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Regional cooperation for financial and exchange rates stability in East Asia

Extending existing currency swap agreements without the linkage to an IMF program and creating the East Asian version of the Special Drawing Rights

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Introduction

East Asian Financial Regionalism: An Alternative Model for Intraregional Financial and Exchange Rate Stability

Facing the continuing European sovereign debt crisis, East Asia has restarted to strengthen regional frameworks for financial and exchange rates stability. After the Asian financial crisis, East Asia has already tried to deepen regional financial cooperation and became the second example for financial regionalism after Europe. In spite of their efforts to prevent another financial crisis, the large swing of foreign capital in- and outflow has repeatedly caused financial instability of emerging and developing countries.

All East Asian countries have incentives to enhance financial regionalism, but with different goals. This includes China and Japan, who are concerned about their neighbours' financial stability. China, on the one hand, has announced the internationalisation of Renminbi as a long-term national strategy and has enlarged its influence on its neighbouring countries. Japan, on the other hand, aims to prevent Chinese hegemony and to maintain a power balance in the region.

East Asian countries have regarded European financial regionalism as an advanced model. Therefore, the European sovereign debt crisis teaches them importance and difficulties of regional cooperation. The implications are twofold: Firstly, the continuing economic crisis in the Euro zone's peripheral countries underlines the importance of exchange rate variability to potential receivers in East Asia. Secondly, the wide-ranging paternalistic assistance of the European Central Bank (ECB) remind the potential donors of the difficulties to distinguish between a country's *liquidity risk* (risk of short-term payment difficulties) and *solvency risk* (risk of inability to repay its debts with interests), and of the importance of an effective regional surveillance for crisis prevention.

Based on the necessity for financial and exchange rates cooperation as well as the experiences from European financial regionalism, East Asian countries are going to strengthen regional measures to reduce their *liquidity risk*. Because of its importance to the global economy, East Asian financial regionalism will

in turn influence the global financial system based on the International Monetary Fund (IMF) and the United States Dollars (USD). Furthermore, it will also contribute to the development of the Eurosystem because the comparison between the two regional systems provides Europe with appropriate precautions when introducing a new assistance program.

How can East Asia strengthen the regional frameworks for financial and exchange rates stability? How will it influence the existing global financial system? What does it tell Europe? This research analyses possible further developments of East Asian financial regionalism and evaluates its influence on the global financial system and the Eurosystem comparing the three systems with macroeconomic statistics and market data.

Results of the study

- *Possible further development of East Asian financial regionalism*: East Asia will create a new mechanism to decrease the *liquidity risk* of the emerging and developing countries. To distinguish *liquidity risk* and *solvency risk* properly, and to prevent moral hazard, the new mechanism will maintain intraregional exchange rates variability, and focus on *ex ante* conditions and the regional surveillance of both the public and the private sector.
- *Influence on the global financial system*: Crisis prevention measures of the IMF are restricted to countries with sound economic fundamentals. Hence, their application has so far been limited to four member countries. The East Asian regional system extends this global system to those countries which are not in the scope of the current IMF's global crisis prevention measures. Therefore, this new regional system will contribute to further enhancing the global crisis prevention measures.
- *Implication to the Eurosystem*: In contrast to the Eurosystem, East Asian financial regionalism is cooperation among totally independent states without a common currency. In Europe, the common currency highlights the character of the current Eurosystem. On the one hand, it integrates the *solvency risk* of a member country with the other member countries through the ECB's liquidity assistance for the ailing country's banks. On the other hand, the foreign exchange reserves of the euro zone countries which were not transferred to the ECB have lost their original role concerning market interventions.

Recommendations

- *Information exchange on a regular basis*: Exchange of information, experiences and opinions with East Asia is also of advantage to Europe, because the long history of European integration, which relies on *bona fide* policies of member countries, makes it difficult to keep on recognising structural weaknesses of the whole system. In addition to academic discussions, consultations at governmental levels promise to be fruitful because the reflection of financial markets and the difficulties in policy implementation cannot be effectively discussed in academic fields only.
- *Use of foreign exchange reserves of the peripheral countries*: Under the current Eurosystem, Germany cannot stay totally free from the *sovereign risk* of other euro zone countries. Thus, it is very important for Germany to maintain the financial stability of the peripheral countries and to avoid capital flight from them. This implies continuous support by the ECB and the European Stability Mechanism (ESM). At the moment, historically high unemployment rates together with continuing recession of the peripheral countries cast doubt about the solvency of the banks and the governments. Germany should encourage them to make economic revival plans financed by selling their foreign exchange reserves to the ECB.

Necessity for financial and exchange rates cooperation in East Asia

The Asian century

Asian GDP will increase from $17 trillion in 2010 to $174 trillion in 2050, thus accounting to half of the global GDP, according to a recent study.[1] In 2050, Asia will have incomes similar to those of today's Europe. However, the successful economic development in Asia during the last century owes to the relatively low labour costs and large amount of foreign direct investments motivated by the low labour costs. These advantages will gradually disappear with the economic development. Therefore, Asia will have to compete with other emerging and developing countries with their own capitals and industrial techniques. If they do not survive this harder competition in the next stage of economic development,[2] the Asian century scenario as described in the introduction will fail.

Why is regional financial and exchange rates cooperation necessary when deciding on appropriate policies to reform economic models? In this chapter, its necessity is analysed from the viewpoints of economic integration, financial globalisation and resource allocation.

[1] Harpaul Alberto Kohli, Y. Aaron Szyf, and Drew Arnold, "Construction and Analysis of a Global GDP Growth Model for 185 Countries through 2050," *Global Journal of Emerging Market Economies* 4 (2012) 2: 91-153.

[2] The phenomenon that middle-income countries often face structural problems for further economic development is called "the middle-income trap". See, e.g., Jesus Felipe, "Tracking the Middle-Income Trap: *What* is it, *Who* is in it, and *Why*? Part 1," *Asian Development Bank Economics Working Paper Series* No. 306 (March 2012). This study points out that out of 52 middle income countries (countries with per capita GDP in 1990 purchasing power parity $2,000-11,750) in 2010, 35 countries were in the middle-income trap, that is, these countries have stayed in the middle income group for more than the standard time as compared to high-income countries.

Economic integration in East Asia

It is generally accepted that excessive volatility of exchange rates has a negative impact on economic growth.[3] Therefore, the creation of a free trade zone in East Asia naturally encourages the participating countries to cooperate on financial and exchange rates stability in the region.[4]

Since the early 2010s some important structural changes have been under discussion in East Asia. The Association of Southeast Asian Nations (ASEAN) has agreed to establish the ASEAN Economic Community and to transform ASEAN into a region with free movement of goods, services, investment, skilled labour and freer flow of capital by 2015.[5] Parallel to the negotiation of the ASEAN Economic Community, another step was accomplished in November 2012, when ASEAN, Australia, China, India, Japan, South Korea and New Zealand (ASEAN+6) declared to start negotiations on the Regional Comprehensive

[3] A statement by G7 Finance Ministers and Central Bank Governors (February 12, 2013) confirms that "excessive volatility and disorderly movements in exchange rates can have adverse implications for economic and financial stability." Source: the HM Treasury of the United Kingdom, https://www.gov.uk/government/news/statement-by-the-g7-finance-ministers-and-central-bank-governors (accessed 15 May, 2013). In the theory, see, e.g., Mathilde Maurel and Gunther Schnabl, "Keynesian and Austrian Perspectives on Crisis, Shock Adjustment, Exchange Rate Regime and (Long-Term) Growth," *Open Economies Review* 23 (2012) 5: 847-868.

[4] For example, the European Union provides member countries which did not adopt Euro with the balance of payments assistance. The United States and Canada made currency swap agreements with Mexico on the Mexican financial crisis in 1994. See EU, *Financial assistance in EU Member States*, http://ec.europa.eu/economy_finance/assistance_eu_ms/index_en.htm (accessed May 16, 2013); Joseph A. Whitt, Jr., "The Mexican Peso Crisis," *Federal Reserve Bank of Atlanta Economic Review* 81, no. 2 (January/February 1996) 1: 1-20, http://www.frbatlanta.org/filelegacydocs/j_whi811.pdf (accessed May 21, 2013).

[5] ASEAN, *ASEAN Economic Community*, http://www.asean.org/communities/asean-economic-community (accessed April 16, 2013).

Economic Partnership (RCEP). This partnership, which is envisaged being completely negotiated by the end of 2015, entails significant improvements of the existing ASEAN+1 free trade agreements.[6] The RCEP encompasses half of the world's population and a third of the global GDP (see Table 1).

Although the negotiations on economic integration in East Asia will pose challenges similar to those experienced by Europe during its integration process, too much is at stake for East Asia to not arrive at a political compromise in the region. In the light of intense international competition as a result of globalisation and the established regional production network, East Asia has so far succeeded in promoting regional economic integration. The proportion of intraregional trade of ASEAN+3 (ASEAN, China, Japan and South Korea) and ASEAN+6, which reached the level of that of the North American Free Trade Agreement (NAFTA) in 2010, is estimated to be approaching the EU level (see Table 2). Economic integration in East Asia will then require further development of financial regionalism, in order to avoid too much volatility of the intraregional exchange rates, which damages stable development of intraregional trades and investments.

Management of financial globalisation

Emerging and developing economies in East Asia have reaped substantial benefits from financial globalisation because of foreign direct investments. However, the more they are seeking to profit from financial globalisation, the more they need to abolish financial restrictions to invite foreign capitals. However, the abolition of financial restrictions makes the economies vulnerable to rapid in- and outflow of foreign capitals because the size of their financial markets is much smaller than that of industrialised countries (see Table 3). As a result, some of the East Asian currencies such as South Korean Won and Indonesian Rupiah are very volatile to external shocks (see Figure 3).

[6] The Ministry of Economy, Trade and Industry Japan, *Joint Press Release with the Ministry of Foreign Affairs: Announcement of the Launch of Negotiations for the Regional Comprehensive Economic Partnership (RCEP)* (November 20, 2012), http://www.meti.go.jp/english/press/2012/1120_02.html (accessed April 16, 2013).

Table 1
Nominal GDP, population, and nominal GDP per capita of ASEAN+3, ASEAN+6, EU27, NAFTA and the world

Countries	Nominal GDP (billion USD)	Population (million)	Nominal GDP per capita (USD)
Indonesia	895	244	3,660
Thailand	377	64	5,848
Malaysia	307	29	10,578
Singapore	268	5	49,936
Philippines	241	98	2,462
Vietnam	138	90	1,523
Myanmar	54	64	849
Cambodia	14	15	934
Brunei	17	0,4	38,829
Lao PDR	9	6	1,454
ASEAN	2,320	617	3,759
China	8,250	1,354	6,094
Hong Kong	258	7	35,961
Japan	5,984	128	46,896
South Korea	1,151	50	23,021
ASEAN+3	17,964	2,156	8,333
India	1,947	1,223	1,592
Australia	1,542	23	67,983
New Zealand	167	4	37,402
ASEAN+6	21,619	3,406	6,347
EU27	16,414	502	32,708
NAFTA	18,586	464	40,056
World total	71,277	6,938	10,274

Source: IMF, *World Economic Outlook Database*, October 2012.

Table 2
Proportion of intraregional trade of ASEAN+3, ASEAN+6, EU27 and NAFTA

	1990	2000	2010	2012
ASEAN+3	28.6%	37.4%	38.7%	38.0%
ASEAN+6	33.0%	40.6%	44.1%	43.2%
EU27	65.4%	65.1%	64.9%	63.4%
NAFTA	37.2%	46.8%	40.0%	40.2%

Source: IMF, *Direction of Trade Statistics*.

In fact, many countries which officially declare free floating or managed floating for their exchange rate policies introduce measures to keep exchange rates to a certain target level. That is, fear of a large exchange rate volatility under a floating exchange rate policy with an open capital account ("fear of floating") is widespread especially among emerging and develop-

ing countries.[7] Moreover, one could recall that even highly developed economies including the G7 countries had shown reluctance for high volatility of their exchange rates. For example, France opened its capital account in 1986 after the unsuccessful experience of an extreme tightening of capital controls in the early 1980's, which did not prevent the devaluation of French Franc.[8] Even recently, the French President Hollande has called for setting medium-term exchange rates targets for Euro.[9] Japan has intervened in foreign exchange markets during the last five years with more than 16.4 trillion JPY[10] (about $190 billion)[11] in order to avoid too much volatility of its exchange rates. Since autumn 2011, Switzerland has kept exchange rates of Swiss Franc (CHF) to the Euro at more than 1.20 and has been continuously intervening in foreign exchange markets. The series of interventions caused the rapid accumulation of its foreign exchange reserves to around 171 billion CHF[12] (about $187 billion)[13] in 2012.

