the objection of the U.S., EU, and the IMF. The AMF idea was revived again when the finance ministers of ASEAN states plus China, Japan, and South Korea (ASEAN+3) agreed on May 6 2000 in Chiang Mai, Thailand to establish a system of swap arrangements within the ASEAN+3 countries in what is known as the Chiang Mai Initiative (CMI).

Since then deputy financial ministers of the ASEAN+3 have negotiated the details of the initiative to produce a basic framework of the ASEAN Swap Arrangement (ASA) and Bilateral Swap Arrangements (BSAs) and Repo agreement among the thirteen countries. The framework was approved at the meeting of the deputies on November 7, 2000 in Beijing. A progress report on the CMI was then reported to the summit meeting of the thirteen countries two weeks later.

The CMI swap arrangements are designed to provide liquidity support for the member countries that experience short-run balance of payment deficits in order to prevent an extreme crisis or systemic failure in a country and subsequent regional contagion as occurred in the recent East Asian financial crisis.

Emergency support facilities such as the CMI, similar in nature to other regional and international "lender of last resort" facilities, are primarily for systemic purposes and as such would likely be used very infrequently. Since the intent of the CMI is to be proactive, there is a need to define a mutually agreed framework for inter country cooperation amongst the ASEAN and ASEAN+3, that can quickly and effectively implement emergency assistance at required levels when a need arises. Moreover, a group approach would ensure that any conditionality associated with the financial assistance would be consistent across countries.

II. The Chiang Mai Initiative (CMI)

The CMI has two components:

(i) an expanded ASEAN swap arrangement; and

(ii) a network of bilateral swap and repurchase arrangements among the thirteen countries.

In 1977, five ASEAN countries -- Indonesia, Malaysia, Philippines, Singapore, and Thailand -- agreed to establish an ASEAN swap arrangement (ASA) – a short-term liquidity support facility for the participating countries suffering balance of payment difficulties. In May, 2000, the ASA was expanded to include the five new member countries under the CMI and the total amount of the facility was raised to US$ 1 billion from the initial amount of US$ 200 million.

The currencies available under the ASA are the U.S. dollar, yen, and euro. The euro, yen and Euro LIBOR interest rates are used as the base rate for swap transactions. Each member is allowed to draw from the facility a maximum of twice its committed amount for a period not exceeding six months, subject to an extension for another period not exceeding six months.

The BSA is a facility for short-term liquidity assistance in the form of swaps of U.S. dollars with the domestic currencies of participating countries. The maximum amount of drawing under each of the BSAs is to be determined by bilateral negotiations. However, it is expected that disbursements to a member in need of liquidity assistance will be made in a concerted manner through consultation among the swap providing countries. One of these swap-providing countries will then serve as the coordinator for the consulting process. The BSA agreement allows an automatic disbursement up to 10 percent of the maximum amount of drawing. However, countries drawing from the facility more than the 10 percent are required to accept an IMF program for macroeconomic and structural adjustments. In this sense, the BSA is complementary to the IMF's financial assistance.

A number of the participating countries have expressed their reservation on the linkage of the BSA with the IMF conditionality and have proposed to increase gradually the 10 percent automatic draw down and also abolish the IMF linkage after a period of transition. For instance, Malaysia advocates complete independence of the CMI from the IMF. Severance of the IMF linkage requires creation of a regional surveillance mechanism for the CMI. At the fifth ASEAN finance ministers' meeting in April 2001 in Kuala Lumpur, however, there was consensus that the BSA should remain complementary and supplementary to IMF facilities until a regional surveillance system is brought into existence. The ASEAN ministers also agreed that "the terms and modalities of the BSA should take into account the different economic fundamentals, specific circumstances, and financing needs of individual countries". This agreement implies that the contracting parties of the BSA could deviate from the basic framework on setting terms and conditions of the swap agreements.

