

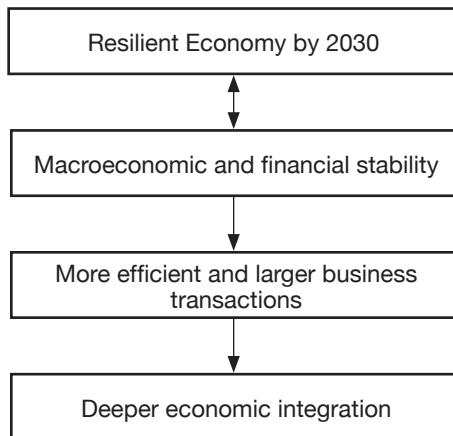
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## Financial Cooperation in ASEAN

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FINANCIAL COOPERATION IS one important aspect of ASEAN integration. ASEAN, in its aspiration for integration by 2030, aims to be “RICH” (resilient, inclusive, competitive, and harmonious). Of these features, the one that is most relevant to this chapter is the first feature, which is that ASEAN aims to be a resilient economy by 2030. According to an Asian Development Bank (ADB) publication on the ASEAN 2030 aspiration, ASEAN needs macroeconomic and financial stability if it is going to be resilient. Stability refers to conditions that are predictable and insusceptible to shocks from both domestic and external sources. Predictable macroeconomic variables help reduce unexpected risk and hence produce more efficient business flows. In brief, achieving macroeconomic and financial stability is important for the region’s business flows—and thus its integration—in its pursuit of a resilient economy as it moves toward ASEAN 2030.

Figure 1. Logical Framework



Regional financial integration is important for several reasons. First, the more open an economy, the more exposed it is to external shocks. Therefore, cooperation is needed to anticipate the risks that countries face. Policy cooperation can be more economically beneficial than individual nations' efforts to manage risks and prevent crises.<sup>1</sup> Second, a larger market due to integration would improve cost efficiency. Financial cooperation tends to insure countries from country-specific shocks.<sup>2</sup> Financial integration is also said to bring direct and indirect benefits, which consist of improving growth opportunities and lowering systemic risk.<sup>3</sup>

Since macroeconomic and financial stability needs at least financial stability, financial integration, exchange rate coordination, and fiscal policy coordination, this chapter addresses all of those elements except for fiscal policy. Each element is discussed starting with an overview of the importance or current level of progress on that element in ASEAN, followed by an explanation of the existing ASEAN-Japan initiatives in that element. The chapter draws policy recommendations in light of what ASEAN aims to achieve by 2030.

**Table 1. Topics covered by the chapter**

Targets	Initiatives/Actions
Financial stability	CMIM
Financial integration through existing infrastructure/mechanism through a deeper/more developed market	ABF and ABMI
Exchange rate coordination	An initiative for RMU
Fiscal policy coordination	Dialogues

It seems that ASEAN member countries have learned substantially about financial stability from the Asian financial crisis in 1997–1998. Currently the financial condition seems to be much less vulnerable than it was in 1997–1998, at least in terms of currency and maturity mismatches. This is the result of the prudent policies that countries adopted. Central banks in Asia have strong mandates to execute monetary policy for financial stability. That kind of mandate is not found on other continents. Also, since the global financial crisis began in 2008, several Asian countries have applied new regulations to control their capital flows in order to maintain the stability of their exchange rates.<sup>4</sup>

The Chiang Mai Initiative Multilateralization (CMIM) serves as evidence of regional cooperation in providing financial safety nets. The reserve pool under the CMIM is apparently lower than the EU's regional financial arrangement (RFA), and the region's access limit under

the CMIM is much lower than its access limit under the International Monetary Fund (IMF). Also, the reserves pool under the CMIM is very low compared with the total of the individual countries' foreign reserves. It is worth mentioning that funds under the CMIM mechanism have never been used despite the mechanism being in existence since 2010. Hence, either its effectiveness has never been tested or it is not effective enough for any country to have wanted to make use of it since 2010. Along with the CMIM, the ASEAN+3 Macroeconomic Research Office (AMRO) has also been operating since 2010. Its function as a surveillance unit on the macroeconomic condition of the ASEAN+3 countries needs to be strengthened in both capacity and authority.

The process of financial integration in Southeast Asia runs slowly. There are relatively few intraregional financial transactions, and people prefer to conduct financial transactions at home, probably because they think that they know domestic financial markets better than foreign ones. The literature also reveals possible explanations for this sluggish progress of regional financial integration: shallow financial infrastructure, relatively low capital account liberalization, relatively high exchange rate volatility, differences in the level of development, and differences in geographical settings and languages.<sup>5</sup> The Asian Bond Fund (ABF) and the Asian Bond Markets Initiative (ABMI) are ASEAN+3 initiatives set up to address this lack of financial integration with the specific purpose of developing local bond markets.