In order to manage financial globalisation, monetary authorities of countries need to monitor capital flows and to respond to the large volatilities of national financial markets. This requires an appropriate risk management of private financial institutions through the establishment of regulatory and supervisory mechanisms. Considering the contagious effects of financial crises, it is also desirable to harmonise these regulatory and supervisory mechanisms in the region[14] by sharing the experiences of member states.

Table 3
Foreign exchange turnover of spot and outright forwards transactions of East Asian currencies in April 2010 (daily averages)

Currencies	Turnover (million USD)	Percentage shares
Chinese Yuan	22,371	1.1%
Hong Kong Dollar	22,438	1.1%
Indonesia Rupiah	5,123	0.3%
Japanese Yen	415,325	21.1%
South Korean Won	39,162	2.0%
Philippines Peso	4,645	0.2%
Singapore Dollar	20,032	1.0%
Thailand Baht	3,943	0.2%
Indian Rupee	27,147	1.4%
Australian Dollar	139,943	7.1%
New Zealand Dollar	26,719	1.4%
United States Dollar	1,579,200	80.4%
Euro	840,897	42.8%
British Pound	267,820	13.6%
All currencies	3,930,424	200.0%

Source: own calculation based on Bank for International Settlements, *Report on global foreign exchange market activity in 2010* (December 2010): 46-49.

East Asia has also learnt from the Asian financial crisis the lesson that it is crucial in the case of financial instability to tackle the problem internationally and to provide sufficient liquidities for ailing countries in order to relieve financial markets and to avoid panic.[15] A rapid and sufficient international response to financial instability requires countries to exchange information and to regularly harmonise the regulatory and supervisory mechanisms.

[7] See, among others, Guillermo A. Calvo and Carmen M. Reinhart, "Fear of Floating," *The Quarterly Journal of Economics* Vol. CXVII (May 2002) 2: 379-408.

[8] OECD, "International capital flows: Structural reforms and experience with the OECD Code of Liberalisation of Capital Movements" (June 2011), http://www.oecd.org/economy/48972216.pdf (accessed April 17, 2013).

[9] Mark John, "France's Hollande calls for stable euro policy," *Thomson Reuters*, 5 February 2013, http://www.reuters.com/article/2013/02/05/us-eu-france-euro-idUSBRE9140J720130205 (accessed April 17, 2013).

[10] The Ministry of Finance Japan, *Foreign Exchange Intervention Operations*, http://www.mof.go.jp/english/international_policy/reference/feio/index.htm (accessed May 15, 2013).

[11] $1 = 86.55 JPY (as of December 28, 2012).

[12] The Swiss National Bank, *Investment of assets*, http://www.snb.ch/en/iabout/assets (accessed May 15, 2013).

[13] $1 = 0.9166 CHF (as of December 28, 2012).

[14] At the global level, the Financial Stability Board is in charge for developing and promoting the implementation of effective regulatory and supervisory policies. However, the member countries are limited to the industrialised and emerging countries. In East Asia, only Australia, China, Hong Kong, India, Indonesia, Japan, South Korea and Singapore participate in the discussion.

[15] In the Asian financial crisis, the central bank of Thailand intervened in the foreign exchange market massively from December 1996, in order to maintain the exchange rate stable. The IMF and Japan coordinated an international rescue package finally in August 1997, however, the total amount of the package ($17 billion) was smaller than the forward commitments held by the central bank of Thailand ($23 billion). Therefore, it was not sufficient to relieve the financial markets. See, e.g., Takatoshi Ito, "Asian Currency Crisis and the International Monetary Fund, 10 Years Later: Overview," *Asian Economic Policy Review* (2007) 2: 16-49.

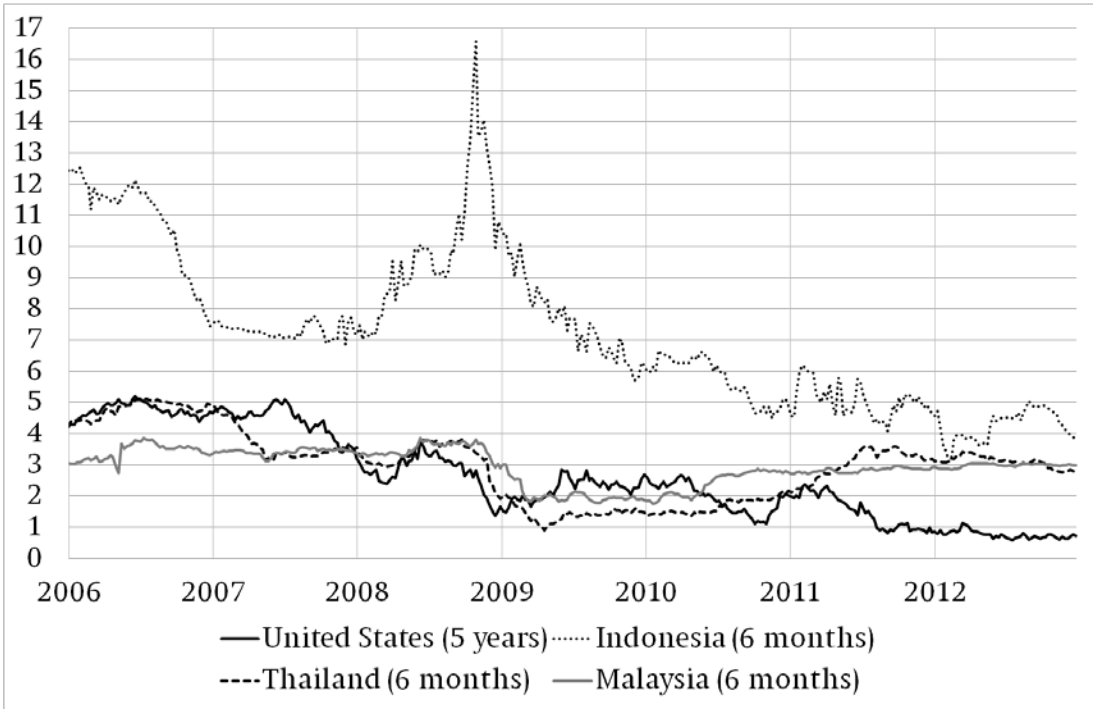
Huge resource misallocation – accumulation of foreign exchange reserves

After the Asian financial crisis in the late 1990s, many East Asian countries have accumulated large amounts of foreign exchange reserves – mainly in USD – for interventions in foreign exchange markets. This accumulation has come at enormous cost of the following three kinds. Firstly, those countries normally borrow money from domestic short-term financial markets and obtain government bonds of reserve currencies such as USD and Euro. The interest rates of the reserve currencies tend to be significantly lower than the domestic interest rates (see Figure 1). Consequently, the central bank loses the difference. Secondly, most of East Asian currencies have been appreciated against USD, which causes additional loss to the central bank whose account is denominated in the local currency. Thirdly, by holding foreign exchange reserves, a country allocates its scarce capitals to leading industrialised countries' governments while the country could otherwise invest in its own economic development.

If East Asian countries would agree on pooling their accumulated foreign exchange reserves for predetermined common purposes, such as preventing financial crises or avoiding excess exchange rates volatilities of all member countries, they could on the one hand allocate more resources for strengthening their long-term competitiveness, for example, to infrastructure, education and research. On the other hand, the establishment of a reliable regional mechanism for financial and exchange rates stability decreases the role of foreign exchange reserves, and thus will lead emerging and developing countries in East Asia to a market-based exchange rate policy which they cannot adopt now. In this spirit, establishing an effective financial and exchange rates cooperation mechanism in East Asia is not only beneficial but also indispensable for a long-term stable development of the region.

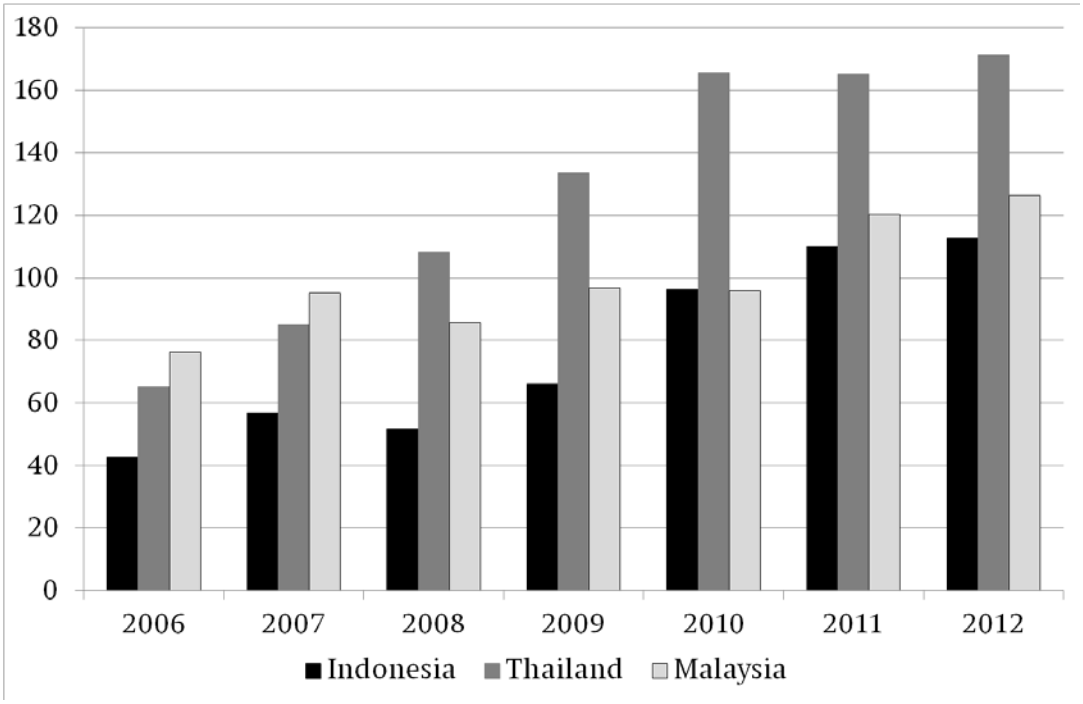
In short, foreign exchange reserves reduce *liquidity risk* of a country but increase the country's *solvency risk* considering the huge maintenance costs. Creating a reliable regional mechanism enables member countries to abandon continuous interventions in foreign exchange markets and accumulation of foreign exchange reserves, which in turn ensures their long-term stable development.

Figure 1
Government bonds yields of the United States, Indonesia, Thailand, and Malaysia, 2006–2012 (percentage)



Source: Bloomberg

Figure 2
Foreign exchange reserves of Indonesia, Thailand, and Malaysia, 2006–2012 (in billion USD)



Source: Bloomberg

Recent development of financial and exchange rates cooperation in East Asia

For analysing the recent developments of financial and exchange rates cooperation in East Asia, it is important to consider the following three aspects: i) the Asian financial crisis and a 'stigma' to the IMF; ii) the evolution of the Chinese exchange rate policy and its influence on ASEAN; iii) the rivalry between China and Japan for regional leadership. The first half of this chapter explains the three aspects.

Financial regionalism can take a wide range of forms. European regional financial and exchange rates cooperation can be categorised to the following three objectives: i) introducing the common currency Euro; ii) the balance of payments supports based on the European Stability Mechanism (ESM); and iii) decreasing volatilities of intraregional exchange rates pursued by the Exchange Rate Mechanism (ERM)[16]. The second half of this chapter overviews the recent development of East Asian financial regionalism according to these three objectives.

The Asian financial crisis and a 'stigma' to the IMF

The Asian financial crisis broke out with speculative attacks on Thailand Baht, followed by Thailand abandoning its USD peg policy and the large devaluation of its currency in July 1997. Contagion of the crisis occurred to the currencies of neighbour countries, particularly those of Indonesia, Malaysia and South Korea. Thailand, South Korea and Indonesia asked for IMF assistance and received loans in exchange for economic reforms they agreed with the IMF. Malaysia, by contrast, did not turn to the IMF and instead imposed strong controls on international capital movements.

