East Asian Economic Cooperation and Integration[1]

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1. Introduction

There have been a surge in regional cooperation in Asia. On the trade and investment front, AFTA is pursuing free trade among 10 ASEAN members. Japan signed its first Free Trade Agreement (FTA) with Singapore—known as Japan-Singapore Economic Partnership Agreement—and implemented it. Korea has signed its first FTA with Chile and waiting for ratification by the Congress. On the monetary front, ASEAN plus Three (Japan, China, Korea) has made a significant progress in the Chiang Mai Initiative (CMI) establishing a network of bilateral currency swap agreements between one of the Three and one of the ASEAN countries.

There had been a failure of attempts for economic cooperation in the past: e.g., EAEC in the beginning of the 1990s and AMF in 1997. Although monetary cooperative frameworks have long-standing frameworks: e.g., SEANZA, 1956; and SEACEN, 1982. On the other hand, regional forums are increasing: APEC since 1989; EMEAP since 1991; ASEAN expansion since 1996; Manila Framework Group since 1997; ASEAN surveillance process since 1998; and ASEAN plus Three since 2000.

2. Rationale for Regional Financial Cooperation

There are several reasons for a surge of economic cooperation in the region.

(1) Economic Fundamentals: More intra-regional trade;
(2) Asian Currency Crises: Contagion, New Miyazawa Initiative;
(3) Proliferation of regional Integration: Euro, NAFTA, FTAA, Dollarization;
(4) Slow Launch and progress in the new WTO round.

3. Further Integration in Four Fronts

3.1. FTA

Traditionally, Asian countries were not enthusiastic about FTAs. Japan and Korea were only two OECD countries without FTAs. The attitude had changed.

Intra-regional trade ratio is increasing. Intra-regional FDI is increasing. It is

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natural to deepen trade and investment relationship by FTAs. Questions are (1) What is an appropriate grouping (AFTA; ASEAN plus Three; or bilaterals); and (2) APEC (Bogor Goal).

Current FTA Progress

FTA	Discussion	Joint Study	Negotiations	Conclusion	Implementation
AFTA	x	x	x	x	x
AFTA-China	x	x	x		
AFTA-Japan	x	x			
AFTA-Korea	x	x			
AFTA-India	x				
AFTA-US	x				
Japan-Singapore	x	x	x	x	x
Japan-Mexico	x	x	x		
Japan-Korea	x	x	x		
Japan-Malaysia	x	x	x		
Japan-Thailand	x	x	x		
Japan-Philippines	x	x	x		
Japan-Indonesia	x				
Japan-Taiwan	x				
Japan-Canada	x				
Korea-Chile	x	x	x	x	
Korea-Singapore	x	x	x		
Korea-New Zealand	x	x			
Korea-Thailand	x	x			
Korea-Mexico	x				

It is very important to speed up the FTA network in the region. Japan has positive reasons to push FTAs in Asia. Economic gains are large; Harmonization in regulation is large. Japan has also defensive reasons. Japanese firms are discriminated against in Mexico, and potentially discriminated against in Asia, if delayed.

Should Japan pursue a network of bilateral FTAs or regional FTA (like ASEAN plus Three)? The faster the better. If Japan can have FTAs with Korea, Thailand, the Philippines, Malaysia, and Indonesia, as well as Singapore (done). Most of the important countries are covered. Japan should pursue high-quality FTAs, so that FTAs with China, CLMV countries, will be at the next stage. The key for speed is the political will in Japan.

In summary, Japan and countries in the region should pursue building an FTA area, but build it with building blocs form where it can be done immediately.

3.2. CMI: See Ito (2003a)

The CMI has been a key initiative for Asian Financial Cooperation. The swap agreement will be important in supplementing the IMF in liquidity crises.

According to the general agreement of the Chiang Mai Initiative, a country can borrow hard currency collateralized by domestic currencies with government guarantees. The swap will be extended up to 90 days and, renewable up to seven times, is aimed at an arrangement. The interest rate is equivalent to the LIBOR plus 150 basis points for the first drawing and first renewal. The premium of 50 basis points will be added every two renewals, subject to a maximum of 300 basis points.

Up to 10 percent of bilateral support can be released immediately, but the rest is subject to a condition that a country will obtain an IMF program. In this sense, the CMI is complementing the IMF. The linkage to IMF is necessary given that CMI itself does not have a secretariat or an independent surveillance function to prevent a moral hazard problem. The CMI will be reviewed in May 2004.

