Toward a Regional Financial Architecture
for East Asia
Executive Summary

- Six years after the East Asian Financial Crisis, several regional facilities have been put in place in concerted effort to prevent another crisis and promote regional financial stability. In an effort to reduce the risks of another regionwide economic crisis, governments in the region are increasing the level of cooperation among themselves. This, in turn, has increased the level of economic integration in the region.

- Despite the increasing cooperation, there are still some critics toward the effectiveness of the current agreement among countries in the region to really minimize the effect of speculative attacks once they occur. This has given rise to the question of what approach the countries in the region should take in strengthening financial coordination in the region that can reduce further the negative impacts of speculative attacks and prevent a regionwide economic crisis.

- There are some claims that the level of financial integration in the East Asia region is comparable to that in the Europe and in the North America. And consequently, the East Asian economy should pursue the European-type economic integration (that is a single currency). This study finds that as the ASEAN+3 countries have become more open toward trade, the international financial integration is taking place in the region. Nevertheless, this study suggests that the financial integration in the region is still far behind the Europe region prior to the unification.

- Four indicators are utilized to asses the financial integration in the region: indicators of credit and bond market integration; indicators of stock market integration; indicators of integration based on economic decisions of households and firms; and indicators of institutional differences that may induce financial market segmentation. For example, the study finds that credit and bond market integration in the region is still low, and significantly lower than that in the Europe prior to the unification. In addition, based on indicators of integration based on economic decisions of households and firms, the study confirms that the ASEAN+3 is not as integrated as the EU was in the 1990s, prior to the formation of the single currency. And the ASEAN+3 countries need around 10 more years (this is a rough estimation assuming that the current trend does not change) to become as integrated as the EU countries prior to the formation of the single currency. However, we believe faster convergence may be reached if ASEAN+3 undertake more drastic measures to facilitate further economic integration. Nevertheless, institutional differences among countries in the region (such as the legal system, the tax system, and the corporate government arrangements) may slow down a further financial integration process.
- The current relatively low (compared to that in the EU countries) economic integration level in the East Asian countries, however, should not deter the region from pursuing a deeper economic integration. Whether the East Asian region should pursue deeper financial integration, by setting up a regional financial arrangement should be determined by the benefits and the costs of further integration in the region. Only if there are sufficient benefits for countries in the region should deeper economic integration be pursued (by forming a regional financial arrangement). With support from the political process, deeper integration in the Asian Region, as in Europe, is attainable, regardless of the initial level of integration in the region. The political process is the most important factor in the success of deeper financial integration. Please remember that the guiding principles of the EMU have always been political rather than economic. That is, initially, it is political reasons that have been the main drive for the unification process in Europe.

- A regional financial arrangement will bring the following benefits, among other things, to the country in the region:
  o Reducing the risk of a region-wide economic crisis as in the 1997 Asia crisis
  o Improving the Current Global Financial System
  o Stabilizing Bilateral Exchange Rates of Regional Currencies
  o Create a more equitable international monetary system

- However, the success of a new regional financial architecture may be limited if there is no improvement in domestic financial conditions in individual East Asian countries. As such countries in the region should also reform their domestic financial system, in particular, they should:
  o Strengthen the domestic financial system
  o Improve transparency, market discipline and corporate governance
  o Conduct sound macroeconomic policies
  o Create prudential regulation of the capital account

- There are already initiatives to improve regional financial cooperation. However, there is lack of coordination between those initiatives. The next logical step to further increase the financial cooperation in the ASEAN+3 counties would be to merge all currently disintegrated financial process in the region under one coordinator, the ASEAN+3 Secretariat. The ASEAN+3 secretariat should utilize the already existing effective ASEAN secretariat infrastructure. There are conceivably four main pillars for the expected ASEAN+3 framework, which are:
- The East Asian Stabilization Fund (EASF):

The East Asian Stabilization Fund (EASF) would act as a regional-based financial institution that provides liquidity support to countries that are hit by financial crises.

- Technical Assistance and Consultancy (TAC):

This technical assistance unit is basically a research and development division, consisting of policy-oriented researchers in the region. This unit has a role in organizing training programs and developing financial standards and codes suitable for the special circumstances of East Asian countries.

- Central Bank Forum (CBU)/East Asian Monetary Institute (EAMI):

One of the roles of the Central Bank Forum is to make the cooperation of monetary policy and the coordination of the CMI BSAs easier and better coordinated. Over time, the creation of a formalized forum of central banks within the ASEAN+3 process would gradually facilitate more effective cooperation in the areas such as reserve pooling, macroeconomic policy coordination and other financial cooperation aspects.

- ASEAN+3 Surveillance Unit (APTSU):

All surveillance activities in East Asia currently conducted by several parties should be conducted by a new body called the ASEAN+3 Surveillance Unit (APTSU). The main task of the unit would be to monitor the macroeconomic status of member countries, including the structural, trade and investment policies, and assessment of financial risk and soundness of financial institutions. In the future, the task of the APTSU may be extended further in line with the increasing degree of integration in the region. The unit should also develop an early warning system that could detect possible occurrence of economic problems in any country in the region, so that it can give a timely recommendation to minimize the impact on the region.

- Within the proposed framework, the ASEAN+3 secretariat would work closely with the ASEAN+3 ministerial level decision-making council. This commission is one of the institutions that would work under the ASEAN+3 secretariat management. The council may involve not only finance ministers and central bank governors (or senior representatives of national treasuries of central banks) of member countries but also capital market and other financial regulators.

- Also of importance is that the regional cooperation should be based on the banner of multilateralism. This kind of construction is based on the reality that the risk of contagion needs the international lender of last resort (the International Financial Institutions (IFIs)) as the size of the rescue packages
has dramatically increased lately. It should have a strong linkage with the IFIs such as the IMF, World Bank, FSF and the BIS. As such, the regional arrangement must follow the implementation of governance and accountability according to the international codes and standards. This regional cooperation through more intensified surveillance will, in turn, contribute to the global financial stability.

- With the ASEAN+3 secretariat in place, it will be easier to coordinate should it opt to pursue a regional exchange rate arrangement. This will be especially true given that the region would already have a clearly defined surveillance procedure, which will make it easier to standardize good practices to target commonly agreed economic indicators. Learning from the European experience, a commonly agreed analysis by strong and independent institutions would be very effective in reinforcing peer pressure to adopt certain policy measures.

- In the long run, the new regional financial architecture should enhance intra-regional trade, promote peace and stability, raise the living standards of the region’s people, and strengthen the regional economies. To achieve this, the region should take and sequence the necessary steps (setting up the ASEAN+3 secretariat, create free trade between member states, create common external tariffs, and create common market).
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Chapter 1
Introduction

Six years after the East Asian Financial Crisis, several regional facilities have been put in place in concerted effort to prevent another crisis and promote regional financial stability. For example, to provide liquidity support for countries balance of payments problem, a network of bilateral swap arrangements is being established among ASEAN countries, China, Japan, and Korea. Furthermore, exchanges of views among senior finance and central bank officials on recent macroeconomic and financial developments and policies have been conducted regularly through the ASEAN+3 framework. Furthermore, regionwide trade liberalization is also being considered. In short, in an effort to reduce the risks of another regionwide economic crisis, governments in the region are increasing the level of cooperation among themselves. This, in turn, has increased the level of economic integration in the region.

Despite the increasing cooperation, there are still some critics toward the effectiveness of the current agreement among countries in the region to really minimize the effect of speculative attacks once they occur. This has given rise to the question of what approach the countries in the region should take in strengthening financial coordination in the region that can reduce further the negative impacts of speculative attacks and prevent a regionwide economic crisis.

This study is conducted to assess the level of integration in the region, and to determine the proper approach that the region should consider to improve the region’s economic stability and to increase economic welfare for all the people in the region. In this regard, the study provides a detailed and comprehensive recommendation on the institutional structure of the East Asian Financial Arrangement.
Chapter 2
Deepening Financial Integration

International financial integration is taking place at a rate unseen before. A study by Gruben and McLeod (2001), for example, suggests that there are more countries that ease current account policies compared to those that tighten. Financial integration is also taking place in the East Asian region, and the trend seems to look stronger than before. Especially after the financial crisis of 1997-1998, the East Asian economies have strengthened regional economic cooperation in the areas of trade/investment and money/finance. East Asia had been achieving market-driven economic integration through liberalizing foreign trade, direct investment and financial flows, within the framework of the WTO and APEC (Kawai (2004)).

Several measures of integration level, which will be discussed in more detail as we proceed, confirm that financial integration in the East Asian countries is deepening. This raises the question as to whether the integration level in the region is comparable to that in the EU prior to the implementation of the single currency. This issue is important since if the region is more integrated than the EU prior to the unification, then the likelihood of success in the formation of the region’s financial architecture (as in the EU area) is quite high (and vice versa).

This chapter discusses the globalisation trend, the trade and FDI integration, and the financial integration in ASEAN+3 countries. The study suggests that financial integration in East Asia countries is indeed deepening. However, the study suggests that the level of integration in East Asia is still lagging behind that in the EU countries prior to the enactment of the Euro. As such, East Asian countries must take further steps to expedite the integration process to reach the EU’s level before undertaking wider and deeper regional cooperation (such as a single currency) as in the EU countries.

2.1. International Financial Integration - A global trend

Many countries have made the effort to create an environment that would be more accommodating for financial integration. For example, Gruben and McLeod (2001) find that from 112 countries, 69 have reduced restrictions on foreign currency transactions, 26 countries kept their current account policies unchanged, while only 17 countries have tightened their foreign currency transactions. Thus, it is unquestionable that international financial integration is taking place at a rate unseen before. Lane and Milesi-Ferretti (2003) contend that, according to their econometric analysis, the main drivers of financial integration are trade openness, GDP per capita (as a proxy for the level of development), and stock market integration.
And as the ASEAN+3 countries have become more open toward trade, it is not a surprise that international financial integration is also taking place in the region. One of the international integration measures is the equity-based measure of international financial integration developed by Lane and Milessi-Feretti (2003). The equity-based measure is described by the following equation:

\[ EQFI_i = \frac{PEQA_i + FDIA_i + PEQL_i + FDIL_i}{GDP_i} \]

- \( PEQA_i \): portfolio equity securities assets of country \( i \) at time \( t \)
- \( FDIA_i \): foreign direct investment abroad of country \( i \) at time \( t \)
- \( PEQL_i \): portfolio equity securities liabilities of country \( i \) at time \( t \)
- \( FDIL_i \): foreign direct investment in country \( i \) at time \( t \)

Graph 1 shows the Index of Financial integration (equity-based) in the ASEAN+3 countries. From 1980 to 2002 the EQFI index of ASEAN+3 increased by more than 7 times. A marked increase took place in the period of 1992 to 1999, where the EQFI index rose by 3.4 times. This indicates that international financial integration is taking place in the ASEAN+3 countries. Nevertheless, the international integration fell somewhat in 2002, mainly due to the fall in FDI flows into and out of the region in that year.

However, the evolution of the EQFI index in the ASEAN+3 countries was not as fast as in the EU countries, which suggests a slower pace of financial integration in the ASEAN+3 countries. According to Pungulescu (2002), from 1980 to 2002, the EQFI index in the EU countries rose by nine times, which is significantly higher than that in the ASEAN+3 countries.
2.2. Trade and FDI Integration

2.2.1. Deepening Trade Integration

Globalisation of economic activities has been increasing as cross border movements of goods, money, information, and people have expanded significantly in recent years. One factor that has contributed to globalisation is trade liberalization, which is mainly carried out under the GATT/WTO. Various problems in creating international free trade agreements under the WTO, however, have led to a number of regional trade agreements. In 1994, countries in north America set up NAFTA to integrate their markets, while European countries set up their own free trade agreement.

