Advances in Social Science, Education and Humanities Research, volume 290
2nd International Conference on Economic Development and Education Management (ICEDEM 2018)

Regional Financial Integration in East Asia: Challenges and Prospects

Chunli Yin*
School of Business management, Tonghua Normal University
Tonghua, China
E-mail: *dbcy9999@163.com

***Abstract*—The adoption and implementation of the CMI can be counted as a major step in strengthening financial cooperation among thirteen East Asian countries. However, ASEAN+3 will face much tougher challenges and tasks in exploring developments beyond the CMI. The East Asian countries need to explain what their motivations are, how they will develop an action plan, and how they believe the plan is in line with the existing global financial system to international community.**

Keywords—Regional financial; Integration; East Asia; Slow Progress

I. INTRODUCTION

The large currency crises of the past decade have been regional in nature. This feature of financial crises suggests that neighboring countries have a strong incentive to engage in mutual surveillance and to extend financial assistance to one another in the face of potentially contagious threats to stability. Regardless of whether the sudden shifts in market expectations and confidence were the primary source of the Asian financial crisis, foreign lenders were so alarmed by the Thai crisis that they abruptly pulled their investments out of the other countries in the region, making the crisis contagious. The geographic proximity and economic similarities (or similar structural problems) of these Asian countries prompted a blanket withdrawal of foreign lending and portfolio investment, with differences in economic fundamentals often being overlooked. If the channels of contagion cannot be blocked off through multilateral cooperation at an early stage in a crisis, countries without their own extensive foreign reserves will not be able to survive independently. Hence, neighbors have an interest in helping put out a fire (a financial crisis) before it spreads to them.

II. REGIONAL FINANCIAL INTEGRATION IN EAST ASIA

But as long as a crisis remains confined to a specific country or region, there is no urgent political need for unaffected countries to pay the significant costs associated with playing the role of firefighter.

The formation of a regional financial arrangement in East Asia reflects in part frustration with the slow reform of the international financial system. The sense of urgency concerning reform of the international financial architecture has receded considerably in the G-7 countries. The slow progress has been further complicated by the perception that the current international architecture is defective. The lack of global governance, including a global lender of last resort and international financial regulation, is not likely to be remedied anytime soon. As long as there continue to be structural problems on the supply side of international capital–such as volatile capital movements and exchange rate gyrations of the U.S. dollar, the euro, and the yen–the East Asian countries will remain as vulnerable as ever to future crises. It is thus in the interest of East Asians to work together to create their own self-help arrangements. The Chiang Mai Initiative (CMI) of the Association of Southeast Asian Nations plus Japan, China, and the Republic of Korea (ASEAN+3)[1-2]is one such available option. However, it is equally important that individual East Asian countries continue to undertake financial sector restructuring and development. Without sound financial institutions and adequate regulatory regimes, Asian financial markets will remain vulnerable to external shocks. Regional policy dialogue should also contribute to strengthening the efforts to restructure and advance the development of financial markets in East Asia. The CMI has emerged as a regional forum for policy dialogue and also for concerted regional efforts at financial reform in the region.

Three pillars – liquidity assistance, monitoring and surveillance, and exchange rate coordination–are essential for regional financial and monetary cooperation. However, the development of this cooperation and its related institutions will follow an evolutionary path, as was the case with European monetary integration. A shallow form of financial cooperation may comprise no more than a common foreign reserve pooling or mutual credit arrangements such as bilateral swaps. In other words, some kinds of shallow financial cooperation are conceivable without any commitment to exchange rate coordination, under which the exchange rates of participating countries would be pegged to each other or would vanish through the adoption of a common currency. The East Asian countries presently appear to be pursuing this form of financial cooperation. [3-7]

Although a full-fledged form of monetary integration is not viable at this stage, East Asia may begin to examine the feasibility and desirability of cooperation and coordination in exchange rate policies.

Evidently, there is a rising sense of East Asian identity today. After the proposal to create an Asian monetary fund was aborted, the leaders of ASEAN responded by inviting China, Japan, and the Republic of Korea to join in an effort to build a regional mechanism for economic cooperation in East Asia. The ASEAN+3 summit in November 1999 released a Joint Statement on East Asian Cooperation that covers a wide range of possible areas for regional cooperation. Recognizing the need to establish regional financial arrangements to supplement the existing international facilities, the finance ministers of ASEAN+3 at their meeting in Chiang Mai, Thailand, in May 2000 then agreed to strengthen the existing cooperative frameworks in the region through the Chiang Mai Initiative.