Participating countries are able to draw from the BSA for a period of 90 days. The first drawing may be renewed seven times. The interest rate applicable to the drawing is the LIBOR plus a premium of 150 basis points for the first and first renewal drawings. Thereafter, the premium is increased by an additional 50 basis point for every two renewal, but not exceeding 300 basis points.

The Repo agreement is also established to provide short-term liquidity to a participating member through the sale and buyback of appropriate securities. Basic features of Repo agreements are to be finalized through bilateral negotiations between the contracting parties. Securities of the Repo agreement are U.S. Treasury notes or bills with the remaining life of not more than 5 years and government securities of the counterparty country of the Repo.

The period of the Repo agreement is one week, but could be extended on the termination value date by agreement between the contracting parties. The minimum amount for each repo transaction requested is five percent of the total amount of the Repo agreement. In each Repo transaction, the buyer will be given a margin of 102 percent for U.S. Treasury notes or bills and 105 percent for government securities of the counterparty country.

III. Negotiations for the BSAs and Surveillance System

III-1 Progress

Since the ASEAN+3 summit meeting in November, 2000, Japan, China, and Korea have been negotiating BSAs with each other and with the ASEAN. Japan has been most active: it has concluded its negotiations with both Thailand and Philippines to establish a BSA amounting to US$3 billion respectively. Japan and Malaysia have agreed to add US$1 billion more to the initial amount of US$2.5 billion of the existing BSA between the two countries. With Korea, Japan has contracted a bilateral swap of US$2 billion. Korea has been negotiating with both China and Thailand for similar arrangements. China and Thailand are expected to conclude a BSA on the order of US$4 billion.

Among the ASEAN states, Singapore and Brunei have shown little enthusiasm from the beginning for the CMI, largely because they believe the BSAs with their neighboring countries will be one-way arrangements in which they will be asked to provide a large amount of liquidity in case of a crisis affecting the ASEAN region. However, Japan has made progress in bringing Singapore into the system by proposing a BSA that uses local currencies rather than the U.S. dollar. In fact, Japan has proposed a similar local-currency BSA with China which is equivalent to US$3 billion.

Indonesia has not shown any strong interest in negotiating BSA arrangements with other participating countries, because of its preoccupation with domestic economic issues and managing its huge foreign debts, not to mention of escalating political instability. Recently, Indonesian has indicated its intention to negotiate a BSA with

Japan, though it does not appear to place a high priority on contracting additional BSAs with other members of the CMI.

At present, the total amount of BSAs covering all 13 countries is estimated to be around US$20 billion. The maximum amount of money any individual country can draw varies a great deal. In the case of Thailand, the maximum is about US$ 6 to 7 billion, 10 percent of which can be drawn automatically (US$ six hundred to seven hundred million).

Given such a relatively small amount of liquidity available through the CMI, doubts have been raised as to whether the BSA system could serve as a credible and effective system of defence against speculative attacks in the future. Participants of international financial markets are not likely to be impressed with the amount of liquidity available and hence ignore the CMI, unless the ASEAN+3 are prepared to increase the number of BSAs and expand the swap amount of each BSA.

III-2 Monitoring and Surveillance

From the inception of the CMI, some of the member countries have opposed the idea of linking the CMI with the IMF program. Other members, in particular Japan and China, have argued for the importance of forging a cooperative relation with the IMF at an early stage of the CMI development to make it more credible. They have succeeded in persuading Malaysia and other opposing members to accept the linkage of the BSAs with the IMF conditionality as a temporary arrangement until a formal surveillance mechanism is put in place. Malaysia agreed to the IMF linkage with the condition of establishing a study group to examine the types of the monitoring and surveillance system the CMI would require to function as an independent regional financial arrangement.

