Discussion Paper Series

RIEB

Kobe University

DP2011-31

Financial Cooperation in East Asia: Its Future Directions

Wataru TAKAHASHI

November 28, 2011

Research Institute for Economics and Business Administration

Kobe University

2-1 Rokkodai, Nada, Kobe 657-8501 JAPAN

November 2011

Financial Cooperation in East Asia: Its Future Directions[1]

Wataru Takahashi[2]
Research Institute for Economics and Business Administration
Kobe University

Abstract

After looking back the achievements of financial cooperation in Asia, this paper argues its future direction. Despite recent financial turmoil of "Euro", the financial integration in Europe still has the aspects from which we should learn.

The other aspect of the financial integration besides the single currency is to develop the good market infrastructure at regional scale. In this respect, Euro has attained good achievement. Financial service has improved much in Europe, which supports the promotion of trade and investment. In Asia, economic integration has progressed in trade and production, while cross border financial service is far behind. There remain many impediments in the financial services. In order to improve them, the priority should be put on the development of financial infrastructure

Keywords: financial cooperation, the single currency, financial integration
JEL Classifications: F36, F55, O19

[1] This paper was originally prepared for a conference held at the Korean Capital Market Institute on April 28, 2011 in Seoul, South Korea.

[2] Research Institute for Economics and Business Administration (RIEB), Kobe University, 2-1, Rokkodai, Nada, Kobe, 657-8501, Japan, Email: wtaka@rieb.kobe-u.ac.jp, Tel/Fax +81-78-803-7005

Introduction

Today there is a widespread and increasing perception that financial cooperation in East Asia is approaching a crossroads. The background to this perception is, first, that cooperation up to now has recorded several major achievements and completed its first stage, and so it appears that the time has come to move forward to the next stage. Second, it is felt that if cooperation stalls now, concrete opportunities will be lost.

With respect to the achievements thus far, some 13 years after the Asian financial crisis, cooperation succeeded in establishing a swap network, the Chiang-Mai Initiative (CMI), and its large amount of foreign reserves is commonly acknowledged to have supported Asian financial markets during the recent global financial crisis. The promotion of the Asian Bond Market Development by means such as the Asian Bond Market Initiative (ABMI) and Asian Bond Fund (ABF) also attained success. The ABF was launched in all the economies of the Executives' Meeting of East Asia Pacific Central Banks (EMEAP), and foreign bonds began to be issued in domestic markets such as China. As the final target of cooperation, the Asian common currency has been on the agenda since financial cooperation in the region began. Various proposals have been discussed, and the Asian Currency Unit has been calculated and published. Discussion of further steps, however, has not progressed. There is no consensus on establishing a common currency, despite the economic integration seen in deepened trade relations.

It is clear that currency risks caused by fluctuations in exchange rates would be contained by the introduction of a common currency. And even if the region remained vulnerable to risks outside its boundaries, the member countries of a common currency would be able to speak with a unified and more powerful voice outside the region. History has shown that Europe enjoyed greater influence in discussions of international financial architecture following its integration. In the case of East Asia, however, political decisions are required, and thus the region lags far behind in reaching consensus. Quite recently, the Chinese government's movement toward internationalization of the renminbi might reflects frustration about the slow progress toward a regional common currency (Yu [2011] and Li [2010]).

Thus, financial cooperation in Asia currently faces the problem of determining whether it should accelerate to promote the idea of a common currency. I would make the argument, however, that there are many things to be done before moving to a single currency. To facilitate the idea of a common currency, it is necessary to improve the market infrastructure. For example, to increase the currency's circulation in cross-border transactions in the region, a stably functioning payment system is required.

Financial cooperation is required to improve the market infrastructure. Harmonization of the infrastructure such as the payment system and the legal framework is very important, since it is a necessity condition for common currency,

The Asian Common Currency: An Impossible Dream?

In addition to differences in terms of monetary policy, there are many differences in the stages of development, political systems, and so on. Because of this, it is sometimes argued that the Asian common currency is an impossible dream.

A look at the region's history, however, tells us that a common currency in East Asia is not a new development. For example, in Japan in the 15th and 16th centuries, both coins minted locally and coins imported from China circulated widely. *Eiraku-sen* copper coins from the Ming Dynasty were widely used in Japan at the time (Picture 1).