Countries hit by the Asian financial crisis depreciated their exchange rates massively in 1997 and as a result the current account balance improved rapidly. Real GDP growth rates decreased drastically in 1998, then recovered rapidly in 1999. Unemployment rates surged in 1998 and decreased from 1999 according to the economic recovery (see Table 4). Those processes of the economic crisis and recovery of the East Asian countries show almost no difference between those which resorted to the IMF program and those which did not. That is, the IMF reform program, which required from the receiving countries strict financial consolidation, substantial increase of interest rates and radical economic reforms simultaneously, did not seem to contribute to the short- and middle-term economic recovery of the receiving countries although it promoted political and social confliction in those crisis-hit countries.[17]

Two months after the outbreak of the Asian financial crisis, Japan made a proposal to its neighbour countries for the Asian Monetary Fund (AMF) to serve as a regional financial crisis prevention fund. The IMF and the United States opposed to the proposal, arguing that it would lead to easier money with weaker conditionality for borrowing countries and thus undercut IMF conditionality. Facing the opposition also from China, the AMF proposal was given up.

An unobservable contribution of the IMF reform programs to the East Asian countries' economy, together with the opposition of the IMF to the AMF proposal led those countries to seek a way to avoid a further IMF involvement. Thailand's former Finance Minister Sussangkarn described this attitude as "a stigma attached to the IMF" and pointed out that "in many parts of the region [...] it would be politically very risky for a government to enter into an IMF

[16] Within the European Monetary System (EMS), currency fluctuations were regulated by the ERM and kept basically within ±2.25% of the central rates (the Italian lira, the Spanish peseta, the Portuguese escudo and the pound sterling were exceptionally allowed to fluctuate by ±6%). In August 1993, these bands were widened to 15% in order to counter market pressures. See European Commission, "Phase 2: the European Monetary System," http://ec.europa.eu/economy_finance/euro/emu/road/ems_en.htm.

[17] In Indonesia, the cut of fuel subsidies caused a large riot in Jakarta in May 1998, which resulted in the resignation of President Suharto. See BBC News World Edition, "IMF policies are 'generic trash'," 15 August, 2002, http://news.bbc.co.uk/2/hi/business/2195461.stm (accessed May 16, 2013).

program"[18]. East Asian countries have also complained that their IMF quotas are not in line with their economic realities and that they are underrepresented in the IMF[19].

The bitter experiences of the Asian financial crisis as well as the dissatisfaction with the IMF conditionality and their underrepresentation in the IMF brought about financial regionalism in East Asia, mainly in the context of ASEAN+3.

To address short-term *liquidity risk*, ASEAN+3 have started a network of bilateral swap agreements called the Chiang Mai Initiative (CMI). To utilise savings of a country for the country's investments, ASEAN+3 has proceeded the development of liquid local bond markets named the Asian Bond Markets Initiative.

In spite of these efforts, some the East Asian countries were proved to be still vulnerable to external shocks such as the Lehman shock in September 2008 and the European sovereign debt crisis since late 2009 (see Figure 4). The continuous increase of foreign exchange reserves after the Asian financial crisis shows their fear to rely on the current global and regional financial system.

Evolution of Chinese exchange rate policy and its influence on ASEAN

The second important aspect for East Asian financial regionalism is the evolution of the Chinese currency policy and its influence on ASEAN. After the collapse of the Bretton Woods system, China has continued to adopt the hard peg exchange rate policy to USD. Together with strong government controls on the capital account China succeeded in maintaining stability of its financial markets even during the Asian financial crisis.

Facing international criticism of its large current account surplus, China announced the change of its exchange rate policy from the hard peg to a managing float in July 2005. Under the new policy, the daily trading price of Chinese Yuan (CNY) to USD in the inter-bank foreign exchange market is allowed to float within a band of ±0.3% around the central parity published by the PBoC.[20] Since then CNY has been gradually appreciating against USD (see Figure 4).

A large difference between the size of China's economy and the economies of ASEAN, increasing intraregional trades as well as competition in third countries make the ASEAN monetary authorities observe closely the exchange rates policies of China and other ASEAN countries. For example, on the day following the announcement of the change of the Chinese exchange rate policy in July 2005, Malaysia changed its exchange rate policy in the same way, i.e., from a hard peg to a managing float.[21]

Moreover, one can find exchange rates correlations of some leading ASEAN+3 countries with CNY, which is the least volatile currency in East Asia against USD except for Hong Kong Dollar and Taiwan Dollar. From July 2005 to December 2012 the exchange rates of CNY, Thailand Baht, Philippines Peso, Malaysia Ringgit, Singapore Dollar and Brunei Dollar[22] against USD had fluctuated for almost all the time during this period by less than 15%[23] (see Figure 4). Astonishingly,

[18] Chalongphob Sussangkarn, "The Chiang Mai Initiative Multilateralization: Origin, Development and Outlook," *Asian Development Bank Institute Working Paper Series*, No. 230 (July 2010).

[19] ASEAN+3, *The Joint Ministerial Statement of the 9th ASEAN+3 Finance Ministers' Meeting* (Hyderabad, May 4, 2006), http://www.mof.go.jp/english/international_policy/convention/asean_plus_3/20060504.pdf (accessed May 27, 2013).

[20] The trading prices of the other currencies are allowed to move within a certain band announced by the PBoC. The floating band against USD was enlarged from ±0.3% to ±0.5% (May 2007) and further to ±1% (April 2012). PBoC, *Public Announcement of the People's Bank of China on Reforming the RMB Exchange Rate Regime* (July 21, 2005), http://www.pbc.gov.cn/publish/english/955/2001/20014/20014_.html (accessed April 17, 2013); *Public Announcement of the People's Bank of China on Enlarging the Floating Band of the RMB Trading Prices against the US Dollar in the Inter-bank Spot Foreign Exchange Market* (May 18, 2007), http://www.pbc.gov.cn/publish/english/955/2020/20204/20204_.html (accessed May 16, 2013); *The People's Bank of China Announcement* (April 14, 2012), http://www.pbc.gov.cn/publish/english/955/2012/20120414090756030448561/20120414090756030448561_.html (accessed May 16, 2013).

[21] Bank Negara Malaysia, *Malaysia Adopts a Managed Float for the Ringgit Exchange Rate* (July 22, 2005), http://www.bnm.gov.my/index.php?ch=en_press&pg=en_press_all&ac=1054&lang=en (accessed April 17, 2013).

[22] Under the Currency Interchangeability Agreement signed between Singapore and Brunei in June 1967, each country undertakes to accept the currency issued by the other in their own country, at par. As a result, the exchange rate of Brunei Dollar is strictly pegged to Singapore Dollar. See Monetary Authority of Singapore, *Response to "Brunei dollar has little currency here" – ST Forum, 16, October 2012* (October 19, 2012), http://www.mas.gov.sg/news-and-publications/letters-to-editor/2012/response-to-brunei-dollar-has-little-currency-here.aspx (accessed April 18, 2013).

[23] Except for the period of October 2007 to March 2008 (Philippines Peso was appreciated up to 21% against CNY) and

the intraregional exchange rates volatilities of these countries are less than those among the three main countries (Germany, France and Italy) of the ERM during the first years of the system (see Figure 5).

Rivalry between China and Japan for regional leadership

The third important aspect of East Asian financial regionalism is the rivalry between China and Japan for regional leadership, which accelerates the integration process with checks and balances. Historically, most of the region of today's ASEAN+3 countries such as South Korea, Indonesia, Thailand, Vietnam, Myanmar, Lao PDR and Okinawa (a prefecture of Japan) were under the China-centred tribute system.[24] This international order was once destroyed by European, American and Japanese intrusion and colonisation of the region, but the independence of South Korea and the ASEAN countries in the middle of the 20th century as well as the recent revival of China as a regional power make it necessary for China, South Korea and ASEAN to seek a new equilibrium of international relations.

Australia, India, Japan and New Zealand were historically outside of this Chinese world order. In contrast to Australia, India and New Zealand, which were also colonised by the United Kingdom and thus had once totally lost its diplomatic influence on other East Asian countries, Japan had maintained its independence and continuously influenced other East Asian countries with its dominant military and economic power. In this context, there was historical rivalry between China and Japan for regional leadership; still today, both countries strive for influence in the region. The fundamental difference between the political systems of the two countries adds significance to this rivalry relationship as a competition between authoritarianism and democracy.

Based on its rapidly growing economy and intraregional trade, China accelerates regional financial cooperation with neighbour countries. i) The People's Bank of China (PBoC) agreed with other East Asian central banks to make currency swap agreements (see Table 5). These agreements provide them with liquidity of CNY, which on the one hand helps using CNY for intraregional trade, and on the other hand stabilises East Asian financial markets by enlarging East Asian central banks' access to foreign exchange in case of financial instability. ii) The purchase of Chinese government bonds in foreign exchange reserves has also been gradually widespread. iii) Considering that the total amount of Chinese foreign exchange reserve is about the double of the financial capacity of the IMF, China can rescue every East Asian country bilaterally in the case of a liquidity crisis. Furthermore, there is visible exchange rates correlations of some leading ASEAN+3 countries with CNY, China has the potential to take the initiative for East Asian financial regionalism and to create a new China centred regional system.

Recent Chinese aggressive diplomatic policies of territorial disputes with Philippines, Vietnam, Malaysia and Brunei (Spratly/Nansha Islands) as well as with Japan (Senkaku/Diaoyu Islands) remind ASEAN and Japan of the importance to maintain a power balance in East Asia and to prevent Chinese regional hegemony. It seems that ASEAN and Japan try to strengthen their strategic relationship regarding Japan – a democratic country with a strong alliance with the United States as well as the third largest economy in the world with a hard currency and sufficient foreign exchange reserves – as a possible balancer of the field of economy and finance against rapidly growing China.

Japan's diplomatic strategy for East Asia has been for a long time to pursue free, open and interconnected economies.[25] This has been embodied in regional financial cooperation such as the AMF proposal as well as introducing and strengthening the CMI. Facing the global financial instability after the Lehman shock and in light of China's large amount of currency swap agreements with South Korea (about $57 billion), Malaysia (about $29 billion) and Indonesia (about $16 billion), Japan proposed "Yen swap initiative" in May 2009, under which it has offered bilateral swap agreements up to 6 trillion JPY (about $69 billion) in cases of sudden external financial

February to March 2009 (Malaysia Ringgit was depreciated up to 16% against CNY). Source: own calculations based on Bloomberg data.

[24] See, e.g., John King Fairbank, "A Preliminary Framework," in John King Fairbank (eds.), *The Chinese World Order: Traditional China's Foreign Relations* (Cambridge: Harvard University Press, 1970).

[25] This traditional strategy was confirmed by the new government of Shinzo Abe in his diplomatic speech. The Ministry of Foreign Affairs Japan, *The Bounty of the Open Seas: Five New Principles for Japanese Diplomacy* (January 18, 2013), http://www.mofa.go.jp/announce/pm/abe/abe_0118e.html (accessed April 15, 2013).

instability.[26] This initiative was partially realised in the Japan-South Korea swap agreements in October 2011, and can be extended to cover the ASEAN countries. In this way, rivalry between China and Japan together with recent concern of regional power balance fosters further development of East Asian financial regionalism.

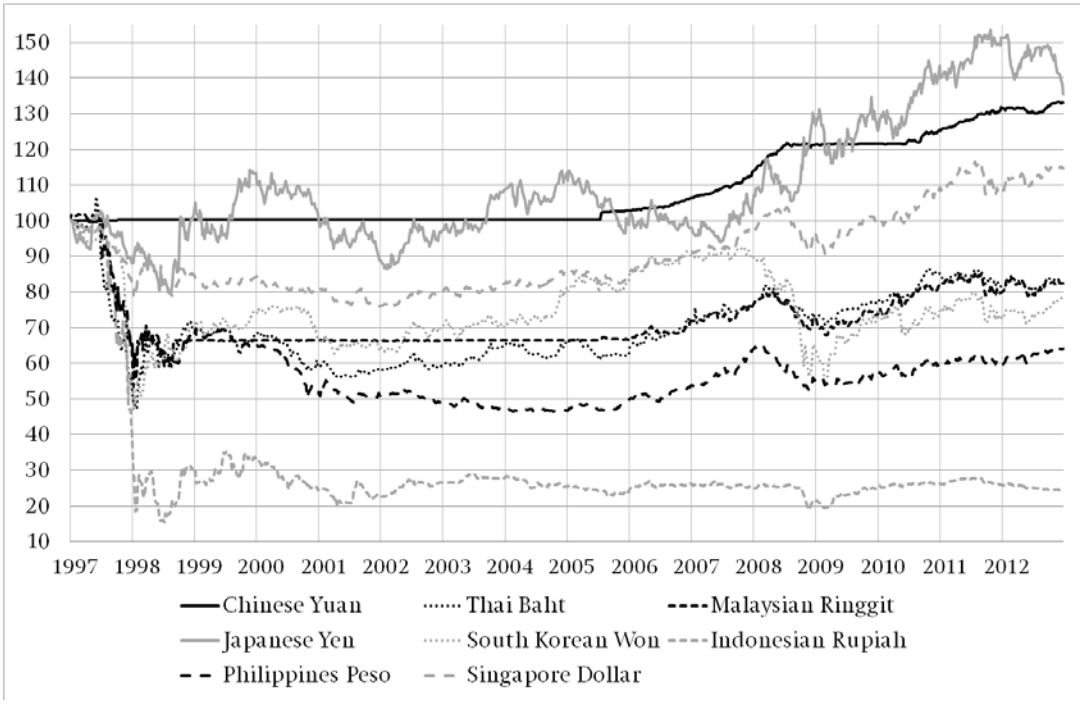
[26] The Ministry of Finance Japan, *Ajia shokoku heno ryuudousei sien (liquidity supports for Asian countries)* (Bali, May 3, 2009), http://www.mof.go.jp/international_policy/convention/asean_plus_3/20090503_2.pdf.