High exchange rate volatility inhibits businesses in the region. This situation calls for exchange rate coordination. However, the idea of forming a regional monetary unit (RMU) should be assessed cautiously to determine whether the coordination that would result from its introduction is more beneficial than the restrictions it would generate as authorities would lose part of their sovereignty.

## ASEAN: FINANCIAL STABILITY AND INTEGRATION

### Level of Stability

Masahiro Kawai and Peter Morgan emphasize the significant risk of financial crisis, which suggests the need for macroprudential policy (i.e., policy dealing with systemic risks). They believe that Asian economies are subject to large and volatile international capital flows.<sup>6</sup> According to Kawai and Shinji Takagi, large capital flows are prone to the following risks:

- a. Macroeconomic risk in which large capital flows may induce excessive domestic credit growth, economic overheating reflected by high inflation, and appreciation of real exchange rates. In the end, all of these may lead to unsustainable economic growth.
- b. Financial instability, in terms of maturity and currency mismatches.
- c. Sudden reversal of capital flows, which may lead to depreciation of exchange rates.<sup>7</sup>

Learning from the Asian financial crisis of 1997–1998, there are at least two indicators that countries should be concerned with to avoid a recurrence of the crisis: currency mismatch and maturity mismatch. Currency mismatches occur when there is a difference between foreign-currency liabilities and export earnings. Table 2 shows that the recent ratio is much lower than that of a decade and a half ago.

**Table 2. External debt to export earnings (percent)**

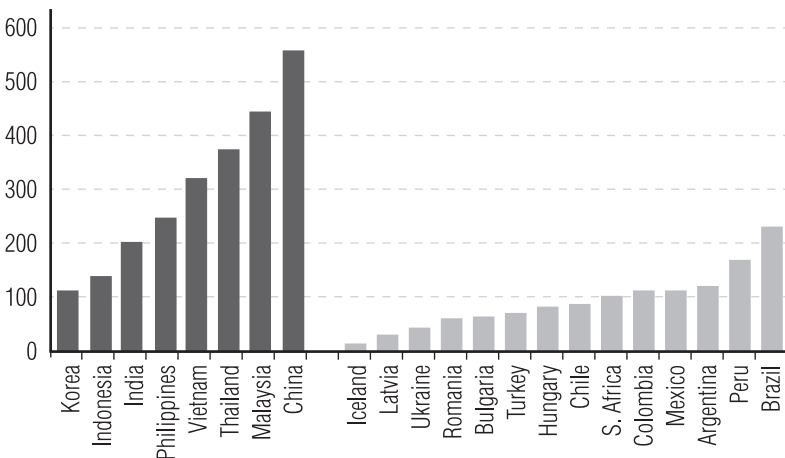
	2010	2007	1997
Indonesia	101	100	209
Malaysia	32	28	49
Philippines	103	102	105
Thailand	30	24	144

Source: CEICData.com.

Maturity mismatches are the difference between long-term illiquid assets and short-term debts. Figure 2 shows that the ratios in Asia are higher than those in Latin America and Central and Eastern Europe.

According to the ADB report, Singapore has excessive credit

**Figure 2. Reserves to external financing requirement, 2009 (percent)**



Notes: Gross international reserves (December 2008) as a percent of external debt maturing in 2009 (projected) plus projected current account deficit for 2009 (zero, if current account is in surplus).

Source: Morris Goldstein and Daniel Xie (2009), "The Impact of the Financial Crisis in Emerging Asia," Working Paper 09-11, Peterson Institute for International Economics, Washington DC.