(Picture1) Eiraku-sen (Eiraku-tuho)
Chinese Copper Coins, Ming Dynasty

This type of usage occurred not only in Japan but also in other countries close to China. The pattern reflected the dominant economic power of China in those days, but it was also the case that Asian economies shared common business practices, and thus the regional economy was integrated to some extent.

It has also been argued that contemporary differences in politics, religion, and culture might act to prevent Asian integration. However, ASEAN provides us with an important counterexample. Despite the diversity in the ASEAN members' economic development, political systems, and religion, their history demonstrates a solid sense of commitment toward closer relations. On this particular point, integration appears to be more deeply entrenched in ASEAN compared to Europe.

Currency Arrangements and Financial Integration

To clarify my argument, I would like to categorize financial cooperation as being of two types: currency arrangements and financial integration. Policy coordination such as exchange rates and monetary policy fall into the first category. The Asian common currency and the Asian Currency Unit are also on the agenda. Financial integration here means capacity building in the Asian financial market. It means harmonization of financial infrastructure such as payment systems, corporate governance, legal systems, accounting systems, business rules and other practices.

The two types of financial cooperation are complementary. However, it is better to achieve financial integration first, since establishing currency arrangements is a difficult and time-consuming process. This is particularly so in Asia, given the large differences among economies. China's monetary policy, for example, is government-regulated, whereas Japan's is market-oriented. Thus, time is required for mutual coordination to implement a single policy.

A Two-Track Approach

As ultimately both currency arrangements and financial integration are important, a good strategy would be to adopt a two-track approach, consisting of currency arrangements and financial integration. With respect to currency arrangements, the ASEAN+3 Macroeconomic Research Office (AMRO), a regional surveillance unit of the Chiang Mai Initiative Multilateralization (CMIM), was established in Singapore in March. It is expected to cover both macro policy and financial stability. Although achieving the Asian Common Currency remains a task for the future, we have seen a reasonable degree of progress in currency arrangements. By contrast, despite the ABMI project has begun intensive study of the creation of financial infrastructure such as a bond market, relatively little progress has been achieved in financial integration such as the harmonization of infrastructure.

The promotion of financial integration has become increasingly necessary in the region. Trade and other forms of economic integration in East Asia have progressed at a rapid pace. Corporations operates beyond home-country borders. Free trade agreements have been contracted in the region, and they support such activities. In the fields of manufacturing and trade, cross-border activities experience less friction. By comparison, many impediments remain in the field of finance.

To promote financial integration, it is important to solicit advice from the private sector. Since firms and investors are the main players in the market, their opinions should be respected by the public sector. Firms require improved financial services, and it is also important to invite the private sector to promote financial integration. The private sector could take a leading role in many areas such as payment, and business rules and practices. This might represent an attractive business opportunity for the private sector. With the collaboration of the private sector, financial cooperation could encourage the development of financial industries in the region. This would be an important objective of economic policy.

As currency arrangements are a task mainly for the public authorities, much cooperation from the private sector should be invited in capacity buildings for financial integration. Some describe the former as a "top-down approach" and the latter a "bottom-up approach," more priority should be placed on the latter.

The Experience in Asia

As I mentioned, we have seen positive achievements in the region such as the CMIM and the ABMI/ABF (BIS(2011)). These were promoted after the Asian financial crisis that began in 1997. In response to the crisis management, the Asian Monetary Fund was proposed but not realized. Japan then launched the New Miyazawa Initiative and the regional countries agreed to set up the ASEAN+3, the most influential policy forum of the regional economy. The CMIM and ABMI are projects of ASEAN+3.[3] Their main concern has been the design of projects to resolve and prevent such a crisis. But there is too much emphasis on crisis solution and prevention. This might be one reason why financial integration has not progressed very far in financial cooperation in Asia.

Lessons from Europe

Even after the serious crisis in Europe, we have much to learn from the European experience of financial integration. The achievement of the euro as a single currency is well known, but much progress has also been achieved in the financial (monetary and capital) market.

One of the positive features of financial integration in Europe is its systemic approach.[4] A clear goal has been set for the single market to provide better

[3] The ABF was promoted by the economies of EMEAP and sought to improve market infrastructure. It introduced the Asian Bond Index to invite foreign institutional investors. By listing on the exchange markets, it promoted the standardization of fund trading. The concrete results of the ABF gained momentum for financial cooperation—another aspect of the success of an Asian bond project such as the ABF.