In East Asia, the intra regional free trade agreement was started by ASEAN countries. In January 1992, ASEAN countries agreed to establish an ASEAN free trade area by eliminating tariff barriers among its member countries (the agreement has been fully implemented since 2003). This agreement has paved the way for a more integrated ASEAN economy. Meanwhile, in addition to the multilateral liberalization framework under the WTO, East Asian countries have also set up their own regional liberalization framework through the Asia Pacific Economic Cooperation (APEC).

As trade in the East Asian region has become more liberalized, intra regional trade in East Asia has also increased, which has made economies in the region more integrated than before. In 1992, intra regional trade in ASEAN+3 countries amounted to 30 percent of the region’s total trade. It has increased consistently since then, and by 2002 the intra regional trade reached 36.1 percent of the total region’s trade. However, if we include Taiwan and Hong Kong data, in 2002 the intra-regional trade contributed around 52.8 percent of the total region’s trade, which is slightly lower than the share of intra regional trade in the EU, but slightly higher than the share of intra regional trade in NAFTA (see table 1).
To assess further the integration of trade in the East Asian region, we utilize the trade intensity index statistic. The trade intensity index statistic (IT) gauges an exporter’s penetration of a market within the context of overall world trade. IT permits comparisons to be drawn across destination and/or origin markets by controlling for market size. In fact, an important feature of this index is that it neutralizes the impact of country size.

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Data Source: 1. For Trade Data of World, NAFTA, EU, ASEAN: United Nations Statistics Division
2. For Trade Data of ASEAN-4, EA-6, EA-7: CEIC

For the intra-regional trade share, the share is defined only for economies within the same region, so that i=j.

1ASEAN-4: Indonesia, Malaysia, Thailand, and Philippines.
EA-6: ASEAN-4 + Japan and South Korea.
EA-7: EA-6 + China.
ASEAN+3: ASEAN + Japan, China, and South Korea.
ASEAN+5: ASEAN + Japan, China, South Korea, Hong Kong, and Taiwan.
Trade Share is defined as: \( \frac{ (X_{ij}/X_i) + (X_{ij}/X_j) }{2} \)
where:
\( X_{ij} \) represents exports of region i to region j.
\( X_i \) represents total exports of region i.
\( X_j \) represents total exports of the world to region i (or total imports of region j).

Figure 1. Intra Regional and Inter Regional Trade Shares in 1993
Our calculation indicates that the IT in ASEAN+3 has increased consistently. In 1992, the intra ASEAN+3 IT was only 0.99, which suggests that ASEAN+3 countries did not consider their own market as an important trade destination for their products. By 2002, however, the ASEAN+3 IT had risen to 1.59, suggesting that the ASEAN+3 countries considered the region’s market as an important export destination for their products. This also means that countries in the region have become more dependent on each other than before, indicating deepening integration in the region.

Please note, however, if we consider ASEAN+3 countries only, the level of dependency in the intra-regional trade is still significantly lower than in both NAFTA and the euro areas. For example, in 1993, intra regional trade in the EU contributed to around 60 percent of the region’s total trade, and in 2002 the share of intra-regional trade was relatively unchanged. In the NAFTA area, the share of intra-regional trade was 41.9 percent, increasing to 47.9 percent in 2002. Meanwhile, the intra regional trade in ASEAN+3 was only 32.6 percent in 1993, and it rose to only 36.1 percent in 2002 (see figure 1 and figure 2). Also, in terms of IT, the ASEAN+3 countries are still behind the NAFTA countries. In 2002, the ASEAN+3 countries’ IT (1.59) had even dropped below that of the NAFTA countries (1.97).
The Trade Intensity Index is defined as: \[
\frac{X_{ij}}{X_{..}} / \left( \frac{X_i}{X_{..}} \cdot \frac{X_j}{X_{..}} \right)
\]
where

- \(X_{ij}\) represents exports of region \(i\) to region \(j\)
- \(X_i\) represents total exports of region \(i\)
- \(X_j\) represents total exports of the world to region \(j\) (or total imports of region \(j\))
- \(X_{..}\) represents total world exports

For the intra-regional trade intensity index, the index is defined only for economies within the same region, so that \(i=j\).

This suggests that, excluding Hong Kong and Taiwan, the degree of regional integration through trade in East Asia is still lower than that in the EU and in the NAFTA countries. However, the measure of regional integration through trade in the region will improve if Hong Kong and Taiwan are included. With Hong Kong and Taiwan included (ASEAN+5), the total share of intra-regional trade jumped to 52.8 percent in 2002. With the inclusion of Hong Kong and Taiwan, the share of intra-regional trade in East Asia becomes closer to that in the NAFTA and in the EU. Only with the inclusion of Hong Kong and Taiwan does the regional integration through trade in East Asia become quite large and comparable to the levels seen in NAFTA or the EU.

### Table 2. Intra-Regional Trade Intensity Index\(^2\) (%)

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<td>1.99</td>
<td>1.99</td>
<td>1.80</td>
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2 The Trade Intensity Index is defined as: \[
\frac{X_{ij}}{X_{..}} / \left( \frac{X_i}{X_{..}} \cdot \frac{X_j}{X_{..}} \right)
\]

Domestic and international developments in the last twenty years have led to a significant increase of FDI flows into the ASEAN+3 countries. On the domestic side, the liberalization of both trade and FDI policies have allowed the FDI inflow to increase significantly. Emerging East Asian countries have realized that deregulation and liberalization of trade and FDI promote economic growth. Furthermore, favourable macroeconomic conditions and the abundant labour supply of well-educated employees, as well as low-wage workers have also helped facilitate the increase in FDI. Meanwhile, on the external side, the substantial exchange rate alignment, especially for the yen in the mid-1980s, was also the main reason behind the increase in FDI flows in the region.

Urata (2002) found that intra-regional FDI in East Asia increased from 4 percent of world FDI in 1980 to 8 percent in 1994. And among the East Asian sub-groups, the stock of intra-regional FDI in the emerging economies registered relatively high growth, increasing from 2 to 6 percent of world FDI during the 1980-94 period. However, he also found some evidence that suggests declining intra-
Although the total world FDI into the ASEAN region fell from 1995 to 2001, the lion share of the fall was attributed to the fall in the intra-regional FDI. This fact can be seen more clearly if we look at the share of FDI inflow into ASEAN by source countries. In 1995, Japan accounted for around 16.8 percent of total FDI in ASEAN. And by 2001, its contribution had dropped to only 6.8 percent. FDI from China and Korea to ASEAN also shows a similar pattern. The FDI in the intra-ASEAN region has also indicated a declining trend. In 1995, total intra-ASEAN FDI amounted to US$ 4.3 bn, but by 2001 it had dropped to US$ 1.8 bn (see table 3).

Table 3. FDI Inflow to ASEAN Countries (BOP Basis, US$ million)

<table>
<thead>
<tr>
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<td>4955.4</td>
<td>6810.0</td>
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<td>506.4</td>
<td>728.6</td>
<td>139.9</td>
<td>601.8</td>
<td>83.6</td>
<td>-269.4</td>
</tr>
<tr>
<td>China</td>
<td>1920.2</td>
<td>1857.0</td>
<td>2957.1</td>
<td>1993.0</td>
<td>1190.1</td>
<td>1472.6</td>
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<td>3866.9</td>
<td>5006.7</td>
<td>2288.1</td>
<td>1243.6</td>
<td>1084.1</td>
<td>1818.1</td>
</tr>
<tr>
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<td>4748.8</td>
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<td>4769.9</td>
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<td>EU</td>
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<td>7122.3</td>
<td>5833.7</td>
<td>5616.9</td>
<td>7758.6</td>
<td>3521.1</td>
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</tr>
<tr>
<td>Total</td>
<td>25367.0</td>
<td>29370.0</td>
<td>30369.0</td>
<td>2288.1</td>
<td>1243.6</td>
<td>1084.1</td>
<td>1818.1</td>
</tr>
</tbody>
</table>

Although the total world FDI into the ASEAN region fell from 1995 to 2001, the lion share of the fall was attributed to the fall in the intra-regional FDI. This fact can be seen more clearly if we look at the share of FDI inflow into ASEAN by source countries. In 1995, Japan accounted for around 16.8 percent of total FDI in ASEAN. And by 2001, its contribution had dropped to only 6.8 percent. Meanwhile, in the same period, Korea’s and China’s FDI shares into ASEAN had also fallen significantly (see table 4). And even the share of intra-ASEAN FDI had dropped from 16.9 percent in 1995 to 13.7 percent in 2001.

Table 4. Share of FDI Inflow to ASEAN Countries (BOP Basis, %)

<table>
<thead>
<tr>
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<td>16.87</td>
<td>22.42</td>
<td>21.92</td>
<td>6.60</td>
<td>(1.22)</td>
<td>6.80</td>
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<tr>
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<td>2.38</td>
<td>1.72</td>
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<td>0.76</td>
<td>3.06</td>
<td>0.76</td>
<td>(2.03)</td>
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<td>China</td>
<td>7.57</td>
<td>6.32</td>
<td>9.74</td>
<td>10.77</td>
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<tr>
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<td>100.00</td>
<td>100.00</td>
<td>100.00</td>
<td>100.00</td>
</tr>
</tbody>
</table>

1 Although we do not have a complete set of FDI data for Korea and China, we believe that this trend is also applicable to the ASEAN+3 region.
Rugman (2002) investigates the puzzle of decreasing intra-regional FDI in the NAFTA area amid an increasing trend of intra-regional trade in the area. According to Rugman, NAFTA intra regional trade rose from 49.1 percent of total regional trade in 1997 to 55.7% in 2000. Meanwhile, intra regional FDI in NAFTA fell to 18.2 percent of the region’s total FDI outflow in 1999, from 21.1 percent in 1997. An explanation for this trend is offered by Hejazi and Safarian (2002), who argue that NAFTA has led to less FDI flows between Canada and the United States but to more trade activities between the two countries since the U.S. MNEs are now better able to serve the Canadian market by trade rather than by FDI.

<table>
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<td>12,233.0</td>
<td>12,911.0</td>
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<td>728.6</td>
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<td>601.8</td>
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<td>Share to ASEAN (%)</td>
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<tr>
<td>Share to ASEAN+3 (%)</td>
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<td>15.3</td>
<td>10.4</td>
<td>11.9</td>
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Hejazi and Safarian’s explanation could well be applicable to the intra-regional trade and FDI pattern in East Asia. Given that the region has become increasingly open toward intra-regional trade, and both tariff and non-tariff barriers have been reduced significantly, multinational companies in the region may realize that sooner or later their ability to serve the region’s market will become better by trade rather than by FDI. Furthermore, as there will be relatively less trade barriers in the AFTA era, multinational companies will not have to set up production facilities in each ASEAN country to serve the ASEAN market. This will reduce intra-regional FDI to some extent.

Against this backdrop, the fall in intra-regional FDI from ASEAN+3 countries to the ASEAN region amid increasing intra-regional trade should be interpreted as an indication of deepening economic integration.

### 2.3. Financial Integration

To assess the stage of financial integration in the ASEAN+3 region, we calculate the indicators suggested by Adam et al (2002). Adam classifies the existing indicators of financial integration into four broad categories:

- A) indicators of **credit and bond market** integration;
- B) indicators of **stock market** integration;
- C) indicators of integration based on **economic decisions of households and firms**, and
- D) indicators of **institutional differences** that may induce financial market segmentation.

#### 2.3.1. Indicators of Credit and Bond Market Integration

Interest rate differential is the most common measure of credit market integration. As an extreme example, in a common currency area there is no depreciation risk. In the absence of transaction costs or any other type of market segmentation, net-of-tax interest rates for assets of the same maturity and the same credit risk class should be identical. A careful approach has to be taken in interpreting a decline in interest rate spreads, however, since the decline may be related to increasingly homogeneous risk characteristics of different credit markets caused by an integration process in the goods and labour markets and not necessarily a sign of increasing financial market integration (Pungulescu (2003), Japelly at al (2002)).