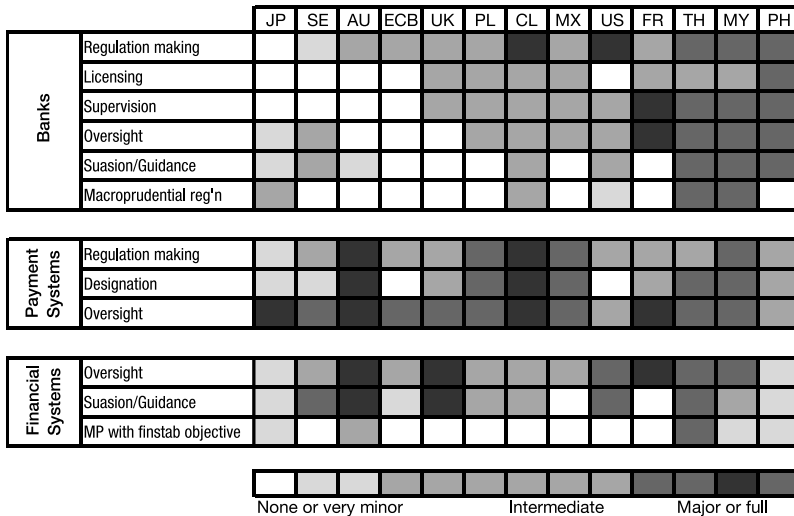
growth, asset price bubbles, and banking vulnerabilities. It also points out that Indonesia is experiencing risky capital flow and exchange rate volatility.<sup>8</sup> And in the past few years, Singapore, together with China and Hong Kong, have witnessed soaring housing prices, which is seen as a sign of new speculative bubbles.<sup>9</sup>

The portrait of financial stability can also be seen by looking at the central banks’ mandates toward financial stability.<sup>10</sup> Table 3 depicts the level of mandates owned by central banks of various countries for financial stability in their respective economies. The assessed mandates include those addressing the banking, payment, and financial systems. Thailand, Malaysia, and the Philippines have strong banking system mandates relative to the other countries in the table. And these three countries adopted explicit monetary policies to achieve their financial stability objectives while many other countries in the table did not.

Moreover, central banks use monetary policy instruments and macroprudential policy tools to achieve financial stability. Monetary policy instruments, through open market operations and reserve ratio requirements, manage the supply of and demand for money. Macroprudential policy

**Table 3. Financial stability–related mandates of central banks in 2009**

(The darker the shading the bigger the mandate)



Notes: AU = Australia; CL = Chile; ECB = European Central Bank; FR = France; JP = Japan; MX = Mexico; MY = Malaysia; PH = Philippines; PL = Poland; SE = Sweden; TH = Thailand; UK = United Kingdom; US = United States;

Source: Adapted from Bank for International Settlements (2011), cited in Masahiro Kawai and Peter J. Morgan, “Central Banking for Financial Stability in Asia,” *Public Policy Review* 8, no. 3 (2012): 215–46.

tools are designed to lessen the likelihood of systemic financial crisis. The macroprudential policy tools adopted by some ASEAN member countries include loan-to-value ratios, tighter lending criteria, tighter supervision, exposure limits on specific sectors, capital surcharges for systemically important banks, and limits on currency mismatches.<sup>11</sup>

Managing capital flow is another tool to control exchange rate fluctuation, and some countries have recently used this tool to maintain financial stability. In 2010, Indonesia imposed a minimum one-month holding period on central bank notes, and in 2006, Thailand imposed an unremunerated reserve requirement (30 percent) on loans, bonds, mutual funds, swaps, and non-resident baht accounts. Then in 2008, Thailand put limits on commercial banks' net foreign currency exposure and in 2010 imposed a 15 percent withholding tax on capital gains and interest income on foreign bonds.<sup>12</sup>

In all, financial stability in terms of currency and maturity mismatches has been well controlled. From a policy perspective, Southeast Asian central banks' mandates for financial stability were relatively strong. Likewise, macroprudential tools and recent measures regulating capital flows indicate the good will of the Southeast Asian authorities to create financial stability.

#### CHIANG MAI INITIATIVE MULTILATERALIZATION

The ASEAN+3 Finance Ministers and Central Bank Governors' Meeting in Manila in May 2012 resulted in an agreement to double the size of the reserve pool under the CMIM without changing the share of contributions. ASEAN contributes 20 percent and China, Japan, and Korea contribute 80 percent. The meeting also agreed to increase the portion of the fund that a country can access without being linked with the IMF-adjustment program; it used to be 20 percent but it is now 30 percent of a country's access limit. Table 4 shows members' contributions to the CMIM, their maximum swap amounts, and voting rights. Moreover, the meeting agreed on new CMIM facilities for its members: a precautionary line (PL) for crisis prevention mechanisms and a stability facility (SF) for crisis resolution mechanisms. A country may use a PL or an SF up to the maximum swap amount. The maturity period of a PL and a non-IMF binding SF is six months, with three renewals, supporting a total period of two years. Meanwhile, the maturity period of IMF-linked SFs is one year with two renewals, supporting a total period of three years.