Most participating countries agree in principle that the CMI needs to be supported by a surveillance system that monitors economic developments in the region, serves as an institutional framework for policy dialogues and coordination among the members, and imposes structural and policy reform on the countries drawing from the BSAs. The ASEAN+3 finance ministers agreed to organize a study group to produce a blue print for an effective mechanism of policy dialogues and economic reviews for the CMI operations at the ADB annual meeting in Honolulu on May 9, 2001. Japan and Malaysia were chosen to co-chair the group. The study group met in KL November 22, 2001 to discuss the report on possible modalities of surveillance prepared by Bank Negara Malaysia and the Japan's Ministry of Finance. However, the member countries could not reach agreement on the surveillance issues except for institutionalising the ASEAN+3 meetings of deputies for informal policy reviews and dialogues.

IV. Barriers to Financial Cooperation and Integration

East Asian policymakers who conceived the idea of the CMI would easily concede that the BSA system as it is currently structured has a long way to go before it can be accepted in the eyes of financial market participants as an effective mechanism of defence against financial crises. Although two years have passed since the system was established in May, 2000, the leaders of the CMI group have yet to produce an operational structure of the BSAs, in particular a monitoring and surveillance mechanism. And it is highly unlikely that they will do so any time soon.

In the absence of clear vision on the scope and modality of financial cooperation through the CMI, many financial industry experts have expressed their doubts as to whether any country facing an incipient crisis could draw from the BSAs they contracted with other members, and if they could, then how much liquidity would be available. Participating countries could refuse any further support exceeding the 10 percent automatic drawal. In particular, unless policy conditionality could be imposed on borrowing countries by a monitoring and surveillance institution, many participating countries are not likely to activate their BSAs for fear of losing what amounts to be their short-term loans.

Negotiations for additional BSA contracts and also the surveillance system will continue, but unless the deadlock over some of the pending issues on surveillance is broken, the future prospects of the CMI do not appear to be promising.

There are many economic, institutional, and political barriers to financial cooperation and integration in East Asia. A large number of empirical studies have shown that although the ASEAN+three by no means constitute an ideal group for an optimum currency area, compared to Europe they are as much qualified for a common currency as the members of the European union were in the 1970s and 1980s. These studies invariably point to a large increase in intra-regional trade in East Asia in recent years as a development conducive to financial and monetary integration in East Asia. Trade and investment liberalization has been the driving force behind much of the increase in intra-regional trade. This increase has in turn exerted the effects of synchronizing business cycles across East Asian countries, thereby producing economic conditions favorable for forcing a currency union in the region.

Against these trade and macroeconomic developments, financial deregulation and market opening have drawn East Asia away from regional financial integration. Financial liberalization throughout East Asia has brought many countries to establish closer linkages with international financial markets than before, but not with other individual country markets in the region. In contrast, however financial markets of European countries were much more integrated with one another in the 1970's and 80's than the markets of East Asian countries are at present. This difference suggests that financial market liberalization and opening may not speed up economic integration in East Asia.

Financial claims are all denominated in the U.S. dollar and the bulk of foreign lending and borrowing are intermediated through international financial markets in New York and London. As far as finance is concerned, therefore, gains from adopting a common currency in terms of lower transactions costs and foreign exchange risk may not be as large as they could be when regional financial markets are integrated. In particular, Singapore and Hong Kong, where a regional financial center is located, could lose a substantial portion of their incomes originating in the financial services industry.

As for institutional and political constraints on further expansion of the CMI, the most serious one has been that the thirteen countries have failed to articulate the ultimate objectives of the CMI arrangement, that is, whether the CMI is going to be fostered as a regional liquidity support program or as a building bloc for a full-fledged regional monetary system in East Asia. If bilateral swap arrangements are activated collectively and supported by a surveillance system, then they constitute a de facto regional monetary fund. The CMI could then be used as the base on which an elaborate system of financial cooperation and policy coordination is built by following the footsteps of the European monetary integration. At this stage of development, many countries in East

Asia are not prepared to accept the idea of or may feel uneasy about restructuring the CMI to make it a forerunner of the AMF.