The purpose of this paper is to examine the current process and future prospects for regional financial and monetary cooperation in East Asia. More specifically, it sketches an institutional design for a regional financial architecture encompassing the three major pillars (liquidity assistance arrangements, policy dialogue and surveillance, and exchange rate coordination). Through an evolutionary process of enlargement and consolidation of the CMI, this study envisions the creation of an Asian monetary fund that is fully equipped with liquidity support facilities and a monitoring and surveillance mechanism. The paper does not, however, contemplate any manifest collective exchange rate coordination under the ASEAN+3 framework.

The paper is organized as follows: The following sections successively discuss the economic rationale for a regional financial arrangement in East Asia; developments in the Chiang Mai Initiative; and major barriers to financial cooperation and integration in East Asia.

III. Economic Rationality for a Regional Financial Arrangement in East Asia

The 1997-98 Asian financial crisis brought home the need to create a regional mechanism of defense against future crises in East Asia. However, other events have also encouraged the regional integration movement. This section discusses some of these developments as background for an examination of whether they can maintain the momentum for enhanced regional cooperation and lead to financial market integration and monetary unification in the long run. Trade Integration and Stability of Bilateral Exchange Rates Since the early 1990s, many of the East Asian countries have made sustained efforts to deregulate and open domestic markets, including financial markets, to foreign competition. As a result of market orientation and trade liberalization, East Asia has seen a large increase in intraregional trade and investment. In terms of imports, intraregional trade in East Asia (among the ASEAN+3 countries and Taiwan Province of China) accounted for 46 percent of the region’s total trade in 2001, when the entire region was still recovering from the crisis. There is every indication that this trend will continue.

Financial liberalization and market opening has also contributed to both regional and global integration of financial markets in the East Asian countries. And there is growing awareness that further integration of intraregional trade in goods, services, and financial assets will call for stabilization of the bilateral exchange rates for East Asian currencies. With deepening in regional trade integration, East Asia is bound to lose disproportionately more than other regions from trade disruptions caused by currency crises. Stability of bilateral exchange rates would also facilitate and increase the benefits of capital mobility in the region.

In the aftermath of the East Asian crisis, the flexible exchange system became the accepted norm in the new international financial architecture. The new consensus, however, did not last very long. Williamson and Frankel argue that intermediate regimes such as the “basket, band, and crawl” system are more likely to be appropriate than “two-corner solutions” for many emerging market economies (EMEs). In particular, Williamson advocates several intermediate regimes with soft margins. Fischer suggests that developing countries that are not exposed to capital flows could choose from a wide variety of intermediate regimes and that flexible exchange rate systems suitable for EMEs could include crawling bands with wide ranges.

If East Asian countries find it desirable to follow some type of intermediate regime, a case can be made for creating regional financial cooperative arrangements that could help stabilize bilateral exchange rates in the region. Although the ASEAN+3 authorities have no plans for transforming the CMI into a monetary union, the East Asian countries could use the CMI as a framework for developing an East Asian common currency area in the long run, after a transition period during which a mechanism for the coordination of exchange rate policies would be established.

The IMF and Capital Account Crisis Management A 2003 International Monetary Fund (IMF) report makes it clear that East Asia suffered a capital account crisis in 1997 and 1998, which required a management and resolution strategy different from the traditional IMF recipe for crises originating from current account deficits. A large increase in capital flows into some of the East Asian countries set off an asset market boom and a precipitous increase in the current account deficit, thereby making these countries vulnerable to speculative attacks. The perception of vulnerability of these countries triggered a sharp and large capital outflow, which was further aggravated by the panic and herding behavior of foreign investors. Once the dollar peg became indefensible, the value of the currencies plummeted. Many banks and corporations with balance sheet mismatches could not service their foreign-currency-denominated debts and eventually became insolvent. A sharp contraction in the level of output then followed.

The crisis resolution strategy of the IMF was twofold. First, it imposed tight monetary and fiscal policies with the aim of stabilizing the exchange rate and generating current account surpluses by contracting domestic demand. These policies, together with weak currencies, were expected to help lure back foreign investors. Second, the IMF required the crisis countries to undertake a wide range of reforms in the corporate, financial, and public sectors to strengthen the structural foundation of their economies. These reforms were intended to help the affected countries return to the pre-crisis path of robust growth; they were also viewed as critical to restoring international lenders’ confidence in their economies.

Once the crisis broke out, output contraction and the turbulence of foreign exchange and other financial markets in one country were rapidly transmitted to other economies in the region through trade and financial market linkages. Pronouncements by international financial institutions, including the IMF and policymakers from the G-7 countries, that the crisis countries had serious structural problems in their financial, corporate, and public sectors did little to inspire confidence in these economies.8 Indeed, to some extent the IMF crisis management program actually helped fuel contagion of the crisis.