We assess financial market convergence using data on four interest rates: the **inter-bank 3-month rate**, the **10-year government bond benchmark yield**, henceforth, the 10-year benchmark yield), the **mortgage rate** and the **corporate loan rate**.
The inter-bank 3-month rate

Graph 2 shows inter bank call rates for ASEAN+3 countries. It shows that while the rate appears to be converging for some counties, the inter-bank call rate is still significantly different (and higher) in Indonesia, Korea, and the Philippines. We believe that at this point the level of integration in the East Asian countries is still significantly below that in the EU countries. In the EU, although prior to 1998 inter-bank call rates in France deviated significantly, the inter-bank call rates in Germany, Italy, and the Netherlands move quite closely together (see graph 3). All in all, it seems the level of financial integration in East Asia in regard to the financial market by this token was not as deep as in the EU in the 1990s, even prior to the launch of the euro.

One main reason behind the slow convergence in the inter-bank 3-month rate is the different levels of inflation in most East Asian countries. A closer inflation rate, we believe, will expedite the convergence in the inter-bank call rates.

Graph 2. ASEAN+3 Inter Bank Call Rate

Graph 3. EU Countries Inter bank call rate

* Three month inter bank call rate
Government bond benchmark yield

The government bond yield in East Asian countries has not shown a significant convergence pattern (see graph 4). For comparison, the government bond yield in the EU countries has shown a significant sign of convergence since 1990, and since 1997 (two years prior to the implementation of the euro) the government bond yield in most of the EU countries has moved together in a very close range (see graph 5). In this regard, the level of integration of East Asian countries is still not as deep as in the EU in the 1990s. We believe that underdeveloped bond markets in most East Asian countries was mainly responsible for the slow convergence in the bond market yield in the region.
Lending Rates to Corporations

Meanwhile, the lending rates by ASEAN+3 banks to corporations have not shown a significant convergence (see graph 6). The slow integration in the corporate loans market is not unexpected, as these types of markets are more prone to be hindered by institutional differences and local conditions (Adam et al. (2002)). The lending rates to corporations in the EU have also shown a slow integration, even after 1999, due to the same reason (see graph 7). This finding is in line with other studies that suggest that lending rates to corporations may not be a good measure of economic integration.

Graph 6. ASEAN+3 Lending Rates to Corporations

Graph 7. EU Countries Lending Rates to Corporations

2.3.2. Indicators of Stock Market Integration

Another possible indicator of financial integration is the correlation of stock market returns. The idea underlying this indicator is that stock market returns should become more correlated as markets become more integrated (Adam et al. (2002)). However, an increase in the stock market correlations does not necessarily mean a high degree of financial integration, since the increases may reflect changes in the
correlation of real and policy shocks in the individual countries (Pungulescu, 2002). Nevertheless, increasing convergence in stock market returns may suggest that financial integration is taking place in the region.

We look at the correlation of stock market returns in the ASEAN+3 countries. It is widely believed that stock market returns should become more correlated as markets become more integrated. For this study, we calculate the correlation coefficient of monthly returns (in US dollars) of the major stock market indices with the monthly return of the Japan Nikkei Index with a moving 12-months time window between January 1985 and December 2003. Furthermore, we average cross-sectionally the ASEAN+3 countries’ correlations. Graph 8 shows the unweighted average of the correlations, while graph 9 shows the weighted average (according to stock market capitalization) of the correlations.

Each point in the two graphs corresponds to the average correlation of the previous twelve months. In each of the two panels, we report the correlation between own-currency returns and that between returns expressed in US dollars. The correlation between exchange rate adjusted returns is computed to control the effect of high exchange rate volatility at the end of the 1990s.

Graph 8 shows that the correlation of the stock markets in the region has risen to a significant level since April 1996. In November 1996, the stock market correlation rose to above 40 percent. It fell to around 20 percent from mid-2001 to the beginning of 2003. However, the stock market correlation has been rising since January 2003. And by the end of 2003, the stock market correlation reached around 40 percent, the same level as in the EU in 2001 (Adam et al (2001)). Furthermore, weighted by market size, the correlation in stock market returns even indicates a higher level of integration. By the end of 2003, the weighted stock market return correlation reached above 60 percent.

Although an increase in the stock market correlations does not necessarily mean a proof of financial integration, we can point out that at this stage the stock market integration in the East Asian countries is not far behind the EU. A relatively more open stock market (foreign investors can invest through domestic or foreign brokerage houses, with few barriers in almost all markets in the region) and more developed infrastructure (compared to the bond market, for example) have led to a more integrated stock market in the East Asian region.
Due to data availability, for ASEAN we only use data of five ASEAN countries (Indonesia, Malaysia, Thailand, Singapore, and the Philippines).

2.3.3. Indicators Based on economic decisions of households and firms

**Saving-Investment Correlation**

Financial integration is often tested by scrutinizing the saving-investment correlation. For example, Feldstein and Horioka suggest that the degree of regional capital segmentation can be measured by assessing the saving-investment correlation. Under the assumption of perfect capital mobility and unchanged investment opportunities, an increase in the savings ratio in one region would cause an increase in investment in all regions. As such, a large correlation between national savings and investment would indicate strong segmentation. To assess the saving-investment correlation in the ASEAN+3:

---

5 Stock market indices used: Jakarta Composite Index (Indonesia), KLSE Composite (Malaysia), SGX all share (Singapore), PSE Composite (Philippines), SET (Thailand), Shanghai Stock Exchange Composite (China), KSE KOSPI (South Korea), Nikkei 225 Stock Market Index (Japan).

6 Graphs prior to June 1996 were constructed without Indonesia & China data.

7 Due to data availability, for ASEAN we only use data of five ASEAN countries (Indonesia, Malaysia, Thailand, Singapore, and the Philippines).
It is clear that the ASEAN+3 is not as integrated as the EU was in the 1990s, prior to the formation of the single currency. The ASEAN+3 countries need around 10 more years (this is a rough estimation assuming that the current trend does not change) to become as integrated as the EU countries prior to

region we estimate the association of investments (as percentage of GDP) with savings (as percentage of GDP), as represented by the following equation:

\[
\left( \frac{I}{Y} \right)_i = \alpha + \beta \left( \frac{S}{Y} \right)_i
\]

Where:

- \( I \) : Investment in country \( i \)
- \( Y \) : GDP of country \( i \)
- \( S \) : Saving in country \( i \)

Theoretically, a small and very low \( \beta \) indicates perfect capital mobility. On the other hand, a closed economy will be indicated by a high and close to one. Table 6 lists the regression results for ASEAN+3, EU, and NAFTA countries for data in the 1980-2002 period.

The regression results suggest an increasing level of regional integration. The strongest trend is evident in the EU regression results, where the value of \( \beta \) dropped significantly from 0.62 in the 1980s, to 0.21 in the 1990s, and to 0.09 in the 2000s. Meanwhile, NAFTA also has shown a strong convergence toward integration among countries in the region. The \( \beta \) value for the NAFTA area dropped significantly to 0.13 in the 2000s from 0.40 in the 1990s.

The integration level in the ASEAN+3 countries, however, has not been as deep as in the NAFTA and the EU areas. Although the \( \beta \) value for ASEAN+3 has dropped in the last twenty years, the fall is not as significant as those in the NAFTA and in the EU regions. Furthermore, the level of \( \beta \) is still significantly higher than those in the NAFTA and in the EU regions. In the 1980s, the ASEAN+3 \( \beta \) was 0.76. The \( \beta \) fell to 0.49 in the 1990s, and fell further to 0.39 in the 2000s, significantly higher than the \( \beta \) of 0.21 in the EU.

<table>
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</tr>
<tr>
<td></td>
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<td>15.62</td>
<td>0.49</td>
<td>0.07</td>
</tr>
<tr>
<td></td>
<td>2000 - 2002</td>
<td>12.41</td>
<td>0.39</td>
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</tr>
<tr>
<td>EU (13)</td>
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<td>0.62</td>
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<tr>
<td></td>
<td>1990s</td>
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<td>2000 - 2002</td>
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<td></td>
<td>1990s</td>
<td>9.55</td>
<td>0.40</td>
<td>0.08</td>
</tr>
<tr>
<td></td>
<td>2000 - 2002</td>
<td>14.47</td>
<td>0.13</td>
<td>0.07</td>
</tr>
</tbody>
</table>

Source: Danareksa Calculation

It is clear that the ASEAN+3 is not as integrated as the EU was in the 1990s, prior to the formation of the single currency. The ASEAN+3 countries need around 10 more years (this is a rough estimation assuming that the current trend does not change) to become as integrated as the EU countries prior to
2.3.4. Indicators of institutional differences that may cause financial market segmentation

The financial market integration in East Asia is far from being an accomplished task. Like in the EU, the legal system, the tax system, and the corporate government arrangements may also act as barriers to further integration. For instance, Djankov at al. (2002) contends that in the credit market one may expect higher judicial efficiency to entail greater availability of credit, lower collateral requirements and, in some cases, also lower interest rates, as shown by Bianco, Jappelli and Pagano (2001).

Djankov constructs an aggregate index of regulation of dispute resolution (RDR) for 109 countries, starting from the description of the exact procedures used to resolve two specific disputes: the eviction of a resident tenant for non-payment of rent and the collection of a check returned for non-payment. The index takes a value between 0 and 7, with higher values corresponding to a more regulated dispute.
Djankov finds that the EU countries are more heterogeneous in their legal system compared to the US. This, coupled with the common law tradition, translates into higher judicial efficiency in the US compared to the EU countries. He concludes that the existence of different legal systems across EU countries might erect further barriers to the integration process in this area as compared to the United States. As such, further integration of financial markets in the EU must proceed broadly parallel with adequate process of tax co-ordination, elimination of the divergences in bankruptcy law, and also deeper administrative reforms to lead to more efficient legal procedure (see Pungulescu (2002)).

Table 7 shows the RDR index and the expected duration of the procedure for the case of collection of a bounced check among East Asian countries. It seems East Asian countries also have diverse legal system efficiencies. Malaysia and Singapore have the lowest RDR index (2.34 and 2.5 respectively), with the shortest expectation duration of procedure (90 days and 47 days respectively). In contrast, Indonesia and Thailand have the longest expectation duration of procedure (225 days and 210 days respectively). Just like in the EU, it is clear that East Asian countries have a diverse judicial system, which may limit the speed of financial markets integration. Against this backdrop, East Asian countries should also attempt to reduce these barriers. For example, East Asian countries should consider eliminating the differences in bankruptcy law, and should also encourage deeper administrative reforms that lead to more efficient legal procedures.