A second institutional reason is related to the need to coordinate the activities of the CMI with other regional arrangements such as the Manila framework supported by the U.S., Australia, and New Zealand. Most of the CMI countries also participate in the Manila framework and APEC regional arrangements. At some point in future, the leaders of the ASEAN+3 may have to decide on the mode of cooperation and division of labor in promoting regional growth and stability between these institutions and the CMI. All thirteen countries have been engaged in policy review and dialogues through the APEC sub arrangements and the Manila framework. Unless the CMI is developed into a credible financing mechanism by increasing swap amounts, it will become in its role similar to other regional economic arrangements. This change will then weaken the coherence of the group as it will raise the question of whether the thirteen countries constitute an appropriate grouping for a regional financing arrangement in East Asia.

A third reason is that as the fear of another round of financial crisis has receded with the recovery that has been faster than previous episodes of crisis would predict the ASEAN+3 countries have become less interested in enlarging and institutionalising the CMI operations. Instead, interests of the ASEAN+3 have recently shifted to creating free trade areas in East Asia. The ASEAN states have already agreed to establish a free trade area among themselves. Japan has concluded a free trade agreement with Singapore and proposed negotiations on a similar agreement with Korea. China has indicated its interest in negotiating free trade with the ASEAN and other neighbouring countries.

The free trade movement is undoubtedly a desirable development, and the CMI could facilitate further liberalization of trade by stabilizing bilateral exchange rates of regional currencies and by minimizing the disruptive effects of financial market turbulence. This advantage suggests that the ASEAN+3 may have incentives to broadening the scope of the CMI in parallel with negotiations on establishing free trade areas in the region. In reality, however, it appears free trade discussions have detracted many East Asian countries from rather their CMI negotiations.

Finally, there is the leadership issue that defies an easy solution. If the thirteen countries have a more ambitious goal of developing a collective exchange rate mechanism similar to the ERM with the long-term objective of adopting a common currency for the CMI group, they will have to increase the number and amounts of the BSAs. As the European experience shows, such an extension requires leadership that could keep the thirteen countries as a coherent group by compromising different interests of different members.

China and Japan, which are expected to provide lendership in forging regional support for expanding and consolidating the BSAs as a regional institution, have not been able to agree on a number of operational issues including the surveillance mechanism. Except for Japan no other potential swap lenders including China are prepared to increase the amounts of their bilateral swaps with other contracting parties. Japan could increase its swap amounts with the ASEAN states and Korea (China is not expected to borrow from Japan) to make the CMI more credible financing scheme. However, unless Japanese authorities receive some sort of assurance that their short-term lending will be repaid, they are not likely to lead expansion and institutionalisation of the CMI. As a minimum condition for expansion of the CMI, Japan would demand creation of an effective surveillance mechanism for the region in which it can exercise its influence commensurate with its financial contribution. China feels that it cannot play second fiddle to Japan in any regional organization in East Asia. This stalemate appears to be the most serious roadblock to further development of the CMI.

China and Japan have different interests in and hence different strategies to economic integration in East Asia. As far as China is concerned, economic integration with the ASEAN 10, South Asian and central Asian countries may be more important both economically and geopolitically than, or take precedence over financial cooperation or free trade with either Japan or South Korea. While China is a super military power, it is still a developing economy with a huge gap to narrow in terms of technological and industrial sophistication vis-à-vis Japan. Although China has been growing rapidly, it has a long way to go before catching up with Japan. These differences in the economic and military status of the two countries may suggest that China and Japan may, even when they could reconcile their troubled historic past, find it difficult to work together as equal partners for regional integration in East Asia.

China borders with Russia and many of the South Asian and central Asian countries in addition to several ASEAN members. It is natural therefore for China to seek expansion and deepening of its trade and financial relations with these neighboring countries. In fact, for this reason, China has been courting the ASEAN for a free trade agreement and joined in November of 2001 the Bangkok agreement on a free trade area which includes Russia and the South Asian countries. China has also taken a leading role in establishing the Shanghai cooperation organization, a cooperative arrangement among Russia, Kazakhstan, Kyrgyzstan, Tajikistan, and Uzbekistan and China.

