



IDSS COMMENTARIES (31/2005)

IDSS Commentaries are intended to provide timely and, where appropriate, policy relevant background and analysis of contemporary developments. The views of the authors are their own and do not represent the official position of IDSS.

Recent Advances in Regional Financial Cooperation: Has ASEAN Plus Three (APT) Overtaken ASEAN?

Helen E.S. Nesadurai*

15 June 2005

IN May 2005, finance ministers of the ASEAN Plus Three (APT) grouping proposed improvements to the Chiang Mai Initiative (CMI). This is a regional facility that pools a proportion of members' foreign exchange reserves to provide short-term financing to countries facing currency crises. Also in May 2005, the regional network of central bank officials, EMEAP (Executives' Meeting of East Asia and Pacific Central Banks), announced implementation details of the second Asian Bond Fund.

These announcements are noteworthy as they indicate the pace and extent to which financial cooperation has taken off in the region. The CMI's reserve pool currently stands at US\$36.5 billion, with plans for expansion. Two regional bond funds have also been launched. Both initiatives are lauded as key elements in an emerging regional financial architecture targeted respectively at crisis management and crisis prevention. In contrast, regional tariff liberalisation at the ASEAN-level took 10 years to get to first base, with predictions that deeper economic integration in ASEAN will proceed at a similarly cautious pace.

Why has regional financial cooperation at the APT-level advanced much faster than regional trade liberalisation at the ASEAN-level? Does this confirm predictions that the APT will overtake ASEAN as the more effective institution for regional economic governance? A closer examination however suggests that regional financial cooperation will come up against some weighty challenges that will determine its future progress. It is also inaccurate to regard ASEAN and the APT in zero-sum terms. Both undertake distinct but functionally interrelated roles in the regional political economy – to enhance member countries' links to beneficial international capital while minimising the risks. They are complementary rather than competing institutions.

The Chiang Mai Initiative (CMI)

APT, which brings together the ten ASEAN states and China, Japan, and South Korea, adopted the CMI in May 2000. It has developed into a network of bilateral currency swaps negotiated between different pairs of APT countries. By May 2004, US\$36.5 billion was available in the pool, with individual countries able to draw on between US\$1 billion to US\$3 billion for up to 90 days, renewable for two years. The CMI includes the US\$1 billion available under the ASEAN Swap Arrangement. The CMI supplements rather than replaces IMF liquidity support. Access by a country to 90% of available funds is subject to adoption of an IMF rescue programme, with only 10% available immediately for emergency assistance.

The CMI's present design however has some limitations. First, a bilateral arrangement is less effective in providing liquidity support than a multilateral one. Second, the CMI's economic surveillance mechanism is based on the voluntary exchange of information. Third, the stipulation that draw-down of more than 10% of funds must be linked to IMF programmes limits its effectiveness as an *emergency* response mechanism.

In May 2005, APT finance ministers identified measures to address these shortcomings. First, new swap arrangements, especially among ASEAN states, will be negotiated to increase the spider-web of linkages among APT members. Second, APT members have proposed doubling current swap amounts, which will result in a funding pool of around US\$70 billion. Third, there are plans to shift to a collective activation of swaps rather than the current bilateral arrangement. Fourth, there are plans to institute a comprehensive surveillance mechanism to detect economic/financial weaknesses in member states that might precipitate a crisis. These are key steps towards multilateralising the CMI. Finally, finance ministers agreed to increase to 20% the amount that may be drawn without IMF-supported programmes to permit a more effective response to emergencies.

Developing regional bond markets

The CMI is aimed at crisis management. It does not directly address structural weaknesses in the financial systems of member countries that could precipitate a crisis. One such weakness is heavy reliance on short-term foreign currency-denominated bank loans for financing long-term projects. This creates a 'double mismatch' problem – in debt maturity structure and in currency mismatch – that has the potential to spark a currency and financial crisis once market sentiments deteriorate, as happened during the Asian crisis. National bond markets offer better financing options in this regard. However, a *regional* bond market would help overcome the deficiencies of smaller, national markets through consolidating risks and expanding liquidity conditions. It will also help channel more effectively the region's considerable savings for use in the region.