<table>
<thead>
<tr>
<th>Country</th>
<th>RDR Index</th>
<th>Duration of</th>
<th>Legal Origin</th>
</tr>
</thead>
<tbody>
<tr>
<td>ASEAN Countries</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Brunei</td>
<td>3.4</td>
<td>142.7</td>
<td></td>
</tr>
<tr>
<td>Cambodia</td>
<td>n.a.</td>
<td>n.a.</td>
<td></td>
</tr>
<tr>
<td>Indonesia</td>
<td>3.9</td>
<td>225</td>
<td>French Legal Origin</td>
</tr>
<tr>
<td>Laos</td>
<td>n.a.</td>
<td>n.a.</td>
<td></td>
</tr>
<tr>
<td>Malaysia</td>
<td>2.34</td>
<td>90</td>
<td>English Legal Origin</td>
</tr>
<tr>
<td>Myanmar</td>
<td>n.a.</td>
<td>n.a.</td>
<td></td>
</tr>
<tr>
<td>Philippines</td>
<td>5</td>
<td>164</td>
<td>French Legal Origin</td>
</tr>
<tr>
<td>Singapore</td>
<td>2.5</td>
<td>47</td>
<td>English Legal Origin</td>
</tr>
<tr>
<td>Thailand</td>
<td>3.14</td>
<td>210</td>
<td>English Legal Origin</td>
</tr>
<tr>
<td>Vietnam</td>
<td>3.25</td>
<td>120</td>
<td>Social legal origin</td>
</tr>
<tr>
<td>Non-ASEAN Countries</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>China</td>
<td>3.41</td>
<td>180</td>
<td>Social legal origin</td>
</tr>
<tr>
<td>Japan</td>
<td>2.98</td>
<td>60</td>
<td>German Legal Origin</td>
</tr>
<tr>
<td>South Korea</td>
<td>3.37</td>
<td>75</td>
<td>German Legal Origin</td>
</tr>
</tbody>
</table>

Source: Djankov, Simeon and LaPorta, Rafael and Lopez-de-Silanes, Florencio and Shleifer, Andrei, “Legal Structure and Judicial Efficiency”: The Lex Mundi Project, March 2002
Chapter 3
Asean+3 Should Deepen Further Financial Cooperation

The discussions in the previous section suggest that even though there are indications that financial integration is deepening, there is enough evidence to say that the integration level in the East Asian region is currently not as deep as that in the Euro zone prior to the implementation of a single currency.

Furthermore, there are indications that financial deregulation and the opening of markets have brought many countries in the region to establish closer linkages with international financial markets than before, but not with financial markets in the region. As such, the financial deregulation and the opening of markets have drawn East Asia away from regional financial integration. This is not a surprise given that the regional financial cooperation in East Asia is still in its infancy.

The current relatively low economic integration level in the East Asian countries has given rise to the question as to whether the region should deepen the integration in the region and pursue economic unification as European countries have. The initial level of economic integration in the region should not determine the answer to the question. Whether the East Asian region should pursue deeper financial integration, by setting up a regional financial arrangement should be determined by the benefits and the costs of further integration in the region.

Only if there are sufficient benefits for countries in the region should deeper economic integration be pursued (by forming a regional financial arrangement). With support from the political process, deeper integration in the Asian Region, as in Europe, is attainable, regardless of the initial level of integration in the region. The political process is the most important factor in the success of deeper financial integration. Please remember that the guiding principles of the EMU have always been political rather than economic. That is, initially, it is political reasons that have been the main drive for the unification process in Europe.

3.1. Rationale for a Regional Financial Arrangement

Lessons From the Crisis

The 1997 Asian crisis has taught us that when a crisis in a country originates in the capital account, policy coordination or at least policy dialogues and reviews among neighboring countries is essential in preventing contagion of the crisis (for example, see Kuroda 2001). The importance of policy cooperation would grow with the increase in the depth of integration of financial markets at the regional level. The contagion effect in the 1997 Asian crisis suggests that the negative impact of a shock in one country is not isolated...
in that country only, but will negatively affect the region as well. This suggests that, although relatively lower compared to the European countries, the economic integration in East Asia is deep enough such that the region cannot ignore a negative development that is occurring in one country.

Furthermore, acting individually, Asian countries could not devise a credible strategy to ward off speculative attacks. As a result, during the crisis East Asia suffered a liquidity crisis compounded by the panic and the herding behavior of foreign investors, which destabilized many currencies in the region. This, in turn, disturbed economic activities and hampered economic growth in the region. The speculative attack would have been handled more successfully if there were solid financial cooperation among countries in East Asia. For example, the speculative attack that triggered the 1997 Asian crisis should not have developed into region-wide currency instability if the region had come up with orchestrated actions that could have supplied a large amount of short-term financing to replenish foreign exchange reserves at the first sign of a speculative attack (instead of tightening monetary and fiscal policy).

In addition, without a constant exchange of information and policy dialogues among close economic partners, individual countries often find it difficult to understand the causes of large changes in capital flows and exchange rates. And to ward off speculative attacks, policymakers will have to be on constant alert to monitor and respond to changes in expectations of market participants.

Please note that at the time of the crisis, there were neither regional nor global lenders of last resort to deal with the bank run problems East Asian countries were facing. It was also true that with limited financial resources, the IMF could not manage the Korean crisis by itself; it had to enlist the financial support of the G-7 and other countries. The G-7 support for the rollover of short-term foreign loans for Korea is then a testimony that as a global institution, the IMF would be more effective in resolving crises if it establishes cooperative relations with its regional counterparts and hence encourages the development of regional financial mechanisms (Bergsten and Park (2002)). As such, the development of regional financial mechanisms will bring benefits to the region, since they will make the region more able to cope with speculative attacks in the future. Furthermore, the regional financial mechanism could also act as the IMF counterpart, which will help improve the IMF’s ability in performing its function as the international lender of last resort as well as in dealing with other economic problems in the future.

The Current Global Financial System Needs an Improvement

The IMF’s response to the Asian crisis was inappropriate and inadequate. For example, its recipe to close sixteen banks in Indonesia at the beginning of the crisis only dented confidence toward financial institutions in Indonesia, which then led to massive bank runs that forced the Indonesian government to bailout its banking system. And the IMF liquidity support for Indonesia was not fast enough to regain
market confidence toward Indonesia. Furthermore, the amount that the Indonesian government received for each disbursement of the liquidity support was too small, with too much conditionality attached to it. This is not to say that strict requirements before the disbursement of the liquidity support are always bad. But better conditionality plans have to be devised such that, with its utmost efforts, the country can attain that conditionality. If the conditionality is rather impossible to reach in a short time, given the situation of the country at that time, then the chance is very slim that the liquidity support would bring back confidence toward the country.

The perceived failure of the IMF in helping countries in the region to recover from the crisis at a faster speed has not created a better image for the IMF. It has also brought about a bad image for the countries that turned to the IMF for assistance. As such, in the future when a country needs liquidity support, instead of regaining market confidence, turning to the IMF for help would only hurt confidence toward the country. This is of course not a good development. The future Indonesian government, for example, would find it difficult to turn to the IMF for help, given that the slow progress in Indonesia’s economic recovery under the IMF has made the IMF become less popular among Indonesia’s people and parliament. And turning to the IMF would incite general protests that could even destabilize the government, which would only deteriorate further the economic conditions.

Against this backdrop, many economists have suggested to reform the current international financial system. However, reform of the international financial system has been slow. The urgency of reform in the G-7 countries has receded considerably despite the collapse of Argentina, instability of Brazil, and economic slump in East Asia. The slow progress has been further complicated 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 (Park and Wang, 2002). As such, the region should explore the potential of financial reform at the regional level.

An East Asian regional financial arrangement could be designed and managed to function as a complement to the IMF. For example, an East Asian Regional Fund could also serve as a source of supplementary financing to the IMF facilities. It could support the IMF’s global surveillance activities by specializing in regional surveillance. Meanwhile, the regional financial arrangement could use IMF’s design and policy conditionality as prerequisite conditions for the borrowing countries (see Bergsten and Park (2002)).

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8 Of course the slow recovery in Indonesia is not solely due to IMF slow response to help the country. The change in political system, combined with scarce of high quality human resources, have also contributed to the slow economic recovery in Indonesia.
Stabilizing Bilateral Exchange Rates of Regional Currencies

McKinnon, points out that the management of exchange rates in East Asia remains a collective problem, which needs a collective solution (see Yongding, (2001)). Nevertheless, thus far, very limited discussion has taken place on tackling the problem of regional exchange rates management in East Asia. And the currently relatively stable exchange rates in the region have created no incentive for the East Asian countries to tackle this issue with more urgency.

Despite the relatively stable exchange rates in the region, the risk of a realignment of exchange rates has not gone for good. For example, if each country just takes into consideration its short-term national interests in deciding its exchange rate regime and exchange rate policy, the final result may be detrimental for the country as well as the region. For instance, due to the temptation to target the real exchange rate, contagious devaluations would actually be built into the rules of the currency basket game (McKinnon (2000)). Even if just for self-interest, each EA country should take a regional view of exchange rate stability. East Asian countries need to cooperate in the management of exchange rates in the region. If they fail to do so, when a new shock wave strikes, East Asian countries’ exchange rates alignment may be in disarray again (see Yongding, (2001)). And the economies in the region may experience another set back in economic growth.

In addition, the importance of regional exchange rate stability to many of the non-Japan Asian countries is reflected in their recent bilateral dollar exchange rate movements. For example, before the 1997/98 economic crisis, most Asian currencies (except the Hong Kong dollar) were officially pegged to a basket of convertible currencies from industrial currencies. However, they actually followed a de facto US dollar peg. One main advantage of the regional financial arrangement is to avoid competitive devaluations and their adverse effects on intra-regional trade and on exports to third markets, in particular the US. During the 1997/98 crisis, a number of Asian currencies depreciated sharply as the exchange rate pegs were abandoned. Since late 1998, however, most Asian currencies appear to have reverted to something like a peg to the US dollar, albeit more flexible than before. The trend has been more apparent recently as the yen has appreciated against the dollar. In this context, closer monetary policy co-ordination could not only help to foster greater exchange rate stability, but also reduce the disruptions caused by large fluctuations in the yen-dollar bilateral exchange rate (see Chui at al. (2002)).
A more equitable international monetary system

Today the world monetary system is pretty much dominated by the dollar. And even trade transactions between East Asian countries are very often settled in US dollars. Furthermore, the Asian crisis has led to the East Asian countries’ belief that in order to deter speculative attacks from occurring they need to build up US dollar reserves as much as possible, which has led to a significant accumulation of US dollar reserves in each country’s central bank in the region. The US dollar reserve in the current flexible exchange rate is significantly higher than prior to the crisis, when fixed exchange rate regimes were still a common practice in the region.

Against this backdrop, the United States is able to extract seignorage from other countries. According to Mundell [1997], the total amount of United States’ currency held outside banks is nearly US$400 billion. Most of the currency is located outside the United States, being used as the international currency of the world. It has been estimated that only 10% to 15% of the US$400 billion in circulation is held in the United States (see Yu, (2001)). The rest of it is used outside the country (by central banks, travelers, drug cartels, tax evaders and foreign banks). As such, the US is able to finance its huge current account deficits and to accumulate more than US$1.5 trillion of foreign debts.

Following the crisis, East Asia economies as a whole now hold more than US $1 trillion with very low returns. East Asians are financing the expenditure of American households (see Yongding, (2001)). Even worse, in line with the current sharp depreciation of the dollar, the real value of East Asian economies’ foreign reserves has fallen significantly. As a result, the Asian countries are investing their savings in assets with depreciating values. East Asian countries should change this situation, and work together to achieve a more equitable international monetary system. The euro has reduced the dominance of the US dollar to some extent. And if East Asian countries could come up with some kind of a regional currency, then the hegemony of the US dollar can be reduced further.

3.2. Domestic Financial Reforms and Capital Account

A new regional financial architecture may reduce the possibility of contagion, herding behavior and other undesirable effects from occurring in the future. Nevertheless, without better domestic financial conditions in individual East Asian countries, the financial coordination in the region may not bring about an optimal result. Furthermore, the regional financial arrangement will not lead to a better condition in individual countries unless there is improvement in the financial conditions in those countries. As such, the ASEAN+3 countries should not forget to conduct the necessary reform on their domestic financial institutions and policies. The following paragraphs discuss some important issues in the reforms of the domestic financial system.
1. Strengthening the domestic financial system

The 1997 Asian crisis shows that the volatility of capital flows may lead to unstable financial conditions that hamper economic growth. The speculative attack on currencies in the region led to massive capital outflows that hurt many countries in the region. Poorer financial infrastructure in some countries even caused a sharper contraction in those countries compared to countries with better financial infrastructure. As countries in the region have become more open than before, the amount of capital flows is likely to be larger than before. And to minimize the negative impact of a possible capital flows reversal, countries with weak financial infrastructure should make the necessary structural reforms.