Table 4
Current account balance, GDP, inflation and unemployment rate of the East Asian countries 1996-2001

Current account balance (percent of GDP)	*1996*	*1997*	*1998*	*1999*	*2000*	*2001*
South Korea	-4,0	-1,5	11,9	5,3	2,8	1,7
Singapore	14,8	15,5	21,9	17,1	10,8	12,8
Indonesia	-3,2	-1,8	4,2	4,1	4,8	4,3
Malaysia	-4,4	-5,9	13,2	15,9	9,0	7,9
Philippines	-4,2	-4,7	2,1	-3,5	-2,8	-2,3
Thailand	-7,9	-2,1	12,8	10,2	7,6	4,4
Gross domestic product, constant prices (percent change)	*1996*	*1997*	*1998*	*1999*	*2000*	*2001*
South Korea	7,2	5,8	-5,7	10,7	8,8	4,0
Singapore	7,6	8,5	-2,2	6,2	9,0	-1,2
Indonesia	7,8	4,7	-13,1	0,8	4,2	3,6
Malaysia	10,0	7,3	-7,4	6,1	8,7	0,5
Philippines	5,8	5,2	-0,6	3,1	4,4	2,9
Thailand	5,9	-1,4	-10,5	4,4	4,8	2,2
Inflation, average consumer prices (percent change)	*1996*	*1997*	*1998*	*1999*	*2000*	*2001*
South Korea	4,9	4,4	7,5	0,8	2,3	4,1
Singapore	1,4	2,0	-0,3	0,0	1,3	1,0
Indonesia	8,4	6,2	58,0	20,8	3,8	11,5
Malaysia	3,5	2,7	5,3	2,7	1,6	1,4
Philippines	8,3	5,7	9,4	6,2	6,6	5,4
Thailand	5,8	5,6	8,0	0,3	1,6	1,6
Unemployment rate (percent of total labor force)	*1996*	*1997*	*1998*	*1999*	*2000*	*2001*
South Korea	2,1	2,6	7,0	6,6	4,4	4,0
Singapore	1,7	1,4	2,5	2,8	2,7	2,7
Indonesia	4,9	4,7	5,5	6,4	6,1	8,1
Malaysia	2,5	2,4	3,2	3,4	3,1	3,7
Philippines	8,5	8,7	10,1	9,8	11,2	11,1
Thailand	N/A	N/A	N/A	N/A	N/A	1,8

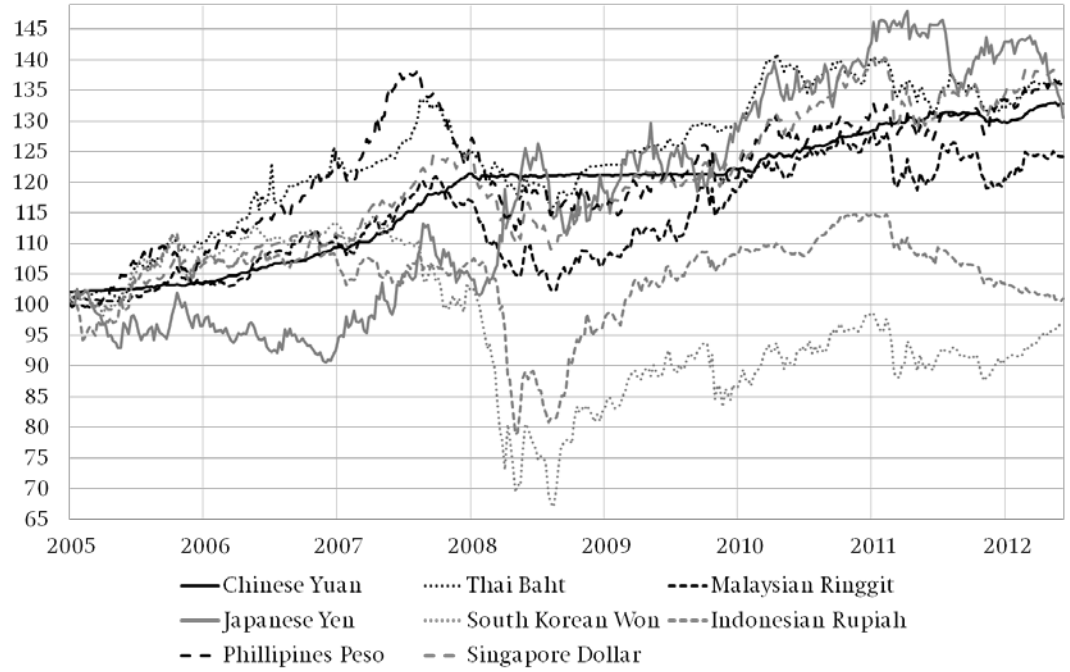
Source: IMF, *World Economic Outlook Database*, April 2013.

Figure 3
Nominal exchange rates of some East Asian countries against USD, 1997–2012 (January 3, 1997 = 100)



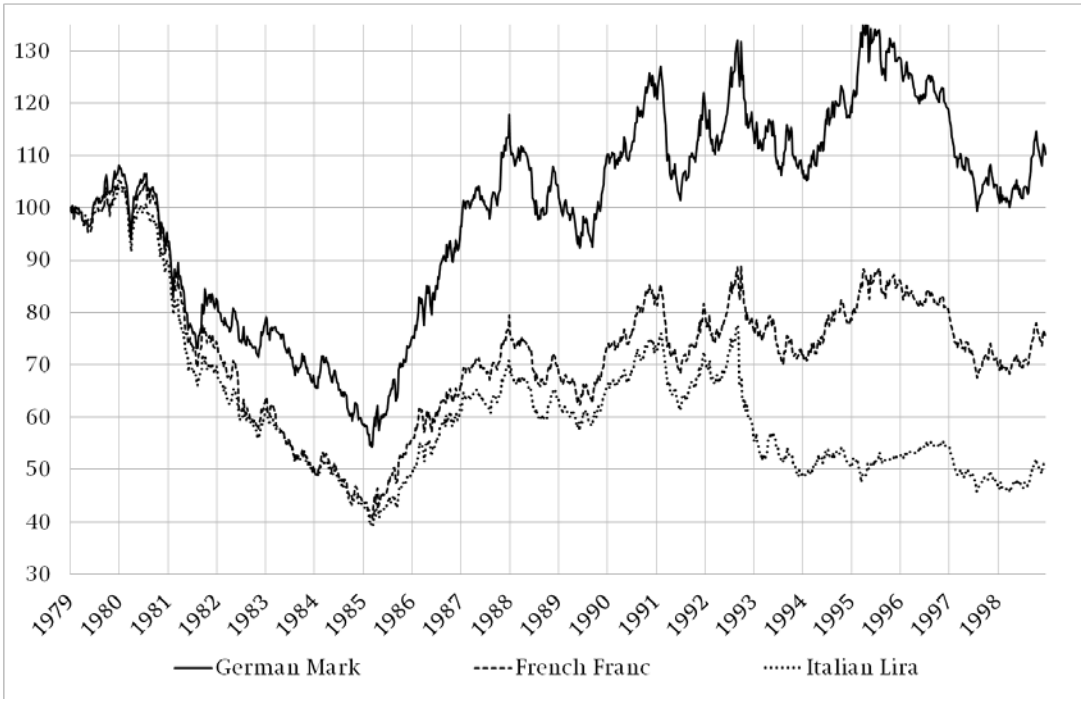
Source: Bloomberg.

Figure 4
Nominal exchange rates of some East Asian countries against USD from July 2005 to December 2012 (July 15, 2005 = 100)



Source: Bloomberg.

Figure 5
Nominal exchange rates of Germany, France, and Italy against USD, 1979–1998 (January 5, 1979 = 100)



Source: Bloomberg.

Table 5
Financial contribution, maximum currency swap amount, and voting-power of the CMI

Countries	Financial contribution (billion USD)	Maximum currency swap amount (billion USD)	Voting power (%)
China	68.40	34.20	25.43
Hong Kong	8.40	6.30	2.98
Japan	76.80	38.40	28.41
South Korea	38.40	38.40	14.77
Indonesia	9.104	22.76	4.369
Thailand	9.104	22.76	4.369
Malaysia	9.104	22.76	4.369
Singapore	9.104	22.76	4.369
Philippines	9.104	22.76	4.369
Vietnam	2.00	10.00	1.847
Cambodia	0.24	1.20	1.222
Myanmar	0.12	0.60	1.179
Brunei	0.06	0.30	1.158
Lao PDR	0.06	0.30	1.158
Total	240.00	243.50	100.00

Source: ASEAN+3, *The Joint Statement of the 15th ASEAN+3 Finance Ministers and Central Bank Governors' Meeting*, (Manila, May 3, 2012), http://www.asean.org/images/archive/Joint%20Media%20Statement%20of%20the%2015th%20ASEAN3%20Finance%20Ministers%20and%20Central%20Bank%20Governors%20Meeting.pdf (accessed May 31, 2013).

Table 6
Bilateral swap agreements of the ASEAN+6 countries[a]

Periods	Countries	Currencies[b]	Maximum amount[c]	The linkage to an IMF program
August 1977 –	ASEAN	USD/domestic currency of the requesting country	$2 billion	no
July 2001 –	Japan – South Korea	USD/KRW	$10 billion	yes
August 2001 –	Japan – Philippines	USD/PHP	$6 billion	yes
March 2002 –	China – Japan	CNY/JPY	$3 billion	N/A
February 2003 –	Japan – Indonesia	USD/IDR	$12 billion	yes
June 2008 –	Japan – India	USD/INR	$15 billion	yes
October 2008 –	USA – Japan	USD/JPY	$60 billion[d]	no
October 2008 – February 2010	USA – Australia	USD/AUD	$15 billion	no
October 2008 – February 2010	USA – New Zealand	USD/NZD	$15 billion	no
October 2008 – February 2010	USA – South Korea	USD/KRW	$30 billion	no
October 2008 – February 2010	USA – Singapore	USD/SGD	$30 billion	no
December 2008 –	China – South Korea	CNY/KRW	CNY 360 billion (about $57 billion)	N/A
January 2009 –	China – Hong Kong	CNY/HKD	CNY 200 billion (about $32 billion)	N/A
February 2009 –	China – Malaysia	CNY/MYR	CNY 180 billion (about $29 billion)	N/A
March 2009 –	China – Indonesia	CNY/IDR	CNY 100 billion (about $16 billion)	N/A
July 2010 –	China – Singapore	CNY/SGD	CNY 300 billion (about $48 billion)	N/A
October 2011 – October 2012	Japan – South Korea	USD/KRW	$30 billion	no
October 2011 – October 2012	Japan – South Korea	JPY/KRW	$30 billion	no
December 2011 –	China – Thailand	CNY/THB	CNY 70 billion (about $11 billion)	N/A
March 2012 –	China – Australia	CNY/AUD	CNY 200 billion (about $32 billion)	N/A

Source: Asian Development Bank, Asia Regional Integration Center, *ASEAN Swap Arrangement (ASA)*, http://www.aric.adb.org/initiativetable.php?iid=71&ssid=2&title=ASEAN%20Swap%20Arrangement%20%28ASA%29 (accessed May 31, 2013); ASEAN, *Memorandum of Understanding on the ASEAN Swap Arrangements* (Kuala Lumpur, August 5, 1977), http://www.asean.org/images/2012/Economic/AFMM/Agreement_on_Finance/Memorandum%20of%20Understanding%20on%20the%20ASEAN%20Swap%20Arrangement%20%281978%29.pdf (accessed May 31, 2013); the Bank of Japan, *Cooperation with Other Central Banks*, http://www.boj.or.jp/en/intl_finance/cooperate/ (accessed May 31, 2013); Fed, *Central Bank Liquidity Swap Lines*, http://www.federalreserve.gov/newsevents/reform_swaplines.htm (accessed May 31, 2013); PBoC, *News* (with South Korea: December 12, 2008 and October 26, 2011; with Hong Kong: January 20, 2009; with Malaysia: February 8, 2009 and February 14, 2012; with Indonesia: March 23, 2009; with Singapore: March 13, 2013; with Thailand: December 28, 2011; with Australia: March 22, 2012), http://www.pbc.gov.cn/publish/english/955/index.html (accessed May 31, 2013).