Ideally, the RFA's assistance to its members does not need to be linked to an IMF-adjustment program. In East Asia, assistance is usually needed to overcome a short-term liquidity problem in the market. Linking the

Table 4. CMIM contributions, purchasing multiple, and maximum swap amount

Countries	Financial contribution (billion US\$)		Share (percent)	Purchasing multiple	Maximum swap amount (billion US\$)
Plus Three	192		80		117.3
Japan	76.8		32	0.5	38.4
PRC	PRC	68.4	32	28.5	34.2
	Hong Kong, China	8.4		2.5	6.3
Rep. of Korea	38.4		16	1	38.4
ASEAN	48		20		126.2
Indonesia	9.104		3.793	2.5	22.76
Thailand	9.104		3.793	2.5	22.76
Malaysia	9.104		3.793	2.5	22.76
Singapore	9.104		3.793	2.5	22.76
Philippines	9.104		3.793	2.5	22.76
Vietnam	2		0.833	5	10
Cambodia	0.24		0.1	5	1.2
Myanmar	0.12		0.05	5	0.6
Brunei	0.06		0.025	5	0.3
Laos	0.06		0.025	5	0.3
Total	240		100		243.5

Source: "Fact Sheet: CMIM Contributions, Purchasing Multiple, Maximum Swap Amount and Voting-Power Distribution," <http://www.amro-asia.org/wp-content/uploads/2012/05/Fact-Sheet-at-AFMGM+3-in-Manila.pdf>.

RFA's facility with IMF programs to address this problem would lead the beneficiary to bear political costs that are higher than its economic benefit.<sup>13</sup> Furthermore, the IMF link reduces the amount of money that CMIM members can enjoy. Under the CMIM arrangement, only 30 percent of each member's access limit can be used without an IMF-adjustment program. This of course diminishes a country's preference to make use of the CMIM, as IMF stigma is still attached to those economies. For example, Indonesia has a right to swap up to US\$22.8 billion according to the agreement; however, merely US\$6.8 billion is de-linked from the IMF and can be used by the country. This amount is insignificant compared with the country's own foreign reserves of around US\$105 billion in 2013. Therefore, in this case, the linkage with the IMF lessens the relevance of the RFA to its member economies because when crisis strikes, countries would rely on their own foreign reserves instead of the CMIM. Hal Hill and Jayant Menon demonstrate that this will also occur even for ASEAN's newer, smaller members, Cambodia, Laos, Myanmar, and Vietnam.<sup>14</sup> Hill and Menon illustrate the insufficiency of the CMIM facility by reflecting on the Asian financial crisis experience and mention that during the crisis Thailand and Indonesia

received US\$17 billion and US\$40 billion respectively as emergency funds while currently their IMF-delinked CMIM rights are US\$6.8 billion.

A further decrease of IMF-linked funds is one action that could be taken to raise the level of funds countries can use. Another option is expanding the membership to include Australia, New Zealand, and India. Chalongsob Sussangkarn argues that more members means a larger reserve pool, and he thinks that these countries together with current CMIM contributors should be included because they are members of the East Asia Summit.<sup>15</sup> This may be a good proposal since many regionalization processes under the East Asia Summit overlap with ones under ASEAN+3, which comprises CMIM members. Hill and Menon add that having a large number of members would serve the principle of risk diversification. Economic crisis may hit any country in the group, possibly spreading to neighboring countries. Having a larger number of members therefore increases the possibility that more countries will be unaffected by the crisis and thus can assist those hit by it.<sup>16</sup>

In addition to size, another key to the functioning of the CMIM is time. The execution of the fund should be fast enough to halt the spread of the crisis. Moreover, the certainty of assistance should not lead to moral hazard. Hill and Menon point out that the disbursement of the CMIM facility fund is time consuming, as it requires a high-level meeting of representatives from all member countries.<sup>17</sup> This is contrary to the bilateral swaps, which can be disbursed quickly. The inability of the CMIM to provide quick and liquid funds may lead to its irrelevancy as members prefer bilateral swaps to the CMIM facility.

Theoretically, regional assistance should step in first as economies in the region are usually more connected and therefore have stronger interest in avoiding contagion. Furthermore, neighboring countries usually obtain information about a country's problems faster than others do as a result of their geographic proximity. In cases in which an RFA has a surveillance unit—like the CMIM with AMRO—the monitoring unit is expected to watch the members' economies more intensively than the IMF does for its near universal group of members. Therefore, regional support in this case is likely to be the first line of defense for an economy in a critical moment. If short-term support from the region does not solve the issue, then IMF support might be needed even with its conditionality.