In particular, countries in the region should overhaul their capacity to supervise, regulate and manage financial institutions, so that the domestic financial system can properly deal with the problems that could arise from free capital movements. Banks, securities firms and insurance companies should be well regulated so that customers can evaluate the wide range of financial services and products offered. In addition, in order to improve the efficiency of saving intermediation and to monitor foreign capital flows, the government should also strengthen the supervision of the financial system, standardize accounting practices, adopt good legal practices, develop the infrastructure for efficient and liquid capital markets including payments and clearing systems, as well as improving credit rating agencies and deposit insurance schemes.

To make sure that the new regulated financial system works, authorities in each country should not omit important prudential guidelines, and should not include provisions that create ambiguity. They also should enforce the regulations.

2. Improving Transparency, market discipline and corporate governance

In the rapidly changing global business environment, strengthening market discipline and self-regulation of banks and other corporate sectors is very important. And in order to achieve this, developing countries in East Asia should create stronger supervisory oversight and enforcement, create adequate infrastructure, improve accounting (new disclosure and accounting standards) and legal frameworks (new laws ruling the activities of banks, finance companies, and corporations; a new bankruptcy law; and a new tax code) that promote transparency, and better corporate governance that promotes integrity and fairness.

In the banking sector, for example, the new banking law should impose more strict disclosure requirements on banks, explicitly limiting the coverage of deposit insurance to small depositors, and
establish clear procedures for the closure and liquidation of insolvent institutions. Lack of manpower and lack of independent supervisors, however, could limit the reform in this regard. As such, improving the quality of human resources and the creation of independent supervisors are crucial for the success of the reform.

3. **Sound macroeconomic policies**

Improving regulatory and the institutional framework, however, are apparently not enough to ensure stability in an economy whose financial system is more internationally integrated. To ensure stability, a developing country should also have sound macroeconomic policy. In a more open economy, capital can flow in massively at a certain period, but unsound macroeconomic policy may deter investors from keeping their investment in the country since they believe a problem is looming. As a result, a capital flows reversal will occur, which will hit the currency and the economic growth in that country.

In an effort to create a sound macroeconomic policy, a developing country should consider limiting the size of its budget deficit, conduct proper monetary policy to keep inflation in check, adopt greater exchange rate flexibility, and maintain the current account deficit within a sustainable range. Furthermore, a transparent monetary and financial policy, and transparent fiscal policy are needed to increase market confidence toward the government and its policy.

4. **Prudential regulation of the capital account**

A liberalized capital account does not necessarily result in better domestic economic conditions. For example, prior to the 1997 Asian crisis, in some countries short term borrowing denominated in foreign currencies dominated the external borrowing of the private sector. With pegged exchange rates and foreign interest rates much lower than domestic rates, banks and firms were encouraged to borrow from Japanese, German, and US financial institutions. They did this with the assumption of no exchange rate or interest rate risks. And, in turn, they invested in long term assets, which created the classic asset-liability mismatch, between un-hedged short-term offshore liabilities and long-term foreign borrowing by corporations. As such, in a country where capital account liberalization has already occurred, foreign capital must be intermediated in ways that provide accurate signals of the interest rate and foreign exchange risks of foreign borrowing.
Another way to minimize the potential problem from capital account liberalization is that developing countries should encourage equity rather than debt flows, and long- rather than short-term flows. In order to attain this, developing countries should develop a credible legal and institutional infrastructure for private investors. In order to encourage equity flow, for example, a country may issue securities denominated in local currency in the international markets. More research and a careful analysis, however, are needed to find alternative measures in this regard for different countries with different constraints.

Meanwhile, for a country with a relatively closed capital account, capital liberalization measures must be properly sequenced. Prior to implementing capital liberalization, these countries must improve their domestic financial system by strengthening prudential rules and supervision for financial institutions, supported by sound macroeconomic management. Moreover, these countries should prioritize long-term-capital liberalization over short–term capital liberalization. In order to do so, for example, restrictions on foreign direct investment must be reduced significantly as soon as possible. In addition, these countries should also create better foreign debt risk management. And monitoring capital flows and foreign debt and improving the monitoring system are very important to improving the foreign debt risk management.
Chapter 4
Developing A New Regional Financial Architecture: A Proposal

East Asia, particularly the ASEAN+3 economies, is a potential candidate for further regional monetary and economic cooperation. On the back of the Asian financial crisis, some countries in the region may have at least a common stake to aim for regional exchange rate stability by conducting more structured regional economic cooperation. For the moment, progress in regional cooperation has been made mostly in the form of trade cooperation. Although the financial cooperation theoretically does not involve trade diversion in respect of trading partners (Rose and Persson 2001), the regional efforts to create a single market are more advanced than regional monetary cooperation.

The ASEAN Free Trade Area (AFTA) has been in operation since early 2003. Also encouraging are ASEAN-China and ASEAN-Japan agreements to create a free trade area over the next 10 years. Furthermore, internal tariffs in ASEAN continue to fall in line with the Bali Concord II agreement in October 2003 to speed up integration in 11 key industries before 2010. Under the Bali Concord II, ASEAN economies are expected to be integrated in a European-style single market by 2020, with a free flow of goods, services and investments in the region.

It is expected that the success of trade and investment cooperation within the region could evolve into more comprehensive cooperation in the areas of financial, macroeconomic policy and exchange rate coordination. Recent developments in terms of East Asian central banks that retain greater independence and better governance within these countries’ institutions also create a conducive environment for further monetary cooperation. A trust building process proved to have proceeded quite well as shown by the ASEAN+3 agreement to launch a monetary arrangement under the CMI in May 2000.

Nevertheless, there are still some weaknesses in the current CMI arrangement. As such, the region should consider other approaches that can coordinate the region’s efforts in creating better regional cooperation more successfully.

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9 At the October 2003 leadership summit, ASEAN plans to speed up integration in 11 key industries before 2010. The industries are wood, rubber, automotive, textile, electronics, agriculture, information technology, fisheries, health care, air travel and tourism sectors. Efforts are to be coordinated by different member countries: wood-based products and automotive by Indonesia, rubber-based products, textiles and apparel by Malaysia, agriculture-based products and fisheries by Myanmar, electronics by Philippines, e-ASEAN (IT linkages and development) and health care by Singapore, and air travel and tourism by Thailand.
4.1. CMI review

4.1.1. Drawbacks of the CMI

East Asian countries have recognized the need to establish a regional financial arrangement to supplement the existing international facilities. The latest and most symbolic endeavour in regard to the long path to regional financial cooperation is the Chiang Mai initiative. The Chiang Mai Initiative proposed by ASEAN+3 finance ministers in May 2000 was a major policy initiative to mobilize the regional foreign exchange reserves as their own system of defense for possible liquidity crisis. This initiative has successfully arranged the bilateral currency swap arrangements among the thirteen countries with the size increased to nearly US$ 44 billion (as of December 2003), excluding the US$ 7.5 billion arrangement under the Miyazawa initiative.

There is some criticism, however, toward the effectiveness of the CMI in its current form in tackling speculative attacks should they occur and toward its role in facilitating further regional economic integration. First of all, the amount involved through CMI is indeed small compared to the huge daily currency transactions that reach on average US$ 3 trillion per day worldwide. Moreover, most of the swap facilities are also still US$ denominated (the exception are Japan-PRC, Korea-PRC and PRC-Philippines, which would swap in their own currencies).

Players in the international financial markets are not likely to be impressed with the amount of liquidity available and hence ignore the CMI, unless the ASEAN+3 is prepared to increase the number of BSAs (Bilateral Swap Arrangements) and expand the swap amount of each BSA. Nevertheless, the arrangement at least creates a deterrent effect to the currency speculators. Orchestrated actions could hopefully boost confidence of countries in the region in defending their currencies.

Furthermore, countries under attack cannot quickly draw from BSA. Only ten percent of the amount specified in the BSAs can be drawn automatically. If a country wants to draw more than ten percent, then it is subject to certain conditionally. This includes, among other things, strict adherence to the IMF macroeconomic and structural adjustment. In addition, there are not clear joint efforts for crisis prevention in the region. As such, it seems that when a country is under attack it will have to face the attack by itself.

Another crucial problem is that the CMI has no clear common policy objectives and vision. In the absence of a clear vision on the scope and modality of financial cooperation, it will be difficult to attain working regional financial cooperation. As a result, 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.
At present, the practices under the ASEAN+3 process cannot effectively identify emerging problems (see Park (2003)). In this regard, an independent surveillance unit must be established. The surveillance unit must be able to monitor the current condition of the region’s economy, serve as an institutional framework for policy dialogue and coordination among the members, and impose structural and policy reform on the countries drawing from the BSAs. It must also be able to identify weaknesses in economic conditions that can lead to a regional recession by developing a sophisticated early warning system.

ASEAN+3 countries will have to address the weaknesses in the current CMI arrangement should they decide to strengthen the ASEAN+3 integration process further.

4.1.2. Going beyond the CMI

Following the Chiang Mai Initiative, the main challenge now is how the CMI member countries can draw a blueprint of regional financial cooperation, before the momentum created by the Asian financial crisis is lost. In order to make the arrangement more effective as a preventive mechanism, the ASEAN+3 is expected to discuss the future enlargement of the CMI by increasing the amounts of bilateral swaps and utilizing the potency of their own currencies. As such, the network of bilateral swaps could be enlarged to include all economies that play an important role in regional finance, trade and investment activities. This means the membership could also include key economies such as Hong Kong and Taiwan, and even collaborating with Australia and New Zealand. Moreover, the swap mechanism would be more effective, if it can be activated automatically and simultaneously in case a member country runs into financial difficulties.

At the same time, the network of BSAs would need a well-coordinated regional surveillance system to organize for speedy activation and disbursement of swaps. However, it is worth remembering that the speedy and collective activation as well as expansion of the available liquidity would require a more formal but independent monitoring and surveillance mechanism.

Beyond the future enlargement of the existing volume of swap arrangements, the next logical step would be the development of BSAs into some short-term borrowing arrangements (Kim, Ryou and Wang 2000) under a multilateral system. A multilateral lending arrangement would enable the regional cooperation system to be more transparent with certain pre-determined conditionality. Furthermore, if such a multilaterally agreed mechanism can be created, the regional institution will have some flexibility in coping with the financing needs of the borrower in accordance with the situation before the country goes to the IMF.
Currently, there is not a clear joint effort for crisis prevention in the region. It appears that when a country is under attack it will have to face the attack by itself. As such, after the crisis, most countries, in particular those that have experienced a financial crisis, increasingly build up their international reserves above the minimum level of four months import requirements. The main justification seems to be to ensure them of the liquidity needed in the event of a future speculative currency attack.

But Asia’s gargantuan forex reserves have, of course, their particular costs in terms of resource misallocation and opportunity lost. First, the building up of reserves deprives the growth potential as imports that could have been financed using the money held as excess reserves are forgone. The region is also unable to undertake investments linked to importing new technology to stimulate productivity and increase competitiveness. For some debt-laden countries, it also reduces the refinancing opportunity as the excess of reserves could actually be used to prepay expensive external debt to have better external debt management.

One of the options to reduce the burdens of holding reserves, which tend to increase with the growing volume of international financial transactions, is to pool a portion of their reserves to create new credit facilities for themselves. Therefore, the CMI in the next phase can be a forerunner to an East Asian Stabilization Fund (EASF). At the initial stage, the function of EASF, however, should be stressed on the promotion of monetary cooperation and regional financial market development. Its role as a financial crisis management agency would only be its supplementary function.