[4] Kuroda (2000) has asserted that one of serious shortcomings of financial cooperation in Asia is that it lacks a clear goal.

financial services equally in the region and to draw a clear workload to proceed from the beginning. Academics and the private sector have been invited to help set the agenda. The Giovannini report of 1997 ("The impact of the euro on the capital market") was made public and determined the direction of the project, with the head of the Group being Dr.Alberto Giovannini of former Professor of Columbia University. The project proceeded with a financial action plan from 1998 to 2005. In the course of progress, internal and external reviews were conducted.

It was a major project to conduct the harmonization of many fields such as law, accounting systems, and business standards. Many regional projects were begun. One of the assignments for the European Central Bank involved the payment system. As part of this, systems such as TARGET, TARGET2, and TARGET2-Securities launched operations.

It should be noted that in the case of TARGET and other systems, some non-member countries of Euro such as the United Kingdom, Denmark, and Sweden join the project. This suggests that it is possible to promote a "single market" separately from a "single currency."

Although the recent crisis in Greece shows that many problems remain concerning the euro, it is undeniable that financial integration has brought numerous benefits. The capital market, for example, has seen reductions in costs through improved efficiency. A more controversial point is that current account imbalances have expanded since financial integration. The trade imbalance between Germany and Spain has rapidly grown after the introduction of Euro. Until recently a current account balance could be financed smoothly under the single currency and market.

The crisis demonstrates the necessity for discipline regarding fiscal and external balances. But financial integration offers the advantage that the external balance can be financed in a smooth and efficient manner.

On the other hand, Europe has also shown us the bitter truth that a single currency is not a magic wand. Introduction of the euro did not give Europe immunity to the crisis. This teaches us the simple lesson that policy discipline is required to maintain a single currency.

Conclusions

In this paper, I have explored the future directions of financial cooperation in East Asia. East Asia must move forward to achieve financial integration (single market/market integration) as well as currency arrangements.

With financial integration, East Asia will be able to provide better financial services for firms operating cross-border businesses in the region.

It can also invite private initiatives from the financial sector in the region. This will enhance development in the financial industry.

All of this will promote a single currency, since a smoothly functioning financial market is the basis for a key international currency.

Mail References

Asian Development Bank (2004). *Monetary and financial integration in East Asia: the way ahead Volume Ⅰ, Ⅱ*, Great Britain, Palgrave MacMillan

Asian Development Bank (2010). *Institutions for Regional Integration; Toward an Asian Economic Community"* Manila, Philippines, Asian Development Bank

Bank for International Settlements (2011). Local currency bond markets and the Asian Bond Fund 2 Initiative,
http://www.emeap.org/emeapdb/upload/WGMeeting/July2011_Local_currency_and_ABF2_Initiative.pdf

Henning, C. Randall (2002). *East Asian Financial Cooperation*, Washington, Institute for International Economics

EMEAP (Executives' Meeting of East Asia and Pacific Central Banks) (2011), Press Statement: The two-phase implementation of the Asian Bond Fund 2 (ABF2) Single-market Funds has been completed,
http://www.emeap.org/emeapdb/upload/Press/14july11.pdf

Jang, Hong Bum (2011). Financial Integration and Cooperation in East Asia: Assessment of Recent Developments and Their Implications, *IMES Discussion Paper E-5*, Bank of Japan,

黒田　東彦(Haruhiko Kuroda) (2004). *元切り上げ (Revaluation of Reminbi)*, Tokyo, Nikkei BP,

李　暁 (Li Xiao) (2010).東亜貨幣合作為何遭遇挫折？(Why financial cooperation in

East Asia have not succeeded ?), mimeo.

李　暁 (Li Xiao) (2011).Why has Monetary Cooperation in East Asia Suffered Setbacks?——On the Internationalization of RMB and its Implication for Future Monetary Cooperation in East Asia, 国際経済評論 (International Economic Review) 2011-1, 中国社会科学院

Takahashi, Wataru (2003). The East Asian economies after the financial crisis: a role for the Japanese yen?, In H. Dobson and G.Hook ed. *Japan and Britain in the Contemporary World : Response to Common Issues (Sheffield Centre for Japanese Studies/ Roultledge Series)*, London and New York, Routledge Curzon,

Yu, Yonding (2011),The-yuans-journey-to-the-world, *http://www.todayonline.com/Business/EDC110602-0000005*