Moral hazard may appear as a result of the size and certainty of the CMIM safety nets. However, at this stage the probability of moral hazard occurring seems relatively low, as fund disbursement requires a long administrative and decision-making procedure. Nonetheless, the likelihood of moral hazard can be lowered with the establishment of an effective surveillance



unit. The CMIM has AMRO as its surveillance unit, and its presence should lessen countries' tendencies to adopt imprudent economic policies. The publication of regular economic reviews produced by the unit should put pressure on the economy to improve its performance. This situation would also create peer pressure among member economies, which can encourage governments to manage their economies well.<sup>18</sup> Consequently, the unit should produce credible economic reviews. Given this responsibility, Hill and Menon think that AMRO should decide who should receive funds from the CMIM facility and how the funds should be given at any point in time. While AMRO currently cooperates with multilateral institutions such as the ADB and the IMF, Hill and Menon emphasize that AMRO should have the final say regarding the amount of loans and conditionality given to members. Here, the independence of AMRO is very important for swift disbursement as well as for the CMIM to remain relevant to its members.<sup>19</sup> According to Hill and Menon, the IMF should be a complementary, instead of the primary, source of funds for the region.<sup>20</sup>

## FINANCIAL INTEGRATION

### Level of Integration

A financial market is said to be well functioning when it helps boost the real sector and when funds can move freely according to the rate of return. A well-functioning integrated financial market in ASEAN will provide liquidity and trade financing useful for advancing intraregional trade as well as infrastructure development. However, ASEAN financial markets are highly segmented with few cross-border transactions. According to IMF data from 2009, only 8.3 percent of Southeast Asia's outward securities portfolios were invested in the region. Moreover, the 2010 data show that although Asians owned 23 percent of the world's total invested assets, which is equal to US\$7.4 trillion, only 6 percent of that amount was managed in Asia. The majority is invested in North American and Western European countries.<sup>21</sup>

There are a number of possible reasons for this. First, price differences between two countries' financial services reflect the differences in underlying risks of those services. Moreover, information asymmetry is by its nature prevalent in every financial transaction. As a result, people prefer to transact with an institution that they think they know. Second, there is a mismatch in the quality of investment instruments that Asian investors want to hold and that Asian companies offer. This is one reason why Asians prefer intermediation in New York or London.

One study that compares real integration and financial integration in East Asia finds that real integration has been advancing fast but that financial integration lags behind. Increasing intraregional trade among countries in the region is evidence that integration based on goods proceeds rapidly. The East Asian goods market is integrated both regionally and globally. On the other hand, regional financial markets are integrated relatively more with global markets than with each other.<sup>22</sup>

Another study utilizes the gravity model to investigate the determinants of financial integration in East Asia. It finds that integration is impeded by underdeveloped financial infrastructure, a low level of capital account liberalization, and higher exchange rate volatility in East Asia as compared with Europe.<sup>23</sup>

An earlier study asks the question as to why there has been less financial integration in Asia than in Europe. It finds that the reasons include very different levels of economic development as well as differences in other factors such as geographic settings and languages. The authors also suggest that, since intraregional exports as a percentage of GDP are only a third of what they are in Europe, Asia needs additional cross-border financing to support further intraregional trades.<sup>24</sup>

The argument that one reason why financial markets in East Asia are less integrated is that financial infrastructure is underdeveloped implies that well-developed markets are one condition for a well-integrated regional market. While the development gap among financial markets is large, in general they are underdeveloped. To be more precise, Cambodia, Laos, Myanmar, and Vietnam have yet to build solid banking systems.<sup>25</sup> Meanwhile, ASEAN-6 members need to make huge efforts to develop their capital markets, such as the corporate bond market. In 2010, the size of the Asia Pacific bond market was only one tenth of the size of the equity market. Furthermore, the shallow nature of the capital market is reflected by the fact that 74 percent of the Asia Pacific debt market in 2010 was denominated only in renminbi and not fully traded or marketed.<sup>26</sup>

## ASIAN BOND FUND 2

The Asian Bond Fund 2 (ABF2) was launched to develop and integrate the regional market.<sup>27</sup> The initiative, which was born in December 2004, aims to invest US\$2 billion in government and semi-government bonds issued in eight places (China, Hong Kong, Korea, Singapore, Indonesia, the Philippines, Malaysia, and Thailand) and denominated in local currencies. The objectives of the initiative are to increase the liquidity of the bond

market, stimulate the market's activity, and encourage regulatory reform and improvement of market infrastructure. Different from the ABMI, the objective of which is to support the bond's suppliers so that governments and corporations may have additional financing sources through bond issuance, the ABF emphasizes its focus on the demand side, which is meant to invigorate local bond markets by both domestic and foreign investors.