The foreseeable EASF would lead the study of possible reserve pooling schemes. The ASEAN+3 monetary authority could earmark a certain percentage of its foreign exchange reserves and place the funds in a common pool on a predetermined procedure. Such multi currency pooling could be drawn to support countries under speculative attack or financial crisis as well as increasing the role of regional currencies. The arrangement should enclose some conditionalities and enforcement in order to be seen credible by the market participants. At the initial stage, the EASF could operate with the IMF terms and conditions if the needed liquidity facility is over the EASF quota. But over time, as the EASF becomes mature and more effective, the arrangement could be activated independently or de-linked from the IMF conditionality. The EASF could build its owned formal conditionalities under the common agreement among the member countries. However, if the regional arrangements failed to resolve the crisis, the IMF with its conditionalities may act as the third tier of liquidity, while the regional and national owned reserves still act as the top and the second tier defense lines.
4.2. Strengthening the ASEAN +3 Process: Setting Up the ASEAN+3 Secretariat

Eichengreen (1999) claimed that East Asia lacks a tradition of integrationist vision and institutional infrastructures. However, the recent developments show that the appetite for deeper cooperation is at least on the way and the plus three countries (China, Japan and South Korea) seem to be in a position to exercise leadership. The plus three countries can exercise leadership to smoothen the transition process towards the envisioned East Asian financial integration.

Therefore, the group needs to utilize this encouraging development by creating a breakthrough initiative to set up a roadmap of a new regional financial architecture. By setting up, for example, the East Asian vision of 2025 as a premise for the regional financial architecture, the regional citizens could thus prepare themselves for the envisioned objective. At this critical stage, the East Asian cooperation therefore requires some figures with strong political leadership who envision long-term objectives towards regional financial integration. This political commitment is deemed important for the confidence building process before the group agrees to establish a formal secretariat in proceeding with the agreement of broad-based economic cooperation.

All of the countries should also realize that early commitment would potentially benefit each country in terms of its valuable contribution and influence over the design of the new regional financial architecture. And what the East Asia group can learn from Europe’s feature of cooperation is that the early buildup of institutions has become a valuable prerequisite for further integration. By creating integrated institutions, East Asian countries could symbolically clarify to the international community what their motivations are and how they believe they fit in with the existing global financial system.

Currently, the region has many disintegrated financial arrangements and policy dialogue forums. It appears that those arrangements operated without a clear path of planning towards common objectives. Unifying or transforming those arrangements into a multilateral regional institution should thus be the next logical step of more cohesive regional cooperation. It is high time for the region to set up an ASEAN+3 secretariat.

The ASEAN+3 secretariat would be a necessary driver to put not only trade and investment cooperation but also further monetary and economic agreements into operation. The secretariat could then establish blueprints or steps of action plans and the timetable for the grand vision of the new regional financial architecture. With such a coordinated mechanism, the process to accomplish the expected objective of financial integration is likely to take less time compared to the currently disintegrated financial
arrangements. It is also expected that the secretariat could act as a catalyst for closing the gap between the developed and the developing countries for having the basic requirements for financial integration to avoid any skepticism from the developing countries.

The next issues are the membership of the East Asian Economic Community and what is the possible location for a regional secretariat. As a rule of thumb, the broader the cooperation the better, although this criterion should be based on the identification of economies that are highly integrated with the rest of East Asia. Within this scope, the issue of involvement of Taiwan, Hong Kong, Australia and New Zealand within this expected monetary cooperation becomes important since these economies are significant to the regional economy and account for much of the world’s foreign exchange reserves. The best solution may be to include them in the double track process as a way of bringing their views into the debate without heightening the political tensions. On the issue of a regional secretariat location, the region could imitate the ‘Brussels solution’ that balances the broad regional interests without aggravating intra-regional rivalry (Ito, 2003).

4.2.1. The ASEAN+3 Secretariat

The ASEAN+3 secretariat could expand the functions and scope of the already effective ASEAN secretariat infrastructure. As such, we propose to merge all currently disintegrated financial process in the region under one coordinator, the ASEAN+3 Secretariat. Figure 3 shows a proposal for the structure of the ASEAN+3 secretariat. There are conceivably four main pillars for the expected ASEAN+3 framework, which are the East Asian Stabilization Fund (EASF), Technical Assistance and Consultancy (TAC), Central Bank Forum (CBU)/East Asian Monetary Institute (EAMI) and the ASEAN+3 Surveillance Unit (APTSU).

The detailed functions and objectives of each unit in the structure will be discussed in the following subsections.

4.2.2. The East Asian Stabilization Fund (EASF)\(^{10}\)

The East Asian Stabilization Fund (EASF) would act as a regional-based financial institution that provides liquidity support to countries that are hit by financial crises. The function of the fund lies in macro guidance to ensure the stability on the Asian financial market and the strengthening of supervision over financial institutions in the region. EASF would be crucial in preventing possible contagion effects originating from a crisis in one country. In other words, the EASF may act as a regional lender of last

\(^{10}\) De Brouwer and Ito, Takatoshi, “Financial, Monetary and Economic Cooperation in East Asia Where We Are, Where We Want To Be, and How We Get There from Here”, 4-July-2003.
resort in times of crisis. The large size of the foreign reserves of East Asian countries would make EASF’s task as a regional lender of the last resort become more achievable. The EASF could also over time raise the necessary funds for its core financing from subscriptions by member governments.

Initially, the CMI framework could actually act as an embryo for the EASF arrangement. While at the next stage, the currently bilateral swap arrangement could evolve into informal regional reserve pooling. As such, this regional pooling could be a frontrunner of a possible multilateral arrangement of regional monetary fund.

The EASF framework would include policy dialogues of all members of the ASEAN+3 economies, which also interacts regularly with private and market participants. Furthermore, the institution should have pre-determined terms and conditions for liquidity support-receiving countries. In this regard, relevant to the nature of the crisis but binding policy recommendations should be imposed on the borrowing countries. Without appropriate lending discipline in place, the EASF would likely be dysfunctional due to the lax supervision of financial assistance. At the final phase of its institution building process, the EASF may stand independent of the IMF conditionality, but still work intimately and cooperatively with the IMF to ensure flawless treatment of crises at the regional and global level.

4.2.3. Integration of central bank governors’ forum into the ASEAN+3 process (the Regional Central Bank Forum)

Although its arrangements are still informal, some instruments and mechanisms for monetary cooperation and policy dialogues among central bankers in East Asia are already in place. At the present time, East Asian central banks have EMEAP, SEACEN and SEANZA for their own policy dialogue processes on issues and problems of common interest and for providing training courses for central bank staff. The ASEAN + 3 countries have also the ASEAN+3 Finance and Central Bank Deputies’ meeting as the channels for financial cooperation. However, each of these forums has a variety of themes with an irregularity of meeting schedules and without secretariat for taking care of their organizational matters.

Notwithstanding these weaknesses, some progress and accomplishments have been achieved. In order to develop a region-wide bond market and help directly channel savings in the region to borrowers in the region, some countries under EMEAP, for example, have been in the process of establishing the Asian Bond Fund. A scheme by the ASEAN+3 monetary authorities in support of regional financial stability has also been arranged under the Chiang Mai Initiative Bilateral Swap Agreements (CMI BSAs).
The other purpose of the central bank governors’ forum integration into the ASEAN+3 process is to make the cooperation of monetary policy and the coordination of the CMI BSAs easier and better coordinated. Moreover, it would smoothen the transition process from the current bilateral swap arrangements into a multilateral one. In this sense, the future arrangement would be more uniform, transparent and more efficient. Over time, the creation of a formalized forum of central banks within the ASEAN+3 process would gradually facilitate more effective cooperation in the areas such as reserve pooling, macroeconomic policy coordination and other financial cooperation aspects.

As already mentioned, it is necessary for the region to formalize many central bank forums into the ASEAN+3 process to facilitate better coordination of those forums. For instance, the central bank forum could make the existing CMI BSA’s arrangement more efficient and thus lead the way from the currently CMI bilateral swap arrangements into the multilateral one. The forum in due course could be transformed or institutionalized into a European-style monetary institute, which is the pioneer of a regional central bank. The East Asian Monetary Institute linked to the ASEAN+3 secretariat would be a forum for collecting ideas and promoting good governance that may work closely with international bodies such as the World Bank and the IMF.

Initially, the coordination could focus on the development of regional capital markets, especially bond markets in East Asia as an essential complement to the bank based financial system. This initial step includes the development of the regional bonds issued in local currencies, including as a combination of regional currencies. The latter scope of coordination may be broadened to the development of an East Asian currency unit (EACU) and the exchange rate arrangement. Over time, the forum could facilitate coordination: for example, of the adoption of the Maastricht-style criteria for targeting key macroeconomic variables, which will make it easier for the region should it decide to pursue monetary union in the future.

4.2.4. Strengthening Regional Surveillance: Asean+3 Surveillance Unit (APTSU)

Macroeconomic surveillance means monitoring the status and prospects of economic conditions by a multi-national forum or an international body. Economic surveillance is not only an observation of economic indicators, but also an assessment of macroeconomic and structural and trade policies and an assessment of financial risk. After a series of currency crises triggered by massive capital flows, surveillance on risk in the capital and financial markets and soundness of financial institutions has become a priority of economic surveillance.

11 REMU (regional economic monitoring unit, under ADB) has not develop a ready to use early warning system as described in this proposal either.
The regional surveillance is not something new to the region. There are already several forums for information sharing, policy dialogue, and economic surveillance in the region (with some duplication). For example, the establishment of the Manila Framework Group in November 1997 initiated a surveillance process in Asia-Pacific countries. This group established an information exchange with the assistance of the ADB, IMF and World Bank that provide surveillance reports. Meanwhile, ASEAN countries established the ASEAN Surveillance Process (ASP) in October 1998. The objectives of the ASP are to strengthen policy dialogue and policymaking capacity in monetary, fiscal, and financial areas through information exchanges, peer reviews and recommendation for action at the regional and national levels.

In addition, the ASEAN+3 Surveillance Process was established in May 2000 under the Finance Ministers of the 13 countries of the region. In the framework of the ASEAN+3 Surveillance Process, the ASEAN+3 Finance Ministers in May 2001 proposed to create the ASEAN+3 early warning systems. So far, however, the development of the ASEAN+3 early warning systems, which is developed under ADB supervision, is still in its early stage\(^\text{12}\). As such there is no early warning system, which can warn countries in the region on whether a crisis is bound to occur, that is in place yet.

Furthermore, the Manila Framework Group, ASEAN Surveillance Process and ASEAN+3 Surveillance Process has not yet been effective since there is no organizational structure that could support the logistics of the process. The absence of a secretariat in some of the processes was also the main reason behind the ineffectiveness. Without a secretariat, work co-ordination become less easy to conduct. Moreover, there are duplications in the work of the existing surveillance processes.

In order to avoid duplication, the entire surveillance process in East Asia should thus be merged into a unified process with common policy objectives. In terms of organizational structure, this surveillance unit could use the existing ASEAN secretariat infrastructure.

**The new ASEAN+3 Surveillance Unit (APTSU)**

We propose to merge all surveillance process in East Asia into a new body called the ASEAN+3 Surveillance Unit (APTSU). At the beginning, the formation of the APTSU would be under the coordination of the ASEAN+3 secretariat. Eventually, however the unit should be fully independent with the competence and professional personnel that acts independently and in non-discriminatory way (see figure 4).

\(^{12}\) Ito, Takatoshi, “Regional Surveillance Mechanism in East Asia”, Institute of Economic Research, Hitotsubashi University
From the beginning, the APTSU should clearly state its specified objective, which is to assure the stability of financial markets and promote economic integration in East Asia. The main task of the unit would be to monitor the macroeconomic status of member countries, including the structural, trade and investment policies, and assessment of financial risk and soundness of financial institutions. In the future, the task of the APTSU may be extended further in line with the increasing degree of integration in the region.