At this writing nine years after the crisis, assessments of the success of the structural reforms are mixed. A 2001 World Bank report continued to argue that progress on structural and institutional reforms remained key to retaining confidence and resilience to shocks in East Asia.9 One lesson of the Asian situation is that when a crisis in a country originates in the capital account, policy coordination or at least policy dialogue and review among neighboring countries is essential to prevent contagion of the crisis. Another lesson is that an appropriate response to a capital account crisis is to serve notice to international financial markets that the country in crisis is prepared to supply−either by itself or in cooperation with regional or global financial institutions, including the IMF− as much liquidity as it takes to thwart an impending speculative attack.

These lessons clearly suggest that regional financial cooperative arrangements such as the CMI could complement the role of the IMF in managing a capital account crisis. In the absence of policy dialogues and exchanges of information among neighbors, individual countries may not be able to find the causes of large changes in capital flows and exchange rates, or more important, respond to the crisis if it spreads. An efficient regional policy coordination mechanism will help monitor and make necessary policy adjustments in response to changes in market expectations. Even smoothing out high-frequency movements in the nominal exchange rate in individual countries may have to be coordinated at a regional level in order not to send wrong signals to foreign exchange markets. Unless the countries in the region maintain close working relationships in coordinating policies and exchanging information, they will not be able to make a prompt assessment of the nature of the crisis and mount a quick response.

The IMF could monitor capital flows within and between regions and also the behavior of market participants. But given its narrow mandate and its small staff, the IMF may not have either the institutional or the professional capacity to keep track of developments in the financial markets of all of its member countries. Since the Fund obtains most of its macroeconomic and market information from the authorities of member countries, its ability to prescribe preventive measures to countries vulnerable to the crisis may be limited. At best it can serve as a lender and as a crisis manager. However, the Asian experience demonstrates that the crisis management ability of the IMF is severely constrained.

At the time of the crisis, the CMI countries as a whole held about U.S.$700 billion in foreign reserves. The total financing required from the IMF, other international financial institutions, and a number of donor countries to restore financial stability in Indonesia, the Republic of Korea, and Thailand amounted to U.S.$111.7 billion. If the IMF had been ready to supply a large amount of liquidity to the crisis countries, or if the thirteen countries had established a cooperative mechanism through which they could pool their reserves to assist other countries in need of financial support, they could have nipped the Thai crisis in the bud and minimized its contagion by supplying only a small fraction of their total reserves. In view of the large loss of output and the fall in employment in the region, such a cooperative response would indeed have been desirable.

Inasmuch as East Asia suffered a liquidity crisis, compounded by the panic and herding behavior of foreign investors, a more effective IMF crisis management strategy−instead of tightening monetary and fiscal policy−would have been to supply a large amount of short-term financing to replenish foreign exchange reserves at the first sign of a speculative attack. Such a strategy could have stopped the spread of the crisis and the ensuing slump throughout the region.10 At the time of the crisis, there were neither regional nor global lenders of last resort to deal with the bank-run problems that East Asian countries were facing. With its limited financial resources, the IMF could not manage the East Asian crisis by itself; it had to enlist the financial support of the G-7 and other countries. This situation is testimony that, as a global institution, the IMF would be more effective in resolving crises if it established cooperative relations with its regional counterparts and hence encouraged the development of regional financial mechanisms.

Once established, an East Asian monetary fund could serve as an institution complementary to the IMF by providing additional resources and by working with the Fund to prevent and manage financial crises. It could also support the work of the IMF by monitoring economic developments in the region and taking part in IMF global surveillance activities. As Henning notes, it is difficult to assess ex ante whether resources supplied through regional financial arrangements are really additional to those supplied by the international community. The “additionality” problem arises in principle whenever there are multiple sources of finance and conditionality, yet it appears to have been managed successfully in numerous historical cases. Potential conflicts can be avoided through consultation and coordination, which may be provided in part by the United States and the East Asian governments.

IV. Limited and Slow Progress in International Financial Reform

One of several developments that have reinforced regionalism in East Asia has been slow progress in the reform of the international financial system. The need for reform is no longer so urgently felt in the G-7 countries, despite the economic collapse of 2001-02 in Argentina and the growing trade imbalance between the United States and East Asia. The slow progress has been further compounded by the perception that none of the many proposals for a new architecture may be effective in sustaining global financial stability. In particular, as long as the structural problems on the supply side of international capital markets are not addressed, the East Asian countries fear that they will remain as vulnerable to future crises as they are now.

Griffith-Jones and Ocampo show that there has been no international reform agenda acceptable to both developing and developed countries. The 2002 Monterrey Consensus produced a new international agenda, but it is not altogether clear whether the new agenda will be put into action. Some of the progress that has been made is asymmetrical in the sense that the reform has focused on strengthening the financial and corporate sectors of developing and emerging market economies instead of rectifying imperfections in international capital markets. Some of the advances in the new architecture have also been jeopardized by the growing reluctance of developing countries to support large IMF financing. Finally, it should be noted that developing countries have been largely excluded from the key institutions and forums involved in international financial reform.