[a] The PBoC made the other currency swap agreements with the following countries outside of East Asia: Belarus (CNY 20 billion, announced on March 11, 2009), Argentina (CNY 70 billion, announced on April 2, 2009), Kazakhstan (CNY 7 billion, announced on June 13, 2009), Pakistan (CNY 10 billion, announced on December 28, 2009), the United Arab Emirates (CNY 35 billion, announced on January 18, 2012), Turkey (CNY 10 billion, announced on February 21, 2012), Mongolia (CNY 10 billion, announced on March 21, 2012), Ukraine (CNY 15 billion, announced on June 27, 2012), and Brazil (CNY 190 billion, announced April 1, 2013).

[b] KRW, PHP, IDR, INR, AUD, NZD, SGD, HKD, MYR and THB refers to South Korean Won, Philippines Peso, Indonesian Rupiah, Indian Rupee, Australian Dollar, New Zealand Dollar, Singapore Dollar, Hong Kong Dollar, Malaysian Ringgit and Thailand Baht, respectively.

[c] $1 = 6.2896 CNY (as of December 28, 2012).

[d] The maximum amount was raised to limitless on October 13, 2008. Source: Fed, *Press Release* (October 14, 2008), http://www.federalreserve.gov/newsevents/press/monetary/20081014d.htm (accessed May 15, 2013).

Introduction of a common currency

After the successful start of Euro in 2002, there have been academic discussions on introducing a common currency in East Asia, too. Several East Asian high-rank policy makers disclosed their supports for a future introduction of a regional common currency.[27] However, at the moment the whole East Asia clearly does not fulfil the optimum currency area criteria – necessary conditions in theory to introduce a common currency[28] – and even sub-groups of very interconnected economies in East Asia such as Japan and South Korea as well as Malaysia and Singapore would face difficulties to realise labour mobility and fiscal integration.

As a result, even in the leading group of East Asian financial regionalism – ASEAN+3 – a research group report[29] proposed introduction of a regional currency unit similar to the European Currency Unit (ECU) for surveillance, but so far no further discussions in political levels have been made. In the framework of negotiations on ASEAN Economic Community, ASEAN does not discuss to introduce a common currency.[30]

Balance of payments supports – the Chiang Mai Initiative

The Chiang Mai Initiative was firstly announced in the ASEAN+3 finance minister meeting in May 2000. At this first stage, the CMI consisted of a network of bilateral currency swap agreements among the member countries, in which a crisis country could obtain USD or the currency of the supporting country in exchange for the equivalent amount of the crisis country's currency. To reduce the moral hazard problem, basically the linkage to an IMF program was required to activate the swap lines and only 10% of the assistance amount of each agreement is available without an IMF program.

The network of bilateral agreements was later integrated to a multilateral agreement with common decision rules and conditions in March 2010. In addition to this multilateralisation, the total assistance amount was enlarged from $80 billion to $120 billion, and the proportion available without the linkage to an IMF program was increased to 20% in exchange for strengthening regional surveillance and establishing a regional research unit called the ASEAN+3 Macroeconomic Research Office (AMRO) in Singapore.

The implementation of the CMI and the setting up of the AMRO are the flagship project of East Asian financial regionalism. Stimulated by the European sovereign debt crisis, ASEAN+3 agreed in May 2012 to strengthen the CMI significantly in quantity and quality as follows, in order to deepen regional cooperation to prevent another financial crisis.

Firstly, the total assistance volume is doubled to $240 billion. It means that ASEAN and South Korea have an access to around $165 billion from the CMI,[31]

[27] The former Presidents of the Asian Development Bank Chino and Kuroda have discussed introducing a common currency in East Asia and analysed a roadmap towards it. See Tadao Chino, "Consider a Single Asian Currency," *The Wall Street Journal*, 1 June 2004, http://online.wsj.com/article/0,,SB108604025025125118,00.html; Haruhiko Kuroda and Masahiro Kawai, "Strengthening Regional Financial Cooperation in East Asia," *The Ministry of Finance Japan, Policy Research Institute Discussion Paper Series* No. 03A-10 (May 2003).

[28] The theory of optimum currency areas discusses the conditions under which the disadvantages of a single currency, which consists largely of the loss of adjustment mechanism, are minimised. The theory utilises integration criteria such as labour mobility, capital mobility, wage flexibility, and fiscal integration, in order to analyse how suitable a region is to a common currency. See, among others, Robert A. Mundell, "A Theory of Optimum Currency Areas," *The American Economic Review* 51 (1961) 4: 657-665; Peter B. Kenen, "The Theory of Optimum Currency Areas: An Eclectic View," in Robert A. Mundell and Alexander K. Swoboda (eds.), *Monetary Problems of the International Economy* (Chicago: The University of Chicago Press, 1969).

[29] The Institute for International Monetary Affairs , "Summary of the Report on "Toward Greater Financial Stability in the Asian Region: Measures for Possible Use of Regional Monetary Units for Surveillance and Transaction"," *2007/08 ASEAN+3 Research Group Final Report and Summary* (February 2008), http://www.asean.org/images/archive/22633-1.pdf.

[30] The Indonesian Trade Minister said that "there is no passion from ASEAN countries to adopt the single currency policy. In fact, there never was." See the Jakarta Post, "No passion for ASEAN single currency: RI Trade Minister," 3 April, 2012, http://www.thejakartapost.com/news/2012/04/02/no-passion-asean-single-currency-ri-trade-minister.html (accessed May 28, 2013).

[31] For the activation of the whole amount, a borrowing country needs to obtain an IMF program. Without an IMF program the country can activate 30% (increasing to 40% in 2014 subject to the AMRO's appropriate development) of the

which is about 5% of their total GDP. Considering that the ESM offers €500 billion, which is about 6% of the total GDP of the Euro zone, the CMI obtains a comparable firepower to the ESM (see Table 6).

Secondly, adding to the existing crisis resolving facility, as a crisis preventive measure, a precautionary credit line without *ex post* conditionality alike the IMF's Flexible Credit Line (FCL)[32] is introduced.

Moreover, the assistance amount available without an IMF program is increased to 30% in 2013, with a view to increase it to 40% in 2014 subject to the AMRO's duly development as a monitoring authority. The supporting period (the maturity of a swap transaction) is lengthened from two years to three years. For the activation without an IMF program it is also lengthened from one year to two years.

Stability of intraregional exchange rates – bilateral currency swap agreements

After Asian financial crisis there happened repeatedly international financial crises such as Lehman shock in September 2008 and the European sovereign debt crisis since spring 2010. The CMI has not been activated so far because it is basically linked to an IMF program and as a result an activation of the CMI would be regarded from financial markets that the *solvency risk* of the country was increased. In fact, the CMI itself is originally structured to support short-term *liquidity risk* and thus does not rule out its usage without balance of payments concern. Instead of the CMI, several bilateral currency swap agreements were implemented and showed their ability for financial and exchange rates stability.

The first example is a series of swap agreements with the Federal Reserve (Fed) of the United States after the Lehman shock. In East Asia, Japan, Korea, Singapore, Australia and New Zealand agreed to set swap lines with the Fed for $60, $30, $30, $10 and $15 billion, respectively. The purpose of the currency swap agreements was to provide USD liquidity to East Asian financial markets while financial institutions of the United States could not offer sufficient credit in USD at that time.[33] The agreements were temporal until February 2010, but they contributed to stabilise financial markets as well as showed their flexibility as agreements between two central banks without formal legislative procedures.

The second and remarkable example for regional cooperation is Japan-South Korea and China-South Korea currency swap agreements in October 2011. Before the agreements, the contagion effect of European sovereign debt crisis hit Korean financial markets and the South Korean Won was under pressure to depreciate. To prevent the instability from deepening into a crisis, Japan and China offered credit lines to South Korea for $60 and $57 billion, respectively (see Table 5). These swap agreements are fundamentally different from those of the CMI in that they do not require an IMF program for their activation. These huge firewalls with more than $100 billion were enough to stabilise South Korean financial markets including its exchange rates. The two currency swap agreements also reflected the rivalry between China and Japan for influence on South Korea, namely they were announced in the same week and for almost identical amount.

whole amount.

[32] The FCL is used for crisis prevention of countries with very strong fundamentals and policies. The credit line has two-year validity and payments are not linked to further conditions or structural adjustments. IMF, *Factsheet: IMF lending* (Washington, April 2, 2013), http://www.imf.org/external/np/exr/facts/howlend.htm (accessed April 15, 2013).

[33] David Lawder "UPDATE 2-U.S. Fed launches four new currency swap lines," *Thomson Reuters* (October 29, 2008), http://www.reuters.com/article/2008/10/29/financial-fed-swaps-idUSN2958009320081029 (accessed April 30, 2013).

Possible further development of regional financial and exchange rates cooperation in East Asia

This chapter explores possible further development of East Asian financial regionalism according to the three objectives examined in the previous chapter. Some pragmatic approaches for regional financial and exchange rates stability as well as moral hazard preventive measures accompanied to these pragmatic approaches are proposed.

Five fundamental obstacles for a common currency

In spite of the support of several East Asian high-rank policy makers, a recent survey to the opinion leaders of ASEAN+3 showed that the introduction of a common currency in Asia is not regarded as urgent while a regional monetary unit, which is recommended by the ASEAN+3 research group in 2007, is regarded as urgently necessary for economic surveillance.[34] In fact, there are numbers of fundamental obstacles towards introduction of a common currency for a foreseeable future.

Firstly, the European sovereign debt crisis continues since 2009 and the cost and benefit of a common currency still remains open. The total costs to assist defaulted countries as well as the distribution of these costs among the euro zone, the European Union and the IMF are unclear.

Secondly, the European sovereign debt crisis makes it clear that under a common currency no single member country has a decisive influence on their central bank. When a financial institution falls in liquidity problems the central bank plays a critical role as "lender of last resort". To protect financial stability of a country, it is usual that both the government and the central bank of the country provides the financial institutions in problem with necessary liquidity in domestic currency.[35] It seems that this kind of role-sharing between the ECB and an euro zone government is difficult because of the rescued financial institution's *solvency risk* and a conflict of interests among the euro zone countries. Namely, whether the European Central Bank (ECB) supplies liquidity to the financial institutions in problem is due to the collective decision of the representatives from the member states and it is possible to reject liquidity support because of the financial institution's *solvency risk*. In this case, the government must firstly inject capital to the financial institution and if the government cannot obtain enough credit from financial markets, it needs to ask for an IMF program.

Thirdly, in contrast to European political leaders such as Konrad Adenauer, Valéry Giscard d'Estaing, Helmut Schmidt and Pierre Werner who all had decisive will to integrate Europe, East Asian policy makers have little or no desire for full labour mobility, capital mobility, fiscal transfer or political integration even in the long term. In East Asia, even democracy and the protection of the human rights – incontrovertible common values in Europe – are not shared.

A former President of the German Bundesbank Tietmeyer wrote that "the currency represents not only the underlying long-term economic strength and the internal politics, but also the appearance of common political world. To that extent, the mutuality of foreign and defence policy is of considerable importance to the valuation of the common currency".[36] In fact, among the members of the European Union, the United Kingdom, Sweden and Denmark stayed outside of the euro zone. Considering these

[34] See Pradumna Bickram Rana, Wai-Mun Chia and Yothin Jinjarak "Monetary Integration in ASEAN+3: A Perception Survey of Opinion Leaders," *The S. Rajaratnam School of International Studies Working Paper* No. 228 (June 2011). In this survey, answers from 35 government officials, 160 academic researchers and 23 businesspersons of private financial sectors in the ASEAN+3 countries to a question sheet are analysed.

[35] For example, after the Lehman shock, the United States government and the Fed rescued the American International Group (AIG) to prevent domino bankruptcy. The Fed agreed on a liquidity line up to $85 billion while the government received 79.9% of its equity in exchange for the liquidity line. Fed, *Press Release* (September 16, 2008), http://www.federalreserve.gov/newsevents/press/other/20080916a.htm (accessed May 15, 2013).