A 2012 study to evaluate the performance of the ABF2 found that it has served its purpose to a certain extent. The study demonstrates the success of the ABF2 by showing the emergence of interdealer brokers as market makers to the newly issued bonds in the eight countries. The authors provide figures of outstanding government and corporate bonds in 2005 and 2010 for every country wherein the amounts rose substantially over the years. These indicate a higher degree of market activity and participation of a larger number of market players. They also mention that several countries relaxed their restrictions on non-resident investors to increase the market's transaction volume. For example, Malaysia, Thailand, and Korea removed their regulation of withholding tax on interest income to nonresidents. Malaysia and Thailand also allowed foreign parties to issue bonds denominated in their local currencies. The authors of the study assert that these policy changes were the result of the ABF2 initiative. However, the study notes that liquidity is still a major challenge in the corporate bond markets.<sup>28</sup>

It is worth noting that this need to remove barriers to foreign investors implies that more integrated markets may be contradictory to the objective of financial stability. More intense cross-border capital flow, while indicating less-segmented markets, may threaten the financial stability of an economy. And risk of sudden capital flight would jeopardize the host economy. This has led some countries to put restrictions on capital flows. Thus, there is a trade-off between financial stability and financial integration to some extent.<sup>29</sup> In line with this idea, Philip Turner observed that in normal times, foreign capital inflow provides a great deal of liquidity, but too much of it may trigger a crisis. Therefore, he suggests that an economy not be too dependent on foreign capital but have a solid domestic investor base.<sup>30</sup> This idea is in line with the development of local bond markets. In addition to developing local bond markets, one prerequisite for integrating financial markets is the adoption of a solid regulatory framework. As Mitsuhiro Osada and Masashi Saito found in their study, countries with good institutions and well-developed financial markets could benefit more from financial integration.<sup>31</sup>

## ASIAN BOND MARKETS INITIATIVE

Another initiative to develop the region's financial markets is the ASEAN+3 ABMI. The initiative, which was born in 2002, was a reaction to the Asian financial crisis of 1997–1998. The crisis was triggered by a sudden reversal of capital flight in the face of currency and maturity mismatches. Afterward, policymakers were aware of the need to lessen their dependency on short-term foreign capital, so they tried to build solid domestic bond markets whereby domestic savings could be channeled to local currency-denominated bonds. Therefore, the ABMI was introduced to develop local currency bond markets. To achieve this purpose, the ABMI makes efforts to increase the number of bond issuers; expand the types of bonds to include those issued by foreign authorities, national governments, and corporations; and create a conducive environment for the bond market to grow.

Although the 2008 New ABMI Roadmap is not binding for the ASEAN+3 member countries and does not have specific numeric targets within a certain timeframe, A. Noy Siackhachanh reports on several success stories concerning the ABMI during the period from 2002 to 2012.<sup>32</sup> First, over that period, the size of government bonds outstanding in the region rose more than five times to US\$3.77 trillion by the end of 2011. The share of local currency government bonds to GDP also rose for each country except for Indonesia and the Philippines, since those two countries had recently brought their fiscal deficits under control. Second, there have been many new issuers of domestic currency bonds such as national governments, state-owned enterprises, the ADB, the World Bank Group, the International Finance Corporation, the Japan Bank for International Corporation, multinational corporations, foreign banks, and policy banks. New issuers emerged because countries changed their policies to allow those institutions to issue bonds. Siackhachanh asserts that the foreign institutions bring about positive impact to the newly emerging domestic bond markets through their international standards of practice in bond issuance. Local market participants can then learn from and imitate the foreign institutions' practices. Third, the share of local currency corporate bonds to GDP for China, Korea, the Philippines, Thailand, Malaysia, and Vietnam rose over the 10-year period. Siackhachanh argues that this is the result of the better environment created for the market through, for example, generation of the yield curve as the benchmark of bond prices and improved and more liberal capital market regulation.<sup>33</sup>

Despite the recent developments in the countries' bond markets, Siackhachanh also notes the limitations of bond markets in the region. First, the number of issuers is limited. For instance, 94 percent of Indonesia's

corporate bond outstanding value is issued by only 50 firms, and 70 percent of Thailand's corporate bond outstanding value is issued by only 30 firms. Furthermore, the majority of the issuing firms are state-owned enterprises. Second, many of the bond markets are not deep or liquid.<sup>34</sup> A market is deep and liquid if the size of bond outstanding is above US\$100–200 billion.<sup>35</sup> Only China, Korea, and Malaysia have exceeded this threshold.