Table 2. Progress on swap arrangement under the Chiang Mai Initiative (as of end-December 2003)

BSAs	Currencies	Conclusion Dates	Size
Japan-Korea	USD-Won	July 4, 2001	US$ 7 billion[a] (1-way)
Japan-Thailand	USD-Baht	July 30, 2001	US$ 3 billion (1-way)
Japan-Philippines	USD-Peso	August 27, 2001	US$ 3 billion (1-way)
Japan-Malaysia	USD-Ringgit	October 5, 2001	US$ 3.5 billion[b] (1-way)
China-Thailand	USD-Baht	December 6, 2001	US$ 2 billion (1-way)
Japan-China	Yen-Renminbi	March 28, 2002	US$ 3 billion[c] (2-way)
China-South Korea	Renminbi-Won	June 24, 2002	US$ 2 billion[c] (2-way)
Korea-Thailand	USD-Won or USD-Baht	June 25, 2002	US$ 1 billion (2-way)
Korea-Malaysia	Won-Ringgit	July 26, 2002	US$ 1 billion[c] (2-way)
Korea-Philippines	Won-Peso	August 9, 2002	US$ 1 billion[c] (2-way)
China-Malaysia	USD-Ringgit	October 9, 2002	US$ 1.5 billion (1-way)
Japan-Indonesia	USD-Rupiah	February 17, 2003	US$ 1.5 billion (1-way)
Japan-Singapore	USD-Singapore $	November 10, 2003	US$ 1 billion
China-Philippines	RMB-Peso	August 29, 2003	US$ 1 billion
China-Indonesia	USD-Rupiah	December 30, 2003	US$ 1 billion
Korea-Indonesia	Under negotiation		

Notes: (a) The amount includes US$5 billion committed under the New Miyazawa Initiative.; (b) The amount includes US$2.5 billion committed under the New Miyazawa Initiative.; (c) The amounts are US dollar equivalents.

In summary, financial cooperation in terms of CMI is almost complete. The next steps should be explored.

3.3. Beyond CMI

(1) Cooperation in the exchange rate regime is important: the currency basket, band system makes most sense. Coordination is needed. See Ito-Ogawa-Sasaki (1998) and Ogawa-Ito (2002). Some signs of basket features in the currency movements of Korea, Thailand, and Singapore.
(2) Asian bond initiative is important to reduce vulnerability of the financial systems in the region.

3.4. Asian Bonds: See Ito (2003b)

Developing local-currency denominated bonds is important for two reasons: (1) Solution to the double (currency and maturity) mismatch problem; and (2) Solution to the twin crisis problem, by reducing over-reliance on the banking sector.
What is an Asian Bond?
Bonds denominated in the Asian Local currency (baht, won, Philippine peso), issued by Asian issuers; (Asian governments, Asian corporations), in Asian financial centers (Tokyo, Singapore), and purchased mainly for Asian investors (with regional bias).

Prime Minister Thaksin of Thailand initiated the movement.
Asian Bond Funds (ABF). Central bank initiative. The central banks in the region (EMEAP) have announced that they will contribute US$1 billion to the Asian Bond Fund (ABF), managed by the BIS, in order to invest in dollar-denominated bonds issued by Asian issuers, namely Yankee bonds.[3] The central banks will set aside a certain portion of their foreign reserves (estimated to be more than 1 trillion US dollars) to invest in ABF. Eligible securities are those issued by governments and quasi-governments. Problems: (1) The use of the U.S. dollar, presumed in the current version of ABF, does not contribute to the financial and monetary stability of the region. (2) under the current version of ABF, the monetary authorities buy and hold the Asian bond fund as foreign exchanges, so the secondary market of Asian bonds would not develop. (3) the ABF is contributed from central banks, but foreign reserves are strictly regulated on their eligible securities. Due to the regulation, the market size of bonds that can be invested by the ABF will be limited.

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3 See http://www.boj.or.jp/en/about/03/un0306a.htm for the announcement.

It has been proposed that the fiscal authorities of Japan, Korea, and Thailand, and any other willing Asian countries, should jointly establish the Asian Bond Corporation (ABC) in offshore market (Tokyo, Hong Kong, or Singapore). The ABC will purchase sovereign bonds (later, corporate bonds and asset backed securities) of the participating countries, issued in the respective local market and denominated in the yen, won, and baht. The ABC's asset side is composed of a basket of bonds in different currency denominations and different coupon rates. The ABC bond, on the liability side of the ABC, is backed by the market value of the bonds on the asset side. Hence, pricing of ABC bonds in the secondary market should reflect the value of the underlying assets.