Initially, monitoring macroeconomic trends and short-term capital flows, preparing a common template for country economic report and developing the region-wide early warning system could be the priority of the unit. As the level of integration increases, the task of enforcement mechanism could be introduced. At the next level, the ASEAN+3 Surveillance Process could include (a) the implementation of common standards such as accounting and settlement systems (b) the imposition of policy reforms and its specific sanctions and (c) macro economic policy coordination among the member countries. As some member countries are at different stages of development with disparate structural and infrastructure characteristics, the member states may integrate into the strict requirement in the ASEAN+3 surveillance process under different timetables. There would be a two-speed ASEAN+3 process: core states would integrate more deeply and the other members would follow when able. A strict benchmark and best practices, however, should be set up for each process to avoid the betrayal of the core goals.

In regard to the mechanism of Surveillance, the process should be decentralized but closely coordinated under the supervision of the ASEAN+3 Surveillance unit. Responsibility for data collections is decentralized to the hands of national authorities, which have the intimate knowledge of local markets and economies. The analysis of the latest region’s economic conditions and the direction of the region’s economy in the near future should be conducted by the APTSU. However, the national surveillance authorities and the ASEAN+3 Surveillance unit should be under intense cooperation and mutual assistance. While, the main database is located in the APTSU, the national surveillance authorities should also be able to access the database easily according to a mutually agreed mechanism.
Figure 3. The Proposed ASEAN+3 Organization

The Currently Disintegrated Financial Arrangements

- Reserve pooling/liquidity assistance mechanism
- Asian Bond Market Initiative
- Private sector & IFIs involvement

- Assist the development of financial infrastructure
- Technical assistance and human resources training
- Lead the debate of appropriate exchange rate arrangement/macroeconomic policy coordination

- Preparation for ABC (Asian Basket Currency)
- Asian Bond Fund
- Preparation for the Setting up of East Asian Central Bank
- EACU (East Asian Currency Unit)

- Monitor macroeconomic trends under the early warning systems
- Implement common standards and policy coordination
- Policy reform & dialogue
- Impose specific sanctions

ASEAN Secretariat

ASEAN+3 Secretariat
Board of Directors
Council of Finance Ministers and Central Bank Governors

Note:
- CMI: Chiang Mai Initiative Bilateral Swap Arrangement
- ASP: ASEAN Surveillance Process
- APTSP: ASEAN+3 Surveillance Process
- EMEAP: Executives’ Meeting of East Asia-Pacific Central Banks
- AFDM+3: ASEAN+3 Finance and Central Bank Deputies’ Meeting
- SEANZA: South East Asia, New Zealand and Australia Central Banks Forum
- ADBI: Asian Development Bank Institute
- IMFI: IMF Institute
- OII: Other independent research and training institutes
- SEACEN: South East Asian Central Banks Research and Training Center
The setting up of an early warning system

The current practices under the ASEAN+3 process cannot effectively signal the early warning of potential risks to facilitate the required individual or collective policy responses. Only monitoring current economic data would not be able to detect a possible problem that is likely to occur in the near future. In this regard, we propose that the APTSU develops an early warning system that could detect possible occurrence of economic problems in any country in the region, so that it can give a timely recommendation to minimize the impact on the region. The following methods of early warning system, which have been developed and used by Danareksa Research Institute to monitor the Indonesian economy, can be considered by the future APTSU to enhance its ability to detect possible economic problems in this area:

a. Prompt and Leading Economic Index

The business cycle literature recognizes three composite indices: the leading index (LEI), the coincident index (CEI), and the lagging index. The coincident index tracks the current state of the economy, which is important since GDP data is usually published with some delay. Meanwhile, the Leading Index can detect the likely movement of the economy in the near future, given that the Leading Index moves ahead of the coincident index (around 6 to 12 months, for the Indonesian case). To set up these indices, Danareksa utilizes the methodology developed by the Conference Board-USA. Components of the coincident index are retail sales, cement consumption, imports, real money supply, and domestic car sales. Meanwhile, data on the number of foreign tourist arrivals, the Jakarta Stock Market Composite Index, total real exports, building permits, foreign
investment approvals, real effective exchange rate, and the CPI in the services sector are used to construct the Leading economic indicator index.

The variables above were selected based on economic judgments and based on certain statistics methods, which includes descriptive statistics (Graph analysis) and inference analysis (correlation analysis and Granger Causality test). The series are also adjusted for seasonality by X12 Arima method (adopted from the U.S. Census Bureau), whereby we can seasonally adjust the data for moving holidays (such as the Muslim holidays) and different trading days.

There are several methods of interpreting the LEI-CEI data. The simple ones are the Two and the Three Consecutive Rule (TTCR). In the Two consecutive rule, declines in two consecutive months in the leading index suggests economic contraction, and an increase for two consecutive months suggests economic expansion. Meanwhile, in the three consecutive rule, three consecutive months of falls in the leading index indicates economic contraction and three consecutive month of increases indicates economic expansion. This methodology, however, is not very accurate, since it detects too many false alarms.

A more sophisticated method is the sequential signaling method developed by Zarnowitz and Moore (1982). Utilizing this method we can determine whether an economy is heading for a slowdown or for a deep recession. This method can also indicate whether an economy is out of a recession or not. In short, a detection of P1 (peak 1), followed by P2 and P3, indicates that a recession is looming.

However, if the detection of P1 is not followed by detection of P2, then the economy is only slowing down, and recession is unlikely to occur in the upcoming months. The business cycle...
trough is detected by the detection of a T1 (trough 1) signal, followed by T2, then by T3. However, the time span between T1 and T2 and T3 detections is quite long. Since, historically, the Indonesian LEI data shows that the detection of a T1 signal is almost always followed by T2 and T3, it is, therefore, quite safe to assume that each T1 detection can be considered as a trough in the business cycle.

This method is quite accurate in capturing the turning point in Indonesia’s business cycle. For example, a P1 signal was detected in March 1997, which indicates that the economy was facing a slow-down period. And a P2 signal was detected in June 1997, indicating that the economy was going to experience a significant slowdown. In September 1997, a P3 signal was detected, indicating that the economy was facing a recession, which occurred in 1998.

In January 1999, a trough signal (T1) was detected, signaling that the economy was entering an expansionary period. The expansion in economic activities was further confirmed by the detection of T2 and then T3 signals in the following months. Indeed, in 1999, and 2000, the Indonesian economy posted positive growth again.

However, in July 2000, a P1 signal was detected, which indicates that economic growth was slowing. Nevertheless, the absence of detection of P2 and P3 signals in the following months suggested that the Indonesian economy was only slowing down, and the threat of recession was remote.
b. Consumer Confidence Index

The Consumer Confidence Index was established to gauge consumer confidence and sentiment via a survey design that is representative, reliable and current. The outputs can be effectively used as an input for corporate decision makers, government policy makers or academicians. The surveys stress the important influence of consumer spending, saving decisions, price expectations and buying patterns in determining the course of the national economy. Therefore, when a positive trend is evident, it implies that consumers may spend more. The more optimistic consumers are, the more they will spend and the more national income will expand.

Consumer spending contributes around 70% towards Indonesia’s GDP. As such, being able to gauge the consumer’s tendency to spend in the near term is important to assess the direction of the Indonesian economy.
c. Business Sentiment Index

A wide range of private sector creditors and investors contributed to the 1997 Asian crisis. As such, monitoring the private sector is very important to assess the economic conditions of an economy. The Business survey was originally set up to supply society (especially the business community) with information about current businesses’ performance and the prospects of the economy.

Respondents of the survey are top executives (Chief Executive Officers) of companies selected from the Business Directory. Currently there are at least 700 top executives participating in the Danareksa Research Institute Business survey. From the survey, a business sentiment index is created. And the reading of the index is quite simple: If the index is over “100”, it can be inferred that positive (optimistic) responses outnumber the negatives (pessimistic). The index will be benchmarked to a base period in a certain year after a series of data has been collected, so that a value of 100 represents the same level of confidence for that year. A consistent increase in the Business sentiment index may suggest improving business conditions. In contrast, a consistent fall in the business index may suggest that an economic problem is looming. And if the index is consistently below “100”, and keeps on falling, then this may indicate a serious problem in the economy.

d. The Banking Pressure Index

To assess the condition of the banking industry, Danareksa Research Institute has developed a banking pressure index (BPI). The BPI is a leading indicator for banking crises. Various literature studies reveal that there are over 20 variables that are commonly used as leading indicators for banking distress. However, they are selected on the basis of statistical adequacy, timeliness and frequency observation (monthly basis) criteria. As a result, there are six variables used in formulating the composite BPI: the real effective exchange rate (REER), the stock market Index (SM6), the money multiplier (SM6), Real GDP (interpolated) or composite leading economic indicator (SM6), exports in nominal US dollars (SM6), and short-term interest rates. The higher the BPI (positive) value, the more likely it is that the banking system will face a banking crisis.

Six-months smoothed annualized growth rate
Danareksa Research Institute has formulated the BPI for 13 countries, namely Indonesia, Malaysia, Thailand, the Philippines, Singapore, South Korea, Hong Kong, Japan, USA, Canada, the UK, Mexico and Chile. The BPI for some of these countries can be seen in graph 16.

The ability of the developed BPI to detect a crisis is promising. For example, according to the calculations, the financial crisis that broke out in Indonesia in mid-1997 had been detected by the BPI as early as March 1997. The BPI index also suggests that pressure in Thailand’s banking system had increased since March 1996, long before the country’s economy started to take a hit from speculative attacks.

In addition to the early warning tools mentioned above, an early warning system for exchange rate should also be developed. Danareksa Research Institute is still in the process of devising this system. However, currently the result is still not satisfying and further research still needs to be done.

A Monitoring unit equipped with an accurate early warning system would enhance the ability of the region in minimizing the impact of a recession on the region’s welfare. The early warning system would allow the region to detect economic vulnerability at an earlier stage than before such that proper measures can be taken promptly.
Graph 16. Banking Pressure Index in Some Asean+3 Countries

Malaysia

Singapore

Philippines

Thailand

Japan

South Korea
4.2.5. Technical Assistance and Consultancy

The new architecture should also have a mechanism to provide policymakers with informed analysis of important issues. This technical assistance unit is basically a research and development division, consisting of policy-oriented researchers in the region. This unit has a role in organizing training programs and developing financial standards and codes suitable for the special circumstances of East Asian countries.

Some important issues of regional economic cooperation such as the financial infrastructure development, the necessary financial supervision and the macroeconomic policy coordination within the region could be addressed within this unit. The unit may also conduct preparatory research on other future cooperative issues, such as exchange rate policy coordination and financial market integration. In terms of human resources, the unit could take advantage of the richness in regional economic policy think tanks, universities or other independent research institutions in East Asia.

Besides assisting the ASEAN+3 secretariat, the unit should also support developing countries with the necessary technical assistance for having basic requirements for financial integration. However, this is not the only approach for the technical assistance mechanism. In order to encourage competition in the market for technical assistance, governments could be let free to choose the source of technical assistance with the best track record. Although the East Asian governments may freely choose the most generous and capable institution, this technical assistance should at least comply with certain standards and conditionalities under the ASEAN+3 secretariat arrangements.

4.2.6. ASEAN+3 Ministerial Council

Within the proposed framework, the ASEAN+3 secretariat would work closely with the ASEAN+3 ministerial level decision-making council. This commission is one of the institutions that would work under the ASEAN+3 secretariat management. The council may involve not only finance ministers and central bank governors (or senior representatives of national treasuries of central banks) of member countries but also capital market and other financial regulators. This council would be nurtured over time like the other elements such as EASF, CBU, TAC and APTSU. When the time is ripe, it will operate independently as an institution although it would be under the ASEAN+3 coordination.