Moreover, ASEAN+3 policymakers have an ongoing discussion on many aspects such as market infrastructure and standardization of regulations. Standardization of credit rating, accounting, and bankruptcy procedures are examples of issues they are now discussing.

Thus, it is clear that despite the improvement brought about by the ABF and the ABMI, local bond markets still need to be strengthened on the demand and supply sides, with the purpose of creating a solid domestic investor base that is resilient to crises and ready for regional and international integration.

## EXCHANGE RATE COORDINATION

As ASEAN aims to be a resilient economy, which can be translated as macroeconomic and financial stability, the region should attempt to stabilize exchange rates. Intra-Asian exchange rate volatility tends to harm trade more than benefit it due to the intense production networks in the region.<sup>36</sup> Depreciation of currency A against currency B in the region would lower import demand of B from A. The low demand will also reduce country A's need for parts and components from B. Hence, trade is reduced because of the depreciation. In this respect, coordination of exchange rate policies among countries in the region is needed. One idea is to have greater coordination in exchange rates through the introduction of an RMU. An RMU may serve one or more of several purposes. First, the RMU is calculated as a weighted average of member countries' currencies, and then each currency is seen relative to the RMU. This would lead to more stable currencies, as the RMU serves as a surveillance tool for the region's exchange rates. Second, the RMU can be used in the RFAs like the CMIM. An RMU may also play a role in special drawing rights in the IMF. Calculations of contributions and withdrawals can be done in the RMU. The stabilizing mechanism is that countries that can maintain the stability of their exchange rates may be rewarded with higher multiples and countries whose exchange rates fluctuate heavily will merely obtain lower multiples. This would lead to a convergence of exchange rates. Third, the RMU may serve as an alternative to international reserve assets. The

idea, supported by China, is to make the RMU a supranational currency. Fourth, the RMU would be introduced with the objective of having a single currency like the euro in the European Union.<sup>37</sup>

A survey of ASEAN+3 leaders found that leaders think that the most challenging aspects to realizing the idea of an RMU are political and institutional. Regarding the political aspects, it may not be easy to agree on currencies and their respective weights to be calculated as the benchmark of the RMU. Regarding institutional aspects, leaders think that there is no institution capable of taking responsibility to establish the RMU. The authors of the survey suggest using the proportion of CMIM voting weights as the basis for the RMU's calculation. They also suggest delegating the tasks of preparing the technical aspects of the RMU and establishing it to AMRO.<sup>38</sup> However, AMRO's website explicitly states that its core objectives are (1) to address balance of payment and short-term liquidity difficulties in the region and (2) to supplement existing international financial arrangements. Therefore, preparing the technical aspects of the RMU may not be a priority for AMRO, which is a relatively new institution that is now struggling to gain relevance as a surveillance unit of the CMIM.

While pursuing exchange rate stability through an RMU as a surveillance tool might enhance further integration in the region, there are at least two points that should be heeded if the region is to work toward the final aim of a single currency. First, member countries should exhibit more or less similar trends in macroeconomic variables such as inflation. Coordinating exchange rates of countries with similar movements of economic variables would be beneficial to every member economy. However, a single currency for countries with very large development gaps can be disadvantageous for certain members. The application of a single currency implies the release of a country's sovereignty over exchange rate policy tools even though the tools are crucial when the country needs to adjust its economy against shocks. Hence, a single currency allows its member countries to fall into crisis, which could possibly contiguously expand to its neighbors. Greece's experience with the euro seems strong enough to validate this opinion. Second, it may not be easy for Asian countries to peg their exchange rates relative to the RMU, as suggested as a purpose above, since Asian countries just removed their pegs in the 1980s and 1990s.

#### WAY FORWARD TO ASEAN 2030

As mentioned at the outset of this chapter, ASEAN aspires to be "RICH" by 2030: (1) managing macroeconomic and financial stability for **resilience**,

(2) promoting economic convergence and equitable growth to ensure **inclusiveness**, (3) using and developing comparative advantages and innovation for **competitiveness**, and (4) nurturing natural resources and sustaining the environment for **harmonious** growth.<sup>39</sup> Maintaining macroeconomic and financial stability are challenges that have to be overcome if the region is to have a resilient economy. Cooperation among countries to achieve macroeconomic and financial stability has at least two objectives. The first objective is to further support the enhancement of a real sector wherein intraregional trade growth has been very high. Favorable macroeconomic and financial systems would help tap the region's growth opportunities. The second objective is to anticipate hand-in-hand the likelihood of crisis and thus maintain economic stability against shock.