[36] Hans Tietmeyer, *Herausforderung EURO: Wie es zum Euro kam und was er für Deutschlands Zukunft bedeutet* (Munich: Carl Hanser Verlag, 2005), p. 305 (translated by the author).

common elements of the euro zone countries which East Asia does not share at all, it is highly sceptical whether East Asian countries with totally different political and economic principles without sharing basic foreign and defence policies can introduce and maintain a common currency.[37]

Fourthly, a common currency without full capital mobility in the currency zone is unrealistic because a fixed exchange rate creates large incentives to evade capital control by cash transfer and profit from the different conditions of financial markets, which destroys the market-based pricing mechanism of the whole currency zone. Some leading East Asian countries such as China and Malaysia, however, still maintain strong government controls of their domestic financial sector. Especially the Chinese government controls the distribution of domestic capitals and the interest rates, which would under a common currency support Chinese firms in the whole currency zone and cause disadvantages to the other countries' competitors. Until those countries completely liberalise the existing controls on domestic and intraregional capital flows, it seems hardly possible to create a currency union in East Asia.

Finally, the huge public debt of Japan (around 220% of its GDP in 2012)[38] would make other East Asian countries hesitate to join a currency union with Japan. If Japan wants to play a leading role for a common currency in East Asia, it is necessary to persuade the neighbour countries of the soundness of its public finance, which requires Japan to go through a series of painful and unpopular reforms such as raising tax rates and reducing social welfare expenditures.

Strengthening the Chiang Mai Initiative

Although introducing an East Asian common currency is unrealistic for a foreseeable future, other forms of regional cooperation – the balance of payments supports and decreasing volatilities of intraregional exchange rates – could be deepened further.

As to the balance of payments supports, the current CMI has the fundamental weak point that it is basically linked to an IMF program whereby the role-sharing between the IMF and the CMI remains unclear. On the one hand, facing the continuing global financial instability after the Lehman shock, the IMF strengthened its financial capacity to a very large extent from 608 billion SDR (about $934 billion)[39] to 1,127 billion SDR[40] (about $1,731 billion). After this reform the IMF has almost limitless capacity to rescue East Asian countries except for China and Japan.

On the other hand, even with regard to the widespread 'stigma' to the IMF, it is unrealistic for the CMI member countries to rely on the recently established AMRO and to reject an opinion of the IMF, which is equipped with longer experiences and much more staff. The role of the CMI is in fact limited to the following two points: bridge loan to an IMF program in the case that a member country hesitates to ask for an IMF program directly and lets its financial instability deteriorate; and a short-term liquidity

[37] In the 19th century, France, Belgium, Italy and Switzerland formed a currency union (the Latin Monetary Union) with different political systems. However, the common currency was bound to the predetermined weight of silver or gold. See, e.g., Luca Einaudi, *Money and Politics: European Monetary Unification and the International Gold Standard (1865-1873)* (Oxford: Oxford University Press, 2012), pp. 38-40.

[38] The Organisation for Economic Co-operation and Development (OECD), *Economic outlook, analysis and forecasts, Japan - Economic forecast summary* (May 2013), http://www.oecd.org/eco/outlook/japaneconomicforecastsummary.htm (accessed 29 May, 2015).

[39] $1 = 0.650652 SDR (as of December 28, 2012). The Special Drawing Rights (SDR) is created and allocated by the IMF to its member countries. Member countries have the rights to ask the IMF or the other member countries for exchanging the SDR for the hard currencies such as USD and Euro. Total allocation volume of the SDR is so far 204 billion SDR (about $314 billion). The annual interest rate for holding SDR is currently 0.08%. Sources: IMF, *Factsheet: Special Drawing Rights (SDRs)* (March 29, 2013), http://www.imf.org/external/np/exr/facts/sdr.htm (accessed April 16, 2013); IMF, *SDR Interest Rate Calculation*, http://www.imf.org/external/np/fin/data/sdr_ir.aspx (accessed April 16, 2013).

[40] The IMF's quotas have doubled from SDR 238.5 billion to SDR 476.8 billion. The IMF also maintains two standing borrowing arrangements – the New Arrangements to Borrow (NAB) and the General Arrangements to Borrow (GAB) – with the total borrowing capacity of SDR 370.0 billion. In April 2012, additional pledges of the member countries to increase the IMF's resources by more than $430 billion were announced. IMF, *Factsheet: IMF Quotas* (Washington, March 31, 2013), http://www.imf.org/external/np/exr/facts/quotas.htm (accessed May 29, 2013); *Factsheet: IMF Standing Borrowing Arrangements* (Washington, April 11, 2013), http://www.imf.org/external/np/exr/facts/gabnab.htm (accessed May 29, 2013); *IMF to Double Lending Power as Pledges Top $430 Billion* (Washington, April 20, 2012), http://www.imf.org/external/pubs/ft/survey/so/2012/new042012a.htm (accessed May 29, 2013).

support without the linkage to an IMF program where the solvency of a receiving country is for all member countries clear but because of very tight market conditions the country is running out of the foreign exchange liquidity.[41] Because the former role is just symbolic, it is crucial to the significance of the CMI whether or not the latter role can be strengthened. To increase the assistance amount available without an IMF program, it is indispensable to improve the capacity of the AMRO as an independent regional surveillance unit to a level comparable to the IMF, which cannot be realised in the short-term.

Including India, Australia and New Zealand is also an important theme for strengthening the CMI, especially when the RCEP of ASEAN+6 is successfully implemented and these economies are gradually integrated to those of the ASEAN+3. Inclusion of India and Australia has already been realised by the bilateral currency swap agreements of China-Australia and Japan-India (see Table 5). Thailand's former Finance Minister Sussangkarn publicly proposed their participation in the CMI.[42] Diplomatic and territorial conflicts, e.g., between China and India as well as Indonesia and Australia, could cause the opposition of some ASEAN+3 members to the inclusion of these countries, but this problem would be solved by inserting an opt-out clause for an assistance from some current members to the new members. As the proposer of the AMF and the RCEP, diplomatic efforts of Japan play a key role for the further development of the CMI.

Introducing a new framework to prevent excessive intraregional exchange rates volatility

The congress dances, but there is no proceed. A common currency is an illusion and the present CMI is of very limited use. Does East Asian financial regionalism stay a mere diplomatic pose without functionable measures?

Necessity is the mother of invention – the word of the great inventor Thomas Edison could be applied to East Asian financial regionalism. As analysed in the first chapter, necessity for financial and exchange rates cooperation in East Asia is continuously growing due to the development of the regional economic integration, a deepening financial globalisation, and the huge costs to prevent financial crisis by each country's efforts. Motivated by the exchange rates correlation among some leading ASEAN+3 countries (China, Thailand, Philippines, Malaysia and Singapore) and rivalry between China and Japan for regional leadership, East Asian countries are going to take further step to collectively defend the regional financial and exchange rates stability.

Extending the existing currency swap agreements without the linkage to an IMF program

The first possibility is an extension of existing bilateral currency swap agreements without the linkage to an IMF program to other East Asian countries. As a permanent mechanism, regular dialogues and coordination of the economic, financial and exchange rates policies as well as appropriate ex ante macroeconomic conditions similar to the Maastricht criteria for the euro zone are required. As mentioned in the previous chapter, China and Japan have already concluded bilateral currency swap agreements without the linkage to an IMF program with some East Asian countries. By extending these agreements to other East Asian countries, the huge foreign exchange reserves of the two countries can be effectively used as a regional "collective defence" framework against financial instability. This framework reduces "self defence" costs of member countries and makes it possible to invest the capitals on their own infrastructures, education and research. By this framework China and Japan assist stable economic development of East Asia and profit from it through their private sectors.

These new agreements have potential to evolve to exchange rates policy coordination in East Asia. In exchange for the mutual access to the foreign exchange reserves, East Asian countries can formally cooperate their exchange rates policies to avoid both competitive depreciation and excessive volatility of intraregional exchange rates. A concrete mechanism

[41] Even after the reform in 2012, the CMI cannot be activated simultaneously with an middle- and long-term IMF program because the maximum supporting period of the CMI is shorter than that of the IMF. In the IMF lending instruments, repayments are, for example, due within 3¼-5 years (Stand-By Arrangements, SBA) or 4½–10 years (Extended Fund Facility, EEF) from the date of disbursement. IMF, *Factsheet: IMF lending* (see note 33).

[42] Chalongphob Sussangkarn, "The Chiang Mai Initiative Multilateralization: Origin, Development and Outlook" (see note 19).

can be established analogously to the ERM of Europe (see Table 7): A currency unit can be calculated as a basket of specified amounts of ASEAN+3 currencies which reflects the relative economic size of the country, for example, the financial contribution to the CMI. To maintain the flexibility of the mechanism, a wide margin around the currency unit such as ±15% can be adopted.[43] This mechanism limits the sovereignty of member countries for monetary and exchange rates policies, which is why the potential donor countries would not participate in it. Nevertheless, if the potential receiver countries can coordinate their exchange rates policies unilaterally in exchange for acquisition of the access to the foreign exchange reserves of the donor countries, the intraregional exchange rates volatilities of the ASEAN+3 countries become much less than the current level (see Figure 6).

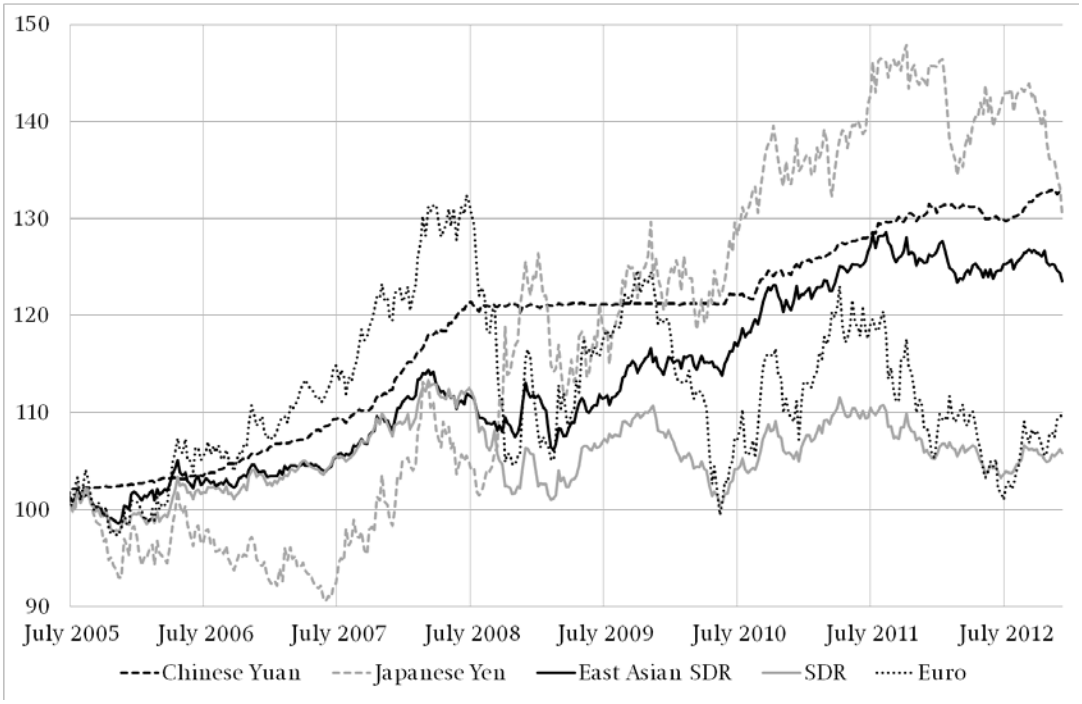
[43] As explained in the previous chapter, the bands of the exchange rates volatilities among the ERM member currency were widened to ±15% in August 1993, and from July 2005 to December 2012, the exchange rates of CNY, Thailand Baht, Philippines Peso, Malaysia Ringgit, Singapore Dollar, and Brunei Dollar against USD had less than 15% for almost all the time during this period. See Note 17 and 24.

Table 7
Overview of the Exchange Rate Mechanism (ERM) in Europe

Concepts	*Description*
Parity Grid	An aggregate of a bilateral central rate vis-à-vis all other EMS currencies. From the central rate a margin (in principle 2.25% until August 1993, then enlarged to 15%) is set.
Compulsory Interventions	Interventions carried out in the member currencies without a limit when a currency reaches the lower or upper margin against any one of the other currencies in the ERM.
Intramarginal Interventions	Interventions carried out within the determined band. The intervention can be carried out in the currencies outside of the ERM (mainly in USD).
Very Short-Term Financing Facility	A network of mutual credit lines without a limit among the central banks of the ERM. The debtor balances can be settled in the ECU.
European Currency Unit (ECU)	A basket of specified amounts of the EMS currencies. The amounts are chosen to reflect the relative economic size of the country.