It is natural that many emerging market economies, faced with the uneven and slow process of the reform, would consider developing their own mechanisms of defense against future financial crises. One such defensive measure is the CMI in East Asia. Instead of waiting until the G-7 creates a new architecture– whose effectiveness would be questionable, at best–the East Asian countries have taken the initiative of working together to create their own system of defense, and have fortified themselves by accumulating large amounts of reserves to deal with sudden and unexpected capital outflows.

V. Accumulating Reserves: A War Chest or Insurance?

Many developing and emerging market economies, in particular those in countries that have fallen victim to financial crises, have taken recourse to amassing foreign reserves as a defense against future crises. Before the onset of capital account liberalization in the early 1990s, foreign currency reserves were held mainly for transactions purposes. The rule of thumb was to hold reserves in an amount equivalent to imports for three to four months. This implicit rule appears to be no longer acceptable. In order to meet the increased volume of their capital account transactions, but above all in order to build a war chest large enough to stave off future speculative attacks, many East Asian emerging market economies have accumulated large amounts of reserves.

For example, at the end of 2005, the volume of reserves as a share of GDP in the Republic of Korea was almost 27 percent, which was more than four times the level in 1996. Similar developments have taken place in other crisis-hit parts of East Asia (see table 8-2). In Taiwan Province of China, the ratio of reserves to GDP almost doubled between 1996 and 2005. The ratio climbed to 54 percent at the end of 2005 from about 20 percent in 1997 in Malaysia. Although reserve accumulation has been relatively modest in both Thailand and the Philippines, these countries have added almost 10 percentage points to their ratios since the end of 1997. The thirteen East Asian countries that constitute ASEAN+3 held collective foreign currency reserves estimated at more than U.S.$2.5 trillion at the end of 2005. By any measure, this level is excessive and costly, and it represents a clear case of misallocation of resources. If these reserves are pooled, a mere 10 percent of the total would be sufficient to provide a formidable line of defense against any future crises.

Their capital account transactions to a considerable degree since the 1997 crisis. However, the shift to floating rates and participation in international financial markets over the past five years has not reduced their reserve holdings relative to their output, largely because capital flows have been unstable and capital account liberalization has not improved their access to international capital markets.

VI. Conclusion

Regionalism in East Asia is taking two forms: free-trade arrangements and financial arrangements. These arrangements imply that geographically proximate countries band together to foster trade on the one hand and to promote financial and exchange rate stability on the other. The two processes reinforce each other. The euro area pursued trade integration first, but from a theoretical point of view there is no clear reason for this. Even in Europe, trade integration slowed down whenever there were concerns about exchange rate stability among member countries, which suggests that some form of monetary integration is an important condition for trade integration.45 Furthermore, there are many good reasons for forming a monetary union before establishing a free-trade arrangement. A monetary union can quite significantly increase trade among member countries by serving as a means of avoiding the bottlenecks that may occur in the process of negotiating and implementing a free-trade arrangement. This increased trade is likely to occur mostly within similar industries, so weakening asymmetric shocks across member countries will also decrease the costs of maintaining a monetary union. In addition, a monetary union can accelerate financial integration in the region, which might not be accomplished otherwise. Hence, a monetary union is a self-validating process.

Acknowledgment

This research was supported by Research Foundation of Education Bureau of Jilin Province (Grant No.JJKH20170444SK).

References

[1] ASEAN+3. 2005a. “Report of the Review of the Chiang Mai Initiative: Ways of Enhancing Its Effectiveness.” ASEAN+3 Finance Ministers Meeting, Istanbul, Turkey.

[2] ASEAN+3. 2005b. Joint Ministerial Statement of the 8th ASEAN+3 Finance Ministers’ Meeting, Istanbul, Turkey.

[3] Bayoumi, T., B. Eichengreen, and P. Mauro. 1999. “On Regional Monetary Arrangements for ASEAN.” Paper prepared for the ADB/CEPH/KIEP Conference on Exchange Rate Regimes in Emerging Market Economies, Tokyo, December 17-18.

[4] Bergsten, C. Fred, and Yung Chul Park. 2002. “Toward Creating a Regional Monetary Arrangement in East Asia.” ADBI Research Paper. Tokyo: Asian Development Bank Institute.

[5] Carstens, A. 2001. “The Mexican Experience with Managing Foreign Exchange Reserves.” Presentation at a seminar on foreign exchange reserve management at the IMF-World Bank Annual Meetings. Washington.

[6] Council on Foreign Relations, Task Force Report. 1999. Safeguarding Prosperity in a Global Financial System: The Future International Financial Architecture, Carla A. Hills and Peter

[7] G. Peterson, chairs; Morris Goldstein, project director. Washington: Institute for International Economics.