In contrast, Japan has not been able to articulate its strategic interests in East Asia. Japan has been in the forefront of supporting a greater economic cooperation among the East Asian countries, but the geographical contiguity of East Asia from the Japanese perspective has not been altogether clear. Japan has been promoting integration among the ASEAN+5, but which are the two countries added to the ASEAN+3? At one point, the five countries were China, Japan, Korea, Australia, and New Zealand. At another, Australia and New Zealand were replaced by Taiwan and Hong Kong.

There is also the suspicion that Japan is not interested in free trade per se in East Asia; instead Japan is engaged in the discussion of free trade agreements and other financial arrangements with other East Asian countries to maintain its leadership role as the region's largest economy by countering China's expansion. Many analysts believe that Japan's active involvement in regional economic integration is therefore motivated by its desire to maintain its traditional pole position.[1] On top of this suspicion, Japan is perceived to be a country insensitive to and unwilling to resolve wartime legacies and disputes on historical and territorial claims. Japan has also been gripped with a decade long recession and unable to restructure its economy. These developments have

[1] See David Wall, "Koizumi Trade Pitch Nests", the Japan Times, April 21, 2002.

combined with the lack of its strategy to East Asian development to undermine Japan's ability to pull East Asian countries together for regional cooperation and integration.

V. Prospects

What are then the likely courses of development of the CMI? How would regional financial integration proceed in East Asia? One possible scenario is that China and Japan may come to realize that despite the differences in their strategies consolidation of the CMI group would serve their interests. This realization could soften their positions to compromise on an institutional setting and augmentation of the existing BSAs. For instance, China may accept Japan's demand for its de facto control over the monitoring and surveillance in return for Japan's pledge for a substantial increase in financial assistance in the form of one-way swaps and ODA to ASEAN members. China could agree to this scheme, if it is confident about concluding a free trade agreement with the ASEAN members in the near future. China's free trade pact with the ASEAN could circumscribe Japan's influence on ASEAN affairs even if Japan is a major provider of finance to the region.

Another scenario focuses on the possibility of China assuming a more aggressive leadership role in regional integration. China may choose to negotiate both the expansion of the BSAs and a free trade pact with the ASEAN. In this case, the original CMI will become ASEAN+one. Realizing that financial integration is an integral part of a successful free trade area, China may indeed seriously consider this option. However, without Japan, the ASEAN+one will not be a viable arrangement for a regional financing scheme simply because China is hardly in a position to commit itself to financing balance of payments deficits of all ASEAN member states. It is also questionable whether the ASEA will join any regional financial arrangement in which China is going to be the dominant member.

A third scenario is the enlargement of the CMI members by including Australia and New Zealand and possibly other countries from South Asia. This is the one favoured by Japan in the sense that Japan will find it easier to deal with China when there are more countries supporting Japan's strategy. However, many members of the ASEAN+3 believe that at this stage forming a critical mass of the CMI should precede any enlargement discussion. Since the enlargement is not likely to increase substantially the availability of short-term financing, the third scenario is not expected to be taken seriously.

Perhaps the most realistic scenario is that the countries participating in the CMI will muddle through, discussing continuously modalities of policy dialogue, the types of the surveillance system the CMI needs, and also augmentation of swap amounts without making any substantial progress. However, a possible breakthrough may come over the next two years during which economic consequences of European monetary unification will be better understood. The enlargement of the EU in 2004, when eight central and East European countries are expected to be admitted, will also have a large impact on the thinking of East Asian policymakers on regionalization in East Asia. If the members of the European monetary union make smooth adjustment to the single currency and the EU enlargement proceeds as planned, then these developments will give a strong impetus to East Asian integration.