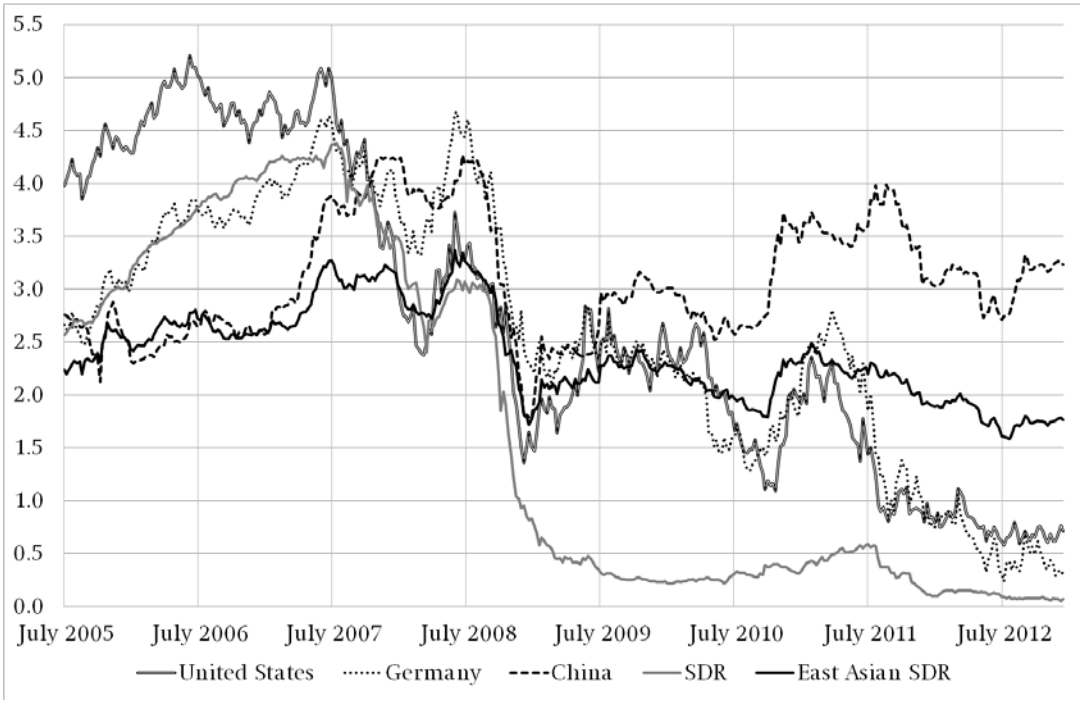
Sources: Daniel Gros and Niels Thygesen, *European Monetary Integration*, (New York: Addison Wesley Longman, 1998): pp. 65-67, 238-243; Cristina Mastropasqua, Stefano Micossi and Roberto Rinaldi, "Interventions, Sterilisation and Monetary Policy in European Monetary System Countries, 1979-87," in Francesco Giavazzi, Stefano Micossi and Marcus Miller (eds.), *The European Monetary System* (Cambridge: Cambridge University Press, 1990).

Figure 6
Nominal exchange rates of China, Japan, the East Asian SDR[a], the SDR, and Euro against USD from July 2005 to December 2012 (July 15, 2005 = 100)



Sources: Bloomberg (for Chinese Yuan, Japanese Yen, the SDR, and Euro) as well as the author's calculation (for the East Asian SDR).
[a] The East Asian SDR is here calculated by a basket of specified amounts of the ASEAN+3 currencies. The amounts are chosen to reflect the propotion of financial contribution to the CMI: Chinese Yuan 28.5%; Hong Kong Dollar 3.5%; Japanese Yen 32.0%; South Korean Won 16.0%; Indonesian Rupiah 3.8%; Thailand Baht 3.8%; Malaysian Ringgit 3.8%; Singapore Dollar 3.8%; Philippines Peso 3.8%; Vietnam Dong 0.8%; Cambodian Riel 0.1%; Myanmar Kyats 0.05%; Brunei Dollar 0.03%; Lao Kip 0.03%.

Figure 7
Five years government bonds yields of the United States, Germany, and China as well as the five years interest rate of the East Asian SDR[a] and the SDR interest rate from July 2005 to December 2012 (percent)



Sources: Bloomberg (for the government bonds yields), IMF (for the SDR), *SDR Interest Rate Calculation*, http://www.imf.org/external/np/fin/data/sdr_ir.aspx (accessed June 5, 2013), and the author's calculation (for the East Asian SDR).
[a] Because of data restriction, the five years interest rate of the East Asian SDR is calculated by the weighted average of five years government bonds yields of China, Hong Kong, Japan, South Korea and Singapore with the following weight: China 34.0%; Hong Kong 4.2%; Japan 38.2%; South Korea 19.1%; Singapore 4.5%.

Introducing the East Asian version of the Special Drawing Rights

The second possibility is an introduction of the East Asian version of the SDR. After the Lehman shock the value of USD and its interest rates decreased rapidly followed by the very loose monetary policy of the Fed. This caused huge loss of many central banks through devaluation of their foreign exchange reserves. As a result, the president of the PBoC Zhou published his opinion calling for reform of the existing international financial system. Zhou pointed out the build-in problem of the current system based on USD, a domestic currency, because the United States is "constantly confronted with the dilemma between achieving their domestic monetary policy goals and meeting other countries' demand for reserve currencies". He proposed that the "desirable goal of reforming the international monetary system [...] is to create an international reserve currency that is disconnected from individual nations and is able to remain stable in the long run" and called for broader usage of the SDR.[44]

The SDR are created by the treaty to establish the IMF (Agreement of the International Monetary Fund) as international reserve asset parallel to gold and USD. The currency value of the SDR is determined by summing the values of a major currencies' basket (currently USD, Euro, JPY and British Pound), and the SDR interest rate is the weighted average of the three months government bond yields of those four currencies considering that the total amount of the foreign exchange reserves of ASEAN+3 is about 19 times as large as the total allocation of the SDR ($314 billion), the objective of the creation as a main exchange reserve currency has not been achieved at all. It seems there are two main reasons to hinder

[44] PBoC, *Zhou Xiaochuan: Reform the International Monetary System* (March 23, 2009), http://www.pbc.gov.cn/publish/english/956/2009/20091229104425550619706/20091229104425550619706_.html (accessed 15 April, 2013).

further usage of the SDR: Firstly, the SDR has only an interest rate for the three months time horizon. That is, creditors of the SDR denominated assets cannot expect higher yields even if the credit period is more than three months. Secondly, there is no condition on the use of the SDR, which in practice stops larger amount of its allocation because otherwise an IMF loan with conditionality is substituted by a usage of the SDR without conditionality.

The East Asian version of the SDR can be created analogously to the SDR correcting the two short points of the original one: The exchange rate of the East Asian SDR is calculated, for example, by the currency basket of the CMI member countries (see Figure 6). The interest rates can be calculated by the weighted average of those countries' government bond yields with several periods, for example, for three months, one year, two years, five years and ten years, respectively (see Figure 7 for the five years' case). Additionally, parallel to the currency swap agreements without the linkage to an IMF program, regular dialogues and coordination of the economic, financial and exchange rate policies as well as appropriate *ex ante* macroeconomic conditions to use the East Asian SDR should be introduced.

Note that since July 2005, the East Asian SDR appreciated against USD, Euro and the SDR while the interest rate of the East Asian SDR for five year was more stable than that of the United States government bonds, the German government bonds and the SDR. That is, the East Asian SDR obtains some of important characters of an international reserve currency.

With regard to the accumulated foreign exchange reserves of China ($3.3 trillion, see Table 8) and Japan ($1.2 trillion), the total allocation of the East Asian SDR can be significantly larger than the original SDR. Furthermore, by creating the East Asian SDR, the member countries obtain more foreign exchange reserves although they basically take the same solvency risks as a currency swap agreement without the linkage to an IMF program.[45] This new mechanism can also evolve to regional exchange rates policy coordination, as explained for the currency swap agreements without the linkage to an IMF program.

Table 8
Foreign exchange reserves, SDR allocations and IMF voting shares of ASEAN+3, ASEAN+6, the United States, the Euro zone, the ECB, and the United Kingdom, December 2012

Countries	*Foreign exchange reserves (billion USD)*	*SDR allocations (billion USD)*	*IMF voting shares (%)*
China	3,312	11	6.1
Hong Kong	317	–	–
Japan	1,194	19	6.1
South Korea	317	4	1.7
Indonesia	106	3	1.0
Thailand	171	1	0.7
Malaysia	135	2	0.7
Singapore	257	1	0.8
Philippines	72	1	0.4
Vietnam	N/A	1	0.3
Cambodia	4	0.1	0.1
Myanmar	N/A	0.4	0.1
Brunei	3	0.3	0.1
Lao PDR	N/A	0.1	0.1
ASEAN+3	5,887	44	18.1
India	262	6	2.6
Australia	38	5	1.3
New Zealand	16	1	0.3
ASEAN+6	6,202	56	22.4
Unites States	50	54	16.5
Euro zone[a]	219	72	21.2
ECB[a]	54	–	–
United Kingdom	65	16	4.0

Sources: IMF, *International Financial Statistics*; *SDR Allocations and Holdings for all members as of December 31, 2012*, http://www.imf.org/external/np/fin/tad/extsdr2.aspx?date1key=2012-12-31 (accessed June 4, 2013); *Quota and Voting Shares Before and After Implementation of Reforms Agreed in 2008 and 2010 (In percentage shares of total IMF quota)*, http://www.imf.org/external/np/sec/pr/2011/pdfs/quota_tbl.pdf (accessed April 15, 2013).

[a] ECB, *Foreign currency reserves (in convertible foreign currencies)*, http://www.ecb.europa.eu/stats/external/reserves/html/assets_8.804.E.en.html (accessed May 16, 2013), $1 = €1.3183 (as of December 28, 2012).

[45] Under the current rule determined by the IMF, a currency swap agreement cannot be counted as the foreign exchange reserves but the SDR can.

Preventing moral hazard – lessons from the European sovereign debt crisis

When introducing a new framework to prevent excessive intraregional exchange rates volatility, it is crucial to construct appropriate ex ante conditions for its usage in order to prevent moral hazard problem. To determine the appropriate conditions, a comparison between the Asian financial crisis and the European sovereign debt crisis provides us with some important points of consideration.[46]

In a classical financial crisis such as the Asian financial crisis and the default of Iceland after the Lehman shock, there are several common automatic mechanisms for economic recovery and prevention of crisis contagion: i) The current account deficit does not last long because without sufficient capital account surplus it results in a depreciation of the exchange rates; ii) The central bank of the crisis country takes the responsibility for liquidity supports in domestic currency to insolvent banks, and thus international support is limited to the government in exchange for economic reforms including a necessary sovereign debt restructuring; iii) the ability of the crisis country to maintain the exchange rate and to support the banks' liquidity in foreign currency is limited to the amount of its foreign exchange reserves; iv) capital flight stops when the crisis country controls transactions in the foreign exchange market without an authorised trade contract; and v) the current account balance of the crisis country improves rapidly due to depreciation of its real effective exchange rates.

In the euro zone, however, these mechanisms do not work: i) The current account deficit is automatically covered by the credit from other euro zone national central banks and can thus last long. ii) The ECB provides liquidity of Euro to ailing banks basically in exchange for the government bonds of the crisis country as a collateral. That is, all member countries automatically take solvency risks of the crisis country through the ECB's liquidity support. iii) The banks' liquidity in foreign currency is also supported by the ECB practically without limit because the banks can sell Euro and obtain necessary currencies without destroying the foreign exchange markets. That is, in contrast to the classical financial crisis, the foreign exchange reserves of the euro zone national central banks do not play a significant role to tackle the crisis. iv) To stop capital flight, the crisis country needs to freeze the whole saving accounts because otherwise savers withdraw savings and hold them as cash. In other words, it is very difficult to tax the crisis country's savings because the mere fear to taxation on savings creates large amount of capital flight which is automatically filled by liquidity support of the ECB. For the same reason, the withdrawal from the euro zone or the introduction of a parallel currency in addition to euro is also very difficult to implement. v) The current account balance of the crisis country does not always improve because the exchange rate is fixed in the euro zone and the exchange rates to other currencies does not devaluate significantly because other euro zone countries' economies are not in the crisis.