The council may lead the policy dialogue process among the policymakers, including the aggregation of national preferences into an agreeable communiqué. It also acts as the main advocate of the integration process and as the main liaison officers to each member government. Besides acting as the lobby in the cooperation procedure, it also undertakes necessary steps to underpin regional policy dialogue in which it also collaborates with the private sector on a regular basis.
The ASEAN+3 ministerial council is essential to ensure a simultaneous joint activation of regional financial cooperation. This decision making body should be under a consensus-based mechanism, with the principal of one member one vote. The mechanism in this supra-national institution should prevent any individual member state from vetoing the council’s decision. In other words, the operational process of the ASEAN+3 secretariat should not be controlled by a few countries alone. All of the member countries views should be heard and they should obtain full participation in the decision making process. All of the ASEAN+3 countries would be the members of decision-making body. Meanwhile, Taiwan, Hong Kong (as important economies in the region), and international financial institutions such as the IMF, ADB, and World Bank would act as observers for consultation.

4.2.7. Invitation of the IFIs and the Private Sector

Under this proposed framework, the new regional financial architecture should be an important complement to stronger global cooperation and governance. Also of importance is that the spirit of regional cooperation should be based on the banner of multilateralism. This kind of construction is based on the reality that the risk of contagion needs the international lender of last resort (the International Financial Institutions (IFIs)) as the size of the rescue packages has dramatically increased lately. It should have a strong linkage with the IFIs such as the IMF, World Bank, FSF and the BIS. As such, the regional arrangement must follow the implementation of governance and accountability according to the international codes and standards. This regional cooperation through more intensified surveillance will, in turn, contribute to the global financial stability.

The regional body should also enhance their cooperation, not only in the public sector but also to include the private sector involvement in integrating the regional financial sector. This is of significance especially if the type of crisis is similar to the previous Asian financial crisis, in which the crisis was caused by the mismatch of excessive private sector debts.

Given that the current volume of official resources is no match to that of private resources, private sector involvement is crucial in preventing and resolving any crises. In other words, the private sector has a role to help fill a financing gap of a crisis country as well as an important element to curtail a free-rider problem caused by speculative players. Furthermore, if the official interventions always bailed out private sectors using taxpayers’ money without making them pay for their bad investment decisions, this would have a serious moral hazard effect. The key point of the private sector involvement is to build effective working and trust relationships between policymakers and the private sector in order to make some of the politically sensitive issues easier to address.
4.3. Exchange Rate Policy Coordination

With the ASEAN+3 secretariat in place, it will be easier to coordinate should it opt to pursue a regional exchange rate arrangement. This will be especially true given that the region would already have a clearly defined surveillance procedure, which will make it easier to standardize good practices to target commonly agreed economic indicators. Learning from the European experience, a commonly agreed analysis by strong and independent institutions would be very effective in reinforcing peer pressure to adopt certain policy measures.

From the European experience, we learn that turning to solely the type of exchange rate cooperation as in Europe prior to the 1992/1993 ERM crisis would prove to be incomprehensive or even futile with the present financial situation of a high degree of capital mobility. Even though the European Monetary System (EMS) had numerous liquidity support facilities including the very short term financing facility such as VSTF, STMS or MFTA, the mechanism did not work as planned. It appears that the bureaucracy, paperwork and disagreements over conditionalities had to some extent a role in the failure of the EMS to prevent the ERM crisis. In other words, the pace of liquidity disbursement may be too slow in times of crisis to face the global hedge funds that require only a push of one button to shift their capital to other regions. Furthermore, the Asian crisis in 1997 revealed that a dollar-pegged and free-float exchange rate regime were also not appropriate for a number of economies within the region.

Against this backdrop, targeting broad-based macro economic policy coordination with specific objectives of achieving the predetermined convergence criteria could be the next logical step rather than focusing only on the exchange rate arrangement. Once the convergence criteria have been achieved, then the region can focus on the exchange rate management.

In the history of European integration, trade integration came first before the cooperation in the monetary aspects was started (Bergsten 2000, Dieter 2001). However, it is theoretically possible to introduce the monetary integration before or in line with the trade integration schemes. Moreover, some studies by Bayoumi and Eichengreen, 1999-2000, reveal that ASEAN and East Asia as a whole almost qualify as an optimum currency area (OCA). As such, once political commitment and the necessary institutional capacity have been established, monetary integration in the region is on the cards. By introducing monetary union in the region, some benefits could be seized. According to Frankel and Rose’s (2000) simulation, the growth in intra-regional trade and investment following the monetary union may even reach 300% while a net gain in terms of reduced transaction costs may vary from 0.25% to 0.5% of GDP.

We do not want to discuss this matter in too detail considering another research group is conducting a deep assessments about foreign exchange coordination in the region.

VSTF: the very short term financing facility, STMS: the short term monetary support, MFTA: the medium term financial assistance.
Against this backdrop, should the region choose to pursue an exchange rate arrangement, the region should consider the following actions:

a. Certainly, China and Malaysia should firstly adjust their exchange rate regime in order to avoid any shocks due to prices disequilibria.

b. The region needs a coordinated simultaneous move to a currency basket system to attain a desirable equilibrium situation (Ito, 2000).

As far as the regional exchange rate arrangement is concerned, one of the alternatives that the CMI countries can adopt is a common basket exchange rate regime (Williamson, 1999). There are many suggestions on how to stabilize exchange rates with regard to a basket of currencies. For instance, the dollar standard was proposed by Mckinnon and Mundell (2001), arguing that the dollar is in fact the most dominant international currency in the region. Williamson, Bayoumi, Eichengreen and Mauro (1999), Ogawa and Ito (2000) and Kawai (2001) have also suggested the adoption of a G-3 currency basket system, which ensures intra-regional stability while allowing some flexibility against the dollar, yen and euro. On the basis of Williamson’s (1999) proposal, the weighting of these three major currencies will be 0.4 for the dollar and 0.3 each for the yen and the euro. This weighting system corresponds relatively to the weighted average of the extra-regional trade of East Asian countries with the rest of the world.

However, there are several weaknesses with this system. First of all, given the spirit of regional cooperation, the G-3 basket system is unfair since it gives the yen asymmetric advantages vis-à-vis other East Asian currencies. This system may provide the Bank of Japan with the ability to pursue an independent monetary policy, while the external stability of the yen is still not addressed. It is better for East Asia to construct a basket of regional currencies that includes all member countries with a specified weighting that reflects the relative importance of the countries in the region. As also suggested by Wang (2002), a collective arrangement similar to the European symmetric approach would be more realistic as it is in line with the spirit of regional cooperation and multilateralism.

c. The creation of an Asian Monetary Unit.

The next step is to create an Asian Monetary Unit of Account (AMU) that will act as a parallel currency or an artificial currency that could be used by all East Asian countries. As mentioned above, the AMU could be constructed based on each currency’s relative GNP. Countries may still retain their own currency, but at the same time the AMU could be used as the non-cash trading and securities market currency in the region (Mundell 2000). The AMU could also serve as the reserve
asset for international liquidity by regional central banks. Each nation’s central bank will guarantee the one-way convertibility from AMU deposits at the clearing union to its domestic money.

The exchange rate between the domestic currency and the AMU will be set initially by member countries. These rates are monitored under a band system. A wide band system would be preferable at the initial phase given possible shocks due to sudden reversals of capital flows. Over time, the band could be narrowed as the confidence of market participants strengthens (Wyplosz 2002). At the final stage of regional financial arrangement, the institution-building process should also include harmonization of financial regulatory system, the rules of seignorage sharing and the terms and conditions of central bank functions.

4.4. A LONG TERM VISION

In the long run, the new regional financial architecture should enhance intra-regional trade, promote peace and stability, raise the living standards of the region’s people, and strengthen the regional economies. To achieve this, the region should take and sequence the necessary steps. Figure 5 shows an alternative of a reasonable time frame to be considered by the region. Some of the target dates were taken from the already announced declaration or MOU by leaders in this region. For example, in August 2003, ASEAN leaders unveiled a road map to integrate the region’s markets by 2020. As such, it is reasonable to extend the targeted ASEAN economic community to the ASEAN+3 economic community by 2020.

After creating the AMU (presumably it would be in place by 2020), the East Asian countries should consider to attain regionwide monetary union and a full currency union. This objective of monetary integration is an integral part of achieving the ultimate vision of promoting peace, stability and prosperity. The early establishment of regional institutions, especially the ASEAN+3 secretariat therefore will be very useful to support this challenging long-term vision. In this connection, the success of East Asia’s monetary cooperation may rely on the strength of political commitment or whether the strong political leadership will eventually emerge in the region. Meanwhile, this grandiose scheme must also give the rationales of how a monetary union and a single East Asian currency would improve the standard of living in the region.

The monetary cooperation has several benefits for member countries. The currency stability will bring about a reduction of costs and risks of doing business. For example, the capital mobility from Jakarta to Singapore would not cause any exchange rate realignments. Furthermore, the international price competitiveness within the region would also not alter suddenly, making the global economy and international monetary system more stable and sustainable. Although this architecture involves a loss of monetary policy autonomy, the benefits still outweigh the costs as it also prevents the beggar-thy-
neighbour or competitive devaluation from happening. As such, the intra-regional trade and investment may also grow faster than the period before monetary integration.

However, monetary integration in East Asia may only proceed in an evolutionary process through several stages of development. The region still faces different degrees of trade and financial market liberalization, not to mention the extent of the diversity of exchange rate regimes. Also challenging is the fact that the regional economies are still widely diverse in terms of per capita incomes, institutional capacity, economic system and structure and the level of financial infrastructure development. Given that kind of situation, any efforts to take joint action for substantial economic convergence will be more difficult.

Improving financial infrastructure as well as technical assistance to the developing countries within the region is thus very important to support the economic and monetary union. The region also needs robust and liquid capital markets as an important step toward harnessing the region’s savings instead of these savings being absorbed into major global markets and recycled back to Asia.

In promoting the new regional financial architecture, all the CMI member countries should take an active role. These efforts include how to enlarge the cooperation to countries that are highly integrated with the rest of East Asia such as Australia, New Zealand and important economies such as Taiwan and Hong Kong. Moreover, Japan, China, and Korea as the leading economies in the region should also further open their domestic markets and increase the transfer of technology to the rest of East Asia. By increasing its technological transfer to the rest of East Asia, the plus three countries would make a great contribution for expediting the process of the regional economic union.
Figure 5. Timeline Toward the Long-Term Vision

**Main Features**
- Setting up the ASEAN+3 Secretariat
- Free trade between member states
- Common external tariff
- Free movement of factors of production
- Harmonization of economic policy
- Centralization of economic and monetary policy
- Single currency

**Preliminary Actions & Prerequisites**
- All the regional forums and surveillance process in the region merge into the ASEAN+3 supervision
- APT countries in 2001 agreed to negotiate a FTA by 2010
- ASEAN agreed in Oct 2003 to speed up integration in 11 key industries before 2010
- China and Japan agreed with ASEAN to create a FTA in the next ten years
- As free trade arrangement goes deeper to all of the member countries, internal tariffs fall.
- The establishment of East Asian Economic Community (of some 2 billion consumers)
- ASEAN in Aug 2003 unveiled a road map to integrate the region’s markets and currencies by 2020

**Regional Financial Arrangement**
- Setting up the new regional financial architecture
- Setting up transitional regional exchange rate arrangements
- Macroeconomic policy coordination
- Stability of regional currencies
- Dual legal tender period
- EACU/AMUA for transaction and securities market
- Monetary coordination
- Transition of East Asian Monetary Institute into regional system of central bank

**Long Term Vision**
- Promote peace and stability
- Raise the living standards of the region’s people
- Strengthen the regional economies
- Enhance intraregional trade

**Timeline**
- **Consolidation Period** 2004-2006
- **Free Trade Area in ASEAN + 3** 2010
- **Custom Union** 2015
- **Common Market** 2020
- **East Asian Monetary Union** 2020-2025

- **Consolidation Period**
- **Free Trade Area in ASEAN + 3**
- **Custom Union**
- **Common Market**
- **East Asian Monetary Union**
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