Several recommendations can be made based on this author's findings. Southeast Asian economies are in general less vulnerable to financial instability than they were in 1997 in terms of currency and maturity mismatches. However, there are risks associated with macroeconomic stability, including among others the housing price bubble and excessive credit growth that Singapore is facing and the volatile capital flows and exchange rate movement that Indonesia is facing.<sup>40</sup> Nevertheless, most Asian countries currently adopt prudent policies to maintain stability, policies related to the financial, banking, and payment systems. The existing ASEAN-Japan initiative for financial stability is the CMIM, an arrangement of ASEAN plus China, Japan, and Korea to keep a reserve pool of US\$240 billion to be disbursed to any member country disrupted by unexpected shocks. This initiative is explicitly written in other forms of ASEAN-Japan cooperation (see table 5).

Given the fact that the CMIM and AMRO have never proved effective at preventing or resolving crises, in the short run Japan is very much expected to strengthen the CMIM as the region's safety net and AMRO as the surveillance unit with the following goals:

1. That the CMIM have *sufficient* funds for crisis prevention and crisis resolution in the event that a crisis strikes one or more of its members. While the amount of funds that will be sufficient is unpredictable, the amount of emergency funds deployed to deal with the Asian financial crisis in 1998 can be a good reference. In addition, the amount should not be too small relative to countries' foreign reserves and their IMF borrowing limits if the CMIM wants to gain relevancy.
2. That AMRO make *independent* decisions on disbursing the facility funds regarding the timing, amount, and conditionality.
3. That AMRO produce a *transparent* assessment of members' economies.

Table 5: ASEAN-Japan financial cooperation

	ASEAN 2030	Jakarta Framework	ASEAN-Japan Plan of Action	Tokyo Declaration	Bali Declaration	ASEAN-Japan Comprehensive Economic Partnership
Trade finance, relating to ASEAN export credit agencies	x		x			
ASEAN Infrastructure Fund	x		x			
Asian Bond Markets Initiatives	x		x			
AMRO	x		x			
CMIM	x				x	

Source: Author's research, drawing on information from the ASEAN+3 Macroeconomic Research Office, [www.amro-asia.org](http://www.amro-asia.org).

Note: x represents the existence of the initiative in each form of ASEAN-Japan cooperation.

The financial integration process in East Asia has been moving slowly. The economies in the region are more integrated globally than regionally. A few probable reasons include the tendency to avoid the risk of investing money in foreign financial markets due to lack of information on foreign markets and unpredictable exchange rates, unattractiveness of financial products due to the dearth of innovation and shallow financial development, countries giving different treatment to foreign and domestic investors, the persistence of the development gap, and differences in language and geographical distance. Existing ASEAN-Japan initiatives include the ABF and the ABMI. Both aim for development of domestic bond markets. The ABF2 invests US\$2 billion in local-currency bonds in eight countries. Meanwhile, the ABMI encourages bond issuance by government, private, and other institutions and improves regulatory frameworks and infrastructure. Recommendations for Japan should focus on ASEAN financial development.

1. Japan should help equip the market with infrastructure, such as clear rules for various markets (e.g., the derivative and repurchase agreement markets). As building soft infrastructure like this usually takes time, this may be tackled as medium-term cooperation.
2. Japan, through its various institutions, should increase its purchase of ASEAN's local-currency bonds in order to stimulate the growth of the market. This should be done in the short run as some initiatives to develop local-currency bonds have already been implemented.



3. Japan should involve itself in promoting financial literacy among ASEAN countries to reduce asymmetric access to information so that people have enough knowledge to invest in capital markets both at home and abroad. As learning is an ongoing process at all times and new innovation in financial markets will always occur, promoting financial literacy should be seen as a continuous mode of cooperation.

Exchange rate coordination is also believed to enhance the business sector, and the idea has been floated of building an RMU—a unit of accounting formulated from Asian local currencies with a range of levels of functions from surveillance to use as a single regional currency. Nevertheless, formulating an RMU will involve political will. The race for influence by China and Japan should not jeopardize the economic interests of other countries in the region or disturb the purpose of exchange rate coordination. One should also consider what the final goal of an RMU is and whether the goal benefits all economies. This should be done while reflecting on what has happened in the EU, where several countries are locked in their commitment to euro application, which then exposes their economies to calamity.

## NOTES

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