This comparison makes it clear that a fixed exchange rate system like the current Eurosystem has the potential to cause the moral hazard problem in the following two senses. Firstly, the current account deficit does not matter to the member country, at least, in the short term. This releases the country of the pressure to go through the inevitable reforms to maintain its international competitiveness. Secondly, the regional central bank can reduce *solvency risk* of the member countries' governments by its support to *liquidity risk* of struggling banks, which gives private sectors incentives to deliberately underestimate *solvency risk* of the member countries' governments and obtain short-term profits from this underestimation, justifying that on the financial crisis the regional central bank will not let the governments default and will provide struggling banks with sufficient liquidity even without appropriate collateral.[47] Although East Asian countries do not seek to introduce a common currency, deepening financial regionalism has basically the same moral hazard problem, although to a lesser degree. It is therefore important to adopt appropriate moral hazard preventive measures, for example, as follows: i) a quantitative ceiling to the current account deficit in addition to the fiscal deficit

[46] The European sovereign debt crisis was similar to the Asian financial crisis in that banks without sufficient risk management abilities borrowed money from abroad when sentiment of international financial markets was risk-taking and then could not pay the debt back when the sentiment changed. However, the development of the crisis countries after the outbreak of the problems was very different due to the fixed exchange rate in the eurozone.

[47] In the eurozone, the government bonds yields of the peripheral countries had been staying almost the same level of those of the core countries until the Lehman shock.

as ex ante conditions (i.e., a violation of these conditions results in failing the status to utilise the new regional cooperation measures); ii) a predetermined quantitative limit for international assistance; iii) regular surveillance of the member countries to transactions relating to the capital account, such as external debt of banking sectors.

Table 9
Current account balance, GDP, inflation and unemployment rate of the main Euro zone countries 2007-2012

Current account balance (percent of GDP)	*2007*	*2008*	*2009*	*2010*	*2011*	*2012*
Cyprus	-11,8	-15,6	-10,7	-9,8	-4,7	-4,9
France	-1,0	-1,7	-1,3	-1,6	-2,0	-2,4
Germany	7,5	6,2	6,0	6,2	6,2	7,0
Greece	-14,6	-14,9	-11,2	-10,1	-9,9	-2,9
Ireland	-5,4	-5,7	-2,3	1,1	1,1	4,9
Italy	-1,3	-2,9	-2,0	-3,5	-3,1	-0,5
Portugal	-10,1	-12,6	-10,9	-10,6	-7,0	-1,5
Spain	-10,0	-9,6	-4,8	-4,5	-3,7	-1,1
Gross domestic product, constant prices (percent change)	*2007*	*2008*	*2009*	*2010*	*2011*	*2012*
Cyprus	5,1	3,6	-1,9	1,3	0,5	-2,4
France	2,3	-0,1	-3,1	1,7	1,7	0,0
Germany	3,4	0,8	-5,1	4,0	3,1	0,9
Greece	3,5	-0,2	-3,1	-4,9	-7,1	-6,4
Ireland	5,4	-2,1	-5,5	-0,8	1,4	0,9
Italy	1,7	-1,2	-5,5	1,7	0,4	-2,4
Portugal	2,4	0,0	-2,9	1,9	-1,6	-3,2
Spain	3,5	0,9	-3,7	-0,3	0,4	-1,4
Inflation, average consumer prices (percent change)	*2007*	*2008*	*2009*	*2010*	*2011*	*2012*
Cyprus	2,2	4,4	0,2	2,6	3,5	3,1
France	1,5	2,8	0,1	1,5	2,1	2,0
Germany	2,3	2,8	0,2	1,2	2,5	2,1
Greece	3,0	4,2	1,3	4,7	3,1	1,0
Ireland	2,9	3,1	-1,7	-1,6	1,2	1,9
Italy	2,0	3,5	0,8	1,6	2,9	3,3
Portugal	2,4	2,7	-0,9	1,4	3,6	2,8
Spain	2,8	4,1	-0,2	2,0	3,1	2,4
Unemployment rate (percent of total labor force)	*2007*	*2008*	*2009*	*2010*	*2011*	*2012*
Cyprus	4,0	3,8	5,6	6,4	7,9	12,1
France	8,4	7,8	9,5	9,7	9,6	10,2
Germany	8,8	7,6	7,7	7,1	6,0	5,5
Greece	8,3	7,7	9,4	12,5	17,5	24,2
Ireland	4,7	6,4	12,0	13,9	14,6	14,7
Italy	6,1	6,8	7,8	8,4	8,4	10,6
Portugal	8,0	7,6	9,5	10,8	12,7	15,7
Spain	8,3	11,3	18,0	20,1	21,7	25,0

Source: IMF, *World Economic Outlook Database*, April 2013.

Influence of East Asian financial regionalism on the global financial system

Role-sharing between the global and the regional system

International assistances to some euro zone governments were in most cases financed both by the global system based on the IMF and the regional system (the European Financial Stability Facility, EFSF). On the contrary, the recent assistance to recapitalise the Spanish banking sector was financed only by the regional system (the ESM). The IMF contributed to it as an advisor because it does not have a suitable financial tool.[48]

A financial assistance is categorised to either for liquidity risks and for solvency risks although in practice it is difficult to distinguish them. Clearly, neither the European nor the East Asian regional system aims to assist an insolvent member country excluding financial contribution of the IMF because Europe and East Asia need the IMF as international pressures to oblige the insolvent country necessary but painful reforms. That is, the both regional frameworks are designed to address liquidity problems of the member countries and their main significance is to fill the gap where global consensus for a new liquidity assistance tool is difficult to reach in a short time but regional consensus for the tool is possible considering the close economic relationship and contagious effect of financial crisis. An innovative tool designed in a regional system will possibly be accepted in the global system when it is proved to have the ability to prevent crisis without creating moral hazard problem. In this sense, a regional system complements the global system and fosters its development, but does not aim to replace it. Specifically, possible development of East Asian financial regionalism to prevent excessive exchange rates volatilities can influence on the IMF's conditions of the FCL or allocation amount of the SDR for their broader usage.

[48] ESM, *FAQ – Financial Assistance for Spain* (February 11, 2013), http://www.esm.europa.eu/pdf/FAQ%20Spain%2011022013.pdf (accessed 13 May, 2013).

Influences on the United States

Even though East Asian financial regionalism does not aim to replace the existing global system, its development restrains further accumulation of the foreign exchange reserves in East Asia. Considering that East Asian central banks are one of the main purchasers of the government bonds of the United States, the pressure for fiscal consolidation and currency value preservation on the United States authorities will increase.

However, the United States will not only be passively influenced by East Asian financial regionalism. As mentioned, the Fed contributed to the stabilisation of East Asian financial markets by concluding bilateral currency swap agreements. Successful implementation of the Trans-Pacific Partnership (TPP), in which Australia, Brunei, Canada, Chile, Malaysia, Mexico, New Zealand, Japan, Peru, Singapore, the United States, and Vietnam are negotiating a comprehensive Free Trade Agreement, will require the United States to further commit to East Asian financial stability. In this sense, development of East Asian financial regionalism can also trigger active participation of the United States so that they can, reflect their national interests on new regional frameworks.[49]

What East Asian financial regionalism tells Europe

Direct influences of East Asian financial regionalism on Europe are probably less significant than those on the IMF and the United States. Nevertheless, it

[49] For example, in academic discussions, a joint commitment of the long-term exchange rate between USD and JPY and a formal USD pegging for East Asia are proposed. See Ronald I. McKinnon, "After the Crisis, the East Asian Dollar Standard Resurrected: An Interpretation of High-frequency Exchange Rate Pegging," in Joseph E. Stiglitz and Shahid Yusuf (eds.), *Rethinking the East Asia Miracle* (New York: Oxford University Press, 2002).

provides Europe with important implications, and thus Europe could benefit greatly from an exchange of information, experience and opinion with East Asia. East Asian financial regionalism differs fundamentally from European financial integration in that the member countries neither aim to long-term political integration nor rely on bona fide policies of other member countries. As a result, East Asian financial regionalism is developing without a view to a common currency. It is these differences that make the comparison between Europe and East Asia fruitful.

The long history of European financial integration makes it difficult to still recognise the unnecessary or structurally weak part of the whole system. For example, although the foreign exchange reserves of the each euro zone country have lost their classical role to prevent a financial crisis, as analysed in the previous chapter, some peripheral countries still hold a large amount of foreign exchange reserves (Italy: €26.4 billion, 1.9% of the GDP; Spain €21.3 billion, 2.3% of the GDP)[50] although the foreign exchange reserves necessary for market intervention are pooled in the ECB (€40.7 billion) [53]. Considering the high yields of their government bonds, the costs of holding the unnecessary assets are not small.

At the moment, historically high unemployment rates together with a continuing recession in the peripheral countries cast doubt about the solvency of the banks and the governments. To avoid crisis contagion and long-lasting supports by the ECB and the ESM to those countries, Germany should encourage them to implement economic revival plans financed by selling their foreign exchange reserves to the ECB. Although domestic fiscal policy is part of the fiscal sovereignty of the struggling countries, the peripheral countries have the responsibility to make their best efforts for a stable development of the euro zone economies and the Eurosystem. To insist on holding their foreign exchange reserves is against the responsibility under the current circumstances.

[50] The outstanding amounts of foreign exchange reserves are as of December 2012. The amounts of the GDP are as of 2012. ECB, *Foreign currency reserves (in convertible foreign currencies)*, http://www.ecb.europa.eu/stats/external/reserves/html/assets_8.804.E.en.html (accessed May 16, 2013); *Statistical Data Warehouse*, http://sdw.ecb.europa.eu/browse.do?node=9484571 (accessed May 16, 2013).

Conclusion

This article analysed the necessity for financial and exchange rates cooperation in East Asia with regard to the prevention of the middle income trap, economic integration, management of financial globalisation, and huge resource misallocation to the foreign exchange reserves.

Based on this common necessity, East Asian countries have developed financial regionalism with different motivations. Some countries have a 'stigma' attached to the IMF and thus seek regional assistance without the IMF's participation. In addition, the rivalry between China and Japan for regional leadership as well as for a regional power balance in consideration of China's growing influence on its neighbour countries play an important role.

Taking the necessity and the motivations into account, this article analysed the possible further developments of East Asian financial regionalism. Although introducing of a common currency is unrealistic even in the long term, the CMI will be developed according to the ability of the AMRO. Moreover, innovative measures such as extending existing currency swap agreements and introducing East Asian SDR were proposed. These measures could further evolve to regional exchange rates policy coordination similar to the ERM of Europe. To avoid the moral hazard problem, the importance of *ex ante* macroeconomic conditions and regular regional surveillance were emphasised.

East Asian financial regionalism does not intend to substitute the existing global financial system based on the IMF and USD, but to complement it by creating innovative measures for crisis prevention as the Eurosystem does. Nevertheless, it will apply pressure to the IMF and the United States for further refinement of the global system. Furthermore, it will also contribute to the development of the Eurosystem because the comparison between the two regional systems provides Europe with appropriate precautions when introducing a new assistance program.

Under financial globalisation, it is crucially important to foresee how international capitals move according to a specific reform of financial jurisdictions. The magnitude of financial instability of a market depends largely on the size of the market. Thus, small and open economies need to continuously keep up with the sentiment of international financial markets abroad and take appropriate policies timely to avoid financial crisis. Repeated financial crises show us its difficulty. Considering the recent economic integration, the construction of an international mechanism to maintain financial stability for emerging and developing economies contributes to the economic development of the industrialised countries, too. In addition to international academic discussions, as the leading explorers for a better international financial system, Europe and East Asia should exchange ideas at the governmental level because reflection of financial markets and difficulties in policy implementation cannot be effectively discussed in academic fields only. Authorities of both regions will benefit from the informative and valuable experiences of the other region because they fight essentially against the same enemies, namely the greedy and self-oriented international capitals and the moral hazard problem, both inevitably attached with financial policies.

List of abbreviations

AMF	Asian Monetary Fund
AMRO	ASEAN+3 Macroeconomic Research Office
ASEAN	Association of Southeast Asian Nations
CHF	Swiss Franc
CMI	Chiang Mai Initiative
CNY	Chinese Yuan (Renminbi)
ECB	European Central Bank
ECU	European Currency Unit
ERM	Exchange Rate Mechanism
ESM	European Stability Mechanism
EU-27	European Union with 27 Member States
FCL	Flexible Credit Line
Fed	Federal Reserve of the United States
GAB	General Arrangements to Borrow
GDP	Gross Domestic Product
G7	Group of Seven Leading Industrialised Countries
IMF	International Monetary Fund
JPY	Japanese Yen
NAB	New Arrangements to Borrow
NAFTA	North American Free Trade Agreement
PBoC	People's Bank of China
RCEP	Regional Comprehensive Economic Partnership
SDR	Special Drawing Rights
USD	United States Dollar