For example, we recommend that the ABC initially purchase Japanese, Korean, and Thai government bonds with value-weights of 50-30-20, respectively. Then the pricing of ABC bond reflects both the exchange rate fluctuations of the yen, won, and baht, as well as the interest rate movements in the three countries. With respect to currency risk, the ABC bonds show a feature of a basket currency, namely a weighted average of the three currencies. The coupon interest rate of the ABC bond will be a weighted average of the underlying bonds.

It is likely that many investors find ABC bonds attractive. Investors have to take some currency and credit risk to receive some extra returns. But risks have to be transparent, fair, and diversified. (The Japanese investors currently receive only 0.8% yield from holding Japanese bonds, but some of them are eager to purchase Australian-dollar-denominated bonds yielding 5%, reflecting currency and credit risk. They may be attracted to an ABC bond yielding 3%, with lower currency risk.) The role of ABC is to bundle bonds from diversified sources, so that a reasonable tradeoff point in the risk-return curve will be offered in a transparent manner. The regional investors who pursue higher returns without increasing too much of risk will regard bonds issued by the ABC as just such financial instruments.

If credit risk of participating bonds makes ABC bonds unattractive to risk-averse bond investors in the region, the partial guarantee may be offered by a credit enhancement agency. When corporate bonds and asset backed securities (ABS) are bundled into a ABC corporate bond, credit enhancement or separating into senior bonds and junior bonds may help widen the customer base. If currency risk, even as a weighted average, is not desirable for some home-biased investors, swap into local currencies may be offered by the ABC, or its foreign exchange swap partners.

The ABC sovereign bonds will not assume any major risk, because the value and coupon payments of assets and liability matches all the time. It should behave like a currency board or a mutual fund. The ABC helps create the Asian bond secondary market. The ABC encourages the issues of bonds in the region. The ABC sovereign bond should give the benchmark for the ABC corporate bonds and ABC-ABS bonds.

In comparison to the ABF proposal, the ABC proposal has several advantages. The ABC promotes local currency bond issues, while the ABF in the current version invests in the dollar-denominated bonds only. The ABC will bundle them as a basket currency bond for investors. My proposal of the ABC bonds promotes the secondary market by issuing the ABC bonds, while ABF does not. In the sense the central banks in the ABF are a buyer-investor, while the ABC is an issuer as well as a buyer. In this sense, the two proposals are quite complementary, while the ABC is based on market participants and principles. The ABC has no limit in what kind of securities to invest in, while the ABF is limited to sovereign and quasi-sovereign bonds. If another crisis comes, then the foreign reserves may have to be sold to help stabilize the currency, then the monetary policy has to sell Asian bonds, aggravating the crisis by depressing the bond market. This kind of procyclicality is something to be avoided in institutional design. The ABC proposal does not have such a deficiency.

4. Future Directions and Challenges

Further deepening in trade and financial cooperation is expected in the East Asian region. Unresolved questions and tentative answers are as follows:

(1) Grouping. An appropriate grouping for economic integration is still unclear, although China and Japan seem to be comfortable with the ASEAN plus Three grouping. China will object to have Taiwan as an independent member. Some ASEAN countries may object to include Australia and New Zealand, although bilateral FTAs may be extended to them.

(2) Regional or bilateral FTA. AFTA is moving slowly toward an free trade area. China is pursuing a regional FTA with ASEAN. Japan has both a regional FTA initiative and a network of bilateral FTAs. In the end, ASEAN plus Three FTAs will become a target, but there seem to be a movement that bilateral FTAs are faster and will become building blocks for the future. FTAs in East Asia is not obstructing the WTO process. It would be at least as clean as NAFTA or EU.

(3) Financial Cooperation Beyond CMI. The network of CMI will be almost complete among the northeast Three and the original ASEAN five. The challenge here is what is next. Whether financial cooperation in the region should move toward an arrangement more independent from the IMF and any other global institutions is an interesting question. Asian Bond initiative is clearly a right path toward an environment that is less affected by external and internal shocks.

(4) Exchange Rate Regime. When the region (say, ASEAN plus Three) become deeply integrated, a strong incentive will emerge to pursue stability among the exchange rates in the region. Most likely, the basket currency will be formed to give an anchor to the regional currencies. Currencies in the region will limit volatility inside the basket but float together against outside currencies, just like a snake or ECU arrangements in Europe in the 1980s. Whether the yen will be inside the basket or outside the basket will be an interesting question, both from political and economic points of view.

The progress toward true economic integration has just begun, and many important decisions have to be made in the next several years before the level of economic integration becomes deep enough to talk about the exchange rate stability among the member countries. However, the path that European countries have traveled is well recognized by Asian countries, and there seems to be a political movement toward them as well as economic rationale.

(END)

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