In June 2003, the region's central bankers, through EMEAP, launched the first Asian Bond Fund (ABF-1). This did not, however, address the currency mismatch problem as it was limited to investing in US\$ denominated bonds. However, the second bond fund (ABF-2) launched in December 2004 will invest in domestic currency bonds. (EMEAP comprises representatives from 11 central banks – Japan, China, South Korea, Hong Kong, Indonesia, Malaysia, the Philippines, Thailand, Singapore, Australia and New Zealand).

With EMEAP concentrating on regional bond funds, APT has focused on supply-side matters. It launched the Asian Bond Market Initiative (ABMI) in December 2002 aimed at developing the infrastructure needed to support well-functioning regional bond markets. Six working groups chart out work programmes for members in areas that are currently under-developed in the region: regulatory frameworks, new securitised debt instruments, credit guarantee mechanisms, foreign exchange transactions and settlement issues, issuance of local currency denominated bonds, and rating systems.

Why has regional financial cooperation progressed so rapidly?

The horrific experience of the 1997-98 Asian crisis was an important driver. A currency crisis very quickly became a financial and then an economic crisis, with Indonesia experiencing

deep political turmoil as well. This sparked interest in regional mechanisms to help protect countries from future crises, especially since APT members realised that their economies would remain vulnerable so long as global financial markets were weakly governed. They also realised that IMF funds may be insufficient in the event of another major crisis involving many countries. It was logical for these initiatives to emerge at the APT rather than the ASEAN level given the considerably larger foreign exchange reserves of the three Northeast Asian states, currently about US\$1.5 trillion.

Both the CMI and bond fund projects promised clear economy-wide gains, while their domestic distributional effects have been muted thus far. Consequently, there was little domestic opposition to these two projects. In contrast, business and other interested parties lobbied early on for protection from ASEAN trade liberalisation, marring its progress.

China's strong interest has also been important, as has Japanese financial, technical and intellectual support. Could China-Japan animosities derail future financial cooperation? Interestingly, the May 2005 decision to advance the CMI was reached during a time when relations were at their lowest in three decades. As Japanese finance minister, Sadakazu Tanigaki, was quoted as saying in *The Straits Times* on 5 May 2005: "Whatever happens, we need to promote financial cooperation even if there are [political] issues."

ASEAN and the APT: complementary rather than competing

Should we then conclude that the APT has overtaken ASEAN as the more effective institutional framework for regional economic governance?

While not denying the advances that have been made by the APT in financial cooperation, major challenges lie ahead. To ensure well-functioning regional bond markets and a credible liquidity facility, the APT countries have to undertake extensive domestic reforms in the banking and financial sectors and in corporate governance. They also have to institute a credible regional surveillance mechanism. However, this is easier said than done. First, powerful domestic interests may now challenge the domestic reform process. Second, governments will come up against the sensitive issue of sovereignty as they seek to develop a more effective, and therefore, more intrusive, surveillance mechanism.

Unlike financial cooperation, the APT has yet to see similar progress in other areas of cooperation. Negotiating an APT-wide free trade area (FTA) will be a formidable task given different levels of development, diverse special interest groups, and other sensitivities. Such dynamics were evident as ASEAN negotiated its own trade liberalisation project; the problem will be magnified at the APT level. It is one reason for the popularity of bilateral FTAs.

Bilateral FTAs cannot, however, replace ASEAN-wide liberalisation given the reality of transnational production networks spread out across Southeast Asia. ASEAN, consequently, will remain an important component of regional economic governance. The setbacks encountered in trade liberalisation notwithstanding, all the ASEAN governments accept that regional integration enables small economies to better position themselves to attract global investment. Progress thus far may be slow, but perceptions of China soaking up investment could well act as a fillip to the ASEAN integration process. ASEAN, moreover, engages in a much broader economic cooperation agenda, including economic surveillance as well as social development projects that help support regional liberalisation.

Both ASEAN and the APT will, therefore, remain at the core of regional economic governance. They have clear, if distinct roles in the regional political economy. This enables their respective members to respond to different pressures and risks associated with participation in the global economy. ASEAN and the APT should not be regarded as competing institutions. As such, any suggestion that the latter has overtaken the former is misplaced.

* Helen E.S. Nesadurai is Assistant Professor at the Institute of Defence and Strategic Studies, Nanyang Technological University. This is a personal comment.